Marko Škreb[i]

speaking notes

(you can quote me at your own risk)

June 2012

Regional High-Level Seminar on the Subject of South East Europe: Prerequisites for Reform

SEESOX and Bank of Albania Seminar

We have heard two papers that explore in detail the role of institutions and limited fiscal space. So, the question we are pondering on is how to have more fiscal space in case we may need it (hopefully in the future) for discretionary fiscal stimulus. This reminds me of an old joke. A gentleman got lost in the Irish countryside and he asked a farmer how to get to Dublin. The farmer replied: If I wanted to go do Dublin I definitely would not start from here.

If we want fiscal space in the future then the position of most of our countries is not the best one to start from, isn't it? But we cannot change our position now.

I have to apologize to the authors of the two papers. Both are very interesting and challenging. However, I have opted for my own general comments on the fiscal space in SEE. So, I will not discuss the two papers in a classical sense. Plus both are published, polished, and thus relatively difficult to comment on. I would like to use my time to address three issues.

1. **Do we have any fiscal space at all?**
   I would like to start with the following point. Maybe the term "fiscal space" does not accurately describe the situation, not only in SEE but in a lot of other countries as well. Why? Fiscal space is obviously a concept with a positive sign in front of it. Being an economist I am used to negative values such as: negative real interest rates, negative growth rates (which of course in plain English means a fall), negative trends in general! So, negative is a variable which goes "south", i.e. falls. Not being a physicist, I was reluctant to propose the term negative fiscal space. For me it was difficult to imagine a negative space. Therefore the closest term I managed to find is a fiscal black hole! There is usually a beam of light that travels from its centre. But not even a beam of light can escape the strong gravity of a black hole.
   The point I am making here is that it seems to me that in the future a lot of countries (including SEE) will not only have a very limited fiscal space (as defined in both of the previous papers) but will have to do just the opposite, that is, decrease their public debt, decrease their deficits, decrease the share of government expenditure in GDP, if they want to grow and attract FDI and external financing in general. Of course, the group of countries we are talking about is very diverse and this may not apply to all of them, but let me first explain what I see as a serious problem.

2. **Role of the state in the economy.**

Actually, this is not only about fiscal space, which is a subtopic, but it is broadly related to the role of the state in SEE, and yes, it will largely overlap with the next session. Therefore I am pleased that the program has been changed and that political constraints are after our session.

I would say in brief that the main problem with fiscal space in SEE is the attitude toward the role of the state in the economy in general. We will need to change such views. This will take a long time. My general opinion (which I will not try to prove rigorously here), is that SEE, or most of the post socialist states, even 20+ years into transition still have very biased views on what a sound fiscal position is and, more generally, what the "appropriate" role of the state in the economy is. Let me give several examples of the latter problem:

- Socialism. In general, there is too much belief in the state. One can often hear about market failures in our countries, but the consequences of state failures, which are sometimes equally or even more devastating, are rarely mentioned. The socialist legacy, paradoxically in my opinion, has left a lot of people with "a belief in the state". My individual reaction is just the opposite, I do not trust the state *ex ante*, but I am obviously a minority. Our societies want more redistribution via the state and always look for help from "the state". To my mind, the major worry is the view that the state can correct all the problems and that it is actually "better than the market". This crisis has only fuelled those views. "We told you so, markets do not work" or even slogans, like: "Marx was right, capitalism will destroy itself".
- A naive view of "an abstract and ideal state". As if some virtual supermen worked in our government bodies, state institutions, agencies etc. They are not humans like us or probably even worse, as usually the most capable and entrepreneurial go to the private sector. I do not want to offend anyone, but in Croatia in the nineties we had a negative selection for administrative public offices in general. Those that were the most risk averse and afraid to go to the private sector or those that could pay for their jobs (corruption) went to work for the state in government administration. So, every time that I hear the state should do this or that (micro manage something) I worry about who will do it.
- Then we overburdened the state and wanted to protect those that cannot be protected. One of the best economists dealing with this subject is definitely Janos Kornai. In the early nineties he wrote about the role of the state and invented the term: "premature welfare state". It seems that in the twenty years since his paper was published not much has changed. This thesis is that the premature welfare state under state socialism in South Eastern Europe offered a level of social protection comparable with that of the most advanced Western welfare states. But the level of development (i.e. GDP per capita) was much lower. So, if we look at the historical development of the welfare state (before this crisis), one would expect much lower social spending.
- Therefore, given the combination of the prevailing risk averse attitude, the negative selection of human capital in public administration in most of the countries and a high level of spending (in relation to GDP), one should not be surprised that the budgetary expenditures are only on the rise in many of the countries, part of it with deficit financing.

