

# **Solutions to the Debt Crisis in the EU from the Slovak Perspective<sup>1</sup>**

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According to the debt database of the International Monetary Fund, the average gross public debt of five peripheral countries of the EU – Portugal, Italy, Ireland, Greece and Spain – rose from 26 per cent of GDP in 1973 to 85 per cent in 1995. Then it fell to 68 per cent in 2007 and shot up to 130 per cent in 2013. Similar pattern is visible for the group of seven richest economies and well developed democracies – France, Canada, Germany, Italy, Japan, United Kingdom and United States. The average gross public debt for these countries was growing continuously from 34 per cent of GDP in 1973 to 120 per cent of GDP in 2013. Thus, it already surpassed the debt peak of 116 per cent of GDP after World War I and moves ever closer to the record level of 145 per cent of GDP after World War II. If we exclude Japan, which is by far the most indebted developed country, the average public debt of remaining six giants rose from 37 per cent of GDP in 1974 to 78 per cent in 1996, then fell to 68 per cent in 2007 and exploded to almost 100 per cent in 2013.

It is important to note that the public debt in most of the richest economies and well developed democracies was growing or at least did not decline sufficiently even in peaceful times with strong economic growth. Why?

The root cause is that the public has not been fully aware of the threats associated with a public debt rising too high. This has led to higher tolerance of debt increases (which was fueled also by inappropriate lower risk-rating for many especially peripheral countries entering the Eurozone) and lower pressure on politicians to behave responsibly. People in democratic elections many times refuse to vote for politicians who are willing to adapt necessary but often painful reforms. More successful are politicians who simply exchange generous promises for higher public debt. We have the same experience in Slovakia.

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Source: Debt Database of the International Monetary Fund (arithmetic average for France, Canada, Germany, Italy, Japan, United States and United Kingdom)

We should concentrate on the public education in order to solve this problem. People should better understand the risks associated with too high debts and view politicians more critically. The formal debt brakes and budget councils guarding public debt are also important. The risk is, however, that if ordinary people do not change their thinking, irresponsible politicians would eventually warp even good rules and institutions. As a result we would move closer to spontaneous and more painful balance striking which has already become reality in some of the peripheral EU members.

### Monetary versus Fiscal Union

By entering monetary union, the country loses its traditional tools for monetary policy such as the ability to change interest rates or to influence currency exchange rate by interventions of its central bank. To solve potential macroeconomic imbalances, the country has to cope with its fiscal policy which involves mainly changing taxes and public expenses. Alternatively, it has to rely on fiscal transfers from other members of monetary union forced either by markets or by regulations.

The Eurozone was built as a monetary union with limited fiscal transfers from cohesion and structural funds. It did not assume massive fiscal transfers enabling to solve macroeconomic

imbalances of particular members. However, the economic integration fueled by common currency intensified to the level, that macroeconomic problems of one member imposed high risks for others. This was a case of Greece asking for financial aid from other members in 2010 and later followed by Ireland, Portugal, Spain and Cyprus. Suddenly, massive financial transfers (mostly in form of guarantees of government debt) among members of the Eurozone became reality.

The main lesson to be learnt is that deeper economic integration among members of monetary union requires deeper fiscal union. Deeper fiscal union means financing standard fiscal expenses from the common budget. The use of cohesion and structural funds should reflect this new reality. It would be better to allow using those funds to pay for expenses typical for any fiscal union including national states. For example, the Eurozone members should be allowed to use money from cohesion and structural funds to pay their contributions to the European stability mechanisms instead of pouring money into projects with questionable and often non-measurable rate of return.

In the long run, the fiscal union will probably deepen beyond safety transfers. For example, greater mobility of labor force means that people educated in one country may easily find job and move to another country. Thus, their home country would pay for their education but it would not collect taxes they pay in the host country. Within national states similar problem appears when people move from countryside to urban areas. Generally accepted solution is that the state compensates the countryside by transfers from the state budget, for example by funding the teachers' wages. Otherwise, the countryside would not be able to pay for good teachers and children born in remote areas would have poor education. Sooner or later, the same solution has to be applied within economically integrated monetary union. Even now it would be better to allow using cohesion and structural funds this way.

The fiscal union should not be restricted to fiscal transfers. Equally important are the rules that would guard public finances of particular members and prevent them from macroeconomic imbalances. The Stability and Growth Pact was designed to meet this purpose. Unfortunately it proved to be too weak and circumvented too often. It is important that the new Fiscal Compact serves its purpose better. In longer term it will probably be necessary to go even further and centralize some competencies of the national ministries of finance especially with respect to constituting and controlling the public budgets.

## **Slovakia attitudes to Eurozone bailouts**

The decisions about Eurozone bailouts and introduction of safety mechanisms aroused intense public discourse in Slovakia and even led to the fall of the government and preliminary elections. Here is a brief timetable of key developments:

8 May 2010: The government coalition led by the strongest social democratic party SMER and its chairman and prime minister Robert Fico approved a loan to Greece in the amount of EUR 818 million (1.24 per cent of GDP) and commissioned the minister of finance (nominated by SMER) to sign a framework contract with Greece. The same day minister signed the contract arguing that "In this case it is not about Greece, it is about Eurozone stability". However, this was not a definite decision. The validity of contract was conditional upon the parliament ratification. The voting was postponed to the new parliament which would be constituted after upcoming elections. This loan should have become a part of the first safety program for Greece based on bilateral agreements between Greece and Eurozone member countries. The final overall amount of this bailout was EUR 110 billion of which EUR 80 billion were bilateral agreements and EUR 30 billion were loans from the International Monetary Fund.

12 June 2010: The parliamentary elections took place. Despite winning the left-wing SMER went to opposition. Four right-wing parties had majority and agreed to form a government coalition.

