Fiscal Vulnerabilities in the CESEE Countries: the Role of Fiscal Policy Structures and Budgetary Discipline

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1. Introduction

When the global financial and economic crisis set in, its impact on budgetary positions and financial market sentiment differed widely across the Central, Eastern and South Eastern European (CESEE) countries.[2] Against this background, this paper discusses whether the conduct of fiscal policies ahead of the crisis has impacted on these countries' fiscal space during the crisis. Put differently, it analyses whether some features of the *historical fiscal track record* ahead of the crisis rendered the CESEE countries particularly vulnerable when the crisis set in and contributed to the perception by financial markets that the sustainability of these countries' public finances was at risk, thereby giving rise to higher risk premia and interest rates. For the purpose of the following analysis, the *historical fiscal track record* does not only focus on common fiscal vulnerability indicators such as structural budgetary positions. It also captures vulnerabilities arising from fiscal policy structures, i.e. the composition of general government revenue and expenditure. To a lesser extent the analysis accounts for lack of fiscal policy

[1] Excellent research assistance from Roberta de Stefani is gratefully acknowledged. The author would like to thank Philipp Rother, Cristina Checherita-Westphal and the participants of the OeNB East Jour Fixe in February 2011 for helpful comments and suggestions. The views expressed in this paper are those of the author and do not necessarily reflect the views of the European Central Bank.

[2] The analysis focuses on ten CESEE countries, which are members of the European Union: Bulgaria, the Czech Republic, the Baltic countries, Hungary, Poland, Romania, Slovakia and Slovenia. Three of these countries have adopted the euro (Slovenia in 2007, Slovakia in 2009 and Estonia in 2011), while Latvia and Lithuania participate in ERM II.

discipline as measured by deviations of actual fiscal outcomes from budgetary targets.

The paper argues that the spending behavior of several CESEE countries prior to the crisis, including substantial increases in social payments and compensation of employees in times of strong growth, fuelled the demand boom and rendered fiscal positions vulnerable. Together with the fact that some CESEE countries consistently failed to meet their structural budget targets, this is likely to have weighed on financial markets' confidence in the prudence of fiscal policies when the crisis took hold. Among several others, these may have been crucial factors triggering the observed increases in interest rate spreads when the downturn deepened. The paper concludes that while the consolidation effort in most of these countries in reaction to the crisis was considerable, in a number of them it has not yet brought about the needed improvement in the growth-friendliness of public spending.

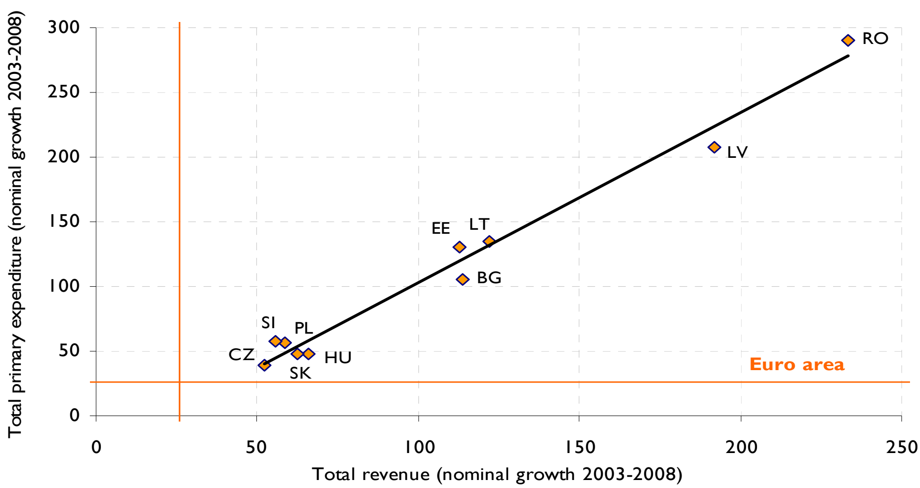
The subsequent analysis builds on literature related to fiscal vulnerability and fiscal space in times of financial crisis. In a recent contribution to the literature, Ostry et al. (2010) argue that countries' fiscal space depends on countries' historical fiscal response to rising debt levels as captured by primary balance adjustment. Fiscal space is then defined as the difference between the current debt level and a *debt limit* beyond which the historical fiscal response to rising debt levels becomes insufficient to maintain debt sustainability. In this respect, this paper argues that countries' fiscal space would need to be adjusted for fiscal vulnerabilities arising from fiscal policy structures and budgetary discipline. A different strand of literature stresses the importance of expectations for countries' default on debt, arguing that pessimistic expectations can push up interest rates, which in turn increases the probability of default (see for a seminal contribution to the literature Calvo (1988) and also Hemming et al. (2003) for a survey).

