

AmCham – ICEG EC Conference

*Central European Outlook for
Chief Executive Officers – CEO for CEOs*

Fiscal policy in Eastern Europe: Does Public Sector Size Matter?

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Objectives

- Trends in the overall size of the public sector across EE
 - The size of public sector and economic growth in EE
 - Fiscal Sustainability and Fiscal Space in EE
 - Main conclusions
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The Objectives of Government

- Post-war enthusiasm for state intervention
 - Musgrave (1959) - three functions of government activity:
 - macroeconomic stabilization
 - income redistribution
 - resource allocation.
 - Hayek: criticised “big government”
 - Consensus view?
 - Need to focus on core objectives and achieve them in an efficient manner
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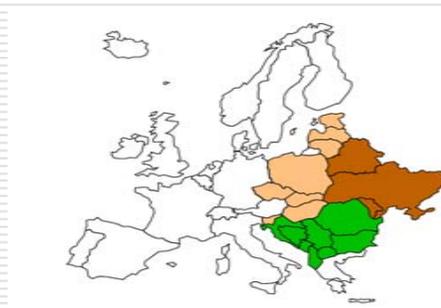
Government expenditure dynamics in the world

General government expenditure (% of GDP)					
	1913	1960	1990	2000	2006
France	17.0	34.6	48.8	51.6	53.4
Germany	14.8	32.4	44.1	45.1	45.4
Italy	17.1	30.1	52.4	46.2	50.1
Japan	8.3	17.5	31.3	38.5	38.0
UK	12.7	32.2	38.5	39.8	44.6
USA	7.5	27.0	36.0	33.4	34.4

Source: European Commission, Tanzi & Schuknecht (2000).

Regions and countries in transition (EE and CIS)

- **Central and Eastern Europe (CEE)**
Czech R., Estonia, Latvia, Lithuania, Hungary, Poland, Slovakia, Slovenia
- **South Eastern Europe (SEE)**
Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Macedonia, Romania, Serbia and Monte Negro
- **Commonwealth of Independent States (CIS)**
Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldavia, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan



CEE



SEE

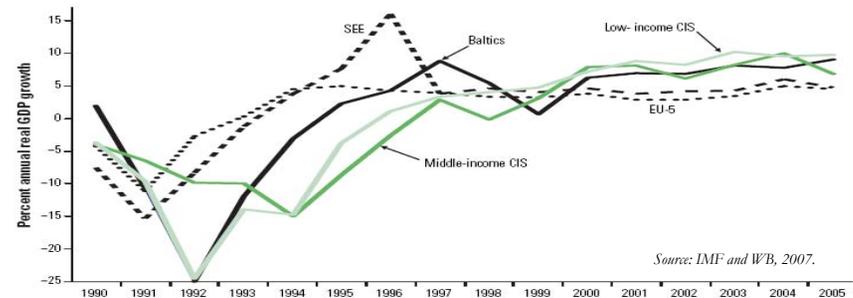


CIS



Public sector in transition period

- From socialism to market economies (dramatic economic downturn) – an important role of fiscal policy