11 August 2010: The parliament did not ratify the framework contract with Greece. Three out of four right-wing parties voted against it and members of parliament from SMER did not participate in the vote. Thus Slovakia became the only Eurozone country that refused to participate in the first bailout of Greece. The prime minister Iveta Radičová gave the following reasons: "The more responsible, poorer [countries] should not be raising money for the less responsible, richer ones." She also quoted "moral hazard" meaning that if others see that the country in problems receives financial support there is greater risk that they will not do their best to avoid similar problems. Another argument was about "privatization of profits and nationalization of losses", pointing to the reservation that the financial burden would have to be taken only by taxpayers and not also by private creditors, most of them banks, that had been profiting on loans given to Greece.

11 August 2010: Immediately after refusing the bilateral contract with Greece, the parliament approved guarantees in the amount of EUR 4.4 billion (6.7 per cent of GDP) as part of the European Financial Stability Facility – EFSF. All parties voted for this proposal. The overall amount of guarantees from all member states reached EUR 440 billion.

11 October 2011: The parliament did not approve the expansion of the EFSF from EUR 440 billion to EUR 780 billion. At that moment, Slovakia was the only Eurozone country that refused the expansion. In effort to gain support for the proposal, the prime minister Iveta Radičová joined this voting with the vote of confidence in her government. This did not help and the vote resulted in the fall of the government. Among the four coalition members the liberal party Freedom and Solidarity (SaS) declined to vote for the proposal. The party members led by their chairman Richard Sulík argued that the poorest countries should not fund those substantially richer neither the banks. Other three coalition members were reasoning that in this case it is not about particular countries but about saving the common currency and the EU. Parliament members from the opposition SMER did not participate in the vote and thus facilitated the government fall and preliminary elections.

13 October 2011: In a repeated vote, the parliament approved the expansion of the EFSF from EUR 440 billion to EUR 780 billion. The Slovak guarantees increased from EUR 4.4 billion (6.7 per cent of GDP) to EUR 7.7 billion (11.7 per cent of GDP). The positive vote was enabled thanks to the parliamentary members from SMER who, after assuring that the preliminary elections would take place, voted for the proposal together with three right-wing coalition parties.

10 March 2012: Preliminary parliamentary elections took place. The left-wing SMER gained majority and formed a single party government.

22 June 2012: The parliament approved the constitution of the European Stability Mechanism – ESM that replaced the EFSF. Slovakia agreed to contribute EUR 5.77 billion (8.8 per cent of GDP) out of which EUR 0.66 billion was in cash transfers. The proposal was approved by the government party SMER and three right-wing opposition parties.

18 December 2012: The parliament approved the EU Fiscal Compact by votes of all parties.

Based on parliament decisions, Slovakia takes part in all safety programs implemented in Eurozone with the exception of the first Greek bailout. The failed vote on the expansion of the EFSF and consequent fall of the right-wing government in 2011 caused a deep rift between Richard Sulík's SaS and other three right-wing parties. Iveta Radičová left her mother party SDKÚ (Christian democrats) and withdrew from politics. The left-wing SMER benefited the most from the political instability. After preliminary elections SMER took the government and its chairman Robert Fico became a prime minister. Mr. Fico is often regarded as a populist politician in Slovakia but he declares pro-European attitudes and interest in deeper integration within the EU even at the cost of partial loss of national

sovereignty. He supports opinion that the solution to the debt crisis is not austerity but stronger economic growth ignited by more intense public investment.

### **Slovak economists' attitudes to Eurozone bailouts**

In November 2012 INEKO carried out a survey among local economists about debt crisis in the EU and its solutions. The aim was to support expert discussion about the crisis. By that time the public discourse was restricted to two strongly opposed positions presented mostly by politicians: Either we should help countries in problems or we should refuse it. Little attention was paid to searching for alternative ways of solving the crisis and to specifying conditions imposed on indebted countries. In the survey we also asked what economists think about the amount of the loans that will be repaid by particular countries. We also asked them whether it should only be Eurozone countries that should participate in the safety programs or other EU members should be included as well. We received answers from 12 local economists mostly from banks and non-governmental organizations.

*Question 1: What do you think how much of financial aid provided to particular country will be paid back?*

Countries benefiting from safety programs	Expected	
	Average	Median
Greece, first package (Slovakia did not participate)	37%	30%
Greece, second package	48%	50%
Ireland	92%	100%
Portugal	75%	78%
Spain	79%	100%
Slovenia (did not ask for assistance yet)	84%	100%
Cyprus	59%	65%

*Source: INEKO survey among 12 Slovak economists, November 2012*

The survey showed clearly that Slovak economic analysts did not anticipate full recovery of the loans provided to indebted countries. Looking at median answers, they expected only Ireland, Spain and Slovenia to repay all the loans. The loans to Greece from the first safety program would suffer the biggest haircut (bilateral agreements that Slovakia refused to take part on) from which only 30% would be paid back to the lenders. The loans provided under the second Greek bailout would suffer 50 per cent haircut. Portugal and Cyprus would recover just 78 per cent and 65 per cent of loans respectively.

The message is clear. We know that we are not going to get all the money back. By now we have seen a controlled haircut of the Greek debt (private creditors lost 75 per cent of their claims early in 2012) and extensions of the loan rescue mechanisms by seven years for both, Portugal and Ireland in 2013. But at least according to our survey more haircuts are yet to come. The key question is if we had some other alternative that would mean lower costs to countries providing financial assistance and what should we do to recover the most of the loans.

*Question 2: Which of the following steps should/would the EU institutions take regarding the extremely indebted members?*

Possible steps the EU should/would take	Should	Would
Exclusion from the Eurozone	10%	0%
Staying in the Eurozone		
without any support	10%	0%
<b>and providing support conditioned on stabilizing measures</b>	<b>45%</b>	<b>45%</b>
and providing unconditional support	0%	5%
and solving problem by ECB: quantitative easing	3%	20%
and solving problem by ECB: purchasing govt. debt with sterilization	5%	20%

*Source: INEKO survey among 12 Slovak economists, November 2012, the table shows median values*

The table shows that according to Slovak economists the best solution to the crises is providing support to indebted countries conditioned on implementation of stabilizing

measures. From among other alternatives they think that the European Central Bank – ECB will play a major role in solving the crises either via quantitative easing or via purchasing government bonds with full sterilization known also as Outright Monetary Transactions – OMT.