The article is structured as follows. Section 2 briefly reviews public finances ahead of the crisis, surveys the spending behavior in the CESEE countries and assesses fiscal policy discipline. Section 3 outlines major challenges for prudent fiscal policies in the aftermath of the crisis. It discusses the impact of the fiscal responses to the crisis on the growth-friendliness of public spending so far and highlights the need for stricter fiscal frameworks. Section 4 concludes.

2. Public Finances before the Crisis

The economic boom that was observed in many CESEE countries in the years prior to the crisis was associated with very strong general government revenue growth. Direct tax revenues more than doubled in the Baltic countries, Bulgaria and Romania over the period 2003–2007, with nominal growth of more than 200% in Romania and Latvia, which compares with growth of 29% in the euro area (see Chart A1 in the Annex for details). This strong rise in direct tax revenues hides in part structural reforms aimed at reducing distortionary labor taxation, which further fuelled the demand boom in these countries ahead of the crisis. In Bulgaria, Romania, Estonia and Latvia, also indirect tax revenue more than doubled over 2003–2007, with growth of more than 150% in Romania and Latvia, compared with nominal growth of 27% in the euro area.[3] In some CESEE countries this strong revenue growth triggered significant increases in primary public expenditure (see also Bakker and Gulde, 2010). As chart 1 shows, when looking at the period 2003-08, this pattern was particularly prevalent in Romania and Latvia, followed by Lithuania, Estonia and Bulgaria.

Chart 1: Nominal Revenue and Primary Expenditure Growth, 2003–2008



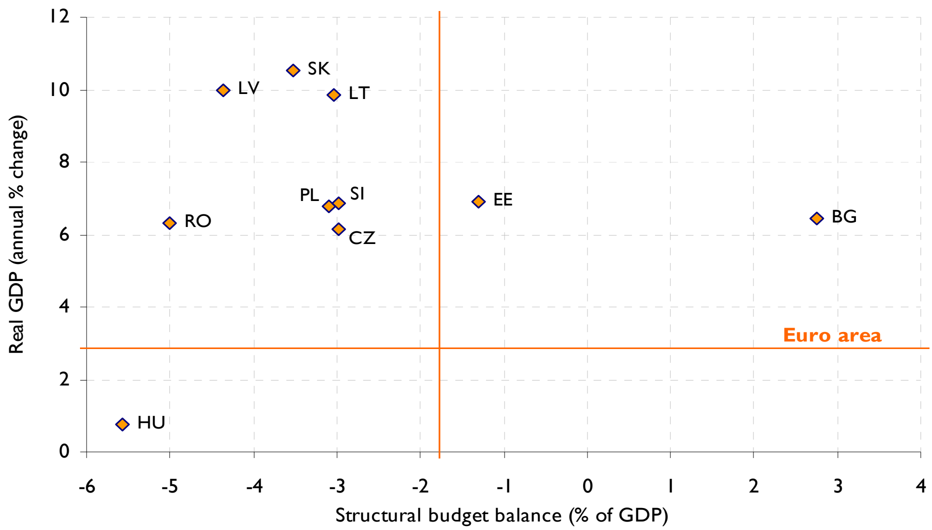
Source: Eurostat and European Commission (AMECO database).

This strong expenditure growth, which implied that the good economic times in the years ahead of the crisis were generally not used to build up fiscal buffers, rendered structural budgetary positions weak. As chart 2 shows, apart from Bulgaria, based on ex-post data, all countries recorded structural deficits in 2007 despite a still very favorable macroeconomic environment. The three CESEE countries that had to call on, *inter alia*, the IMF and the EU for international financial support entered the crisis with the largest structural deficits: Hungary recorded a structural deficit of

[3] As shown in chart A2 in the Annex, the CESEE countries tend to rely stronger on indirect tax revenue and to a lesser extent on direct tax revenue when compared with the euro area average, as indicated by their shares in total general government revenues.

about 5.5% of GDP, followed by Romania (5.0% of GDP) and Latvia (4.4% of GDP).

Chart 2: Structural Budget Balances and Real GDP Growth in 2007



Source: Eurostat and European Commission (AMECO database).

