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Working Paper

Poltical trust and the success of fiscal consolidations

TIGER Working Paper Series, No. 101

Provided in Cooperation with:
TIGER - Transformation, Integration and Globalization Economic Research, Warsaw

Suggested Citation: Győrffy, Dóra (2007) : Poltical trust and the success of fiscal consolidations, TIGER Working Paper Series, No. 101, Transformation, Integration and Globalization Economic Research (TIGER), Warsaw

This Version is available at:
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TiGER Working Paper Series

No. 101

Political Trust and the Success of Fiscal Consolidations

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Warsaw, July 2007

Dóra Győrffy[1]:

Political Trust and the Success of Fiscal Consolidations

ABSTRACT

The paper examines the effects of political trust on fiscal consolidations. Building on the works of Easton (1965) and Gamson (1968) a theoretical framework is derived on the main channels through which the success of fiscal consolidation can be affected by the level of political trust in the system. The predictions of the theory are tested quantitatively based on evidence from the Economic and Monetary Union and qualitatively through a most-likely – least-likely case comparison between Hungary and Sweden. The results provide strong support for the hypotheses and indicate that in the absence of external pressures lasting fiscal consolidations can take place only in a high-trust regime. In a low-trust regime even if an external crisis triggers adjustment, the incentive to buy support through short-term promises ultimately erodes the commitment to restraint and imbalances reemerge.

Keywords: trust; fiscal consolidation; budgetary reforms; economic populism; role of ideas

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By the 1990s high levels of debt and population ageing made the consolidation of public finances a public policy priority worldwide. Governments in advanced and emerging economies alike implemented large-scale fiscal adjustment programs, which led to the observable decline of fiscal imbalances in the last decade (IMF, 2001; OECD, 2003). During this process a considerable amount of research was devoted to the questions why some consolidations are more successful than others and what makes these adjustments lasting.

Mainstream economic thinking attributes the success and sustainability of fiscal consolidations to their composition. Due to gains in policy credibility, adjustments, which cut politically sensitive expenditure such as government wages and social tranfers, are more likely to be lasting than consolidations, which rely on revenue increase and cuts in public investment (Alesina & Perotti, 1996; Alesina, Perotti & Tavares, 1998; Von Hagen, Hallett & Stracuh, 2001; Fatas et al, 2003; Ardagna, 2004; Briotti, 2004). Besides the composition of adjustment economists have also emphasized the importance of fiscal institutions governing the budget process in the sustainability of public finances (Von Hagen, 1992; Perotti, Strauch & Von Hagen, 1997; Perotti & Von Hagen, 1999). According to this line of research strenghtening institutions can lead to improved fiscal performance through two channels. First, by constraining the discretion of policy-makers, they can reduce the potential for electionary spending. Second, institutions can also reduce the problem of common pool resource dilemma in fiscal policy, which means that particular constituencies can internalize the full benefit of extra spending but pay only a fraction of the social cost.

The superiority of expenditure-based consolidations and the importance of strenghtening budgetary procedures arouse little debate among economists today and have become standard advice of the international financial institutions to countries facing a fiscal adjustment[1]. At the same time in spite of the considerable advance in understanding the conditions for long-term fiscal sustainability, budgetary imbalances persist around the world

(Garrett, 1998; Tytell & Wei, 2004). Even where some form of adjustment takes place imbalances reemerge, which is best illustrated by the experiences of eurozone member states. This raises two related questions. What drives governments' choice about the method of fiscal consolidation? Under what conditions are international best practices implemented?

This paper aims to answer the above questions by analyzing the effects of political trust on fiscal policy decisions. The idea about the potential relavance of trust for fiscal consolidations relies on the insights of Easton (1965) and Gamson (1968), who showed that support for the authorities, regime and the political communities is a major input of political decision-making. Support is particularly important when citizens are asked to make material sacrifices, which is the case during fiscal consolidations. Building on these considerations the main thesis of the paper is that in the absence of strong external pressures long-term consolidation of public finances can be achieved only in a high-trust regime. In a low-trust environment even if an external shock triggers adjustment budgetary imbalances are likely to re-emerge given the incentives of politicians to continuously buy political support through short-term spending. This incentive strongly reduces the possibility of consensus on necessary institutional reforms as well as the demand for implementing international best practices in public finance management.

The argument proceeds in three stepts. The next section analyzes the potential channels through which political trust can affect the success of fiscal consolidations. Then I offer simple statistical evidence on the theory based on the experiences of current EMU member states. In the following section I conduct a most likely – least likely case comparison between Hungary and Sweden examining their experiences with fiscal consolidation since the mid-1990s. After discussing some potential counter-arguments to the theory the final section concludes with some implications.

Political Trust and Fiscal Balance

According to classical theories of political trust, low level of trust negatively affects citzens' compliance with governmental demands. Easton (1965) uses the concept of diffuse support and explains its consequences as the following:

> Members are capable of directing diffuse support toward the objects of a system. This forms a reservoir of favorable attitudes or good will that helps members to accept or tolerate outputs to which they are opposed or the effect of which they see as damaging to their wants. . . . It is a kind of support that a system does not have to buy with more or less direct benefits for the obligations and responsibilities the member incurs. (p.273)

In the interpretation of Gamson (1968) "when the supply in the reservoir is high, the authorities are able top make new commitments on the basis of it and, if successful increase such support even more. When it is low and declining, authorities may find it difficult to meet existing commitments and to govern effectively" (pp. 45-46).