Here is a comment by one of respondents, Martin Senkovič, who works as an economic analyst at the biggest Slovak refinery Slovnaft: “Help should be conditional without a doubt. Indebted economies have to regain their competitiveness via internal reform, reduction in salaries, various state benefits, reducing government spending, privatization and so on, so that these countries become attractive to the investors who bring work opportunities as well as export markets. Assistance through the ECB should be limited to situations where the threats of disruption of markets, interbank lending freeze, enormous speculative rise in bond yields (despite efforts to reform) and massive cash withdrawals from banks by households are a real possibility. Buying bonds should be conditioned on recovery measures in the country and the delivered liquidity should be neutralized through sterilization.”

The analysts declared much less preference to alternatives that would refuse any support to indebted countries including their exclusion from the Eurozone. As they explained in commentaries such solutions would cause uncontrolled bankruptcy of indebted countries possibly leading to Eurozone breakdown with severe negative consequences on all members of the EU.

Thus the sense of providing financial assistance to indebted countries is to avoid uncontrolled bankruptcy and resulting chaos. We should regard the financial help as an investment that has its own rate of return. Similarly to bankruptcies in the private sector, creditors often have to give up part of their claims in order to preserve healthy parts of the bankrupt firm. It is in their interest (and in the interest of broader society) to recover most of their claims and to make the firm healthier in order to conclude future contracts. In other words by writing off part of their claims creditors in fact invest into the bankrupt firm and, after recovery, they collect remaining claims and profit on future contracts, i.e. they search to maximize the rate of return on that investment.

The philosophy of the private and the public bankruptcy is the same. The question is how to make sure that the creditors get the highest possible return on their investment. In the private sector the bankrupt firm has to meet certain conditions agreed by creditors such as caps on expenditures, employee dismissals, changes in product portfolio and cost cuts. In the same way, creditor countries can influence the rate of return by controlling the



conditions that the indebted countries should fulfill to regain competitiveness and by enforcing the implementation of those conditions.

*Question 3: In case of providing conditional support what stabilizing measures should/would the EU institutions require from indebted countries?*

Possible stabilizing measures the EU should/would require	Should	Would
Cutting public expenditure	23%	10%
Increasing public revenues by higher taxes on labor	0%	5%
Increasing public revenues by higher indirect taxes	3%	10%
Increasing public revenues by higher property taxes	4%	10%
Creating the banking union	0%	15%
<b>Implementing structural reforms (more flexible labor code, higher pension age, higher fees in healthcare and tertiary education, more transparent public procurement, etc.)</b>	<b>33%</b>	<b>15%</b>
Privatization	13%	10%
Stronger central supervision of public budgets of all EU members	0%	10%
Stronger central supervision of public budgets of EU members with excessive public finance deficit	10%	10%

*Source: INEKO survey among 12 Slovak economists, November 2012, the table shows median values*

According to the survey the financial support provided to indebted countries should be conditioned on structural reforms such as introduction of more flexible labor code, higher pension age, higher fees in healthcare and tertiary education, and more transparent public procurement. The conditions should include cuts in public expenditure and privatization. The EU should also introduce stronger central supervision of public budgets of countries with excessive public finance deficit. On the other hand, the indebted countries should not be

required to raise taxes on labor. In case the EU decides to raise taxes, it should prefer indirect and property taxes.

Interestingly, Slovak economists expect that the actual conditions will put lower emphasis on structural reforms and austerity compared to their desire. Instead they expect greater emphasis on increasing taxes and creating the banking union.

*Question 4: Who should help indebted countries, members of the Eurozone only or members of the whole EU?*

Who should help?	Answers
Members of the Eurozone	50%
Members of the whole EU	50%

*Source: INEKO survey among 12 Slovak economists, November 2012*

The survey showed exact split among economists considering whether only Eurozone countries should participate in the safety programs or other EU members should also be included. Arguments in favor of the first option mentioned that the aim of safety programs is to save the Euro as a common currency and therefore it is in vital interest of countries using Euro. Arguments in favor of the second option mentioned that due to deep economic integration, the spontaneous bankruptcy of indebted members and potential breakdown of the Eurozone would harm all EU members in the same way regardless of their currency.

This question is especially sensitive for Slovakia because all other members of Visegrad 4 countries, i.e. Czech Republic, Hungary and Poland use their own currency and do not have to participate in European stability mechanisms EFSF and ESM. Thus they do not have to bear financial burden of these mechanisms. The same is valid for Finland which is the only participating Scandinavian country.

Here is another comment by Martin Senkovič from the Slovnaft refinery: "All the states of the Union should participate in the assistance, while "sinners" should temporarily lose some of the voting power in the bodies of the Union. EU countries that have (so far) retained their own currency would also significantly lose on the collapse of the Eurozone. The euro area is a good idea that can bring together some 500 million Europeans in the strongest and most

influential union in the world. The euro is also the anchor that contributes to peace in Europe. The euro currency is not the reason why some countries were in economic difficulties. Differences between countries have always been and will be present, similarly to the differences between Bratislava and the Eastern Slovakia even though we had a functioning state with one common currency. The problem arose when the indebted countries were not able to maintain their competitiveness with respect for example to Germany via keeping the domestic economy wage growth and government spending in check. The second problem was that the union did not follow the rule of thumb "trust but keep in check", and that the problems were not clearly named, not only in Greece but also in other countries that exhibited high deficits shortly after the Eurozone."

### **Austerity versus Growth dilemma**

Recently there has been an intense discussion in the EU and around the world about what should be the priority in solving current debt crisis – austerity measures (i.e. reducing budget deficit during adverse economic conditions) or supporting an economic growth. In the past several years the EU preferred tough austerity measures but faced rapid unemployment growth and recession. On the contrary, the US and Japan chose less austerity and recorded at least modest recovery. Recently, the EU has postponed the deficit reduction in several countries including France, Spain, Poland and Slovenia receiving extra two years for deficit reduction to 3 per cent of GDP and Netherlands, Belgium and Portugal receiving extra one year. The European Commission insisted that the extra time should be used to support growth by adopting structural reforms such as making the labor market more flexible and reforming the pension system. The governments should avoid debt-fueled rise in public expenditure.

