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Fiscal austerity and economic growth in CEE countries

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Abstract. This article presents the effects of the fiscal austerity on the growth of GDP for the countries in Central and Eastern Europe. Austerity has become the watchword of all heads of state or government. Its effects are being felt increasingly in the pockets of citizens, including, or perhaps we should say especially in Central and Eastern European countries. Are the austerity measures taken the right answer to the problems currently facing the region? The paper's findings invalidate the assiduously promoting by Eastern European countries of the fiscal austerity, this actually leading to a decrease in economic growth.

Keywords: fiscal austerity, economic growth, CEE Countries

1 Introduction

Day by day, we discover the depths of increasingly larger economic crisis. In 2008 and even in 2009 we were talking about a rapid economic recovery after the crisis. Important measures were adopted to support the economy at that time convinced that this will overcome the crisis easier. The need for these measures is generally not disputed. In 2010 however it became clear that problems would not end here. Economic recovery is slower than anticipated, and markets are increasingly reluctant to finance the huge debts accumulated after recession and finance the banking sector rescue packages and stimulus packages. What has happened to Greece seems to have scared mainly the European countries, but not only these countries. We feel more and more that we are assist to hysteria of austerity.

Most European countries have recently introduced austerity measures as being a solution to the public debt crisis. Political leaders believe that these cost cuts will restore the trust in the public finances of the countries and that will ensure a healthy long-term growth. Austerity measures usually have these main effects:

- ✓ Lower demand. Reduce public spending means a lower aggregate demand, which affects growth. Then the production capacity of companies decreases so they are forced to resort to layoffs. By default, the unemployment increases, and the lines of those without a job increase too, because the public device restricts its activity, and many state employees get fired.
- ✓ Inflation down. Keeping costs low means more demand for goods and services and thus, the prices decrease.
- ✓ Competitiveness is influenced. This could increase; less money being available, companies will have to make greater efforts to attract customers.

The budget deficit decreases. The higher the taxes are, in theory, the more money is being collected in the budget. However, if austerity measures significantly affect the economic growth, the number of unemployed increases, so the tax base is reduced.

2 Austerity measures adopted in CEE countries

The Eastern European countries have not escaped the EU and IMF pressure or severe reductions imposed by the West to reduce the deficit. Romania, Hungary and Latvia have had to be saved in terms of international financial institutions, because they were on the point of reaching bankruptcy. However, they should show greater austerity than most EU peers.

In **Romania**, the government implemented an austerity plan supervised by the IMF by reducing the wages with 25%, and reductions between 15% and 25% from grants and benefits. In mid 2010, the Romanian government introduced radical fiscal measures to combat the effects of economic contraction, deeper than expected, measures that would have contributed to lower economic output. Measures - mostly on the expenditure side, in order to bring costs to 2007 levels - have assumed a 25% cut in the public sector wages, social benefits by 15%, further reductions in the public spending on goods and services, a decrease of more than 8% in the number of public sector employees. An increase in VAT by 5 percentage points to 24%, was also operated in July 2010. However, these measures have resulted in a very pro-cyclical position, basically delaying the economic recovery.

And **Hungary** has approved a tough austerity plan, which included: VAT increase to 25% and subsequently to 27%, charge 18% basic food, delaying retirement, 15% reduction of wages, real estate loans currencies other than local currency were banned, banks were extra charged.

The **Baltic States** followed the same example. **Latvia**, which has a 22% unemployment rate and a GDP falling by 18% in 2009, reduced the costs of the key sectors such as education, civil service, so the salaries decreased with 20%, 14,200 state employees were made redundant/got fired, the equivalent 20% of total income tax increased from 16% to 23% and VAT of 18% to 21%. In turn, **Lithuania** cut the public spending by 30%, public sector wages were reduced by 20% (in some cases up to 30%) fired 20% of government employees, pensions were reduced by 11% since in 2010, income tax increased from 15% to 20% Value Added Tax (VAT) was increased from 18% to 21%.

At the same style, **Bulgaria** has also reduced social spending, decreasing the base budget in areas like health, education and military pensions. Also Bulgaria reduced by 20% public administration body, it overburdened the property, banks and oil companies and it increased the retirement age.

