Debt and Deficit in the Age of Fiscal Councils
The Role of Institutions in Belgium and Slovakia, 1990-2018

by
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Declaration

I, the undersigned Ákos Máté, candidate for the degree of Doctor of Philosophy at the Central European University Doctoral School of Political Science, Public Policy and International Relations, declare herewith that the present thesis is exclusively my own work, based on my research and only such external information as properly credited in notes and bibliography. I declare that no unidentified and illegitimate use was made of work of others, and no part the thesis infringes on any person’s or institution’s copyright. I also declare that no part the thesis has been submitted in this form to any other institution of higher education for an academic degree.

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Abstract

The stubbornness of high public debt and volatility in deficits motivated many policy solutions to fight the root causes of these issues. Recently a new breed of fiscal institutions were introduced to complement fiscal rules, called independent fiscal councils. The dissertation explores when and how these new institutions can work to fulfill their mandate in the European Union.

I argue that the effectiveness of fiscal councils are highly context dependent and cannot be separated from their respective domestic and international institutional environment. In the dissertation I show that in order to have an impact on policy direction, fiscal councils need to be perceived as supporting institutions by the government in order to have their recommendations taken into account. When the government's preferred policy trajectory diverges from the recommended policy actions by the councils they are viewed as adversary institutions and due to a lack of enforcement tools on the part of the fiscal watchdogs their policy advice can be ignored by the government. The effectiveness is also conditional on the presence of external pressure such as the market pressure on the governments and the supranational fiscal framework of the European Union. I find that the reformed European framework does present a considerable amount of peer pressure and the European Commission can serve as an external support for the domestic fiscal councils. I also introduce a novel approach to the field by analyzing the policy network structure in which these new fiscal councils are embedded. I find that their position in the network facilitate their role by having access to the key governmental agencies and ministries.

Combining a case based approach with network analysis I investigate institutional reforms and fiscal policy developments through the cases of Belgium and Slovakia from 1990 to 2018. The two countries provide a diverse set of cases with different levels and complexity of fiscal institutions as the Belgian High Council of Finance is the oldest fiscal council in Europe as opposed to Slovakia which performed an impressive institutional leapfrogging starting in the early 2000's. This methodological approach allows to shed light on how key institutional and political changes impacted fiscal policy. By including Slovakia in the dissertation, the research contributes to the literature by adding a detailed analysis of how institution building affected fiscal policy in a post-transition Central Eastern European member state. Both the case studies and the network analysis relies on original data collected via interviews and institutional surveys.
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# Table of Contents

1 Chapter 1 - Introduction
   1.1 Fiscal councils: the end of deficits? ........................................... 3
   1.2 Europe and domestic budgets ...................................................... 4
   1.3 Outline ......................................................................................... 5

2 Chapter 2 - State of the field
   2.1 Sources of public debt ................................................................. 9
   2.2 The role of (fiscal) institutions ................................................... 12
   2.3 Fiscal policy and institutions in the European Union .................... 21
   2.4 But (how) do they work? ............................................................. 27

3 Chapter 3 - Methodology
   3.1 A mixed method approach .......................................................... 34
   3.2 Narrative approach and process tracing ....................................... 35
   3.3 Network analysis and institutions ............................................... 39
   3.4 Tools for analysis ........................................................................ 41
   3.5 Conclusion .................................................................................. 42

4 Chapter 4 - Belgium, 1990-2008
   4.1 Historical background ................................................................. 45
   4.2 Meeting Maastricht ..................................................................... 52
   4.3 The end of consolidations and the great moderation ..................... 58
   4.4 Conclusion in the middle ............................................................. 66

5 Chapter 5 - Belgium, 2008-2018
   5.1 Fiscal policymaking during and after the reforms ......................... 70
   5.2 Institutions in the shadows of financial and political crises .......... 80
   5.3 Conclusion .................................................................................. 93

6 Chapter 6 - Slovakia, 1993-2008
   6.1 Historical background ................................................................. 98
   .................................................................
6.2 Fiscal policy in transition .......................... 104
6.3 Steady reforms and political change .................. 108
6.4 Conclusion in the middle ......................... 120

7 Chapter 7 - Slovakia, 2008-2018 ............. 123
  7.1 Institution building and maintaining .............. 124
  7.2 Political change and financial crisis .......... 134
  7.3 Conclusion ........................................ 145