2.1 Fiscal Policy Structures: the Composition of Public Expenditures

As shown in chart 3, the rise in primary public expenditure in the years ahead of the crisis related to a considerable extent to spending on less productive items such as social payments and compensation of employees. Social payments include most importantly old age pensions and unemployment benefits, while compensation of employees comprises in particular wages and salaries as well as employers' social security contributions. As the chart shows, social payments account for a smaller share of total public expenditure in all CESEE countries except Slovakia when compared with the euro area average. However, starting from these lower shares, nominal growth of social payments prior to the crisis was considerably stronger in all CESEE countries when compared with the euro area. The boost in social payments over 2003–2007 was particularly significant in the strongly growing

Baltic countries and Romania (+180%), reflecting also sizeable increases in pension benefits. At the same time, the share of public spending on compensation of employees in total public spending was in 2007 larger in all CESEE countries except the Czech Republic and Slovakia when compared with the euro area average. In most countries public spending on compensation of employees rose markedly in the years prior to the crisis, reflecting mostly strong increases in public sector wages. As the chart shows, compensation of employees grew stronger in all CESEE countries considered here when compared with the euro area. Nominal growth was particularly strong in Romania and Latvia, where it reached more than 100%, followed by Estonia with about 90% over 2003–2007. Overall, this public spending behavior clearly fuelled the domestic demand booms in these countries further. And it may have weighed on financial markets' confidence in the prudence of fiscal policies, raising the prices at which they were willing to provide financing means when the crisis took hold.

Chart 3: Social Payments and Compensation of Employees, 2003–2007

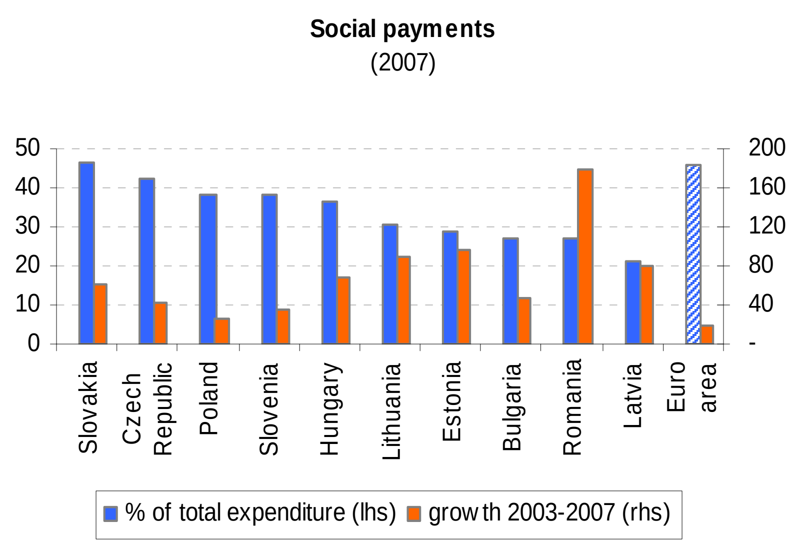
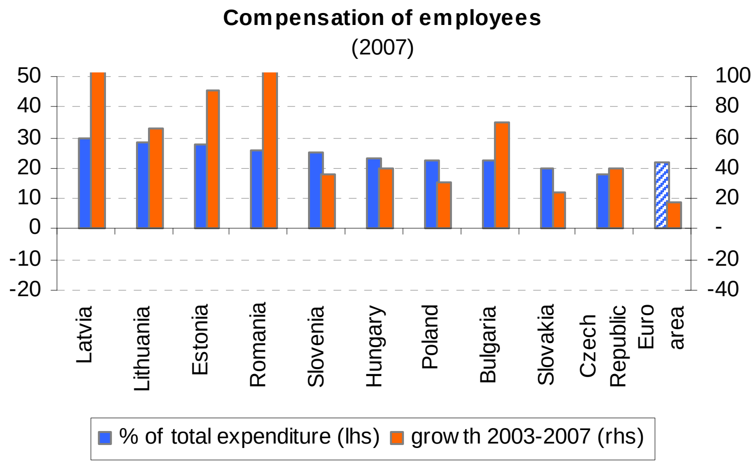


Chart 3 continued: Social Payments and Compensation of Employees, 2003–2007



Source: Eurostat and European Commission (AMECO database).

