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FISCAL CONSOLIDATION IN THE BALTIC STATES

Abstract. The strong growth performance of Baltic states, in the period 2000-07, was accompanied by rapid changes across the economy. Between 2004 and 2007 the Baltic states stood among the EU countries for their high growth rate. The global financial crisis hit the Baltic states much harder than other countries in the EU. In order to improve public finance sector were necessary radical consolidation.

The aim of the article is to show the impact of the consolidation processes to improve the financial performance of the public finance sector.

Key words: Baltic states, macroeconomic situation, budget deficit, fiscal consolidation.

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КОНСОЛІДАЦІЯ БЮДЖЕТІВ В КРАЇНАХ БАЛТІЇ

Анотація. Високі показники зростання країн Балтії, в період 2000-07, супроводжувалися швидкими змінами всієї економіки. У період з 2004 по 2007 рік країни Балтії були серед країн ЄС за високим рівнем зростання. Глобальна фінансова криза вдарила по Прибалтиці набагато складніше, ніж в інших країнах ЄС. Для того, щоб поліпшити сектор державних фінансів необхідна консолідація бюджетів.

Мета статті показати вплив процесів консолідації, які покращують фінансові показники сектора державних фінансів.

Ключові слова: країни Балтії, макроекономічна ситуація, дефіцит бюджету, бюджетної консолідації.

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КОНСОЛИДАЦИИ БЮДЖЕТА В СТРАНАХ БАЛТИИ

Аннотация. Высокие показатели роста стран Балтии, в период 2000-07, сопровождались быстрыми изменениями всей экономики. В период с 2004 по 2007 год страны Балтии были среди стран ЕС по высокому уровню роста. Глобальный финансовый кризис ударил по Прибалтике гораздо сложнее, чем в других странах ЕС. Для того, чтобы улучшить сектор государственных финансов необходима консолидация бюджетов.

Цель статьи показать влияние процессов консолидации, которые улучшают финансовые показатели сектора государственных финансов.

Ключевые слова: страны Балтии, макроэкономическая ситуация, дефицит бюджета, бюджетной консолидации.

Формул: 0; рис .: 2, табл .: 3, библ .: 8

Introduction.

The Baltic states regained independence from the Soviet Union in 1991 and established market-based economies. In order to combat high inflation and to facilitate international trade, the countries established fixed exchange rate systems at an early stage;

Estonia and Lithuania opted for a currency board, while Latvia chose a conventional but tight peg. The countries privatized most enterprises and cut spending to reduce the size of the public sector. All three countries have flat income tax systems. The strong growth performance in the period 2000-07 was accompanied by rapid changes across the economy. Consumption and investment increased quickly, aided by rapid credit growth and extremely low or even negative real interest rates. The construction sector boomed as real estate prices skyrocketed. Eventually, high rates of wage growth and inflation ensued. These developments culminated in 2006-07, with signs of overheating becoming increasingly evident. The economic boom in the period leading up to the global financial crisis was in large part driven by favorable international financing conditions, as large amounts of capital flowed into the Baltic states and other countries in the European periphery.

The global financial crisis hit the Baltic states much harder than other countries in the EU. The cumulative output loss in 2008 and 2009 was 18.3 per cent in Estonia, 21.0 per cent in Latvia and 11.9 per cent in Lithuania. The unemployment rate shot up, and substantial emigration followed. The austerity measures implemented in the Baltic states rested on two pillars: the countries retained their fixed exchange rate policies and embarked on substantial fiscal consolidations for 2009, which included tax increases and spending cuts, comprising inter alia reductions in public sector wages.

The aim of the article is to show the impact of the consolidation processes to improve the financial performance of the public finance sector.

The study used the following test method:

- analysis of the literature on the subject,
- analysis of normative acts,
- analysis of statistical data.

1. The impact of the financial crisis on the macroeconomic situation of the Baltic States.

Since regaining independence, the Baltic states have stood out among the European transition countries as radical pro-market reformers. After accession to the EU, all three economies witnessed an unprecedented boom. Between 2004 and 2007 the Baltic states stood among the EU countries for their high growth rate (Figure 1). These period were, however, accompanied by signs of overheating, including double-digit inflation, a housing boom, appreciating real exchange rates, accelerating wage growth—that exceeded productivity growth, especially in Latvia and Estonia and, to a lesser extent, in Lithuania—a fast accumulation of net foreign liabilities and soaring current account deficits. To a significant extent, the growth was fuelled by cheap credits, available through foreign-owned banks, which drove up domestic demand and which were channeled into real estate, construction, financial services and private consumption[1].

