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Fiscal discipline in EU: question of transparency and commitment

Iveta Radičová
Prime Minister of Slovakia

London School of Economics and Political Science

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The problem with New Year's resolutions is not the fact that people do not take them seriously - at least for the first two or three days after the New Year they do. Moreover, many people are really committed to quit smoking and make healthy changes to their lifestyle or start to be more proactive. However, a majority of such resolutions don't last longer than the first few weeks of the year. The live-for-the-moment impulse eventually overcomes the planning impulse.

Perhaps a number of you recognize the website stickk.com. A group of economists from Yale University created this site in order to help people achieve their resolutions successfully by signing contracts. The main idea is based on a wide range of research from behavioral economics and is based on a simple premise: people do not always do what they say and what they want to do, but a desired goal can be achieved if they have proper incentives. The basis of every contract is the definition of a goal and a sum that the person is willing to bet on its completion as well as the selection of referees and supporters for the fulfillment of the resolution.

Smokers, alcoholics and politicians who irresponsibly indebt their own country are notorious for having a single thing in common. The time when they are best capable of breaking their bad habit is always "tomorrow" and few of them are able to openly admit their bad habit. Have you ever heard a politician announce publically and honestly that his or her goal is to devastate public finances, to encumber future generations with huge debts and leave the resolution of these problems to his or her successors?

Every single one of them will speak in favor of responsible politics and will work out budgets that are "fiscally responsible". Then they draft a strategy for consolidating public finance and promise numerous measures and structural reforms. Finally, the end of the year arrives and suddenly it becomes clear that the spending limits have been exceeded and the deficit is larger than planned – always, of course, for "objective" reasons. Politicians cover their backs and promise that the next public budget will be different, offering assurances that this time they really intend to complete this consolidation. Just the same as for New Year's resolutions, this goal rarely survives a period exceeding a number of weeks or months.

The reason? While every politician is not so irresponsible, as has been shown for example during the debt crisis in the EU, politicians almost never expose themselves to risks. Referees who would have added caution and prudence to the process and supporters are missing. European cities are full of protests but I cannot remember when the main goal of any demonstration was an ultimate support for successful austerity measures taken by a government.

In Slovakia, consolidation of public finances already received the title of "belt-tightening" years ago. From this name it is clear that every government undertaking the adventure of consolidation and fiscal discipline does not win over many supporters. Despite this fact, certain governments and politicians undertake this effort, some because they are responsible and others because there is no other choice. However, the key problem is how to make fiscal discipline long term project. This means preventing the bon vivant, live-for-the-present impulse take over after a number of short months or, in the best case, after a number of years of austerity.

This is huge economic, political and social problem. Slovakia is a country where three words: "transition, change and reform" have dominated public policy for more than two decades. We are a society that is in a state of permanent and rapid change. Our citizens do not have a chance to take a break and enjoy any sense of lasting stability. At the start of the 1990s the country underwent a fast and active process of transforming from a planned economy to a market economy. At the same time, public finance and the banking sector collapsed. At the start of this millennium the government was forced rescue the financial sector, with costs stretching up to 10% of GDP. It was forced to combat 20% unemployment and to consolidate public finances, to undertake wide-ranging tax, pension and social systems reforms and to build up the institutions necessary for a functioning and modern democratic state. In addition, the country also had to meet the strict criteria and to adopt a huge, almost unbelievable, amount of new rules within the process of planning its entry into the EU and later the Eurozone.

At the end of the last decade, just when it finally appeared that we would be able to take a break, the global financial and economic crisis hit. This, combined with irresponsible fiscal policy, resulted in a public deficit of 8% of GDP in each of the past two years and unemployment levels of nearly 15%. So we found ourselves once again in a period of strict fiscal consolidation and deep structural changes instead of a period of simple fine-tuning, in order to restart economic growth, increase the level of employment and try to avoid debt trap, which has caused a number of countries in the EU to fall. This is one of the reasons why it is not shocking that after nearly 22 years in a free society 45% of Slovak citizens retain a sense of nostalgia for the period under communism, which they connect to a sense of stability and certainty.

The government that I lead has promised our citizens to decrease the deficit of the public finances under 3% of GDP from the previous year's level of more than 8% of GDP by 2013. Thanks to these efforts, the increase in gross public debt should peak at around 45% of GDP and then begin to fall in the following years. This is a demanding task. The pace of consolidation is both fast and brings with it all of the political problems that can be associated with it: resistance from the public, unions and other interest groups. Slovakia also finds itself in a situation where the level of tax and mandatory contributions is less than 29% of GDP, which is the lowest within the EU for the coming

years based on our calculations. Despite this, we are attempting to consolidate public finances by decreasing public spending, which places immense pressure on efficiency and the ability of the state to finance quality public services.

