Crisis and Consolidation – Fiscal Challenges in Emerging Europe

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Abstract

The global crisis has led to a sharp increase in fiscal deficits in emerging Europe.[2] Many countries have already implemented significant adjustment measures, but further consolidation is needed. The immediate cause of the large deficits was the sharp revenue declines during the crisis, but the underlying problem was too rapid spending growth during the boom times, and it will be important to keep spending growth under control during future booms.

1. The Impact of the Global Crisis on Public Finances in Emerging Europe

Prior to the global economic and financial crisis, public finances in emerging Europe seemed in good shape. In 2007, the average fiscal balance in the region showed a surplus of more than 1½% of GDP, well above other emerging markets in Latin America and Asia (chart 1). Average gross debt was less than 25% of GDP

[1] The views expressed in this paper should not be reported as representing the views of the IMF. They are those of the authors and do not necessarily represent those of the IMF or IMF policy.
[2] Countries included in this paper comprise Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Hungary, Kosovo, Latvia, Lithuania, the former Yugoslav Republic of Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Turkey, and Ukraine. Estonia was reclassified as an advanced country by the IMF after it adopted the euro on January 1, 2011. Hence, Estonia is not included in emerging Europe averages.

– less than half of the average in advanced countries. However, there were a few exceptions: Hungary's debt was high (66% of GDP) (chart 2), and deficits in Hungary, Albania, and Romania were above 3% – in Romania increasing to almost 5% of GDP in 2008, despite very rapid GDP growth.

These favorable headline figures masked a significant deterioration of the underlying structural fiscal situation during the pre-crisis boom years. A capital-inflows-fueled domestic demand boom had led to a surge in government revenues, which had been used to increase government spending, rather than building up buffers (chart 3). Public expenditure growth was particularly rapid in the countries that had the strongest private sector boom – including the Baltics, Romania, Belarus, Ukraine and Russia. With rapid public spending growth, many countries barely had a balanced budget – despite years of very strong GDP growth above potential. In turn, cyclically adjusted balances were significantly worse than headline numbers suggested.

This deterioration became visible during the crisis when revenues dropped sharply. The drop in revenues was the result of a sharp contraction in real GDP and an unprecedented decline in domestic demand. The revenue drop was sharpest in the countries that had previously had the biggest revenue booms (chart 4). While during the boom years rapid expenditure increases exacerbated imbalances (chart 5), during the crisis expenditure cuts further reduced domestic demand.

At the same time, financing deficits became much more difficult. Financing pressures first became evident in Hungary, where auctions in the primary market failed in early October 2008, forcing the government to suspend the issuance of government bonds,[3] but also became visible in other countries.

While immediate financing pressures were addressed through substantial IMF/EU packages, including in Hungary, Latvia, Romania, Serbia, and Ukraine, many countries needed to take unprecedented adjustment measures. Adjustment was particularly pronounced in the Baltics, Serbia, Romania, and Hungary (chart 6). Only a few countries, including Poland and Russia, were in a position to let automatic stabilizers work or even stimulate the economy (box 1).

[3] Foreign investors sold more than one quarter (EUR 3.5 billion) of their holdings of domestic currency denominated government bonds between mid-September and end-November 2008.

Box 1: Fiscal Adjustment in Selected Countries

In **Latvia**, expenditure cuts dominated the close to 13% of GDP fiscal tightening during 2009 and 2010. Measures included a 4% of GDP cut in remuneration (an average 30% wage cut for central government employees) and a 3% of GDP cut in investment. Revenue measures were also part of the consolidation efforts, including a 3 percentage point increase in the personal income tax (PIT) to 26%, a decrease in the tax-free PIT allowance, and a VAT increase from 18 to 21% (in addition to increasing the reduced rate VAT from 5 to 10%). Though the size of the fiscal tightening is impressive, measures included across-the-board cuts, and public sector wage cuts were uneven. Additionally, pension cuts were initially also among the consolidation measures but these were later reversed after the Constitutional Court deemed them unconstitutional (IMF, 2010a).

