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Fiscal Policy and Sustainability in View of Crisis and Population Ageing in Central and Eastern European Countries

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Policy Briefs are a publication series providing a synthesis of topics of research and policy advice on which European Centre researchers have been working recently.

This Policy Brief examines the interrelated aspects of the recent economic and fiscal crisis – such as the GDP growth, budgetary deficit and public debt, fiscal policy and austerity measures – as well as the long-term impact of population ageing on the sustainability of public finances in the former communist states of Central and Eastern Europe (CEE). The countries surveyed have all recently joined the European Union (EU): Bulgaria and Romania (2007); the Baltic States: Estonia, Latvia and Lithuania (2004); and the so-called Visegrád Four: the Czech Republic, Hungary, Poland and Slovakia (also 2004). The threat posed to the fiscal sustainability of the CEE countries by the combination of demographic trends and a unique economic context needs detailed examination.

The EU accession and increased opportunities of trade cooperation and foreign direct investment further strengthened the transition to the market economy of these countries, and as a result they became the fastest growing economies in the whole of EU. It is somewhat ironic that the same greater links with the global economy that followed EU membership were a big factor in making these countries particularly vulnerable to economic shocks. It is the interest of this Brief to review the CEE countries' economic growth during the boom period (around 2006-2007), to assess the impact of the crisis in these countries as well as to analyse the source and extent of their recovery during 2010.

Counteracting the recession during 2009 has been the principal economic challenge in Europe and unprecedented fiscal and monetary policy measures were deemed necessary at the national level to stimulate economies and stabilize financial markets. Consequently, partly as a result of stimulus spending, almost all European governments faced a significant deterioration in their public finances. Government deficits among EU states have risen substantially, from an average of 0.8% of GDP in 2007 to 6% in 2009 (Economic Policy Committee 2009a), leading to an accumulation of large government debts, and raising further concerns regarding the sustainability of public finances in all European states. Within CEE countries there are additional challenges which can be traced to their young market economic status. Having made the transition to the market economy not long ago (during the 1990s) CEE countries have not had the benefit of long (or prolonged) periods of economic growth and prosperity and also have gone through the political transition towards democratic institutions and governance relatively recently. It is therefore interesting to also analyse, as done here, how debts and deficits have changed in CEE countries during recent times, not only in comparison with the EU's 'old' states but also by reference to fellow CEE bloc of countries.

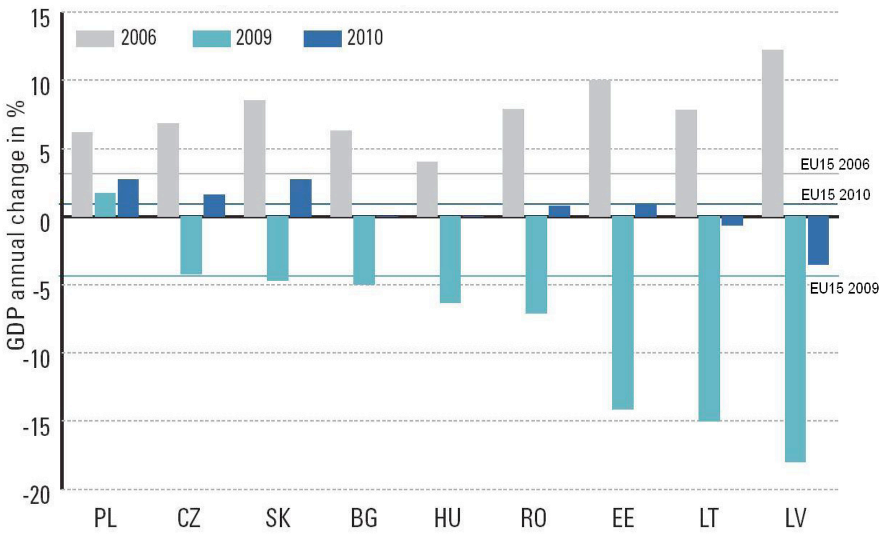
A further question of interest is how ageing populations will exacerbate the adverse situation of CEE countries' fiscal sustainability in the future. The prospect of gains in human longevity has indeed been a welcome trend, particularly in CEE countries where life expectancy is lower than in other EU countries. But, rising longevity combined with falling fertility and higher emigration has led to shrinking working age populations in many CEE countries. Such challenges will exert significant additional demands not just on future public finances in the form of rising expenditures on pensions, health and long-term care but also they will have an adverse impact on the growth potential. This Brief provides an analysis of the indicator of financial sustainability devised by the European Commission's Ageing Working Group (namely: S2), with a focus on the additional challenges that ageing contributes to the fiscal sustainability gap in CEE countries.

The rest of the Brief is laid out in four sections. Section 1 sets the context by analysing changes in GDP growth before, during and after the recent financial and economic crisis. Section 2 analyses the fiscal stimulus packages, levels of government debt and deficit as well as austerity measures introduced so far in CEE countries. Section 3 analyses the fiscal sustainability indicator, S2, and highlights what additional challenges population ageing contributes to the sustainability of public finances. Lastly, Section 4 provides some policy implications of analyses included in this Brief.