The concept of diffuse support and its importance during sudden crisis situations have particular relevance for the problem of fiscal adjustments which can strongly affect the material well-being of citizens. If acceptance for such temporary hardship is missing the government has an incentive to choose a method of adjustment, which is seen as less costly in terms of support: generating higher inflation or cutting public investment. Given the substantial difficulty in understanding the true tax level (Buchanan & Wagner, 1977) even increasing revenues is less likely to arouse protest than cutting sensitive government expenditure.

The above tendencies can be particularly acute if the country is approaching an election. If citizens do not trust the system to deliver goods in the long-term, their support can be bought only through making short-term material promises. Consequently a prisoners' dilemma situation emerges where the dominant strategy for both the government and the

opposition is making short-term promises or election spending, while the long-term interest of the country would require responsible fiscal policy[2].

INSERT FIGURE 1 HERE

The prisoners' dilemma situation is not impossible to solve however. If the two opposing parties can come to a consensus on the necessity of long-term fiscal restraint it might be possible to undertake measures, which are most conducive to long-term sustainability. At the same time lack of trust in the political system makes such a consensus difficult.

The first potential channel from political trust to lack of consensus is the iterated nature of the prisoners' dilemma situation. If the actors have gone through numerous rounds of the game and defection was the characteristic strategy, then lack of trust in the political system can lead to the deterioration of trust within the elite. The absence of trust in the elite makes consensus on self-restraint unlikely and it becomes more and more difficult to solve the prisoners' dilemma.

A second potential channel from political trust to elite polarization is the perceived need for taking confrontational positions in the policy debate. If the public is disillusioned from the political system it often implies that this disillusionment refers not only to the ruling government but to the elite in general including their own party or union leaders. The endemic distrust towards representative institutions in the transition countries (Ulram & Plasser, 2003) indicates the reality of this assumption. Such distrust can have important consequences for the strategies of elite. In order to gain support politicians need to articulate positions in line with the perceived short-term interests of their potential voters. If they move towards consensus and accept short-term sacrifices, they might be easily seen as betraying the interests of their voters, since long-term benefits are not credible in a low-trust environment. Consequently confrontation rather than cooperation becomes the norm. In contrast in a high-trust regime,

where long-term gains for short-term sacrifices are seen as credible cooperation within the elite is more likely to emerge.

In an environment characterized by populist tendencies and a confrontational political culture demand for ideas and international best practices to provide a lasting solution for fiscal imbalances is likely to be lower than in a high trust regime. According to Walsh (2001) an idea matters if three conditions are fulfilled: 1. an evident policy failure; 2. low levels of societal opposition; 3. high level of authority of the state over the relevant policy field. The idea of an expenditure-based consolidation clearly goes against the second criterion. Its difficulty in a low-trust environment has been discussed above related to the incentive of policy-makers to minimze the short-term sacrifices of voters. At the same time the strengthening of fiscal institutions should face no such problem in theory: fiscal rules are unlikely to arouse large societal opposition and their implementation is dependent primarily on the state itself. At the same time the introduction of stricter rules cannot be taken for granted even in countries facing strong fiscal pressures. Low level of political trust provides two sources of disincentive for governments to introduce such self-binding mechanisms. First, given the need to buy votes through short-term promises governments are unlikely to limit their discretion over the use of public money. Second, if the iterated prisoners' dilemma situation has eroded trust within the elite and thus the government cannot be sure that the opposition will respect the new rules, unilateral self-binding is not a rational strategy.

Overall the main hypothesis that can be derived from the above theory is that in the absence of external pressures lasting fiscal consolidation can be achieved only in a high-trust environment. In a low-trust environment even if an external shock triggers adjustment imbalances are likely to reemerge due to the incentives of politicians to buy support through short-term spending.

The Experiences of EMU Countries 1993-2005

The experiences of EMU countries present a unique opportunity to test the hypothesis derived from the above theory. The present members of the EMU (with the natural exception of Slovenia, which joined in 2007) all consolidated their public finances during the Maastricht convergence process between 1993 and 1997. In all the member states a there was a strong consensus on the need for reducing the fiscal deficit below the required 3% of GDP. The reduction of deficits is shown in Figure 2.

INSERT FIGURE 2.

After the convergence process the eventual introduction of the common currency provided a new environment for fiscal policy. The Stability and Growth Pact, which was designed to ensure discipline aftre the qualification period was over, proved to be ineffective: in spite of its regular breach by EMU countries no fine was ever imposed on the threspassers[3]. At the same time credibility of the euro was strongly established on the international financial markets, which is shown by the steady decline of interest rates (Figure 3).

INSERT FIGURE 3.

The above developments imply that there is only a moderate external pressure on the EMU member states to conduct responsible fiscal policy. Under such circumstances it is reasonable to assume that the maintenance of fiscal restraint will be primarily determined by domestic forces. Consequently the period since 1998 provide an excellent opportunity to examine the effects of political trust on fiscal discipline.

In order to test the hypothesis on the positive effects of political trust on fiscal restraint the question of measuring support needs to be addressed. Measuring diffuse support and political trust is prone to difficulties as noted by Easton (1975) as well as Muller, Jukam & Seligson (1982). In this section I use the results of Eurobarometer surveys on satisfaction with democracy. While this is not a perfect indicator of diffuse support, taking a longer-term

average can smooth out some of the temporary effects and approximate the level of diffuse suport in individual countries.