Poland, the only country in EU and OECD which has not suffered a recession and it has slowed deficits and increased taxes. VAT increased to 23% in 2011, after the government supported a privatization plan that would result in the increased revenues, while avoiding the costs and rising public debt above 55% of GDP, it increased other types of taxes, it also froze the budgetary wages and at the same time reducing their number.

The **Czech Republic**, the most advanced country in former communist Europe, has achieved 10% salary cuts for civil servants, cutting public spending by 380 million Euros to keep the deficit below 5.3% of GDP in 2011. The measures have led to layoffs in the public sector, increasing the retirement age, reducing other categories of expenditure, pensions taxation, increased VAT, excise and other tax categories.

3 Literature review

Krugman (2012) talks about "bad logic of austerity measures", "fiscal fantasy" or "madness." Austerity does not necessarily bring economic recovery. Rising the unemployment and enlarging the crisis are the main effects of cutting costs. The obsession of huge deficits makes the government to adopt long term measures that do nothing but worsen the economic situation. Unemployment and deepening the economic crisis are the main adverse effects of austerity measures, namely cutting spending, adopted by the Government. He argues, therefore, the theory of John Keynes, who said in 1937 that the austerity measures are welcome in times of economic boom, not in the regression. The last two years have been an example in this regard. The orientation of the developed countries focusing exclusively on reducing deficits and less on job creation has its limits. The states that have adopted such measures, subject to international financial institutions, saw their economy being pulled down.

Wolf (2012) tries to make his own analysis of the situation using the latest data from the International Monetary Fund (IMF). His conclusion is that there is no evidence that the fiscal constraints may boost economic growth so as to cushion the direct effects of economic slowdown. To make predictions for 2012, Wolf considered two variables: the fiscal restraint as the percentage change of the structural deficit (or cyclically-adjusted) government in 2008, the year of crisis, and growth as a percentage change of GDP, from 2008 to 2012. He assumes that the change is policy results rather than cyclical effects. The analytical result: the higher the structural constraint, the greater the percentage changes in GDP. He calculated that each percentage point of fiscal structural constraints reduce GDP by 1.5% compared to was in 2008. Thus, budgetary adjustment of 8 percentage points of Greece's GDP decreased by 12%.

Blanchard et. al (2010) show that the impact of fiscal austerity programs depends on the degree of economic openness and financial integration of countries that apply. For example, in small open economies such as Central and Eastern European countries, for fiscal austerity package to be successful, the economy should aim primarily targeting alcohol in order to ensure a higher multiplier effect of policy tax. Also the authors point out that excessive austerity is as dangerous as lack of rigor of spending, recommending moderate austerity thus allowing economic recovery. Excessive austerity can bring disaster; Europe needs, first, a model of sustainable growth before the economic crisis that it is facing.

4 Austerity measures impact in CEE countries

Next we present the main macroeconomic indicators for the seven EU member countries in the Eastern Europe. The first table depicts the values for the pre-crisis indicators and the second in crisis. As you can see, there is a worsening of macroeconomic indicators for 6 of the 7 countries.

Table 1 Evolution of pre-crisis main macroeconomic indicators in CEE countries

		2003	2004	2005	2006	2007	Mean
Bulgaria	GDP Growth	5.50	6.74	6.35	6.51	6.44	6.31
	Unemployment rate	15.19	13.41	11.13	10.07	8.13	11.58
	Public debt	46.47	39.07	29.43	23.40	18.55	31.38

