The political economy of strong fiscal adjustments in aspiring euro area countries

Jean-Philippe Cotis
OECD Chief Economist

and

Vincent Koen
Economic Counsellor
OECD Economics Department

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Overview

This conference features many excellent papers approaching the political economy of strong fiscal adjustments from an academic perspective. Here we try to address the issue from a policymaking viewpoint, focusing on the fiscal challenges facing the aspiring euro area countries known as the Visegrád group, *i.e.* the Czech Republic, Hungary, Poland and the Slovak Republic.

One of the key criteria for euro qualification is public finance sustainability, which neither large incumbents nor the aspiring four fully satisfy currently. A lot has already been said about this public finance requirement, which is meant to preserve the long-run sustainability of the Monetary Union by minimising negative spillovers, in terms of collectively higher interest rates and eventual monetisation, arising from fiscal slippages in individual Member countries.

But beyond fiscal altruism and the containment of negative externalities, there are good selfish reasons as well for Monetary Union members to engage in large fiscal adjustment, chiefly preparing for ageing and, in the realm of economic policies, the capacity to cope with asymmetric shocks and other macroeconomic idiosyncrasies. In coping with asymmetries, the role of fiscal policy should not be overlooked: after all, once in the Monetary Union, budgetary policy will become, by necessity, the main instrument available for economic stabilisation, in a context where markets flexibility remains imperfect.

At the same time, fiscal developments over the past few years suggest that within the Monetary Union “external” incentives to engage in fiscal adjustment have been severely blunted: financial market signals in the form of various risk premia are now of negligible magnitude while the enforcement record of the Stability and Growth Pact is mixed. Paradoxically, EMU’s framework thus places the burden on fiscal policy for dealing with asymmetric perturbations while inhibiting in practice incentives for fiscal adjustment, in a context where the spontaneous capacity to conduct forward-looking budgetary policy often remains very elusive.

With hindsight, a major source of asymmetries that could have been mitigated by stronger fiscal adjustment is the persistence of above-average inflation in various European countries. Chronically above-average inflation is seriously afflicting Italy and other Southern European countries and has become an increasing source of concern for policymakers there since 1999.

Indeed, when entering Monetary Union, various countries with a recent inflationary past benefited from considerable and persistent monetary policy relaxation, while the political incentives to offset this expansionary bias through fiscal tightening weakened in the absence of financial market or institutional disciplining. Such fiscal passivity most likely contributed to the domestic-demand-driven boom accompanying entry, which was to be followed, in most cases, by a gradual and lasting slowdown in activity, as well as continuous competitiveness losses and crowding out of the higher-productivity tradeables sector.

Aspiring euro area countries will likely face similar pressures, in a context where, due to the so-called Balassa effects, long-term inflation may significantly exceed the 2%-minus EMU benchmark. This may lead to persistently below-neutral real interest rates and abnormally strong domestic demand, even as the capacity for fiscal tightening may be no less inhibited than it currently is for the incumbents.

In such a context, the move towards fiscal retrenchment should be particularly ambitious in the run-up to Monetary Union, whilst political incentives are still strong and as interest rate convergence with the euro area eases adjustment by reducing the weight of public debt service. Although fiscal policy’s ability to rein in domestic demand once in the EMU may be attenuated by expansionary private saving offsets, the case for fiscal restraint remains strong, both from a short-term and from a longer-term perspective.
Introduction

The 10 countries that joined the European Union (EU) a year ago *ipso facto* became euro area candidates. In fact, even before accession, several had already linked their fate to the euro’s through currency board arrangements. And since May 2004, three have entered the European Exchange Rate Mechanism mark II (ERM II). In this presentation, however, we will focus on four newcomers who have not yet gone that far but who have already been OECD members for some time and whom we therefore know somewhat better: the Czech Republic, Hungary, Poland and the Slovak Republic, also known as the Visegrád group.¹

One of the key criteria for euro qualification, which partly conditions the fulfilment of some of the others, is public finance sustainability – a criterion which, alas, some incumbents do not fully satisfy, or appear to be less compliant with in retrospect than when they were selected for Monetary Union. At the moment, the fiscal situation in the aspiring four is not that bright either, and fiscal adjustment is one of the main challenges lying ahead, irrespective of any Maastricht commandments but even more so if the latter are taken into account.