1. Differential impact of the crisis on economic growth

An essential context for this paper is to assess the overall performance of the economy in terms of GDP growth. A large positive growth ensures a steady influx of government revenues, whereas a low or negative growth often requires expensive demand-generating stimulus spending as well as expenditures arising from automatic stabilizers such as unemployment benefits. Therefore, it is important to highlight how the selected CEE countries have plummeted from high growth to a situation of contraction as a result of the recession in 2008-2009 and whether they have been able to get back on a positive growth path during the recovery observed in 2010. The better the response towards the GDP growth, the higher the prospects the country has for a fiscally sustainable development path.

Figure 1:
GDP growth rates in CEE countries, 2006, 2009 and 2010



Source:
Statistical Annex, Spring 2010 Economic Forecast. European Commission.

As seen in Figure 1, CEE countries were experiencing impressively high levels of economic growth during 2006, with growth rates surpassing the EU15 average of 3% in all CEE states. At the height of the crisis (during 2009), all CEE countries went through a significant decline in the economic growth. All but a single CEE country (Poland) entered a period of contraction that was in most cases much more severe than the EU15 average of -4.3%. Central and Eastern Europe was hard hit by the global financial crisis because of the region's close trade links and reliance on foreign capital flows and direct investment, and less reliance on the domestic economy (with the exception of Poland). Ironically, these were the reasons that allowed the CEE countries such brisk economic growth that made them plunge into such severe recession.

The Baltic 'Tigers'

The worst decrease in GDP growth occurred among the three Baltic States: Latvia, Lithuania and Estonia. In Latvia GDP growth fell by over 23 p.p. and reached a contraction level of -18%. In Lithuania output growth plunged to -15% and in Estonia to -14%. The three countries, with their small domestic economies, were extremely vulnerable to crisis, partly as a result of the fact that the preceding boom created large imbalances in their economies and was causing them to overheat. Following these countries' entry into the EU, foreign-owned banks moved in and liberalized lending, often in foreign currency, to a public largely unaccustomed to credit. The economies were fuelled by this easy access to credit and low interest rates in real terms, especially for first-time homebuyers and for companies (Andersen 2009b).

Moreover, in the three Baltic states the local currencies were pegged to the Euro. While a fixed exchange rate appeared advantageous during the pre-crisis boom, the downturn that followed had also been intensified as a result. After EU accession, the 'peggers'[1] saw wages grow at double-digit annual rates from 2004 to 2008. The average rate reached about 25% a year in Latvia – more than ten times the Euro-area average (Dadush and Shimelse 2010). The crisis resulted in a sudden stop of the capital inflows that had financed the boom. Foreigners restricted their lending to e.g. Latvia, foreign depositors withdrew funds, wages dropped from their unsustainably high boom levels and in late 2008 the Baltic 'tigers' plunged into one of the world's deepest recessions (Andersen 2009a).

The CEE countries experienced an impressive economic growth during 2006, matched by a similarly impressive contraction during 2009. Undoubtedly, these countries were hard hit because of their trade links and reliance on foreign capital flows and direct investment, and less reliance on the domestic economy (with the exception of Poland). These are the same reasons that allowed CEE countries such brisk economic growth.

The worst recession occurred in Latvia as a result of its particularly vulnerable economic situation prior to the crisis. In 2007 bank credit to the private sector was reaching 95% of GDP, current account deficit peaked at 25% of GDP (i.e. Latvia was borrowing roughly 25% of its income from abroad), and private external debt amounted to about 130% of GDP. When the crisis hit, the government faced severe difficulty in borrowing from markets. An international support package, worth €7.5 billion agreed by the IMF and the EU in 2008, avoided the economy to become insolvent (Andersen 2009a).

Lithuania was only slightly less vulnerable to the crisis. Skilful policy management since the onset of the downturn had been crucial to maintaining stability. The authorities responded promptly to the decline in banking deposits with an increase in deposit insurance coverage and a reduction in the reserve requirements for banks from 6% to 4% (IMF 2008b), all to ease liquidity constraints. Nevertheless, Lithuania as much as Latvia, did not manage to bring GDP growth back up and are experiencing contraction still in 2010, due partly to the scale of the decrease observed in 2009.

Estonia was hit least by the recession among the three Baltic States, thanks in large part to policies during the boom years of 2004 that maintained the bursting economy relatively under control. Estonia, running fiscal surpluses during the boom, accumulated sizable fiscal reserves, which amounted to about 10% of GDP at the end of 2007. As a result, the country had virtually no public debt going into the crisis. Also, Estonia's finances were not as exposed as many other countries' to the drying up of global financial markets, for a number of reasons. Firstly, Estonia has virtually no domestic-owned banks, which meant that the main banks operating in the country were fully backed by strong Nordic parents. Secondly, the central bank increased capital requirements and imposed reserve requirements amounting to 15% of all liabilities prior to the crisis, which meant the banks had sizeable buffers when the crisis hit. Lastly, Estonia has a highly flexible labour economy, and wages have already come down significantly, even in nominal terms (Andersen 2009b). As a result Estonia could meet the Maastricht budget deficit criterion of 3% of GDP in 2009 and 2010, despite this year's decline in GDP (IMF 2010d).