The solution to the austerity versus growth dilemma is tricky because for highly indebted country neither austerity nor higher economic growth may lead to public debt reduction. The indebted country has to pay a big part of its revenues on debt service which reduces its growth potential and pushes up the budget deficit. In the short term, the austerity usually increases unemployment leading to fall in tax revenues and rise in expenditure on social benefits which has a counter-effect on both the budget deficit and the economic growth. In an economic terminology it is pro-cyclical. Thus the combination of weak growth and austerity may lead to even weaker growth or recession resulting in higher public debt-to-GDP ratio. This seems to be the case in the EU. On the other hand if the indebted government postpones austerity to support growth (and to wait for better times) it may end

up with slightly higher GDP but also with much higher debt. This happens mainly if the government runs large deficits and if it spends inefficiently. Moreover, better times might not come that soon as has been the case of several past decades in Japan or past decade in Italy. Then the result is again higher public debt-to-GDP ratio.

What other options does highly indebted country have if it wants to reduce its debt? Here are some of them:

- Sell some assets and reduce debt from the privatization revenues.
- Foster growth by implementing structural reforms and by improving the efficiency of public expenditure. This should be an essential part of solution to the EU debt crisis because it guarantees long term public finance sustainability. However, this is also a hard task because it requires implementation of unpopular measures. It is important to notice here that after implementing structural changes even the impact of austerity may be different in the long term. The unemployment does not have to rise or stay high if there is a flexible labor market. People may simply get used to work for lower salaries just as they did for centuries before. Also the social benefits do not have to rise. On the contrary they should be falling if the public revenues decline.
- Expansionary monetary policy aiming at support of economic growth. Nowadays, with almost zero interest rates this option is restricted to unconventional tools such as quantitative easing or outright monetary transactions. So far quantitative easing has been successfully applied in the US. The risk is however higher inflation and inflating bubbles as well as moral hazard, i.e. higher risk of irresponsible behavior of monetary union members whose debt would be purchased. Therefore, debt purchasing should be conditioned by implementing structural reforms and decreasing budget deficit.
- Debt mutualization among members of the monetary union for example by issuing common Eurobonds. The disadvantage is that this option spreads risks to other members and increases the risk of moral hazard. Therefore, it should not be implemented unless there is an efficient central supervision of the public finance management.
- Write off part of debt. It is important that this happens in an ordered way and that the country avoids spontaneous bankruptcy. This solution has to include a plan for bank recapitalization as the banks usually hold large part of the government debt. The disadvantage of debt write-off of one member of the monetary union is that it leads to increase of the risk premiums of all other members – as was the case after the Greek debt haircut before its second bailout.
- Exit monetary union. This option would lead to currency depreciation, high inflation and deprivation of savings. Therefore we consider it as least acceptable.

Slovakia has a strong positive experience with privatization and structural reforms. At the turn of millenniums the Slovak economy was in very bad shape. The budget deficit recorded 7.3 per cent of GDP and the economic growth fell to zero in 1999. The banking sector was overwhelmed with bad debt and nearly collapsed. To save it the government launched a large scale recapitalization of banks amounting to almost 15 per cent of GDP. As a result the public finance deficit peaked at 12.3 per cent of GDP and the public debt exceeded 50 per cent of GDP in 2000. The unemployment rate jumped to almost 20 per cent in 2001. Immediately after bank recapitalization the government launched a massive privatization of financial sector, telecom and energy industry. In 2003 it overhauled the labor code by substantial weakening of unions' power and strengthening the flexibility in employee-employer relations. In 2004 a profound tax reform cancelled numerous exemptions, introduced a single 19 per cent flat tax, and shifted the tax burden from direct to indirect taxes. In the same year the retirement age for both men and women started to prolong to 62 years. The privatization and reforms played a major role in attracting foreign investors and generating rapid economic growth that peaked at 10.5 per cent of GDP in 2007. Over the period 2000-2010 Slovakia had the highest GDP growth in the EU. Thanks to this boom, the unemployment rate fell below 10 per cent and the public debt fell below 28 per cent of GDP by 2008. This example shows clearly that the structural measures help to generate economic growth and reduce debt levels. In just one decade a country on the verge of collapse became the first in the Visegrad region to adopt the Euro as from 2009.

### **Banking union**

Many EU members suffer from recession that has been lasting for several past years. Particularly those on periphery have been hit hardly. If economy suffers, the risk of defaults on paying back the debt by firms and individuals goes up. Thus the debt portfolio of banks gets worse. Additionally, many banks in the EU are loaded with bad debt from pre-crisis investment boom and consequent burst of real estate bubbles. Ireland and Spain are the most visible examples of how big can be the scale of this problem. In Cyprus the banks collapsed mainly due to their risky investment in Greek bonds that had later been written off. The last burden to mention comes from the requirements for increasing banks' capital adequacy ratios.

This overview shows that there are many reasons why to worry about the health of European banks especially those on periphery. Their good condition is crucial for normal functioning of economy. The sick banks have usually worse access to external capital

because other financial institutions do not trust them. As a result they try to hoard deposits and are reluctant to lend money to businesses and individuals. Worse access to loans means fewer transactions and lower economic growth.

To solve this problem it is crucial to get banks healthy. Better sooner than later. First of all it is necessary to know their exact condition. Secondly the authorities should draw a plan how to get away bad debts and who should bear the costs. And thirdly it is necessary to have the financial backing for the case that all private sources have been exhausted and the bank still needs financial injection. These are three pillars of the banking union – common supervision, common resolution authority that sets up the plan for bank recapitalization and common reserve fund or deposit-guarantee scheme with public backing.

By now in the Eurozone all these functions have been performed by national states. However, the crisis has shown in Greece, Ireland, Spain and Cyprus that these states have been unable to prevent and to solve problems of their banks and the European stability mechanisms had to step in. If common funds are being used either to rescue the failing banks directly (as in Spain) or to finance governments that bailed out the banks (as in Ireland) it is logical that the need for a common banking union has become imminent.