Taking a longer-term average is also useful with regard to fiscal deficits as well since it helps to smooth out the effects of the economic cycle, which can have a significant effect on the level of deficit. Figure 4. shows the relationship between the average level of satisfaction with the government and net lending. In line with the original hypothesis a strong correlation can be observed between the two variables during 1998 and 2005.

INSERT FIGURE 4.

In the simple linear regression model satisfaction with democracy explains over 56 percent of the variation in net lending at the 1 percent level between 1998 and 2005. The prediction, which can be derived from the analysis, is that a one percent increase in public trust, approximated by the level of satisfaction with the workings of democracy, leads to a 0.148 percentage point decrease in fiscal deficit. Naturally, given the small number of observations these numbers have to be treated carefully. At the same time the effect of trust on fiscal performance remains significant even if we increase the number of observations through dividing up the sample into shorter intervals. The results of the bivariate regression analysis are summarized by Table 1, which shows the relationship between satisfaction and fiscal deficit over periods of 1, 2 and 4 years. These result provide some empirical support for the hypothesis about the significant effect of trust on fiscal outcomes.

When interpreting the above results a number of observations have to be made. First, given the small number of countries in the sample, simple regression analysis cannot give conclusive support for the hypothesis. At the same time taking a different sample of countries can pose considerable difficulties because the presence of financial market pressures towards disipline in other countries makes it hard to isolate the effect of political trust from external variables. The greatest problem in this regard is the strength of financial market pressures –

first, these exhibit considerable variety across countries[4] and second, the perception of policy-makers about the strength of these pressures, which guides their actions, might also vary considerably and might be different from the objective strength of these pressures.

A second consideration in interpreting the above results is the potential for reverse causality. This would mean that voters are unsatisfied with those governments, which cannot manage public finances. While this might be a logical statement in countries, where the level of fiscal illusion is low, the problem of incentives has to be addressed. As it has been already discussed in the introduction of the paper, international best practices for consolidating public finances are available. It means that if the objective of the government is fiscal restraint there are available methods for this purpose. This claim was well illustrated by the successful fulfillment of the Maastricht criteria by all the countries in the sample. Consequently if vote-maximizing governments knew that their voters were fiscally conservative they would have little reason for fiscal profligacy. If this logic is accepted the problem of reverse causality can be excluded.

A further potential problem is the presence of a third factor, which drives the value of both variables. The most likely candidate for this factor is GDP per capita. It is well established in the literature on political trust that the level of GDP per capita strongly effects trust in the political system. Inglehart (1999) argues that after the industrial revolution „mass publics have come to expect their governments to provide for their wellbeing" (p. 105). There might also be arguments for high level of deficit for countries at low levels of developments such as the need for substantial investment. These considerations however cannot account for the correlation between trust and deficits for two reasons. First, the experiences of the Baltic states show that low level of development does not necessarily imply high deficits. These countries regularly have a fiscal surplus while growing at an annual rate around 8 percent since 2000. It is also notable that the establishment of fiscal restraint was critical for the

development of the old member states of the European Union as well, the best examples being Ireland and Spain (Csaba, 2005, p. 187). The negative relationship between fiscal deficit and growth has been also shown formally by Adam and Bevan (2005). Second, even if the relationship between GDP per capita and political trust exists, trust still remains a mediating factor when explaining the link between GDP per capita and deficits.

The above considerations indicate that in order to establish the existence and mechanisms of causality between political trust and the sustainability of fiscal consolidations further empirical support is needed. To address this issue, in the next section I will consider the experiences of fiscal consolidation in two non-EMU countries, Hungary and Sweden. The comparison between these two cases can shed further light on how the level of political trust shapes the method and sustainability of fiscal adjustment.

The Experiences of Hungary and Sweden

Methodology and case selection

At first sight Hungary and Sweden seems like an unlikely pair for comparison. While Sweden is one of the most advanced countries in the world, Hungary is a transition country, which needs a a long way to catch up with its Western neighbours[5]. In the first case fiscal surplus was the norm in the past decade, while in the latter case persistent fiscal imbalances have become a serious constraint on the country's growth potential. In spite of their different levels of development such stark differences are not self-evident. They are both small, open economies, which implies an important role for the the disciplinary forces of the international financial markets (unlike in the case of EMU countries). Furthermore state redistribution is traditionally high in both countries and they also have considerable amount of public debt[6]. Fiscal discipline and profligacy could not be taken for granted in either case as both had to face large fiscal imbalances and financial difficulties in the mid-1990s. During this period

Sweden embarked on a path of structural reforms, expenditure reduction and institution-building, while Hungary relied on surprise inflation, wage freeze and import surcharge to consolidate its finances. Subsequently fiscal discipline proved to be lasting in Sweden, while large imbalances reemerged in Hungary within less than a decade after consolidation.