Granted, preaching fiscal rectitude is easier than making it happen. In practice, the political economy of fiscal adjustment is notoriously challenging. Witness this letter, sent to the current President of the National Bank of Poland in an earlier life, back in the heroic early 1990s: “Dear Mr. Minister, Do you realise, Sir, that your financial policy has led people, peasants, and other workers to suicide? What kind of Catholic are you?”²

The period preceding EMU entry may, however, provide a window of opportunity where political economy impediments are less pronounced than usually. The prospective political and economic benefits from EMU participation may increase both public opinion’s willingness to endure short-run economic costs and policymaker’s ability to carry out large fiscal adjustment. The considerable size of current public deficits, in a context of rapid ageing, may also induce Ricardian private saving offsets that minimise the economic cost of retrenchment.

Fiscal consolidation with little collateral impact on domestic demand may help meeting Maastricht criteria but would be less of a blessing once in EMU, however. Indeed, past experience suggests that after entry incoming countries with a relatively inflationary past tend to benefit from a marked monetary relaxation with the potential to durably rekindle price pressures. It is then desirable that fiscal consolidation have a strong impact so as to mop up excess demand. Whether fiscal policy will achieve the feat of being weakly contractionary before EMU entry and more so after will depend on private saving behaviour. In the best of worlds, conditionally Ricardian households would mitigate the domestic demand impact of fiscal consolidation only when deficits are high.

Fiscal pressures

The current fiscal situation in the Visegrád countries is difficult:

- Headline fiscal deficits have tended to shrink in recent years but remain larger than in the euro area as a whole, where they are already several percentage points of GDP away from the

¹ After the name of the Hungarian town where presidents Václav Havel, Arpád Göncz and Lech Walesa met in 1991 and signed a declaration on close co-operation on the road towards European integration.

² Quoted in Balcerowicz (1992).
“surplus or close to balance” target (Table 1). Indeed, in all four countries, the Stability and Growth Pact’s Excessive Deficit Procedure was activated shortly after formal accession.

- Public debt ratios are lower than in the euro area as a whole, but this indicator is approaching the 60% of GDP mark in Hungary, and in Poland its rise has only been contained in the short run by privatisation operations and currency appreciation (Table 2).

Looking ahead, limited consolidation is in the offing in the near term and considerable fiscal pressures loom over the longer run. In Hungary, the underlying fiscal balance is actually set to deteriorate this year, as the headline projection is flattered by the removal of motorway construction expenses from the fiscal accounts. In the Czech Republic, prolonged delays in pension and health sector reform are causes for concern in the face of the impending acceleration in population ageing. In Poland, the modernisation or creation of infrastructure will call for large-scale public investment, which will only partly be shouldered by EU funds. Furthermore, in several of the Visegrad countries, tax and contribution rates remain relatively high while only limited progress has been achieved to date in reforming the social transfer system.

**Inflationary pressures**

An important lesson from the first six years of Monetary Union is that adopting the euro while underlying inflationary pressures remain higher than average may be a source of serious future complications. Italy and Spain in particular stand to mind, where real interest rates markedly fell after EMU entry thus rekindling inflationary pressures. Later an inflation multiplier set in where higher inflation lowered real interest rates further. In this case, inflation convergence does take place endogenously, but only gradually and through real exchange rate appreciation and a negative contribution of net exports. The ensuing crowding out of the productivity-intensive tradeables sector, and associated compression of potential growth, has been spectacular and very painful in Italy, where competitiveness, measured by unit labour costs in manufacturing, has been eroded by 25% over the past five years (Figure 1). It has been significant in Spain as well, where competitiveness deteriorated by about half as much. The Italian problem has been aggravated by lax fiscal policy – taking into account one-offs and other special factors (Table 3). But even in the case of Spain, where a rather rigorous fiscal policy has been pursued (Figure 2), the stance has arguably not been tight enough, with domestic demand running ahead of potential output.