From 2014 the ECB will take up the common supervision of bigger banks. The rules of bank recapitalization should be harmonized. Much less is clear about further steps. Will depositors bear some costs of the bank recapitalization? This has already become reality in Cyprus although only for uninsured depositors. Officials quickly denied that the same approach would be applied for other countries. The risk of bank runs was too high. But the logic is clear – why should taxpayers pay for the bank recapitalization if depositors do not bear any cost at all? The depositors take profits so they should also take some responsibility for the shape of their bank. If depositors knew they might lose some money they would be more cautious when choosing the bank. The pressure to keep a healthy banking sector would grow.

Another sensitive question is about the third pillar. Will there be some kind of common financial backing? The taxpayers from countries with healthier banks are less willing to pay for the sick banks mostly situated in peripheral countries. The risk is however that the national governments will refuse to take over bad debts of their banks in effort to avoid bankruptcy. In such a case, the banking misery in peripheral countries would drag down their economic growth for much longer which would potentially inflict the whole Eurozone. The quick resolution seems to be a better choice. However, to prevent the risk of moral hazard, any bank recapitalization from common funds should be conditional upon adopting

structural reforms in the financial sector and the economy. It should be a last resort option and not a way how to avoid Troika.

Last but not least, full implementation of the banking union should include completing a single market for banking services that would enforce their availability for customers and thus the competition among banks all over the region. Administrative barriers to enter and operate on national markets should be diminished and foreign healthy banks should have an equal opportunity to start their businesses where local ones have failed.

### **Structural changes adopted by indebted countries**

Slovakia and other Eurozone members participate in the financial aid programs to Greece, Portugal, Ireland, Spain and Cyprus. The public should therefore have information about what changes are occurring in these economies. All participating countries should actively join the discussion on what further changes are necessary for the sustainability of public finances and for strengthening their competitiveness. Transforming the overly indebted countries into competitive and prosperous economies with sustainable public finances is in fact crucial for the effective use of investment, which is in the form of financial assistance from members of the euro area, including Slovakia. The following overview contains relevant indicators of economic development in countries taking financial aid, as well as reform measures implemented by these countries as a solution to the crisis.

#### *Overview of key indicators of Eurozone countries taking financial aid*

	Greece	Portugal	Ireland	Spain	Cyprus
Financial aid agreement, year	V/2010, III/2012	V/2011	IX/2010	VII/2012	V/2013
Total aid, billion EUR	245.6	78	67.5	100 (41.4) <sup>1</sup>	10
Total aid, % of GDP	120%	46%	43%	10% (4%) <sup>1</sup>	61%
Final maturity (EFSF, ESM), year	2032-48	2025-40	2029-42	2025-27	2027-28
Average maturity	30 years	21 years	21 years	12 years	14 years
Real GDP Growth, 2013	-4.2%	-2.3%	+1.1%	-1.5%	-8.7%
Public debt, 2012, % of GDP	157%	124%	118%	84%	86%

Budget deficit, 2012, % of GDP	-10.0%	-6.4%	-7.6%	-10.6%	-6.3%
Primary deficit, 2012, % of GDP	-5.0% (-1.3%) <sup>2</sup>	-2.0% (-1.6%) <sup>2</sup>	-3.9%	-7.7% (-4.0%) <sup>2</sup>	-3.1%
Unemployment rate, 2012	24.3%	15.9%	14.7%	25.0%	11.9%
NEET rate <sup>3</sup> , 2012	20.3%	14.1%	18.7%	18.8%	16.0%

Sources: Eurostat, European Commission, EFSF, ESM, Wikipedia, INEKO calculation

<sup>1</sup> Number in brackets displays overall expected transfer if it is different from approved aid package.

<sup>2</sup> Number in brackets displays primary budget deficit (i.e. deficit net of interest payments) after subtracting one-off payments on bank recapitalization.

<sup>3</sup> NEET rate means share of young people from 15 to 24 years old who are not in employment and not in any education and training.

To show the effort of particular governments in fiscal consolidation it is useful to check the development of the structural primary balance, i.e. of the cyclically-adjusted primary (net of interest payments) balance excluding one-off and other temporary measures. The following table shows the enormous effort of Greece reducing its structural primary deficit by around 15 per cent of GDP over 2009-2012. In Portugal the reduction was almost 8 per cent of GDP in the same period, in Ireland and Spain around 6 per cent of GDP.

#### Structural primary balance

	2009	2010	2011	2012	2013	2014 (p)	2015 (p)	2016 (p)
Greece	-13.6%	-6.1%	-1.2%	+2.1%	+4.3%	+5.2%	+5.6%	+6.1%
Portugal	-6.8%	-6.9%	+0.1%	+1.0%	+0.9%	+1.8%	+2.8%	+2.9%
Ireland	-8.9%	-6.2%	-4.3%	-2.9%	-1.3%	+0.7%	+2.2%	+2.3%
Spain	-8.9%	-6.9%	-5.7%	-2.6%	-1.2%	-1.8%	-1.7%	-1.7%

Source: IMF, Fiscal Monitor, April 2013



*(e) – estimates, (p) – projections*

The next section is more technical as it offers an overview of the most important structural changes implemented by countries taking financial assistance. We focused on Greece, Portugal and Ireland where it is possible to evaluate the reform process more than two years after an agreement on financial aid.

## **Greece<sup>2</sup>**

Following the financial assistance from 2010 and 2012 Greece is committed to consolidate public finances and to implement economic reforms. Double parliamentary elections in May and June 2012 have held the reforms back. Although the report of the European Commission assesses the country's reform efforts generally positively, the problem remains a high risk for the implementation of reforms in case of further political turmoil. The report evaluates the implementation of the 13 priority areas and 276 objectives, of which 189 (68 per cent) were fully implemented, 31 (11 per cent) partly implemented and the remaining not implemented.

