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Fiscal Stabilisation in the Light of Crisis – the Cases of Lithuania and Poland

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Abstract. *This paper is a theoretical and empirical study addressing the issues of imbalances in public finance. After several initial remarks, the authors provide an overview of literature discussing the employment of fiscal tools to stabilise the economy and threats to the state budget or public debt. Next, the EU and national fiscal regulations are described. In the subsequent parts of the study, the authors analyse the condition of public finance in the EU as well as the measures taken to restore its economic stabilisation. The empirical part of the study presents the results of a study into the condition of public finance in Lithuania and Poland. The research spans over the years 2004-2011, a period long enough to allow the authors identify the trends observed for the analysed economic phenomena. The findings are summarised in conclusion.*

Keywords: *fiscal stabilisation, deficit, public debt, economic crisis.*

Raktažodžiai: *fiskalinio deficito stabilizavimas, biudžeto deficitas, valstybės skola, ekonominė krizė.*

Introduction

The global economic crisis brought a variety of negative effects in the European Union. Those leading to changes within public finance are of particular relevance as they result in the escalation of the crisis. In response to financial disturbance, most states have invested vast amounts of public money so as to prevent – at least in the short run – the collapse of the eurozone or the entire European Union. This has led, on one side, to increasing deficits and debts of the general government sectors in the EU Member States, more uncertainty and higher risk related to financing debt on the other. As a consequence, the financial crisis has transformed into a debt crisis. Under these circumstances, disputes have arisen between the proponents and opponents of the active role of the state. The former emphasise the need to support economic growth and reduce unemployment at the expense of disturbance in the financial sector, which should decrease public debt to GDP ratio in the future. The

opponents, on the other hand, question the efficiency of such actions, while indicating the need for stabilisation in the sector of public finance. The problem of imbalance in public finance is an enormous challenge not only to Europe but also to the rest of the world – given the existing close economic interrelations. These issues therefore seem a relevant subject for exploration.

The major aim of the paper is to evaluate fiscal stabilisation of the EU in the light of an economic crisis, with particular emphasis on and a comparison and contrast with the measures undertaken in Lithuania and Poland. Thus, the authors have analysed the data available on the websites of the Eurostat, the European Commission, the Ministries of Finance of Lithuania and Poland and the European Central Bank. Both statistical and descriptive methods have been employed. The analysis spans over the years 2004-2011, a period long enough to reveal the trends in public finance. The analysis is preceded by theoretical remarks, i.e. a description of the evolution of approaches to the functions of fiscal policy and relevance of the state budget deficit and public debt for economic stabilisation.

Fiscal Stabilisation, State Budget Deficit and Public Debt – Selected Theoretical Issues

Fiscal policy is one of the key instruments used by the state to affect economic processes, mostly total output and employment. It refers to the instruments related to the budget, i.e. revenues and expenses. In the age of economic crisis, it is widely discussed whether extensive use of fiscal instruments in response to the existing economic disturbances is justified as it escalates the crisis under deteriorating condition of public finance.

The history of economic theory is rich in different views concerning the impact of employing fiscal instruments on the economy. Within the classical approach (A. Smith [27], D. Ricardo [23] or Say [25]), a concept of the minimal state, known also as the night-watchman state, was coined; the concept was later developed by the neoclassical school. Since the market itself can guarantee balance in the economy, the government should follow a policy so as not to reverse the natural course of events. Following the crisis of the 1930s, in turn, it was J.M. Keynes whose works profoundly affected economic policy-making. Government intervention as a means to correct market imperfections was a vital element of his theory. Special attention was paid to the government budget policy. It was believed that automatic stabilisers were useful yet insufficient as sole neutralisers of fluctuations in GDP. In the 1970s, the concept of active fiscal policy visibly lost popularity. It was related to its inefficiency in fighting both unemployment and inflation. The theories classified among the neoclassical school of economics revived the paradigm of natural measures and a sustainable economic cycle which questioned the need for fiscal policy. The employment of fiscal policy to mitigate the effects of GDP fluctuations was challenged in particular by M. Friedman [15] and R. Lucas [19]. They observed that the government alone was responsible for economic imbalances. Financing public expenditure with currency only triggers inflation whereas financing it with debt crowds out private investment. The 1990s, owing to the revival of

Keynes' concept, witnessed a comeback of fiscal policy as an instrument to dampening economic cycles. The positive impact of automatic stabilisers was emphasised in particular. It was believed that instruments of active fiscal policy could significantly reinforce economic cycles rather than smooth them as a result of their delayed effects. Furthermore, it was emphasised that governments used active fiscal policy mostly to target inflation rather than economic downturns [20, p. 3].