In a number of aspects these two cases can be considered crucial cases for the theory about the role of trust in the sustainability of fiscal consolidations. Crucial cases were defined by Eckstein (1975) as ones „that must closely fit the a theory if one is to have confidence in the theory's validity, or conversely, must not fit well any rule contrary to what is proposed." (p. 118). In the interpretation of Gerring (2007):

> A most likely case is that, on all dimensions except the dimension of theoretical interest, is predicted to achieve a certain outcome and yet does not. It is therefore disconfirmatory. A least-likely case is one that, on all dimensions except the theoretical interest, is predicted not to achieve a certain outcome and yet does so. It is confirmatory. (p. 232)

Hungary can be considered a least likely case for lack of fiscal discipline based on a number of considerations. First, in the 1990s the country was a leader in the region during the transition process. It is politically stable with a strong mandate for the prime minister, which is signalled by the fact that all coalitions have survived their four-year terms in office. Furthermore, trade unions, which are generally a major obstacle to reforms in large European countries such as Germany or Italy, are very weak similarly to other transition countries. Hungary faced no major economic downturn either since the transformational recession, which could have justfied the reemergence of imbalances. Finally, the country announced already in 2001 that it plans to introduce the euro and fulfill the Maastricht criteria as soon as possible. No official governments deviated from this objective eventhough the target date was changed almost every year.

In contrast a number of argument can be made for why Sweden could be considered as a most likely case for lack of disicpline during the mid-1990s. Sweden has an extremely

proportional system, which regularly yields a minority government. According to research on budgetary deficits this arrangement should lead to excessive imbalances given the need to buy votes in order to pass the budget (Edin & Ohlsson, 1991). Furthermore the country is not a member or a candidate to join the Euro-zone and thus conventional wisdom would suggest that it has less incentive from the EU level to maintain low deficit than Hungary, which aims to introduce the common currency. Finally, the cooperation between labor and capital, which lay behind the success of the Swedish 'model' until the 1970s showed considerable signs of erosion by the 1990s, which made it more difficult to arrive to consensus on major issues (Pontusson & Swenson, 1996, Martin, 2000).

As noted above the two countries share some important economic similarities (state redistribution, public debt, economic openness). At the same time they are very different along the main dimension of interest, political trust, which is hypothesized to be the critical variable in determining fiscal performance. Although comparable Eurobarometer data on satisfaction with democracy is available only since 1995 for Sweden and 2002 for Hungary these already show that political trust is considerably lower in Hungary than in Sweden[7]. Data from other sources on Hungary indicate that at the time of fiscal consolidation in the mid-1990s less than 15 percent felt that regime transformation exceeded or largely fulfilled his or her expectations, while 70 percent was disappointed (Ulram & Plasser, 2003, p. 33).

In order to provide further illustration about the differences in political trust in the two countries, it is useful to consider the development of those indicators, which are generally considered the main predictors of political trust. According to Inglehart (1988) subjective well-being is one of the major determinants of political satisfaction. Citizens in Sweden are considerably more satisfied with their life than citizens in Hungary. Based on a 10-point scale, where 10 signals the highest level of satisfaction, the average level of life satisfaction in Sweden was 7.97 before the consolidation between 1990 and 1993 and 7.64 after the

consolidation between 1999 and 2002. In Hungary the respective averages are 6.03 and 5.80 (Kornai, 2006, p. 234).

Evidence from a number of developing countries (Seligson, 2002; Mishler and Rose, 2005) show that corruption is another major determinant of political trust. The most widely used measure on corruption, the corruption perception index of Transparency International, shows a large difference between Hungary and Sweden. While Sweden is steadly among the six least corrupt countries in the world, since 1996 Hungary is steadly falling behind and since 2003 it ranks around 40. In the past 10 years the score of Sweden (on a scale of 10) has ranged between 9 and 9.5 points, while in Hungary this has been between 4.8 and 5.3[8].

Finally two country-specific characteristics need to be mentioned that contribute to the different level of political trust. In Sweden the large universal welfare state, which provides basic material security to every citizen, enjoys widespread popular support and thus is a major guarantee for the high level of political trust in the country (Rothstein, 1998; Timonen, 2001). In Hungary political trust is affected negatively by cognitive problems: material satisfaction is consistently among the lowest among transition economies, while a large majority of the population (steadily around 70 percent) feels that it was better during the previous regime (Rose, 2006, pp. 37-38). These attitudes do not vary with objective factors such as per capita GDP or the rate of growth.

Overall it can be established that Sweden and Hungary have very different level of political trust, which should be reflected in their fiscal performance according to the theory. In the following I will examine how the theoretical predictions prevail in the two cases through considering the method and sustainability of fiscal adjustment.

Fiscal adjustment in Hungary

During the socialist period Hungary was the country of „goulash communism" where market reforms started as early as 1968. By the time of transition 90% of the prices were

already liberalized so there was not need for macroeconomic shock therapy as for example in Poland (Csaba, 1995, pp. 193-195). At the same time the large debt burden accumulated since the 1970s required strong fiscal discipline, which was very difficult at the time of transformational recession – GDP fell by 11 percent in 1991. As domestic savings were low, the widening fiscal deficit had to be financed by borrowing from abroad. This had negative effects on the current account: its deficit reached 8 percent of the GDP by 1993 (European Commission, 2006, p. 116). With elections taking place in 1994 the first democratically elected government was unwilling to tackle the problem while the incoming government postponed adjustment measures until after municipal elections, which took place half a year later than the parliamentary elections. As a result the country came close to a financial crisis, which became evident after the collapse of Mexico in 1994.

The collapse was avoided by a surprise stabilization package implemented by the incoming finance minister, Lajos Bokros in March 1995[9]. The package consisted of an immediate devaluation of the currency by 9 percent and the introduction of a crawling peg exchange regime with a narrow band of ±2.5 percent. In terms of fiscal policy the package imposed an 8 percent import surcharge. There were signals about the need to reduce welfare provisions but these together composed only 12 million HUF from the 170 million package (vs 70 million HUF from the import surcharge). Regarding incomes policy the package implemented a wage freeze in the public sector, which meant that workers were not compensated for the loss of income from higher inflation, which rose from 18 percent to 28 percent due to the devaluation of currency. In 1995 this led to a 12 percent real wage decrease followed by another 6 percent in 1996.

