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# **The Greek Fiscal Crisis and the Role of Fiscal Governance**

**Georgia Kaplanoglou and Vassilis T. Rapanos**

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# The Greek Fiscal Crisis and the Role of Fiscal Governance

Georgia Kaplanoglou<sup>#</sup> and Vassilis T. Rapanos<sup>\*</sup>

## ABSTRACT

In view of the growing attention paid to the role of fiscal governance in budgetary outcomes, this paper tries to shed light on the link between the recent Greek fiscal crisis and aspects of fiscal governance. It reviews fiscal developments in Greece over the last decade and challenges the widely held view that optimistic macroeconomic forecasts adopted by the Greek government, as well as three international organisations, were responsible for unrealistic fiscal deficit forecasts. Instead, the weak domestic institutional budget framework and the ineffectiveness of international organizations to act as signaling mechanisms emerge as the main reasons for weak fiscal performance. In this light, the paper puts forward some ideas for improving the domestic institutional framework for conducting fiscal policy in Greece.

Keywords: fiscal governance, fiscal forecasts, fiscal discipline, budget institutions, public financial management, Greece

JEL codes: H61, H62, H68, H11, E62

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# The Greek Fiscal Crisis and the Role of Fiscal Governance

## 1. Introduction

Persistent fiscal deficits and higher levels of public debt seem to be common features among many OECD countries since the early 1970s (OECD, 2007a). Fiscal deficits, once small and controlled in most of such countries, have soared after the outbreak of the recent global financial crisis, as a result of both the direct fiscal costs of bank and other enterprise rescue operations and of government policies aimed at sustaining domestic demand within an environment of rapidly weakening economic activity (van Riet, 2010). In a number of countries, including Greece, the deterioration of the fiscal outlook has been so severe, that the financial markets' reaction to the perceived threat in fiscal sustainability, has brought the cost of financing for these countries to prohibitive levels. One of the factors that have with little doubt intensified the fiscal impact of the financial crisis has been the failure of governments to take advantage of the good times preceding the crisis to consolidate public finances. In this light, an increasing number of both theoretical and empirical studies tries to explain the persistence of fiscal deficits even in favorable macroeconomic conditions (the well-known deficit bias problem) on the one hand and to find effective ways to ensure fiscal discipline on the other.

An exploration of the deficit bias phenomenon is beyond the scope of this paper, but several explanations have been put forward by political economy and public finance theorists (see for example, Shepsle and Weingast (1981), Krogstrup and Wyplosz (2007) and (2010), Tabellini and Alesina (1990), Rogoff (1990), Persson and Svensson (1989), von Hagen (2010)). As far as the urging policy question on how fiscal discipline can be effectively ensured is concerned, attention is growingly shifting towards the importance of fiscal governance for budgetary outcomes. Fiscal governance is perceived as the set of fiscal institutional arrangements governing the conduct of fiscal policy in a country. Such institutional arrangements include, for example, legally binding fiscal rules, medium-term budgetary frameworks, budgetary procedures and the establishment of independent fiscal authorities (European Commission 2009a, OECD (2007b), Pretorius and Pretorius (2008), Alesina et al (1996), Ayuso-i-Casals (2010)).

Furthermore, the strengthening of fiscal governance *at a national level* has recently received particular attention in view of the difficulties to effectively enforce the fiscal rules set at the European level by the Stability and Growth Pact (European Commission, 2010b). Despite the empirical difficulty in measuring the quality of institutions, a large number of studies has attempted to establish an empirical link between institutions, budgetary processes and budgetary outcomes, see for example European Commission (2007), Ayuso-i-Casals et al. (2007), von Hagen et al. (2009), von Hagen (2010), IMF (2009),

Calmfors (2005), Debrun and Kumar (2007), Larch and Turrini (2008).<sup>1</sup> Each paper explores a different aspect of the quality of fiscal governance and its possible link with fiscal outcomes, but on the basis of the empirical evidence one could argue that on the whole budget processes and fiscal rules do matter for the outcome of fiscal policy.

Against this background, the example of Greece is particularly interesting. It is true that Greece has been living with a high public debt for a long period of time. In the 1990s, in its effort to join the EMU, the government made a major effort to reduce fiscal deficits and control the rise of public debt, and succeeded in fulfilling the criteria for becoming member of the Euro area. Unfortunately, this effort was not continued in the following years, and with the turmoil of the international markets after the recent economic crisis, Greece found itself in the brink of a financial collapse. At the same time, the country appears so far to have scored low in almost any evaluation regarding different aspects of the quality of fiscal governance (European Commission, 2007, OECD, 2002, for a review see Rapanos, 2007) and has long been criticised on these grounds (IMF, 2006, OECD, 2008, Vraniali, 2010).

The questions that arise for Greece are particularly acute. What were the underlying causes for the severe fiscal crisis that emerged about a year ago? What was the link between existing budget institutions and the persistence of fiscal deficits, especially in the period after Greece became a euro area

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<sup>1</sup> A recent strand of literature studies the impact of fiscal institutions on government bond yields (see, for example, Hallerberg and Wolff, 2008, Iara and Wolff, 2010), but this issue is beyond the scope of this paper.

member? The purpose of the paper is to explore the link between aspects of fiscal governance and budgetary outcomes in the case of Greece and draw some conclusions regarding the underlying causes of the inability of Greek fiscal institutions (namely the Ministry of Finance, the government and the Parliament) to check on the apparently uncontrollable persistence of deficits and the increase in public debt. More precisely, the paper focuses on the magnitude of deviations of budgetary outcomes from the targets set at a central and general government level. There is a widely held view that in many EU countries politically motivated systematic optimism concerning economic growth played a potentially significant role in generating excessive deficits (Jonung and Larch, 2004 and 2006).<sup>2</sup> A similar argument has been put forward for Greece (IMF, 2006, Vraniali, 2010). We challenge this view for the Greek case and argue that the weak institutional framework for setting up and following the execution of the budget, as well as the ineffectiveness of international organisations to play a signalling role, are the key factors behind Greece's fiscal derailment. In this respect, we set out some ideas on possible directions of reform of the domestic institutional framework and briefly evaluate some recent initiatives of the Greek government regarding the setting up of a Parliamentary Budget Office and the improvement in fiscal management.

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<sup>2</sup> Buettner and Kauder (2010) in their study on revenue forecasting performance of 12 OECD countries in the 1996-2008 period, also conclude that the GDP forecast error exerts a strong effect on the error of revenue forecasts.

The remainder of the paper is structured as follows. Section 2 gives a brief account of the fiscal performance of Greece in comparison to its euro area partners over the last fifteen years. Section 3 tries to detect the main reasons for the very poor performance of the political system regarding the control of fiscal deficits within the rules-based fiscal framework provided by the Stability and Growth Pact. In section 4 we make some proposals that could improve the domestic institutional and legal framework for conducting fiscal policy, and analyze in more detail the idea for a parliamentary budget office. In the last section we summarize the main findings of our analysis.

## **2. A short story of Greek public finances since 1999**

It is rather generally agreed that a root-cause of the ongoing Greek fiscal crisis was not only the soaring public deficit in the last couple of years, but also the opacity of public accounts. Revisions in the size of the deficit and debt were a particularly common phenomenon since 2004, when the then newly elected government changed retroactively the rules for recording defense expenditure. In October 2009, following a change in government, the budget deficit announced for 2009 was far larger than anticipated.<sup>3</sup> As a result Greece suffered a sharp erosion of credibility and financial markets reacted with a huge increase in the spreads of the Greek government bonds that made borrowing by

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<sup>3</sup> More precisely, the 2009 general government deficit notified by the Greek government to Eurostat was revised from 3.7% of GDP in April 2009 to 6.0% of GDP on October 2<sup>nd</sup> 2009. The new government, elected in October 2009, notified a deficit of 12.5% of GDP on 21<sup>st</sup> October 2009. This figure has been upwards revised three more times since then.

the Greek state impossible. A short story of Greek public finances over the last fifteen years allows one to draw some rather revealing conclusions regarding the effects on budgetary outcomes of the weak fiscal governance framework within which fiscal policy was set.

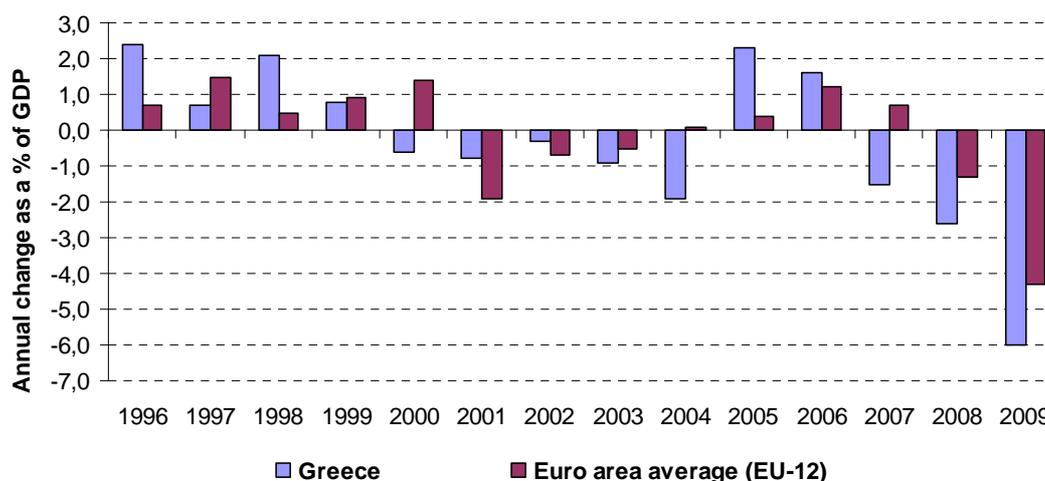
During the 1993-1999 period, Greek public finances were set on an ambitious fiscal adjustment path in an effort to comply with the relevant Maastricht criteria and enter the Eurozone. Indeed, the budget deficit, which stood at almost 13% of GDP in 1993, was reduced to below 3% by 1999<sup>4</sup>, while the public debt-to-GDP ratio started declining. At the same time, the Greek economy attained impressive growth rates, among the highest within European Union countries.