8 Chapter 8 - A comparative view ............... 150
  8.1 The great moderation before the crisis ........ 151
  8.2 Tectonic changes after the crisis .............. 158
  8.3 Policy network analysis .................... 164
  8.4 Conclusion ........................................ 173

9 Chapter 9 - Conclusion ......................... 175
  9.1 Theory implications ............................ 176
  9.2 Going beyond the cases and limitations .... 183

A Survey and interview details ...................... 186

B Parties and party families ...................... 188

C Government polarization ........................ 191

D Network statistics and diagnostics .......... 193
## List of Tables

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1</td>
<td>Tasks and roles of fiscal councils</td>
<td>16</td>
</tr>
<tr>
<td>5.1</td>
<td>Overview of the Belgian fiscal councils</td>
<td>71</td>
</tr>
<tr>
<td>5.2</td>
<td>Belgian budgetary process timeline</td>
<td>74</td>
</tr>
<tr>
<td>7.1</td>
<td>The road to the Council for Fiscal Responsibility</td>
<td>126</td>
</tr>
<tr>
<td>7.2</td>
<td>Overview of the Slovak fiscal council</td>
<td>128</td>
</tr>
<tr>
<td>7.3</td>
<td>Overview of the Slovak constitutional debt rule</td>
<td>131</td>
</tr>
<tr>
<td>7.4</td>
<td>The Slovak budgetary process</td>
<td>133</td>
</tr>
<tr>
<td>8.1</td>
<td>Importance and reputation of institutions in fiscal policy</td>
<td>154</td>
</tr>
<tr>
<td>8.2</td>
<td>Key elements of European fiscal framework after 2008</td>
<td>162</td>
</tr>
<tr>
<td>8.3</td>
<td>Summary statistics for the Belgian and Slovak fiscal policy networks</td>
<td>164</td>
</tr>
<tr>
<td>8.4</td>
<td>ERGM models</td>
<td>172</td>
</tr>
<tr>
<td>A.1</td>
<td>Interviews and survey responses</td>
<td>186</td>
</tr>
<tr>
<td>A.2</td>
<td>Semi structured interview items</td>
<td>187</td>
</tr>
<tr>
<td>B.1</td>
<td>Parties and party families in Belgium, 1990-2017</td>
<td>189</td>
</tr>
<tr>
<td>B.2</td>
<td>Parties and party families in Slovakia, 1993-2017</td>
<td>190</td>
</tr>
<tr>
<td>C.1</td>
<td>Belgian government ideological distances</td>
<td>191</td>
</tr>
<tr>
<td>C.2</td>
<td>Slovakian government ideological distances</td>
<td>192</td>
</tr>
<tr>
<td>D.1</td>
<td>Institutional importance in the policy network</td>
<td>194</td>
</tr>
</tbody>
</table>
List of Figures