The crisis of the late 2000s and early 2010s witnessed another comeback of the concepts based on the employment of active policy tools in reaction to the problems in the financial market. Persisting problems with budget imbalances and the increasing public debt which followed resulted in the doubts as to the favourable impact of active fiscal policy on the economy. The literature on the subject points mostly to the threats related to imbalances in public finance. If the deficit and public debt serve financing current needs only, then the society is living on credit. The government's higher borrowing needs to drive interest rates up thus crowding out private investment. According to the research carried out by S. Fisher [13], budget deficits reduce productivity of production factors thus suppressing economic growth. A similar conclusion was reached by R. Levine and D. Renelt [18] based on the analyses they had carried out. Furthermore, dynamic and uncontrolled increases in the budget deficit and public debt add to the risk and uncertainty in the market. It gives rise to a negative feedback spiral which is triggered by the deficit and public debt and later transferred to financial markets and the real sphere of the economy. It is expressed, among others, by higher profitability of securities and CDSs (Credit Default Swap) as well as by falling international ratings. Difficulties with debt repayment frequently lead to monetarisation of debt, which in the long run escalates the crisis. If, however, the rising levels of deficit and debt are accompanied by increasing production capacity of the economy, e.g. through investment in infrastructure, R&D or new technologies, then evaluation becomes ambiguous. In such cases, the benefits generated by the creation and exploitation of public assets may offset or even outweigh the costs related to the imbalances in public finance. The rises in the deficit and debt are an alternative to tax rises (the implications related to the Laffer curve, however, should not be forgotten [see: 14]).

The ongoing disputes concerning the employment of deficit or public debt in the government's economic policy can be traced back to the different views on their social and economic impacts presented by individual economic schools [21, p. 101-103]. The classical school argues that public debt should be limited, which is a prerequisite for the neutral character of public finance in relation to the economy. According to A. Smith, at a certain level of national debts there is no example of their loyal and complete repayment [28, cited in 1]. D. Ricardo [23], on the other hand, claims that there is no interchangeability between financing public expenditure with taxes and public debt. Tax reductions aimed at boosting GDP are a straight path to increasing deficit. This deficit, in turn, needs to be covered with the issuance of government bonds. The annual debt service gradually increases the deficit. As a result, the debt drives the deficit, while the deficit drives the level of debt. As a consequence, taxpayers will pay higher taxes in the future, and their real income will inevitably shrink. The recommendations of the Keynesian school allow, for instance, the government to increase public debt to finance a public investment

programme under recession or persisting high unemployment. Keynes regarded the increasing level of public debt only as a form of income redistribution, although he did not recommend financing consumption with public debt. He considered the increasing public debt as an at least neutral phenomenon, if not a positive one, since it did not deplete national wealth and served only as a certain form of income redistribution. R. J. Barro [2] was another researcher who investigated the issues related to public debt. Among his other achievements, he formulated a hypothesis of public debt neutrality (the equivalence theorem). It assumed that the private sector behaved in a rational way and did not treat the bonds purchased as wealth accumulation but as a hint of future tax rises instead [33, p. 168]. Nevertheless, this theory was challenged, among others, by M. Feldstein [12] and J.M. Buchanan [4]. The views of the latter seem particularly interesting as he explored debt through analogies between the government budget and a household budget. He argued [5] that the government nearly always was able to pay for the current deficit with new debt. He also suggested that this ability did not encourage a strict budget discipline and it separated budget expenses and revenues as a result. J. Tobin [31] also presented his views on the imbalances in public finance; he pointed out to the crowding out effect and the threats related to a build-up of costs related to public debt service. According to Tobin, the amount of public debt should be restricted to a certain percentage of GDP (the concept of acceptable debt increase). A different approach to public debt can be found in the works by A.H. Hansen. He emphasised, even more than Keynes, the relevance of this tool as a form of indirect impact on the economy. He recommended new debt to be obtained from commercial banks mostly at the time of economic recession [21, p. 104].

The issues related to exerting influence on the economy by means of fiscal policy as well as the effects of imbalances in public finance caused controversy. It should be mentioned, however, that it is hard to find examples of countries that would suffer as a result of an excessively strict fiscal discipline. On the contrary, the fastest-growing economies are characterised also by sound public finance. Empirical evidence for the long-term negative impact of the general government deficit on the domestic product was presented, among others, by Levine, Rental [18], Fisher [13], Bleaney, Gemmel and Kneller [3] [24, pp. 44-46]. Empirical evidence for a negative impact of high debt on economic growth rate, in turn, was shown by C.M. Reinhart and K.S. Rogoff [22].

The authors believe that a debt can be considered "good" if it increases both the net level of assets of a country and the efficiency of the economy which assures compensating for or even exceeding the costs related to its financing. "Bad" debt, in turn, is useless, as it finances current expenses and interest and serves as a means to satisfy the objectives of selected groups of stakeholders only[1].

1 The occurrences of government budget deficit or increase in public debt are not always related to the direct activities undertaken by the government. It can also be the effect of an economic downturn, which – through automatic stabilisers – may lead to a crisis in public finance.

Public Finance in the EU – Regulatory Environment

Issues related to fiscal stability are regulated at EU and national level. In the European Union they have been enshrined in the EU Treaty of Maastricht [32], where it was set out that the conditions for the smooth functioning of the euro area are strengthened by economic policy coordination between euro area Member States to harmonise their economic structures [17, p. 330]. It was also decided that the fiscal policy, unlike monetary policy should remain the responsibility of individual states. The result is a diversity of fiscal redistribution rate and the structures of budget expenditure and revenue. At the same time, disciplinary mechanisms have been adopted to prevent excessive imbalance in public finances. In addition, it was forbidden for the European Central Bank (ECB) and National Central Banks to grant loans to cover deficits or any other loans to public authorities and businesses as well as to purchase debt securities directly from them. It also defined the reference level for budget deficit (3% of GDP) and public debt (60% of GDP). In the case of excessive deficit the EC assesses whether the excess reference level is exceptional and temporary, and what are the prospects for achieving the reference level[2]. The interesting fact is that penalties are imposed for exceeding the 3% deficit to GDP and that the steps and procedures are discretionary, i.e. depending on the decision of the Economic and Financial Affairs Council (Ecofin).

