68th East Jour Fixe
Limited Fiscal Space in CESEE: Needs and Options for Post-Crisis Reform[1]

Compiled by
Markus Eller[2]

Introduction

The aim of the 68th East Jour Fixe hosted by the OeNB on February 28, 2011, was to provide answers to the following three main questions: (1) What were the reasons for the limited budgetary room for maneuver and for the limited crisis resilience of public finance systems in the CESEE economies during the 2008–09 financial and economic crisis? (2) What are the related implications and what kind of reforms are necessary to provide more fiscal space[3] in the future? (3) Can an improved access to and a more effective use of international funds be considered as a possibility to create more fiscal space in CESEE?

Peter Mooslechner, Director of the OeNB's Economic Analysis and Research Department, opened the workshop and pointed out that knowledge on fiscal policy developments is crucial for a central bank in order to properly guarantee price stability, contain inflation expectations and keep financial markets stable. The workshop's focus on CESEE countries did not only reflect a strategic research priority of the OeNB but was also highly topical as the financial and economic crisis was the first real test for fiscal positions and institutions in most CESEE countries since the start of transition. During the crisis, only a few countries were able to implement stimulus packages while fiscal headline positions deteriorated strongly in most countries of the region (though, on average, public deficit and public debt ratios increased less in the CESEE EU Member States than in the EU-27). Mooslechner also addressed the broader implications of this fiscal deterioration. Excessive deficit procedures (EDPs) were opened for all CESEE EU Member States, except for Estonia, in 2009–10, setting back possible time lines for euro adoption in those countries that are not yet members of the euro area. Moreover, the question arises how a prolonged period of fiscal consolidation can be reconciled with a renewed promotion of the catching-up process in the region.

Fiscal Impact of the Crisis and Importance of Appropriate Fiscal Consolidation

In the first keynote address, *Bas Bakker,* Chief of the Emerging Europe Regional Division at the IMF, emphasized that, prior to the crisis, headline fiscal positions appeared to be favorable in most CESEE countries (compared to both advanced European countries and other emerging market regions). However, strong revenue growth during the pre-crisis boom period boosted government spending and thus led to the deterioration in underlying structural positions. This came to the fore during the crisis as sharp declines in real GDP and domestic demand eroded

[1] *The proceedings of this event will be published in the OeNB's Workshops series (No. 17) in May/June 2011. The presentations and the workshop program are available at http://ceec.oenb.at (Activities).*

[2] *Compiled by Markus Eller on the basis of notes taken by Mariya Hake, Antje Hildebrandt and Katharina Steiner.*

[3] *There are several definitions of fiscal space in the literature, e.g. financing the deficit without either a sharp increase in funding costs or undue crowding out of private investment (Ostry et al., 2010). In this workshop, the notion of fiscal space denoted the capability of fiscal policy to respond to shocks (e.g. a recession), depending on fiscal headline positions at the time of the shock and the historical track record for fiscal adjustment, which, in turn, depends on the credibility of the government and the quality of fiscal institutions*

revenues. At the same time, several countries faced difficulties in financing deficits, such as Hungary, Latvia or Romania. Unprecedented adjustment measures were therefore necessary, diminishing the leeway for the free operation of automatic stabilizers or for stimulating the economy (except in Poland and Russia). Bakker advocated continued fiscal consolidation given that the rapid build-up of debt during the crisis has put the countries at risk (their vulnerability threshold of public debt is lower than that of advanced countries) and contagion from sovereign solvency problems in advanced European economies cannot be fully precluded. Fiscal consolidation should be intensified in 2011 compared with 2010, since there are now fewer concerns that economic recovery would be nipped in the bud, and it should focus on expenditure cuts rather than on tax increases. To achieve more prudent fiscal policy during boom years in the future, Bakker suggested that expenditure growth should be kept in line with cautious estimates of potential GDP growth and, additionally, revenue over-performance should be used to build up buffers that can be used during the next economic downturn.

In the ensuing discussion it was argued that the private boom-bust cycle rather than the fiscal side should be addressed in CESEE in the first place. Bakker countered that there are only limited possibilities to steer the private sector directly, especially in countries with a fixed exchange rate regime, and therefore fiscal policy is one of the primary options.