An important factor susceptible to drive up inflation relative to euro average is the Visegrad countries’ ongoing catch-up process, which exerts inflationary pressures in the non-tradeables sector via the Balassa-Samuelson (BS) channel, as it has done since the 1980s in Greece, Portugal and Spain: with productivity growing faster in manufacturing than in services, and wage awards granted in the former sector spilling over to the latter, the relative price of services rises and overall inflation is magnified. Empirical estimates of the BS effect vary in a relatively wide range around 1% per annum or so. Going forward, its exact contribution to inflation depends on the evolution of productivity differentials, which is difficult to predict, but it is likely to persist. Balassa-Samuelson inflation is part and parcel of economic convergence and should have no impact on the competitiveness of the tradeable sector. But once in the Monetary Union, having lost the capacity to run monetary policy at

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3 In the Czech Republic, the deficit bulge in 2003 is largely a statistical artifact, reflecting the activation of guarantees issued mainly for the banking sector, which accounted for over 7 percentage points of the deficit ratio. In 2004, one-off factors worked in the opposite direction, reducing the deficit ratio by close to 2 percentage points. In Poland, the headline deficit would be around 2% of GDP larger if second-pillar pension contributions were excluded from the general government accounts, as will be the case after 2007. In Hungary, this same factor embellishes the fiscal balance by about 1% of GDP.

4 See OECD (2005). Another key consideration in Spain is the presence of large ageing-related implicit liabilities.

the national level, inflationary pressures can spread to the tradeable sector and damage competitiveness and long-term growth. Real interest rates in the non-traded would indeed be too low, putting upward pressures on domestic demand and wages across the entire economy and compromising long-term competitiveness. These adverse developments would require substantial further fiscal tightening to avoid a long-term crowding out of the higher-productivity tradeables sector.

At present, Visegrád countries still suffer from large public deficits, inflation remains high in Hungary and Slovakia and, when contained as in Poland, it is associated with high short-run real interest rates. These characteristics would make participation in EMU today unrealistic. But, later, even “borderline” compliance with entry requirements would make life in the EMU difficult, as illustrated by the example of Southern European countries. Allowing inflation to be moderately above euro area average before entry, while public deficits and short-run real interest rates remain relatively high, is precisely what Visegrád countries need to avoid.

The moral for the Visegrád countries is that on the road to euro accession they should not indulge in fiscal complacency, but aim squarely for substantial fiscal surpluses, as some of the Nordic EU countries have done in recent years. The convergence of interest rates towards euro area levels will help achieve this, by lowering public debt service. In effect, in a situation where a fixed exchange rate constrains monetary policy, fiscal restraint is required to keep inflation in check and avoid that exports and potential growth be undermined by overly rapid real exchange rate appreciation. If fiscal policy lacks ambition, the inflation multiplier will set in train the deleterious dynamics witnessed in Italy, and near-term euphoria may be followed by disenchantment.

In the context of transition to Monetary Union, an additional source of inflationary pressures relates to capital inflows. Large capital inflows are also part and parcel of the integration and convergence process. They help boost the modernisation and expansion of the recipient countries’ capital stock. However, if the fiscal policy stance does not adequately take these demand pressures into account, there is a risk of overheating, with rising inflation and widening external deficits.

**Political economy hurdles**

As recognised upfront, establishing the need for fiscal consolidation is the easy step. Far more difficult is implementation. The experience of the incumbent euro area members since the late 1990s shows that even when economic conditions are propitious – or perhaps precisely because they were so favourable – fiscal adjustment may not be forthcoming. One of the member countries’ commitments under the aegis of the Stability and Growth Pact was to move towards a budget surplus, in view of the clearly foreseeable build-up of fiscal pressures associated with ageing populations. Around the turn of the millennium, the economic times were good in the new Monetary Union, but the opportunity was not seized to step up the pace of consolidation, on the contrary (Figure 3). The mobile phone license manna combined with accumulated adjustment fatigue and buoyant revenues weakened policymakers’ resolve to internalise the new European medium-term fiscal framework, especially in the larger euro area countries. As a result, the latter found themselves with precious little room for fiscal manoeuvre once the downturn materialised.

More generally, and as is painfully clear from the predicament faced today in France, Germany and Italy, organising fiscal rectitude is a tall order. One reason pertains to the political cycle, which tends to encourage an expansionary fiscal stance on the eve of elections. But even in the absence of a near-term vote, elections are never that far away in the mind of homo politicus. Therefore, political calculus applies a different discount rate to tax and spending measures than economic calculus does. In this perspective, the sectoral pain associated with many tax increase or spending cut measures outweighs

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6 Only in the Czech Republic have both inflation and short-run real interest rates been low over the past few years.

7 See Buti and van den Noord (2004).
their typically more diffuse macroeconomic benefits, even when economic calculus would assign a higher value to the latter. Likewise, there is a perennial temptation for politicians, even of the benevolent kind, to opt for shifting the burden of taxation to future generations. In essence, the politically-driven deficit bias stems from the fact that the discount rate applied to “invisible” effects – be they diffuse or distant – is far higher than the one used to gauge “visible” effects. This bias will of course be even stronger during the honeymoon years around the time of euro adoption, when declining interest rates boost activity and ease the servicing of public debt.