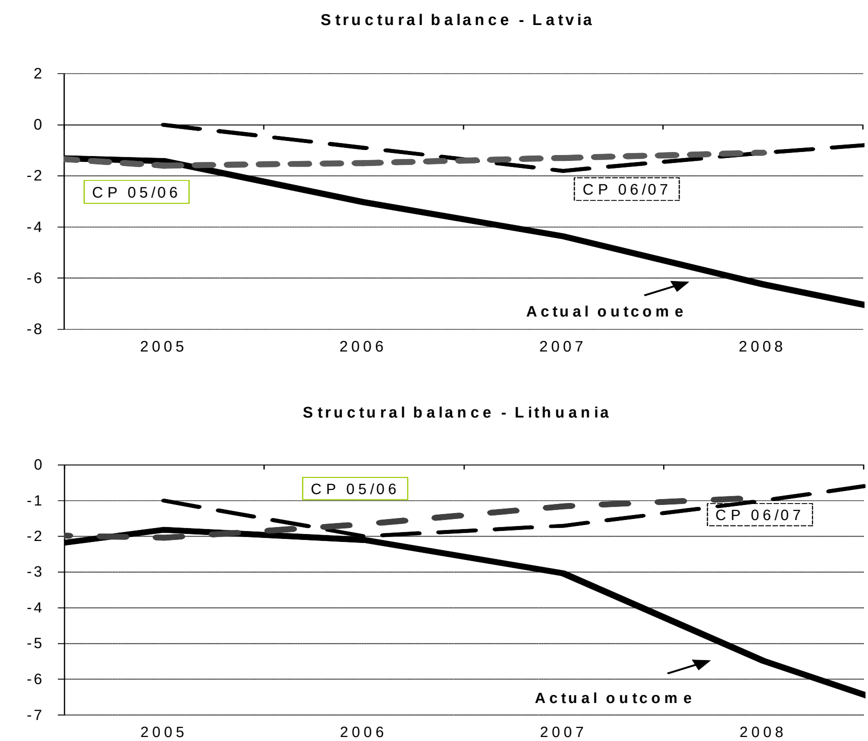
2.2 Fiscal Policy Discipline: Fiscal Plans versus Actual Outcomes

The public spending behavior prior to the crisis just described can be taken as an indication that the budgetary frameworks in these countries did not provide for the necessary spending constraints when economic growth accelerated. As a consequence, most countries did not use the economic good times prior to the crisis to build up fiscal buffers and to ensure trust in fiscal discipline. Such fiscal discipline may be captured by compliance of fiscal policies with targets as outlined in countries' convergence programs.[4] One may conjecture that a country which ensures compliance with its (prudent) fiscal targets receives more credit by financial markets in the form of trust in their policies than countries that fail to achieve such targets. In the years of strong growth prior to the crisis, nominal budget balance targets as outlined by governments in their convergence programs were usually met, with some countries out-performing them by a sizeable margin. By contrast, as shown in chart 4 for the examples of Latvia and Estonia, structural

[4] Darvas and Kostyleva (2011) construct a budgetary discipline index for 26 CESEE countries in 2007/08, based on information related to fiscal institutions governing budget preparation, legislation and implementation. According to this index, all ten CESEE countries considered here have a lower budgetary discipline than the OECD average. Among these countries, budgetary discipline is highest in Slovakia and Slovenia and lowest in Romania.

budget balance targets were often and consistently not met. As the chart indicates, structural positions repeatedly turned out worse than planned. Such fiscal slippages may be conjectured to have negatively affected financial market sentiment as the crisis deepened, at a time when the competition for financing means intensified and financial markets increasingly discriminated against markets that they perceived as riskier.

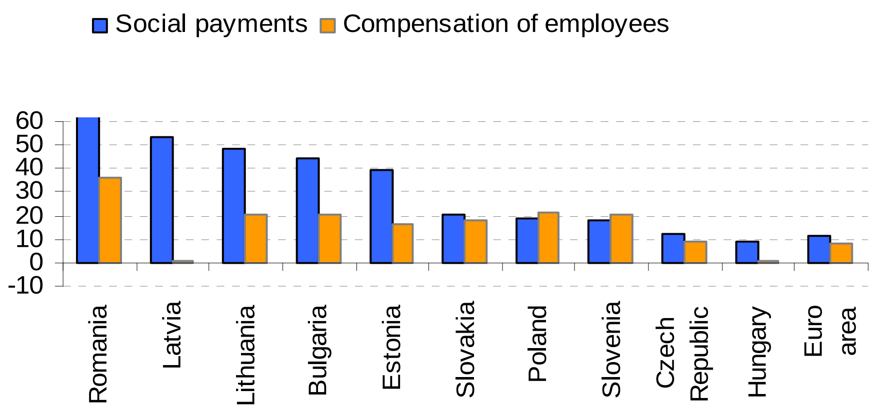
Chart 4: Fiscal Plans versus Fiscal Outcomes, 2007



Source: Eurostat and European Commission (AMECO database), convergence programs.

When the global financial and economic crisis took hold, all countries experienced deteriorating budgetary positions, with Latvia and Lithuania facing the strongest rises in their budget deficits, amounting to about 10 and 8 percentage points of GDP over 2007–2009, respectively. This budgetary deterioration reflected, *inter alia*, the sharp correction of GDP growth, revenue windfalls turning into revenue shortfalls as well as delayed adjustment in public expenditure. The latter was associated particularly with nominal increases in social payments and compensation of employees during the years 2007–2009. These increases reflected to a sizeable extent rises in pension benefits and public wages that derived from fiscal plans enacted ahead of the crisis, which only became effective as the downturn deepened (see chart 5). Particularly in the Baltic countries, this continued spending conflicted with the comprehensive consolidation effort required to increase confidence in the sustainability of public finances in order to reassure financial markets. It can be taken as another indication that the fiscal frameworks in a number of these countries were insufficiently effective in ensuring fiscal discipline.

