How to Remove Bad Incentives?[1]

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1. Introduction

Deficit persistence has been a well-known phenomenon in Central Europe (Czech Republic, Hungary, Poland and Slovakia) even before the outbreak of the Great Recession. National fiscal frameworks and the Stability and Growth Pact failed to eliminate excessive deficits and pro-cyclical policy. Good times were used to reduce deficits only occasionally. Despite the fact, that no Central European country had to bail out its banking sector, the financial crisis has brought new challenges for fiscal policy makers.

The decline in potential output and its growth rate together with the attempts to adopt stimulus measures resulted in substantial widening of general government deficits. At the same time, financial markets started to penalize unsustainable government policies very heavily. All this brought into the forefront the need to adopt credible exit strategies. This contribution illustrates how reforms in fiscal frameworks (based on region-specific circumstances) can help to put budgetary positions on sustainable footing in Central Europe (CE).

2. Deficit Bias in the Region

Excessive deficits in the past 30 years have lead to an increase in gross public debt in the OECD to 100.7 percentage points of GDP in 2011 from 68.7% in 1993. Gross debt in CE is approaching 60% of GDP (simple average) compared to 45%t ten years ago. It is a well accepted fact that sustained deficits and increasing debt levels are to some extent due to the so called deficit bias. Politicians have many incentives to operate with high deficits. Based on the extensive literature I can mention at least six possible reasons for this bias: informational problems, impatience, myopia, common-pool theory, time inconsistency and electoral competition. As I argue below, in my view informational problems, myopia and the common-pool theory are the most relevant explanatory factors of the deficit bias in

[1] This contribution to the panel discussion draws heavily on Ódor (2011).

CE. One should keep in mind the source of the bias when designing fiscal policy frameworks.

Despite the prevalence of big deficits in CE, according to opinion polls, voters and companies usually care about future generations and increasing public debt. Around 90% of citizens consider public debt as a major threat in Hungary and the Czech Republic. In Poland less than 50% of voters were in favor of increasing the constitutional debt limit. In Slovakia, rising public debt was one of the main topics before the 2010 parliamentary elections.

At the same time, the transparency of budgets in CE is still – despite many improvements in recent years – below Western European standards. The public awareness of government debt and the low transparency of budgets in CE suggest that informational asymmetry has been an important source of the deficit bias. Therefore, decreasing this asymmetry between the public and the government could have substantial benefits in the form of additional costs imposed on policy makers departing from sustainable policies.

The second major source of the deficit bias in CE is myopia. Structural deficits in election years were on average 1 percentage point higher than one year prior to elections. Moreover, there were significant upward revisions to the deficit because of reclassification of public private partnership (PPP) projects (Hungary) and financial transactions into capital transfers (Slovakia). It clearly shows that governments often care only about the short-term consequences of their action. Their interest for the future is lessened due to the uncertainty over next elections.

The third significant cause of the deficit bias in CE is the common-pool theory. Decision makers under the pressure of various interest groups are unable to internalize the overall costs of higher debt. This incentive is stronger in good times and leads to substantial pro-cyclicality of policy. The years from 2006 to 2008 were especially good for CE countries. According to the estimates of the European Commission, the output gap showed significantly positive values in all four countries. Despite buoyant economic environment, structural primary balances net of one-off effects showed no substantial improvement during this period.

3. How to Eliminate the Deficit Bias?

The deficit bias in principle should not be a long-term problem if financial markets would react to inadequate fiscal policy early enough. However as the recent sovereign crisis shows markets seems to penalize unsustainable fiscal policies in a non-linear fashion and only at a later stage. In monetary unions with some degree of political integration such as the euro area, the problem is worse, since the delays can be much longer due to the little credibility of no bail-out clauses.

Another line of defense against the deficit bias would be if voters put more pressure on fiscally non-responsible governments. As the experience from the last 30 years shows, to rely solely on this assumption would be problematic. One

explanation is that voters themselves discount the future heavily. The other, more important cause is informational asymmetry; it is often hard for voters to distinguish between bad policies and bad luck.

The third possibility to fight against sustained deficits is designing better fiscal frameworks as commitment devices. The current crisis with countries close to default created at least ex-ante political will to consolidate public finances. To profit from this relatively widespread agreement between politicians across the political spectrum, national fiscal institutions should be strengthened. Of course there is no one-size-fits-all fiscal framework. One should take into account country-specific circumstances.