Thanks to pressure of the Troika (European Central Bank, International Monetary Fund, European Commission) Greece is undergoing radical reforms since 2010 after decades of stagnation, which significantly improves the prospects for its competitiveness. However, the austerity measures contributed to the prolonged and deeper recession lasting for six consecutive years from 2008. In 2012 the Greek GDP fell by 6.3 per cent and is expected to fall by 4.2 per cent in 2013. The public debt peaked at 170.6 per cent of GDP in 2011 and fell to 156.9 per cent of GDP in 2012 thanks to the 75 per cent haircut of private debt. The unemployment rate rose from 7.7 per cent in 2008 to 24.3 per cent in 2012. Greece has reduced its structural primary budget deficit by around 15 percent of GDP between 2009 and 2012 mainly thanks to radical reduction of expenditure on pensions, healthcare, and public sector wages.

Here is an overview of the most important changes:

Pension system: Repeal of the 13th and 14th retirement pensions, decrease in the pensions above 1,400 EUR (concerns about 10 per cent of retirees) by an average of 8 per cent, the extension of the minimum retirement age to 60 and the normal retirement age to 65. Before the reform, employees in the public sector normally retired at age 55 in the private sector at

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<sup>2</sup> Key sources: EC – Greece (2013), Goliaš (2013)

age 60 mainly due to the use of early retirement. Other changes include binding minimum and normal retirement age to life expectancy and the introduction of indexation of pensions to inflation rather than to growth of average wages in the economy. A second wave of reforms was approved in 2012, namely the reduction of pensions by 5 per cent for pensions from 1,000–1,500 EUR, by 10 per cent for 1,500-2,000 EUR, by 15 per cent for 2,000-3,000 EUR, by 20 per cent for 3000 to 4000 EUR and by 25 per cent over 4,000 EUR, further extending the retirement age from 65 to 67 years, as well as the introduction of merit – strict binding of pensions to the amount of social contributions paid.

Public administration: Repeal of the 13th and 14th salaries in 2010, reducing salaries by 20 per cent since November 2011, decline in the number of government employees in the years 2011-12 by about 80 000, while in 2015 the number of government employees is expected to fall by further 70 000 (according to Eurostat, 1.228 million employees worked for the public sector in 2008). The decline was mainly due to the rule applied since 2010 that only one person can be given a job for every five people leaving the public sector.

Improving the business environment: Greece has improved by 11 places and jumped to 78th place in the World Bank's Doing Business 2013 ranking, making it one of the ten best climbers. Improvements were apparent in the categories of investor protection, paying taxes, foreign trade and the bankruptcy conditions.

Labor market: Lowering the minimum wage which, according to Eurostat, fell in 2012 from 877 EUR to 684 EUR, i.e. from about 50 per cent to 39 per cent of the average wage. Wages in sectors with collective bargaining decreased by about 20 per cent in 2012, which is unprecedented in the EU and the developed world.

Tax system: Increasing taxes on tobacco and gambling, increasing taxes on interest from 10 per cent to 15 per cent. Repealing special tax regimes (e.g. for farmers and fishermen), tax expenditures and concessions (e.g. for self-employed and so called "Professional" occupations, for mortgage interest payments, payments for life insurance, student expenses, etc.). Previous overall child tax benefits began to be tested by means, i.e. income and assets (means testing). Profit tax for companies increased from 20 per cent to 26 per cent and the dividend tax was reduced from 25 per cent to 10 per cent. Thus, the effective tax on corporate profits has been reduced from 40 per cent to 33.4 per cent. Tax progressivity has been maintained, but instead of eight tax brackets the new tax reform introduces three. It also increases so called tax credit that makes the tax burden on low-and moderate-income households intact (about 1 million workers and retirees will pay no tax).

Health care: Introduction of one of the most advanced electronic prescription systems in Europe which is used to prescribe more than 90 per cent of medicines. The system enables real-time monitoring of the health insurance company expenses on drugs, prescriptions of drugs by specific doctors and their issuing by pharmacies to specific patients with a given diagnosis. They can thus help to detect possible fraud, check the adequacy of the prescribing drugs for a given state of health of the patient and improve overall control and management of drug expenditures. Mandatory prescription of active substance (called generic prescription) as well as mandatory generic substitution of medicines in pharmacies (i.e. it is mandatory to swap expensive medicines prescribed for cheaper ones) was introduced in March 2012, drawbacks are still in compliance with these measures. Patient fees for drugs have been expanded (except for specific medicines); referencing drug prices by three EU countries with the lowest price has been introduced. A web application has been established that allows real-time registration and control of all major activities and financial flows in hospitals.

Education: The closure of small schools is continuing; about two thousand schools have been cancelled.

Judiciary: The priorities are the creation and dissemination of statistics on the activities of the courts, the introduction of electronic submissions to the courts (e-justice applications), reducing the number of lawsuits pending, in particular the ones on paying taxes, promoting amicable settlement of disputes and judicial review of the Code.

Energetics: In November 2012 parliament approved a temporary tax (solidarity contribution) on the revenue from the sale of electricity produced from renewable energy sources (mainly from solar panels), which were previously favored. Full market opening and final release of electricity prices was presumed for mid-2013.

Telekom: In order to enhance competition in the wireless communications market frequencies in the 800 megahertz band are being released (so called digital dividend) and the digital television is launching.

Shipping: In order to strengthen competition, license facilitation of road freight and occasional passenger traffic has been simplified. In early 2012 due to restructuring, the economic results of several state companies, such as rail transport, have been balanced. Privatization of these companies is being prepared.

Retail: In the first half of 2012, the Government abolished the ban on selling goods below their cost price.

Social benefits reduction: Addressable targeting of low-income households (replacing various family benefits with only one benefit, based on means testing), reduction of benefits to farmers, abolition of seasonal benefits for people working in seasonal industries, limiting subsidized transport for patients.

Municipalities: Reducing subsidies for regional government (220 mil. EUR in 2013-14), the obligation of balanced budgets, monitoring of economic results, and penalties for deviations from the plan.

Defense: Decreased defense spending in 2010 by 1.2 per cent (to 2.2 per cent) and in 2011 by a further 0.5 per cent of GDP.

Fight against corruption: Increased use of e-procurement at central and regional level. The Economist weekly writes that hundreds of people have been arrested in the fight against tax evasion, including several influential Athenian entrepreneurs.