		2003	2004	2005	2006	2007	Mean
Czech Republic	GDP Growth	3.76	4.74	6.75	7.02	5.73	5.60
	Unemployment rate	7.81	8.32	7.92	7.14	5.32	7.30
	Public debt	28.57	28.94	28.41	28.28	27.95	28.43
Hungary	GDP Growth	3.9	4.8	4	3.9	0.1	3.34
	Unemployment rate	5.5	6.3	7.3	7.5	7.7	6.86
	Public debt	58.51	59.43	61.68	65.85	66.95	62.48
Latvia	GDP Growth	7.19	8.67	10.60	10.52	9.6	9.31
	Unemployment rate	10.74	10.61	8.82	6.99	6.20	8.67
	Public debt	14.60	14.41	11.77	9.90	7.79	11.69
Lithuania	GDP Growth	10.27	7.36	7.79	7.80	9.79	8.60
	Unemployment rate	12.41	11.37	8.27	5.62	4.29	8.39
	Public debt	21.04	19.30	18.38	17.94	16.82	18.70
Poland	GDP Growth	3.86	5.34	3.61	6.22	6.785	5.1682
	Unemployment rate	19.64	18.97	17.74	13.84	9.60	15.96
	Public debt	47.05	45.68	47.08	47.73	44.98	46.51
Romania	GDP Growth	5.23	8.49	4.15	7.87	6.31	6.41
	Unemployment rate	7.02	8.07	7.17	7.27	6.41	7.19
	Public debt	24.18	21.09	17.63	12.62	12.72	17.65

Source: IMF World Economic Outlook, April 2014

Thus, **Bulgaria** from 6.314 average GDP growth falls to 0.7154, the unemployment rate slightly decreases from 11.5886 to 10.3476 and public debt in turn greatly decreases from 31.3874 to 17.2214. We say that this country has gone very well the economic crisis.

Before the crisis, the Czech Republic had an average GDP of 5.6032, an unemployment rate of 7.3056 and 28.4338 public debts. After the crisis, this country is anemic GDP growth of only 0.5838, the unemployment rate fell to 6.4102, but public debt reached 37.1876.

Hungary does not deny the evolution of the other countries in the region: from a GDP growth of 3.34 before the crisis it falls to a negative value of -0.5856, public debt is increased from 62.4898 to 78.1188, while unemployment increased by 50% (from 6.86 to 10.3536).

Baltic countries have witnessed the painful effects of economic crisis: the growth of GDP by 9319 (Latvia) and 8.6082 (Lithuania) to -2.7664 and -0.5188, through the steepest decline of GDP of this region in one year: -17,729 (Latvia) and -14,839 (Lithuania). The unemployment rate almost doubled (from 8.6742 to 15.0416 to Latvia and from 8.3964 to 13.472 for Lithuania), and public debt as (triple if at 11.6984 to 33.3618 Latvia and Lithuania for at 18.7026 to 32.5494 doubling).

Poland, the champion of this region fared best in this period: it did not enter into recession and it has the largest GDP growth in value of 3.5326, halving the unemployment rate (from 15.961 to 8.7864), also with only a slight increase in public debt (from 46.5102 to 52.7982).

The same, the poor economic performance knows that **Romania,** like other countries in the region: a modest increase in GDP of only 0.6084, maintains constant unemployment rate, but instead increased by 90% of public debt (from 17.6528 to 27.1602).

Table 2 Evolution of main macroeconomic indicators in CEE countries during the crisis

		2008	2009	2010	2011	2012	Mean
Bulgaria	GDP Growth	6.19	-5.47	0.39	1.66	0.8	0.71
	Unemployment rate	7.14	8.21	11.48	12.45	12.45	10.34
	Public debt	15.45	15.57	16.70	17.04	21.33	17.22
Czech Republic	GDP Growth	3.09	-4.69	2.73	1.65	0.12	0.58
	Unemployment rate	4.392	6.66	7.27	6.7	7.01	6.41
	Public debt	28.71	34.29	37.55	41.46	43.91	37.18
Hungary	GDP Growth	0.9	-6.8	1.27	1.69	0.01	-0.58
	Unemployment rate	8	10.07	11.24	10.95	11.5	10.35
	Public debt	72.88	79.70	81.31	80.44	76.25	78.11
Latvia	GDP Growth	-3.27	-17.72	-0.33	5.46	2.03	-2.76
	Unemployment rate	7.82	17.31	18.97	15.63	15.47	15.04
	Public debt	17.19	32.8	39.88	37.77	39.09	33.36
Lithuania	GDP Growth	2.91	-14.83	1.44	5.87	2.01	-0.51
	Unemployment rate	5.84	13.71	17.80	15.5	14.5	13.47
	Public debt	15.50	29.35	37.98	38.96	40.93	32.54
Poland	GDP Growth	5.12	1.60	3.94	4.35	2.63	3.53
	Unemployment rate	7.11	8.16	9.62	9.64	9.37	8.78
	Public debt	47.10	50.92	54.88	55.38	55.68	52.79
Romania	GDP Growth	7.34	-6.57	-1.64	2.45	1.46	0.60
	Unemployment rate	5.78	6.85	7.27	7.21	7.19	6.86
	Public debt	13.63	23.78	31.19	32.95	34.22	27.16