- Macroeconomic stabilization and fiscal adjustments

- Reduction in public spending

- Increases in revenues

- Size of public sector

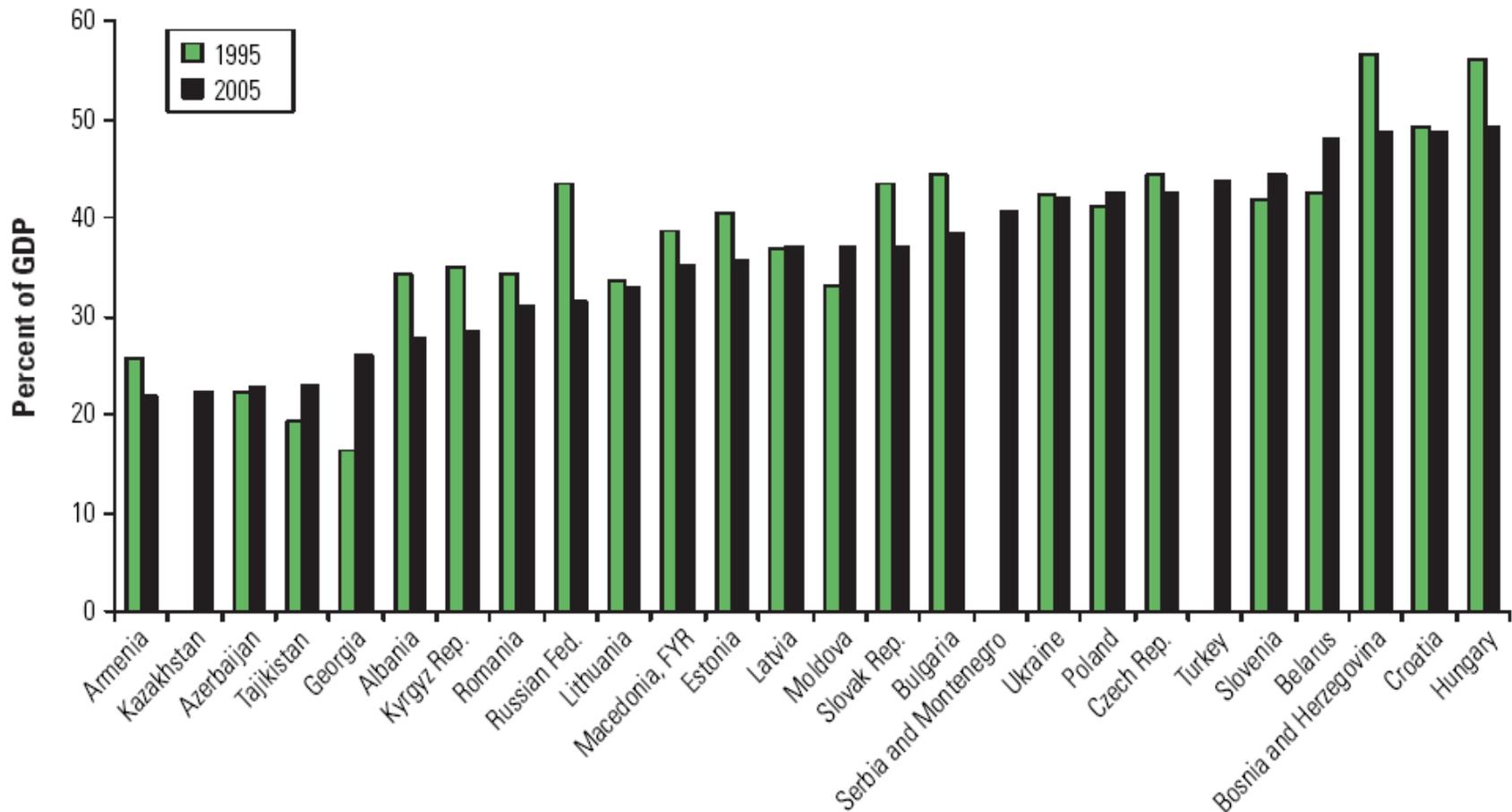
- CEE similar to EU-15

- CIS similar to Asian tigers

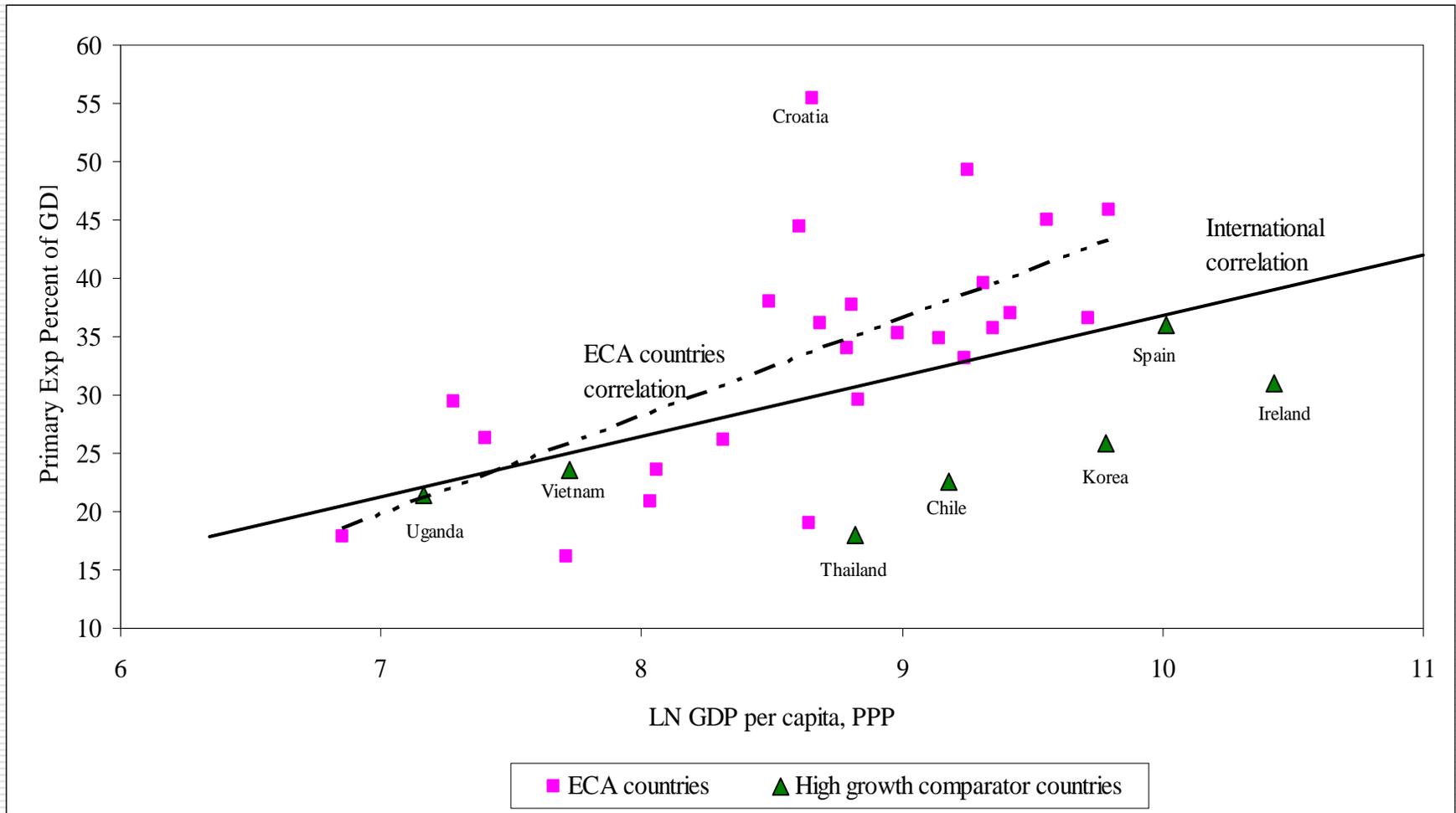
Countries	Fiscal balance (% of GDP)			
	1989–2005	1989–95	1996–2001	2002–05
EU-8	-2.7	-2.4	-2.8	-3.1
Southeastern Europe	-4.3	-6.1	-4.4	-2.2
Middle-income CIS	-3.7	-6.9	-3.0	1.0
Low-income CIS	-5.5	-9.4	-4.3	-1.1
Turkey	-	-	-15.2	-9.9
EU-15	-2.4	-4.3	-0.8	-1.4
Non-EU high-income OECD ^a	-0.8	-2.5	0.6	0.2
High-income OECD outside Europe ^b	-1.9	-3.0	-0.8	-1.5
Fast-growing Asia ^c	0.1	1.5	-0.7	-1.0
Latin America ^d	-2.3	-1.7	-2.7	-2.6
Fast-growing comparators ^e	-1.0	-1.5	-0.9	-0.3