Public finance issues are also underlined in the EU Stability and Growth Pact (SGP), which was outlined during the European Council Summit in Amsterdam in June 1997. Its provisions [17, p. 333-337] came into force on 1 January 1999. The task of the SGP was to detail the excessive deficit procedure and the rules on penalties. The control mechanism and procedure for strengthening fiscal discipline within the SGP contained three groups of instruments: the system of multilateral surveillance and control of the fiscal situation in each country, fiscal rules as a set of quantitative limits on the budget deficit and public debt and operational detailed extension of the excessive deficit procedure. The final assessment of competence for compliance with those rules has again been granted to the Council (Ecofin). This opened the path for discretionary decisions. Paradoxically, in early 2002, the first preventive measures have been taken against Germany - the country that initiated the adoption of the SGP. In mid-2005, the SGP was reformed, formally changing its procedure of application. An exit clause and the medium-term budgetary objective (MTO) were introduced. More emphasis was placed on the medium-term stability of public finances with lesser importance awarded to the size of the annual budget deficit, and more attention was paid to the country's structural deficit (it may reach at most 1% of GDP, the correction mechanism 0.5% of GDP per year for the countries that have excessive deficit) and trends in public debt. Therefore, the Council relaxed the excessive deficit procedure and increased the importance of subjective factors that will be assessed arbitrarily by the EU bodies. The extent of the potential "relevant factors" that may justify the problems in public finances resulted in a discipline which has become an illusion [16, p. 81]. The effect of non-compliance with fiscal rules during the present crisis has lead to unprecedented diversity

2 However, the Treaty does not require that its ratio to GDP is close to the reference level.

in bond yields of individual euro area countries, especially those associated in the informal group PIIGS (Portugal, Ireland, Italy, Greece and Spain). Higher risk premium resulted in higher cost of servicing the debt and the need to raise taxes, because budget revenues declined due to weak economic growth and rising unemployment.

A lack of effectiveness of fiscal regulation led to a series of measures aimed at improving public finances in the EU, in particular in the euro area. They concerned the creation of a common fund for making transactions that enabled keeping funding public spending for countries faced with debt problems and, in parallel, introduction of further regulations that limited budget expenditures and implemented fiscal consolidation. The first group may include, e.g. European Financial Stabilization Mechanism (EFSM) [40], already benefited by Ireland and Portugal, European Financial Stability Facility (EFSF) [10], benefited by Greece, Portugal and Ireland, European Stability Mechanism[3] (ESM) [11], which is to replace EFSF, with initial value of 500 billion euros that may be increased to 2 trillion euros, if Spain and Italy ask for help. A controversial ECB instrument of Outright Monetary Transactions (OMT) [7], whereby the ECB can buy government-issued bonds with a maturity of 2 or 3 years, may be mentioned. OMT aims to bring bond yields down, especially in Greece, Spain and Italy. Thanks to this, borrowing costs and the cost of servicing the public debt for these countries will be reduced, which may prevent them from insolvency. Despite this, one can point to a number of doubts related to the OMT. Reduced yields will not completely reflect the real risk associated with the purchase of government bonds. In addition, these transactions can encourage governments into "moral hazard", risky short-term borrowing, which is even more risky. Purchasing of bonds by the ECB can also be regarded as exceeding the competence of the ECB and the socialisation of losses of the European banking sector. The ECB's main task is to maintain the euro's purchasing power, and not to be a bank of last resort for governments. Of course, it can be assumed that the OMT is going to save the euro area, so the ECB does the job. This assertion, however, is debatable. The consequence of these transactions may in fact give way to rising inflation, the flow of capital to raw material markets, resulting in their increased prices and the depreciation of the savings of the population.

The second group of actions are those aimed at reforming public finance in the EU, including the euro area in particular. In line with this idea is the so-called "Six-Pack" [34] [35] [36] [37] [38] [39], i.e. six legislative proposals and "the fiscal pact", also called the Euro-Plus Pact, i.e. the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) [42]. The first one contains legislative positions to maintain sound and sustainable public finances during the prosperity period, in order to maintain an appropriate safety buffer for the duration, and prevent deterioration of economic conditions. Public debt is treated on equal terms with the budget deficit in the context of decisions related to the excessive deficit procedure. It was introduced as a regulation for the

3 Its implementation required to define paragraph 3 in Article 136 of the Treaty establishing the European Community. According to it, the Member States whose currency is the euro may establish a stability mechanism that will be activated if it is necessary to ensure the stability of the entire euro area. Provision of the required financial assistance will be possible under the mechanism, if strict conditions are fulfilled.