In the period after the introduction of the euro, fiscal consolidation efforts lost momentum in almost all euro zone countries, despite the fact that the Stability and Growth Pact envisaged the attainment of balanced budgets over the medium term. In fact, the period 2001-2003 witnessed significant increases in budget deficits, as shown in Figure 1. In many countries, the general government deficit breached the 3% of GDP limit, and as a result these countries were subjected to the Excessive Deficit Procedure, as envisaged in the framework set by the Stability and Growth Pact. The same was the case with Greece in 2004.

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<sup>4</sup> This figure was revised to 3.1% after a fiscal audit that took place in 2004.

**Figure 1. Annual changes in the general government balance (% of GDP), 2000-2009**



Source: Authors' calculations based on European Commission (2010), General Government Data, Part II: Tables by series, Spring 2010.

The governments of these countries adopted fiscal consolidation packages which brought the deficit below the 3% limit and managed to bring the EDP to an end (see Figure 1). In the case of Greece, in June 2007 the Council of the European Union, based on the European Commission's recommendation that the public deficit had been brought below the 3% to GDP reference value in a sustainable way, decided that the excessive deficit had been corrected and brought the excessive deficit procedure to an end. Nevertheless, by the end of 2007, the general government deficit had once more surpassed the 3% limit.

The eruption of the global financial crisis in mid-September 2008 and the subsequent worldwide economic recession had a marked negative impact on the fiscal positions of euro area countries (Figure 1). In 2009 all euro area countries recorded deficits which, with the exception of Finland and Luxembourg, exceeded 3% of GDP. Public deficits rose as a result of both declining revenues and large public spending packages aimed at supporting

domestic consumption and the financial sector (for an overview, see van Riet, 2010). Nevertheless, blaming the world financial turmoil for the recent explosion of fiscal deficits in Greece would be rather misleading (see Bank of Greece, 2009 and Rapanos and Kaplanoglou, 2011). For example, the banking system in Greece maintained sound capital positions throughout the crisis, while any present bank liquidity problems are the result rather than the cause of the unsustainable fiscal position of the public sector.

### **3. Greek fiscal governance and budgetary outcomes**

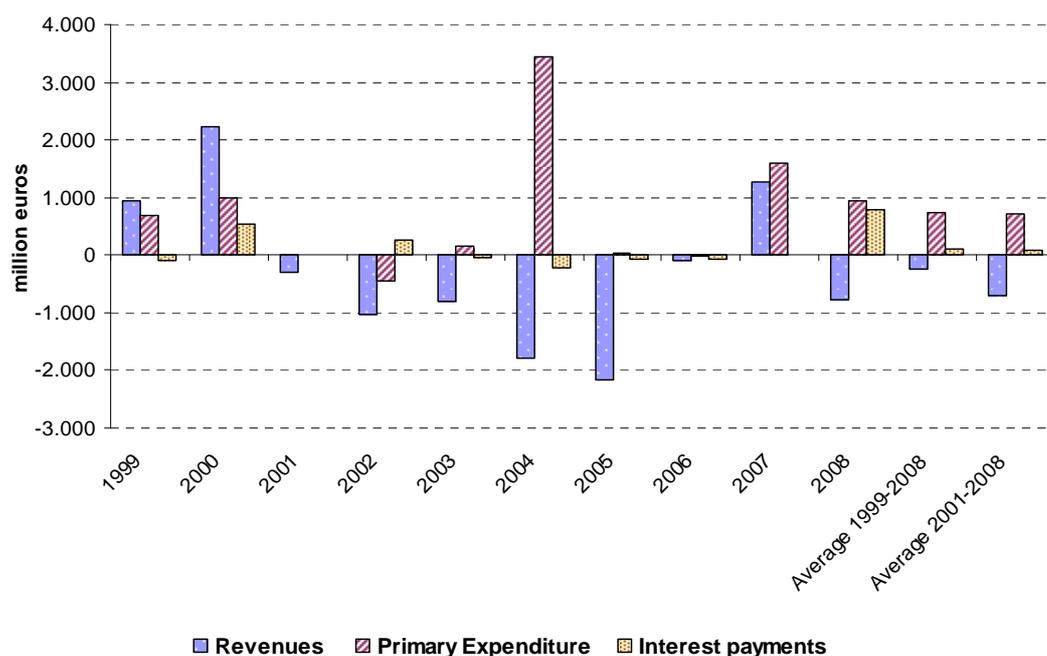
Despite the fact that the Greek economy attained high growth rates throughout the last decade, fiscal imbalances were never effectively brought under control. One can find many explanations for high deficits. In the first instant, one could draw attention to the incompetence of the government to control expenditures and to collect budgeted revenues. The most fundamental reason, however, has been the weak institutional framework of budgeting and tax administration. A basic weakness of the Greek fiscal system is the poor mechanism of setting up the budget, and the lack of any systematic monitoring of its implementation. While the Parliament has a powerful constitutional role in voting the state budget, not only as a whole but also by Ministry, it does not have any kind of mechanism to follow up on the budget execution, and to monitor developments on public expenditures and revenues.

It would be rather revealing to give a retrospective account of the budget data presented to the Parliament and approved by it over the last decade. Every November the Parliament examines the Introductory Report of the State Budget for the following year and is asked to approve it. Information for local government, public hospitals and social security funds finances appears only in a fragmentary manner and is largely missing. During the course of the following year, the only information regarding the developments on the execution of the budget is presented to the Parliament in October or November of the budget year (already too late to address any deviations). The Parliament is finally asked to approve of the final outcome of the budget in November of the year following the budget year. Just to take an example, the 2007 State Budget is approved by the Parliament in November 2006, its implementation progress is approved in November 2007 and its final outcome is approved in November 2008. Therefore, there appear to be large gaps in the flow of information regarding the execution of the budget, thus rendering the monitoring role of the Parliament ineffective.

Had deviations from the targets not been large, the problem would perhaps not have been important. However, apparently that was not the case. How had major fiscal components of the state budget (total revenues, primary expenditure and interest payments) evolved one year after the approval by the Parliament of the respective targets? As Figures 2a and 2b show, not

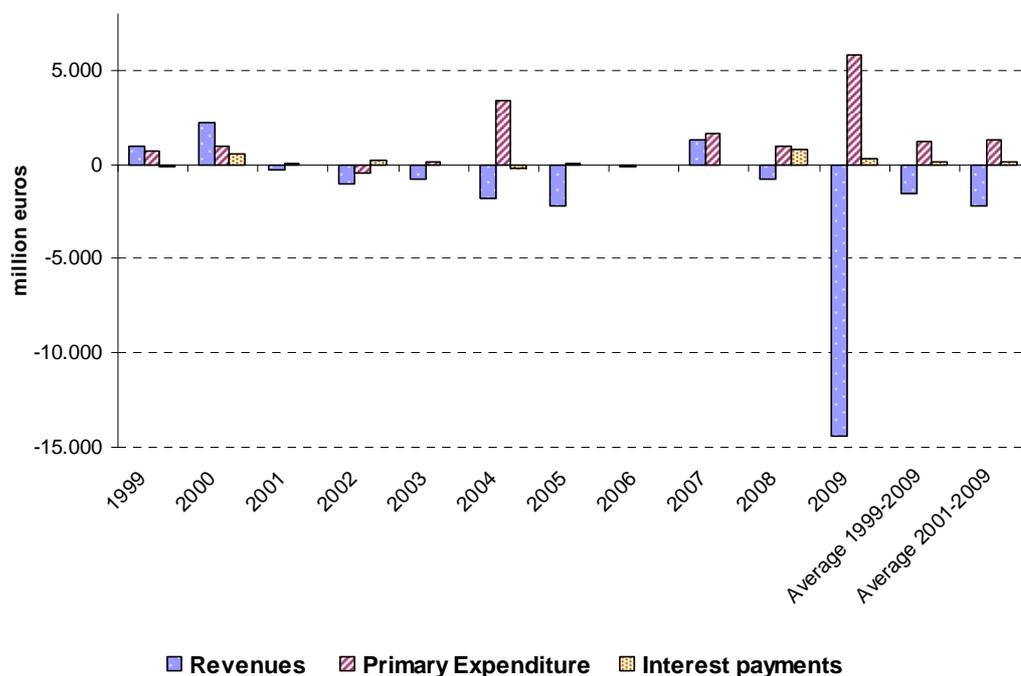
particularly well, with deviations varying from year to year<sup>5</sup>. Smaller deviations and even positive surprises coincide with the periods of fiscal consolidation episodes imposed by the European fiscal framework, as described in the previous section. On the whole, however, total revenues and primary expenditure were not evolving according to plan. In most years, there were significant shortfalls in revenues and serious expenditure overruns.