The consolidation was successful in averting the crisis and avoiding recession[10]. At the same time expenditure cuts during the consolidation did not come from structural reforms but rather from high inflation and from easily reversible measures. After the threat of crisis was

gone Bokros was forced to resign from his post and his reform agenda remained unfinished (Bokros, 1998). As a preparation for the next election in 1998 the government increased pensions by 22 percent and public sector wages between 13 and 16 percent. By 1999 the share of public wage expenditure reached the pre-package level (Benczés, 2006, p. 185).

The stabilization package and its afterlife indicate the political constraints of fiscal adjustment in a environment characterized by low level of political trust. The package was prepared in secret by six economists without consultation with the social partners, who learned the details only three days before the announcement (Greskovits, 2001). For the public the announcement of the measures came as a shock. In line with the incentives of the prisoners' dilemma the opposition never admitted that the package was needed (Matolcsy, 1997) and took advatage of the difficult situation of the government. In the next three election campaigns, the Bokros package came to play a central role in the conservative campaign to frighten people about the return of the Socialists. This threat could be effective because of the high level of fiscal illusion in the country (Csontos, Kornai & Tóth, 1998) as well as the historical inheritance of goulsh communism and state paternalism (Kornai, 1995).

After the 1998 elections the incoming conservative government reversed a number of elements of the package including the cuts in family allowance, childcare and maternity benefits. The real deterioration of the budget took place after 2000, when a global slowdown and approaching elections gave strong incentive for the government to overspend. The logic inherent in the prisoners' dilemma manifested itself fully again. Before the elections the government doubled the minimum wage and implemented a 30 percent wage increase for civil servants. They still lost the elections to the Socialists, who promised even greater benefits. After they assumed power, they fulfilled these promises: they abolished personal income tax for minimum-wage earners as well as implemented a general 50 percent wage raise for all public servants (OECD, 2004). As a result of these measures the general

government deficit on ESA95 basis reached 9 percent of GDP (European Commission, 2006, p. 177).

After the large election and post-election spending the government was unable to reign in the budget. Efforts to contain wages proved to be ineffective, while the government was unwilling to initiate structural reforms that could contain spending in the long-term (Benczés, 2006, p.189). There was also considerable unwillingness to limiting discretion over spending, which could be observed in the institutional framework governing the budget process. According to Gleich (2003) the Hungarian fiscal framework is the weakest among the eight Central European countries, which joined the EU in 2004. The trend of strengthening budgeting institutions, which characterizes not only the advanced economies but also Latin-American countries (Petrei, 1998), did not reach Hungary in spite of regular warnings by the international financial institutions (OECD, 2004; IMF, 2006). The weakness of the institutional framework is strongly reflected in fiscal performance. The regular overestimation of revenues and underestimation of expenditures as well as the considerable flexibility during the execution of the budget has been a constant target of criticism by the State Audit Office (SAO, 2004, 2007). Furthermore in order to contain the deficit the government regularly turns towards creative accounting measures such as providing public services in PPP construction, delaying payment of agricultural subsidies or VAT refund. At the same time these efforts often fail due to Eurostat monitoring thus increasing the fiscal deficit ex post[11].

Overall the case of Hungary provides an illustration about the prospects of fiscal consolidation in a low-trust environment. Although the threat of a financial crisis was effective in fostering fiscal adjustment, lack of consensus in the political elite about the importance of adjustment made the results temporary. As elections were approaching overspending could not be contained and populist promises dominated the campaigns. In such an environment there is very little demand for international best practices about strenghtening

fiscal rules, which is indicated by the excessive weakness of Hungarian budgetary institutions. In order to shed further light on these processes I now turn to Sweden, which faced a similar need for stabilization around the same time as Hungary.

Fiscal consolidation in Sweden

The celebrated Swedish welfare state faced a severe crisis at the beginning of the 1990s. Following a period of overheating in the economy, when a fixed exchange rate and accelerating inflation led to the real appreciation of the currency and a corresponding decline in competitiveness, the international slowdown caused a severe recession in Sweden. Between 1991 and 1993 GDP fell by 4 percent, while unemployment rose from 2 percent to 9 percent. Given the automatic stabilizers from the extensive welfare arrnagements, the level of fiscal deficits reached 10 percent of the GDP, while public debt surpassed 70 percent of the GDP[12].

In order to handle the crisis the Swedish government introduced a package in 1994, which decreased state redistribution by 9 percent within the next four years. This was achieved mainly through the cuts in welfare expenditure under structural reforms including health care, education and pension systems. Between 1994 and 1998 government balance improved by 11 percentage points (IMF, 1998, p. 9). These changes proved to be sustainable over the long-term as the reforms also included a change in the institutional framework governing the budget process during the planning, adoption and implementation phases as well as its transparency. This meant the introduction of a top-down planning and adoption process, the introduction of a multi-year budgeting framework, as well as a commitment to a 2 percent fiscal surplus over the economic cycle (Molander, 2001).

The achievements of the package proved to be sustainable: in spite of its large level of redistribution Sweden has a regular surplus in its budget[13]. The country is among the most competitive economies in the world[14] while it was able to preserve the universality of its welfare provisions.