What can or cannot be done also depends on the circumstances, of course. In times of deep crisis, the parameters entering the above calculus change. A prominent case in point is the period of “extraordinary politics” in the late 1980s and very early 1990s in Poland. Hyperinflation and shortages, against the background of the collapse of the Soviet bloc, made radical fiscal consolidation – with a turnaround of the fiscal balance amounting to 10 percentage points of GDP – politically acceptable (Figure 4). This window of opportunity, however, was short-lived, and soon gave way to the “normal politics” of political parties and interest groups, and to large deficits.

Another and more recent example of long overdue but bold fiscal adjustment is the Slovak Republic’s, which saw the headline deficit decline from around 6% of GDP in 2001-02 to only marginally above 3% in 2004. Remarkably, the policy package combined an overhaul of the tax system – cutting marginal rates and broadening the base, with a major shift from direct to indirect taxation – and a broad range of expenditure reforms, straddling pensions, social benefits and health care. Over the same period, economic growth accelerated substantially, to 5½ per cent.

Offsets

To some extent, the recent Slovak experience is reminiscent of earlier so-called “expansionary fiscal contractions” in long-time EU countries, notably the canonical cases of Denmark and Ireland in the 1980s. Indeed, under certain conditions, the non-Keynesian effects associated with fiscal consolidation may offset its adverse short-run impact on growth. Specifically, the restraining effect on aggregate demand will be damped if changes in the fiscal stance are partly offset by concomitant changes in private saving. The latter may arise insofar as agents internalise the government’s intertemporal budget constraint and factor in the fact that fiscal consolidation today reduces the tax burden in the future. This may be more likely if the adjustment effort is large and thereby signals a strong commitment to break with the past, implying possible non-linear relationships between changes in the underlying fiscal balance and in activity.

Another important channel through which the contractionary impulse imparted by fiscal retrenchment can be offset is via its impact on long-term interest rates, both for Keynesian reasons and via confidence effects (shrinking risk premia). In the Irish case for example, interest rates declined sharply, crowding in private investment and consumption and easing the burden of servicing a large public debt.

To what extent offsets are actually observed remains a controversial question. Recent OECD research found evidence of significant, if partial, offsetting movements in private and public saving, with an offset of two thirds on average. In line with earlier studies, it also found that the composition of the policy package matters.

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8 See Balcerowicz (1995).
9 See Giavazzi and Pagano (1990) and the subsequent literature.
10 The decline in interest rates and crowding in, however, were only partly home-made, as fiscal consolidation took place against the background of falling world interest rates and buoyant external demand (OECD, 1999).
11 See De Mello et al. (2004). It should be noted, however, that private saving measurement conventions induce some spurious negative correlation between public and private saving: while realised capital gains are not included in disposable personal income, taxes paid on them reduce it and raise government revenue, making for an apparent shift of saving from households to the government when the private sector enjoys larger-than-usual capital gains, as was the case in the United States in the late 1990s (de Serres and Pelgrin, 2003).
fiscal shift matters for the magnitude of the offset. Changes in public investment in particular do not seem to elicit an offsetting private saving response, consistent with the view that such spending should yield returns accruing to future taxpayers.

Ideally, and focusing on the aspiring euro area countries, the political cost of frontloaded fiscal consolidation should be mitigated by neorricardian offsets, insofar as the latter are more potent when the fiscal position is dire and perceived as such. As fiscal restraint is sustained, and as public finances are seen to be put on a sounder footing, the magnitude of such offsets would diminish, which would then most helpfully work to enhance the Keynesian effects of fiscal policy on aggregate demand and inflation. In other words, the leverage on inflation of fiscal restraint would become greater over time. Such a non-monotonic impact of fiscal policy has some plausibility but it rests on a type of conditional saving behaviour that is not yet indisputably established.

The quality of fiscal adjustment

The Slovak episode further illustrates that expenditure-based consolidations are generally more durable than those hinging on tax increases. Ireland’s experience in the late 1980s, when much of the adjustment was focused on health spending and the public sector wage bill, offers another good example. As well, in the run-up to Monetary Union, those euro area members that relied more on tax hikes than on lasting expenditure restraint measures were less successful in upholding the consolidation gains: again, contrast Spain’s experience with that of Italy. Developments in transition economies, including the new EU members, tend to confirm this pattern.

