Fiscal Space in CESEE Countries: Lessons from the Crisis with a Special Focus on Poland

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1. Introduction

The global economic crisis has brought about a profound worsening of fiscal positions around the world and throughout the European Union (EU). The EU Member States from Central, Eastern and South-Eastern Europe (CESEE) were no exception. A majority of them have experienced an increase in fiscal deficits to levels more than double the 3% of GDP limit of the Stability and Growth Pact, while debt ratios have on average increased by 14.4 percentage points of GDP between 2007 and 2010.

In general, the worsening of fiscal positions related to the economic crisis may be attributed to four factors:

- impact of automatic fiscal stabilizers
- reversal of extraordinary tax revenue windfalls related inter alia to asset price bubbles
- undertaking of discretionary fiscal stimulus measures by governments
- cost of government support to troubled financial institutions

The distinguishing feature of CESEE countries vis-à-vis EU-15 Member States, is that the former two factors appear to have played a greater role, while the latter two were less prevalent[1]. In this sense, the fiscal deterioration in the region was largely automatic and not a consequence of discretionary government decisions. At the same time, however, it should be emphasized that fiscal problems experienced in recent years may be traced back to a procyclical loosening of fiscal policies before the onset of the crisis. The first set of conclusions to be drawn from the experience

[1] According to European Commission estimates, (EC, 2010) only two countries from the CESEE region recorded increases in public debt related to assistance to the financial sector and only one increased its contingent liabilities as a result of such assistance. The magnitude of support in these cases was considerably lower than in the most affected euro area Member States.

of recent years therefore needs to refer to ensuring sound fiscal positions in 'good times'. Secondly, some lessons for fiscal policymakers during the crisis may also be drawn. The third key aspect concerns the path towards attaining these sound fiscal positions.

2. Fiscal Policies in Poland and the CESEE Region before the Onset of the Crisis

The CESEE region had enjoyed very strong growth in the pre-crisis period of 2005–2007, far exceeding that of EU-15, both in terms of growth rates, as well as in terms of positive output gaps. In a number of cases, this was accompanied by credit booms, asset price bubbles and a build-up of external imbalances.

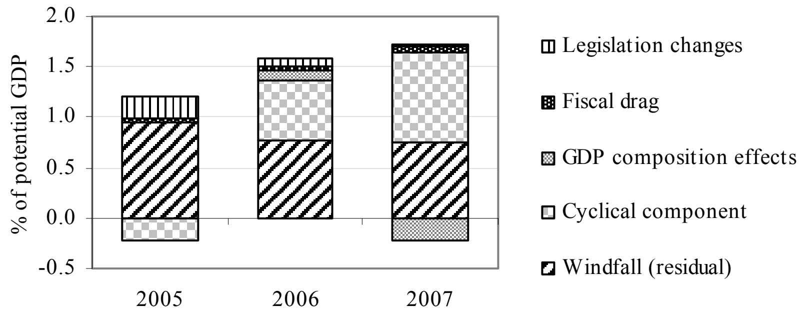
These developments appear to have had a marked impact on fiscal positions of CESEE countries. Larger positive output gaps had a direct impact on the estimated levels and change of cyclical components of the budget balance. According to estimates of the European Commission[2], between 2004 and 2007 the cyclical component of budget balances in this group of countries on average improved by more than 2 percentage points of GDP, whereas the average change in the EU-15 was half of this size. Moreover, estimates of the European Commission[3] indicate that CESEE countries have also experienced higher revenue "windfalls," i.e. extraordinary gains in tax revenue not captured by traditional cyclical adjustment methodology. These windfalls are generally considered to be related inter alia to asset prices, but, particularly in the case of emerging market countries, they may be associated with improvements in tax collection (World Bank, 2008). If such improvements had materialized, subsequent developments have shown them to be of a temporary nature.