Chart 5: Nominal Increases in Social Payments and Compensation of Employees, 2007–2009



Source: European Commission and ECB calculations.

3. The Response of Fiscal Policies to the Crisis

With budget deficits soaring and financial market concerns related to long-term fiscal sustainability rising, most CESEE countries responded to the global financial and economic crisis by consolidating their public finances.[5] In Latvia, Hungary and Romania, the international financial support programs called for strict consolidation. Also Bulgaria, Estonia, Lithuania and to a lesser extent the Czech

[5] See for an overview of fiscal adjustment strategies Bornhorst et al. (2010). For an assessment of adjustment strategies in the Baltic countries see Purfield and Rosenberg (2010). See for a discussion of previous consolidation episodes in the Central and Eastern European countries Afonso et al. (2006).

Republic implemented comprehensive fiscal consolidation measures aimed at containing the rapid budgetary deterioration. By contrast, in Poland automatic stabilizers were allowed to operate, while the reduction of labor taxes legislated ahead of the crisis acted as fiscal stimulus when the crisis took hold.

Apart from Estonia, all countries considered here are currently subject to an EU Council decision on the existence of an excessive deficit. The deadlines to correct the excessive deficit situation by reducing the deficit-to-GDP ratio to below the 3% of GDP reference value range from 2011 for Bulgaria and Hungary, to 2012 for Latvia, Lithuania, Poland and Romania to 2013 for the Czech Republic, Slovenia and Slovakia. The respective Council recommendations provide guidance on the required average annual structural fiscal effort to reduce the deficit-to-GDP ratios, generally recommending improved national fiscal frameworks (see table 1 for details).

Table 1: Council Recommendations under Excessive Deficit Procedures

Country	Council decision	Deadline for correction	Recommended annual average structural	Other recommendations
Bulgaria	13.07.2010	2011	3/4	strengthen fiscal governance
Czech Republic	07.10.2009	2013	1	structural refoms, strengthen quality of public finances
Latvia	18.02.2009	2012	2 3/4	strengthen fiscal governance, financial market regulation
Lithuania	13.05.2009	2012	2 1/4	strenthen fiscal governance
Hungary	12.05.2004	2011	cumulative 0.5 over 2010-11	improved budgetary planning, monitoring of budgetary execution
Poland	13.05.2009	2012	1 1/4	strengthen medium-term budgetary framework, legal ceilings on primary expenditure
Romania	13.05.2009	2012	1 3/4	implement pension reform, fiscal council, more cautious revenue forecasts
Slovenia	07.10.2009	2013	3/4	reform pension system
Slovakia	07.10.2009	2013	1	strengthen enforceability of medium-term budgetary framework, avoid expenditure overruns

Source: http://ec.europa.eu/economy_finance/sgp/deficit/countries/index_en.htm.

3.1 Changes in Public Expenditure Structures

Empirical evidence indicates that the long-term benefits of consolidation are largest, if fiscal adjustment focuses on the expenditure side of the budget.[6] A number of studies find that expenditure-based fiscal adjustment tends to be less contractionary than tax-based fiscal adjustment (see e.g. IMF, 2010), with some analyses suggesting that declines in expenditure are even accompanied by an expansion of economic activity (see e.g. Alesina and Perotti, 1995 and Alesina and Ardagna, 2010). As shown in chart A3 in the Annex, fiscal consolidation as captured by the decline in deficit-to-GDP ratios over 2009–2012 is projected to rely largely on expenditure restraint in most of the countries considered here. As chart 6 indicates, the reduction in public expenditure-to-GDP ratios is broad-based, relating, *inter alia*, to lower spending on social payments, compensation of employees, public investment and intermediate consumption (as a percentage of GDP).

Nonetheless, there are some indications that in a number of countries this consolidation will not bring about an improvement in the growth-friendliness of public spending.[7] For example, as shown in chart 5, public spending on social payments as a percentage of GDP is projected to decline in all countries except Slovenia, with the strongest declines envisaged in Estonia, Lithuania and Hungary of about 1.5% of GDP and more. This notwithstanding, the share of public spending on social payments in total public expenditure is expected to be higher in 2012 when compared with 2007 in all countries except Poland. At the same time, the chart shows that public spending on government investment is projected to decline in all countries except the Czech Republic, Hungary and Poland over 2009–2012 as a percentage of GDP. In the majority of countries considered here, the share of public spending on government investment will, however, be lower in 2012 when compared with prior to the crisis, with this difference being largest in the Baltic countries and Romania.[8] In addition, it should be noted that in all of these countries, public spending on government investment is projected to account for less than 15% of total expenditure in 2012. Generally, higher shares of public spending on social payments and lower shares of public spending on government