Source: IMF World Economic Outlook, April 2014

Next we apply the model developed by Krugman and Wolf for the euro area countries, the non-euro area countries in Eastern Europe, and members of the Union.

To make predictions for 2012, we consider the same two variables presented in Krugman and Wolf models: fiscal restraint as the percentage change in the structural deficit (or cyclically-adjusted) government in 2008, the year of crisis, and growth as a percentage change of GDP in 2009 to 2012. Also we start from the premise that the change is the policy results rather than cyclical effects.

Calculations and cyclical budget deficits and potential gross domestic product (using production function Cobb Douglas) are based on OECD and EC methodology described by Van den Noord (2000) and Girouard (2005). According to the methodology outlined above, the budget's structural components are obtained by subtracting the cyclical component of the current budget, using the following formula:

$$CAB_t = B_t - B_t^c = B_t - \Sigma B_{t\,j}^c \quad (1)$$

Cyclical components of each category, income and expenses ($B_{t\,j}^c$) are calculated by using the output gap and the estimated elasticity of GDP (α_j^{PIB}). The formula used to calculate the cyclical component is the following:

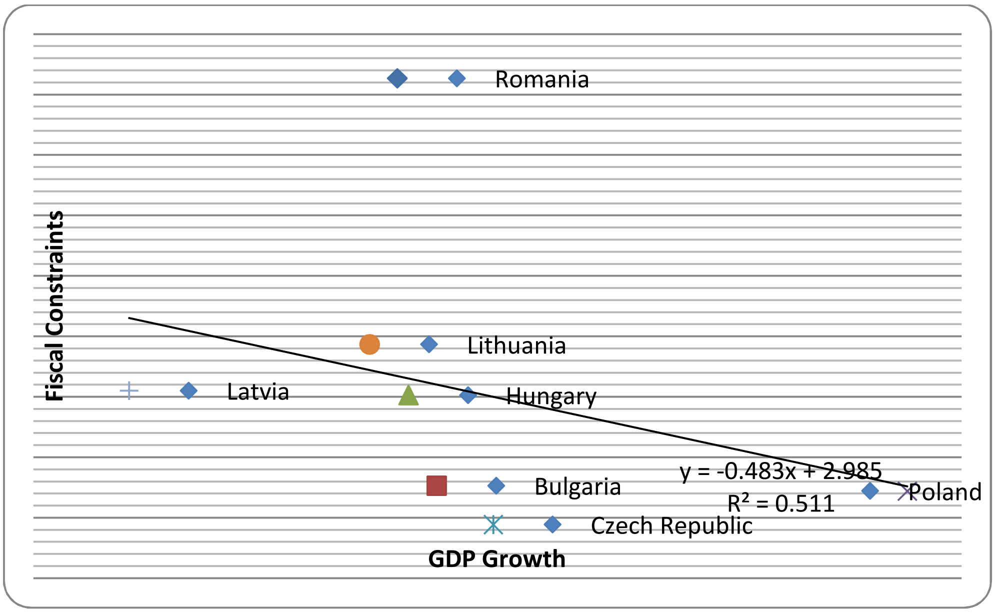
$$B_{t\,j}^c = B_{tj} \text{ x } \alpha_j^{PIB} \text{ x } output\_gap_t \quad (2)$$

The budget deficit is strongly influenced by the economic position in relation to the economic cycle. Determining the structural deficit involves cyclical adjustment of budget revenues, eliminating the

component generated by excess / deficit of demand. Adjustment result provides a measure of sustainability / non-sustainability of total public expenditure levels.
The proposed model is a single factor such as:

$$F\ (GDP\ Growth) = constant + (fiscal\ constraint)\ x\ coefficient \qquad (3)$$

The data were used as source Eurostat database and IMF data in 2000 basic prices, (desezonalized by TRAMO - SEATS).