prevention macroeconomic imbalance and defined corrective measures for the excessive macroeconomic imbalance. If the State fails to implement the recommendations of the EU Council on excessive imbalance, then it will have to pay a yearly fine amounting to 0.1% GDP. In this case, it will apply the principle of immediate enforcement. Only the Council of the EU will be able to undo this. The economic crisis resulted in the actions taken towards greater fiscal integration of the EU. In its present form, due to its small size, the EU's central budget did not serve as a stabilizer of the economic situation or as a guarantor of social incomes during asymmetric shocks. A result of these actions was the introduction of the aforementioned "Fiscal Pact" signed by 25 EU countries (the Czech Republic and the United Kingdom did not sign it). In fact, it is a response to the permanent non-compliance with fiscal rules. This pact will take effect in early 2013. It should enforce balancing of the budget, increase the control of the Ecofin and the European Commission over the public finances of the Member State and improve the coordination of economic policy. An important element is the so-called "Golden Rule", according to which the annual structural deficit should not exceed 0.5% of nominal GDP. Countries will have to transpose it into their national law, and, at best, into their constitutions [43]. If the debt exceeds the permitted level, then the country will be obliged to reduce the debt at a rate of up to 5% per year. In case of 17 euro area Member States, penalties will feed the above-mentioned fund of the ESM. Countries like Poland or Lithuania, who are not in the euro area, will pay the funds due to penalties to the EU budget.

Of course, similar rules on public finance have already been introduced several times, but, unfortunately, they were not respected. There is no certainty that these new mechanisms of stabilisation will make any difference. Moreover, increasing social protests, mainly related to rising unemployment and taxes, may discourage politicians from enforcing the new regulations. As a result of new regulation there will be, after all, a substantial reduction in financial-budgetary and fiscal sovereignty of the EU Member States. In the opinion of the authors, the majority of the signatories of the Treaty are not currently prepared for this, and the formula used in "the fiscal pact" does not take the current level of debt into account. It can be concluded that a disability of the "fiscal pact" consist is the fact that it does not take the diagnosis of the budget deficit creation into account. It is obvious that the nature of the debt and its importance for the economy is different when the debt is incurred due to excessive consumption rather than where the debt is incurred because the government wanted to improve the efficiency of its economy, e.g. when it increased spending on infrastructure investments and growth of innovations. In the second case, there is a chance to increase the competitiveness of the economy in the future, the growth of GDP and the socio-economic development. In this context, there is a different diagnosis for the problems in the public finance of Greece, Spain or Ireland. The "fiscal pack" did not take this fact into account and, in the opinion of the authors, this determined its weakness. In addition, every State has a different fiscal structure, i.e. budget expenditure and budget revenue are differently distributed between central and local government budgets. Fiscal consolidation can be helpful in overcoming the crisis in the EU, but it is not enough. To overcome the debt crisis, the EU needs to increase economic growth and employment. This aspect is clearly missing here. It is necessary to stimulate confidence in the private sector,

which should be the driver of growth. The adoption of the EU budget for the years 2014–2020, including the determination of its value and a breakdown of the funds by countries will be of key importance. Many countries would like to agree on the EU budget that reflects fiscal consolidation efforts now undertaken by the EU Member States. However, it seems that it should mainly be a pro-growth instrument.

Apart from the EU instruments stabilising public finance in the EU Member States, national stabilisation mechanisms are used. National fiscal rules, i.e. numerical limits imposed for the debt or the budget of public finances are the main instrument for maintaining budgetary discipline. They are usually defined as a ratio to GDP, after exceeding which the government should take certain fiscal saving measures. For the research period, of the 27 Member States of the European Union, 24 countries had such national fiscal rules. The only exceptions were Cyprus, Greece and Malta.

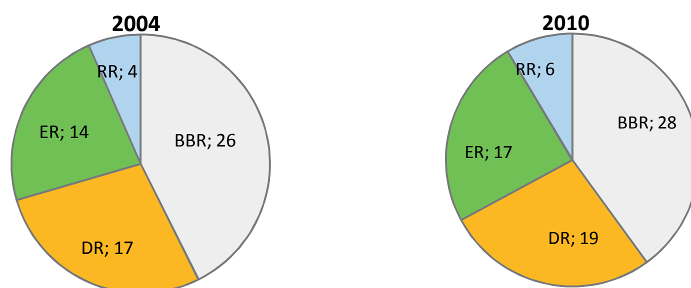

Figure 1. **Number of numerical fiscal rules in the European Union in 2004 and 2010**

Source: authors' calculations based on [30].

In practice, there are fiscal rules for debt, budget balance, revenue and expenditure. They can refer to general government sector, central government sector, regional or local government sector. The number of fiscal rules increased during the research period (see Figure 1). The most effective are the fiscal rules that apply to general government sector. In practice, however, only 16 of 70 existing fiscal rules applied to general government sector at the end of 2010 in 10 EU Member States [see: 30]. In addition, 18 fiscal rules have been set for central government that generates most of the public debt in the EU Member States. This means that despite the relatively large number of numerical fiscal rules, they were usually concerned only with local government, therefore, covered only a small part of the general government sector. Another important issue is the strength of the impact of these fiscal rules, their statutory base and the possibility of sanctions in case of non-compliance. The best way to ensure fiscal rule strength is to base it on the Constitution and to create a body in charge for the monitoring and enforcement of the rule. Germany, Sweden (for budget balance rule) and Poland (for debt rule) were the only EU Member States with fiscal rules based on the Constitution. However, there was no enforcement body in Germany and Sweden (an enforcement body was only present in Poland). All this explains why in most euro area countries a carefree process of approach to imbalance in public finance was

observed, especially in view of the high level of debt existing before the financial crisis (see Figure 2), increasing significantly in 2008-2011.