**Figure 2a. Deviations of within-year estimated of major fiscal aggregates from the targets set at the Introductory Report of the State Budget, 1999-2008 (excluding “outlier” 2009)**



<sup>5</sup> Despite the fact that deviations from targets were usually rather high almost all years, they appear condensed once the exceptionally high revenue shortfalls of 2009 are added. Therefore, we present the data both including and excluding the “outlier” year 2009.

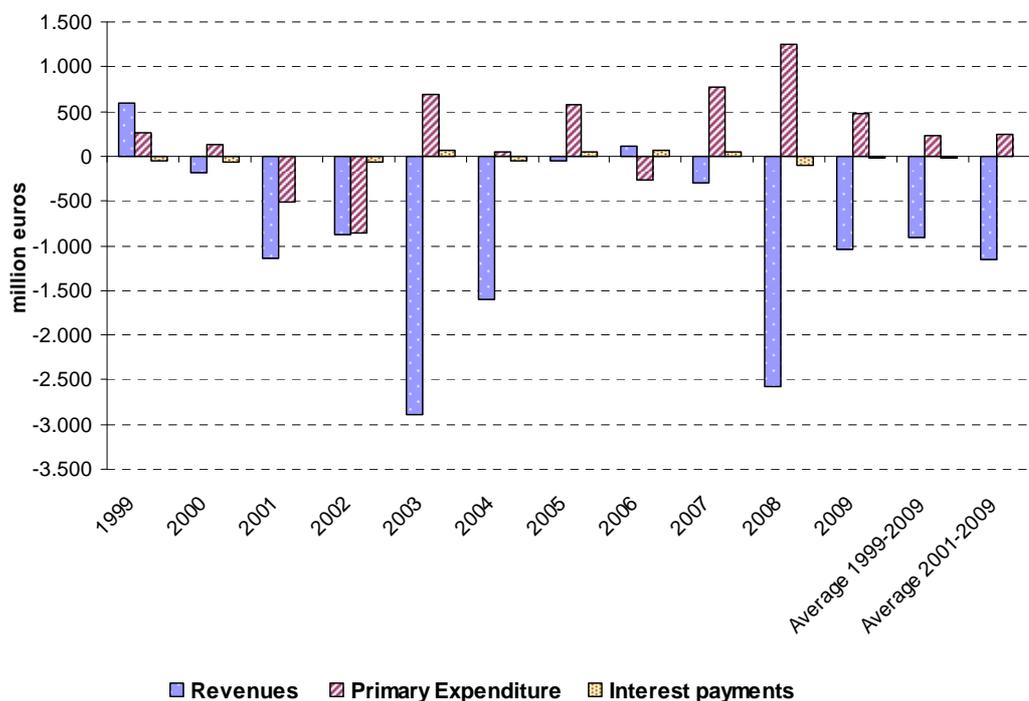
**Figure 2b. Deviations of within-year estimated of major fiscal aggregates from the targets set at the Introductory Report of the State Budget, 1999-2009**



*Source:* Authors' calculations based on Ministry of Economy and Finance, *Introductory Report of the State Budget*, Athens (various issues).

More notably, the Parliament apparently could not impose any corrective action in the cases where the targets for revenue and expenditure were evidently going to be missed. The final outcome instead exhibited a further deterioration. Figure 3 presents the deviations of within-year estimates of the same fiscal aggregates from the final outcomes. Deviations from both the revenue and the expenditure targets expand further.

**Figure 3. Deviations of within-year estimates of major fiscal aggregates from final outcomes**

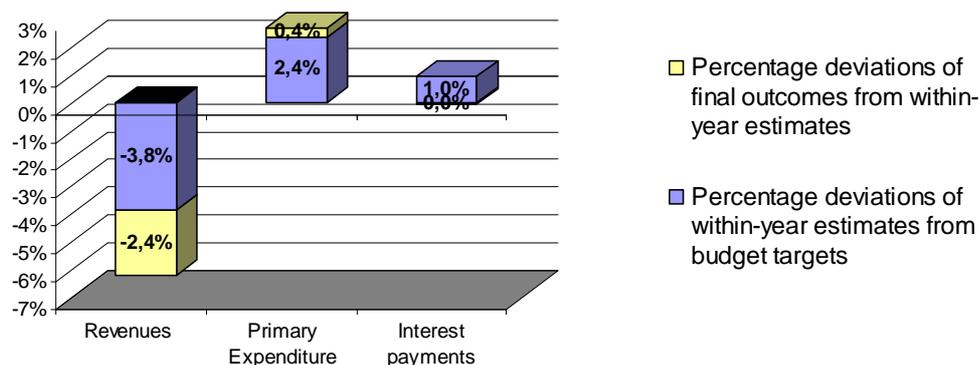


Sources: Authors' calculations based on Ministry of Economy and Finance, *Introductory Report of the State Budget*, Athens (various issues).

Figure 4 presents the size of the average *percentage* deviations of final outcomes from the targets set in the budget over the 2001-2009 period. The within-year estimates presented to the Parliament indicated that revenues were falling short of the budgeted amount by 3.8%, while primary expenditure was going to exceed the targeted amount by 2.4% and interest payments by 1%. The final outcome drew an even bleaker picture, with revenue shortfalls reaching over 6% and expenditure overruns having further increased. The deviations of revenues and expenditures in percentage terms might not strike too large, but when fed into the State Budget deficit, they imply that the final figure for the

state budget deficit stood every year on average 67% higher than the budgeted amount.

**Figure 4. Percentage deviations of major fiscal aggregates of the State Budget (average 2001-2009)**



Sources: Authors' calculations based on Ministry of Economy and Finance, *Introductory Report of the State Budget*, Athens (various issues).

An inherent inconsistency of the Greek budgeting system stems from the unbalanced power of the Parliament over the *state* budget vis-à-vis *general government* data. The Stability and Growth Pact, which sets the framework for conducting fiscal policy at the EU level, requires fiscal aggregates to be reported at a *general government* level respecting the accounting rules set in the European System of Integrated Economic Accounts (ESA 95). State budget data have, therefore, to be adjusted to a national accounts basis and be aggregated with data covering local authorities, social security funds and hospitals. The approval of fiscal forecasts included in the Stability and Growth Programs submitted to the European Commission is simply a responsibility of

the Ministry of Finance, therefore the Parliament is rarely presented with such data, let alone asked to monitor them.

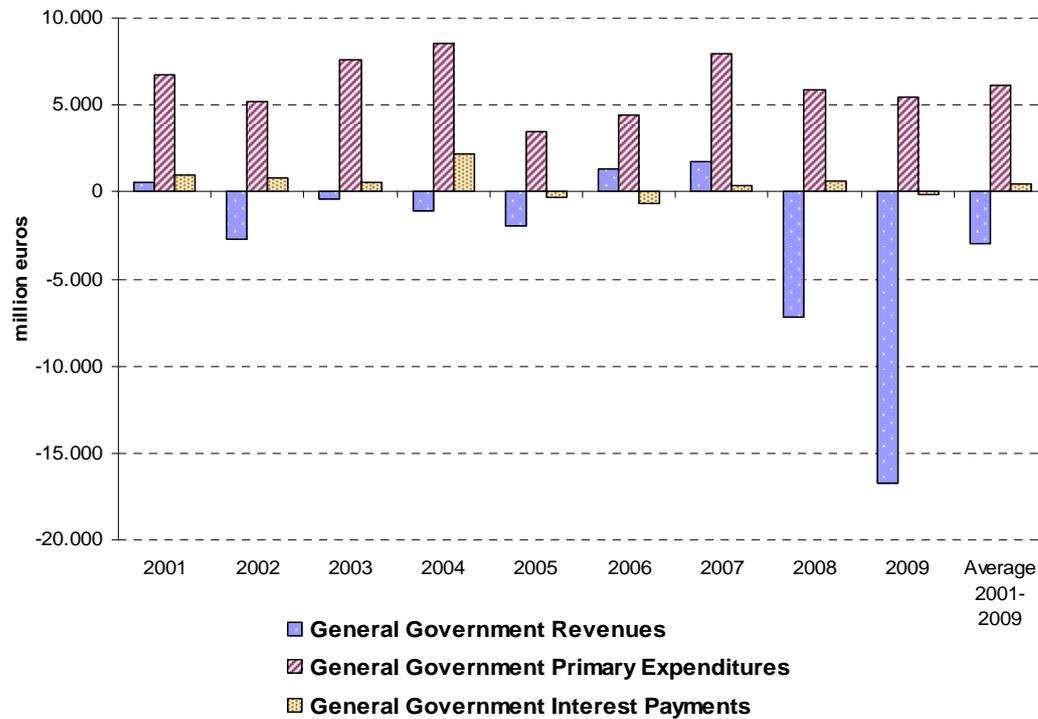
The even greater lack of monitoring at a national level of the targets set for the general government balance and its components goes, not surprisingly, hand in hand with even higher deviations. Figure 5 has been constructed in a similar way with Figure 2. It compares the targets set at various updates of the Hellenic Stability and Growth Programme for the revenues, primary expenditure and interest payments at a *general government* level. When we move from the state to the general government level, deviations appear slightly lower in absolute amounts in the case of revenue shortfalls, but almost three times higher in the case of primary expenditure overruns. The relative improvement in the performance of revenue once we move to the general government level is primarily attributed to the considerable surpluses recorded every year by social security funds, an issue that has attracted the attention of Eurostat more than once.<sup>6</sup> One could argue that from 2004 onwards Greek fiscal data have been revised many times (see European Commission, 8.1.2010 Report) and such ex post revisions could not have been possibly anticipated by Greek governments. Figure 6 presents similar information with Figure 5, excluding the effect of ex post revisions of general government revenue and expenditure data. Deviations from targets now appear much smaller in the case of government expenditure,

