THE FISCAL-BUDGETARY POLICIES OF THE CENTRAL AND EASTERN EUROPEAN COUNTRIES ON THE ROAD TO EURO ADOPTION

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Abstract:
This paper intends to analyze the constrictions to which the fiscal-budgetary policy of the member states of the European Union is subject in the process preparing the implementation of euro, highlighting particular aspects for the Central and Eastern European countries. The first part focuses on the presentation of the European fiscal framework and the extent to which the fiscal-budgetary policy of the new member states have adapted to its requests. The second part of the paper focuses on the role of the budgetary policy in the achievement of the real convergence process, highlighting the challenges generated by the fact that sustained efforts will be necessary in the future, especially in the Central European states.

Key words: *fiscal-budgetary policies, Central and Eastern European countries, the Maastricht Treaty, the Stability and Growth Pact, real convergence*

JEL classification: *E62, H62, H63, N44*

1. Introduction

In 2004, together with Cyprus and Malta, 8 countries of the Central and Eastern Europe joined the European Union: The Czech Republic, Estonia, Hungary, Lithuania, Poland, Slovakia and Slovenia. In 2007, Romania and Bulgaria joined them as well. Nevertheless, the accession to the European Union is not the final stage of the integration process. Unlike Great Britain and Denmark, countries that originally signed the Maastricht Treaty and benefit from the opting-out clause, all the other countries are members of the Economic and Monetary Union with a derogation, which means that they are obliged to adopt – sooner or later – euro as single currency. Up to the present, this performance was reached only in Slovenia, which adopted euro on January 1st 2007 and Slovakia, on January 1st 2009.

No fiscal, monetary or exchange rate-related criteria had to be fulfilled in order to join the European Union. Consequently, during the preparatory period for the adherence to the European Union, the fiscal-budgetary policy of the candidate states was subject to no explicit constriction.

Nonetheless things are different in the next stage, the one of the adoption of euro. The European monetary integration is conditioned by the fulfillment of a series of nominal convergence criteria, which limit the action margin of the member states to the level of the sustained fiscal-budgetary policies, and by their making-up for the gaps between them and the member states of the euro area, by requesting appropriate fiscal-budgetary policies. This issue is even more obvious for the countries of the Central and Eastern Europe, member of the socialist, Soviet-run system, for which the values of the real indicators are much below the ones of the developed states of the European Union, which calls for sustained efforts, even on behalf of the public authorities, in order for development gaps to be made up for.

2. The European fiscal framework and adapting the fiscal-budgetary policy to its requirements

As the countries join the European Union, their fiscal-budgetary policy is subject to a series of constrictions, though it remains under the control of the national authorities. These constrictions are reflected by the convergence criteria stipulated in the Maastricht Treaty that the states undertake to observe with the purpose of adopting the single currency, as well as the criteria of the Stability and Growth Pact, implied by the Economic and Monetary Union.

The Maastricht Treaty, signed in 1992, sets the criteria depending on which the performance of the countries candidate to the monetary union is assessed. These criteria impose limits for the variations of the exchange rate, the interest rate, the inflation rate, the budget deficit and the public debt. The budget deficit must not exceed 3% of the GDP and the public debt must not exceed 60% of the GDP or the rapport between the public debt and the GDP must decrease enough to be considered that it is approaching the reference value at a satisfying pace.

The fiscal constrictions became even more rigorous in 1996, upon the signing of the Stability and Growth Pact. This pact implies the maintenance of the same limits for the budget deficit and the public debt stipulated in the Maastricht Treaty, in the event the member states fail to fulfill its requirements (except for a few exceptional situations), the "Excessive Deficit Procedure" is initiated and corrective measures are taken, which go from recommendations to imposing fines.

With respect to the Stability and Growth Pact, the Central and Eastern European Countries are classified as „member states with derogation", which means that those countries are expected to comply with SGP limits for government budget deficit and debt. Although they can not be fined for breaching those limits, they are put under Excessive Deficit Procedure and subsequent intensified fiscal surveillance process and can be prohibited to draw financial resources from EU Cohesion Fund.