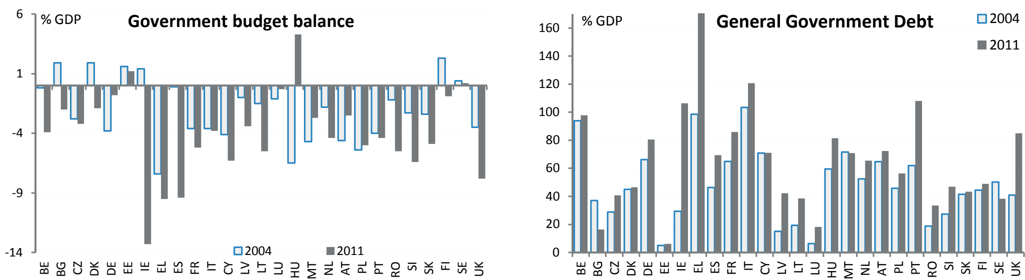

Figure 2. **General government budget balance and gross debt in the EU Member States**

Source: authors' calculations based on Eurostat data.

It is worth noting that during the research period 2004-2011 debt levels increased in almost all of the European Union Member States. Bulgaria, Malta and Sweden were the only exception to this trend. This resulted in persistently high budget deficits which grew rapidly starting from 2008 as a consequence of the economic and financial crisis. For this reason, most EU Member States had the excessive deficit procedure. By the end of October 2012, 21 EU Member States incurred excessive deficit procedure. The effects of Keynesian fiscal Policy in the EU (financing expenditures by budget deficit), and especially in the euro area, were extremely negative. This policy has led to negative developments in public finance, which in turn limited the potential for a successful application of this policy to counter the economic crisis [6, pp. 216-223]. It is worth noting that in the near future, hidden debt will pose a major threat to public finance due to the escalation of expenditure for pensions and health care. This results from negative demographic trends. The financing of these expenditures without increasing taxes will result in the EU having to generate permanent, annual surplus in budget balance, which seems to be impossible.

Instruments Stabilising Public Finance in Lithuania and Poland

During the research period, fiscal problems were also related to Lithuania and Poland. They belong to the group of EU Member States that do not belong to the euro area; therefore, the main instruments for stabilising public finance were national numerical fiscal rules. In Lithuania, two fiscal rules were used before 2008. One of them imposed limits set on central government sector's net borrowing, and the second entailed budget balance in nominal terms of local government. Due to the economic crisis, two additional fiscal rules were introduced for the central government: the expenditure rule and the revenue rule. The expenditure rule applies when general government budgets show a deficit on average over

the period of last five calendar years. In this case, the growth rate of budget expenditure is limited. However, revenue rules are aimed at adapting the size of the budget deficit to the size of the planned budget revenue. In case of failure to comply with revenue rule, non-approval of the budget is possible. It should be added that the Ministry of Finance is the body responsible for monitoring the condition of public finance and for enforcement. Therefore, in Lithuania the basic actions concerning public finance were directed primarily to balance the budget balance. Three out of four existing fiscal rules were related to this problem. However, public debt attracted less focus.

On the other hand, as regards Poland, more attention was paid to debt issues during the research period. 60% debt-to-GDP ratio was imposed by the Constitution. In addition, legal [41] prudential and remedial standards were set for the total public debt. After exceeding 55% of GDP, in the following year the central government budget must not increase the central government debt-to-GDP ratio. However, if the public debt exceeds 60% of GDP, any government borrowing is forbidden in the subsequent year and surplus in the public accounts is obligatory. In addition, in 2007-2008 it applied a nominal anchor of PLN 30 billion (or 3% of GDP) for the central government budget.

Referring to the EU instruments that stabilized public finances in Lithuania and Poland, it should be noted that the provisions of the EU Stability and Growth Pact undoubtedly played their significant part. Both countries are subject to the excessive deficit procedure. It was introduced on 7 July 2009, a deadline for the correction of the excessive deficit was 2012. For this reason, efforts were undertaken to reduce budget deficit. In Lithuania, the first recommendation was to limit the deterioration of public finances in 2009 and in 2010 and 2011 with an average fiscal effort of at least 1.5 percentage points of GDP. For this purpose, the Lithuanian authorities decided to increase corporate income tax and tax on dividends from 15% to 20% and VAT from 18% to 19%, also increase excise duties on fuel, tobacco and alcohol. In addition, they made cuts of the current government expenditure, public sector wages and reduced transfers to local governments [9, p. 231]. In 2010, a review of the actions carried out so far recommended further reduction of the budget deficit with an average annual fiscal effort of 2.25 percentage points of GDP over the period 2010-2012. In addition to the implementation of the fiscal measures planned in the 2010 budget, adoption of additional measures, where necessary, and continued consolidation in 2011 and 2012 was proposed [8, p. 91]. However, three kinds of actions were recommended in Poland. The Council recommended implementing fiscal stimulus measures in 2009 as planned, ensuring average annual fiscal effort of at least 1.25 p.p. of GDP starting in 2010, and spelling out the detailed measures necessary to bring the deficit below the reference value by 2012 [8, p. 118]. To achieve this goal, the Polish authorities undertook three types of actions: taxes were increased (mainly VAT), considerable public investments were made, mainly infrastructure investment financed by the EU funds, and it introduced a package of structural reforms to reduce budget expenditure and public debt, including freezing of wages in the public sector and reform of the pension system consisting of extending the retirement age.