The sustainability of fiscal restraint can be traced back to the high level of political trust in the country. The different environment provided very different opportunities for lasting consolidation than in Hungary. The process of solving the crisis and implementing long-term measures is well illustrated by the implementation of pension reforms described by Anderson (2001, pp. 1078-1079). As a short-term measure and a way to distribute the social burden of deficit reduction equally, government and opposition agreed on a 2 percent-point reduction of pension benefits in 1992. After a change of government the Social Democrats introduced a rule, which extended the reduction of pension benefits until the budget deficit exceeded SEK 100 billion. In order to solve the long-term sustainability of pension funds they also initiated a far-reaching reform of the pension system based on a consensus among the five major parliamentary parties.

In the design and implementation of the reforms economists played a major role. The strong reliance on the advice of economists is a characteristic of Swedish policy-making as economists since the early twentieth century consider it their duty to engage in public life and fight public ignorance (Jonung, 1992, pp. 39-42). The strengthening of the budget process provides a striking illustration about the importance of this factor.

The first paper, which systematically examined the relationship of budgetary framework for fiscal outcomes, was published in 1992 by Jürgen Von Hagen. The same year, Per Molander, head of the research department in the Swedish Ministry of Finance, undertook an examination of the Swedish budgetary framework based on the research of Von Hagen. His report (Molander, 1992), showed that Sweden's budget framework ranked between Greece and Italy, which were the weakest in the European Union. This finding was very important in ensuring support for modifying the fiscal framework (Hallerberg, 2004, pp. 160-167) The process of reform started almost immediately and by 1995 a completely new budgeting system was in place.

The experiences of Sweden show a very different way of fiscal adjustment than Hungary. In a high-trust environment an elite consensus could emerge on both the short-term and long-term measures to consolidate public finances. In this consolidation process experts could play an important role, as consensus created a demand for international best practices.

The role of crisis and consensual tradition

The experiences of fiscal consolidation in Hungary and Sweden provide support for the importance of trust for fiscal consolidations. While political constraints dominated the choice over the adjustment method in Hungary, the presence of trust in Sweden allowed the implementation of first-best solutions. As a result ten years after the adjustment a virtuous circle is present in Sweden between fiscal restraint, growth and political trust, while a vicious circle of lack of fiscal discipline, slow growth and political distrust prevails in Hungary.

When comparing the two countries two possible counterarguments can be mentioned against the critical role of trust. First, adjustment was provoked by crisis in Sweden, while in Hungary there was only a threat of crisis. Second, Sweden has a tradition of elite consensus, while Hungary has a long tradition of internal political conflicts within the elite[15]. Both of these factors could play an important role in the different approaches to consolidation.

With regard to crisis the difference between short-term and long-term consolidation needs to be stressed. After the devaluation of the crown and the implementation of short-term adjustment measures the financial crisis was halted in Sweden. At the same time long-term reforms only started afterwards and continued by different governments until 1998 showing a shared commitment of the political elite to fiscal discipline. This implies that crisis in itself is insufficient to explain the implementation of long-term structural reforms.

While crisis cannot be considered as an ultimate explanation for the implementation of reforms, the long tradition of consensual policy-making in Sweden was certainly an important element in the implementation of long-term reforms. At the same time as noted in the

theoretical framework in a democracy characterized by low level of trust there are strong incentives for short-term promises to the electorate and defection from cooperation. This implies that as the external threat was gone consensus could have easily broken down if the public did not trust the elite. That was the case in Hungary, where the elite consensus, which was the hallmark of the transition process, broke down in face of the mounting economic difficulties (Ágh, 2001). Consequently the maintenance of consensus itself can be considered conditional upon trust in the regime.

Conclusions and implications

In this paper I have provided evidence on the effects of political trust on fiscal consolidations. Using both quantitative and qualitative analysis I have shown that the prospect for successful fiscal consolidation is very different in a high- and a low-trust democracy because of the temptation of populist solutions in the latter case. Given their relative insulation from international financial market pressures the experiences of the member states of the Economic and Monetary Union have provided a unique opportunity to test for the predictions of the theory. The most likely – least likely case comparison between Hungary and Sweden was useful to illustrate the main mechanisms through which the relationship between trust and consolidation prevails.

These findings provide new evidence on the effects of political support for fiscal policy. Previous studies, focusing primarily on the United States, have found a positive relationship between trust in government and tax compliance (Scholtz & Lubell, 1995; Scholtz, 1998) as well as between trust and suport for government actions to address domestic problems (Chanley, Rudolph & Rahn, 2000; Rudolph & Evans, 2005). By contributing to a broader understanding of the effects of political support on fiscal policy, this paper can also take us closer in understanding the relationship between trust and economic development.

While it is widely accepted both in political science and economics that social capital is important for growth (Putnam, 1993; Fukuyama, 1995; Knack & Keefer, 1997; Zak & Knack, 2001; Guiso et al, 2006), the effects of political trust on economic performance have received less attention. If we accept the claim by Adam and Bevan (2005) that responsible public finances are important for economic growth than trust in the system need to be considered instrumental for development.