Table 1: General government deficit (-)/surplus (+)* in Central and Eastern European EU Member States, 1997-2009 (%GDP)

Country	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*
Bulgaria	5.3	1.7	0.4	-0.5	0.2	-0.8	-0.3	1.6	1.9	3.0	0.1	3.3	2.9
Czech Republic	-3.8	-5.0	-3.7	-3.7	-5.7	-6.8	-6.6	-3.0	-3.6	-2.7	-1.0	-1.2	-1.3
Estonia	2.2	-0.7	-3.5	-0.2	-0.1	0.3	1.7	1.7	1.5	2.9	2.7	-1.4	-2.2
Latvia	1.1	0.0	-3.9	-2.8	-2.1	-2.3	-1.6	-1.0	-0.4	-0.2	0.1	-2.3	-5.6
Lithuania	-11.9	-3.1	-2.8	-3.2	-3.6	-1.9	-1.3	-1.5	-0.5	-0.4	-1.2	-2.7	-3.6
Hungary	-6.1	-8.0	-5.4	-2.9	-4.0	-9.0	-7.2	-6.4	-7.8	-9.3	-5.0	-3.4	-3.3
Poland	-4.6	-4.3	-2.3	-3.0	-5.1	-5.0	-6.3	-5.7	-4.3	-3.8	-2.0	-2.3	-2.5
Romania	...	-3.2	-4.5	-4.6	-3.3	-2.0	-1.5	-1.2	-1.2	-2.2	-2.6	-3.4	-4.1
Slovenia	-2.4	-2.4	-2.0	-3.8	-4.1	-2.5	-2.7	-2.2	-1.4	-1.2	0.5	-0.2	-0.7
Slovakia	-6.3	-5.3	-7.4	-12.3	-6.5	-8.2	-2.7	-2.3	-2.8	-3.5	-1.9	-2.3	-2.2

*under the Excessive Deficit Procedure

Source: European Comission, 2008

Many of the candidate states of the Central and Eastern Europe – as they were not obliged to observe any terms regarding the level of the fiscal indicators – experienced a significant deterioration of the budget situation during the period preceding the integration in the European Union. Apparently these countries did not realize that, once they are members of the European Union, they will be subject to severe budget constrictions, although it is well known that the 3% limit of the budgetary deficit and the 60% limit of the public debt, as well as the requirements of the Stability and Growth Pact, apply to each member state.

The data presented in table 1 reveal that, the year before the integration, three of the 8 member states of the Central and Eastern Europe that joined the European Union in 2004 registered budgetary deficits superior to the limit of 3% of GDP (The Czech Republic, Hungary and Poland), and levels very close to this limit (Slovenia and Slovakia). In exchange, Romania and Bulgaria, which became members in 2007, made a better start, as they registered a lower budget deficit or even a surplus, as it was the case with Bulgaria.

Table 2: General government consolidated gross debt* in Central and Eastern European EU Member States, 1997-2009 (%GDP)

Country	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*
Bulgaria	105.1	79.6	79.3	74.3	67.3	53.6	45.9	37.9	29.2	22.7	18.2	13.8	10.6
Czech Republic	13.1	15.0	16.4	18.5	25.1	28.5	30.1	30.4	29.8	29.6	28.9	26.6	26.4
Estonia	6.2	5.5	6.0	5.2	4.8	5.6	5.5	5.0	4.5	4.3	3.5	4.2	5.0
Latvia	11.1	9.6	12.5	12.3	14.0	13.5	14.6	14.9	12.4	10.7	9.5	12.3	17.7
Lithuania	15.6	16.6	22.8	23.7	23.1	22.3	21.1	19.4	18.4	18.0	17.0	17.5	20.0
Hungary	62.3	60.4	59.5	54.2	52.1	55.8	58.1	59.4	61.7	65.6	65.8	65.4	66.0
Poland	42.9	38.9	39.6	36.8	37.6	42.2	47.1	45.7	47.1	47.7	44.9	43.7	43.4
Romania	...	18.8	22.1	24.7	26.0	25.0	21.5	18.8	15.8	12.4	12.9	13.4	15.4
Slovenia	21.1	21.8	24.3	26.8	27.4	28.1	27.5	27.2	27.0	26.7	23.4	21.8	21.1
Slovakia	33.8	34.5	47.8	50.3	48.9	43.4	42.4	41.4	34.2	30.4	29.4	28.8	29.0

*under the Excessive Deficit Procedure

Source: European Comission, 2008

As regards the stock of public debt, as resulting from table 2, the countries of Central and Eastern Europe benefited from a privileged position in comparison to other European states. As a consequence of the low level of the debt accumulated during the communist period, although important budget deficits were registered in the transition period, these did not lead to exceeding the threshold stipulated in the Maastricht Treaty in most states. The exceptions are Bulgaria, which nevertheless made sustained efforts to reduce the debt stock and Hungary, the only country from the former communist block whose debt degree was approaching alarmingly the limit of 60% of GDP in 2004.

By analyzing the behaviour of the fiscal-budgetary policies in the Central and Eastern European countries during the pre-integration period, we may ascertain the existence of two categories of states [Lewis, 2007]. The first of these, the Baltic countries (Estonia, Latvia and Lithuania) promoted rather restrictive budgetary policies. On the contrary, the larger countries belonging to Central Europe (the Czech Republic, Hungary, Poland as well as smaller countries, such as Slovakia and Slovenia) promoted more relaxed budgetary policies, even on the background of a favourable economic situation, characterized by a positive rhythm of economic growth, registered during the period following the year 2000.