4. Requirements for Good Fiscal Frameworks in CE

Policy makers in CE face a slightly different environment for fiscal policy than their counterparts in more developed countries. I do not want to state that the features identified are not present in developed countries; however in my view their importance is higher for catching-up economies.

One can identify at least seven interrelated characteristics for policy consideration: (1) higher macroeconomic volatility, (2) frequent "regime switches" and stop-and-go policies, (3) FDI dependence, and high current account deficits, (4) lower tax potential, (5) expenditure pressures, (6) higher corruption and lower law enforcement, (7) relatively low public debt and higher growth potential. It is important to bear in mind that many of these problems are not exogenous to the setting of fiscal policies.

4.1 Higher Macroeconomic Volatility

It is a well documented fact in the literature that emerging market business cycles are more volatile than their counterparts in developed economies. The reason is mainly the presence of frequent supply shocks and financial underdevelopment. Fiscal frameworks in CE thus should take into account that it is almost impossible to assess in real time the cyclical position of the economy and the structural deficit.

4.2 Frequent Regime Changes

Regime switches are endogenous factors contributing to higher macroeconomic volatility. Frequent changes in political cycles are not unknown for developed countries; however political and economic cycles are more intertwined in CE and in developing countries in general. Dramatic reversals of fiscal and monetary policy or substantial changes in structural reform appetite are frequent in catching-up countries.

In CE especially large structural changes are visible mainly in Slovakia and Poland. In Slovakia there were at least four important structural breaks in the past 15 years, from which three are closely related to domestic stop-and-go policies.

Any fiscal framework which limits the ability of the government to reverse policies or has a built-in bias against structural reforms is probably not politically sustainable. Frameworks should be flexible enough to accommodate government policies, which rest on very different value judgments. Therefore, normative elements are not recommended for fiscal frameworks in CE.

4.3 FDI Dependence and High Current Account Deficits

Recently much attention has been focused on the appropriateness of the FDI-led catching-up growth model for new Member States. Question marks arose mainly after the huge output drop in the Baltic States. The majority of the post communist countries is undercapitalized. Without foreign direct investment the catching-up process would be much longer. On the other hand, business cycles would be probably less volatile. In my view, the roots of the recent problems are not in the basic set up of this growth model, but in the choice of the exchange rate regime before the euro area entry and underestimating the signals from the widening current account deficits, which can lead to substantial problems if international capital flows stop. Although it is important in all the four countries, especially Slovakia should pay a lot more attention to counter-cyclical fiscal policy to mitigate the possible negative side-effects of the FDI-led catching-up strategy.

Therefore, fiscal frameworks should allow automatic stabilizers to fully operate as a minimum requirement. Since automatic stabilizers in CE are not as strong as in countries with more progressive tax systems and higher share of public expenditures on GDP, fiscal frameworks should send a warning signal if more adjustment is needed beyond the work of stabilizers. This leads to requirement for sufficient flexibility via incorporation of judgments into the fiscal framework.

4.4 Lower Tax Potential

The tax burden in CE is much lower than in the western part of Europe. Lower GDP per capita and high openness are obviously among the reasons. Since catching-up economies are FDI-dependent, capital taxation is understandably lower than in more mature economies. Therefore, the majority of the tax burden falls on consumption and labor, mainly in the form of social security contributions. Moreover, the relatively high taxation of labor creates incentives to move certain activities to the shadow economy. Underreporting of earnings and higher share of self-employment (with minimum reported income) are common in the region. That is one of the reasons why the macroeconomic effectiveness of the labor taxation is so low.

In the long run these tax systems will at least partially converge to western standards, however the immediate challenge is to put in place simple and well functioning tax systems to contain tax avoidance. To achieve these goals, fiscal frameworks should not discriminate tax reforms. This requirement is important also from the political economy point of view. Fiscal frameworks to be sustainable should be compatible with both a small and a big role of the state in the economy.

4.5 Expenditure Pressures

Expenditure pressures are also present in CE mainly as a heritage from the past. After the regime change a lot of physical and human capital became obsolete. Moreover, the basic infrastructure (roads, communications, railways, etc.) is also underdeveloped compared to western countries. The latter creates a lot of needs for investments in physical capital and infrastructure, while the lack of adequate skills represents a challenge for employment policies. In many cases the policies to put these people back to the job market failed and the "lost generation" ended in social safety nets as early retirees or disabled. The employment rate in CE is therefore far lower than for example in Germany.