Funded Pensions as a Countercyclical Tool to Create More Fiscal Space

In the second keynote lecture, *Karsten Staehr,* Professor at Tallinn University of Technology and research supervisor at Eesti Pank, argued that large business cycle fluctuations are a major public finance challenge in CESEE, both in terms of appropriate business cycle stabilization and as regards the avoidance of budget crises. Most of the CESEE EU Member States have already adopted a three-pillar pension model (first pillar: unfunded public pension, second pillar: compulsory funded pension, third pillar: voluntary saving). The Czech Republic and Slovenia, which have not yet implemented a second pillar, and Hungary, which recently abolished the second pillar, are exceptions. Staehr proposed to use funded pensions actively as a countercyclical instrument, thereby enhancing the crisis resilience and stabilization capacity of public finance systems in CESEE. This could be done in two ways. First, contributions to funded pensions could be discontinued or lowered in bad times and increased in good times. This option has already been implemented in a few CESEE countries since the outbreak of the recent crisis. Second, households would be allowed to withdraw all or part of already accumulated savings under the second and third pillars in bad times; this option has not yet been tried in CESEE. A positive impact on the budget balance – and thus an expansion of fiscal space during bad times – can be expected if released pension savings are taxed (not least in order to steer withdrawals) and public spending increases can be avoided given the domestic demand impetus.

The ensuing discussion revealed that it is important to consider the asset composition of funded pensions as, e.g., the price of stocks behaves procyclically and, therefore, withdrawals of pension savings during bad times can amplify price declines and increase systemic risk. Equally important is the design of appropriate incentives for rebuilding savings during good times.

Limited Fiscal Space: Structure of Fiscal Measures Matters

Session 1, chaired by Peter Mooslechner (OeNB), analyzed the structural composition of fiscal policy before and during the crisis to improve the understanding of the reasons for limited fiscal space in CESEE.

Nadine Leiner-Killinger, Principal Economist at the Fiscal Policies Division of the ECB, showed that the pre-crisis demand boom in the CESEE EU Member States led to a comparatively strong increase of indirect taxes, often combined with rises in less "productive" expenditure categories (such as social benefits and public wages). At the same time, several countries consistently failed to meet structural balance targets and therefore were not able to build up trust in fiscal policy before the crisis. Once the crisis hit the CESEE region, the comparatively strong reliance on indirect taxes resulted in a quick erosion of revenues whereas expenditures were adjusted only slowly (social benefits and compensation of employees even continued to increase substantially in 2007–09, often because of past decisions). Leiner-Killinger cast some doubt on whether the ongoing consolidation process has gone hand in hand with sufficient changes in the expenditure structure towards more productive items that would sustain potential growth in the future. On the positive side, a sizeable part of the 2009–12 fiscal consolidation is (planned to be) driven by expenditure restraint. On the negative side, the share of social benefits in total expenditures is set to increase (partly driven by the crisis) while the share of government investment is scheduled to decrease in most of the CESEE EU Member States in comparison with 2007.

Markus Eller, economist at the OeNB's Foreign Research Division, summarized the reasons for limited fiscal space in CESEE, emphasizing the issue of sovereign liquidity constraints that emerging economies often face during recessions. Procyclical discretionary fiscal policy before the crisis and public spending growth stronger than potential GDP growth led to a deterioration of structural balances, leaving no buffers when the crisis hit. Moreover, steeply widening sovereign CDS spreads at the beginning of the crisis (reinforced not least by trust problems) made the financing of deficits much more costly. Finally, as governments in the region largely relied on the external financing of public debt, and access to international financial markets became precarious at the beginning of the recession, several CESEE countries experienced liquidity constraints. As a result of these different factors, most CESEE countries had to put more effort into avoiding a budget crisis instead of using fiscal policy for crisis mitigation. Eller also stressed that liquidity constraints could be relaxed by restructuring government debt toward domestic holders, long-term maturities and local currency denomination (strengthening of domestic currency capital market is crucial in this context), by proper risk assessment to account for contingent liabilities, and/or by the implementation of credible medium-term frameworks and an improvement of fiscal rules.