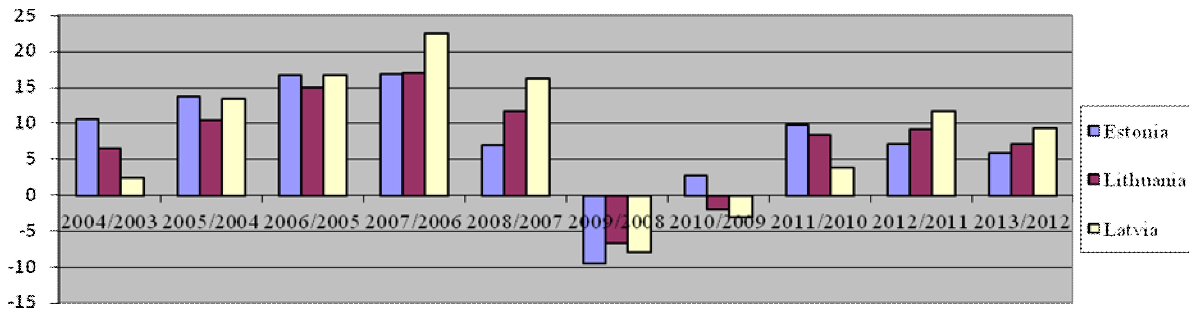

Figure 1. GDP growth in the Baltic countries in real terms over the period 2003-2013 in %
Source: Eurostat

[1] Reiner M., Boom and Bust in the Baltic Countries – Lessons to be Learnt, in : Intereconomics, Vpl. 45, No 4, 2010, pp 220-226.

As we can see, all Baltic economies were rapidly losing competitiveness in addition to becoming massively indebted. Latvia, with the highest wage growth and the lowest productivity growth became the most overheated of the three and Lithuania the least. Latvia also recorded the highest current account deficit, the highest GDP growth rate and the highest rate of inflation. The high growth rates induced a lulling effect, leaving the political elites oblivious to the few warning signals that pointed to increasing external imbalances. Furthermore, the governments even added to the overheating of the economies by loose fiscal policies, including the spending of boom-generated windfall revenues from supplementary budgets adopted in the course of the fiscal year.

The crisis, of 2008, hit all Baltic republics quickly and painfully. The immediate consequence was a sudden stop of capital flows to the Baltic states. Export demand collapsed, which affected the Baltic states disproportionately, as their economies are very open and have large export sectors integrated into Western European supply chains. The crisis also impaired sentiment among households and firms, leading to lower consumption (Table 1) and investment demand. The situation was exacerbated by the disruption of financial markets, which spurred banks to tighten credit standards and made stock markets illiquid, in turn making it difficult for many enterprises to access working capital[2].

Table 1

The evolution of the domestic demand and private consumption and public in the Baltic States in the years 2003-2013

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Final domestic demand in billion euro											
Estonia	9,4	10,4	11,9	14,8	17,6	16,9	13,2	13,3	15,7	17,2	18,1
Lithuania	17,5	19,5	22,5	26,5	32,6	36,2	27,1	28,2	31,8	32,7	34,3
Latvia	11,2	12,9	14,8	19,4	25,3	26,0	18,8	18,3	21,2	23,1	23,8
Private consumption in billion euro											
Estonia	4,7	5,2	5,8	6,9	7,9	8,1	7,4	7,1	7,6	8,4	9,0
Lithuania	10,8	11,9	13,3	14,9	17,4	19,1	17,4	17,5	18,6	20,1	22,0
Latvia	6,5	6,7	7,7	9,7	11,8	12,2	10,9	11,5	11,7	13,0	14,4
Government consumption in billion euro											
Estonia	1,5	1,6	1,8	2,0	2,3	2,8	3,0	3,0	3,0	3,2	3,6
Lithuania	3,2	3,4	3,6	4,0	4,7	5,1	6,1	5,6	5,7	5,8	5,9
Latvia	2,1	2,2	2,3	2,4	2,8	3,8	4,2	3,3	3,4	3,6	4,1

Source: Eurostat

The collapse in demand and the disruption of financial markets led to large output contractions in the Baltic states. In the early stages of the crisis, the sectors most severely affected were construction, manufacturing and retail sales.

The astonishing magnitude and pace of the output declines in the Baltic states after the outbreak of the global financial crisis were in large part a reflection of pre-existing vulnerabilities. Empirical studies have found that countries that had a large foreign debt stock, large current account deficits and a high share of exports before the crisis suffered the largest output declines after the outbreak of the global financial crisis (Table 2)[3].