1.1 Public debt and fiscal rules in the Euro area 12, 2000-2016 ................. 4
2.1 Institutional diversity in European fiscal councils .......................... 17
2.2 Fiscal institutions in the European Union, 1985-2015 ....................... 24
2.3 Public debt in the Euro area countries, 1990-2017 .......................... 31
3.1 Undirected and directed networks ............................................ 40
4.1 Regional GDP in Belgium, 2000-2017 ....................................... 47
4.2 Interest payment on public debt (% GDP), 1980-2008 ....................... 49
4.3 Deficit driven fiscal consolidation, 1980-1990 ............................ 50
4.4 Deficit driven fiscal consolidations, 1990-2008 ............................ 54
4.5 Public debt and deficit in Belgium (% GDP), 1990-2008 ................... 56
4.6 Change in governments, 1990-2008 ........................................ 59
4.7 Economic orthodoxy in election manifestos, 1987-2007 .................. 61
4.8 Media coverage of the HCF, 1998-2008 ..................................... 63
5.1 Change in governments, 2007-2018 ........................................ 81
5.2 Change in primary expenditure due to the Special Financing Act reform (% GDP) ................................................................. 83
5.3 Share of expenditure by sectors ............................................... 85
5.4 Spread between Belgian and German 10 year government bonds ........ 86
5.5 Economic orthodoxy in election manifestos, 2007-2010 .................. 88
5.6 Public debt and deficit in Belgium (% GDP), 2007-2018 .................. 90
5.7 Excessive Deficit Procedures, 2003-2018 .................................. 92
5.8 Media coverage of the HCF, 2007-2017 .................................... 95
5.9 Deficit driven fiscal consolidations, 1990-2014 ............................ 96
6.1 Historical debt in Czechoslovakia (% GDP), 1920-1937 .................... 102
6.2 Public debt and deficit in Slovakia (% GDP), 1993-2008 .................. 110
6.3 Change in governments, 1992-2008 ....................................... 112
6.4 Budget institutions in Central Eastern Europe, 2003 ....................... 114
<table>
<thead>
<tr>
<th>Number</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.5</td>
<td>Economic orthodoxy in election manifests, 1993-2008</td>
<td>117</td>
</tr>
<tr>
<td>6.6</td>
<td>Spread between the Slovak and German 10 year government bonds</td>
<td>118</td>
</tr>
<tr>
<td>7.1</td>
<td>Media coverage of fiscal topics in Slovakia</td>
<td>129</td>
</tr>
<tr>
<td>7.2</td>
<td>Spread between the Slovak and German 10 year government bonds</td>
<td>135</td>
</tr>
<tr>
<td>7.3</td>
<td>Change in governments, 2006-2018</td>
<td>136</td>
</tr>
<tr>
<td>7.4</td>
<td>Public debt and deficit in Slovakia (% GDP), 2006-2018</td>
<td>139</td>
</tr>
<tr>
<td>7.5</td>
<td>Excessive Deficit Procedures, 2003-2018</td>
<td>142</td>
</tr>
<tr>
<td>7.6</td>
<td>Economic orthodoxy in election manifests, 1993-2016</td>
<td>147</td>
</tr>
<tr>
<td>8.1</td>
<td>EA-12 public debt and Excessive Deficit Procedures opened, 1990-2015</td>
<td>163</td>
</tr>
<tr>
<td>8.2</td>
<td>Belgian technical communication network</td>
<td>165</td>
</tr>
<tr>
<td>8.3</td>
<td>Slovak technical communication network</td>
<td>166</td>
</tr>
<tr>
<td>8.4</td>
<td>Normalized degree distributions</td>
<td>168</td>
</tr>
<tr>
<td>D.1</td>
<td>Diagnostics for the Belgium-Technical communication network model</td>
<td>195</td>
</tr>
<tr>
<td>D.2</td>
<td>Diagnostics for the Belgium-Political communication network model</td>
<td>196</td>
</tr>
<tr>
<td>D.3</td>
<td>Diagnostics for the Slovak-Technical communication network model</td>
<td>197</td>
</tr>
</tbody>
</table>
Introduction

There's nothing to prevent the federal government from creating as much money as it wants and paying it to someone.

Alan Greenspan

Public debt has been the subject of numerous academic and policy debates on and off, depending on how recent the memory is of the latest crisis. Data shows that public debt has been on a secular rising path in the last five decades despite numerous policy innovations intended to manage its ever increasing expansion. Debt and deficit became a topic of heated debates during the firefighting after the 2008 European sovereign debt crisis and the "fiscal cliff" moment of the United States also put a spotlight on the fact that economic development and debt management does not walk hand in hand. The root causes of deficits are widely explored in the literature, where opportunist politicians and common resource pool problems dominate the discussion. The answers to these structural factors were institutional reforms in the forms of centralizing the budgeting process, creating fiscal rules and lately, establishing fiscal councils who would act as watchdogs over the fiscal process issuing warnings should it get derailed.

The discussion on the relations between discretionary fiscal policy and rules have long been part of the literature (Kydland and Prescott, 1977). The rise of the independent fiscal institutions (also called fiscal councils) is a more recent policy innovation. As taxation and government spending (on education, infrastructure, health care) redistributes resources in the economy it is a political process to the very core. The idea that fiscal policy making
should behave akin to monetary policy is one that is floated in the academic discussion but which results in the inevitable conclusion that democratic norms make it impossible to carry it out (Wren-Lewis, 2013). This tension motivates my research, as I seek to understand how the power dynamic between the political will and the moderating influence of the institutional setting affects policy processes and outcomes. While there are many influential research which deals with the question of delayed stabilization and the likely explanatory variables, many of these studies have been conducted prior to the exponential rise in the quantity and quality of dedicated fiscal safeguards.\(^1\)

In my dissertation I look at when fiscal councils are working as they are intended to and when and how they are sidelined by the governments. The research delves into this aspect as it is important to understand the particular contextual elements that determine when fiscal councils can carry out their mandate and then under these conditions how they are able to affect policy. In addition to examining the domestic contextual factors I also analyze how the development on the European level affected member state fiscal policy conduct over the past three decades.