In **Hungary,** several expenditure cuts were implemented in 2009, including cuts in operating budgets of line ministries and health care institutions, reductions in housing subsidies, and reductions in top-up payments on farm subsidies. On the revenue side, personal income tax payments were reduced but offsetting measures were implemented, including a 3 percentage point increase in the VAT rate (IMF, 2009a). In 2010, the new government, which formed after the April 2010 elections, changed course and allowed the IMF/EU-supported program to lapse and initiated fiscal stimulus, including tax relief for households and enhanced family benefits. It was partly financed by temporary revenue measures. In order to contain the deficit, the government in mid-2010 adopted an emergency package, including a special levy on financial institutions, some spending cuts, and reductions in the corporate income tax (CIT). Later in the year, a second package included the imposition of sectoral taxes and a diversion of 2nd pillar private pension contributions to the budget (IMF, 2011a). In 2011, asset transfers from the 2nd to the 1st pillar of the pension system are estimated at 10.1% of GDP.

In **Romania**, fiscal policies included a focus on rationalization of public sector institutions, employment, and costs, and strengthening structural reform commitments in wage and pension areas (IMF, 2009b). Measures in the 2010 budget on the expenditure side included a rationalization of the public sector wage bill, better control on fraudulent disability pensions, and reorganization of state agencies. Budget revenue measures included a new turnover tax on medical goods suppliers and net lending repayments (IMF, 2010b). However, due to weaker than expected fiscal performance, an adjustment package was implemented in mid-2010, including a 25% cut in public sector wages, a 15% cut in most social transfers, and a 5 percentage point increase in the standard VAT rate (IMF, 2010c).

Box 1: Fiscal Adjustment in Selected Countries – Continued

In **Estonia**, fiscal consolidation started early in 2008 following an early onset of recession. In 2009, the government passed supplementary budgets in February and June, totaling 7½% of GDP in measures of which the expenditure side accounted for about 2/3. In September, further measures were taken, which included one-off dividends from state-owned enterprises. However, the consolidation also comprised structural reforms, including VAT increase, increase in excise taxes, and decreased social benefits. Other measures included operating spending cuts and one year measures such as land sales and discretionary spending cuts (IMF, 2010d). Overall, the efforts led to a 2009 fiscal deficit of 2.1% of GDP (or 1.7% of GDP in ESA terms) – below the 3% Maastricht criterion – which allowed for euro adoption on January 1, 2011. In 2010, strict expenditure control and one-off revenues, including the sale of CO_2 emission rights, led to a better-than-expected fiscal outcome (IMF, 2011b).

In **Poland**, limited pre-crisis imbalances allowed room for policy-makers to provide fiscal stimulus to the economy, which was further backed by Poland's Flexible Credit Line arrangement with the IMF. This helped avoid an outright recession during the crisis, and overall growth reached 1.7% in 2009. The estimated 2½% of GDP fiscal relaxation in 2009 (1¾% of GDP in 2008) included already planned tax cuts, which were not offset by expenditure measures (IMF, 2010e). As a result, the fiscal deficit, which in 2007 was below 2% of GDP, increased above 7% of GDP in 2009. In 2010, the deficit was even higher – estimated at 7.9% of GDP. Subsequently, in 2011 Poland is consolidating public finances with measures in the 2011 budget that amount to about 1% of GDP, including a limit on discretionary expenditure growth – which in turn includes a freeze in the central government wage bill – and lower spending on active employment promotion as well as a 1 percentage point increase in VAT rates and lower VAT refunds on corporate cars (IMF, 2011c). Additionally, measures redirecting part of contributions from the 2nd to the 1st pillar of the pension system are expected to lower the deficit by 1% of GDP over the medium term.

In **Russia**, pre-crisis oil windfall created room for fiscal expansion. However, the fiscal expansion, which amounted to about 9% of GDP, mostly comprised permanent measures and will therefore require subsequent fiscal consolidation. Furthermore, despite the substantial fiscal relaxation in 2009, most of the stimulus was not implemented until the second half of the year and was poorly targeted at low-multiplier areas such as strategic sectors and defense and security. As a result, the stimulus could not prevent a sharp real GDP contraction of close to 8% (IMF, 2010f).

