

# Fiscal Consolidation and Economic Growth in Post-Transition EU Countries: Descriptive Analysis

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The logo for 'dabar', featuring a stylized black and red graphic above the word 'dabar' in a lowercase, sans-serif font.

DIGITALNI AKADEMSKI ARHIVI I REPOZITORIJI

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## FISCAL CONSOLIDATION AND ECONOMIC GROWTH IN POST-TRANSITION EU COUNTRIES: DESCRIPTIVE ANALYSIS

*Concerns about sustainability of public finances during global economic crisis in 2008 resulted in stronger implementation of fiscal consolidation measures. The literature does not offer a consensus on the impact of these measures. Empirical research offers a rationale for both contractionary and expansionary effect of fiscal consolidation on economic activity. Studies that examine the macroeconomic and fiscal effects of consolidation in developed countries are neither frequent nor have a long history, while the same effects in the post-transition countries are un-investigated. This paper tries to shed some light on this relationship. The research results do not support the expansionary fiscal consolidation hypothesis. Therefore, descriptive analysis suggests that, apart from minor corrections of current account of the balance of payment and lower labor costs, fiscal consolidation in post-transition countries did not achieve declared goals such as economic growth. The results of the analysis have to be observed with caution. Namely, this research did not include an econometric estimate of the effects of fiscal consolidation,*

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*which would take into consideration other factors (control variables) that affect the observed fiscal and macroeconomic variables.*

**Keywords:** *fiscal consolidation, economic growth, descriptive analysis, post-transition countries*

## 1. INTRODUCTION

Fiscal consolidation or fiscal adjustment is a term which represents the process of harmonization of public revenues and public expenditures by reducing expenditures and / or increasing revenues. The objective of fiscal consolidation is to reduce the budget deficit and to balance the state budget in each fiscal year. Fiscal adjustment is closely related to austerity policy- reducing the expenditure side of the state budget. Although fiscal consolidation has been recognized as a hot issue, the literature does not offer a consensus on the impact of consolidation measures. As a consequence of ambiguous results (both contractionary and expansionary), this amounts to quite a big problem for policy makers as they are on one side pushed towards fiscal consolidation while on the other side they lack a clear idea what these measures might be bringing about across the economy.

Identification of fiscal shocks in models can be recursive (Cholesky), structural (Blanchard-Perotti) and narrative (Romer and Romer). In this paper, we will investigate the macroeconomic impacts of fiscal consolidation in post-transition countries, using only descriptive analysis. We will also try to answer the question: how strong is the evidence on the expansionary fiscal consolidation hypothesis, according to which economic growth is accompanied by a reduction in expenditures and / or increased revenues?

The paper begins with the theoretical framework followed by the review of empirical research. After that we present the descriptive analysis of the effects of consolidation on selected fiscal and macroeconomic variables in post-transition countries. The last part of the paper is a conclusion with research limitations as well as recommendations for future research.

## 2. THEORETICAL BACKGROUND

Theoretical evidence for the expansionary fiscal consolidation is related to two channels: the wealth channel (the role of expectation) and the channel of trust (the impact on the interest rate).

The approach according to which budget spending cuts increase private consumption is not new in neoclassical growth models. Reducing public expenditures perceived as permanent will cause wealth effects. Due to the decrease in expenditures, market actors expect that future taxes will also be lower, which increases the wealth of the private sector (Alesina and Perotti, 1997). Consequently, fiscal consolidation achieved through a permanent reduction in public spending increases private consumption, under certain conditions.

The first such condition is the level of public debt at the beginning of the consolidation period, compared to the three-year period before consolidation—the higher the public debt growth in the pre-consolidation period, the greater the likelihood of fiscal adjustment (Alesina and Ardagna, 1998). In other words, the cumulative change in public debt over the three-year period before successful consolidation is higher than the change in unsuccessful consolidation.<sup>1</sup> Successful fiscal adjustments are made when the share of public debt in GDP is relatively high, which would mean that the effects of fiscal policy are greater in the situation when there is a significant fiscal imbalance.

