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“Weathering the storm”: Book Review on István Benczes, *Trimming the Sails: The Comparative Political Economy of Expansionary Fiscal Consolidations, A Hungarian Perspective*, CEU Press, Budapest-New York, 2008

There has been a rising popularity to study non-Keynesian effects and that of the fiscal multiplier to be negative (fiscal cuts are followed by output growth). For readers on this East-Central European part of the world this book is sailing on some un-chartered waters when providing some clues and a vast array of empirical evidence for the fiscal consolidation experience of the recent past of leading OECD and EU countries. The aim is clear: helping to solve the puzzle when and under what conditions can fiscal consolidation lead to accelerated growth even in the short run. The ultimate goal of the book is to contribute to our understanding why only a few countries have experienced short term non-Keynesian effects while others, not at all. This remarkable effort to enrich our understanding of unusual fiscal phenomenon has been almost entirely successful, it did deliver on its promise. The study of István Benczes is a concise, well-structured scholarly work that offers rich, albeit careful analysis with balanced views on the diverse literature. The monograph pays special attention to critically assessing the underlying theories and marshals solid evidence on the growing relevance of non-Keynesian effects in markets both East and West. The work sheds new light, long sought after, on why there has been only slight progress made and on why repeated failures characterized the Hungarian fiscal scene.

Part I, – as can be expected from a genuine scholarly piece – guides us through the relevant branches of the literature that identify and explain the exceptional fiscal episode. The introduction offers a clear structure to be followed and a reasonable explanation why a comparative political economy perspective was chosen. In chapter 2, the study goes on to survey and critically assess some major fiscal episodes from the EU countries’ experience. It convincingly demonstrates that not all fiscal consolidations resulted in improved public finances (when improvement is measured by lower debt/GDP ratios). In fact, – proceeds Benczes to argue – it was rare to have lasting debt reductions (p. 29). It is argued with thorough elaboration, and it gets firmly proven that not all fiscal consolidations had lead to output acceleration. Conditions and adjustment paths vary as a function of many variables. As opposed to common belief, one can learn that the size of the adjustment itself is not a good predictor of either persistence, or when and whether expansionary effects are likely to come at all. Many caveats apply though. If that is not enough uncertainty, methodological complications also abound in trying to predict acceleration. However, the problems with the predicting power of models cannot hide the fact that international comparative studies have all found some evidence on non-Keynesian effects in the OECD countries.

Next, in chapter 3, the arguments of the so called expectational view (with the nonlinear approach) of fiscal consolidation are surveyed and put to an interesting discussion. The author duly emphasizes that a very careful identification is needed to understand likely changes in individuals' expectations. The size of fiscal adjustment itself, the going levels of the acceleration of the debt ratios, and the structure of government spending were singled out as the main factors which trigger changes in expectations to alter current spending and the discounting of future tax liabilities. The deep scrutiny of modern consumption theory has underlined the importance of the expectational view as well as that of the liquidity constraint. Benczes claims – very reasonably – that the relevance of the liquidity constraint is still bothering, it does not support the automatic appearance of non-Keynesian effects. A key message of this chapter – and, I hasten to add, it may also be considered as key finding of the entire study – is that the due relevance of the financial deepening still remains. In countries with relatively underdeveloped financial systems and banking traditions, (e.g. Hungary, as we shall read later in the book) this fact gains an even further leveraged importance.

Chapter 4 should be looked at as the rich treasury of most valuable track records accumulated by the developed labor markets, where critical adjustments took place: reference is made to the EU 14, and to some other specific country experiences throughout the 1980s and 1990s, Ireland (1987-1989), Denmark (1983-1984), UK (1997-1998). These adjustment experiences, although different in composition, speed, and underlying structure, have all pointed to the same direction. Namely, pretty much in line with the supply side literature, they claim that there should be no sacred cows in the items destined to be cut. Benczes argues that even the cutbacks in politically sensitive items may give additional support to the crowding in effects for firms wishing to invest more, due to their enhanced competitiveness. Within a simple statistical analysis of the sample countries, this chapter has shown that it is not just the size of the adjustment alone, but the composition also matters in debt reduction to help non-Keynesian effects to take off. As cited by the author himself, the more than decade-old idea of Alesina-Perotti (1995, p. 250) is still alive and kicking:

"There is bad news and good news in these results. The bad news is that one cannot avoid cutting transfers and government employment; quite simply, permanently favorable results typically do not follow from politically palatable policies. The good news is that major fiscal adjustments do not cause major recessions. Politicians and their advisers must stop thinking of just about everything on the expenditure side of government budgets as untouchable." (cited by B. I., p.102)