In the discussion it was recalled that fiscal policy in countries with weak institutional credibility is often subject to a vicious cycle: Short-run stimulus measures can quickly result in concerns about long-run sustainability, which, in turn, requires immediate consolidation measures and therefore limits the business cycle stabilization capacities of fiscal policy.

How to Make CESEE's Public Finance Systems More Crisis-Resilient and Improve Their Macroeconomic Stabilization Capacity

Session 2, chaired by *Peter Backé,* Deputy Head of the OeNB's Foreign Research Division and Head of the Unit for Central, Eastern and Southeastern European Analysis, featured a panel discussion among fiscal policy experts from CESEE public institutions debating country-specific lessons and reform options to create more fiscal space in CESEE in the future.

Tomasz Jędrzejowicz, Head of Section in the Bureau of Public Finance, Institutions and Regulations at Narodowy Bank Polski, emphasized that the pre-crisis boost in revenues in Poland can be attributed more to revenue windfalls than to improvements in the cyclical position. Nevertheless, Poland was one of the few countries in CESEE that was able to provide considerable countercyclical fiscal support during the crisis given favorable general conditions, such as the comparatively good growth performance that translated into financial market confidence and allowed automatic stabilizers to play freely. With regard to the current fiscal consolidation, Jędrzejowicz stressed that a simple reversal of 2008–10 fiscal loosening may have a negative impact on potential growth. In particular, it is important that public investment is not being cut. Finally, Jędrzejowicz advocated expenditure ceilings as effective fiscal rules and provided evidence that EU countries which pursue an expenditure-based fiscal rule contain public spending during boom periods more effectively than the remaining EU countries.

Petr Král, Director of the Monetary Policy and Fiscal Analyses Division at Česká národní banka, called for sound and enforceable fiscal rules. In this context the current tightening of the macrofiscal framework at the EU level ought to be useful. It does, however, not substitute for the necessity to pursue responsible fiscal governance at the national level in times of solid economic growth. Král demonstrated that Czech fiscal policy was mostly procyclical in the past as extra revenues were typically spent and shortfalls in receipts were not accompanied by adequate expenditure cuts. Král also responded to Karsten Staehr's presentation, emphasizing that currently a pension reform is being discussed in the Czech Republic, which should become effective in 2013 and is expected to comprise the creation of a fully funded second pillar.

Neven Mates, Chief Advisor to the Governor of Hrvatska narodna banka, emphasized that not only initial public deficit and debt levels but also the current account position of a country are important determinants of fiscal space. Mates uses the change in sovereign CDS spreads as a proxy for fiscal space, arguing that "as long as you can borrow cheaply, you have fiscal space." He identified notable cross-country differences. Those who entered the crisis with a sound fiscal position and without external imbalances were able to afford some expansionary fiscal policy without seeing their sovereign spreads substantially deteriorating (such as the Czech Republic, Slovakia and Slovenia). Other countries, which posted good fiscal indicators but also large current account deficits at the onset of the crisis, or which recorded both a weak fiscal and external position, saw their spreads shooting up and the access to private capital weakening. These countries were not able to afford fiscal stimulus and had to finance increasing headline deficits either from budgetary reserves (Estonia and Bulgaria) or by resorting to IMF and EU aid (Hungary, Latvia and Romania).

Lúdovít Ódor, Advisor to the Prime Minister and Minister of Finance of the Slovak Republic, sketched region-specific challenges for fiscal policymakers in CESEE which, in the end, have contributed to limited fiscal space. Elevated macroeeconomic volatility and frequent "regime changes" (like supply shocks or election cycles) make it difficult to calculate the cyclical component of the budget accurately and thus contribute to a procyclicality bias. The tax potential is limited due to tax evasion and dependence on FDI. Low employment, bad infrastructure, non-competitive state-owned companies or unsustainable pension and healthcare systems create an additional burden on public finances. Corruption and problems with law enforcement reduce transparency. Ódor argued that multi-year nominal expenditure ceilings based on changes in public net worth (public sector assets minus public sector liabilities that also contain contingent liabilities) together with independent fiscal councils (which are not equipped with any normative power but provide regular assessments to decrease information asymmetries between fiscal policymakers and the public) constitute the most suitable fiscal policy framework for CESEE.