As a result of the crisis, and despite large adjustment in a number of countries, fiscal deficits in emerging Europe deteriorated significantly and by 2010 were no longer low compared to other emerging market regions. The region's estimated fiscal deficit exceeded 4% of GDP in 2010 – a deterioration of more than 6 percentage points of GDP from 2007. While fiscal balances in emerging Asia and Latin America also deteriorated from 2007 to 2010, the regional averages did not fall far below –3% of GDP (chart 7).[4]

2. The Need for Fiscal Consolidation

The current level of fiscal deficits[5] in the region raises a number of concerns:

High deficits create fiscal vulnerabilities. While debt ratios are still lower than in advanced countries, the vulnerability threshold of public debt is lower than in advanced countries (see for example IMF, 2003). An additional consideration is that without fiscal consolidation, concern about high sovereign debt, so far contained to advanced Europe, could spread to emerging Europe.

High deficits may be difficult to finance. Financial markets may be particularly unwilling to finance high deficits that are largely structural.

High deficits leave no buffer for next crisis. Automatic stabilizers can cushion the social and economic impact of recessions. However, to allow for fiscal space, they require that excess revenue during boom times is saved for recessionary periods.

For several of the new EU Member States, fiscal consolidation is also necessary to meet the Maastricht criteria and associated Medium term budgetary objectives. It should be noted that in order to remain below the 3% deficit ceiling during the entire business cycle, during good times, the deficit should remain well below that ceiling.

Containing deficits and debt levels is also desirable in light of the aging of the population, which over time will add to expenditure pressures.[6]

To reduce the deficits, further consolidation is needed – even though in some countries substantial adjustment has already taken place.

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[4] As of the time of writing, 2010 fiscal deficits in many countries still relied on projections and were not yet final.

[5] The paper focuses mainly on headline balances rather than structural balances. While from a theoretical perspective, structural balances are clearly a superior measure to headline balances, in practice it is very difficult to measure structural balances properly, as both the output gap and the impact of the cycle on the public finances are subject to large uncertainty and frequent revisions.

[6] Pension reform is discussed in the subsequent chapter of this conference bundle (contribution of Karsten Staehr).

2.1 How Should Fiscal Consolidation Occur?

The judgment that further consolidation is needed leads to a number of questions: how much consolidation should occur, how fast, and should it occur through expenditure or revenue measures?

How Much Consolidation Is Needed?

Ideally, fiscal consolidation should bring countries back to a situation where revenue and expenditure are structurally in balance. Some countries are close to this level, while others still have a longer way to go. In Estonia, following a very deep recession, preliminary data suggest a fiscal surplus of ¼% of GDP in 2010, while Poland, which avoided an outright recession – in large part a result of fiscal stimulus measures – had a deficit of 7.9% of GDP.

It is important that fiscal consolidation leads to a genuine improvement in government solvency. Some measures, such as reducing contributions to the second pillar pension system may reduce deficits and financing pressures in the short run, but do not improve government solvency and thus are no substitute for fiscal consolidation.

How Fast Should Fiscal Consolidation Be?

The desired pace of fiscal consolidation depends on the cyclical situation, the amount of fiscal pressures, and political economy considerations. There is no "one size fits all" approach as these elements differ across countries.

Demand management considerations suggest that a country should not adjust too quickly before recovery has firmly taken hold. The quality of adjustment may also improve if it is carried out more slowly, as it is difficult to avoid across-the-board cuts when consolidation needs to be carried out quickly.

Countries that are under severe fiscal pressure have little choice but to improve their public finances quickly. Moreover, political economy considerations suggest that large upfront adjustment during a crisis may in fact be easier than years of steady adjustment that continues after the economy has recovered – which may lead to adjustment fatigue.

Overall, with the recovery taking hold more firmly and with output gaps closing, arguments in favor of rapid adjustment have become more powerful. It is not just that worries about the impact of fiscal consolidation on the recovery have diminished, in some countries faster consolidation would now also be *desirable* from a demand management perspective. Moreover, a faster adjustment would also reduce the risk that sovereign debt concerns in advanced Europe spill over to emerging Europe.

Should Fiscal Consolidation be Expenditure or Revenue-Based?

In general, expenditure-based consolidations tend to be more successful than revenue-based ones. IMF (2010g) found that fiscal consolidations that rely on spending cuts tend to be less contractionary than tax-based adjustment.[7] The European Commission in its 2010 report on public finances in EMU in a summary of the literature over the past twenty years noted that successful fiscal consolidations were preponderantly expenditure-based. Such consolidations tended to be longer lasting than those based on tax increases or investment cuts. However, options for expenditure consolidation differ by country. During the recent crisis, expenditure measures included cuts in civil servants' wage bill, transfers, inefficient health care costs, pensions, and structural reforms.