State companies represent a special case for expenditure pressures. Many countries failed to privatize or restructure state companies. Many of them create losses, which have to be covered by the general government from time to time.

Aging of the population is another potential source for pressure. While it is not an immediate problem for new Member States as for Western Europe, its impact will be substantial in the long run. Central European countries are expected to stay below the EU average as far as the old-age dependency ratio is concerned at least until 2040. However, the cumulative growth of this indicator between 2010 and 2060 will be enormous in Slovakia and Poland (around 50 percentage points). In this context it is not surprising that the European Commission has classified the Czech Republic and Slovakia as "high risk" countries in terms of fiscal sustainability.

The implication is that good fiscal frameworks should not discriminate structural reforms with long-term positive impacts in CE and should focus on the entire public sector including state enterprises.

4.6 Corruption and Law Enforcement

Central European countries rank high as far as corruption is concerned and low in terms of budget transparency. The room for creative accounting and off-budgetary operations is significant. One of the major sources of the deficit bias is non-transparency of public accounts. Law enforcement is also very low in the region, which in many cases creates bad incentives. For example state organizations and companies do not pay their dues in time, because they know that it will take a lot of

time for the courts to decide. Therefore, reporting cash outlays is in many cases not sufficient to monitor fiscal performance.

Any fiscal framework, which improves the transparency of public accounts, can cause substantial efficiency gains in CE. Much more attention should be devoted to activities outside the general government and to quasi-fiscal operations. Focusing on the whole public sector is a must.

4.7 Low Debt Levels[2] and Higher Growth Potential

Compared to Western Europe, gross debt levels in CE are lower and potential output estimates higher. This means that CE can in principle face fiscal challenges more easily. The reality is however more complex. Limited tax potential and higher expenditure pressures together with low initial debt levels created an environment for increased deficit bias. Postponing the solution between the lower taxes and higher expenditures through deficit financing is possible if a country starts with a low level of debt. However, this "strategy" can be successful only up to a certain debt level, since – as the recent crisis illustrated – financial markets do not accept as high debt levels in emerging markets as in the case of developed economies.

Good fiscal frameworks might consider limiting government debt explicitly or implicitly at much lower level than the harmful limit – 90% of GDP – suggested by the empirical work of Rogoff and Bertelsmann (2010).

Table 1: Requirements for Good Fiscal Framework in CE

CE characteristics	Implications for fiscal frameworks
macroeconomic volatility	operational target not for structural deficit
regime changes, policy reversals	allow for different value judgments, no normative elements
FDI-dependence, current accounts	counter-cyclicality, flexibility, judgments
low tax potential	no built-in bias against tax reforms
expenditure pressures	no built-in bias against structural reforms
high corruption, low law enforcement	maximum transparency possible, focus on the whole public sector
low debt, high growth potential	implicit or explicit debt limit

Source: Author's compilation.

[2] With the exception of Hungary.

5. Designing a Fiscal Framework in CE

Requirements for fiscal frameworks in CE presented in table 1 are sometimes in conflict; therefore it is not straightforward to design appropriate frameworks. However if we consider the key sources of the deficit bias in CE, some basic characteristics emerge. One of the most important problems is the still big room for creative accounting practices and off-budgetary operations. Therefore, rules for transparency and reporting requirement for off-budgetary items can be very useful.

Many of the current bad incentives come from the fact, that policymakers and the public focus their attention more on flows rather than stocks, on general government rather than the public sector and on explicit liabilities ignoring implicit and contingent liabilities. In principle, there are two ways to fix this problem. The first is to identify these shortcomings and to build adjusted general government indicators. The second option is to broaden the focus of the debate on public finances systematically by calculating indicative intertemporal public balance sheets. In my view the concept of net worth (public sector assets minus public sector liabilities) could play an important role in this regard.

The proposal to base fiscal frameworks in CE on the concept of net worth does not mean, that I advocate for an operational target for net worth. Due to valuation and data problems it would be highly problematic. However, it can serve as a good benchmark for transparency. Moreover, if reliable numbers for the *changes* in net worth are available, these can serve as a starting point for the operational framework.