Let's assume now that there are rigidities in the labor market rent. In that case, the increase in budget spending has two effects (Alesina and Ardagna, 2012). The first effect is the increase in employment, and thus income and consumption, while the second effect implies a reduction in the private sector's wealth, which is due to the increase in the tax rate that is discounted to the present value. If there is a large share of credit-limited entities on the market, the first effect will prevail. If the current tax value and the debt level are high, the second effect will prevail. This model provides an explanation for the positive correlation between public spending shocks and changes in private spending in situations where debt levels are not high and negative correlation when the problem of excessive public debt is present.

Like budget spending, tax increases also have two different impacts on private consumption. Increase in taxes reduces disposable income, and therefore the consumption of credit-limited entities. However, if public expenditures are unchanged, the current tax increase implies lowering taxation in the future. If the initially expected tax movement can be described as growing, it will affect the reduction of tax distortion. When the level of public debt is high and if initial tax distortions are present, the benefits of tax deduction are significant, and the second effect prevails. At low levels of debt, the first effect will prevail (Alesina and

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<sup>1</sup> Fiscal consolidation is successful if a) in the three-year period after consolidation, the cyclically-adjusted primary deficit decreased by min on average 2% below its value in the year of consolidation; or b) if three years after consolidation the ratio of public debt to GDP is min. 5% lower than the ratio in the year of consolidation (Alesine and Ardagna, 1998, Mirdala, 2013).

Ardagna, 2012). Therefore, in so-called normal circumstances there is a negative correlation between taxation and changes in private consumption, while in a situation where there is a significant fiscal imbalance the correlation is positive.

The second channel of fiscal consolidation concerns the risk premium. Heavily indebted countries pay a risk premium when borrowing money abroad. Therefore, a change in fiscal policy can have significant effects on the interest rate given the possibility of reducing the risks and hence the premium. Risk premium activity can be explained by the existence of so-called multiple equilibrium (Alesina, 2010). A certain balance can be characterized by a high budget deficit which, through high interest rates on public debt, makes it difficult to achieve fiscal sustainability. In this case, the high-risk premium is justified. In the second case, lower risk premium allows a lower interest rate and easier budget balance. Therefore, the reduction of the budget deficit can contribute to the change of the state of the economy from a sub-optimal balance with a high-risk premium to an optimal balance with low risk and interest rate. So, the channel of trust can stimulate all those components of aggregate demand that are sensitive to interest rate changes, especially investments.

And in this case, the initial level of public debt is an important issue. Research indicates (Alesina, 1992) that the risk premium is a non-linear public debt function, which means that it does not exist at moderate levels but occurs at a higher debt and GDP ratio. In addition, reducing the risk premium reduces the budget deficit more when the initial debt level is higher.

The theoretical basis for a critique of the previously described approach and application of Keynesian policy in the period of crisis can be found in Gali et al. (2007), who explore the effects of fiscal policy in the situation of the existence of credit and financial constraints when the credit market does not function efficiently. Authors develop a sticky price model in which a certain proportion of households always spend their current income. Such non-ricardian consumers exist along with those ricardian- the higher the share of non-ricardian consumers in the total population, the greater the impact of fiscal policy on production and employment. Such consumers are most often credit-limited and have no access to financial markets. In a situation where the number of such consumers is significant, government spending multipliers are higher than usual. (Krugman, 2005., Tagkalakis, 2008.).

In their most recent book, Alesina, Favero and Giavazzi (2019) discuss whether austerity policy was introduced too soon after the 2008 crisis. One side believes that the introduction of austerity policies was necessary because if the states had not done so, the situation would have been even worse. The authors describe in detail how European countries introduced austerity policies in the period 2010-2014, with some countries using tax increases, which proved to be a worse choice, and some a reduction in spending, which, according to the authors, proved to be a bet-

ter choice. Based on their analysis, the authors conclude that the Keynesian view which implies that increasing consumption drives the entire economy is not valid.

### 3. REVIEW OF EMPIRICAL RESEARCH

The existing literature covers various determinants that affect fiscal consolidation, from economic (public finances, business cycle) to political factors (consolidation intensity, political consequences). This review provides an insight into the most relevant aspects of fiscal consolidation, from the structure over the period in which consolidation implements the macroeconomic consequences that it causes.