The different behaviour of these states is justified most often in the specialized literature by invoking the size of the country and the foreign currency regime adopted by the same [Lewis, 2007]. The fiscal-budgetary policy of the large Central European countries registered a significant relaxation after 1999, as the idea that their integration was ensured became rooted, while the Baltic countries were forced to keep maintaining the discipline, as the exclusion threat seemed more credible for them, as a result of their lower geopolitical importance. At the same time, in the countries that have a foreign currency council, its success is related directly to the sustainability of the budgetary policy, subsequently the governments are "forced" to lead healthy budgetary policies. This would justify the rather restrictive budgetary policies registered in the Baltic countries, which have a fixed exchange rate system.

Taking into account the performance regarding the fiscal consolidation achieved by the Baltic countries in the pre-integration period, the post-integration adjustments – though necessary – proved to be more easily achievable. These countries managed to maintain a low level of the budget deficit (Lithuania) or even a surplus (Estonia). As regards the countries of Central Europe (Romania is not far from this situation), their conformation to the requirements of the Stability and Growth Pact and the fulfillment of the Maastricht criteria proved to be a real challenge during the post-integration period. Though certain progresses were made until the present (obviously except for Hungary), the problem of the fiscal consolidation is still far from being solved. Since 2004, 5 of the 10 Central and Eastern European EU Member States (namely Poland, Czech Republic, Slovakia, Hungary and, most recently, Latvia) have been subject to the Excessive Deficit Procedure.

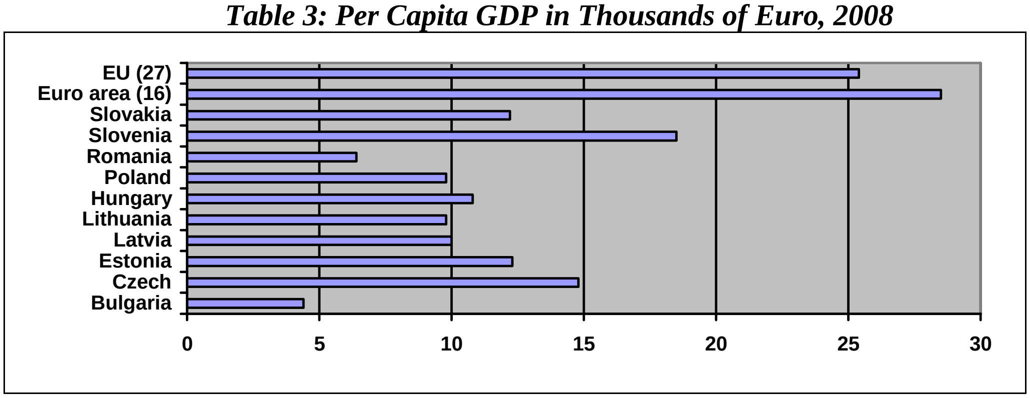
Under the conditions of the international financial crisis and of the decrease of the economic growth pace at global level, significant progresses regarding the budget deficit reduction are not envisaged within these countries in the immediate next period of time either. According to the European Commission's previsions, in 2009 Latvia, Lithuania, Hungary and Romania are expected to exceed the 3% limit of GDP for the budget deficit and Poland is expected to keep itself alarmingly close to this limit, which confirms the necessity to heighten the future consolidation efforts.

3. The role of the fiscal-budgetary policy in supporting the real convergence

The achievement of the budget deficit and public debt target stipulated through the Maastricht Treaty proves to be an even more difficult task for the fiscal-budgetary policy of some countries from Central and Eastern Europe, taking into account the fact that the public authorities from these states are asked to support the real convergence process and the promotion of the durable economic growth, through public financial means.

The economic development level is far beyond the European average in these countries. By using the GDP per inhabitant as a reference indicator we can ascertain that, although significant progresses were achieved in this regard, there are still important discrepancies by comparison with the situation of other European Union Member States (table 3).

Table 3: Per Capita GDP in Thousands of Euro, 2008



Source: http://ec.europa.eu/economy_finance/ameco/user/serie/ResultSerie.cfm

On the average, the GDP per inhabitant in the Central and Eastern European countries represents approximately 42.9% of the average GDP of the EU member states.

The highest values are recorded by Slovenia, which is already a member state of the Economic and Monetary Union and by the Czech Republic. On the contrary, the countries integrated in the European Union in 2007, Romania and Bulgaria, also record the biggest development discrepancies. The differences are even more significant when they are related to the developed member states of the EURO zone.