Bulgaria and Romania

Bulgaria stands out as another country in which no positive growth has been observed during 2010. In Bulgaria, with its currency pegged to the euro, the boom led to an overheating of the economy, with high wage growth and double-digit inflation and a private sector external debt amounting to around 100% of GDP at the end of 2008 (IMF 2009c). Domestic demand contracted sharply, by 15%, and its continuing weakness prevented the economy from picking up in 2010. However, the situation was not dire because Bulgaria experienced the downturn with considerable public sector buffers. Foreign exchange reserves were high, of about €5 billion, and there was also a large fiscal surplus. Also, most banks in Bulgaria are owned by foreign institutions, and thus supported by their foreign parent-institutions (IMF 2010b).

The situation in Romania was more dramatic, so much so that the Romanian government had to turn to the international community for assistance. Unlike Bulgaria, Romania has never enjoyed a budget surplus: it had a budget deficit prior to the crisis. The country also suffered a significant depreciation of its currency going into the crisis: the exchange rate weakened by more than 15% against the euro. Before the crisis, Romania prioritized currency stability, and as a result it had to sacrifice a control over monetary policy and also tolerate higher inflation and domestic contractions. However, the Romanian banking system remained well capitalized and highly liquid and the banks had a cushion of capital that they could rely upon to take them through the recession. Nevertheless, the fact that the European economy is recovering less quickly than some other regions is affecting Romania and a return to positive growth is delayed and somewhat weaker than was originally anticipated (Andersen 2010b; IMF 2009a).

Slovakia and the Czech Republic

Slovakia and the Czech Republic, though suffering a contraction of close to -5% in 2009, dealt relatively well with the recession by returning to a positive growth path during 2010. Slovakia is the only country of CEE to have adopted the Euro, and this recovery trend is good news to Eurozone countries. It has a sound financial sector and a healthy banking sector that is focused on traditional domestic banking activities and avoids foreign currency denominated lending. Banks are currently well capitalized and rely mainly on domestic retail deposits. However, the country is highly dependent on external economic developments, and hence the pronounced economic weakening in the euro area caused a sharp drop in output (IMF 2009b).

The Czech Republic, though not a member of the Eurozone, was also able to weather the global financial crisis thanks to its sound economic fundamentals including healthy trade balances. Nevertheless, due to its highly open nature, the economy was hit by spill-over effects of the crisis and a downturn in the euro area depressed exports, while investment declined and the banks tightened lending standards. The adverse effects of the crisis are likely to be long-lasting, and growth is not expected to reach pre-crisis levels owing to the abating convergence process and worsening demographic trends (IMF 2010c).

Hungary

Hungary is a special case to examine as it had been undergoing economic crisis of its own before the onset of the global 2008 crisis. In the process, it was assisted by the IMF and EU to raise money in capital markets to fund its government-spending overruns. The IMF Stand-By Arrangement with Hungary was approved in November 2008 as part of a €20 billion international financial package, which provided Hungary with the amount of reserves that was sufficient to meet its external obligations and created conditions necessary to facilitate appropriate reforms in government finances and in the banking sector. In exchange, Hungary promised to curtail government spending and shrink its budget deficit. The target for 2010 is 3.8% of GDP (IMF 2008a).

Poland

Poland was the only country in the EU that did not experience a negative growth rate as a consequence of the 2008 global crisis, even though GDP growth did fall significantly from 6.8% to 1.7% in 2009. One of the reasons behind this is Poland's fairly large domestic market, which makes it less dependent on exports and less prone to a spill-over through the trade channel. It also has a well-capitalized and profitable banking system, which helped mitigate possible contagion through the financial channel. Additionally, other contributory factors were its flexible exchange rate and that Poland did not have any severe macroeconomic imbalances on the eve of the crisis. The government was able to implement a significant fiscal stimulus package by enacting a discretionary fiscal relaxation of 4.5% of GDP and allowing the automatic stabilizers to work (Andersen 2010a).

2. Stimulus packages, public finances and austerity measures

By 2010, most CEE EU countries have regained a positive growth (or they are close to attaining it). However, this increase in growth has been heavily tarnished by a large deterioration of government accounts. Heavy public spending either in the form of large fiscal stimulus packages or spending used up in automatic stabilizers has put enormous additional strain on public finances. This has led to a steep rise in government deficit among EU states of an average of 6% in 2009.

Fiscal stimulus packages that contributed to the rise in government debt are considered (quite justifiably) as a necessary means to stimulate these countries out of recession. However, spending tends to create a spiral of spending, which is not sustainable. Thus, stimulus measures must meet the requirements that they are temporary, timely and targeted.

The level of public debt and deficit is an important measure of assessing the sustainability of public finances of a country. A high government deficit over several years leads to an accumulation of government debt. If debt becomes sufficiently large, governments may not have enough revenues to service it and are likely to default on their payments and become insolvent, as was the recent scenario with Greece. Fiscal stimulus packages that contributed to this rise in government debt and deficit are regarded by some as a necessary means of stimulating the economy to bring these countries out of recession. However, stimulus, even when it is designed well, entails substantial costs and harbours risks to fiscal sustainability, without being certain about how it will boost the economy. It is sometimes hard for governments to find worthwhile projects to put money into, and it is nearly impossible to take back the spending if these programmes are worthwhile. Spending tends to create a spiral of spending, which is hard to control.