Source: own calculations according to IMF World Economic Outlook, April 2014

Figure 1 The correlations between fiscal austerity and GDP growth in CEE countries

As you can see from the graphic, between the increase of GDP and fiscal austerity reverses a link to the countries of Central and Eastern Europe. Slope coefficient is negative, with a value of -0.48, which means that 1 percent increase in fiscal austerity has been a decrease in growth of 0.48 percent.

The results are similar to those obtained by Krugman and Wolf for the euro area countries, the value obtained by them, the 1.5, but is much higher than the value 0.48.

One explanation for this difference could be the serious imbalances in the economies of these Eastern European countries: too much dependence on the European market, which faces many problems, stimulates consumption through unsustainable decisions, huge trade deficits of the order of 10-14% GDP, fiscal policies procyclical, abrupt and direct foreign investment inflows and lower elasticity of GDP in relation to fiscal policies.

In addition to the result obtained we support the idea that austerity does not help economic recovery, at least under present conditions, this analysis captures two aspects.

First, Poland's economy has evolved surprisingly: despite the increase of austerity. But fiscal constraints in Poland are the smallest, and were taken at the appropriate time, after passing the first phase of the economic crisis, the onset of the crisis; the country has taken steps expansionary stimulus.

Second, economies of Hungary and Lithuania have decreased slightly, although the tax measures were restrictive. For these two countries it is shown a striking relationship between the fiscal restraint and the economic growth (there is a decrease in growth due to fiscal austerity). For the other analyzed countries (Romania, Bulgaria and Czech Republic) the fiscal constraints, although large, have resulted in a weak economic growth. With regard to fiscal constraints in Latvia, they were very large indeed and led the country in a critical situation.

So there is no evidence that the austerity can stimulate economic growth so as to offset the direct effects of economic slowdown. Small economic slowdown leads to recession and steep declines lead to depression. Moreover, the overall performance of the economies of Central and Eastern Europe between 2008 and 2012 is very weak. Only one country, Poland has sound economic performance, others remaining 6 countries with weak GDP growth, significant increases of public debt and unemployment.

5 Conclusions

We discuss more and more often about the risk of over-reaction. Austerity measures taken in times of crisis may have a negative effect on resumption of growth and can condemn such countries to adopt on a resumption of a slower economic activity. This is particularly true for countries with good fiscal credibility, still having in principle a potential debt. By reducing the public spending, it would slow further consumption and investment, reducing economic growth.

Adopting an austerity plan should be based on an objective analysis based on the belief that there is no single recipe for all states. Although it is true that all countries should adopt structural reforms already now to ensure fiscal sustainability over the medium term, they should be tailored to the specific context of the country depending on available fiscal space.

For each country there is still opportunity to make savings without jeopardizing the economic recovery. There are still enough examples of lack of efficiency in spending public money, of course with relevant volume differences from country to country. From the waste of the French political class to the Greek military budget, each country has its history of waste. Moments of crisis are opportunities to eliminate the favorable management of public money shortfalls.

In addition, a series of austerity measures can be taken, both in reducing costs and in terms of increased taxes or to correct a number of existing distortions, or to cause the least possible. With respect to public expenditure, governments could focus on rationalization of staff costs, increased efficiency of allocation of subsidies, transfers and social spending, keeping in check the growth rates of health care reforms aimed at keeping costs reasonable and same time improving the coverage and the quality of basic health services and pensions, reforms should aim at raising the retirement age (up to two years would stabilize the current costs for the next 20) and possibly reduce or increase the benefits contributions.

In terms of taxes, governments can increase their revenues by focusing on taxes with a broad base and relatively immobile tax and raise taxes to reduce externalities. In that regard, we have to sustain the uniformity of VAT (tax exemptions and reduced rates of VAT) and the growth in countries where the level is low. Eliminating the unjustified tax breaks or social economic and fight against tax evasion is still a source of revenue that should not be neglected in times of crisis.

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