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<sup>6</sup> Regarding the size and revisions of the surpluses of social security funds and the explanations provided by the Greek authorities, the European Commission notes in its latest report on Greek statistics that “it does not find these explanations sufficient and will carry out in the coming months a thorough investigation of the process of calculation by the Greek authorities of the surplus/deficit of the social security sector” (European Commission, 2010a).

which is to be expected since most revisions referred to the methodology in recording expenditure items (e.g. military expenditure).

**Figure 5. Deviations of final outcomes of major fiscal aggregates from targets set at the Hellenic Stability and Growth Programmes**

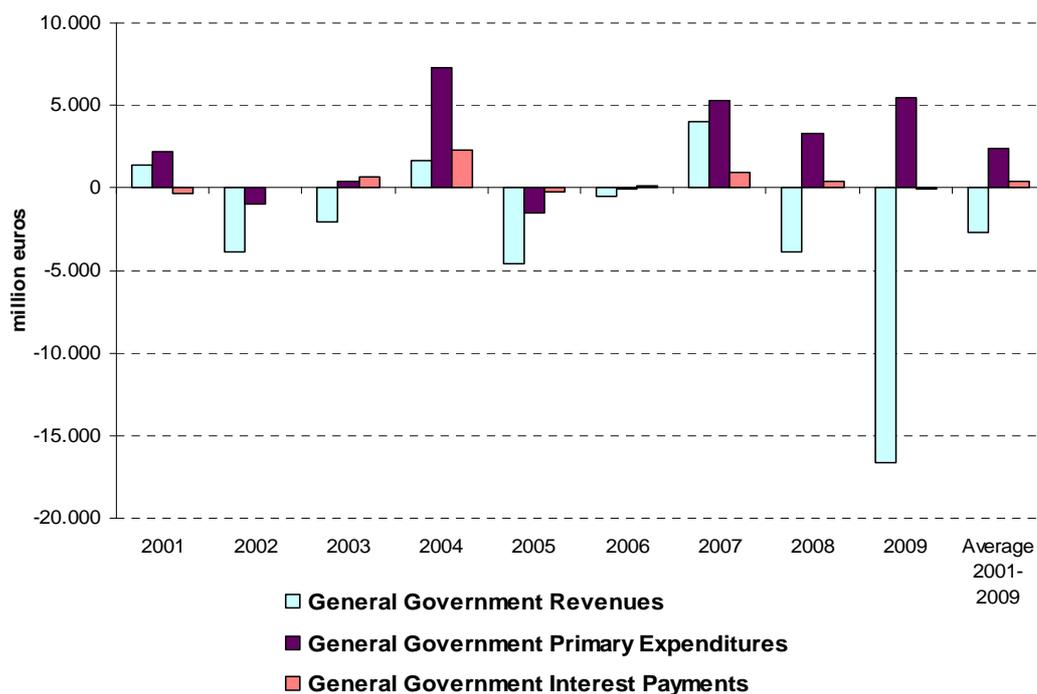


Sources: Authors' calculations based on Ministry of Economy and Finance, *Update of the Hellenic Stability and Growth Programme*, Athens (various issues), and European Commission (2010), *General Government Data, Part II: Tables by series*, Spring 2010.

One fact can be established with hardly any doubt: on the whole fiscal targets were systematically being missed by a wide margin. A natural question arises: is there something intrinsically flawed in the way fiscal targets were set either at the state or at the general government level? A view widely held among both national and international organizations is that the problem can be traced to the fact that the government consistently based its fiscal forecasts on an overly optimistic outlook for the economy as a whole, thus inflating government

revenue forecasts and underestimating expenditure. In other words, GDP growth was being overestimated and subsequently, when the harsh face of reality revealed itself, public revenue and expenditure targets were being missed. Despite its popularity, this view can be challenged rather easily.

**Figure 6. Deviations of final outcomes of major fiscal aggregates from the targets set at the Hellenic Stability and Growth Programmes (excluding the impact of ex-post statistical revisions)**

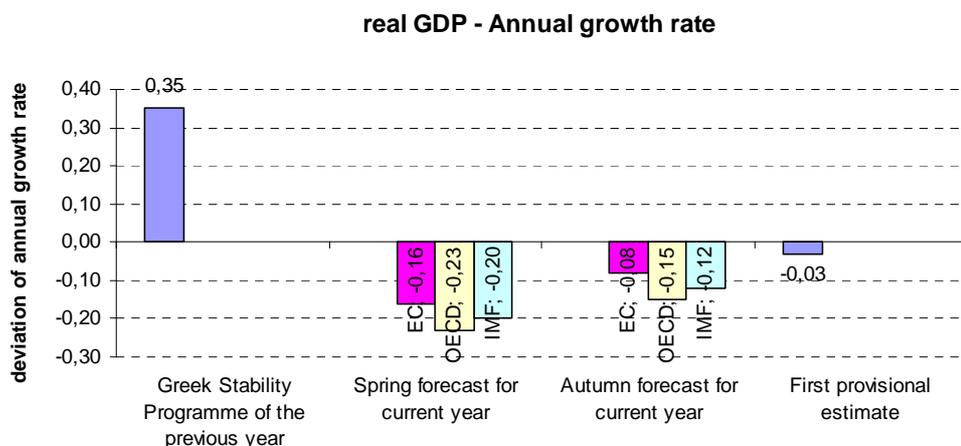


Sources: Authors' calculations based on Ministry of Economy and Finance, *Update of the Hellenic Stability and Growth Programme*, Athens (various issues), and European Commission (2010), *General Government Data, Part II: Tables by series*, Spring 2010.

Referring to the period 2000-2009, the first column of Figure 7 shows the average deviation of the forecast for the real growth rate adopted by the Stability and Growth Programme for the following year from the final outcome. It appears that Greek governments do tended to overestimate real GDP growth, yet by a rather small margin of 0.35 percentage points. The European Commission, as part of the monitoring of the finances of member

states, conducts biannual forecasts (each spring and autumn) for major economic aggregates. As becomes evident from Figure 7, the within-year forecasts for GDP growth were rather conservative, marginally underestimating the Greek GDP growth rate. The magnitude of the underestimation halves in the autumn forecast as the calendar year approaches its end.

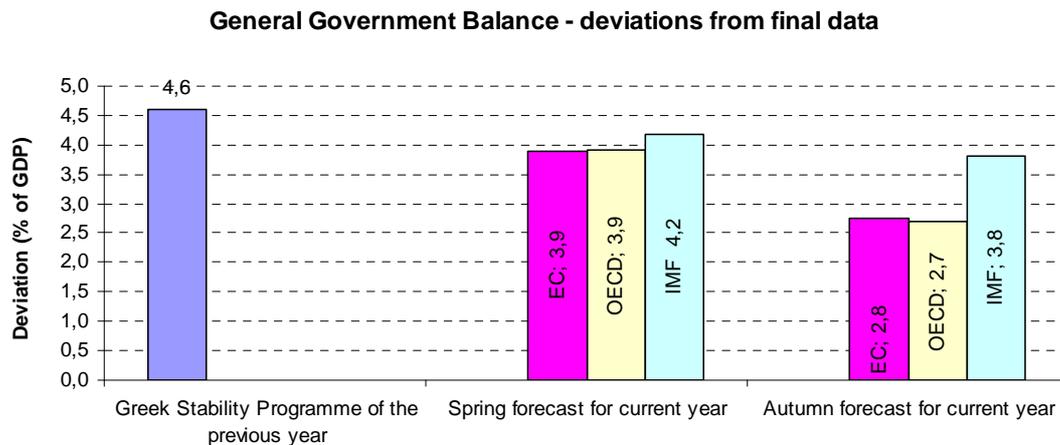
**Figure 7. Deviations of GDP growth rate (2000 – 2009)**



Sources: Authors' calculations based on Ministry of Economy and Finance, *Update of the Hellenic Stability and Growth Programme*, Athens (various issues), European Commission (2010), *General Government Data, Part II: Tables by series*, Spring 2010 and European Commission, *European Economy*, Brussels (various issues).