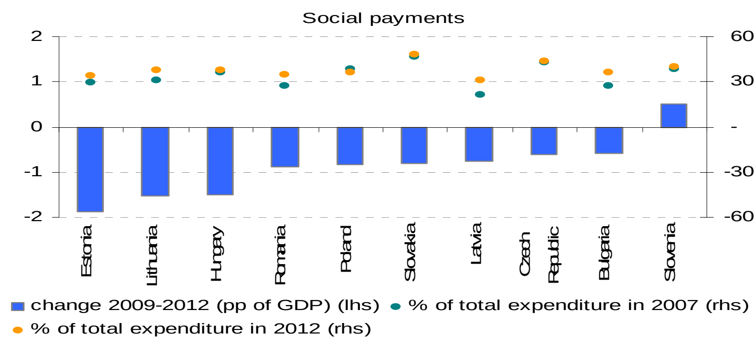
[6] See Rother et al. (2010) for a discussion of the benefits of fiscal consolidation.

[7] In this respect, growth-friendliness of public expenditure relates to the share of "productive" expenditures in total expenditures. "Productive" expenditures are assumed to include those expenditures that have a positive impact on the marginal productivity of capital and labor. In turn, "unproductive" expenditures are assumed to include those directly increasing households utility (Aschauer, 1989, Devarajan et al., 1996; for a discussion of the literature see Ferreiro et al., 2009).

[8] In order to improve public spending efficiency in times of fiscal consolidation needs, Daianu (2010) calls for higher disbursements of EU structural and cohesion funds. See Kamps et al. (2009) for a survey of the impact of EU funds on economic growth.

investment would point to less growth-friendly expenditure structures. The picture is less clear for public compensation of employees. All countries considered here are projected to reduce public spending on compensation of employees as a percentage of GDP, which for at least half of the countries is projected to be associated with declining shares in total spending. This would indicate a step towards more growth-friendly public expenditure structures. As regards intermediate consumption, the respective declines tend to be associated with lower shares in total public expenditure in most countries, possibly pointing to an increase in the growth-friendliness of public spending. Overall, while a country-by-country approach would be required for a full picture, there are some indications that the comprehensive consolidation effort in response to the crisis was in some countries not used as an opportunity to increase the growth-friendliness of public spending. In some countries weaknesses are remaining and in order to increase competitiveness, more needs to be done to shift expenditure structures towards productivity enhancing outlays.

Chart 6: Public Expenditure Structures, 2007–2012



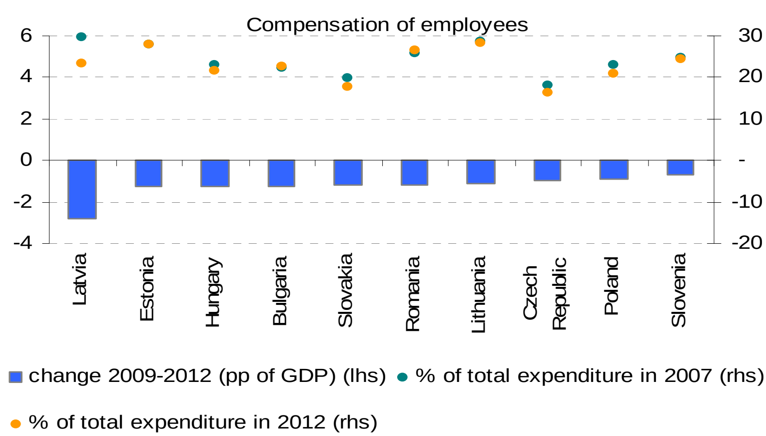
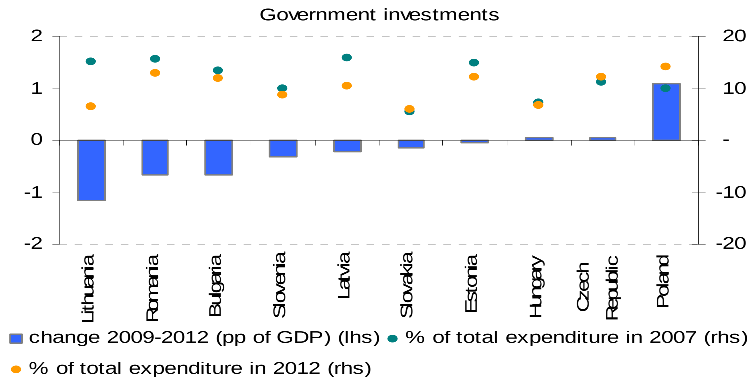
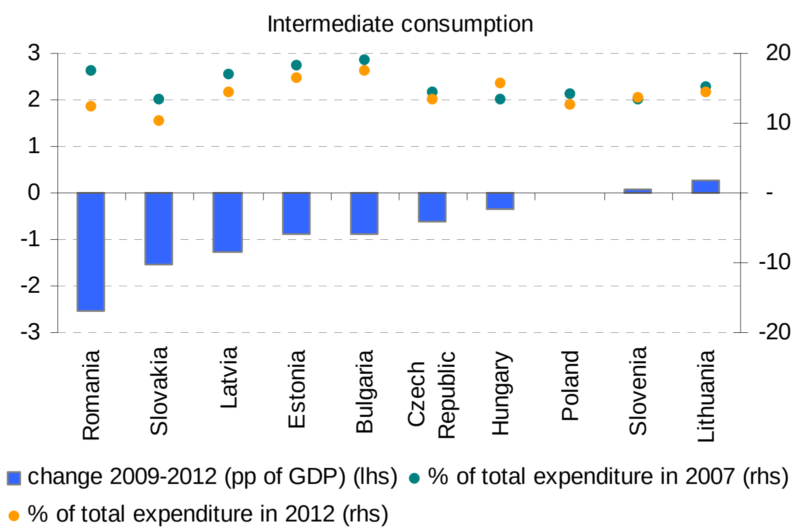