One can be in full agreement with the author's major argument in this regard when he states: In modern democracies the basic question does remain: "*how can fiscal consolidation based on welfare cuts and government wage bill reduction be implemented in a highly rigid labor market?*" (p. 103). Indeed this is the tough assignment for all serious thinkers. This dilemma probably points much further beyond than known frameworks of pure macro-economics, it carries us to the realm of political economy. The author is more than aware of that and uses this awareness to the benefit of his own argument. Benczes' analysis of the very concrete consolidation cases, mainly regarded as success stories of the Netherlands, Ireland and the UK, leaves no doubt in my mind about his commendable convictions that fiscal consolidation based on expenditure cuts has a better chance of success (even with non-Keynesian effects) than revenue based adjustments. This conviction of his, however, has been, after a rigorous analysis, converted into a well founded conclusion. Neither the conviction nor the conclusion, of course, are enough, admits the author himself, without a minimum level of social consensus. The latter is the most indispensable factor of success and is, at the same time, the most difficult to arrive at. I gather, recipes for such arrivals vary more than do fiscal consolidation adjustment paths. With all that in mind, Benczes honestly claims that "*it would be an exaggeration to state that we have found and verified a causal relationship between fiscal adjustment and growth acceleration*." The different views as well as the supply – and demand side interpretations are naturally not mutually exclusive as Rzonca and Cizkowicz (2005, p. 9) put it: "*the different views are not competing, but complementary*". This balanced view is most probably fool-proof, but will this scientifically sound observation get anybody closer to policy action? Well, as always, that is not up to science to tell. Nonetheless, a little more decisive stand here would have been more appreciated.

Part II of the book takes us closer to some harsher realities, to those of the Hungarian fiscal scene, which in the last 15 years has been repeatedly labeled as deeply troubled. In this second part of the volume one gets a fair display of how sound principles and fine consolidation concepts work in the real world of government books and machineries. They tend to perform poorly. Adding, of course, that when investigating, all application of principles is assumed to be put in place as prescribed. When confronting actual Hungarian practices some surprise do await us. The broad comparative perspective which is offered in this chapter for the testing the institutional conditions of non-Keynesian effects in Hungary, come as no surprise. Much rather, some of its findings: the very inflexible, remnants of ancient socialistic labor market conditions that still prevail prompt the reader for a head scratch. One otherwise gets the largely expected results of a properly structured, disciplined survey on matters such as the role of financial intermediation, a good, detailed structural analysis of the expenditure side, and the inevitable, market-principle-driven, yet down-to-earth discussion of the Hungarian labour scene. Chapter 5 has clearly reestablished that the Hungarian financial market (banking sector) is by now developed enough – as confirmed by Szapáry (2002, p. 115) – to facilitate the emergence of expansionary effects by eliminating the credit constraint. Indeed, over the last 6 years, consumer loans have grown at double digit rates, and at present make up an important component of banks assets. These types of lending are rapidly closing the formerly existing gap with company loans. It got a marked indication in this section of the book that the euro adoption will most likely increase credit growth. This is a very valid point worth the attention of policy makers. The exposure of most Hungarian banks' consumer loan portfolio is large to foreign exchange risk, since CHF, Euro, and yen-denominated assets have been increasing at an unexpectedly high rate. Easy access to credit has had radical changes to occur to alter borrowing preferences. In Hungary, there have been probably much quicker reactions and more responsiveness to changes in available credit facilities than earlier thought by anybody in the financial sector. Between 2000 and 2004, financial firms mostly car leasing and purchase were able to double their share in the market and stabilized since then. True, the foreign exchange risk exposure involved is not seen, or is not properly understood by many participants. However, from the point of view of financial intermediation the global credit channel have for sure helped the spread of non-Keynesian effects. Along with the growing availability of foreign funds, the fiscal discipline has definitely worsened as there was less competition for domestic savings. As a negative consequence, global sources of funding removed a domestic savings constraint on budgetary overspending. At the end of this 5th chapter, it is rightly pointed out that the open economy environment brings further complications for the adjustment since there was deterioration of both internal and external equilibrium. To use Benczes' term, the "*vicious circle*" of budgetary overspending did not seem to disappear. On the contrary, it seemed that the ease of borrowing foreign funds did not help the cause of macroeconomic adjustment at all.