[2] Purfield C., Rosenberg C.B. Adjustment under a currency peg: Estonia, Latvia and Lithuania Turing the global financing crisis 2008-2009, IMF Working Paper, No 10/213, 2010.

[3] Blanchard O, Das. M, Faruqee, The initial impast of the crisis on emerging market countries, Brooking Papers on Economic Activity, Spring 2010 pp 263-323.

Table 2

The indicators of foreign trade in the Baltic countries in the period 2003-2013

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
The volume of exports of goods and services in billion euro											
Estonia	5,9	6,9	8,4	9,2	10,1	10,9	9,1	11,0	14,0	15,5	16,1
Lithuania	8,6	8,8	11,1	13,5	14,6	17,2	16,9	17,0	21,4	26,7	29,4
Latvia	4,3	4,6	5,9	6,6	8,0	9,2	8,6	9,2	10,9	13,0	13,9
The volume of import of goods and services in billion euro											
Estonia	6,8	7,7	9,2	10,7	11,8	11,4	8,4	9,9	13,3	15,3	15,7
Lithuania	9,6	10,8	12,6	15,4	18,4	21,3	16,6	17,6	21,9	26,3	29,0
Latvia	5,7	6,4	7,6	9,7	12,4	11,8	8,9	9,4	12,1	13,4	14,5
The foreign trade balance as% of GDP											
Estonia	-9,5	-7,8	-7,4	-11,3	-10,7	-3,2	4,9	8,1	4,4	1,0	1,4
Lithuania	-5,9	-11,3	-7,1	-8,9	-13,1	-12,4	0,9	-2,3	-1,7	1,4	1,3
Latvia	-14,1	-15,9	-13,2	-23,7	-20,7	-11,7	-1,7	-1,4	-6,2	-1,9	-2,9

Source: Eurostat

The rapid decline in production was followed by increasing unemployment (Figure 2). The output decline particularly affected labour-intensive sectors such as construction, manufacturing and retail services. This effect was initially dampened somewhat, as some companies kept excess staff on the payroll until the depth of the crisis became evident.

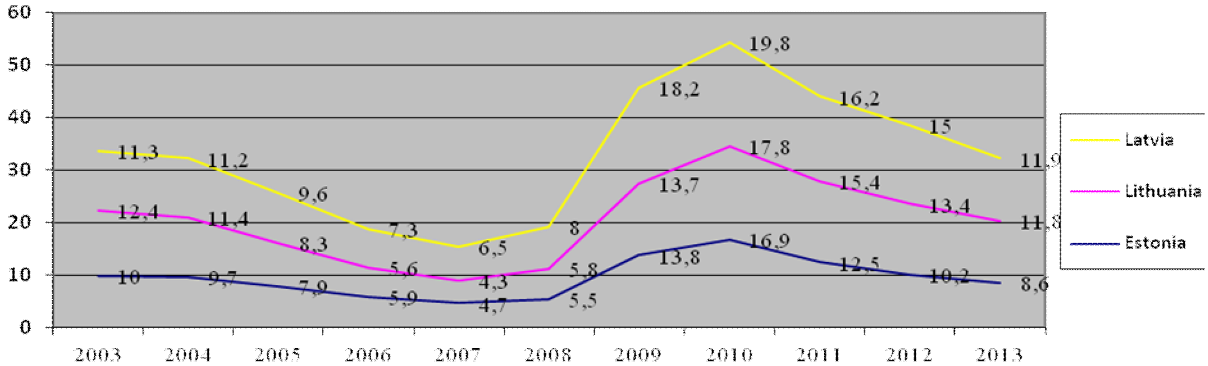

Figure2. The unemployment rate in the Baltic States in the years 2003-2013 in%
Source: Eurostat

The cornerstone of the policy response to the crisis in all three Baltic states was to maintain their fixed exchange rates towards the euro. This came in spite of numerous calls from foreign commentators and policy advisors to devalue the national currencies or let the exchange rates float and depreciate. The argument was that a depreciation of the nominal exchange rate would provide a badly needed demand stimulus by improving external competitiveness and helping exports and import-competing sectors.