Convergence to EU levels of GDP per capita is going to be a long term phenomenon. Thus, for a few decades, Central and Eastern European Countries should display higher rates of growth than those of EU countries. According to some opinions, CEECs should grow at a rate that is 2 procent higher than the average EU [Coricelli, 2004]. In this context, the budgetary policy's task is to support the high economic growth potential by ensuring a proper level of public investments.

Numerous studies recognize the existence of a direct link between public investments' level and the economic growth performances of a country. The decrease of the rate of the public investments in the gross domestic product, in the context of the fiscal adjustment programs applied by many countries, mainly from Latin America, and the insufficient involvement of the private sector in infrastructure projects are considered to be the main causes of the decrease of the economic growth pace recorded in these countries between 1998-2003 [Calderon, 2004]. Establishing this, higher public investment spending are recommanded as a precondition for boosting one country's growth potential over the medium term.

The public expenses regarding infrastructure investments (communications, transportation networks) are generally considered to produce economic growth, leading directly to the increase of the physical capital stock of a nation. However, we cannot neglect the positive effect of the expenses regarding the investments in human capital (education, healthcare system) or scientific research and development.

In accordance with the revised Stability and Growth Pact's provisions, member states are allowed to register "temporary" or closed to the reference value of 3% budget deficits without facing an Excessive Deficit Procedure, when some "relevant factors" can be called for, including, among others, policies encouraging public investment. Nevertheless, maintaining fiscal discipline still means that the public deficit should be lower than 3% of GDP. From this point of view, finding money to invest in infrastructure and other public projects without jeopardizing fiscal stability still is a key topic in Central and Eastern European Countries, seeking to boost economic growth.

A solution for increasing investment in infrastructure and protecting priority projects when fiscal adjustment is called is finding alternative sources of financing. Such an alternative could be public-private partnership (PPPs), which holds the promise of increasing the supply of infrastructure and other services without overburdening a country's public finances. An infusion of private capital and management can ease fiscal constraints on infrastructure investment and boost efficiency. For these reasons, PPPs are taking off around the world, and there are now well-established programs in a number of countries, including Australia, Ireland, Mexico.

Nevertheless, the employment of that solution is only at its beginnings in EU Member States, only Great Britain and Portugal having registered important progresses in this respect. In all other countries, including Central and Eastern European Countries, even the stock value of signed public-private partnership contracts is small compared to annual public investment flows, which reinforces the necessity of ensuring an adequate level of budget financing.

The new member countries from Central and Eastern Europe also receive substantial funds from the EU budget (structural funds and cohesion funds), including for financing infrastructure investments. The EU funds could insure some relief for public finances in the new member states, especially those of Central Europe. However, the absorption of these funds has been relatively slow until now and, besides, one condition of the so-called structural funds is co-financing by the beneficiary country.

Consequently, as public-private partnership can only offer limited support quantitatively speaking and European funds need co-financing by beneficiary country, public budgets remain the main source of financing infrastructure projects and, more generaly, public investment in Central and Eastern European EU Member States. From this perspective, the fiscal consolidation efforts, which are an essential concern for some countries, cannot be carried out no matter how, in order not to have negative consequences on economic growth.

The budget deficits reduction, as it has been suggested many times in the specialized literature, should be achieved mainly by diminishing current expenses. Although it is more difficult to apply (as political pressure makes it problematic for governments to cut major current spending programs during periods of fiscal adjustment because such spending often benefits interest groups that have political influence), this would allow the accomplishment of the fiscal adjustments without affecting the real convergence. This situation does not always tally with practice, therefore the measures recently applied by countries from Central and Eastern Europe aimed at the reduction of the budgetary incomes (see the Hungarian case).

4. Conclusions

In view of the EURO adoption, the EU Member States from Central and Eastern Europe must fulfill certain criteria regarding the size of the budget deficit and of the public debt, settled by the Maastricht Treaty, complying at the same time with the Stability and Growth Pact's requirements.

The observance of these criteria calls for restrictions in the formulation of the fiscal-budgetary policies of the EMU candidate countries, which are forced to take fiscal consolidation measures, often severe. If these restrictions are practically non-existent for the Baltic countries, we cannot say the same thing about some Central European countries, for which the promotion of expansionist budgetary policies before the adhesion to EU led to the significant deterioration of the budget balance.

At the same time, taking into account the specific situation of the Central and Eastern European countries, there are additional pressures on the public budget, caused by the necessity to increase the public investments, especially in infrastructure, in order to remedy the discrepancies in development and co-financing assurance for the EU funds.

Taking into account that future adjustments are necessary, as we have also tried to emphasize during the paper, the way in which they are produced is not indifferent. Although they are more difficult to be applied, the measures should mainly aim at current expenses' cutting, leaving a manoeuvre margin for the increase of the expenses regarding the public investments and the co-financing of the EU funds, so that the real convergence process is not affected.

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