Source: IMF, 2007.

Total Public Sector Spending in CEE, SEE and CIS Countries, 1995 and 2005



Primary Public Expenditures and Per capita Incomes (PPP) (average 2000-2004)

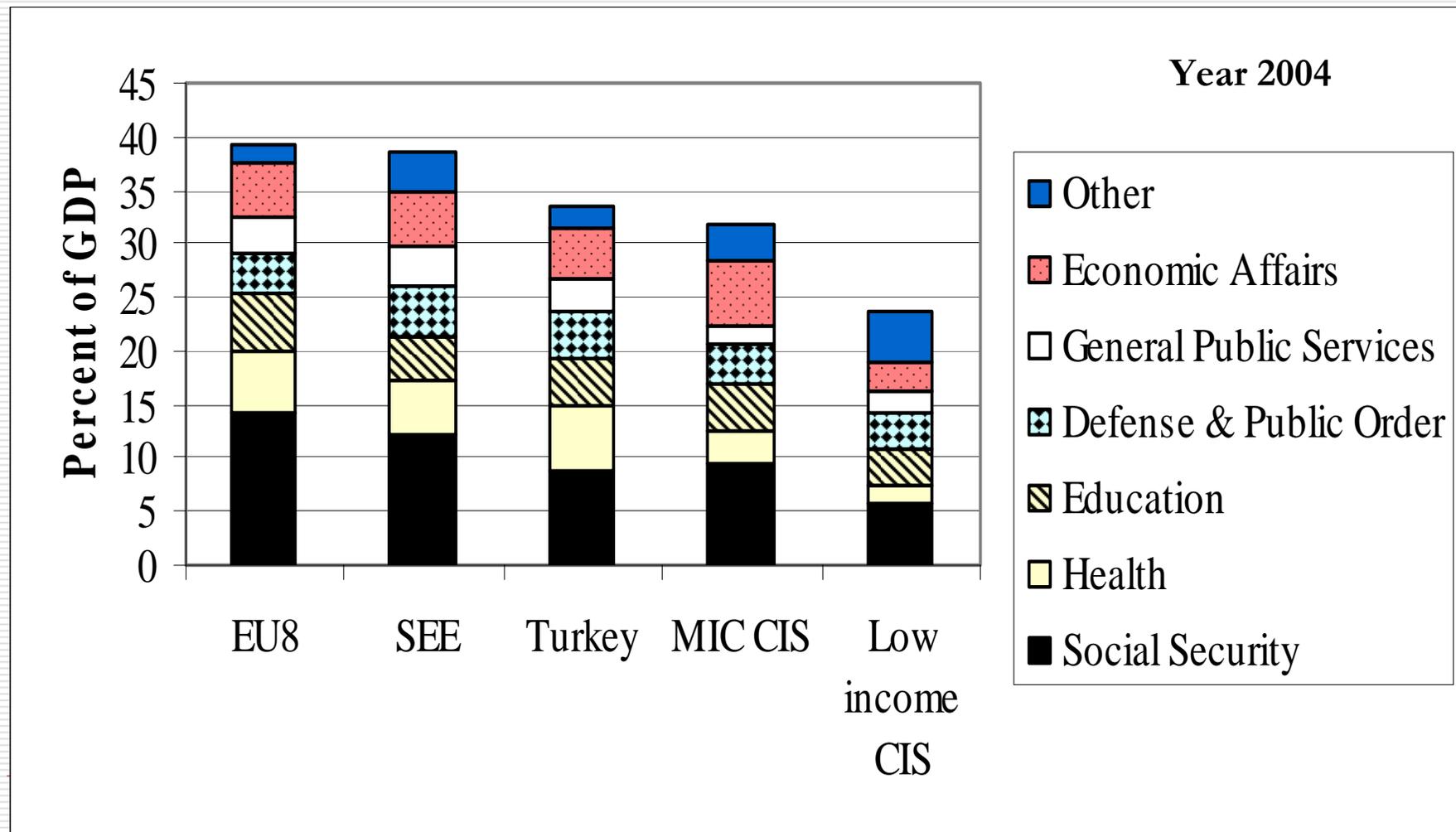


Government size and economic growth

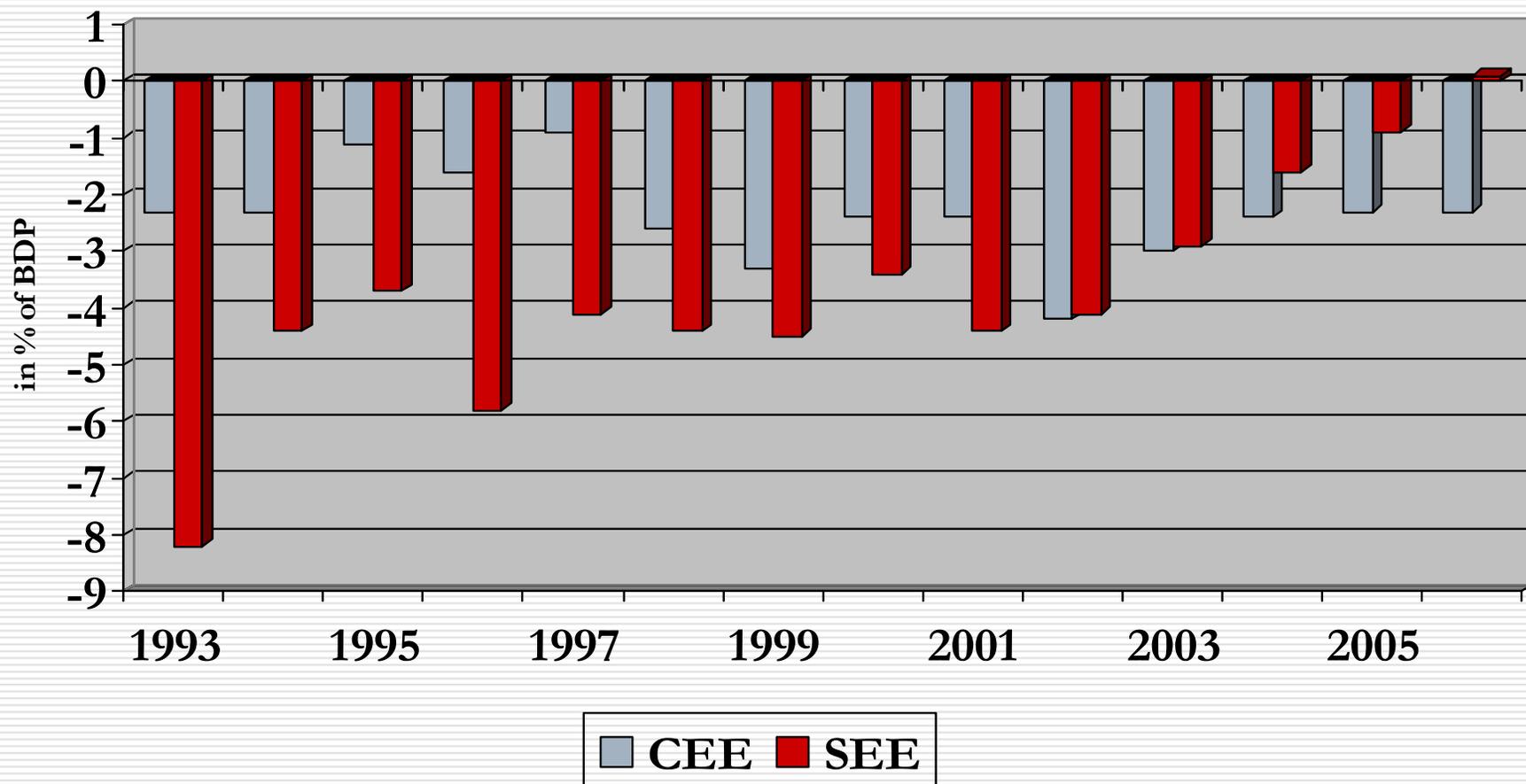
- Large public sector (expenditure) can hinder growth by:
 - difficulties to control fiscal deficits
 - higher taxation if government solvency is to be preserved
 - composition of spending
 - poorly designed expenditure programs

 - Empirical evidence – inconclusive
 - Barro (1991) – negative relationship; Chen and Lee (2005) – threshold exists; Devarajan et al. (1996) – composition matters
 - for transition countries: Campos and Coricelli (2000); Beck and Laeven (2005); Åslund and Jenish (2005) – negative relationship
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Large size of public expenditure reflects large spending for social transfers?