The choice to retain the fixed exchange rates was based on economic and political arguments. A devaluation or float could have proven difficult to manage when financial markets were illiquid and unpredictable. The result could have been extreme exchange rate instability, which may have then led to further uncertainty and loss of confidence. Furthermore, if the result were a substantial depreciation of the exchange rate, those households and companies that had borrowed in euros or other foreign currencies would have seen higher debt servicing costs with knock-on effects on domestic demand and the real estate sector. Another, partly political, argument was that a large depreciation of the currency could be seen as expropriation or unjustified redistribution of resources. Finally, the countries were striving to join the euro area and therefore had joined the Exchange Rate Mechanism (ERM2), which required that the exchange rate with the euro remain within a +/- 15 per cent band. A devaluation or float of the currencies would have jeopardised membership in the ERM2 and thus the prospects of joining the euro area[4].

2.The impact of the financial crisis on public finances in the Baltic countries.

In fiscal policy, the response to the crisis differed across the three countries. Until 2007 the budget in Estonia was balanced or had small surpluses, while the budgets in Latvia and Lithuania exhibited small deficits (Table 3). This picture changed markedly after the onset of the global financial crisis. In 2008 all three countries had deficits of three to four per cent of GDP due to the downturn.

Table 3

Indicators of the public finance sector in the Baltic countries in the years 2003-2013

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Public revenue as% of GDP											
Estonia	36,5	35,6	35,2	36,1	36,4	36,7	42,8	40,6	38,7	39,2	39,5
Lithuania	32,5	32,5	33,5	33,7	34,3	34,6	35,5	35,0	33,2	32,7	33,0
Latvia	33,3	34,9	35,4	37,8	35,6	34,9	34,0	35,3	34,9	35,1	35,8
Public expenditure as% of GDP											
Estonia	34,8	34,0	33,6	33,6	34,0	39,7	44,7	40,5	37,5	39,5	38,9
Lithuania	33,8	34,0	34,0	34,2	35,3	37,9	44,9	42,3	38,7	36,1	35,5
Latvia	34,9	35,9	35,8	38,3	36,0	39,1	43,7	43,4	38,4	36,5	35,7
Budget balance as% of GDP											
Estonia	1,7	1,6	1,6	2,5	2,4	-2,9	-2,0	0,2	1,1	-0,2	-0,5
Lithuania	-1,3	-1,5	-0,5	-0,4	-1,0	-3,3	-9,4	-7,2	-5,5	-3,2	-2,6
Latvia	-1,6	-1,0	-0,4	-0,5	-0,4	-4,2	-9,8	-8,1	-3,6	-1,3	-0,9

Source: Eurostat

Despite a large output contraction in 2009, followed by a period of subdued economic growth, Estonia managed to keep the budget deficit at two per cent of GDP in 2009, and the budget remained roughly in balance in the following years. Latvia had a budget deficit of almost ten per cent of GDP in 2009 despite some budgetary consolidation in line with the requirements in the IMF-led lending package. By 2012 the deficit was down to 1.2 per cent of GDP, well below the three per cent threshold stipulated in the Maastricht Treaty and the Stability and Growth Pact. Lithuania also exhibited a budget deficit of close to ten per cent in 2009, but the consolidation was more gradual than in Latvia, and in 2012 the deficit was still above three per cent of GDP[5].

3. Consolidation processes in the Baltic States.

Fiscal consolidation in all three countries entailed both expenditure and revenue measures. However, the relative importance of the measures shifted in time and followed somewhat different dynamics in the three countries. In Latvia, for example, the consolidation efforts were driven by spending cuts in 2009, but shifted more towards the revenue side in 2010. In Lithuania, the adjustment in 2009–2011 was driven by the expenditure side measures and the government was more willing to increase taxes at an earlier phase of adjustment than later on. In Estonia, the fiscal adjustment in 2008 and 2009 focused more on the expenditure

[4] Staehr K, Austerity in the Baltic States During the Global Crisis, Public Finance and Management,Volume 48, 2013 Number 5 pp. 14-15.

[5] Staehr K, The global financial crisis and public finance in the new EU countries in Central and Eastern Europe, Public Finance and Management,Volume 10, 2010 Number 4 pp. 671-712. Data of Eurostat.

side, whereas in 2010 the austerity measures were almost equally divided between the expenditure and revenue sides[6].