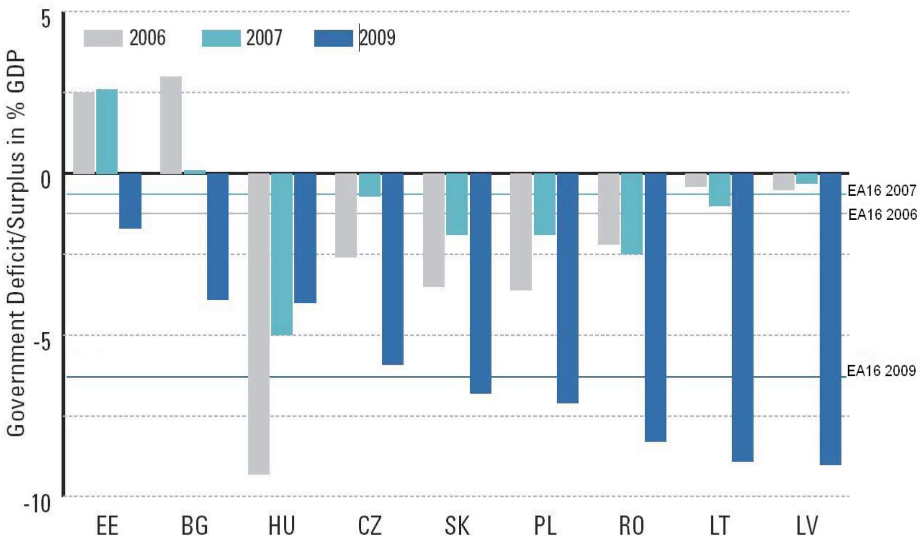
Thus, stimulus measures must meet three basic requirements to ensure they are fiscally sustainable: they must be **temporary**, **timely** and **targeted.** Timely measures, once triggered, stimulate new spending quickly and so kick in right away, not once the economy is already reviving. Targeted stimulus packages are aimed at individuals who will spend quickly the new resources they receive, for example high-income individuals are poorly targeted to provide stimulus, because they are more likely to save a large share of any increase in disposable income. Finally, temporary measures

The CEE countries have appeared to side with the austerity 'now' arguments and have therefore embarked on various austerity measures. Such a choice is partly driven by the IMF and the EU conditions so as to raise market confidence on public governance and partly due to CEE countries' own ambitions to deal with their own structural problems and join the Eurozone countries.

must expire once the economy improves. This is crucial for maintaining the fiscal sustainability of public finance as the country should not be stuck with permanent, deficit-increasing tax cuts or spending increases because of a temporary economic downturn. It is thus essential that all stimulus measures terminate when the economy strengthens as a means of preventing further increases in deficit and debt (Cox and Stone 2008).

Now that the economic outlook of many EU countries is improving after the recession, governments have begun to realize that deficit-reduction measures are required in order to safeguard the fiscal sustainability of their public finances. They have been made acutely aware of this fact through the example of Greece, and are now deciding to cut spending so as not to share the fate of their Mediterranean neighbours. This Brief will now look into the different stimulus packages implemented by CEE countries on a case-by-case basis and analyse their levels of deficit and debt. Furthermore, the ways in which governments have addressed these mounting levels of debt, in the form of austerity measures or otherwise, will be compared for CEE states in relation to each other and in part to other 'old' EU countries.

Figure 2:
Government deficit/surplus in % of GDP, 2006, 2007 and 2009



Source:
EUROSTAT. Selected Principal European Economic Indicators. 5th July 2010

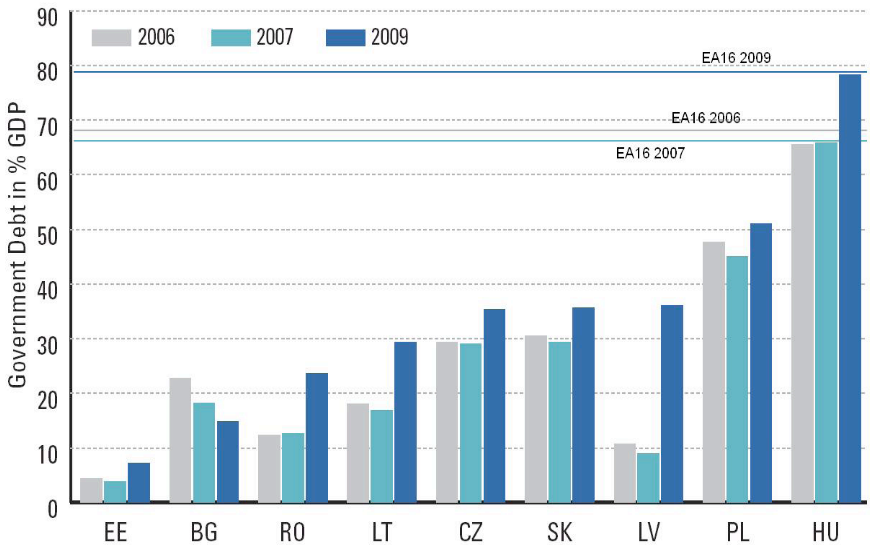
Poland

Among the countries that implemented substantial fiscal stimulus packages was Poland. The government fuelled an additional €20.6 billion into the economy in December 2008. It enacted a discretionary fiscal relaxation of 4.5% of GDP and allowed the automatic stabilizers to work. As a result, the fiscal deficit, after having significantly improved between 2006 and 2007, rose from less than 2% of GDP in 2007 to more than 7% of

GDP in 2009, which is one of the higher rates among CEE countries. Moreover, Poland has the second-highest (after Hungary) debt accumulation as a percentage of GDP among CEE states, amounting to 51% of GDP. However, it must be noted that this debt accumulation was also second-highest even prior to the crisis, as Poland had already accumulated a substantial level of debt before 2008.