Investigating periods of fiscal consolidation for all OECD countries in the period 1960-1994, Alesina and Ardagna (1998) come to the conclusion that spending cuts are much more efficient for economic growth than tax increases. Their results show that there are more periods in which government spending cuts are followed by economic expansion than with recession. The same authors come up with similar results on a sample that covers an extended period of time (Alesina and Ardagna, 2012). On the other hand, Guajardo et al. (2011) find evidence that fiscal consolidation is followed by the contraction of economic activity. The decrease in consumption and investment in the private sector was followed by a slight increase in exports due to the decline in domestic currency values. The International Monetary Fund also emphasizes that the consolidation is accompanied by negative rates of economic growth in the short term and possible expansion in the long run (IMF, 2010). Regarding the post-transition countries, Ghosh and others (2009) point out that there is not much evidence supporting the argument that fiscal consolidation leads to recovery in times of crisis.

Fiscal consolidations based on the expenditure side of the budget are more efficient than those relying on the revenue side (Maroto and Mulas Granados, 2007). Consolidation based on the revenue side of the budget can be successful if the initial share of tax revenues in GDP is relatively low (Tsibouris et al., 2006). Reducing expenditures is most often associated with reforms that increase the efficiency of public service, while tax increases are perceived as the absence of structural reforms (Kumar et al., 2007).

When it comes to initial economic conditions for consolidation, the results of the research are also different. While one group of authors argues that fiscal adjustments are more successful if they take place during or immediately after the recession period (Drazen and Grilli, 1993), others consider expansion to be the right time to consolidate (Von Hagen and Strauch, 2001).

Fiscal consolidation is closely related to the strength of a fiscal multiplier. On a sample of post-transition countries, Kabashi (2017) states that expansive fiscal shocks have a positive, but relatively low impact on output. The author estimates the strength of a fiscal multiplier at 1.2, in the year of shock and in the next year, while in the other period the multipliers are lower. The effects of fiscal policy depend heavily on the country's structural characteristics: fiscal multipliers are higher in countries with low public debt and lower trade openness. The results of the analysis also point to increased multipliers in the period of crisis in relation to the pre-crisis period.

If we look at the situation in Croatia, regardless of the stabilization of public finances and the increase in fiscal capacity, it should be noted that much of the fiscal consolidation was based on reducing expenditures on non-financial assets, i.e. cuts in capital investment. A large number of studies indicate that public investments are the most productive part of public expenditures in Croatia. If governments had cut unproductive expenditures and maintained the level of public investment at a higher level, there is a possibility that the recession in Croatia in 2008 would have been less intense (Grdović Gnip, 2013; Šimović, Ćorić, Deskar-Škrbić, 2014).

However, there is a significant lack of studies dealing with the impact of fiscal consolidation in the post-transition countries. The abovementioned review points towards a lack of consensus concerning the impact of fiscal consolidation, allowing for both positive and negative effects on economic activity. Without an ambition of resolving this conflict of theoretical points of views and the related empirical findings, the present paper attempts to add a modest contribution to the debate through an empirical investigation of the effects of fiscal consolidation on the variables that appear to be under-investigated.

#### 4. DATA AND METHODOLOGY

Afore-presented papers identify periods of fiscal consolidation based on changes in the cyclically adjusted primary balance. The literature review presented in the previous section suggests a lack of consensus on the impact of fiscal consolidation on economic activity. In this context, one natural suspect comes to mind as to why this is so. How do you identify and measure fiscal consolidation? This becomes a crucial question in empirical investigation of fiscal consolidation and its effects. A usual approach in the literature (e.g. Giavazzi and Pagano, 1990 or Alesina, 2010) to identify fiscal consolidation has been to use the budget outcomes (primary balance) in the form of the cyclically adjusted primary balance. As argued by Ball et al. (2013), the cyclical adjustment is needed because tax revenue and government spending move

automatically with the business cycle. Unfortunately, it may be revealed that previous empirical literature has been contaminated by using these indicators for fiscal consolidation which may be subject to serious mismeasurement errors leading to a strong bias towards finding an expansionary effect of fiscal consolidation. Ball et al. (2013) argue that cyclical adjustment does not fix the problem as cyclical adjustment suffers from measurements errors. More specifically, it fails to remove swings in government tax revenue associated with asset price or commodity price movements from the fiscal data, resulting in the changes in cyclically adjusted primary balances that are not necessarily linked to actual policy changes. An additional problem is that this ignores the motivation behind fiscal measures.