Doing the dirty work and taking unpopular steps is only one part of the task at hand. It is also important to take efforts to ensure that the unpopular belt-tightening has a long-term and sustainable effect. We must try to ensure that public finances do not fluctuate between extremes, so that periods of strict austerity measures are not alternated with period marked by sharp increases in debt levels. Fiscal consolidation cannot be a New Year's resolution that only lasts for a few weeks of a painful cure. We need for those political costs to be borne by those that generate the debt for the country and not those who clean it up. This is why we need referees and supporters. In short, we need a tool, a commitment device, and a transparent system of institutions in order to secure fiscal discipline.

We have decided to call the prepared commitment device, a fiscal stickk.com, the Constitutional Act on Budgetary Responsibility, in short a fiscal constitution. It will contain all four of the necessary components along with proper incentives. The goal of course will be fiscal discipline that we want to maintain using a set of rules. The new act will entail six main provisions: (1) a greater emphasis on the net worth of the state to enhance transparency of public accounts, (2) an upper limit on gross public debt set below 60 % of GDP, (3) aggregate nominal expenditure ceilings, (4) new tougher rules for municipalities, (5) rules for the disclosure of data and (6) an independent fiscal council. The costs that will be wagered will be the political and economic costs for an undisciplined government using a range of escalating sanctions. In the worst case, if the debt exceeds a given limit, the government will be forced to resign. The referee in the case would be the newly established fiscal council and a supporter will be whole public, which will be able to better control the government thanks to transparent information on the condition of public finances.

One of the first measures taken by my government was the publication of all contracts related to public finance on the Internet. Since January of this year, no such concluded contract enters into force until published in the central web register. This measure has been a significant aid in the fight against corruption and cronyism while increasing pressure on improving the efficiency of public spending. Every single signed contract is available to become the subject of on-line, immediate public discussion and doubts.

The fiscal constitution is not to serve to normalise economic policy across the political spectrum. Every government will be able to freely select its spending priorities, the manner in which consolidation takes place (via taxes or spending cuts) and to preserve their own view on the role of the state in the economy and the degree of redistribution. However, they will be forced to deal with the fact, that undisciplined actions will have political and economic costs if debt approaches the critical values defined in advance.

We are not so naive to believe that any well-defined mix of institutions and proper incentives will turn every single politician to a fiscal hawk. The goal here is to at least minimise the extremes. It really does matter if an irresponsible government generates deficit of 6 or generates deficit of 8% of GDP. There is a difference, if a gap of 3 or 5% of GDP must be closed by taking consolidation steps over a three year period, which is the tempo defined by the Slovak government in order to halt

increasing levels of debt and for directing the development of public finances to the trajectory of long-term sustainability. Every single percent of GDP in practice means painful, unpopular and demanding measures.

All of that which applies to little Slovakia also applies to the entire EU. We could spend long hours, days and weeks discussing about causes of the financial, economic and finally debt crisis in the Eurozone. Insufficient regulation of the financial sector, incorrect monetary policy, the deep structural differences, etc... All of these are significant challenges that must be addressed by the European institutions and national governments. However, in terms of the practical performance, it was lack of transparency and credibility of commitments that destroyed fiscal policy framework in the EU and the Eurozone. Fiscal discipline in the Eurozone on paper was based on three pillars - the Stability and Growth Pact, the "No Bail-Out" Clause and the obligation of the European Central Bank to refrain from resolving the fiscal problems of the member states. The events of the previous years have beaten these pillars to dust. The Stability and Growth Pact has been ignored and breached by everyone, as no real sanctions were ever threatened. If the mechanisms included in the Pact failed or were ignored, it is too late to then make reference to other rules in a situation of absolute panic and uncertainty. For example, in a situation called EU summit in Brussels, where 27 highly stressed and nervous prime ministers were called on to find a solution in a single night to avoid the worst-case scenario, caused by a decade of easy breaches of rules and obligations as well as insufficient transparency. The debt crisis in the Eurozone may "technically" have started as a result of the financial crisis and the global economic recession, but in fact it started when the first member state breached the Stability and Growth Pact and was not punished.

This means we must focus on wide-ranging reforms of fiscal rules in the EU, the European Stability Mechanism and all other tools we can use to attempt to prevent the escalation of a crisis and to lay the foundations of a new fiscal infrastructure to prevent such a future crisis. This is an extremely demanding task. Agreement on fiscal rules at the national level is truly hard work, but pales in comparison with the need to find consensus between 27 member states of the EU. The result is always compromise, but such compromise must pass a stress-test of transparency and credibility of our commitments. This is one of the reasons why Slovakia has been a supporter of the strictest rules and the highest possible levels of automatic sanctions for breaking these rules during negotiations. This is why we have insisted on the private sector involvement, e.g. creditors, as the part of the resolution of the debt crisis. If the opposite occurs, the live-for-the-present advocates will again win over the fiscal discipline and the best time for the austerity will once again become "tomorrow".

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