The results also have important practical relevance for emerging economies, which are generally characterized by low level of political trust and struggle with the challenge of fiscal consolidation. In these countries the sustainability of public finances is a high priority, which however cannot be separated from the broader issue of democratic quality. This means that fiscal adjustment need to be accompanied by measures that increase trust in the regime (such as an anti-corruption strategy) in order to be successful. Neglecting such measures can easily lead to a strong deterioration of political trust during the adjustment and result in a downward spiral of lack of trust, economic populism and slow growth. This consideration might be particularly important for the new member states of the European Union, which will face considerably less external pressure for responsible fiscal policy after they introduce the common currency than other emerging economies.

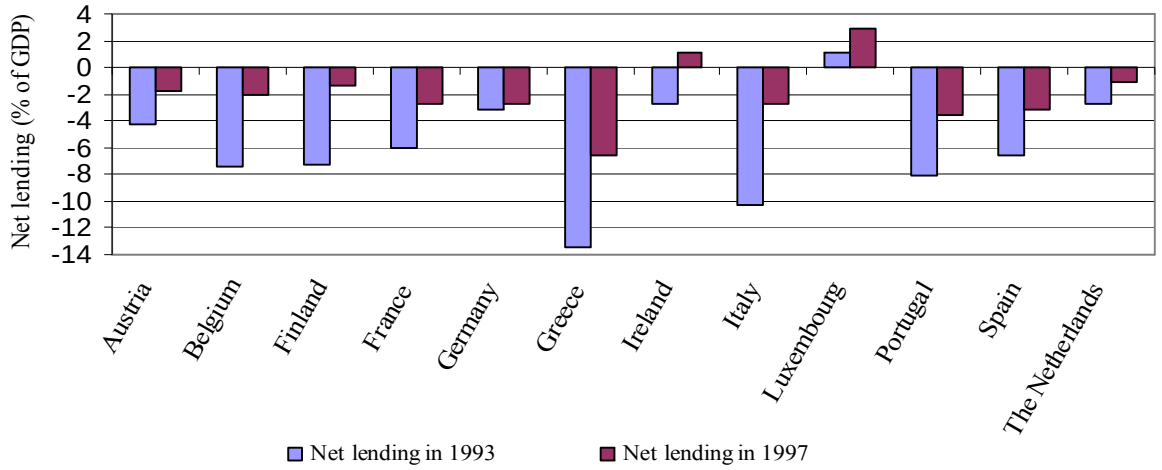
Overall the bad news of the research is that achieving fiscal sustainability is considerably more challenging than mainstream economics and the international financial institutions generally suggest. The good news however is that the requirements for political and economic development presuppose rather than contradict one another.

FIGURES AND TABLES

Figure 1. Prisoners' dilemma during elections in a low-trust regime

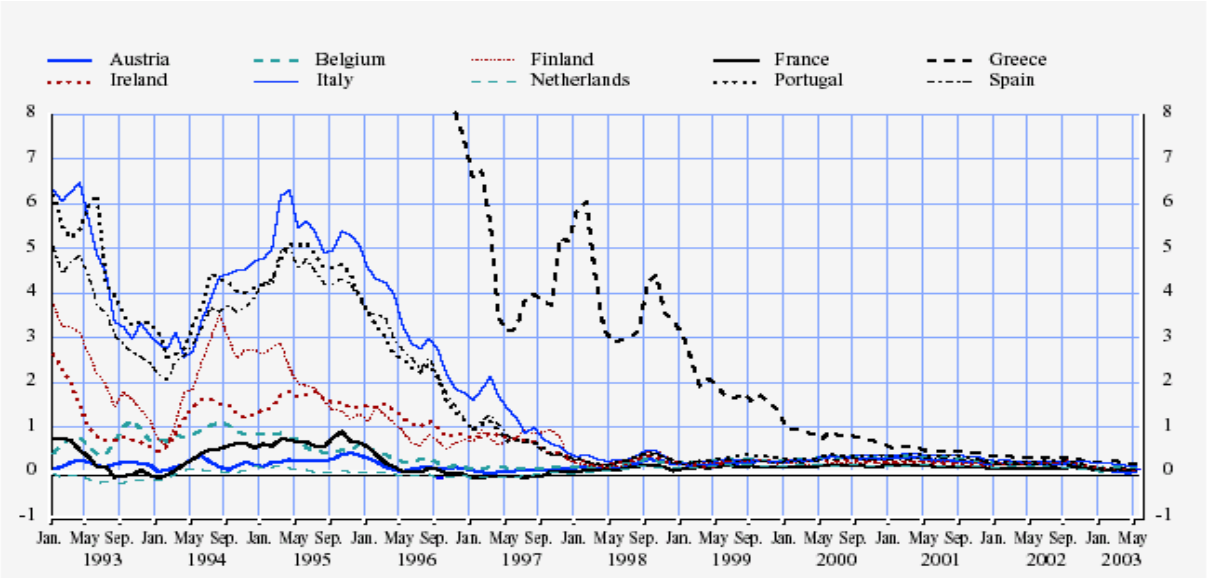
		Government	
		Election spending	*Responsible fiscal policy*
Opposition	*Overspending promises*	Election outcome uncertain	Opposition wins the election
	Responsible campaign	Government wins the election	Election outcome uncertain