Following Devries et al. (2011), in this paper we look directly at policy actions, and examine the accounts and records of what the countries actually did. Combining changes in cyclically adjusted budget balances with proclaimed fiscal policy intentions, we obtained the database which removes some of the problems in providing the representative indicators for fiscal consolidation. This database includes 11 post-transition countries covering the period 1995 – 2015. The sample includes the following countries: Latvia, Lithuania, Estonia, Poland, Czech Republic, Slovakia, Hungary, Slovenia, Croatia, Romania and Bulgaria. The brief data on fiscal consolidations is reported in Table 1. Table provides the identified fiscal consolidations by country and by the year.

In this study we focus in particular on the macroeconomic consequences of fiscal consolidation. Therefore, macroeconomic and fiscal variables are statistically analyzed before, during and after fiscal consolidation. Individual components of expenditures (transfers, wages, non-wage spending and investments) are considered depending on whether fiscal consolidation is accompanied by a period of expansion or contraction.<sup>2</sup>

## 5. RESULTS AND DISCUSSION

According to the analysis, a total of 44 periods of fiscal consolidation (Table 1) have been identified in post-transition countries, EU member states from 1995 to 2015. If we look at the impact on GDP we can notice that only 39% of consolidation has been followed by the expansion of economic activity. One way to look at the results of fiscal consolidation is to separate the periods followed by the expansion

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<sup>2</sup> Fiscal consolidation is expansionary if the average GDP growth rate in the consolidation period and two years after that period is higher than the average growth rate at the beginning of the consolidation period (Alesina and Ardagna, 1998., Mirdala, 2013.).



of economic activity from the contraction period. Tables 2-3 and 4-5 show different fiscal and macroeconomic variables associated with consolidation accompanied by expansion or contraction of economic activity. The “before” period refers to the two-year period preceding consolidation, while the “after” refers to the two-year period after consolidation. The “during” period refers to the year/s of fiscal consolidation.

### Tables

TABLE 1. FISCAL CONSOLIDATION PERIODS IN POST-TRANSITION COUNTRIES, 1995-2015

Estonia	1997,	2000,	2006,	2010		
Latvia	1997,	2011,	2012			
Lithuania	1998,	2002,	2010,	2012,	2014	
Poland	1999,	2007,	2011			
Czech R.	1996,	2004,	2007,	2011,	2013	
Slovakia	1997,	2001,	2003,	2007,	2011,	2013
Hungary	1996,	1999,	2001,	2003,	2007,	2012
Slovenia	1996,	2012,	2015			
Croatia	2012,	2015				
Romania	2010,	2012,	2013			
Bulgaria	2001,	2004,	2012,	2015		

Source: author analysis according to Eurostat and national sources

The results of the research do not confirm the *expansionary fiscal consolidation hypothesis* that other authors indicated on a sample of developed countries (Barrios et al., 2010; Alesina et al., 2012). The average growth of GDP in the consolidation period followed by expansion is only 0.78%, which represents a decrease of 2.09 pp compared to the pre-consolidation period, while unemployment in the same period grew by 1.04 pp. The decline is even more obvious if the contraction period is observed (5.28%). There is no evidence to confirm the argument that expansionary consolidation is followed by periods of rapid growth in public debt, as this growth is higher in contraction periods (2.79 pp versus 2.49 pp). The reduction of the cyclically adjusted primary budget deficit was lower (1.71 pp) in consolidation followed by expansion than when followed by contraction (2.61 pp), which is the opposite of what Perotti (2011) shows in the sample of four developed European countries. The wealth effect stimulated by positive expectations did not significantly affect post-transition countries, given the fall in personal consumption of 2 pp in periods of expansionary consolidation.

Table 2.