The motivation behind examining the institutional context within which fiscal policy is made and structural outcomes are shaped is not rooted in a normative argument. While there is an ongoing debate in the academic literature on the effects of debt on growth my research does not try to speak directly to that field. Nevertheless, fiscal policy choices are affecting the structure of redistribution in a given country, it affects taxpayers expectations and a reliance on external funding does create crisis moments when markets are not accommodating to the governments’ financing needs. One key debate was centered around the work of Rogoff and Reinhart (2010). Their finding of a negative association between debt and growth spurred wide media coverage and follow up studies that called into question their main findings. Herndon et al. (2014) shows that the Rogoff and Reinhart (2010) findings were based on selection bias and coding errors and they could not replicate the results which showed decelerating growth above 90% debt to GDP. While the dramatic cliff could not be replicated, an important contribution showed that it might not be the debt levels that matter, but debt trajectory. Pescatori et al. (2014) showed that countries with high

\(^1\)For seminal contributions on these topics, see Alesina and Drazen (1991) and Roubini and Sachs (1989).
levels of debt with decreasing trajectory achieved the same growth performance as their peers. Related to this debate is the merits of expansive fiscal policy and the advances in research on fiscal policy analysis is summarized by Ramey (2011, 2019).

1.1 Fiscal councils: the end of deficits?

Fiscal councils are envisioned to be an effective tool for achieving high level fiscal objectives and an effective way to depoliticize the fiscal process by having a neutral watchdog which issues warnings if the fiscal situation warrants it and otherwise offers policy support for the governments (Calmfors, 2011; Debrun et al., 2013). They are also expected to overcome the main problem with fiscal rules as if they are too rigid or too lenient they cannot fulfill their role properly. Fiscal councils in turn can play a supporting act to these rules which might soften their tightness if necessary (Wyplosz, 2005). The concept gained traction within policy makers as is evidenced by the proliferation of fiscal rules and later the widespread establishment of fiscal councils. The European Union was among the leading actors who advocated for these new institutions and later on pushed for their establishment in each member state.

Both fiscal rules and councils are associated with lower debt and deficit levels and the evidence underpinning this association is plentiful in the literature (Eslava, 2011). However, there are several reservations in the literature that alters this picture. Firstly, the used econometric models (mostly panel regressions) are not able to decisively determine a casual relationship between institutions and macroeconomic variables. This is due to the inherent endogeneity problem with institutions, where it is hard to know if they are set up as a result of already existing fiscal preferences or as a means to create a straight jacket for the government (Alesina and Passalacqua, 2016). Secondly, there are evidence that many non-significant finding does not make it out of the peer review process, dooming these research findings to collect dust in the drawer (Heinemann et al., 2018). Thirdly, fiscal councils come with widely varying attributes and mandates which means that their effectiveness is highly contextual. Regression based analysis suffer from the same problem, that overcoming endogeneity is still problematic (in lieu of strong and valid instruments for fixed effects.
estimation) as well as limited sample size, as these institutions are relatively new and mostly limited to the OECD and European Union countries.

1.2 Europe and domestic budgets

Among the developed countries, the European Union has been a front-runner in developing a rules based fiscal coordination system with the introduction of the Stability and Growth Pact to ensure that member states can meet their obligations under the Maastricht Treaty in 1991.\textsuperscript{2} The race to enter the Euro area in the first wave triggered a quick increase in the number of fiscal rules and a slight decrease of public debt (for illustration, see Figure 1.1).

While fiscal rules proliferated and the new Stability and Growth Pact also provided a supranational rules based framework the results were heavily criticized in the literature. The early criticism focused on the arbitrary thresholds of the SGP and the heavily politicized

\textsuperscript{2}The non-European countries that had fiscal rules in place since the 1980s are the United States, Singapore, Malaysia and Japan
process of its conception to match the preferences of the fiscally more conservative member states such as The Netherlands and Germany (Heipertz and Verdun, 2004a). The failure to launch an excessive deficit procedure against France and Germany in 2003 prompted the 2005 reforms of the SGP which did not manage to create a better enforced framework (Hallett and Hougaard Jensen, 2012). It took the 2008 financial crisis which morphed into the European sovereign debt crisis to have the second overhaul of the Pact coupled with other institutional reforms that put emphasis on the establishment of fiscal councils in each member state. These new reforms, commonly referred as the Two-Pact, Six-Pact and the Fiscal Compact, makes up the post crisis European fiscal framework. The renewed framework has increased the complexity of the fiscal governance system greatly which can undermine its effectiveness (Ódor and Kiss, 2017). While Wyplosz (2017) theorizes the possibility to build a fiscal union from the templates of the Banking Union and the reworked fiscal framework he also highlights that such developments would need to greatly simplify the existing rules and to establish a European Fiscal Council.