Chapter 6 gives a decompositional analysis of the expenditure side of the Hungarian general government. It covers a wide range of issues and analytical aspects. The main thrust of the argument is that the public indebtedness is well above the justified level. In addition, the redistribution rate, in GDP terms, is about 50 %, some 10 percentage points higher than the CEE-8 average. However, it equally exceeds the EU-15 average, reaching levels of countries who have twice the per capita income of Hungary. These are more than visible disproportions that cry for change. The Hungarian case is the sad saga of stubborn fiscal deficits giving us the worst spots in EU public finance rankings. Benczes admits that the composition of the budget does not offer any space for much pride either. The maintained levels of state employment reflect a heavy dose of over-employment (in 2006, some staggering 25 % were on state pay roll). Disability, sick leave pay, early-retirement benefit related payoffs are also way too generous, which are all representing strong disincentives to work. What is more, subsidies on drugs and housing are also heavy-weight items for current expenditures. For Hungary, the sustainable level of debt to GDP, according to Benczes, is about 40 % (which appears reasonable, though the number does not get any further reference or calculus-driven support). True, the officially registered debt levels have been (and are currently) way above that, hitting the lower 60s. The sad indebtedness picture does get any rosier by the fact that foreigners are holding ever larger shares. Over the last three years, foreign holdings have run up above 25 % of total public debt outstanding. The price of borrowing (with climbing risk premium) has gone up steep north, seriously hurting the fiscal balance. We are sorry to report that in the last two years, (for which the study could account), in this regard, there is no change on site. So, the warnings of Benczes are warranted, on target, and are as timely as ever.

The descriptions and analytic comments made in the next chapter on the rather slow developments of the Hungarian labor market, which have long left its working soldiers in the woods of socialistic traditions, are all in good fit with the main line of the arguments for the slow start of expansionary effects. Theoretically, flexible labor markets can enhance expansionary effects, if government is willing to go ahead with cuts on welfare items and on wage bills. One gets the impression from this 7th chapter also that theory is fine on paper in Hungary, too. Yet, because of a complete lack of social consensus on what government should or may do, vital encompassing social agreements are not on the horizon. Governments past and present could only weather the storms of fiscal consolidations but they never successfully navigated out of the storm zone. Way more than nothing that many of them managed to do, but all of them have lost direction and gained no or very little mileage. There were only look-warm efforts – and with that adjective we are forgiving – to pull social partners together and more importantly, to have their political representatives, sitting in on both sides of the isle, arrive on a social minimum. The crucial effort to reach that minimum is slipping away repeatedly. As a last dramatic episode of that unmoving story, an ill-defined, knowingly budget-related referendum in March 2008 just put an end to such efforts for quite a while.

It has been richly documented and convincingly argued throughout the book that demand and supply side non-Keynesian effects alike are highly sensitive to institutional settings. In the presence of liquidity constraint their strong impact would be most doubtful. What is more, many lead to disillusionment, and worse, to reversals. To avoid all these bad outcomes policy makers have to go through a long check list of necessary conditions to be aligned with when they wish to take their consolidation efforts to success (Table 8.1/ p. 219 / offers that list for easy and rapid reference). When it come to assessing the Hungarian relevance of non-Keynesian effects Benczes stays pragmatic in drawing relevant conclusion from the vast array of possible theoretical outcomes. He firmly concludes that the consolidation road followed in 1995-96 with deep currency depreciation and a loosening of monetary policy is not open any more. This view is fully supported by Csaba (2005, p. 201).

The GSP with its strict Maastricht criteria leaves the door open for fiscal measure only. With an increased credibility along with a speeding up of euro adoption there can be hope that financial intermediation will further help the convergence progress. On matters such as what Hungary can or may learn or adopt from the rich EU experience I do not share the author's skepticism. In my view, there are ample opportunities to adopt good practices from the more mature EU members to increase social cohesion and consensus building. It is also a matter of wills and serious (honest) efforts. Despite the fact that Hungarian social partners are fragmented and often hostile to each other, the lack of collective action of the dominant player may be overcome.

Finally, the overall assessment of and prediction of Benczes on Hungary's special case is straightforward: In Hungary, it is still unlikely that the fiscal multiplier could turn out to be negative and provide acceleration. Despite that unfavorable forecast, Hungary has to go forward with its far reaching fiscal consolidation, otherwise international market forces will force the country to adjust. The latter will be, without the slightest doubt, more painful (I allow, occasionally even brutal) and more costly to everyone. One can promptly agree, no further discussion is needed on that score.

To summarize, this book is a very good and timely piece of a young scholar, who is armed with all the modern artillery of contemporary macroeconomics. His work gave many new insights into the options to remedy the plagued Hungarian fiscal scene. Especially valuable are his contributions to the issues of financial intermediation, which to quote the words of György Szapáry, former vise Governor for the Hungarian National Bank: "*A most welcome novelty of his work is the investigation of the role of the financial system in the examination of non-Keynesian effects*". The book is eminently suited for classroom use and as reference volume. It could only be wished that some super diligent members of parliament devote their precious time to this volume as bed side reading.

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