The phenomenon of revenue windfalls may be illustrated using the example of Poland. Between 2005 and 2007 there have been no substantial increases in tax rates, other than a relatively minor carryover effect of indirect tax increases, which took place upon Poland's EU accession on May 1, 2004. In spite of this, the ratio of revenues from taxes and social contributions to potential GDP increased by more than 4 percentage points in that period, of which the majority may be attributed to revenue windfalls (chart 1).

The increase of tax revenue took place against the background of booms in asset prices. The Warsaw Stock Exchange WIG20 index rose from levels below 1900 points at the beginning of 2005 to a peak of 3918 points in October 2007. In the same period, prices of residential real estate in the largest cities more than doubled (NBP, 2010).

[2] AMECO database.
[3] Public Finances in EMU, 2009.

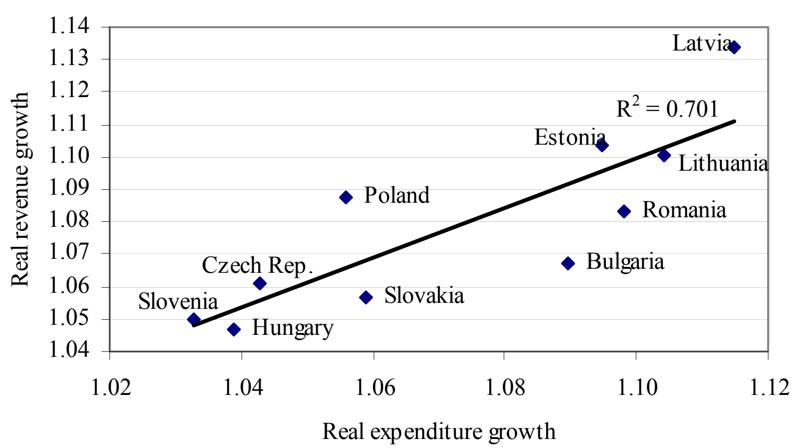
Chart 1: Decomposition of Increase in Ratio of Taxes to Potential GDP in Poland (2005–2007)



Source: Author's calculations, following the approach described in Kremer et al. (2006).

CESEE countries have generally used the buoyant tax revenue to improve their fiscal positions during the 2005–2007 upturn (the timing of the upturn varied slightly in some cases). However, the majority of them have not done so to a sufficient degree, instead choosing to increase expenditure, as shown in chart 2.

Chart 2: Average Real Growth of General Government Tax Revenue and Primary Expenditure in the Period 2005–2007



Source: AMECO database.

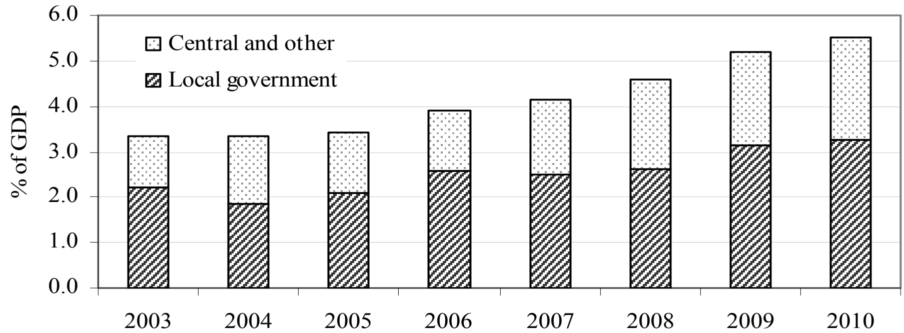
Throughout the upturn, only Bulgaria and Estonia have shown signs of consistently disciplined fiscal policies, managing to achieve their medium-term objectives (MTO) under the Stability and Growth Pact (SGP) for more than one year. Meanwhile, Latvia and Slovenia only attained this target in the single, peak year of 2007, in the case of Latvia clearly with the help of large revenue windfalls of a transitory nature, while the remaining countries failed to reach their MTOs altogether.