General Government Fiscal Balances in CEE and SEE Region, 1993–2006



Source: EBRD Transition Report, Various Issues.

Medium-term fiscal sustainability in CEE

Country	Calculated primary public balance		Actual primary public balance (b) (2002-05 averages)	Diff. (Actual-Calculated (actual public debt assumption))	Public debt (D/Y) after 5 years	Public debt (D/Y) after 10 years
	Actual public debt assumption	Targeted public debt assumption (60 % of GDP)				
CEE (average)	-0.6	-1.7	-1.3	-0.8	33.7	37.7
Czech R.	-0.3	-0.9	-2.6	-2.3	33.3	43.6
Hungary	-0.9	-0.9	-3.8	-2.9	73.6	86.6
Latvia	-0.6	-2.7	-0.8	-0.2	14.7	15.4
Poland	0.3	0.4	-2.7	-2.9	61.6	76.9
Slovakia	-1.1	-1.6	-1.7	-0.6	44.4	46.9

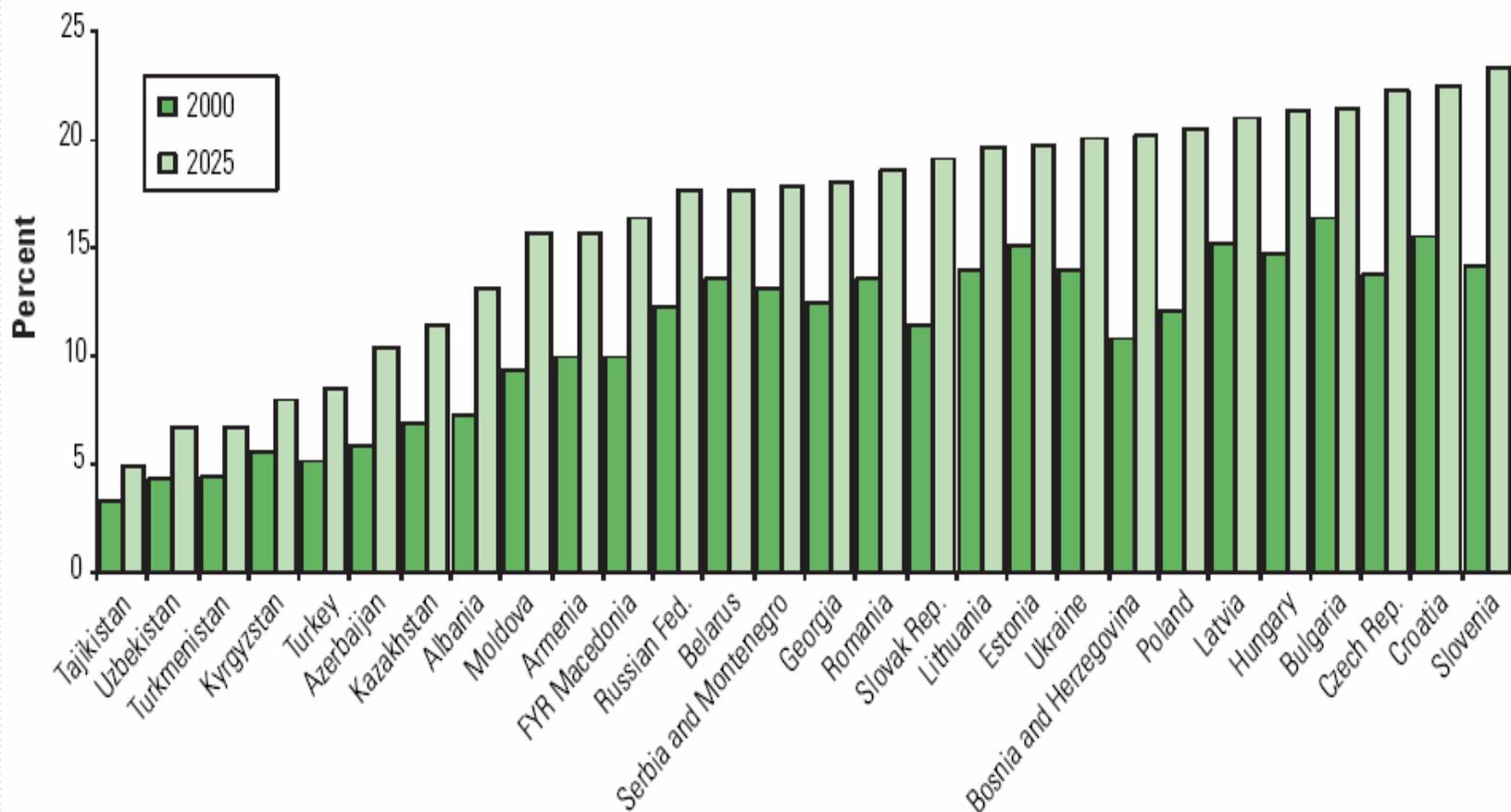
Sources: EBRD (2007), IMF (2007), author's calculations.