EXPANSIONARY FISCAL CONSOLIDATIONS – SIZE AND STRUCTURE

	<b>before</b>	<b>during</b>	<b>afer</b>	<b>difference</b>	<b>difference</b>
	<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(2-1)</b>	<b>(3-1)</b>
Public debt	41,23 (2,92)	43,72 (3,13)	43,56 (3,21)	2,49	2,33
Primary deficit	5,05 (1,31)	3,34 (1,09)	3,96 (1,20)	-1,71	-1,09
Public expenditures	40,02 (3,97)	39,25 (3,81)	41,12 (4,02)	-0,77	1,10
Social benefits	19,86 (1,93)	19,16 (1,82)	19,56 (2,01)	-0,70	-0,30
Wages	10,34 (1,09)	11,09 (1,18)	11,96 (1,23)	0,75	1,62
Non-wage consumption	3,87 (0,79)	3,05 (0,70)	3,45 (0,74)	-0,82	-0,42
Investments	3,03 (0,45)	3,18 (0,41)	3,25 (0,43)	0,15	0,22
Public revenue	34,97 (3,65)	35,91 (3,89)	37,16 (3,93)	0,94	2,19

Note: Variables are given as annual averages and shares in GDP. Public expenditures, public revenues and primary deficit are cyclically adjusted. Standard deviations were given in the brackets below the variables.

Source: Eurostat, author calculation

Table 3.

**CONTRACTIONARY FISCAL CONSOLIDATIONS  
– SIZE AND STRUCTURE**

	<b>before</b>	<b>during</b>	<b>after</b>	<b>difference</b>	<b>difference</b>
	<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(2-1)</b>	<b>(3-1)</b>
Public debt	45,52 (3,89)	48,31 (4,31)	51,07 (4,45)	2,79	5,55
Primary deficit	4,53 (1,23)	1,92 (0,89)	2,76 (1,10)	-2,61	-1,77
Public expenditures	42,34 (4,31)	43,04 (4,42)	44,08 (4,47)	0,7	1,74
Social benefits	21,12 (2,09)	21,97 (1,86)	22,65 (2,14)	0,85	1,53
Wages	12,09 (1,25)	11,51 (1,02)	11,87 (1,21)	-0,58	-0,22
Non-wage consumption	5,06 (0,91)	6,21 (0,79)	5,98 (0,81)	1,15	0,92
Investments	3,95 (0,52)	3,02 (0,45)	2,93 (0,50)	-0,93	-1,02
Public revenue	37,81 (3,91)	41,12 (4,08)	41,32 (4,12)	3,31	3,51

Note: Variables are given as annual averages and shares in GDP. Public expenditures, public revenues and primary deficit are cyclically adjusted. Standard deviations were given in the brackets below the variables.

Source: Eurostat, author calculation

*Table 4.*

EXPANSIONARY FISCAL CONSOLIDATIONS – MACROECONOMIC EFFECTS

	<b>before</b>	<b>during</b>	<b>after</b>	<b>difference</b>	<b>difference</b>
	<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(2-1)</b>	<b>(3-1)</b>
Unit labor costs	3,08 (1,52)	-0,82 (1,32)	1,05 (1,36)		
Exchange rate	1,52 (1,09)	-0,65 (1,02)	0,95 (1,08)		
GDP growth	2,87 (1,41)	0,78 (1,27)	3,12 (1,44)	-2,09	0,25
Unemployment rate	11,77 (3,12)	12,81 (3,05)	12,93 (3,17)	1,04	1,16
Personal consumption	2,56 (1,09)	0,56 (0,98)	2,77 (1,16)	-2,00	0,21
Current account of the BOP (%GDP)	-7,32 (2,12)	-6,67 (2,01)	-6,15 (2,34)	0,65	1,17
Real interest rate	3,52 (0,67)	3,97 (0,77)	3,08 (0,61)	0,45	-0,44
Inflation	4,23 (1,21)	2,54 (1,03)	3,12 (1,12)		

Note: Unit labor costs, exchange rate and personal consumption are given as annual growth rates. The unemployment rate, the current account of the balance of payments and the real interest rate are annual averages.

Source: Eurostat, author calculation

Table 5.