Fiscal Problems in Lithuania and Poland in the Context of the Crisis

The crisis phenomena in the economy of the EU also impacted the fiscal situation of Lithuania and Poland. Figure 3 presents the data on the balance of the state budget and public debt in both countries in 2004-2011.

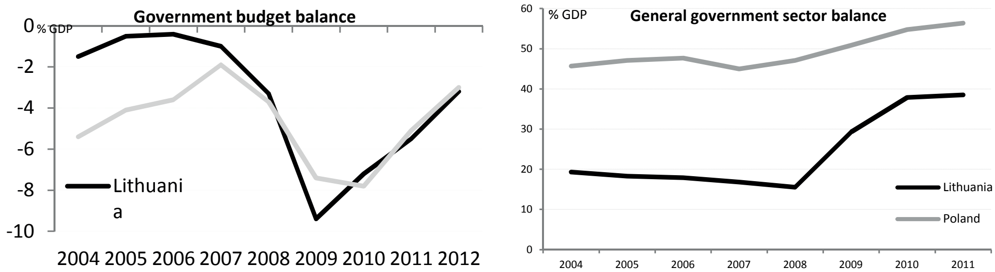

Figure 3. **General government sector balance and gross debt in EU Member States**

Source: Eurostat data.

Until 2008, Lithuanian had small deficit, while in Poland it was above the reference level (the exception was 2007). In 2009, there was a sharp increase in the budget deficit in both countries. In Lithuania, it rose up to 9.4% of GDP while in Poland – to 7.4%. In subsequent years, the situation systematically improved, although it still remained above 3% of GDP. With regard to public debt, attention should be paid to its doubling in Lithuania in 2009-2011, compared to 2004-2008. In Poland, public debt grew at a slower pace, but still it was much higher than in Lithuania. It should be noted that the negative reaction of the public finances to the economic crisis in Lithuania was stronger than in Poland. This increased the risk of debt financing, particularly in 2009. The confirmation of this fact was the increase in government bond yields. The increase in the cost of debt financing contributed to the deterioration of public finances in Lithuania. The relatively good assessment of the situation of the Polish economy was certified by the stable level of yields on Polish government bonds (Figure 4).

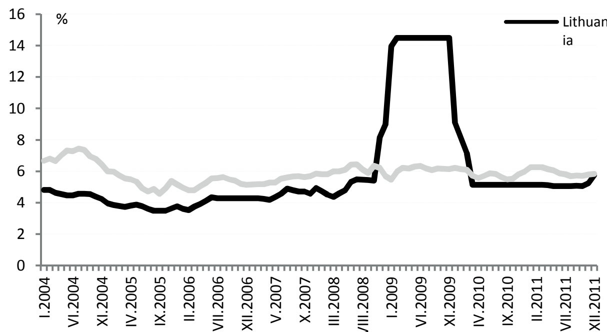

Figure 4. **Long-term government bond yields interest rates**

Source: Eurostat data.

As referred above, both countries were included in the excessive deficit procedure. For this reason, measures were taken to reduce the budget deficit. The data analysis shows that the Lithuanian and Polish authorities took effective fiscal action (see Figure 3).

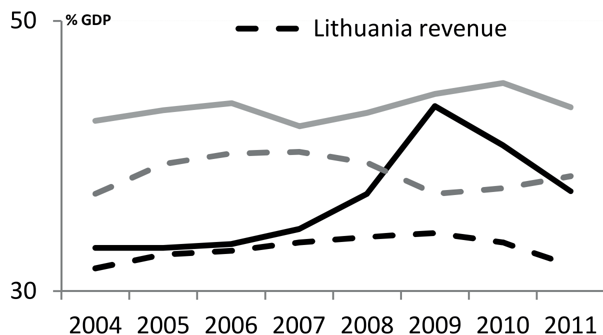

Figure 5. **Total general government revenue and expenditure as percentage of GDP in Lithuania and Poland**

Source: Eurostat data.

In Lithuania, the main factor supporting the achievement of the objective set out in the excessive deficit procedure was the significant reduction in public expenditure (Figure 5). Within two years, starting from 2009, they were reduced from 43.8% to 37.5% of GDP. Despite the fact that the total budget revenue also decreased during this period, the annual dynamics of change on the revenue side was smaller than in total general government expenditure. Meanwhile, in Poland fiscal targets were achieved by increasing the total budget revenue in 2009-2011 by 1.3 percentage points of GDP and the reduction of the total expenditure by 0.9 percentage points of GDP. In both countries, these actions resulted in the reduction of the public finance deficit from 9.4% to 5.5% of GDP (in Lithuania) and 7.4% to 5.1% of GDP (in Poland).

In 2004-2011, the structure of budget revenue in Lithuania and Poland also changed. Figures 6 and 7 represent the data on the structure of government budget revenue in 2004-2011.

The analysis of the data shows that the structure of budget revenue and tax revenue were definitely leading their part in Lithuania. Until 2008, they amounted to about 80%. In 2009 they dropped sharply (-24.4%), resulting in the fall of the tax revenue share in the revenue budget to less than 68%. Those negative trends in tax revenue contributed to the decrease in the total budget revenue and the balance budget. In the Polish case, during the period under consideration, there was no change in the value of tax revenue. However, in 2009 the share of tax revenues declined in total budget revenue. The reason for this was the increase in non-tax revenue and non-refundable funds from the EU. In both countries, there was an increase of EU funds in budget revenue. In Lithuania, the value of EU funds increased mainly in 2005, 2007 and 2009, while in Poland this value increased in 2007-2009.