The tendency towards pro-cyclical loosening of fiscal policies in the most recent upturn was clearly visible in Poland. In 2006 and 2007, the Parliament approved a number of new laws, with substantial negative impact on public finances. These were in particular focused on reduction of the tax wedge, but also included spending increases. The measures included:

- a reduction in social contribution rates in the part allotted to financing disability benefits by 5 percentage points of the salary on the employee side and an additional 2 points on the employer side, costing around 1.5% of GDP;
- an introduction of a new child-raising tax deduction in personal income tax, costing 0.5% of GDP
- a reduction of personal income taxes in the form of a move from a three-bracket schedule with 19%, 30% and 40% rates to a two-bracket (18% and 32%) one, costing around 0.6% of GDP
- special legislation securing extraordinary salary increases for a number of professional groups in the public sector, including doctors, police and border guard, as well as teachers, altogether costing more than 0.4% of GDP,
- change in the pension indexation formula, from inflation-only to inflation plus 20% of real salary growth, which may be estimated to cost around 0.2%–0.3% of GDP in the medium term

In addition, it should be noted that these measures were introduced against the background of strongly increasing public investment, associated with absorption of EU structural funds, additionally contributing to spending growth.

Chart 3: Public Investment in Poland, by Government Subsectors



Source: Eurostat.

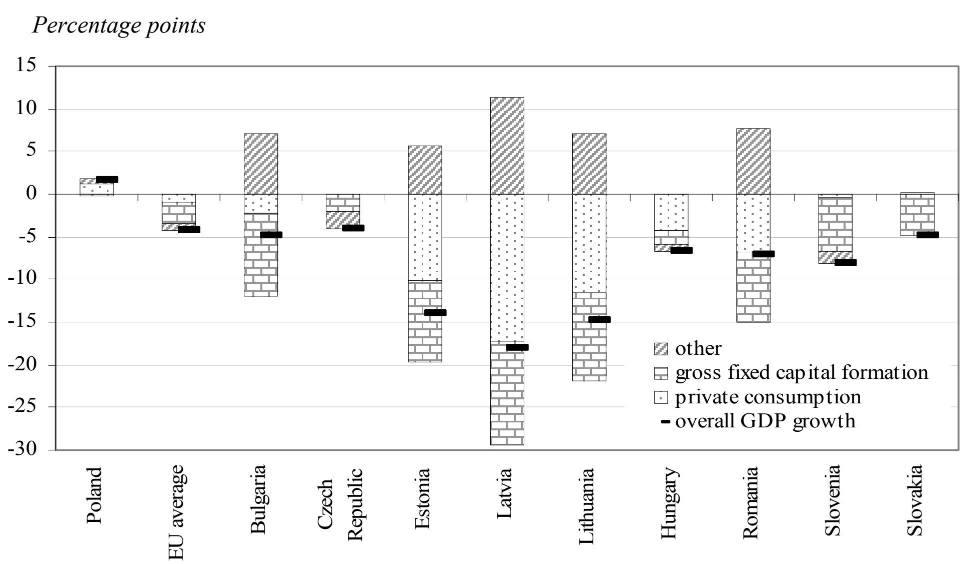
3. Fiscal Policies during the Economic Crisis

Facing a severe economic slowdown, leading advanced economies implemented sizeable fiscal stimulus programmes. While the recession in some of the CESEE countries were just as acute, if not worse, they were generally not in a position to undertake such stimulus measures. Increased risk aversion in the face of the crisis has severely limited the borrowing potential of emerging market governments. Two countries of the region, Hungary and Latvia, were forced to resort to financing from the IMF and EU as early as in 2008. Despite ongoing fiscal consolidation efforts, the perception of Hungary as a high risk country due to liabilities accumulated in the first half of the decade, has led to capital outflows and a sharp rise in CDS (Credit Default Swaps) and government bond yields (World Bank, 2009). Meanwhile, in the case of Latvia, external assistance was necessary in view of a deep recession coupled with a banking crisis. Later on, Romania also entered an IMF programme in April 2009.