Now that Poland is in a relatively strong position compared to other countries in terms of GDP growth, it may be time to gradually withdraw the fiscal stimulus and cut spending, following the lead of other EU nations (in particular the UK, but also Spain). However, the Government faces elections in October 2011 and this will pose challenges to policymakers. The Constitution limits public debt to 55% of GDP and the current budget deficit could push it over, yet the political considerations imply that government may want to postpone cuts until after elections (Andersen 2010a).

Figure 3: Government debt in % of GDP, 2006, 2007 and 2009



Source: EUROSTAT. Selected Principal European Economic Indicators. 5th July 2010

Latvia

While other countries tried to boost economic growth by spending their way out of recession, and are only now in the process of introducing austerity measures, Latvia had already undergone serious spending cuts in the preceding years of the 2008 recession (McGuinness 2010), thus effectively worsening the impact of the current crisis. Latvia's budget was not balanced during the boom times to afford a fiscal stimulus. Instead, a tough programme of austerity measures and spending cuts to balance the budget was implemented in 2009 in order to reach the IMF requirement of 3% of deficit. The condition was imposed as a prerequisite for receiving the joint EU, IMF, World Bank, financial assistance package worth €7.5 billion in December 2008 (IMF Survey 2010a).

As a result of the recession, government deficit rose most steeply in Latvia among all of CEE countries and was 9% in 2009. The highest increase in government debt of 2009 in comparison with 2007 was also observed in Latvia (27 p.p.). In order to remedy the situation and fulfil its deficit-reduction obligation, Latvia's austerity measures for 2010 included tax increases and spending cuts of around €700 million. Among them were hospital budgets cuts of 40%, disappearance of 30% of public sector jobs and wage cuts of government workers of 25%. Government will also not devaluate the currency and is committed to keeping it pegged to the euro. This is seen as the best way to gain accession to the euro by 2014 (McGuinness 2010). Recently, in March 2010, the coalition government lost its majority in Parliament, which is seen to be a protest vote against attempts to cut public sector pay. It is now facing a battle for re-election on October 2nd, 2010 and thus it has muted its previous plans for tax rises and a radical overhaul of welfare benefits (Maddox 2010).

Lithuania

Similarly to Latvia, Lithuania could not afford to increase public expenditures to counter the recession. With a budget deficit of 9% of GDP, government debt reaching 30% of GDP at the wake of the crisis and the currency fixed to the euro, the government of Lithuania had no choice but to implement a package of austerity measures. The country raised the VAT rate to 19% from 18%, scrapped most VAT breaks, raised social taxes for the self-employed and excise duties on petrol and alcohol in the original budget for 2009 (Reuters 2009). Corporate taxes rose to 20% from 15% and public spending was cut by 30%, including slashing public sector wages by 20-30% and reducing pensions by as much as 11% (Landon 2010). In addition, in order to help to balance the social budget, the government slashed transfers to private pension funds to 3% from 5.5% of social tax payments (Reuters 2009). These steps effectively worsened the recession but will result in savings equal to 9% of GDP, which is the second-largest fiscal adjustment in a developed economy, after Latvia's, since the crisis began. Now, further austerity measures are being planned that would bring the deficit down to 3% in 2012 and help Lithuania achieve its goal of joining the Eurozone in 2014. These additional steps include extending a two-year freeze in public administration wages beyond the end of 2010, gradually raising the pension age to 65 and slashing parental leave benefits from two to one year. More austerity measures are to be considered when approving the 2011 budget at the end of the year, including a reform of the social security system (Reuters 2010b).

Estonia

Of all CEE states, Estonia has been doing best in terms of deficit and debt levels. It was enjoying a substantial government surplus of 2.5% of GDP in 2006 and in 2009 had a small deficit of only 1.7% of GDP. The country implemented slight measures to curb spending such as reducing public sector wages. In order to keep government deficit below 3% and stay on track for joining the Eurozone bloc of countries in 2011, the government backed a budget savings of 6 billion kroons (€400 million[2]). It also passed a 2 p.p. increase in value added tax to 20% and increased the excise duties on motor fuel (Reuters 2009).

Hungary

As noted earlier, Hungary had been undergoing financial difficulties even before the onset of the 2008 crisis. The country had a skyrocketing budget deficit of 9.3% in 2006, by far the highest among all CEE states, as well as the highest debt level, reaching 66% of GDP. As part of its 2007 budget, it introduced severe austerity measures aimed at slashing spending. For example, 12,500 public sector jobs were planned to be cut, leading to savings of €140 million. The remainder of public sector workers would be paid on an individual merit basis and no longer on the basis of seniority. They would also lose an additional month's salary and other premiums. Major tax reforms were also introduced: VAT was raised from 15% to 20% and additional taxes were imposed aimed at preventing tax evasion. Moreover, gas prices were raised by 30% and electricity prices by 10-14% (AFP 2006). With these measures, the country did manage to decrease its deficit to 5% of GDP in 2007. It was also the only CEE country to see a decrease in the deficit in the period between 2007 and 2009.