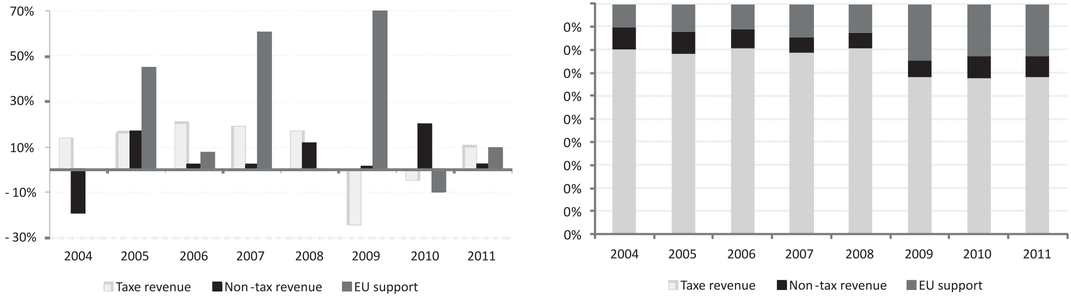

Figure 6. **Change in national budget revenue of Lithuania and the structure of the national budget revenue in Lithuania**

Source: Statistical Yearbook of Lithuania 2005, Vilnius 2005. http://www.stat.gov.lt/uploads/metr_2005/en/948/index.html#view [2012-11-15]; the Ministry of Finance in Lithuania data.

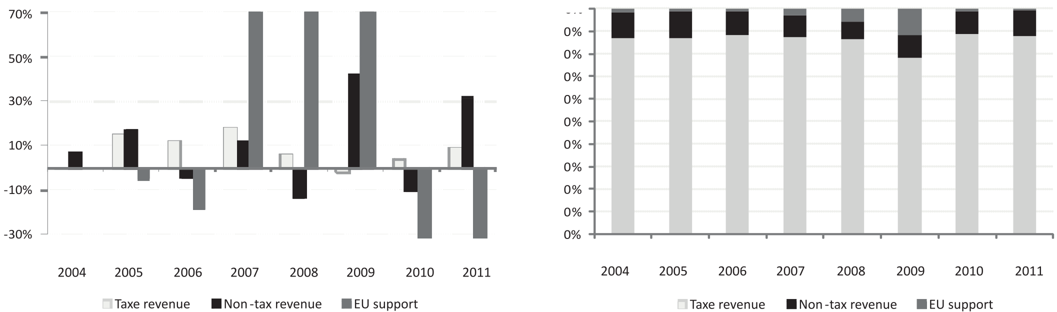

Figure 7. **Change in state budget revenue and the structure of the state budget revenue in Poland**

Source: Polish Ministry of Finance: Execution of the State Budget in 2004-2011.

GDP fluctuations were the factors causing such fiscal problems in Lithuania and Poland, characterised by different intensity. The recession of 2009 had a major impact on the rapidly deteriorating situation of public finances in Lithuania. After the high growth rate of GDP in 2004-2007, 2008 earmarked a slowdown and a decrease by 14.8% of GDP next year. These negative factors affected the labour market. The unemployment rate increased from 5.9% in 2008 to 13.9% in 2009 and peaked to 18.0% in 2010[4] (see Figure 8). Reduced employment led to a decline in tax revenue. In Poland, no such trends were observed, which was a consequence of avoiding recession (Poland was the only such Member State in the EU). Furthermore, after the rapid fall in 2004-2008 (from 19.4% to 7.2%), unemployment increased in the following years, but only by 2.6 percentage points (Figure 8).

4 It should be noted that one of the main reasons for the recession and the deterioration of the situation on the Lithuanian labour market was the collapse of the housing (residential) market.

Figure 8. **Key economic indicators in Lithuania and Poland in 2004-2011**

Source: Eurostat data.

Another key factor affecting GDP volatility in both countries during the research period was the exchange rate (Figure 9). While strong depreciation of the zloty in 2009 contributed to increased exports and thus maintained positive GDP growth in Poland, in Lithuania, with a fixed exchange rate against the EUR, the value of exports sharply declined the same year. It should also be noted that exports contributed to a very large share of GDP (the value of exports of goods and services to GDP in Lithuania amounted to 77.6% in 2011 (to compare with 45.2% in Poland)).

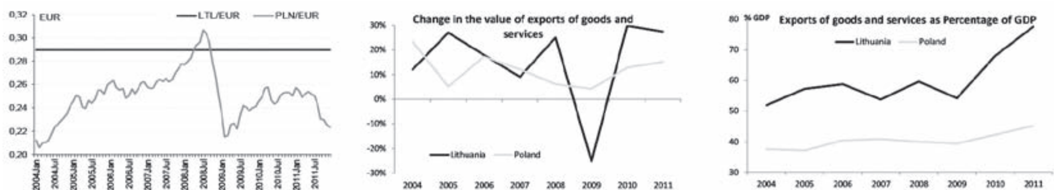

Figure 9. **Weighted average exchange rates of Lithuanian litas and Polish zloty against Euro and export in national currency**

Source: authors' calculations based on Eurostat and European Central Bank data.