Despite progress in reforms there are downsides in Greek economy. Disappointing is the pace of privatization, as mainly due to political instability that occurred from December 2011 to November 2012 no transactions have been completed. Due to delays in the privatization, revenues estimate was decreased from 24 billion EUR in 2016 to less than 8.5 billion EUR. The situation has not changed until September 2012, when the government announced several privatization tenders.

Compared with expectations markets for goods and services liberalization is also lagging. Reduction in the severance pay to a maximum of 12 months' salary as well as in the notice period to 4 months might prove insufficient. Reduction in pensions up to 1,000 EUR represents another scope for savings not only due to the need for consolidation but also because of the need to spread the consolidation on all voters in order to reduce future preference for populism in politics. Further savings may be achieved by reduction in subsidies to pay excise tax for fuel for farmers, which dropped from 95 per cent to only 80 per cent of the tax. Hot candidate for cancellation is also a special pension fund for employees of the Central Bank, "social" contributions to pension contributions for engineers, journalists and lawyers, as well as many other privileges for so called regulated professions.

### **Portugal<sup>3</sup>**

Portugal came to the brink of bankruptcy in 2011 when it was saved by the Troika that has been drawing international financial assistance in the period 2011-2014 amounting to EUR

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<sup>3</sup> Key sources: EC – Portugal (2013), OECD (2013), Goliaš (2013)

78 billion. Until recently Troika marked Portugal as an example of model implementation of reform objectives. That changed in April 2013 when the Constitutional Court indicated its plans to cancel the thirteenth (in the summer) and fourteenth (during Christmas) salary and pension in the public sector, as well as a plan to reduce sickness and unemployment benefits as unconstitutional.

Year 2012 also showed the negative impact of dramatic savings and tax increases on the economy. The problem is particularly the continued growth of unemployment (increased to 15.9 per cent in 2012) and the decline in GDP (by 2.7 per cent in 2012). The public debt rose from 108 per cent of GDP in 2011 to probably unsustainable 124 per cent of GDP in 2012. It is primarily for these reasons that the EU has extended the term of the loan rescue mechanisms by seven years for both, Portugal and Ireland. Extension of maturity should help the two countries reach the financial markets after the complete execution of the rescue loan package (this should occur in May 2014 for Portugal).

Positive impact of reforms is mainly a decrease of the structural primary government deficit from 6.9 per cent of GDP in 2010 to a small surplus in 2012 and increase in the competitiveness of the workforce which can be seen in the sharp drop in unit labor costs and labor productivity growth.

Here is an overview of the most important changes that have been implemented in Portugal:

Raising taxes: The standard VAT rate increased from 21 per cent to 23 per cent in January 2011. Portugal increases the income tax even though this tax measure is amongst the ones slowing down economic growth the most, which is also criticized by the OECD. Tax on profits of companies increased from 26.5 per cent in 2010 to 31.5 per cent in 2013, while the tax on dividends increased at the same time from 20 per cent to 28 per cent. The combined rate has increased from 41.2 per cent in 2010 to 50.7 per cent in 2013, thus Portugal became one of the states with the highest business taxes in the developed world. From 1st of January 2013 personal income taxes have increased. Instead of seven tax brackets with rates from 11.5 per cent to 46.5 per cent, five tax brackets with the rates from 14.5 per cent to 48 per cent were established. The tax rate for the band with the largest number of employees increased from 24.5 per cent to 28.5 per cent. In addition to the base rate, high incomes are subject to high income surtax, which was 2.5 per cent in 2012 for incomes over € 153.300. In 2013, operating margin of 2.5 per cent for incomes above 80 thousand EUR is applied and 5 per cent for incomes over 250 thousand EUR. Special surtax of 3.5 per cent also applies to income above the minimum wage. Altogether, people with the highest incomes are subject to a rate of 56.5 per cent (48 per cent +5 per cent +3.5 per cent).

Labor market: Reduction of the long-term protection of employees against dismissal where the amount of compensation fell from 30-day salary to the 20-day salary for each year of service; it is expected to further decline to 12-day salary in 2013. The change applies only to employees who started work after November 2011; in addition these employees receive allowances as a compensation for dismissal that are dependent on their age. The reform also introduced a 12-month cap on the amount of severance pay, before the reform the upper limit did not exist. The maximum unemployment benefit fell from 1,257.66 EUR to 1,048.05 EUR, the maximum duration of receiving benefits fell from 38 to 18 months (minimum duration remains 9 months), while the unemployment benefits paid after six months decreased by 10 per cent.

Public administration: Since 2011, it was not possible to accept new government employees; salaries in the civil service were limited through their progressive cuts since 2011: about 3.5 per cent of the basic monthly incomes up to 1,500 EUR, salaries above 1,500 EUR were shortened by up to 10 per cent. Working week in the public service was extended from 35 to 40 hours a week.

Pension system: Pensions over 250 per month have been frozen since 2011. Pensions above 660 EUR per month were reduced by 10 per cent. Pensions from 1,350 EUR to 1,800 EUR are subject to a "solidarity tax" of 3.5 per cent, which gradually increases up to 40 per cent for higher pensions. Tax-free part of pension income has decreased from 6,000 EUR to 4,104 EUR per year. The penalties for early retirement have been introduced as well as increased reward payments for late retirement; the possibility for early retirement has been completely abolished until 2014. Retirement age is increasing in 2013, from 65 to 66 years.

PPP projects: Portugal financed its large public investments, particularly highway construction, through the so-called PPP projects. With a share of over 10 per cent of GDP Portugal has become a world leader in their use. Interestingly, according to the OECD, the use of PPP projects above European average applies to all countries benefiting from the EFSF and ESM assistance. The main motivation to implement PPP projects in Portugal was to circumvent the public finances, which led to hidden indebtedness of the country. After the outbreak of the crisis, the government began to have problems with repayments; arrears amounted to 1.9 per cent at the end of 2012. Under the pressure of the Troika, Portugal has included several projects in public deficit and gradually restructures them as well as severely decreases repayments.

Privatization: The planned privatization includes rail (freight in 2013), energy, banking, aviation (already took place in February 2013), state post office (in the second half of 2013), state water company and public transport in Lisbon and Porto.