However, in spite of these efforts and moderate successes, Hungary was still in a difficult financial situation and in November 2008 it was given €20 billion by the IMF and EU as part of a financial assistance package, under the condition that it significantly cuts its budget deficit to 3.8% of GDP (IMF 2008a). In 2009 the country had the highest debt level of all of CEE (78.3%) and saw one of the highest government debt increases between 2007 and 2009 (12.4 p.p.). In order to achieve the IMF-imposed reduction of deficit to 3.8% of GDP, the newly elected Hungarian government led by Victor Orbán of the Fidesz party, has put forward an unprecedented package of austerity measures that are yet to be implemented. These include replacing the graduated income tax system by a uniform flat tax of 16% on all incomes. Wages for employees in the public service, which have already undergone major reforms, are to be further cut by an average of 15%. An increase in the retirement age is also currently being considered (Salzmann 2010).

Hungary's current funding programme will expire in October 2010, and it seems Hungary badly needs a new IMF deal to avoid the risk of further downgrading by the international rating agencies. On July 20th, 2010, as this Brief was getting ready for the printer, the talks between Hungary and the IMF were suspended without a new deal. The IMF has been concerned that the Orbán government wishes to slow down its fiscal consolidation and it is seen to be courting popular support ahead of local elections in October. The point of contention appears to be the demand from the IMF that Hungary cuts its budget deficit from 3.8% of GDP in 2010 to 3% in 2011, and the Prime Minister Orbán is reluctant that his government is lumbered with a programme agreed by his predecessors.

Romania and Bulgaria

When the crisis hit, Romania's government turned to the international community for assistance, and in March 2009 received a €12.9 billion loan from the IMF and EU as part of a coordinated financial support package of €20 billion. The condition for receiving instalments of the loan was a reduction of the country's budget deficit to 6.8% of GDP in 2010, down from 7.2% of GDP in 2009. To achieve this objective and qualify for the instalments, the government is in the process of implementing new austerity measures. The centre-right government proposed wage cuts of 25% and pension cuts of 15%. However, it did not manage to put into effect some of the austerity measures demanded by the IMF as the country's Constitutional Court declared the intended 15% cut of retirement pensions unconstitutional. In response the government had to resort to a shock rise of the value-added tax from 19% to 24% as of July 1 2010 and to cut all budget sector salaries by 25%. It has also imposed a 25% tax on lottery sums, and a 16% tax on deposit interest income (Fairclough 2010). The government also expressed its intention to restructure its agencies. In March 2009 the Chancellery of the Prime Minister was dissolved, the staff of dignitaries' offices will be reduced by 20%, and some other offices will be merged. These measures would result in the loss of almost 8,000 workers. Overall, management of public institutions and public authorities must reduce personnel expenses by a monthly average of 15.5% (Chivu 2010).

In 2006 Bulgaria was enjoying a government surplus of 3% of GDP that deteriorated in subsequent years to a deficit of 3.9%, which is nevertheless low compared to the rest of CEE countries. The country's fiscal stimulus in 2009 was made up of a 5.6 billion levs (€2.9 billion) increase in capital expenditure for 2009 that will go into infrastructure projects, public building repairs and education and healthcare-related projects (Reuters 2010a). In 2010, in light of its plans to join the Eurozone in 2013, the government is currently putting forward a range of austerity measures aimed at preventing its finances from spiralling out of control. For example, pension increases will be cancelled and the government will try to sell off excess CO^2 emissions quotas in an attempt to raise revenue (Gentle 2010). However, the political situation in Bulgaria is not favourable to major reforms as the rift between Bulgaria's centre-right government and the left-wing president threatens to distract them from efforts to cut the budget deficit (Salzmann 2009).

Slovakia and the Czech Republic

The two countries show very similar levels of government deficit and debt before and during the crisis. Government debt in both countries is around 35% of GDP and they both saw an increase of about 3 p.p. in their deficit between 2006 and 2009. This was due largely to generous fiscal stimulus packages put in place in both countries. For the Czechs, the stimulus amounted to 1.9% of GDP and was 73 billion crowns (€2.9 billion) in revenue and spending. Slovakia in turn fuelled €332 million into its economy from reshuffling of budget expenditures. The measures include a partial and temporary reduction of payroll taxes, subsidies for new jobs and an increase in non-taxable income (Reuters 2010a). As a result of these stimuli, deficit levels rose to 5.9% and 6.8% of GDP in 2009 for the Czech Republic and Slovakia respectively and the countries have taken steps and curb public spending. The Czech government plans a series of spending cuts and tax hikes to trim the budget gap by 68 billion crowns (€2.7 billion) and keep the 2011 deficit on target of 4.8% of GDP (Reuters 2010c).