In spite of the precarious financing conditions, prevalent in particular in the second half of 2008 and in 2009, some countries of the region have managed to allow their automatic fiscal stabilisers to operate and in some cases, to relax the fiscal policy stance. Poland is a particularly notable example of such fiscal support to the economy for two reasons. The first was the magnitude of fiscal loosening, which was among the largest in the region. Secondly, Poland managed to maintain a positive growth rate throughout the crisis, which was unique not only in the region, but also in the whole EU. There were a number of reasons behind this remarkable growth performance. These included the currency depreciation of around 30% between the beginning of 2008 and early 2009, the highest of all floating rate countries of the region. However, aside from the positive contribution of net exports to growth, domestic demand components also grew more strongly (or contracted less) than in other countries. In this context, it appears that fiscal policy played a vital role, as it contributed to supporting all components of domestic demand (see chart 4):

- Private consumption – Poland recorded the strongest growth of private consumption in the EU in 2009. Compared to other CESEE countries, a lower degree of openness of the economy is likely to have played a role, limiting the negative external impact of the global crisis on household incomes. But the large-scale cuts in the tax wedge implemented in 2007–2009, which totaled 2.6% of GDP were also crucial. At the same time, expenditure on compensation of public employees was also growing robustly, rising by 8.1% in nominal terms.
- Public consumption – Poland was one of the few EU Member States with a positive contribution of public consumption to growth, as current expenditure grew strongly throughout the crisis, particularly at the local government level.
- Gross fixed capital formation – while Poland did not manage to avoid a sharp decline in corporate investment, this decline was partly offset by public investment which increased in nominal terms by 17% in 2009. As a result, the magnitude of the negative contribution of gross fixed capital formation to growth was the lowest in the EU.

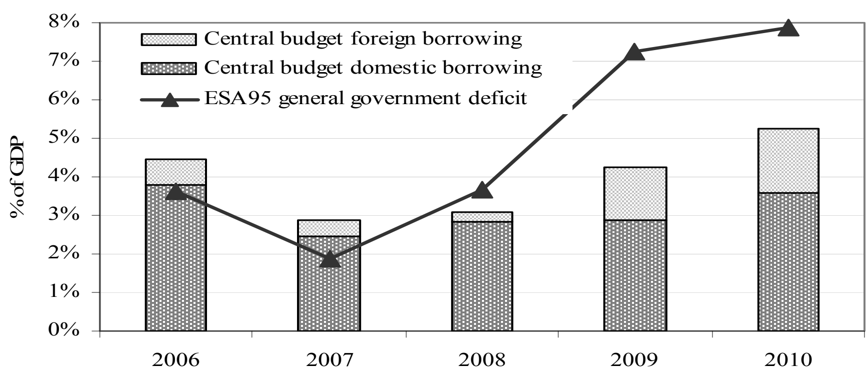
Chart 4: Contribution to Real GDP Growth in 2009



Source: European Commission, AMECO database.

In this context, it is worth devoting some attention to Poland's fiscal stimulus which was not only among the highest in the region, but also exceeded that introduced in a number of EU-15 Member States. In view of significant financial market tensions, particularly in the early months of 2009, a crucial aspect of that stimulus was its financing. While the general government deficit increased by 3.6 percentage points of GDP, the level of net issuance of Treasury securities on the domestic market had actually remained almost unchanged relative to 2008. The explanation behind these developments lies in the massive worsening of fiscal positions of other units of general government[4]. This was partly due to the economic slowdown (decline in tax and social contribution receipts of these units), partly related to independent decisions of these units (increase in investment spending at the local government level) and partly a deliberate decision of the government to shift a part of the deficit out of the central budget. One example of this was the shifting of expenditure on road construction in the amount of around 0.7% of GDP from the central budget to the National Road Fund.

Chart 5: ESA95 General Government Deficit versus Central Budget Borrowing Requirement – Poland



Source: Eurostat; Ministry of Finance, Republic of Poland.

While such practices had a negative impact on the transparency of public finances, they also allowed the government to signal to financial markets its commitment to contain its borrowing requirements. Market participants often focus on the level of Treasury bond issuance, which they can monitor in real time, rather than on the overall general government balance, as this information only becomes available with a considerable lag.