Nonetheless, revenue increases can also play a role, particularly in countries where expenditure is already low. The level of government expenditure differs substantially across countries (chart 8), and in some countries there may be less room to cut expenditure further. In OECD countries, spending cuts have generally been favored due to the relatively large size of the public sectors in many of these countries. However, in some emerging and developing economies, revenue measures have had a more prominent role as they have typically started from low revenue-to-GDP ratios (Everaert, 2010).

While the choice of revenue measures depends on the particular country situation, some taxes are less distortionary or have higher compliance rates than others. For example, single-rate VATs will tend to have lower administration costs than more complicated VAT systems (ITD, 2005). A residential real estate tax can provide an important revenue source, and may be less distortive than alternative taxes as it is levied on an immobile factor (Bahl, 2009). Reforms to improve tax compliance may also increase revenues in several emerging European countries.

2.2 What Are Countries Planning?

Most countries in the region are planning continued deficit reductions in 2011 and 2012. Latvia plans to reduce its deficit by around 6 percentage points of GDP in 2011 and 2012 (chart 9), which will enable the country to meet the Maastricht deficit criterion. Poland and Romania aim at improving their fiscal balances from their 2010 positions by around 3½ percentage points of GDP by 2012. There are, however, a few exceptions. In Hungary, the fiscal deficit is not expected to decline between 2010 and 2012[8], partly as a result of the introduction of a 16% flat-rate personal income tax, aimed at spurring growth (IMF, 2011a).

[7] Based on a sample of advanced countries.
[8] The improvement in 2011 reflects the transfers of assets from the 2nd to the 1st pillar of the pension system.

Even with planned improvements in fiscal balances, deficits in 2011 and 2012 will remain high in some countries. Based on announced policies to date, IMF staff projects 2012 fiscal deficits to exceed 3% of GDP in Lithuania, Kosovo, Croatia, Hungary, Albania, and Poland (chart 10).[9] Thus, with growth strengthening (chart 11), it will be important that any revenue overperformance is used for deficit reduction.

3. Using Fiscal Policy Wisely in the Next Boom

While fiscal policy has not been the *cause* of the boom-bust cycle in emerging Europe, it has definitely *contributed.* An important lesson from the crisis therefore is that fiscal policy should be more prudent during good times, and temporary revenue windfalls should not be used for permanent increases in expenditure. Fiscal rules may help anchor fiscal policy during good times, when pressures to increase spending are strong. Empirical studies suggest that fiscal rules have been generally associated with improved fiscal performance (IMF, 2009c). Of course, fiscal rules can only be successful if there is sufficient political commitment to them: without this, they are unlikely to be sustained.

Among fiscal rules, expenditure ceilings are probably the best tool to contain expenditure during good times, while rules that set debt or deficit ceilings may still be too pro-cyclical:

Debt ceilings are unlikely to be binding during good times. They are more likely to become binding during downturns, necessitating fiscal tightening at the wrong moment.

Deficit ceilings suffer from similar problems. In theory, these problems could be addressed by using cyclically adjusted deficit targets. In practice, however, structural deficits tend to be underestimated during good times, both because potential GDP growth tends to be overestimated, and because the impact of the cycle on revenues tends to be underestimated.

Expenditure ceilings address the problem of too rapid expenditure growth during boom times directly. Expenditure ceilings should set a steady path for real expenditure that does not depend on the cyclical situation. By setting the growth rate of real expenditure in line with *cautious*[10] estimates of potential GDP, the expenditure to GDP ratio will fall during good times and rise during bad times, and

[9] Forecasts may assume more ambitious fiscal policy for program than for non-program countries. Forecasts for non-program countries reflect announced policies; forecasts for program countries typically reflect program goals.

[10] During the boom years, potential output was often overestimated. Therefore, to avoid procyclical fiscal policy due to procyclical potential output estimates, it is important that *cautious* potential output estimates are used.

be constant seen over the entire cycle[11] (see IMF (2009c) and EC (2010) for further discussion about fiscal rules).
If these rules had been in place during the previous boom, many countries would have run large fiscal surpluses. While it should be acknowledged that running large surpluses during boom times may be politically difficult, such a policy would have left the countries in a much better position to deal with the downturn, and would have pre-empted the need for sharp fiscal tightening during the recession.