Chart 6 continued: Public Expenditure Structures, 2007–2012





Source: Eurostat and European Commission (AMECO database).

3.2 "Preventive Fiscal Surveillance": Efforts for Stricter Fiscal Rules at the National and the EU Level

The role of insufficiently strict fiscal frameworks at the national and international level as factors contributing to the weak budgetary positions of many EU countries prior to the crisis is widely acknowledged (ECB, 2011).[9] Against this background, the European Council is expected to agree on a strengthened fiscal surveillance framework in June 2011. Major elements will relate to the strengthening of fiscal governance under the Stability and Growth Pact at the EU level as well as recommendations for reinforced national budgetary rules. Under the preventive arm of the Stability and Growth Pact, an expenditure rule is being put forward, according to which general government expenditure growth must not exceed the potential medium-term GDP growth rate as long as countries have not reached their Medium-Term Budgetary Objectives (MTOs). As shown in Holm-Hadulla et al. (2011), numerical expenditure rules can contribute to reducing pro-cyclical spending biases, thereby increasing fiscal discipline. To fully capture the benefits of such a rule, it should be enshrined in national budgetary frameworks, preferably not just as general agreements but as part of countries' constitutions. Moreover, strengthened fiscal rules should be accompanied by independent macroeconomic forecasts as well as independent Fiscal Councils.

Overall, the importance of stricter national fiscal frameworks is being acknowledged in most CESEE countries[10], although there are exceptions: Hungary in early 2011 abandoned its independent Fiscal Council. More efforts are needed at the country level to enshrine public expenditure rules that avoid pro-cyclical fiscal slippages and thus increase budgetary discipline. Bold steps in this direction would clearly enhance financial market confidence in the prudence of fiscal policies in these countries.

4. Conclusion

This paper argues that the spending behavior of several CESEE countries prior to the crisis, including substantial increases in social payments and compensation of employees in times of strong growth, fuelled the demand boom and rendered fiscal positions vulnerable. Together with the fact that some CESEE countries

[9] See Van Riet et al. (2010) for an early assessment of crisis-related challenges for the EU fiscal framework.

[10] An expenditure rule is in place e.g. in Poland. According to this rule, the increase in discretionary and newly legislated public expenditure is limited to the increase in the Consumer Price Index plus 1 p.p. It should be noted, however, that by limiting expenditure growth, such a rule would not contribute to consolidating public finances.

consistently failed to meet their structural budget targets, this weighed on financial market sentiment as the crisis took hold, at a time when the competition for financing means intensified and financial markets increasingly discriminated against markets that they perceived as riskier. Among several others, these may have been crucial factors triggering the observed increases in interest rate spreads when the crisis took hold. The paper concludes that while the consolidation effort in most of these countries in reaction to the crisis was considerable, in a number of the CESEE countries it has not yet brought about the needed improvement in the growth-friendliness of public spending. In particular, higher shares of public spending on social payments and lower shares of public spending on government investment when compared to prior to the crisis point to less growth-friendly expenditure structures.

Overall, to increase these countries' budgetary resilience to economic shocks, it is important that the weaknesses associated with expansionary fiscal policies in strongly growing economies are remedied. This requires notably improved national fiscal frameworks with stricter fiscal rules on the expenditure side. Such reforms would increase financial market confidence and could contribute to larger fiscal space in future economic downturns.