Forecasts for the general government balance convey an entirely different picture (Figure 8). The targets set in the Stability and Growth Programmes were highly unrealistic and therefore unreliable, since they were missed by a large margin (on average the annual deficit was 4.6% of GDP higher than the target). More surprisingly, the prudence of European Commission GDP forecasts does not translate into analogous prudence when it comes to public deficit. The EC forecasts appear to highly underestimate public deficits, even in the autumn forecasts, just one month before the end of the year in question.

**Figure 8. Deviations of General Government balance from final data (% of GDP), 2000 - 2009**



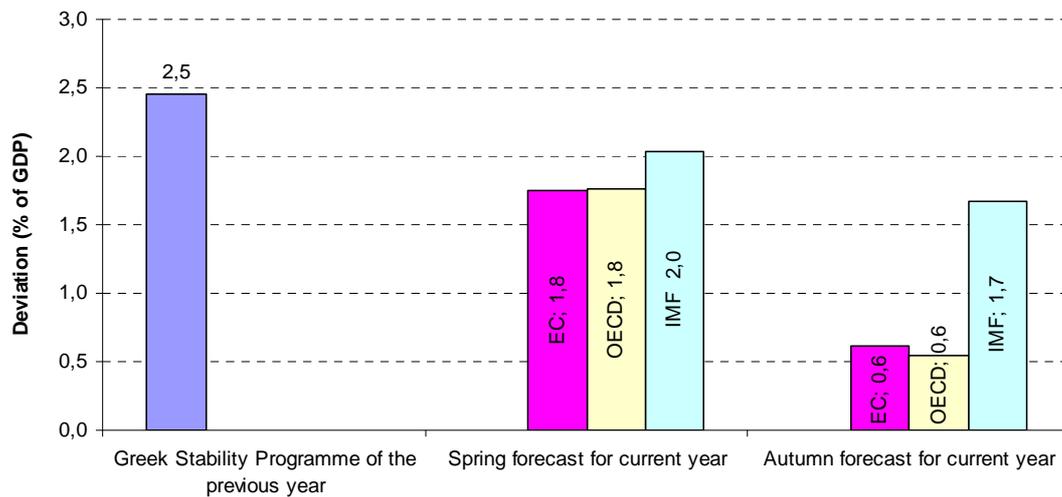
Sources: Authors' calculations based on Ministry of Economy and Finance, *Update of the Hellenic Stability and Growth Programme*, Athens (various issues), European Commission (2010), *General Government Data, Part II: Tables by series*, Spring 2010 and European Commission, *European Economy*, Brussels (various issues).

Part of the deviations can be attributed to the fact that Greek fiscal deficits were subject to multiple ex-post statistical revisions, which of course the government or other institutions such as the EC could not foresee. If we take these revisions into account,<sup>7</sup> the performance of forecasts certainly improves, but still falls short of what could be expected (see Figure 9). The spring forecasts underestimated fiscal deficit on average by almost 2pp of GDP, while the autumn forecast still underestimated deficits by more than 0.5% of GDP. Figures 7-9 also present the spring and autumn forecasts for GDP and fiscal deficit of two other international organizations (the OECD and the IMF). These forecasts are similar to those of the European Commission, i.e. prudent on GDP and seriously underestimating fiscal deficits, with IMF forecasts being the most

<sup>7</sup> Revisions are defined as the differences between the final outcome of each year and the figure appearing as the first provisional estimate (in the EDP of March the following year).

unreliable (partly owing to the fact that they are conducted slightly earlier than those of the other two international organizations).

**Figure 9. Deviations of General Government balance from final data (% of GDP), excluding the impact of ex-post statistical revisions, 2000 – 2009**



Sources: Authors' calculations based on Ministry of Economy and Finance, *Update of the Hellenic Stability and Growth Programme*, Athens (various issues), European Commission (2010), *General Government Data, Part II: Tables by series*, Spring 2010, European Commission, European Economy, Brussels (various issues), OECD, *Economic Outlook*, Paris (various issues) and IMF, *World Economic Outlook*, Washington D.C. (various issues).

One could argue that the suboptimal recording of fiscal data for the general government and the weak monitoring of the budget execution made it difficult for EU or other international institutions to establish precise signaling mechanisms. In order to proceed to a thorough quantitative and qualitative assessment of the fiscal situation in question, credible and timely data should have been available, which was definitely not the case for Greece. Nevertheless, recurring forecast errors should have acted as warnings that something was going wrong, for example that some model parameters (e.g. revenue elasticities) were perhaps inaccurate. Revenue developments in excess

of what GDP growth would imply should not have been incorporated in official forecasts unless accompanied by specific policy measures. On the whole, stricter scrutiny of fiscal data and forecasts and an effort to embed past forecast errors into the assessment procedure would have certainly enhanced the effectiveness of international signaling mechanisms, especially those of the EU.

The major conclusions one can draw from this short analysis are rather clear. Budget balance targets in Greece were being missed, while on the whole revenue shortfalls and expenditure overruns appear to be equally responsible for missing these targets. Despite the fact that the Greek constitution envisages a powerful role for the Parliament in the approval of the State budget, in practice the Parliament had little information and, therefore, power to monitor the execution of the budget it had approved. At the same time, international organizations failed to effectively act as signaling mechanisms. The previous analysis has also demonstrated that the widely held view that optimistic assumptions on GDP growth are largely responsible for unrealistic forecasts for public revenue and expenditure is not accurate. Despite the fact that the economy did appear to grow in line with what the government (and other international organizations) had assumed, budgeted revenues did not find their way into the public purse, while expenditures (especially primary expenditures) were not kept under planned control. All these conclusions point to the same direction: the weak institutional framework for setting up and monitoring the execution of the budget is the fundamental reason for the weak fiscal performance and, therefore, any attempt to correct fiscal imbalances is rather

doomed to fail unless the reform of this framework is also given serious thought. The following section puts forward some ideas on possible ways of improving this institutional framework.

#### **4. Improving the domestic fiscal framework in Greece: some proposals**

A detailed analysis of the ways in which the institutional framework for setting, executing and evaluating the budget should be reformed is perhaps beyond the scope of the present paper.<sup>8</sup> We will, however, attempt to lay out some key dimensions of such reform in the areas of budgetary procedures, tax administration and also regarding the possible role of an independent fiscal council.

##### *4.1. Budgeting procedures*

The issue of poor budget management in Greece is neither neglected nor newly discovered. There is indeed a long series of studies identifying the key aspects of this issue and proposing ways for reform, see for example HM Treasury (2002), Diamond et al (2005), IMF (2006), Rapanos (2007), Hawkesworth et al (2008), OECD (2010), Vraniali (2010). A very brief outline of the main

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<sup>8</sup> For a recent review of several aspects of public financial management and budgeting, see Shah (2007) and, more specifically on Greece, see Rapanos (2007), Vraniali (2010) and OECD (2010).

weaknesses of the budgeting framework in Greece can be summarized as follows<sup>9</sup>:

- Lack of transparency. The drafting of two separate budgets (the ordinary and the investment budget) with overlapping expenditure categories, the existence of significant off-budget operations, the lack of coherent reporting of the finances of general government bodies not included in the central government (i.e. local authorities, social security funds and hospitals), are the main elements introducing confusion and ambiguity regarding fiscal aggregates and impede any meaningful breakdown of these aggregates.
- Lack of a medium-term budgetary framework. The budget drafted each November concerns the following calendar year. Although the approval of an annual budget involves important decisions on budgetary policy and is a key step, most fiscal measures have budgetary implications that go well beyond the yearly budgetary cycle. Therefore, a single year perspective provides a poor basis for fiscal planning. The government did submit every December an update of the Stability and Growth Programme with a three-year horizon. Such updates, however, were usually not submitted to Parliament, while fiscal targets set for the medium-term were not binding. They were drafted in order to meet the obligations set in the Stability and Growth Pact, but did not reflect in a reliable way the strategic goals and objectives of the government.

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<sup>9</sup> For more detailed comprehensive reviews, see Rapanos (2007) and Vraniali (2010).

- No program budgeting. International practice has shown that public funds are more effectively used in the framework of a program budgeting system with a focus on policy objectives, which addresses the quality of expenditure, reviews program results and addresses value for money. In the Greek case, the expenditure control and accountability framework is characterized by excessive and overlapping ex ante controls and ex post multiple expenditure controls inclined towards compliance and legality (Vraniali, 2010). Furthermore, input budgeting in the framework of an extremely detailed budget structure makes the budget inflexible and results in thousands of budget adjustments per year (OECD, 2010).<sup>10</sup>
- Weak top-down budgeting process and lack of real accountability. The Greek budget preparation is to a large extent a bottom up exercise. Line ministries enjoy a large degree of freedom to propose their spending wishes with little early guidance from higher levels of government. They have little incentives to think in terms of reallocation and prioritizing instead of asking for additional funds. In the present system, the Ministry of Finance interferes at all stages of the budget process at a very detailed level, thus eliminating any sense of ownership of the line ministries budget, attenuating their accountability and removing any incentive for improvement in the management of public funds.
- Organisational weaknesses. The General Accounting Office, which is entrusted to monitor the execution of the Ordinary (but not the Investment)

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<sup>10</sup> In 2007, for example, there were 6,650 budget adjustment decisions, which regarded reallocations of expenditures (OECD, 2010).