Conclusions

1. As George Sorose was right to observe: "it is the vital feature of the current financial crisis that it was not caused by any external shock, as for instance in the case of the oil crisis (OPEC) [...]. This crisis was caused by the system itself" [26, cited in 29, p. 208]. It originated in the United States, at the heart of the world financial system, in the country where numerous financial innovations had been developed. As a consequence, this crisis is a global crisis, while in fact it is a globalisation crisis. We are facing three types of failures. First and foremost, the institutional crisis: banks are no longer institutions of public trust

and have become casinos instead. The second failure is of an intellectual nature: people succumbed to the efficient markets hypothesis, which reflects the intellectual failure of the mainstream economics. The crisis also means a moral failure: a failure of the system based on excess debt [29, p. 209].

Fiscal stabilisation and the need for efficient, i.e. feasible and enforceable rules to achieve it are now the two major problems. It relates to the experience of the majority of EU Member States, particularly the members of the Eurozone with defined fiscal rules, and yet the Member States did not obey them. Complex tools concerning public finance, defined, among others, in the Maastricht Treaty or the EU Stability and Growth Pact, proved inefficient in preventing excess debt in those countries. As a consequence, they failed to protect the entire EU and the Eurozone from the crisis.

3. In the period under consideration a variety of activities of financial and fiscal nature were undertaken in the EU to fight the negative effects of the fiscal crisis on the economy, such as the ESM, OMT or the fiscal pact. The authors argue that a standard fiscal policy at the level of the EU is vital, as it should reduce to minimum the temptation to incur excess debt and ought to generate an initial budget surplus instead. It is not clear whether fiscal consolidation could span over the entire EU. Economic cycles which do not overlap, a wide variety of budget-related problems, differences in the profitability of government bonds or various political objectives can be real obstacles to this process. Nonetheless, the nominal convergence criteria should be absolutely respected without searching for ways to evade them.

4. The problem of imbalances in public finance during the period under consideration also affected Lithuania and Poland, although the impacts were much less severe than in the majority of other EU countries. In Lithuania, fiscal problems occurred during the crisis in the financial markets and were related mostly to the budget deficit. In 2009, it was estimated at as much as 9.4% of GDP. In the following years, despite considerable improvement, it remained above 3% of the GDP threshold. As a result, it led to a surge in public debt, which more than doubled in the relatively short period between 2009 and 2011. Despite that, it remained on a relatively safe level (the maximum level reported in 2011 amounted to 38.5% of GDP). The problems were caused mostly by the recession of 2009 which triggered huge fall in tax revenues. Additional rise in unemployment was related to the falling GDP and a breakdown in the property market that added to those problems, as a result Lithuania suffered from fiscal problems until 2011. Poland, on the other hand, reported a deficit of above 3% of GDP throughout the entire period under analysis and a rising public debt which approached 60% of the GDP threshold. This deterioration in the condition of public finance was, however, less sudden than in Lithuania. The reasons can be traced back to the simple fact that Poland remained unaffected by the recession. Apart from the relatively high domestic demand (reductions in taxes and social security contributions in 2007 supported the consumption in 2008-2009), the Polish zloty was appreciated in relation to the Euro, which improved the competitiveness of the Polish economy and supported exports, but at the same time this did not cause additional problems for the banking system. At all times, Poland followed a liberal and free-market policy rather than protectionism. It is worth noting that the relatively good condition of public finance both in Lithuania and Poland, as

compared and contrasted to the other EU Member States, was mostly due to extensive use of EU funds which supported both economic growth and budget revenues.

5. It can be assumed that the increasing awareness of the problems in public finance, expressed, *inter alia*, by the increasing number of fiscal rules, will result in more rational behaviours. The governments should aim for long-term economic stabilisation, also in the area of public finance. It is essential to become aware of the threats – as stated, for instance, by Tobin – related to the increasing costs of debt service. They may affect the rate of economic growth, as it has already been observed by Reinhart and Rogoff, and may lead to the insolvency of governments, as pointed out e.g. by Smith.

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Mokesčių stabilizavimas ekonominio nuosmukio sąlygomis – Lietuvos ir Lenkijos atvejis

Anotacija

Šiame straipsnyje nagrinėjama viešųjų finansų būklės disbalanso problematika. Straipsnis yra teorinis-empirinis, jame atlikta analizė literatūros, kurioje aptariamos fiskalinių priemonių, pasitelkiamų stabilizuojant šalies ekonomiką bei rizikas, susijusias su biudžeto deficitu bei valstybės skola, naudojimo teisėtumas. Nagrinėjamos ir tiriamųjų šalių bei Europos Sąjungos fiskalinės taisyklės. Taip pat analizuojama viešųjų finansų situacija ES bei veiksmai, kurių imamasi stabilizuojant ekonomiką. Empirinėje dalyje pateikiami tyrimo rezultatai, kurie atspindi

Lenkijos ir Lietuvos viešuosius finansus. Nagrinėjamas 2004–2011 metų laikotarpis, kuris yra pakankamai ilgas, kad būtų galima apibrėžti analizuojamų ekonominių klausimų tendencijas. Straipsnis baigiamas konstruktyviomis išvadomis.

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