3. **Fiscal standards have changed in the crisis.**

As I explained in one of the previous seminars (SEESOX ones), a big change that happened in central banking in the eighties and is still evolving and developing is the central bank focus on price stability (usually with inflation targeting). It was clear that to fulfil this single goal central banks needed independence.

Why independence? The idea was to take “the monetary toy” out of politicians’ hands. Technocrats managed to persuade legislators that money was a very dangerous toy that could explode in their faces (printing money before the elections and being faced with a rising inflation afterwards) and that it was therefore better to leave it to experts (independent ones[1]). And yes, it did happen in the eurozone and in many other countries. I am sure many politicians now regret this decision as their lives would be much better off, at least in the short run, if they had kept hold of the toy.

I see something very similar happening now, but in the fiscal area.

The Stability and Growth Pact, i.e. the Maastricht Treaty, was the first quasi international attempt to introduce international standards into the fiscal arena. For the first time we had “benchmarks” in fiscal policy (similar to benchmarks in monetary policy, i.e. low inflation). I am not surprised that perfect fiscal standards could not be established on the first attempt and they will have to evolve. So, we are now seeing a lot of attempts to this effect. We can read about: fiscal brakes, fiscal responsibility councils, central fiscal authorities in the eurozone, etc., etc. Again, I see a parallel with the central bank need for independence.

What we are trying to do with all the new rules is *de facto* limit the possibility for politicians to “play with the fiscal toy”. As we have seen in this crisis (and with public debt higher than 100% of GDP and double-digit deficits), we should not trust politicians too much when it comes to conducting fiscal policy.

In my view, a huge problem is that one cannot have the same type of independence in fiscal policy as one has in monetary policy. Budgets are for national parliaments to decide, so this is to a large extent a political game. Some sovereignty has already disappeared, some more will go, but it is a big question how much of it should go, and it seems to me that the story in the EU and the fiscal game is all about this problem. And it is first and foremost a political economy issue.

Finally, just as a note, fiscal policy has its international consequences (especially in the case of big countries) and policy makers, no matter how nationally oriented, have to take this into account. Price stability is not the only goal for central banks, so budgets have to adapt to this new role as well.

Will we succeed in developing new fiscal standards and tying the hands of politicians in the fiscal area? Monetary policy was given up relatively easily. When the ECB and euro were formed someone observed that this was the biggest peaceful transfer of power, “peaceful” meaning without a war. I doubt we can have a similar situation in the fiscal area. Giving up fiscal sovereignty is difficult.

But new rules will come in, and I guess they will go along the following lines:

[1] Truth to be told, central bank goals are changing with time. Initially, it was only price stability. No doubt that price stability is important, but we have increasingly realised that without financial stability, price stability is not enough, and that a lot of risks build-up in the economy (i.e. the financial sector) can pass below the central banking radar screen. So this role is now changing both formally and informally (or *de facto* and *de iure*).

- much tighter rules in terms of deficit and public debt (tighter for SEE than the Maastricht rules are now);
- even more importantly, regarding the medium term, and especially in the light of some countries' external imbalances, it is possible that for some a surplus is needed (especially the primary surplus). This will be a difficult political sell at home (locally), but I think we all need to start addressing this issue. Yes, there is a need to deleverage and yes, some countries might need a surplus. Why a surplus? There are three ways to lower public debt: to have a surplus, to inflate the debt or to default. Another possibility is to grow out of it, but for this we would need a substantially higher growth in the medium term.

In my view, inflation is a risky prospect for a lot of our countries that suffered from high and hyper-inflation, as we remember only too well, default is not an option, so surplus seems to be a way to go. Can one sell it? I do not know, but I know that politicians, including the ministers, have to start telling the truth.

I am not familiar with other countries' details, but I do not recall that in the recent Croatian history fiscal numbers have ever been better than forecasted, on the contrary. So, fiscal projections are constantly undershot, deficit is larger than expected. Actually the so-called "deficit bias" is a well-known phenomenon in the political economy literature. See Price, 2010. But for me the bigger part of the problem is that not only the MoF, but societies at large are constantly in denial on that. Apparently, our brains are programmed to learn from mistakes, but it seems that in this area this does not work.