In the discussion the question was raised whether fiscal policy in CESEE could get "addicted" to structural EU support. Mates argued that the associated transfers have helped a lot in improving fiscal headline positions. Král replied that no macroeconomic effect has been found yet, but, from a microeconomic point of view, many projects would not have been realized without these funds.

International Funds as a Possibility to Create More Fiscal Space? – The Role of International Transfers in Public Investment in CESEE

Session 3, chaired by *Doris Ritzberger-Grünwald,* Head of the OeNB's Foreign Research Division, addressed the role of international transfers in public investment. Improved access to and a more effective use of international funds are often considered as one possibility to create more fiscal space in CESEE, and these funds are deemed to have served as valuable buffers during the recent crisis.

Philippe Monfort, Policy Analyst at the European Commission, Directorate General for Regional Policy, stressed that existing empirical evidence on the macroeconomic impact of the EU's cohesion policy is rather mixed. Convergence analysis shows that the disparities between EU-27 regions have decreased. Some econometric investigations indicate that a positive economic growth impact of the EU's Structural Funds can only be found in countries whose institutional quality is satisfactory. Moreover, policies that facilitate structural change and increase research and development capabilities in poorer regions seem to be crucial to get the maximum out of the support. With regard to the effectiveness of structural funds, Monfort highlighted that the absorption capacity in the CESEE EU Member States is not worse than in the EU-15. However, the financial management and control system emerges as a major subject of criticism in qualitative sample studies. Another shortcoming is the lack of an appropriate strategic approach, which has led to a dispersion of resources into incoherent and unconnected projects. EU Member States and regions should be required to formulate regional development strategies and targets which concentrate EU and national resources on a small number of themes, closely linked to the priorities of the Europe 2020 growth strategy.

Jean Vrla, Head of Division at the European Investment Bank (EIB), Directorate for Operations in the European Union and Candidate Countries, explained that the EIB nearly doubled its lending volumes to the CESEE EU Member States in the course of the crisis. The funded projects are focused on areas such as cohesion and convergence policy, small and medium-sized enterprises (SME), environmental sustainability, the knowledge economy, Trans-European Networks or energy. Large-scale infrastructure projects still form the lion's share of the EIB's lending to CESEE, with the share of SME funding having considerably increased during the last two years. Vrla asserted that the demand for EIB lending in EU and pre-accession countries is expected to weaken in the period 2011–13 as the access to alternative funding is expected to recover. While the disbursement flows to projects will remain high in the next few years due to the time lag between signature and project implementation, the EIB's 2011–13 lending volumes are expected to return gradually to pre-crisis levels due to the need for fiscal discipline in CESEE and the uncertain future demand for large public-private partnership (PPP) projects.

Finally, *Christian Kummert,* Managing Director at Kommunalkredit Austria AG, from the practicioner's perspective discussed the role of commercial banks in co-financing large-scale infrastructure projects via multinational banks and specifically elaborated on the funding of PPP projects in CESEE. Kummert pointed out that during the crisis many banks faced difficulties in obtaining long-term funding, which banks need to be able to offer long-term loans for the funding of PPP projects. As a consequence, a number of banks withdrew from PPP lending altogether, and the share of cancelled PPP projects increased. Kummert stressed that multinational banks, such as the EIB and the EBRD, have recently played an important role in the financing of PPP projects in CESEE, as they are able to replace the shortfall in commercial debt in sizable projects and provide credibility to individual transactions. Also, their capability to raise local currency funding in the markets and utilize these funds for infrastructure debt makes them a valuable project partner. Kummert's assessment of future perspectives for PPPs is twofold: On the one hand, increasing public indebtedness might reduce future investment in public infrastructure. On the other hand, higher public debt might also stimulate off-balance sheet models such as PPPs to procure public infrastructure projects.

References

Ostry, J. D., A. R. Ghosh, J. I. Kim, M. S. Qureshi. 2010. Fiscal Space. IMF Staff Position Note SPN/10/11. September.