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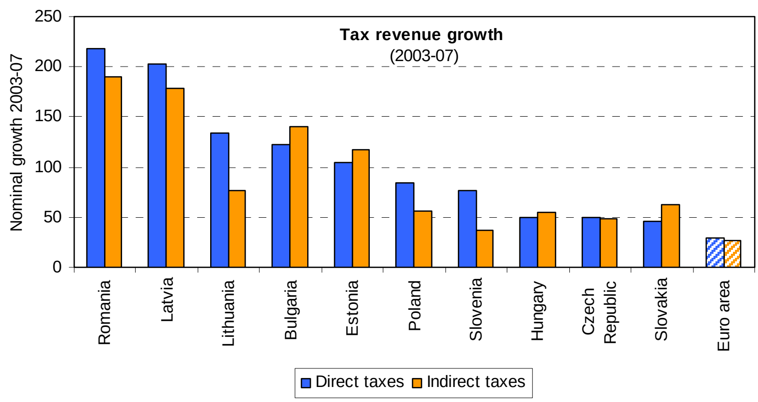
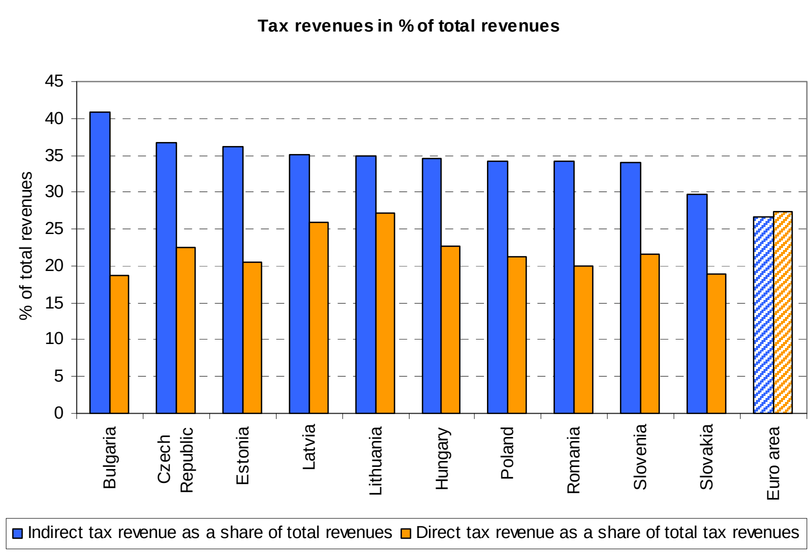
Annex

Chart A1: Tax Revenue Growth over 2003–2007



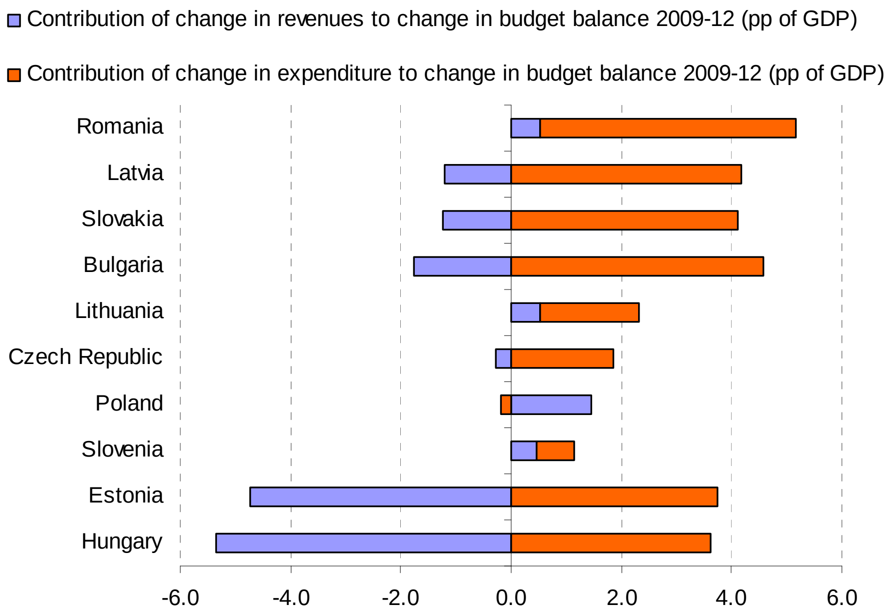
Source: Eurostat and European Commission (AMECO database).

Chart A2: Indirect and Direct Tax Revenue, 2007



Source: Eurostat and European Commission (AMECO database).

Chart A3: Composition of Fiscal Consolidation, 2009–2012



Source: Eurostat and European Commission (AMECO database).