Budget, has no coherent information system that will enable it to have an overview of total public revenues and expenditures at any point in time. Local information systems managed by e.g. local fiscal audit offices or different bodies of the central or general government are not on-line with the General Accounting Office, thus making the collection of information on both the revenue and the expenditure side a hard task.

The directions of desired reform are rather self evident, if the above weakness of the Greek budgetary framework are set against the main features of a system of sound budgetary procedures identified by, for example, the European Commission (2009a) and briefly outlined in Kaplanoglou and Rapanos (2011). The list of budgeting reform recommendations is indeed long and has been analysed in detail by other authors (e.g. OECD, 2010, Rapanos, 2007, Vraniali, 2010), but its main elements can be summarized as follows:

1. Consolidate budgeting procedures by merging the ordinary and the public investment budgets and placing them under the auspices of the General Accounting Office. The latter should be given more autonomy, with a permanent undersecretary as its head.
2. Introduce a new accounting system compatible with the International Public Accounting Standards for all bodies of the general government.
3. Improve the timeliness and reliability of budget execution reports. There should be full computerization of all transactions, while all offices of public expenditures should be connected on line. The General Accounting Office

should draft and make available monthly reports monitoring **all** expenditures of central government, local authorities and public entities.

4. Introduce a new effective internal auditing system, but also use external auditors. Audits should not be limited to checking formal compliance with procedures, but should also address the quality of expenditure, make performance assessment, or even assess risks in terms of “sustainability”. The French case of *Cour des comptes* could serve as a useful point of reference (Lefas, 2010).
5. Introduce stronger top-down budgeting. As OECD (2010) notes, a more top-down process, where early decision is taken on overall expenditure which is then subdivided into ministerial ceilings has shown to be more effective in constraining costs and making the line ministry feel ownership for fiscal decisions within the ministry. In this context, line ministry autonomy and accountability should be strengthened, while the primary responsibility for budget execution should be transferred to spending units.
6. Introduce program budgeting. More focus should be given to policy objectives and more attention should be paid to the quality of public expenditure and the results of public expenditure programs (for a comprehensive review of program and performance budgeting, see OECD, 2002 and 2007b).
7. Introduce national fiscal rules, incorporated in law, which should be open, transparent and comprehensive of all fiscal activity of the public sector.

Greece could benefit from the international experience on the implementation of national fiscal rules.

8. Introduce a medium term fiscal framework, incorporating multiyear estimates (e.g. on a three-year horizon) which reflect the strategic goals and objectives of the government. Such estimates could serve as the basis for top-down budget ceilings.
9. Consider the introduction of “accruals accounting”. Such a system could enhance transparency in the allocation of public funds and the impact of commitments, and improve the decision making process (Blöndal, 2003). Cash accounting practices need not, however, be removed, as they serve as a necessary basis for the operating, investing and financing activities of the government (Vraniali, 2010).

In recent years, there have been some attempts to address some of the weaknesses listed above. The Introductory Report for the 2007 Budget, for example, attempted to introduce a unified expenditure classification system covering both the ordinary and the investment budget (see Ministry of Economy and Finance, 2007). Beginning with the 2008 Budget, the Greek government launched reforms to its public financial management, through e.g. establishing a Government Budget Reform Unit with the aim of introducing initially at a pilot basis a results-oriented program budgeting system.

Perhaps the most wide-ranging attempt to reform public financial management in Greece has been Law 3871/2010 on “Fiscal Management and

Responsibility”, which was voted in August 2010. A detailed description and evaluation of the new provisions are perhaps beyond the scope of the present paper, but it is worth mentioning a few points of key importance. The new Law introduces a medium-term budgetary framework for the general government to be approved by the Parliament. This framework includes detailed fiscal targets, a clear reference of the macroeconomic assumptions on which fiscal forecasts are based, sensitivity analysis of fiscal targets, identifications of main upside risks, etc. A top-down approach is introduced for public expenditure, since ceilings for all levels of general government (and also by Ministry) will be included in the budget on a three-year horizon. All bodies of the central government, local authorities and social security organizations (including hospitals) are required to draft annual budgets and communicate to the General Accounting Office on a monthly basis reports including data on expenditures, revenue, financing and liabilities, on a cash basis. The General Accounting Office is required to submit to Parliament and make available to the press consolidated reports at a general government level covering public revenue, expenditure, liabilities and financing on a monthly, quarterly and biannual basis. In this way, the execution of the general government budget will be closely and transparently monitored. Internal audit procedures for public expenditures are specified in detail and a double-entry accounting system is introduced for the central administration. A unified expenditure classification system is introduced for all levels of government and the scope for expenditure reallocations is seriously limited. Important amendments to the approved

budget (e.g. if public borrowing requirements exceed the budget forecast by more than 10%) have to be approved by the Parliament, after the Minister of Finance has submitted a Complementary Budget.

The scope of the proposed reforms to the Greek budgeting framework is indeed ambitious and the extent to which they will transform the quality of fiscal governance remains to be seen in practice. However, close scrutiny allows one to identify some areas of potential concern. International experience has shown that national fiscal rules (e.g. expenditure rules, balanced-budget rules for certain levels of general government, etc.) can play an important disciplining role. No such rules are introduced. Furthermore, the medium term plan has to be submitted to Parliament by mid-April and be approved by mid-May. In case the Minister of Finance realizes that the assumptions or forecasts of the plan have changed by September, he has the right to submit to Parliament an update of the medium term plan, which will be more in line with the annual budget to be approved for the next year. If we also take into account the obligation of the Greek government to submit an update of the Stability and Growth Programme to the European Commission every December, one starts wondering about the degree of commitment to and binding power of “rolling” medium-term targets.

Given the mounting level of public debt, one would expect draconian measures to be introduced regarding public borrowing procedures for all levels of general government. The new Law indeed envisages such procedures regarding the financing of the State budget (i.e. central government). The discretion left to

other levels of general government (for example local authorities) regarding both levels of borrowing and borrowing procedures is inexplicably large and rather worrying.<sup>11</sup>

One of the apparent intended aims of the new Law is to introduce accruals accounting. In general, reporting on an accruals basis implies that revenues are recorded when they are “earned” (verified), while expenditures are recorded when they are incurred. Several developed countries (e.g. the United States, France, the UK, Australia and New Zealand) have opted for such an accounting system for their government accounts, with a view of making the cost of government action and the impact of commitments more transparent and to improve the decision making process (Blöndal, 2003, Khan and Mayes, 2009). In the Greek case, a kind of accruals accounting is introduced for public revenues, since the budget of a certain year will include revenues verified within this year or verified, but not cashed, in the previous year. Strict accruals accounting would not allow the transfer of the latter kind of revenues. In case verified revenues are not cashed within the budget year, the possibility is open for negative surprises at the end of the year regarding the size of the budget deficit. Furthermore, one cannot see why accruals accounting is not introduced for public expenditure as well.

Despite the above points of criticism, the importance of the Law 3871 should not be underestimated. It could be the starting point of a radical reform in

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<sup>11</sup> The Minister of Interior Decentralization and E-Government announced in late January 2011 that a series of measures will be endorsed for containing local government debt, once the recording of the financial position of municipalities has been finalized by end February 2011.

public financial management in Greece. Whether this will indeed be the case depends on a number of factors. As international experience shows, any reforms in fiscal governance are foremost political processes, and not just technical ones. They have to be based on realistic timescales, need country ownership and political commitment and, most importantly, they should be in line with a country's historical, political and social heritage.

#### *4.2. Tax reform and tax administration*

The large revenue shortfalls identified in section 3 can at least partly be attributed to the poor performance of tax administration mechanisms in Greece and the related problem of widespread tax evasion.<sup>12</sup> Most Greek governments, in the recent past, have acknowledged this issue and announced their firm intention to address it, mainly through adopting new pieces of legislation that would supposedly enhance revenue collection and intensify tax controls. The numerous tax reforms introduced year by year involved mainly changes of tax bases and tax rates, while the structural weaknesses of the tax and tax administration systems remained intact.

The recent fiscal crisis spurred renewed interest in the aim of containing tax evasion, as an effective way of raising tax revenue and spreading the costs of fiscal adjustment fairly. Over the last months, the government has announced a series of measures involving increases in tax rates on the one hand, and ways of

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<sup>12</sup> For a recent attempt to estimate its extent, see Mylonas et al (2010).

combating tax evasion on the other, including intensified tax controls and lifting bank secrecy. In general the adopted measures aiming at the containment of tax evasion are in the right direction, but a more ambitious approach is necessary in order to address the weaknesses of the institutional framework of the tax system and tax administration mechanism.<sup>13</sup>

The importance of tax administration in the proper functioning of any tax system has long been recognized. The main mandate of tax administration mechanisms is the enforcement of tax laws, which are indeed extensive in their range and nature, involve many persons and businesses and result in the collection of a vast bulk of revenues needed to support the state (Crandall, 2010). In this respect, the effectiveness, efficiency, fairness and impartiality of revenue collection mechanisms are key ingredients of a good tax system. In Bird's (2004) terms, effectiveness requires establishing an environment in which citizens are induced to comply with tax laws voluntarily, while efficiency requires that this task be performed at minimum cost to the community.