Indeed, raising taxes from what are often already high levels is detrimental to work or investment incentives and thus to potential growth, casting doubts on the durability of the consolidation. In contrast, expenditure reductions achieved through comprehensive structural reform work in the opposite direction. In the aspiring euro area countries, credible adjustment should speed up the convergence of long-term interest rates to euro area levels with, as noted, a positive feedback on the overall fiscal balance. Furthermore, insofar as public expenditure cuts are achieved by limiting public employment or salaries, they will dampen economy-wide wage pressures and spur private-sector hiring and investment, and thereby overall growth.

In policy debates, the prospect of becoming a euro area member tends to overshadow the other economic challenges facing the Visegrád four. Yet, for euro entry to be a success, strong fiscal consolidation is in order before the currency switchover and in fact even ahead of ERM II membership – in the form of high-powered, lasting adjustments rather than of ephemeral one-off accounting gimmicks. Despite the truly extraordinary nature of the metamorphosis from Soviet-imposed central planning to European market-based economics, the political climate today is less conducive to such efforts than it has been in earlier stages of transition. In this respect, the case for fiscal responsibility in the aspiring members is undermined by the poor fiscal performance of the largest euro area incumbents and by the rather cavalier interpretations of the revamped Stability and Growth Pact put forth by some politicians. Even so, sound public finances are key if the convergence process and the catch-up in living standards are to continue both prior to and following euro area accession.

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12 A glaring exception to this pattern is the seemingly non-ricardian US economy (see Cotis et al., forthcoming).
13 This hypothesis of conditional neorricardian behaviour has recently been revisited for OECD countries by Benedetti et al. (2005) and for the new EU member countries by Rzońca and Cizkowicz (2005).
15 See Purfield (2003) and Afonso et al. (2005).
References


### Tables and Figures

#### Table 1
**Headline fiscal balance in four aspiring euro area members**
in % of GDP

<table>
<thead>
<tr>
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<th>2001</th>
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<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
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<tr>
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<td>-6.8</td>
<td>-11.6</td>
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<tr>
<td>Slovak Republic</td>
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<td>-5.7</td>
<td>-3.7</td>
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<td>-3.4</td>
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<td>-2.7</td>
<td>-2.8</td>
<td>-2.7</td>
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*Source*: OECD Economic Outlook No. 77 database.

#### Table 2
**Headline public debt ratio in four aspiring euro area members**
in % of GDP

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
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<td>Euro area</td>
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*Source*: OECD Economic Outlook No. 77 database.

#### Table 3
**Estimates of one-offs and the like in selected euro area countries**
in % of GDP

<table>
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<th>2001</th>
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<th>2003</th>
<th>2004</th>
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<tbody>
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<td>Greece</td>
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<td>3.4</td>
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<tr>
<td>Italy</td>
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<td>1.9</td>
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<tr>
<td>Portugal</td>
<td>0.0</td>
<td>1.4</td>
<td>2.5</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Figure 1

Competitiveness trends diverge across euro area members

Index, 2000=100

2000 2001 2002 2003 2004 2005

Italy
Spain
Germany
France

Note: The competitiveness indicator is relative unit labour cost in the manufacturing sector corrected for changes in nominal effective exchange rates.

Source: OECD Economic Outlook 77 database.
Figure 2

The fiscal tale of two euro area countries

In % of GDP

Fiscal positions

Cyclically-adjusted fiscal balance

Gross public debt

Italy

Spain

Cyclically-adjusted fiscal balance

Real interest rate

Cyclically-adjusted fiscal balance

Real interest rate

1. Adjusted for the one-offs identified by the European Commission (2005) and by Koen and van den Noord (2005) for the late 1990s.
2. Taking into account the 19 May 2005 revision of official GDP estimates.
3. Adjusted for the one-off imputation of past debt to 2004 spending.
4. Ten-year government bond yield deflated by contemporaneous CPI inflation.

Source: OECD Economic Outlook No. 77 Database; European Commission (2005); ISTAT release 24 May 2005.
Figure 3
**Euro area: cyclically-adjusted balance**
In % of GDP

Source: OECD Economic Outlook No. 77 database.

Figure 4
**Heroic stabilisation: Poland in 1990**
Fiscal balance, in % of GDP

Source: IMF, various reports.