Cuts were applied to all expenditure categories, though operating expenses and transfers took a larger hit than investments. In all three countries, the governments curtailed those parts of capital budgets that were not financed from EU funds and accelerated spending on EU-financed investments, facilitated by the new EU rules that allowed the governments to front-load the disbursements. The expenditure measures combined across-the-board cuts with targeted reductions. Among a cross-the-board measures, the cuts to operating expenses of the public sector—especially salary reductions—were the most prominent. Following a 'cheese-slicing' strategy, cuts in operating expenses took place in several rounds via negative supplementary budgets. In 2009, the largest wage cut took place in Latvia (by 18%), followed by Lithuania (10%) and Estonia (8%). Pay cuts continued in 2010 and 2011, especially in Latvia, although they were somewhat less dramatic than in 2009. Altogether, public sect or employees faced the largest cut in Latvia: the salaries of central government officials, for example, were cut by 30% between 2009 and 2011. The wage bill expenditure decreased by 17% in Lithuania between 2008 and 2011. Pay cuts were less progressive in Estonia and Latvia than in Lithuania where cuts varied from 8% to 36%, depending on how high the previous level had been, with the highest earners taking the largest hits. In Estonia, teachers were subjected to a lower pay cut than the rest of the public sector. In Latvia, in contrast, the education and health care sectors were particularly hard hit by cuts so that, for example, teachers' gross monthly pay was reduced from 494 euro to 358 euro. Among social benefits, pensions and sickness benefits took the first hit. Sickness benefits were curtailed in all three countries, either by cutting the benefits for the first days of sick leave, as in Estonia, or by reducing the payments that exceeded a certain threshold by 50%, as in Latvia. In Estonia, pensions were increased by 5% instead of following the indexing formula that would have led to a 14% increase. In Latvia and Lithuania, old-age pensions were cut, but in both countries the cuts were contested by judicial review and were found to be unconstitutional. In Estonia a planned increase in unemployment benefits was postponed while those parts of the new employment law that made redundancies and layoffs easier were still enacted. In other words, from the so-called 'flexicurity' package, the flexibility aspects were introduced, while the security elements were postponed. In all three countries, significant savings were attained by diverting all or part of the contributions to the compulsory private funded pension pillar to the 'public pay as you go' pillar[7].

Instead of increasing one particular tax significantly, the governments opted to spread increases across a large number of different taxes, both direct and indirect. Apart from increases in nominal tax rates, there was also extensive broadening of tax bases, especially in Latvia and to a lesser extent in Lithuania. Value added tax and excise duties on cigarettes alcohol and fuel were increased in all three countries. They all also broadened the base for personal income tax by reducing the number of allowances. Income tax rates also saw some changes. In Estonia, a planned reduction was postponed[8]. In Latvia, the income tax rate was subject to fluctuations, first decreasing from 25% to 23% in 2009, then increasing again to 26% in 2010, followed by a reduction to 25% in 2011. In Lithuania, the 2009 increase in corporate income tax rate,from15%to20%,was reversed in 2010. In Estonia, unemployment insurance contributions were increased from 0.9% to 4.2% of gross wages. In Latvia, the employee's social insurance contribution rate was increased from 9% to 11% in 2011. Latvia also introduced a progressive real-estate tax, with higher rates applying to buildings with

[6] Raudla R. Kattel, R. Fiscal Stress Managament in the Baltics Republics in 2008-2011 ,Europe –Asia -Studies , Vol 65 no 3 2013 pp 426-449.

[7] *Ibidem*

[8] Kasperowicz-Stępień A., Taxation in the Baltic States – the case of Estonia, in: Zarządzanie finansami w przedsiębiorstwach i jednostkach samorządu terytorialnego, red D. Zarzecki, Zeszyty Naukowe Uniwersytetu Szczecińskiego nr 803, Szczecin 2014, pp.105-114.

higher value, in 2009 and doubled the tax rates in 2011. Lithuania introduced a real-estate tax in 2011. No new taxes were introduced in Estonia during the crisis. It is worth noting that, while in Estonia and Latvia the governments primarily imposed tax increases, in Lithuania the picture is more complex, with some reductions alongside increases, as exemplified by the reduction in personal income tax rates and the addition of exemptions to excise duties. In the autumn of 2009, in order to secure adherence to the Maastricht deficit criterion, the Estonian government also resorted to a number of one-off revenue-generation measures, such as taking dividends from state-owned enterprises and selling the shares of Estonian Telecom, with the condition that additional dividends would be paid out in 2009 and 2010[9].

Conclusions.

The strong growth performance of Baltic states, in the period 2000-07, was accompanied by rapid changes across the economy. Between 2004 and 2007 the Baltic states stood among the EU countries for their high growth rate. The global financial crisis hit the Baltic states much harder than other countries in the EU.

In order to improve public finance sector were necessary radical consolidation. Consolidation concerned both the revenue side and the expense. Consolidation measures used included: tax increases and spending cuts, comprising inter alia reductions in public sector wages. s a result of the consolidation of the operations employed managed to achieve the requirements of the European Union fiscal discipline.

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