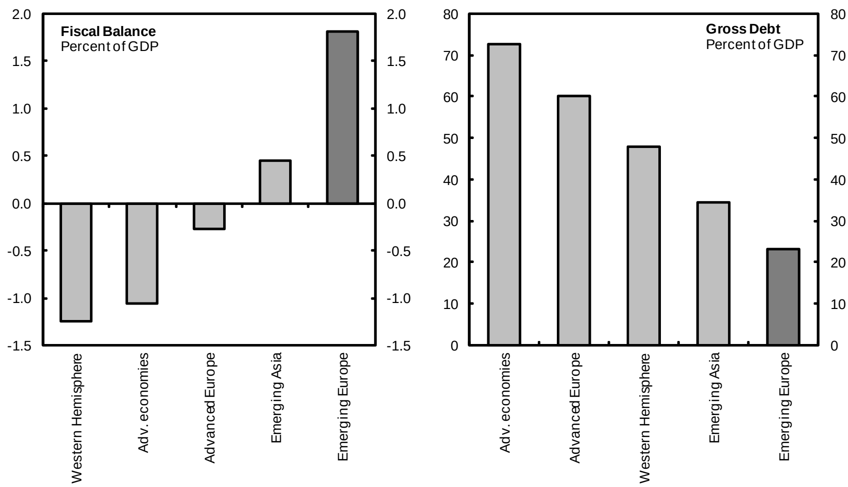
4. Concluding Remarks

The crisis in emerging Europe has shown that focusing on headline balances during boom times can lead to a false sense of security. In times of rapid revenue growth, fiscal authorities can easily keep headline deficits low while also increasing expenditure. Going forward, it will therefore be important that medium-term frameworks help counter future potential fiscal crises and include the creation of fiscal buffers. It will be important that expenditure does not display excessive growth during boom times. The implementation of fiscal rules can help obtain this. In particular, expenditure ceilings that keep expenditure in line with cautious estimates of potential GDP growth would allow governments to use revenue surprises to build up buffers, which can be used during the next downturn. Had this been standard practice in emerging Europe prior to the crisis, the fiscal situation in emerging Europe would have been in much better shape and fiscal space would not have been as limited.

[11] Expenditure ceilings that are set as a percent of GDP still have a procylical character as they allow for rapid expenditure growth during good times.

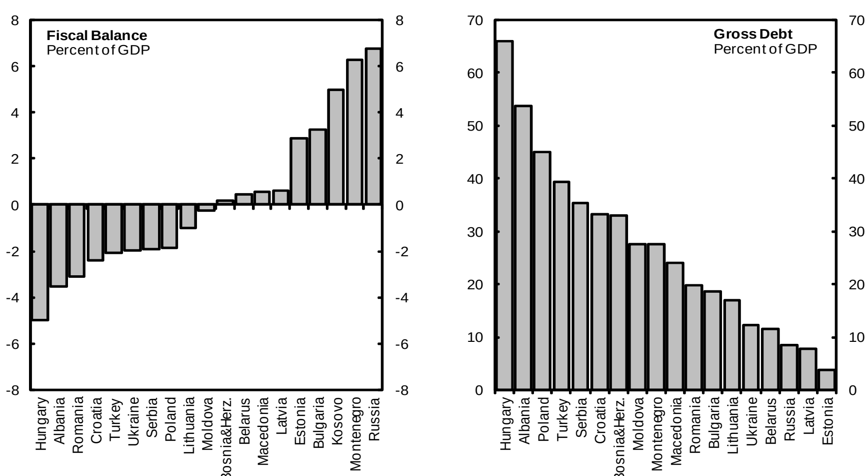
Annex

Chart 1: General Government Deficits and Debt in Emerging and Advanced Regions, 2007