**CONTRACTIONARY FISCAL CONSOLIDATIONS**  
**– MACROECONOMIC EFFECTS**

	<b>before</b>	<b>during</b>	<b>after</b>	<b>difference</b>	<b>difference</b>
	<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(2-1)</b>	<b>(3-1)</b>
Unit labor costs	2,43 (1,45)	-0,32 (1,24)	0,89 (1,30)		
Exchange rate	2,32 (1,14)	1,22 (1,07)	1,03 (1,01)		
GDP growth	3,75 (1,56)	-1,53 (1,32)	2,76 (1,41)	-5,28	-0,99
Unemployment rate	9,65 (2,91)	12,76 (3,05)	12,98 (3,09)	3,11	3,33
Personal consumption	4,33 (1,12)	2,63 (1,02)	3,53 (1,09)	-1,7	-0,8
Current account of the BOP (%GDP)	-8,43 (2,41)	-7,76 (2,11)	-7,97 (2,28)	0,67	0,46
Real interest rate	3,02 (0,57)	3,34 (0,69)	3,1 (0,64)	0,32	0,08
Inflation	5,34 (1,41)	3,97 (1,35)	4,67 (1,38)		

Note: Unit labor costs, exchange rate and personal consumption are given as annual growth rates. The unemployment rate, the current account of the balance of payments and the real interest rate are annual averages.

Source: Eurostat, author calculation

There are several possible reasons for the partial success of fiscal consolidation in post-transition countries. One possible reason is the unfounded theoretical background of the expansionary fiscal consolidation hypothesis which neglects negative short-term effects on aggregate effective demand while simultaneously overestimates the effects of lower interest rates, competitiveness and positive effects on the current account of the balance of payments. But testing that hypothesis is not the scope of this paper.

## 6. CONCLUSION

This paper investigated the macroeconomic effects of fiscal consolidation. While the topic of the effects of fiscal consolidation has been extensively explored in developed countries, the focus on its effects in post-transition countries has been rare in previous literature. The paper thus contributes to the theoretical and empirical literature by investigating this important issue on the sample of 11 post-transition economies covering the period 1995 – 2015.

The research shows that, apart from minor corrections of current account balances and lower labor costs, fiscal consolidation in post-transition countries did not achieve declared goals such as economic growth.

The results of the analysis have to be observed with caution. Namely, this research did not include an econometric estimate of the effects of fiscal consolidation, which would take into account other factors (control variables) that affect the observed fiscal and macroeconomic variables. One of the important factors is the role of political actors and events such as regular and / or early parliamentary elections. However, such an analysis goes far beyond the scope of this paper. A panel analysis that takes into consideration all these factors is a proposal for future research. So, this research is just a step in the right direction, but it is by no means sufficient to provide hard and reliable conclusions on the different effects of fiscal consolidation in the post-transition countries.

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FISKALNA KONSOLIDACIJA I EKONOMSKI RAST U POSTTRANZICIJSKIM  
ZEMLJAMA EU: DESKRIPTIVNA ANALIZA

Sažetak

Zabrinutost za održivost javnih financija tijekom globalne ekonomske krize 2008. godine rezultirala je snažnijom provedbom mjera fiskalne konsolidacije. Literatura ne nudi konsenzus o utjecaju ovih mjera. U empirijskim istraživanjima postoje argumenti kako za kontrakcijski, tako i za ekspanzivni učinak fiskalne konsolidacije na gospodarsku aktivnost. Studije koje ispituju makroekonomske i fiskalne učinke konsolidacije u razvijenim zemljama nisu česte niti imaju dugu povijest, dok su isti učinci u posttranzicijskim zemljama potpuno neistraženi. Ovaj rad korak je više u rasvjetljavanju tog odnosa. Rezultati ovog istraživanja ne podržavaju hipotezu o ekspanzivnoj fiskalnoj konsolidaciji. Deskriptivna analiza pokazuje da, osim manjih korekcija tekućeg računa platne bilance i nižih troškova rada, fiskalna konsolidacija u posttranzicijskim zemljama nije postigla deklarirane ciljeve poput gospodarskog rasta. Rezultate analize treba promatrati s oprezom. Naime, ovo istraživanje ne uključuje ekonometrijsku procjenu učinaka fiskalne konsolidacije koja bi uzela u obzir druge čimbenike (kontrolne varijable) koji utječu na promatrane fiskalne i makroekonomske varijable.

Ključne riječi: fiskalna konsolidacija, ekonomski rast, deskriptivna analiza, post-tranzicijske zemlje