[4] According to Eurostat figures, the combined deficit of the local government and social security funds subsector deteriorated from +0.2% of GDP in 2008 to –2.0% of GDP in 2009.

4. Fiscal Challenges in the Aftermath of the Crisis

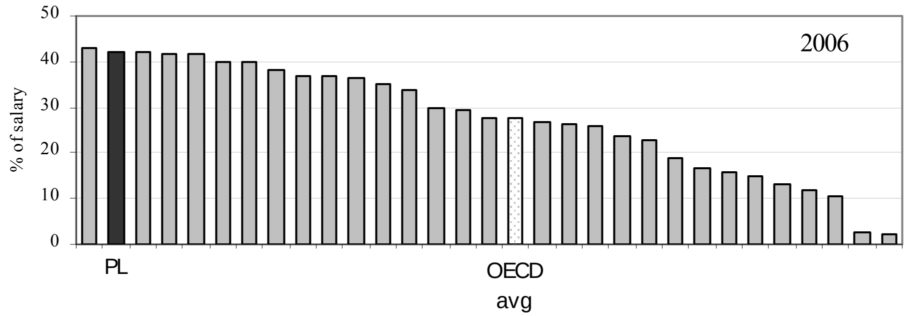
In the aftermath of the global economic crisis, CESEE countries were facing large fiscal deficits and public debt levels 10–30 percentage points of GDP higher than before. Given that in case of emerging economies, debt ratios that can be sustained are generally considered to be lower than those for advanced economies (Ali Abbas et al., 2010), this implied an urgent need for fiscal adjustment. The majority of countries in the region began consolidating public finances in 2009–2010, while some were forced to introduce adjustment measures as early as 2008. Poland was an exception in this regard, as it was the only country in the region, where the general government deficit noticeably increased in 2010. This was largely related to continued weakness of direct taxes, rather than a discretionary loosening, nonetheless the decision to postpone consolidation to 2011 and afterwards was quite unique in the region.

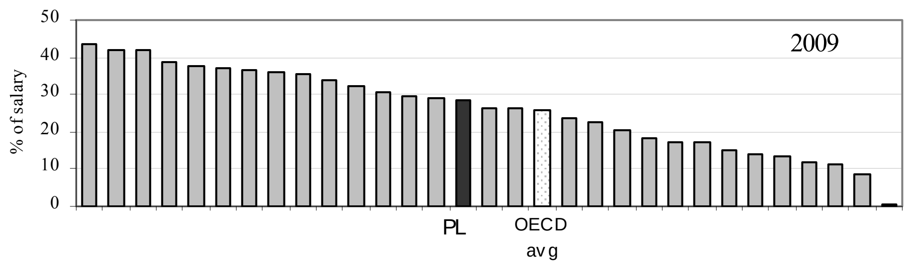
Empirical literature indicates that expenditure-based fiscal consolidations are generally likely to be more durable and less harmful for economic growth. In addition, during the crisis government expenditures in CESEE countries increased to around 41% to 50% of GDP, the highest level since the early years of transition. Nonetheless, the actual composition of fiscal adjustment in the region is quite mixed, with countries relying both on spending cuts, as well as tax increases, particularly in the area of indirect taxes.

As noted earlier, in the case of Poland, the fiscal loosening which took place during the economic slowdown and in the period immediately preceding it, largely consisted of significant reductions in the tax wedge.

A full or at least partial reversal of these tax cuts would go some way towards solving the fiscal problems at present. At the same time, however, it would imply a reversal of the labour market incentive effects arising from the lower tax wedge (see chart 6). It is worth noting in this context, that at the beginning of the previous upturn in 2005, Poland's overall employment rate stood at just 52.8% and was the lowest in the EU. The tax wedge was among the highest in the OECD, particularly for families with children.