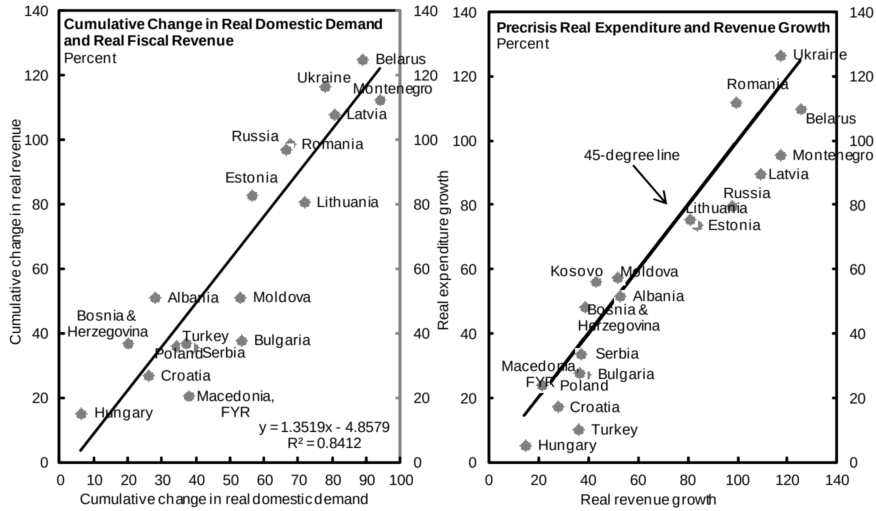
Source: IMF, World Economic Outlook database and IMF staff calculations.

Chart 2: General Government Deficits and Debt in Emerging Europe, 2007



Source: IMF, World Economic Outlook database and IMF staff calculations.

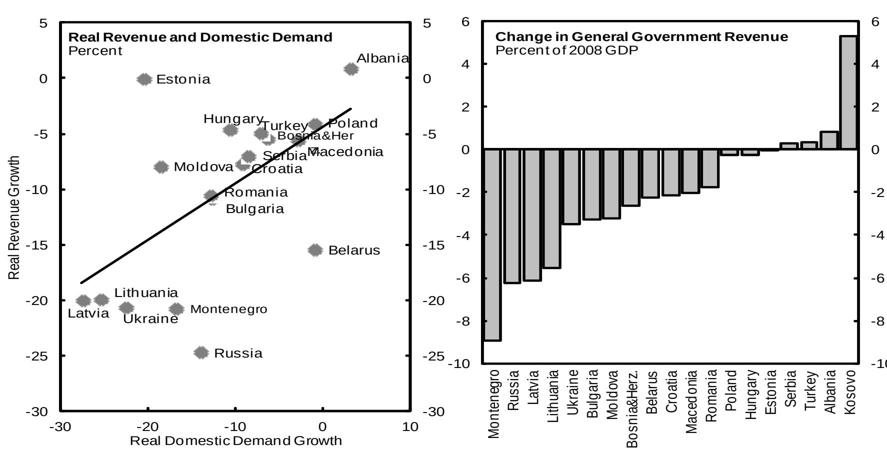
Chart 3: Revenue and Expenditure Growth, 2003–2008



Note: As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–2007.

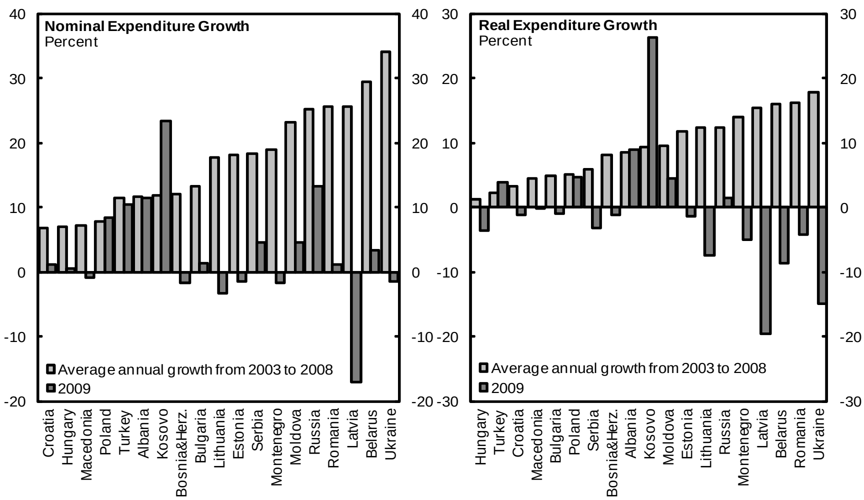
Source: IMF, World Economic Outlook database, Government Finance Statistics, and IMF staff calculations.