Figure 2. Reduction in fiscal deficit in the EU-12 1993-1997



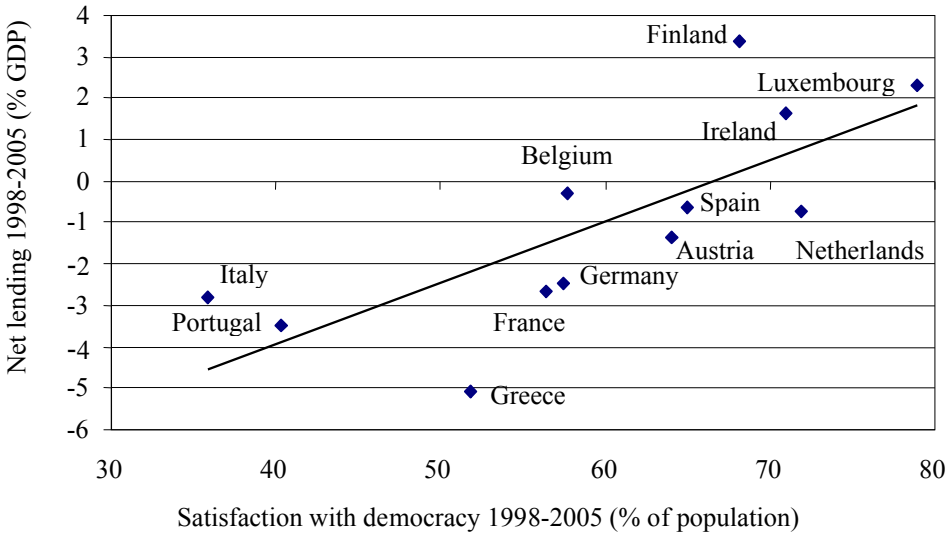
Notes: Although Greece only introduced the common currency in 2001, it is included into the sample because the process of consolidation was in progress during the period under examination. In the Spanish case data is available only between 1995 and 1997. Source: European Commission (2006): 176

Figure 3. Yield spread for 10-year government bonds relative to Germany



Source: Baele et al (2004): 37 Chart 8.

Figure 4. Satisfaction with democracy and fiscal outcomes in the EMU 1998-2005



Net lending = 0.148Satisfaction – 9.875. R-square=0.568 Significance: 0.005

Note: The level of satisfaction indicates the share of population who is either 'very satisfied' or 'fairly satisfied' with the way democracy works in her country. Source: Eurobarometer No. 49, 51, 53, 56, 58, 59, 61, 63. Data on fiscal deficits is from European Commission (2006): 176

Table 1. Satisfaction with democracy and general government balance in the EMU 1998-2005

	Number of time periods in the sample		
	8	**4**	**2**
Constant	-7.669	-8.534	-8.922
	(1.036)	(1.448)	(2.015)
Satisfaction	0.111	0.126	0.132
	(0.017)	(0.024)	(0.033)
N	96	48	24
R-square	0.316	0.380	0.422
Significance	0.000	0.000	0.001

Dependent variable: general government balace. Standard errors are in parentheses.

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Endnotes

[1] Recently such considerations have been included into supranational law as well: the reform of the Stability and Growth Pact emphasizes the need to evaluate the quality of fiscal adjustments and recommends the implementation of fiscal rules at the national level (European Council, 2005).

[2] Naturally, if the above situation is repeated multiple times, the electorate ultimately learns not to believe in populist promises. This might be a potential reason for the finding that election cycles are mostly a characteristic of developing countries – once advanced states are taken out of the sample evidence on the presence of a fiscal election cycle disappears (Brender & Drazen, 2005). However, in a number of countries fiscal illusion, theorized originally by Buchanan & Wagner (1977), seems to be very persistent as the case study on Hungary will illustrate.

[3] The ineffectiveness of the Pact has given rise to a considerable literature. For an extensive survey of this literature see Fischer, Jonung & Larch (2007)

[4] The threshold for the tolerable level of debt („debt intolerance) varies considerably across countries. While for some states debt levels over 100 percent of the GDP are acceptable for the financial markets, for other countries even 20 percent debt might be considered too much. See: Reinhart, Rogoff & Savastano (2003)

[5] In 2004 GDP per capita measured in purchasing power parity was $28,400 in Sweden and $14,900 in Hungary. Source: CIA World Factbook. Available: http://geography.about.com/library/cia/blcindex.htm

[6] This is part of the reason why Sweden was regularly viewed as a model country during the transition process in most Central and Eastern European countries. On the lessons from Sweden to the transition countries see Lindbeck (2001).

[7] According to Eurobarometer surveys, satisfaction with democracy was never lower than 50 percent in Sweden, while in Hungary it rarely reaches 40 percent.

[8] For the yearly data see the Transparency International website: http://www.transparency.org/policy_research/surveys_indices/cpi

[9] The description of the package relies on Győrffy (2006) pp. 243-245.

[10] While growth slowed to 1,3 percent by 1996 due to the contractionary measures of the package, it accelerated to 4,6 percent in 1997 (European Commission, 2006, p. 49)

[11] The most significant revision occurred in September 2005, when the Eurostat decided that the planned sale of existing motorways to the state owned motorway company as a PPP operation cannot be considered as public revenue. This decision increased the deficit by 1.9 percentage points for 2005.

[12] For a more detailed description of the crisis see Lindbeck et al (1994) as well as Cerra and Saxena (2005).

[13] Sweden registered a fiscal surplus every year between 1998 and 2006 with the exception of 2002 when it had a moderate deficit of 0.2 percent (European Commission, 2006, p. 177)

[14] See the annual surveys of the World economic Forum at http://www.weforum.org.

[15] For a more detailed examination of the sources of these cleavages see Győrffy (2006) pp. 252-253.