Long-term fiscal sustainability in CEE

Country	Public debt (D/Y) (2002-05 averages)	Growth rate of real GDP (g) (2000-40 project.)	Calculated (long-term) public balance (g*(D/Y))		Actual public balance (2002-05 averages)	Diff. (Actual-Calculated)	
			Actual public debt assumption	Targeted public debt assumption (60 % of GDP)		Actual public debt assumption	Targeted public debt assumption (60 % of GDP)
CEE (average)	29.8	3.1	-0.9	-1.8	-3.3	-2.3	-1.4
Czech R.	22.2	2.4	-0.5	-1.4	-5.0	-4.5	-3.6
Hungary	59.5	2.6	-1.5	-1.6	-7.6	-6.1	-6.1
Latvia	13.9	3.6	-0.5	-2.2	-1.6	-1.0	0.6
Lithuania	20.4	4.0	-0.8	-2.4	-1.7	-0.9	0.7
Poland	46.7	3.7	-1.7	-2.2	-5.4	-3.6	-3.2
Slovakia	41.6	3.2	-1.3	-1.9	-4.7	-3.3	-2.7
Slovenia	29.1	2.1	-0.6	-1.3	-1.7	-1.1	-0.4

Sources: EBRD (2007), IMF (2007), author's calculations.

Percentage of population age 65 or over, 2000 and 2025 (estimates)



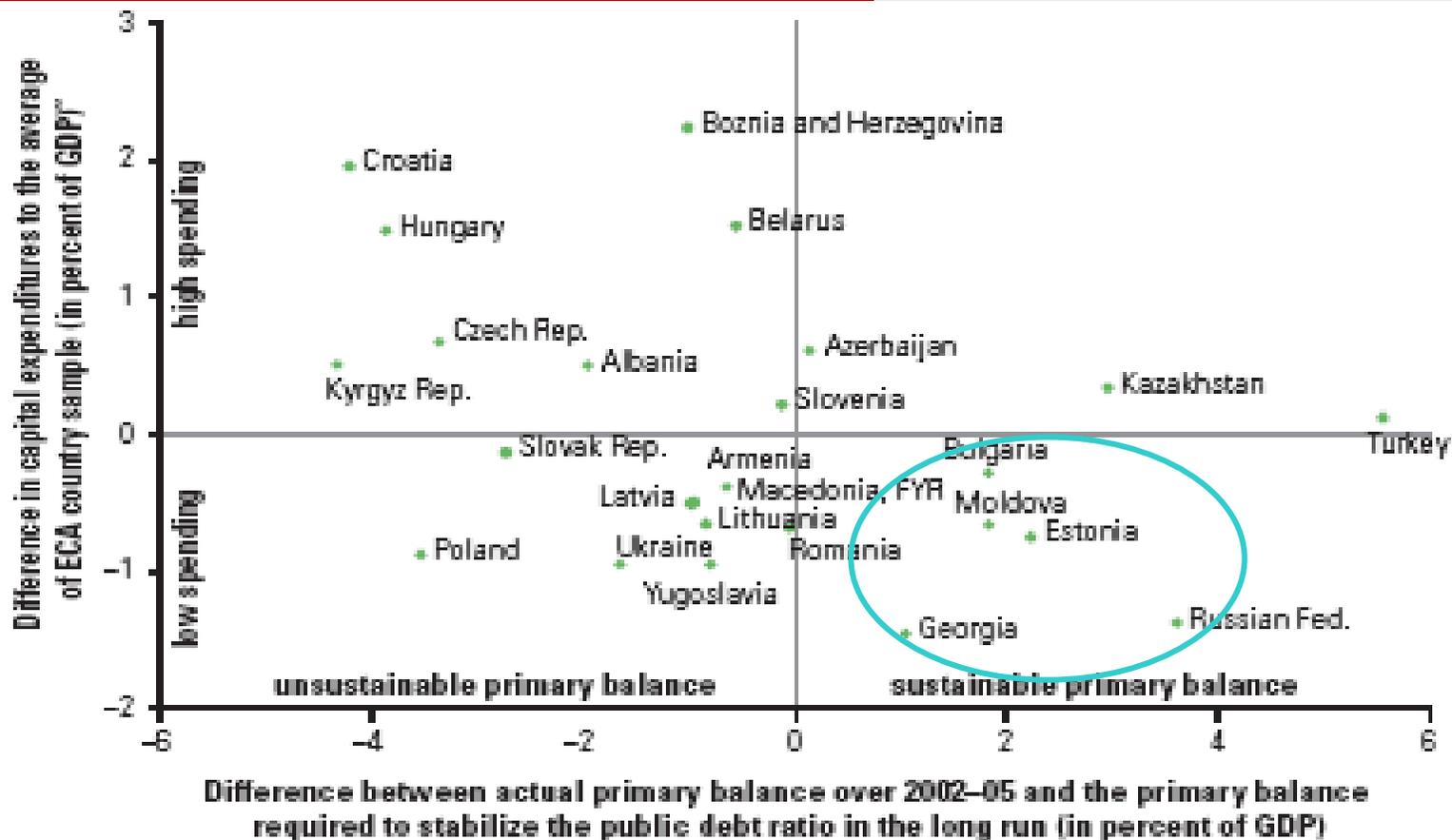
Is there any fiscal space for additional spending in the EE region?