As perhaps expected, there is no single set of prescriptions that, once introduced, will automatically ensure improved tax administration in any country. Nevertheless, certain aspects seem to characterize good tax administration systems (Bird, 2004 and 2008). First, a tax administration must have adequate resources in terms of manpower, infrastructure and an

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<sup>13</sup> For a recent insightful view on the weaknesses and ways of improving the tax administration mechanism in Greece, see Bank of Greece (2010), pp. 170-181.

appropriate organizational structure. Second, a tax administration needs an information system to ascertain the existing and potential tax base, including the collection of information from potential taxpayers themselves, from third parties, and from internal sources of the tax administration through an internal communication system. Third, a tax administration needs a system of penalties for non-complying taxpayers, where the structure, severity and coverage of penalties are carefully planned, and perhaps also a system of rewards for complying taxpayers. Fourth, a tax administration must select strategies and set out administrative rules to counter each type of non-compliance by different groups of taxpayers. Finally, since no tax administration is flawless, provision must be made to redress mistakes, aiming at both redressing taxpayer grievances (appeals, administrative remedies, ombudsmen), and identifying and correct (or prevent) errors by the tax administration (internal reviews, inspection and anti-corruption).

Based on this set of principles and also taking into account international experience, as well as the features of the Greek reality, an approach aimed at improving tax administration in Greece could indicatively (though not exhaustively) include the following:<sup>14</sup>

1. Reorganising and consolidating tax administration offices and appointing members of staff on the basis of meritocracy and not party affiliation criteria. Giving more autonomy to tax administration by, e.g. appointing a

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<sup>14</sup> For a more detailed analysis, see Rapanos and Kaplanoglou (forthcoming).

permanent undersecretary as its head with a term of office exceeding the electoral cycle could enhance its effectiveness.<sup>15</sup>

2. Simplifying and rationalizing the entire tax system. It is not possible to address issues of enhancing the efficiency of tax administration without taking into account both the degree of complexity of the tax structure and the extent to which this structure remains stable over time.<sup>16</sup> Tax provisions are currently scattered in numerous pieces of legislation, complicating the task of tax auditors and tax payers alike. Tax provisions should be encoded in one body that the Ministry of Finance would upload and continuously update on its website.
3. Radically changing the tax audit system. Tax audits should be organized on the basis of centralized controls that identify individuals or enterprises with high risk of evasion. This method should replace the current enormous discretion of individual tax officers which creates incentives for corruption.
4. Stopping resort to “tax amnesties”. In theory a tax amnesty could be effective if it is given to wipe off old offences in order to launch a new era of tough tax enforcement. International evidence shows that *repeated* tax amnesties generally signal that the government is unable to enforce taxes effectively. Such policies have been proved common in Greece whenever revenue receipts fell short of targets, have worked clearly for the benefit of those who evade taxes and have created strong incentives for tax evasion.

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<sup>15</sup> There are several studies on the various aspects of autonomy in tax administration and on the international experience regarding the ways to improve the effectiveness of tax administration, see e.g. Crandall (2010), Kidd and Crandall (2006), Kidd (2010).

<sup>16</sup> Complexity and its implications for tax administration has long been an issue of concern in many developed countries, see for example IRS (1988).

5. Creating an effective dispute resolution mechanism, so that resort to tax courts becomes the last solution.
6. Improving the efficiency of the judicial system. Currently revenues worth millions of Euros are blocked in courts for several years until decisions are taken. Tax courts should make decisions in a speedier manner.
7. Aligning tax audit practices with those of other OECD countries for the purpose of tackling new forms of tax evasion in a globalised setting.

Reforming tax administration is not a short-term exercise, and quickly increasing the tax take through more vigorous collection efforts does not guarantee sustainable improvement.<sup>17</sup> Improving tax administration is rather a long-term game of building up adequate domestic institutional capacity, while the chances of success rest with a number of factors, such as a clear recognition at high political levels of the importance of this task and the cultivation of a higher level of trust between the citizens and the government. The latter could certainly be reinforced in the case of Greece, if taxpayers were viewed by the tax authorities as “clients”, who are not necessarily willing ones but whose needs must be met, and not simply thieves to be caught. Last but not least, such trust could be gained if the soundness and perceived fairness of public expenditures that tax revenues finance also increased.

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<sup>17</sup> The example of Argentina is particularly interesting, where better tax administration increased revenues markedly (from 13 to 23 percent of GDP over the 1989-92 period. However, this increase was not sustained over time since political pressures soon offset the increase in the tax ratio (Martinez-Vasquez, 2001).

#### *4.3. The Greek Parliamentary Budget Office: can it be a success story?*

Another element of a domestic fiscal framework that could be conducive to fiscal discipline is the establishment of non-partisan public bodies acting in the field of budgetary policy. In fact, the idea of independent fiscal councils acting as “national watchdogs” has started gaining ground as a way of institutionally strengthening domestic fiscal frameworks (see van Riet, 2010 and European Commission, 2009b). The successful delegation of monetary policy to independent central banks led some authors to propose the setting-up of independent fiscal policy councils (Eichengreen et al, 1999, Calmfors, 2003, Wyplosz, 2002, 2005). The delegation of fiscal policy to an independent council does pose a number of serious problems (Wyplosz, 2008, Debrun et al, 2009), but in practice independent fiscal councils have been established in a growing number of countries, perhaps the most recent example being the formation of the UK Office for Budget Responsibility last May. The precise mandate of such councils varies considerably across countries (see European Commission, 2009b), yet none is responsible for the conduct of fiscal policy.

More specifically, most independent fiscal councils in operation today perform, at least, three core functions. First, they produce independent economic forecasts, on which forecasts on fiscal aggregates are based. In fact, in some countries (for example Austria, the Netherlands and Belgium), the macroeconomic forecasts produced by fiscal councils are binding for the government’s budget planning process. Second, they analyse and assess the forecasts on public revenue and expenditure, and highlight possible risks of

deviation from the targets set by the government itself in the budget (Calmfors, 2010a, Chote et al, 2010). Third, they monitor the budget implementation process throughout the year, and provide relevant information and statistical data at regular intervals.

The precise scope and type of activities vary among countries, depending on each country's institutional framework, historical evolution, challenges to be met and, not least, on the resources and personnel devoted to the council. Such activities may include, for example, the assessment of policies over a short- and medium- term horizon, the examination of the long-run sustainability of public finances, institutional analysis of specific sectors, cost-benefit analysis of public infrastructure projects, etc.

Just to cite a few examples, the oldest fiscal council is the Central Planning Bureau (CPB) in the Netherlands, which has provided governments and political parties with independent opinions and analyses since 1945. It employs around 150 staff members and has a really broad scope of activities. Its reports and studies are widely accepted and constitute points of reference in public debates. The Congressional Budget Office (CBO) in the US is an independent authority that reports to US Congress. It has the highest number of staff members (around 235) and its primary objective is to provide the Congress Members with quantitative and qualitative information regarding proposed policies. In the case of Belgium, the country's transformation into a federal state raised concerns that budgetary stability would be jeopardized due to lack

of coordination among the various levels of government. The Belgian fiscal council (the High Council of Finance), in addition to its other activities, plays an important coordinating role, setting medium-term targets for the budget of the central government and of the regions. In Chile, the role of the independent advisory committee (ACRCP) is to provide, among other things, forecasts on the potential level of world copper prices, which determine a sizable part of public revenues.

Similar councils have been recently established in other countries as well, e.g. Sweden, Hungary and Canada, while the most recent example is the Office for Budget Responsibility (OBR) in the UK, which was formed in May 2010 with the mandate to make independent assessments of the public finances and the economy.

Through the above functions, an independent fiscal council aims to safeguard a high level of economic policy discussion by ensuring that policies are explained and motivated in a proper way and that they are based on sound analytical foundations. It contributes to fiscal transparency and accountability, strengthens democratic control and raises the political cost of “bad policies” in terms of credibility of the policymakers.

However, the setting-up of an independent fiscal authority does not automatically imply that its role will be played effectively. The experience of countries where such councils do act effectively shows that establishing and maintaining an independent research unit that provides objective budgetary

information and exerts peer pressure in the formation of fiscal policies is an important challenge. It seems that certain fundamental characteristics must be present in order for the council to be successful.

Foremost is its independence from the government, all political parties and any pressure groups, that is its nonpartisan character. As Anderson (2009) stresses, “‘nonpartisan’ is much different from ‘bipartisan’: the former connotes lack of political affiliation; the latter connotes affiliation with both (or all) political parties.” It is, therefore, of critical importance the members of the independent fiscal council to be appointed on the basis of their merit and professional capability, and not in a way that satisfies the political parties that will be called to appoint these members, in an effort to seek a bipartisan equilibrium. If the composition of the independent fiscal council turns out to be the result of a political compromise, its effectiveness and credibility will be seriously undermined from the very outset (Rapanos, 2010). To cite a recent example, the appointment of Robert Chote as the new Chair of the Office for Budget Responsibility in the UK in October 2010 was justified on the grounds that “he is very well qualified professionally for the post, having demonstrated his independence of mind and expertise during his time at the Institute for Fiscal Studies” (UK Parliament, 2010). In order to further enhance the independence of the PBO, one of its members could be a public finance expert from abroad, as is the case with e.g. the Swedish Fiscal Policy Council. Another parameter that contributes to the actual independence of a fiscal council relates to the duration of its members’ mandate. It is advisable for this duration to exceed the

government's term of office. In several countries it has been set to 5 years, and council members can only be replaced in case of a serious breach of their duties. Their dates of appointment could be different, so as for their terms not to expire simultaneously.