Chart 4: General Government Revenue, 2009



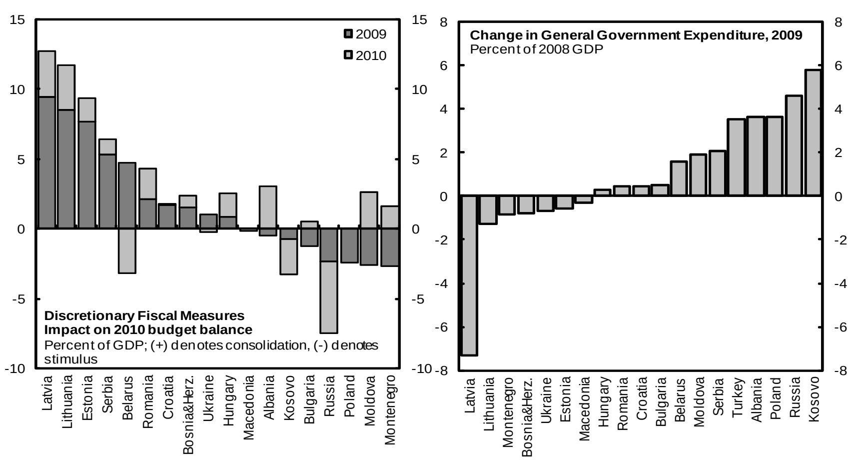
Source: IMF, World Economic Outlook database and IMF staff calculations.

Chart 5: General Government Expenditure Growth, 2003–2009



Source: IMF, World Economic Outlook database and IMF staff calculations.

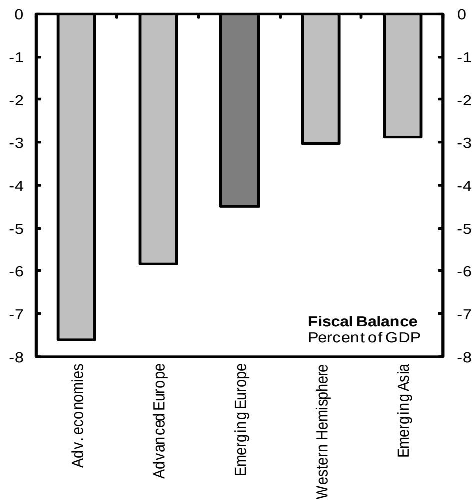
Chart 6: Fiscal Consolidation



Note: The left chart depicts the fiscal measures as estimated by IMF staff. For Romania, several measures (including 25% wage cut, 5 percentage point increase in VAT) were taken in mid-2010; hence, only half was effective in 2010 – the rest is effective for the 2011 budget only.

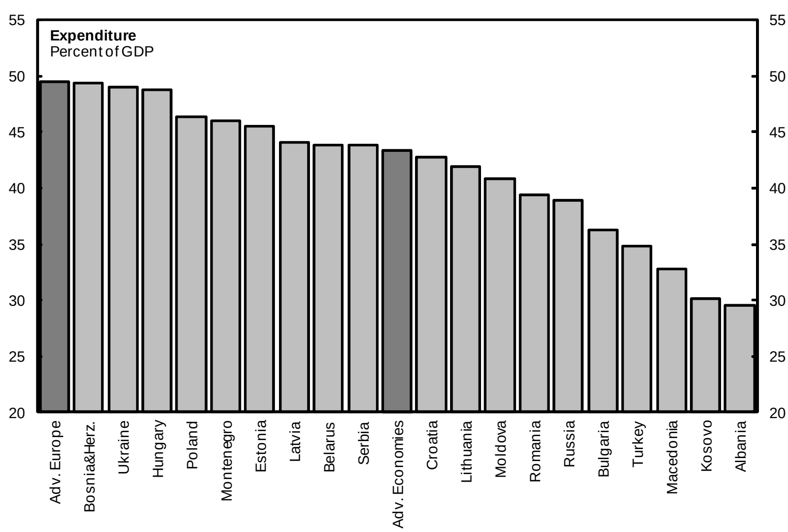
Source: IMF (2011d) and IMF staff estimates.