The more complicated issue is the question of fiscal rules versus independent fiscal institutions[3]. In my opinion, important synergies exist between the two. Rules without councils have to be simple to be understood by the public. Then there is no problem to go around them, especially in a less transparent environment. Councils without rules could end as purely academic debates. So the best way is to combine both: we can have more complicated (and therefore effective) procedures, because the council can serve as an interface between the government and the public. One can combine this way the strictness of rules with the flexibility of councils.

The next issue is the selection of appropriate fiscal rules. Since it is almost impossible to calculate structural deficits in real time – frequent supply shocks, regime changes, etc. – an operational target for the structural budget balance would be highly problematic. Focusing on headline budget balances would be equally wrong: due to high business cycle volatility, it would create significantly pro-cyclical fiscal policy. An operational target for the debt level is very transparent, but it also incorporates a pro-cyclicality bias. So the most appropriate operational framework in our view is employing medium-term expenditure ceilings. If these

[3] By independent fiscal institutions, I mean in this contribution fiscal councils with no normative roles.

ceilings are defined in nominal terms, the evaluation is straightforward and if cyclical expenditure items are excluded from the ceiling, it allows automatic stabilizers to operate freely. In addition, if tax expenditures (such as basic allowances and exemptions in the tax system) are also included, it reduces the possibilities to go around the rules by creating more loopholes in the tax system. It is also important to have a very broad definition of ceilings, since lot of operations are taking place outside the state budget.

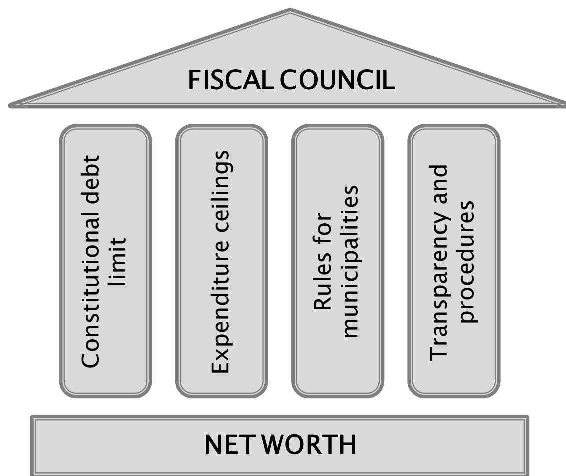
How to derive expenditure ceilings? The basic requirement is to set up these ceilings for at least three years in advance and to derive them from some measure of sustainability. All these calculations should be based on cautious macroeconomic assumptions.

Another important question is the neutrality against structural reforms and tax reforms. How to reward good policies and punish bad ones? Here the concept of net worth can help us. We see an alternative for deriving the expenditure ceilings using the change in net worth. Since net worth in a broad sense incorporates also implicit and contingent liabilities, reforms improving the long-term sustainability of public finances can increase the expenditure ceiling. Fortunately there is a benchmark available for this exercise – the projections of the Economic Policy Committee's (EPC) Working Group on Ageing Populations and Sustainability. On the other hand, deriving expenditure ceilings from the changes in net worth (or adjusted CABs) grossly complicates the understanding of such rules. This is the case where independent fiscal institutions can help once again.

How to set up such independent fiscal councils? Frequent policy reversals in CE are more often than not the result of the very different view of political parties on the role of the state in the economy. Therefore the council should have no normative role.

The current reform proposal in Slovakia includes all these elements as illustrated in chart 1.

Chart 1: Reform Proposal in Slovakia



6. Conclusions

There is no one-size-fits-all fiscal framework. However, based on the characteristics of Central European countries, one can have some recommendation regarding the choice of basic building blocks. The paper argues that for catching-up countries it is very important to decrease the informational asymmetry between the public and policy makers and to broaden the scope of the debate to the whole public sector. The concept of net worth can serve as a useful informational benchmark in this regard.

In countries where the room for creative accounting is relatively large, there are important synergies between fiscal rules and independent fiscal institutions. Among fiscal rules we favor expenditure ceilings and implicit or explicit debt ceilings as a second line of defense. Of course, one cannot forget about appropriate rules for municipalities, whose influence in the region is not negligible. We advocate including all these key ingredients in one Fiscal Responsibility Act together with basic requirements for transparency and procedural rules.

It is however important to bear in mind that the reform of the fiscal framework is not a magic solution. Without an ex-ante backing from the major political parties it is probably not viable. The good news is that the current financial crises and the need for exit strategy have created broad political consensus to carry out revisions to the existing frameworks in many countries.

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