1.3 Outline

Throughout the dissertation the questions that motivate the research flow from these two factors of institutional innovations at both the national and supranational level in the Euro area. The dissertation offers new insights into the conditional effectiveness of fiscal councils and broadens the scope of the literature by examining Slovakia and Belgium’s experience with fiscal reforms and the impact on their policy process by the changing European environment.

The dissertation is composed of three main sections. In the first, the aim is to lay the theoretical and methodological foundations of the research. In Chapter 2 I provide a current overview of the state of the literature on how fiscal councils and fiscal rules can counteract the driving forces of debt and deficit. This chapter shows that the combination of watchdogs and rules can be effective in constraining fiscal policy, an association which is confirmed by a number of empirical research. However, the aforementioned shortcomings are also pointing to the need of better understanding the conditional nature of this effect. Based on the
review I hypothesize that fiscal council effectiveness is largely dependent on their perceived role by their governments. If a council is viewed as a supporting institution its reports and goals will have more traction. If in turn it is viewed as an adversary institution, the council’s recommendations will diverge from the government’s preferred course and will try to sideline the institution. These effects are amplified and mitigated (respectively) by the presence of strong fiscal rules. Focusing on the fiscal councils I also hypothesize that their institutional position within their respective policy networks should affect their effectiveness and the older an institution is the more connection it has. The chapter also provides the case selection justification of choosing Belgium and Slovakia as the cases for the research.

Chapter 3 provides a brief reasoning behind the chosen methodology of case study research and how the use of network analysis can uncover a previously unseen dimension of fiscal policy. That is, institutions do not exist in vacuum and their connections to their peers in the policy process can have important consequences. I use original data for my cases, collected in the forms of semi-structured interviews and for the network study I use data from an institutional survey I conducted. In addition to these original data sources I also make use of primary policy documents and macroeconomic databases. Interviews greatly increased the data that the case studies could draw on. I also had the opportunity to have talks with former and current (respectively) heads of the Hungarian fiscal council, George Kopits and Árpád Kovács and high ranking officials in both the Slovak and Belgian fiscal policy circles.

In the second section of the dissertation I conduct the two in-depth case studies on Belgium and Slovakia to examine how the political economy of institutional reforms contributed to the fiscal processes. In Chapter 4 the impressive fiscal performance of Belgium in the 1990’s is underpinned by the political consensus on the need to be in the first wave of Euro members as well as as reforming the fiscal council as part of the federalization process. The chapter later finds that despite the highly praised developments backsliding happened in the 2000’s great moderation period and the primary surplus position of the budget started deteriorating. A key finding from this chapter is how the status of the fiscal council changed as the governments’ goals started to diverge from its recommendations. The case concludes with Chapter 5 which shows how the post crisis developments affected fiscal policy making.
This period is characterized by reluctant compliance with the Excessive Deficit Procedure lunched by the European Union to correct the ballooning deficit and debt. The role of the fiscal council in this time period is mixed as governments often paid lip service to their importance but later ignored and circumvented their recommendations. Finally the chapter concludes with findings on the increased impact of the reworked European fiscal framework.

The Slovak case differs from Belgium fundamentally. In Chapter 6 the historical and transitional experiences shape how fiscal policy is conducted. The case also presents the puzzle of the continued fiscal policy direction despite political rhetoric of the left parties. The 1990-2008 period is characterized by a drive for international recognition and integration which was paralleled by domestic institution building. The second half of the case in Chapter 7 takes stock of how the fiscal council and rules were established as a result of a homegrown policy initiative. The fiscal policy continuity despite government changes are also reviewed. I found that a key answer to this puzzle is rooted in Slovakia’s historical experiences, the influence of the European peer pressure and later the newly developed fiscal institutions.

The third section is dedicated to situating the sample cases in the broader universe and drawing more general conclusions. Chapter 8 presents a novel methodological approach to study fiscal policy making by introducing a network based analysis, based on an original dataset collected via survey. The network analysis is used to tease out the micro level connections between various member state and EU and international institutions. The data also contains observations on information flows and perceived importance in the policy process which allows me to make a more fine grained assessment of the weight of these specialized institutions. This section closes the dissertation with a conclusion in Chapter 9 and stating the how the findings contribute to the literature and the policy implications they carry.