Chart 7: General Government Deficits in Emerging and Advanced Regions, 2010



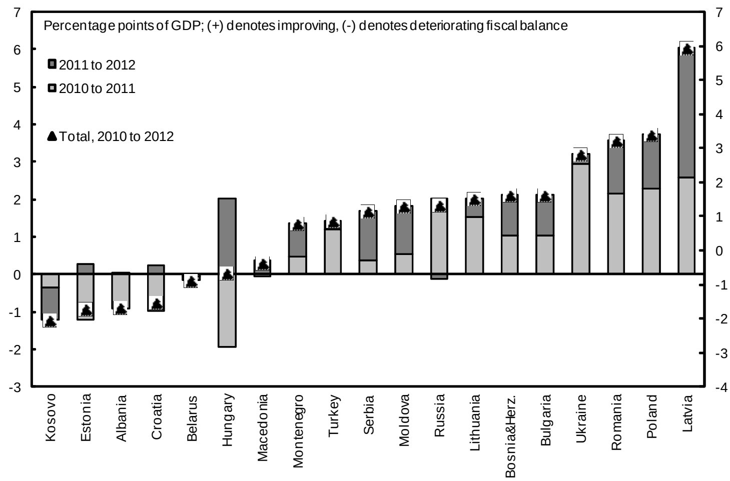
Source: IMF, World Economic Outlook database and IMF staff calculations.

Chart 8: General Government Expenditure, 2010



Source: IMF, World Economic Outlook database and IMF staff calculations.

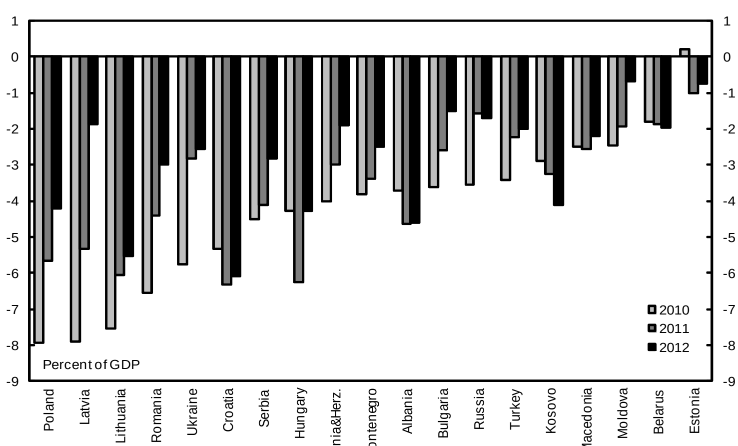
Chart 9: Change in General Government Fiscal Balance, 2010–2012



Note: Data refer to IMF staff forecasts. Data for Hungary are adjusted for the transfer of assets from the 2nd to the 1st pillar of the pension system.

Source: IMF, World Economic Outlook database and IMF staff calculations.

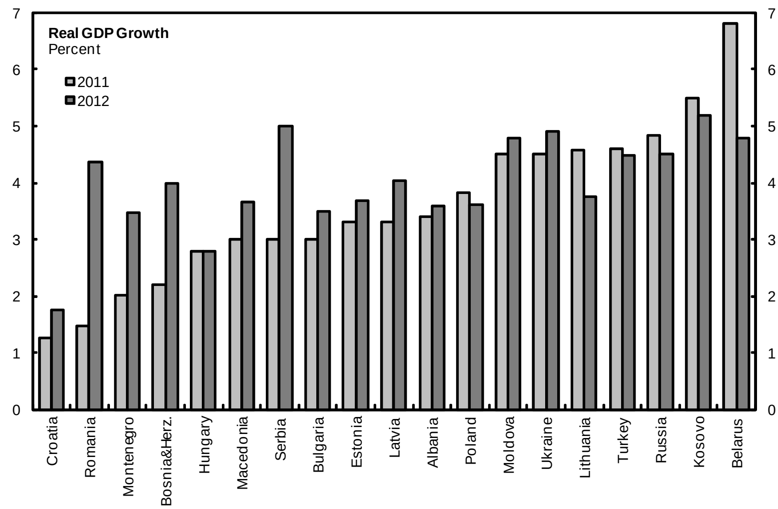
Chart 10: General Government Fiscal Balances, 2010–2012



Note: Data refer to IMF staff forecast. Data for Hungary are adjusted for the transfer of assets from the 2nd to the 1st pillar of the pension system.

Source: IMF, World Economic Outlook database and IMF staff calculations.

Chart 11: Real GDP Growth, 2011–2012



Note: Data refer to IMF staff forecast.

Source: IMF, World Economic Outlook database and IMF staff calculations.

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