- Finally, part of the problem is that the countries SEE has been looking up to as an example to follow, have to change themselves and have to change substantially. In other words, mature economies "which we from the south periphery tended to view as ideal standards" have to "deleverage" in terms of fiscal adjustment and have to do it to a significant degree. That makes the message for local politicians in our countries even more difficult. How can we "advocate" a 30% public debt when Italy's is 120%, France's almost 90% and even that of virtuous Germany about 80% of their respective GDP? The old Latin saying, *quod licet Iovi, not licet bovi,* does not bode well with domestic politicians.

4. What may the new fiscal standards for SEE look like?

It is too early to say as yet, but I would speculate that the Maastricht numbers are way off the charts for our economies. We do not have much scientific evidence or many numbers, it will take a long time to establish the new rules for SEE, but I would argue for example that our public debt should be closer to between 30% and 40% of GDP than to the Maastricht figure. Or even the levels that some advanced economies have today. If we want to be a on the safe side and have some fiscal space in the future, we need to be close to 30%. See Mates, 2011 (OeNB Workshop No. 17).

As we have (re)learned during the crisis, even a sound fiscal stance can quickly deteriorate if there is a problem in the financial system (like the ones in Spain or Ireland, to say nothing of Iceland).

The expenditure to GDP ratio should be lower as well. The most efficient states have a public expenditure to GDP ratio of around 30%. See Afonso et al, 2006.

These new standards may come as a **cognitive shock** to politicians. They may look at them in disbelief; sometimes even regard them as a conspiracy theory to drive them out of office. We all remember well what Jean Claude Junkers said: *We all know what to do, but we do not know how to get re-elected after we have done it*. So, it is a political economy problem, more than a pure economic problem.

But ultimately, unless we change the attitude of both policy makers and the population at large towards "fiscal space", due to the "political character" of the budget we cannot apply to it the same standards that we can to monetary policy. I doubt that we can create the needed fiscal space in the future unless these attitudes are changed. We will end up in a fiscal black hole.

This cognitive shock, or disbelief, can be illustrated with an episode I had with a former finance minister. I remember talking to a long time finance minister about the need for fiscal adjustment. And his answer was blunt: What do you want? Our deficit is below 3% (well, it was somewhat above) and public debt is below 60%. So, I am doing great, better than most WE countries, why should I worry?

And indeed, why should he have worried about losing the elections as markets at the time were willing to finance his deficits abundantly?

The catch is that market perception has changed now, and what looked like "normal" is excessive today. Imagine this. All your adult life you have been told to get your blood pressure below 140/90. Having taken all the precautions, changed your diet, started to exercise, quit smoking, you managed to get it below that level. However during the next visit to your medical doctor you are told that the "new normal" standards are now 120/80. Of course you would be very disappointed, in disbelief, it would be a cognitive shock to you. You would start doubting your MD, would you not? This is probably how politicians look at us, economists, who are telling them, twenty years after Maastricht, that the "new normal" is not 60%, but closer to 30%. And they are not to be blamed.

My ultimate conclusion is that we need to **rebrand fiscal policy,** i.e. fiscal standards, or the benchmarks for SEE. Maastricht, which is either implicitly or explicitly in the minds of many people, is dead for a lot of reasons. We need a long and ongoing "public awareness campaign" to teach both the public (especially the beneficiaries of the budget) and the MoF that statistics have revealed that the safe norms are different today.

References:

Afonso, A., L. Schuknecht and V. Tanzi (2006): Public Sector Efficiency: Evidence for New EU Member States and Emerging Markets, Working Paper Series, ECB, No. 581, at: http://www.ecb.int/pub/pdf/scpwps/ecbwp581.pdf.

Mates, N. (2011) How to Make CESEE's Public Finance Systems More Crisis-Resilient and Improve Their Macroeconomic Stabilization Capacity? at: http://www.oenb.at/en/img/08_mates_tcm16-245378.pdf.

Price, R. (2010), The Political Economy of Fiscal Consolidation, OECD Economics Department Working Papers, No. 776, OECD Publishing, at: http://dx.doi.org/10.1787/5kmddq798lls-en.

---

[i] Marko.skreb@pbz.hr, views are my own and in no way should be connected to the institution where I work.