Chart 6: Average Tax Wedge on Families in OECD Countries – 2006 and 2009



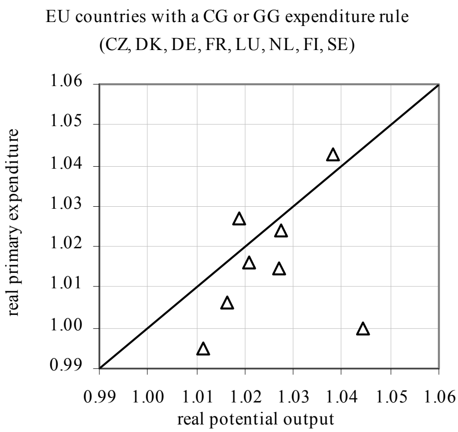


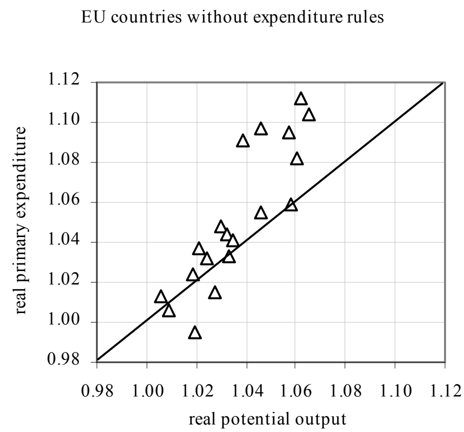
Source: OECD Taxing Wages.

Once the necessary adjustment is implemented, the key challenge will be to secure it, when the next economic upturn takes hold. Previous errors of using the positive cyclical component of the budget balance and extraordinary revenue windfalls stemming inter alia from asset price bubbles to finance procyclical spending increases, must be avoided.

As recent literature indicates, one of the ways to preserve fiscal discipline is by strengthening the framework of fiscal policy, in particular by introducing fiscal rules, which have been shown to positively affect fiscal performance (Debrun et al., 2008). As reflected in the information on fiscal rules collected by the European Commission, the number and coverage of rules in European countries has increased substantially over the past two decades. Nonetheless, it is important to note that rules differ in strength, coverage and the incentives they provide. Notably, not all rules enforce fiscal discipline in "good times" – e.g. rules focusing on the budget balance and public debt are easier to comply during an upturn and may not prevent the spending of revenue windfalls. Meanwhile, expenditure rules focusing on containing spending growth in the medium-term, may help preserve unexpected revenues and assign them to deficit reduction.

Chart 7: Real Growth of Potential Output and Primary Expenditure in the EU (2005–2007 Average)





Source: AMECO database, EC fiscal rules database.

As shown in chart 7, during the 2005–2007 upturn, EU Member States with such rules at the central or general government level have generally been more successful in containing the growth of primary expenditure below that of their potential output, while for the majority of remaining countries, the opposite has been the case. This may be a valuable lesson for CESEE countries, given that according to the EC database, only one of them (Czech Republic) had an expenditure rule in place during the most recent upturn.

5. Concluding Remarks

The fiscal problems in which CESEE countries found themselves in the aftermath of the economic crisis can be largely traced back to the preceding upturn. Despite favourable cyclical conditions and the appearance of significant revenue windfalls, a majority of these countries have failed to reach sound budgetary positions. Instead, the buoyant tax revenues fuelled expenditure increases. These developments point to the need for a better assessment of the underlying fiscal position in real time, including a very careful evaluation of revenue windfalls, which may later prove to be of a transitory nature.

Once the crisis began, fiscal positions worsened dramatically, although in the CESEE region this was to a large extent an automatic effect of the reversal of the previously positive cyclical component of budget balance and revenue windfalls. Few countries were in a position to apply discretionary fiscal policy to stimulate the economy. Poland was perhaps a notable example in this regard, as fiscal policy played a key role in sustaining all major components of domestic demand.

From the current perspective, two main challenges remain. On the one hand, fiscal consolidation is a priority in the short-run, as all countries of the region, with the exception of Estonia, are in an excessive deficit procedure (EDP). In the medium-term, the main challenge will be to safeguard sound fiscal positions over the economic cycle. In this context, fiscal rules, particularly those limiting public expenditure growth in economic upturns, may play a useful role.

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