Despite reforms the weaknesses among the Portuguese economy include insufficient flexibility in the labor legislation and a high tax burden on labor and corporate income. It is clear from this overview that the scope for further reforms is significant. Reducing severance pay should not be applicable to new employees only; there are reserves also in shortening the maximum amount of severance pay or the maximum period of receiving unemployment benefits, in repealing 13th and 14th pensions and salaries in the public sector and reductions in direct taxes.

#### **Ireland<sup>4</sup>**

Ireland has received a pledge in November 2010 for a rescue package amounting to 67.5 billion EUR of which 45 billion EUR comes from temporary rescue mechanisms in the EU and the euro area and 22.5 billion EUR comes from the International Monetary Fund. The maturity of EFSF loans will expire in the years 2029 to 2042, an average of 21 years. Ireland, along with Portugal has had their average maturity extended by 7 years in April 2013, in order to facilitate the full return to financial markets.

Ireland's international financial assistance finishes at the end of 2013. Thus, Ireland becomes the first example, whether austerity measures that the financial aid was conditional on, have worked. So far it appears that it will be a success story. This is supported by the fact that Ireland has been able to partly finance its public expenditure and long-term loans in the financial markets since 2012. In this regard, Ireland is the most successful country among the states being rescued. Moreover, after three years of recession, the Irish economy in 2011 returned to growth, and is currently the only state among the ones being rescued, that is not in recession.

It should be noted, that especially in comparison with Greece and Portugal, Ireland had significantly better starting position in a number of structural indicators. Ireland has long been standing as one of the OECD countries with the lowest payroll tax burden on labor income, has a very good position in Doing Business Ranking of the World Bank as well as in the competitiveness ranking of the World Economic Forum, low spending on social benefits and pensions, and a relatively flexible labor market.

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<sup>4</sup> Key sources: EC – Ireland (2013), Goliaš (2013)

Unlike Greece and Portugal, Ireland has not been led into the crisis via irresponsible management of public finances, but due to a banking crisis. The rapid growth of the public debt forced Ireland to request international assistance after the government had to bail out banks that suffered from the burst of the real estate bubble. Public debt has skyrocketed from 25 per cent of GDP in 2007 to 118 per cent of GDP in 2012; the unemployment rate has risen from 5 per cent to 15 per cent over the same period.

Financial assistance to Ireland was conditioned on recovery measures in the amount of 15 billion EUR, representing about 9 per cent of GDP. Here is an overview of the most important measures already implemented:

Tax system:

- Increase in the VAT from 21 per cent to 23 per cent.
- Introduction of a property tax of 0.18 per cent up to the value of 1 million EUR. Properties above this threshold will be taxed at a rate of 0.25 per cent. One-time annual fee of 100 EUR for each residential household has been temporarily introduced from 2012, so called "Site Value Tax". As the values of the properties will be gradually obtained over the next years, one-time fee will change into a fee linked to the value of the property on the assumption of progressivity between the value of the assets and the amount of the fee.
- Increase in the excise taxes on cigarettes, alcohol, car and solid fuels. Increase in the taxes on cars by 10 per cent.
- Increase in the total income tax burden through lower applicable tax credits.
- Introduction of a single 1 per cent tax on real estate sales volume up to 1 million EUR, 2 per cent tax will be applied for the transactions over this limit.
- Restriction of R&D tax credit by increasing the exemption base (of 100 thousand EUR) for the first investment. Only higher (over 200 thousand EUR) investments will be eligible to obtain the credit.

Social benefits: Reduction of the allowance for the third and fourth child. The allowance eligible for the third child falls by 19 EUR from 167 EUR to 148 EUR per month. The allowance for the fourth child falls by 17 EUR from 177 EUR to 160 EUR per month.

Public administration: The 2013 budget reduces the number of public officials by about 8% (from 312 thousand to 287 thousand). Salaries in the public sector were frozen until 2013.

Labor market: The hourly minimum wage has been frozen since July 2007 at 8.65 EUR/h with a short exception in 2011 when it was temporarily reduced to 7.65 EUR/h. Support of the employment of long-term unemployed – employers who employ workers from the register of unemployed will receive a pay of 96 EUR per week for a period of two years for



employing people who have been unemployed for more than 24 months and 72 EUR per week for employing people who have been unemployed for 12-24 months.

Education: One time registration fee for third-degree education of 1500 EUR will be replaced by annual tuition fee of 2000 € or 200 € for participants in professional training centers. The Government is committed to gradually raise tuition fees to 2,500 EUR in school year 2013-2014, 2750 EUR in school year 2014-2015 up to 3000 EUR in school year 2015-2016.

Pension system: The retirement age will be gradually increased to 66 years in 2014, 67 years in 2021 and up to 68 years in 2028. Pensions of people who work in the public sector were reduced by 4 per cent. License fee and free travel subsidy for pensioners will be frozen until 2014 (at the 2010 level).

Health care: The current 50-cent fee per prescription (for each drug) increases to 1.50 EUR. Increase in the threshold for the amount that patients pay monthly for drugs before getting covered by the state from 132 EUR to 144 EUR.

## **Conclusion**

In order to make the highest return on investment, which Slovakia and other Eurozone members participate in via the rescue mechanisms for indebted countries, political leaders should call for a continuation of reforms with an emphasis on areas where the greatest lags appear. In order to better inform the public about ongoing changes in beneficiaries' countries, regular disclosure of a clear and detailed comparison of reform measures and competitiveness indicators of all countries benefiting from assistance should be published. Description of measures should be detailed, it should, apart from others, include a schedule of retirement age extension, or the length of the severance pay and notice periods before and after the reform for each relevant group of employees.

It is crucial for the public, which ultimately gives money to rescue indebted countries, to have an overview of the ongoing changes and to be able to form an opinion about the effectiveness of the use of rescue resources. Otherwise, there is an increased risk in the possibility that the uninformed public will not learn from others' faults and that it will reject a proposal of providing help in the future even if the aid would be effective for Slovakia or other Eurozone countries.

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