3. Financial sustainability challenges: Ageing as a contributory factor

The concept of fiscal sustainability concerns the long-term ability of governments to meet the financial obligations linked with their current debts and future expenditures (Economic Policy Committee 2009a). A sustainable position involves a debt level that does not entail interest payments so large that they cannot be paid and thus the government is not able to service the cost of its debt through future revenues.

What exacerbates fiscal sustainability challenges in EU countries is the effect of population ageing. Longevity gains amounting to 7-8 years over the next 50 years, combined with falling fertility rates, will lead to shrinking working age populations in Europe. This will have an adverse impact on employment and economic growth. If current policy trends continue, Europe will see an increase of age-related public expenditure of 4.3% of

The CEE countries have fast ageing populations, as a result of a rising longevity and a falling fertility as well as higher emigration. The ageing populations exacerbate the fiscal sustainability challenges. The S2 indicator of the European Commission provides estimates of how the long-term changes in the population structure will have an impact on the fiscal sustainability challenges faced by CEE countries.

GDP by 2060 (Economic Policy Committee 2009b). In order to assess the fiscal sustainability challenges faced by European countries, an indicator has been devised by the European Commission that quantifies the gap that must be closed to ensure that all public obligations can be financed in the future.

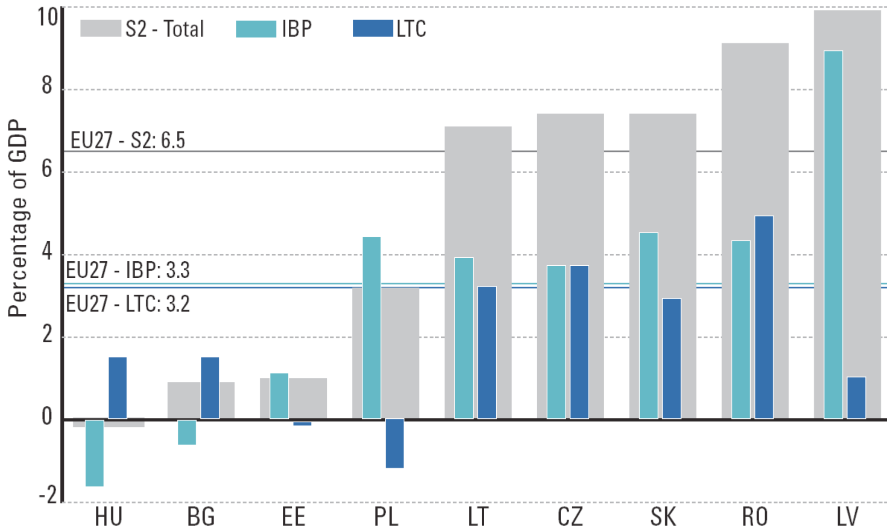
The so-called S2 indicator assumes a continuation of the current revenue and expenditure policies over an infinite timescale and shows the adjustment required to the current primary balance to fulfil the infinite horizon inter-temporal budget constraint. The main factors taken into account in calculating the indicator are: levels of gross government debt, the structural primary balance and the expected additional costs arising from population ageing. Thus, the indicator can be decomposed into two parts, characterizing the required adjustment given the initial budgetary position (IBP) and the required adjustment given the long-term change (LTC) in expenditures due to population ageing. The greater the value of the indicator, the greater is the adjustment that is required to restore the sustainability of public budgets. Note that the indicator says nothing about how the adjustments should take place but they can occur as a result of increase in government revenues, reductions in spending or structural reforms.[3]

Note that the sustainability gap results presented here incorporate the initial impact of the crisis in the IBP only, but for the LTC they still rely on the employment and GDP growth assumptions of the pre-crisis period. The results presented are on the 'optimistic' side because they underestimate the extent of future challenges arising due to the impact of crisis on employment and economic growth.

Financial sustainability indicator

The value of the sustainability gap for all of EU is 6.5% of GDP, and this represents the permanent adjustment needed in order to make public finances sustainable. The decomposed results show that for the EU27 the IBP is responsible for 3.3 points of the S2 gap, signifying that even without taking the cost of ageing into consideration, the EU would have to tighten its fiscal stance in terms of structural primary balance by 3.3% of GDP to achieve fiscal sustainability. The LTC is responsible for 3.2% points of the S2 gap, meaning that the projected increases in ageing-related costs also have an equally significant fiscal impact.

Figure 4:
S2 Indicator of fiscal sustainability for CEE EU countries, 2009



Source:
Economic Policy Committee (2009a) "Sustainability Report 2009", European Economy 9/2009

Latvia and Romania have sustainability gaps of significantly above 6.5% of GDP, surpassing the EU average. Latvia has the highest S2 (9.9%) and is characterized by a disproportionately high level of IBP compared to LTC. This is due to fiscal imbalances that Latvia was experiencing prior to 2009. Because Latvia was already having financial problems this early, the IBP accurately portrays the government deficit that amounted to 9% of GDP in 2009, as seen in Figure 4 above. It is possible that with the IMF requirements to curb the deficit to 3% of GDP, Latvia's IBP has already improved slightly or will do so in the near future.