A further issue relates to where the fiscal council is accountable to and its sources of financing. The practice followed in other countries is not universal. In some countries (e.g. the US and Canada) the council reports to parliament (Congress); in others it operates under the Ministry of Finance (e.g. the Netherlands, Chile); while in certain others it reports to government (Sweden) or is a totally independent authority. In the case of countries with powerful single-party governments that enjoy absolute control over budget preparation and implementation, placing the independent fiscal council under the auspices of the parliament is a rather appropriate choice (see Anderson, 2009, Schmidt-Hebbel, 2010). As regards the financing of the council, in other countries this is usually covered by government or parliament funds, while a small fraction is offered by the private sector. Financing an authority with funds from the government, the policies of which this authority is called to transparently and objectively assess, could potentially be a problem. In practise, however, reducing the funds available to the council as a result of its criticism is rarely attempted since it entails a huge political cost for the government, exactly because such actions are widely publicised.

A connected issue relates to the recruitment of specialised and properly trained personnel for the council. The number of people supporting the work of fiscal councils varies significantly across countries, from 4 people in Sweden to roughly 250 people in the US (CBO), and the scope of activities these councils can undertake is of course conditional on that number. Regardless of their precise number, strong professional leadership and high quality analytical staff are a key aspect (Rivlin, 2010).

A final issue of critical importance for a fiscal council to gain credibility for its assessments is to make all of its reports and analyses available to the public and the press, and try hard to make them clear and readable to all. Enhancing the transparency in the conduct of fiscal policy is possible, only when information is disseminated, accessible and understandable to all, and not just to a small number of technocrats or to the members of parliament. This has been the case with all active independent fiscal councils, which have managed to build up the reputation of providing reliable assessments, and of being truly independent and unbiased.

Perhaps the best blueprint for an effective independent fiscal council is given by Alice Rivlin, the first director of the Congressional Budget Office of the U.S.. She eloquently identifies four aspects on which the acceptance of CBO by the political players rests (Rivlin, 2010):

1. It has had strong professional leadership and attracted high quality analytical staff.

2. It has been aggressively non-partisan and never allowed politicians to appoint members of staff.
3. It never makes recommendations on policy matters, but offers estimates of budgetary costs or analysis of options and alternatives. It has always tried to help politicians evaluate their choices and steadfastly refused to tell them how to choose.
4. It makes all of its reports and analyses available to the public and the press and tries hard to make them clear and readable.

In Greece, in July 2010, the government submitted to Parliament a Draft Bill, which envisages the establishment of a Parliamentary Budget Office under the aegis of the Parliament. Establishing such an office is with little doubt a move in the right direction. What Greece lacks today is credibility, not only in its fiscal policy but also in the quality of its fiscal data. Rebuilding confidence is a long process and the Parliamentary Budget Office could play the role of a catalyst in this process. But what are its chances of doing so?<sup>18</sup>

According to the legal provisions, the Greek Parliamentary Budget Office administratively belongs to the Secretary General of the Parliament and submits its reports to the Special Standing Committee responsible for examining the Financial Statement and the General Balance Sheet of the State.<sup>19</sup> Its mandate is defined rather generally as “collecting information on the State Budget, classifying it in a systematic way, and providing general support

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<sup>18</sup> For a review of the rationale for setting up and the possible role of a Parliamentary Budget Office in the Greek context, see Rapanos and Kaplanoglou (2010).

<sup>19</sup> This committee is a sub-Committee of the Standing Committee on Economic Affairs.

to the Parliament work". The Ministry of Finance and other government agencies are required to provide all necessary data. The Parliament is responsible for financing the Office, which will be staffed by 10 members in total with university or high school education.

Financing the parliamentary budget office with funds from the Parliament's own budget (approved only by the Parliament itself and not by the Ministry of Finance) and placing it under the auspices of the Parliament are right choices in the case of Greece, because the legislature can now potentially be on a more equal footing with the executive branch.

However, the prospects for this office to effectively fulfil its intended goals are not favourable. First of all, its mandate appears rather poor and imprecise. Most importantly, the key requirement for wide publicity of the office's reports is not met. If the office's reports are accessible only to Members of Parliament, the amount of peer pressure to the executive branch does not increase, and hence fiscal transparency is not enhanced. The structure of the office is not clear, neither is the way the staff members will be appointed, while the impression is given that high professional skills, experience and competence, are not an evident requirement. Terms of appointment are not specified and the non-partisan character of the Office's leadership is also under question. Evaluating the design of the Greek PBO in terms of Rivlin's four points, one feels that it does not score high in any single one of them.

The above criticism is not meant to imply that the Office is doomed to fail. The legal provisions for the creation of the Office do allow sufficient flexibility, for its effectiveness to be enhanced. The choice of a chairman with high professional qualification and independence of mind, the recruitment of competent staff, the specification of the core functions to be performed along the lines described earlier and the accessibility by all to the Office's analyses are profoundly issues of critical importance. All these, however, remain to be seen in practice.

## **5. Conclusions**

The activist fiscal policies in response to the recent financial crisis and the deep recession, and the serious fiscal imbalances now facing many countries, including those of the euro area, suggest that the mechanisms for ensuring fiscal discipline face new challenges. A broad consensus has emerged that the domestic institutional settings of a country are of primary importance for the conduct of sound fiscal policies, since such settings create the environment, the incentives and the constraints under which fiscal policy decisions are taken. Thus, recent discussion on fiscal governance has focused on precisely how domestic fiscal frameworks can be institutionally strengthened.

Greece is a prime example of how poor fiscal governance, if combined with other negative factors such as the instability of global financial markets, can indeed lead an economy to the brink of financial collapse and at the same time

create a systemic problem for a common-currency area as a whole. In the case of Greece, as well as of quite a few other European countries, primary public deficits and a high level of public debt are likely to persist for a long period of time. So is the skepticism of world financial markets and, thus, an even distant threat of default. In such an environment, the adoption of fiscal consolidation packages that will reduce the size of the public deficit is simply inadequate, unless institutional mechanisms that will enhance commitment to credible, sustainable and growth-enhancing long-run fiscal plans are also put in place.

As our research has shown for Greece, the accumulation of public deficits appears to have been a choice of governments, rather than the unfortunate result of macroeconomic conditions turning out less favourably than expected. At the same time, there were no mechanisms in place, either internal or external, that would effectively pinpoint the systematic deviations of public revenues and expenditures from the targets set, and act on their containment. In this respect, the fundamental reason underlying poor fiscal performance in Greece has been weak fiscal institutions and inadequate public financial management. Thus, unless serious effort is directed towards increasing the effectiveness of such institutions and in strengthening public financial management at all levels of government, Greece runs the danger of seeing the fruits of the very painful fiscal effort undertaken being wasted once the severity of the present situation has been hopefully overcome in a few years time.

The news is not all bad. There is a growing accumulation of both theoretical studies and practical experience of countries around the world which have faced in the past or are currently facing similar challenges. The importance of certain elements of sound fiscal governance like national fiscal rules or well structured budgetary procedures, seems to have been established beyond much doubt. The optimal balance between different forms of fiscal restraints, e.g. rules versus fiscal councils, is still a matter of ongoing debate (see Krogstrup and Wyplosz, 2007, and Debrun and Kumar, 2007, Hagemann, 2010, Calmfors, 2010b), and as perhaps expected a “one size fits all” approach is an unavailable luxury. Furthermore, Greece appears to be in such an embryonic stage regarding almost all aspects of fiscal governance, that the potential gains to be yielded from a serious reform of the national fiscal framework along the lines proposed in this paper are indeed large. Such gains do not simply refer to the arithmetic reduction of the fiscal deficit, but range from promoting a fair distribution of the tax burden through the effective tackling of tax evasion to enhancing economic growth through addressing issues of the quality of public finances.

The need for reforming public financial management in Greece seems to have been realized by Greek authorities and to have been highly prioritized by the international organizations surveilling the Greek economy. The first steps have been done, but a lot more is still under question and remains to be seen in practice. Over the longer run, effective budget procedures do not necessarily assure sound policies, unless they reflect a broader political will for fiscal

discipline. Many countries in the past have engaged in the modernization of their budget systems, yet seem to lack fiscal discipline. Therefore, improving budget procedures is not sufficient on its own to alleviate deeply rooted problems.

As Pretorius and Pretorius (2008) note, the successful implementation of such institutional reforms requires high-level political commitment and public support. From a political economy perspective, Greece's record on both has been particularly low in the past. Under the present situation political commitment is at least in the medium term strengthened by the commitments the government has undertaken vis-à-vis the three international organizations, but is an open bet after these organizations will stop their surveillance. Regarding public support, in our view it can be built up only if the public is convinced that the burden of fiscal adjustment will be spread fairly and that this adjustment will not seriously hamper the growth prospects of the economy and destroy social cohesion.

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