- ❑ **Fiscal space – government's ability to increase expenditure without impairing fiscal sustainability**

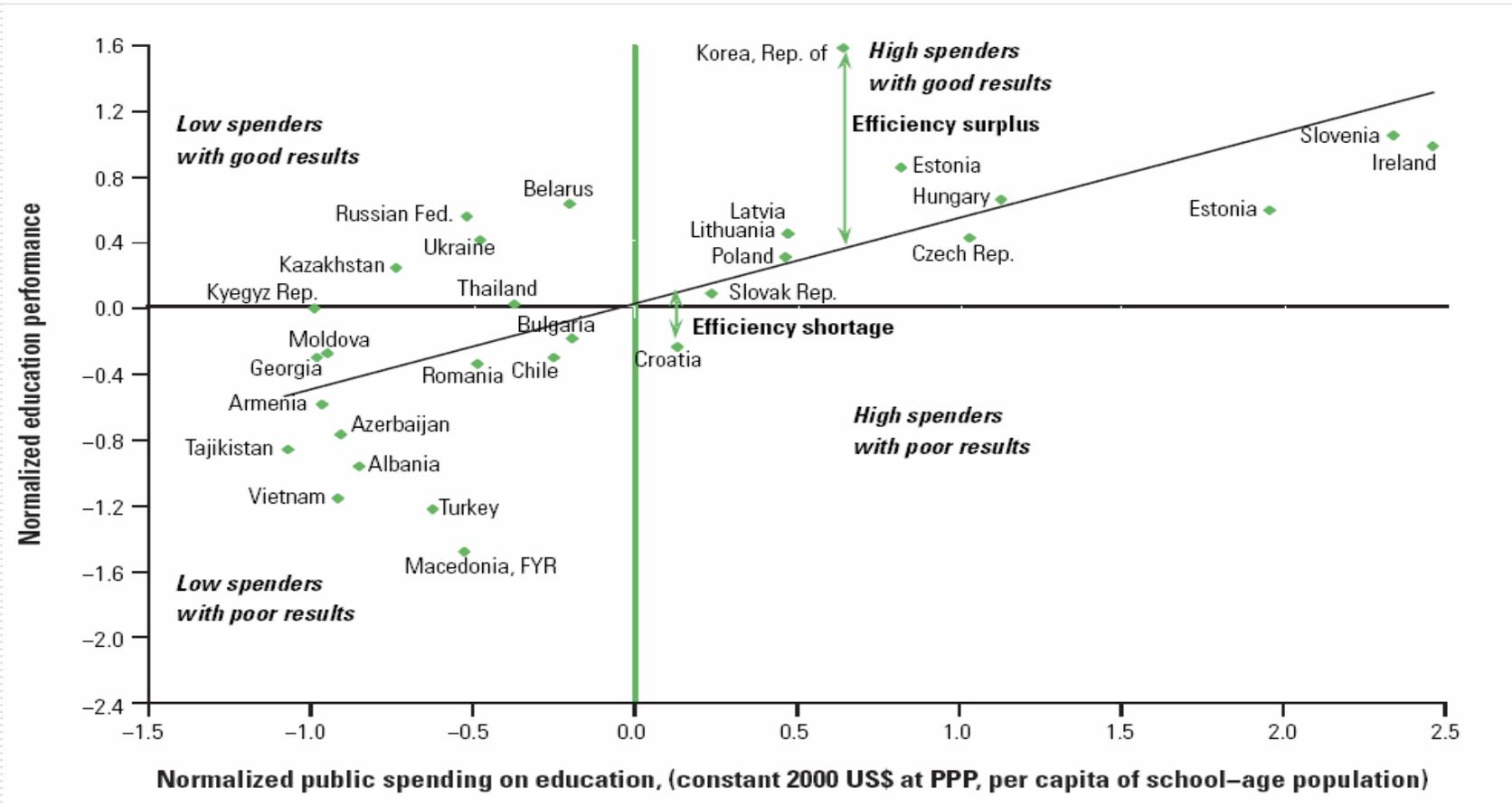
 - ❑ **Fiscal space appears to be limited in many EE countries**

 - ❑ **IV. groups of countries:**
 - **fiscal space available/public spending in growth-promoting sectors is below the group average**
 - **fiscal space available/public spending in growth-promoting sectors is above average for the whole group (EST, BUL)**
 - **additional fiscal space is needed/public spending in growth-promoting areas is below the group average (e.g. POL, LAT, LIT, SLK)**
 - **additional fiscal space is needed/public spending in growth promoting areas is relatively oversized(e.g. HUN, CZ, BiH, CRO, ALB)**
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Is there any fiscal space for additional spending in the EE region?