For Romania the impact of LTC and IBP is fairly equal, as can be seen in Figure 4. The LTC gap is the result of a very large projected increase in the age-related expenditure. However, the IBP is based on a projection of government deficit level that is smaller than the one actually recorded in 2009, which in reality amounted to 8.3% of GDP. Closing these gaps requires consolidation programmes but given the existing challenges Romania is facing in implementing austerity measures agreed with the IMF, the prospects of further fiscal consolidation seem unlikely in the near future.

Lithuania shows a moderate level of the S2 gap that is close to the EU27 average of 6.5%. However, this may also be an early estimate, which can be an under-estimate given the fact that the actual government deficit during 2009 was much higher than the one used to calculate the S2-gap indicator. Slovakia and the Czech Republic also show a moderate level of S2, close to the EU27 average. Their levels of both LTC and IBP also correspond to the European average values of 3.2% and 3.3%, respectively.

As for Lithuania, these IBP results are based on a slightly lower projection of the level of government deficit in 2009 (for both Slovakia and the Czech Republic). These two countries will witness a relatively high increase in pension expenditures during the coming decades and should look into ways to further reform their social protection systems.

Poland is an interesting case to examine. It has an S2 level significantly lower than the EU27 average (3.2%). However, it has a disproportionately high level of IBP (4.4%), which is higher than the EU average. Also, its LTC is negative (-1.2%) and counteracts the high level of IBP. The counteracting LTC is due to the fact that in Poland the long-term costs of ageing are not projected to be particularly high, largely due to the fact that the reformed pension system is less redistributive and there will be a cut in public pension benefit ratio (for more details, see Zaidi 2010). The initial budgetary position looks much worse because of the large continuing structural primary deficits that Poland is facing.

Both Estonia and Bulgaria have sustainability gaps below the EU27 average with regards to both IBP and LTC levels. In Bulgaria the level of IBP is negative (-0.6%) because Bulgaria's debt and deficit levels are among the lowest in CEE countries and the rest of Europe. Estonia's sustainable public finances would remain unchanged even if these results were compounded by more accurate debt and deficit levels that take into account the full impact of the crisis. Estonia, being the only country running a surplus before the crisis hit, has not had the sustainability of its public finances jeopardized. Hungary has a negative IBP of -1.6%, much lower than the EU27 average of 3.2%. The overall S2 indicator is -0.2%, which means Hungary is a very low risk country in terms of the sustainability gap.

4. Policy implications

Fiscal sustainability concerns and consolidation measures have recently acquired a great prominence in European states, especially in view of the sovereign debt crisis in Greece. During these recent times, it has become clear how mounting government debt and deficits can lead a country to the brink of insolvency. This is a genuine concern for the CEE countries as well, especially for the fact that these young market economies are still learning to deal with the global economic fluctuations and face the prospect of rapidly ageing populations.

One of the reasons why many of these countries are now witnessing deterioration in their budgets is that governments were very justifiably proactive in adopting fiscal policy measures that increased public spending. Such demand-generating policies have generated positive results in the form of an economic recovery, but they have also put a strain on public finances. The resultant high levels of government debt and deficit now jeopardize fiscal sustainability and austerity measures are currently being put in place in many European countries.

Recently, the substantial debate about the appropriate fiscal policy measures is whether to provide yet more fiscal stimulus to the economies or whether to start curbing government debt and deficit through cuts in public expenditures. There has been some substantial disagreement on this issue, especially between the 'reluctant' US and the 'cautious' Europe. The CEE countries have appeared to side with the austerity-now arguments and have therefore embarked on various austerity measures. This choice is partly driven by the IMF and the EU conditions so as to raise market confidence on public governance and partly due to CEE countries' own ambitions to deal with their structural problems and join the Eurozone countries (exception here is Slovakia that is already a Eurozone country).

What further accentuates the problem of the sustainability of public finances is the ageing nature of populations in CEE countries, caused by a combination of longevity gains, falling fertility and emigration. The sustainability gap indicator S2 of the European Commission – which provides an estimate of the long-term overall sustainability gaps of public finances, while also taking into account the fiscal pressures created by ageing societies – has been used to carry out a comparative analysis of the overall financial sustainability of CEE EU states. The results show that the demographic transition will have a significant effect on public finances of many CEE European states, in particular Romania, the Czech Republic, Slovakia and Lithuania.

Given how much ageing-related spending will contribute to exacerbating fiscal sustainability challenges faced by EU countries, the question that policy-makers face is: how to limit this ageing burden, but without compromising the social objectives set for the welfare state. Many EU countries have introduced reforms that reduce public pension benefits, and these entrenchments raise serious concerns about preserving the adequacy of pension benefits. The balance between current and future economic and social policy issues as well as between the future financial and social sustainability issues is one that policy-makers will have to address, in a competent and timely manner. One of the objectives should remain: improve sustainability of public welfare systems and also avoid impacting negatively on one of society's most vulnerable groups – the elderly – and reduce the risk subjecting them to a life of poverty in old age.

Notes

1 'Peggers' in this case refers to CEE countries that maintain their currencies 'pegged' to the euro (Estonia, Latvia, Lithuania and Bulgaria), thus depriving their Central Banks of independent monetary policy measures.

2 The exchange rate used here and throughout the rest of the Brief is as of July 12th, 2010.

3 See Zaidi (2010) for a discussion of policy dilemmas faced by European policy-makers.

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