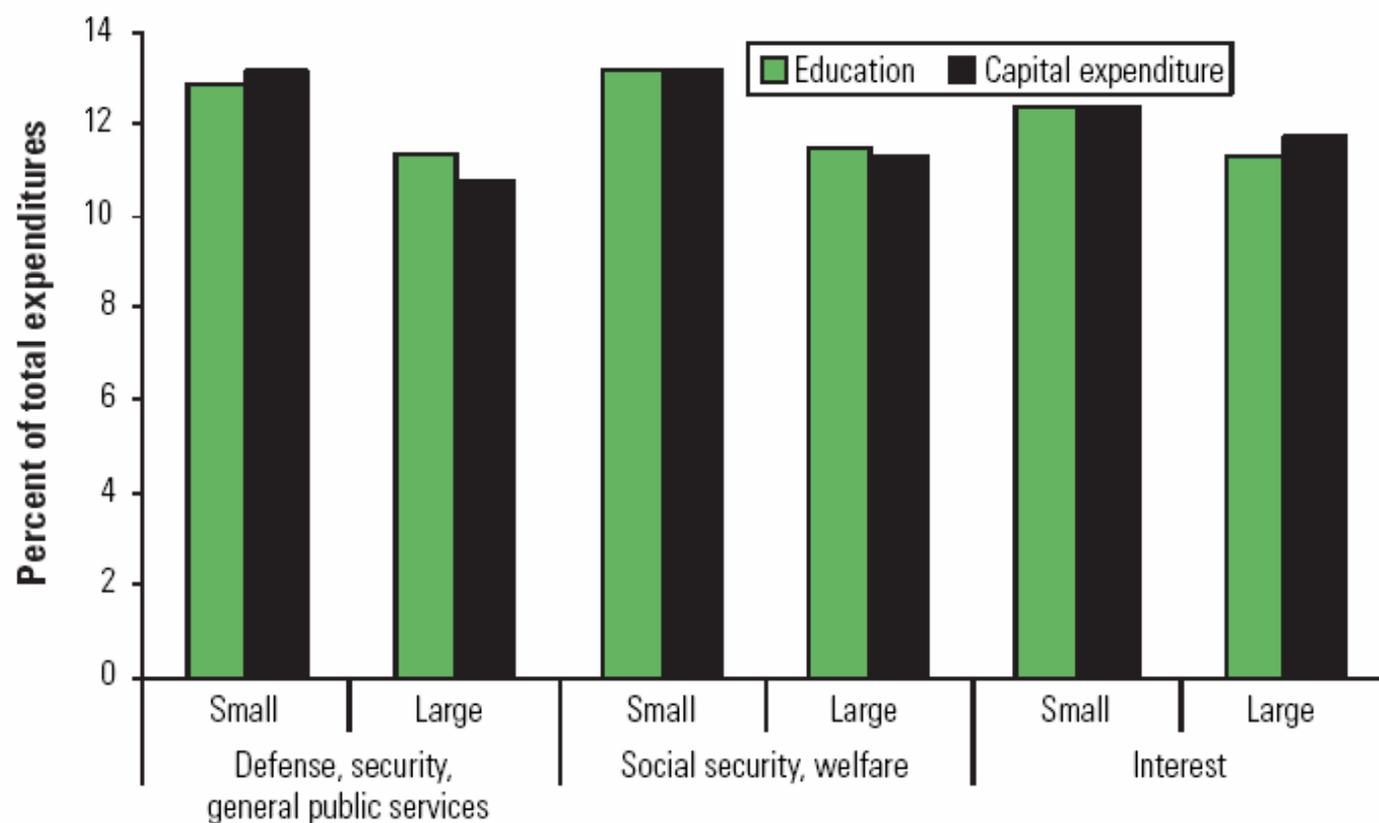


Education Performance Compared with Public Spending Per Capita of School-Age Population, Average, 1995-2004



Source: World Bank, 2007.

Productive vs. Unproductive Expenditure Allocations in CEE, SEE and CIS, (2002-2004 averages)



Source: World Bank, 2007.

Conclusions

- Fiscal consolidation helped to promote economic growth in the region:
 - lower fiscal balances → greater macroeconomic stability
 - public sector size matters (“less is more”) but also the quality of governance
 - Composition of expenditure matters (reduction of potentially “unproductive” spending is needed)
 - Improved efficiency and quality of spending (policy and institutional reforms) is crucial
 - Further fiscal consolidation is a precondition for EE to join the EMU as soon as possible
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