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Public Finance Sector Stability in Central European Countries (Part 3)

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The Spring 2023 economic forecasts published by the European Commission indicate that, despite a gradual improvement in the stability of the public finance sector, many Central European countries will continue to experience budget deficits exceeding 3% of GDP. The largest budget deficits will be observed in Slovakia and Poland. Despite these challenges, both economies will maintain the ratio of public debt to GDP below the EU's reference value of 60% (as stipulated in the Maastricht Treaty).

The European Commission's economic forecasts. Although the European Commission's Spring 2023 economic forecasts show a gradual improvement in the budget deficits of EU countries, some of them will still find it difficult to reduce these deficits. By the end of 2023, budget deficits are expected to exceed 3% of GDP in fourteen EU member states, mainly in Central Europe. It is also anticipated that all EU member states, except Cyprus and Ireland, will have a worse budgetary situation in 2024 than before the pandemic in 2019. The deficit sizes in the group of Central European countries are projected as follows: in countries outside the eurozone: Poland – (5.0%), Bulgaria (4.8%), Romania (4.7%), Hungary (4.0%), and the Czechia (3.6%). Meanwhile, in countries within the eurozone: Slovakia (6.1%), Latvia (3.8%), Slovenia (3.7%), and Estonia (3.1%). This distinction may be significant due to the impact of fiscal policy on the exchange rates of countries outside the eurozone and also on the single market. Exchange rate changes will shape the competitiveness of exported and imported products and services, subsequently affecting the balances of current accounts and the external balance of individual economies.

Expansionary Fiscal Policy and Economic Growth. A relatively stronger expansion of fiscal policy in Central European countries may be justified by their lower level of economic development compared to Western EU countries. Lower GDP per capita values often result in a stronger feeling of economic fluctuations, especially during recessions. Economists are divided on whether in difficult situations, besides automatic stabilizers of the economy (e.g., corporate tax revenues), governments should employ an expansionary fiscal policy by increasing spending, or less often, by reducing taxes. In Central European countries, economic recessions such as those caused by the global financial crisis or the COVID-19 pandemic („Komentarze IEŚ", nr 383), more strongly provoke fiscal expansion to stimulate economic growth („Komentarze IEŚ", nr 750, „Komentarze IEŚ", nr 916). In 2023, the projected economic growth in the aforementioned Central European countries is generally smaller than in 2022, ranging from minus 0.4% in Estonia to 1.7% in Slovakia. Therefore, it can be argued that fiscal expansion could be justified in most cases. However, when the economic growth slowdown is less keenly felt – for example, in Romania, where GDP growth was 4.7% in 2022 – it is important that the approach to fiscal interventions is more balanced, especially due to possible delays in their implementation and effects. It should also not be expected that expansionary fiscal or monetary policy will halt a recession – such actions do not work as quickly and effectively as pressing an elevator start button.

Lowering the unemployment rate. The expansionary fiscal policy aimed at reducing high levels of unemployment is most effective during a recession. However, when economies reach full employment, it may lead to inflation without reducing unemployment („Komentarze IEŚ", nr 914). In 2023, unemployment levels in Central European countries ranged from 2.8% in the Czechia to 6.8% in Latvia. These are values that should not cause major tensions in the labour market and thus should favour a policy of reducing budget deficits. Exceptions may be countries with forecasted negative or sluggish economic growth, which, besides Estonia, include the Czechia (0.2%), Hungary (0.5%), Lithuania (0.5%), and Poland (0.7%). Furthermore, in some countries, additional trends will favour unemployment reduction (i.e., ensuring internal balance). For example, long-term labour market trends in Latvia indicate a decrease in the population. Since 2000, it has exceeded 0.5 million, which constitutes about 1/5 of the population at the beginning of the analysed period. Other significant factors affecting demographic trends in Latvia include an ageing society, a low birth rate, and emigration („Komentarze IEŚ", nr 887).

Slovakia has the largest projected budget deficit. According to the European Commission's Spring economic forecasts for 2023, the largest budget deficits among the group of Central European countries are projected to occur in Slovakia and Poland. This implies that reducing deficits to the reference value, specified in the Maastricht criteria, may be the most challenging and socially noticeable in these cases. After a low budget deficit of local and national government institutions in Slovakia in 2022, amounting to 2.0% of GDP, a rise of this indicator to as much as 6.1% is expected in 2023. Several factors may contribute to such a sharp increase in the deficit. On the expenditure side, these include 1) high net budget costs of energy support measures, which, in 2023, are expected to increase to 2.0% of GDP, up from 0.2% in 2022; 2) an increase in the salaries of employees in the public sector; 3) a reduction of VAT rates in some sectors; 4) a family package, including a tax bonus and increased child benefits, the introduction of a parental bonus as part of pension reform, and the reintroduction of free lunches for school pupils. On the other hand, the withdrawal of temporary extraordinary measures related to COVID-19, which according to estimates amounted to 0.8% of GDP in 2022, is expected to contribute to reducing the deficit. It is anticipated that in 2024, the deficit will decrease to 4.8% of GDP as inflationary pressures ease and measures related to energy prices are withdrawn. Despite these challenges, the public debt to GDP ratio will still be below the threshold set in the Maastricht treaty, standing at 58.3% in 2023 and 58.7% in 2024.

Budget Deficit in Poland. In 2022, the budget deficit in Poland was close to the reference value and amounted to 3.7% of GDP. However, the costs of actions related to the energy crisis and assistance to refugees from Ukraine, combined with the reform of personal income tax, continue to exert negative pressure on the budget balance. The EC forecast anticipates that the net budget cost of energy support measures will amount to 1.7% of GDP in 2023, compared to 1.9% in 2022. Additionally, factors contributing to the deficit increase include pension indexation, salary increases for public sector employees, and higher government spending due to high inflation. The government also decided to increase expenditure on healthcare and defence. On the other hand, the assumed complete withdrawal of temporary extraordinary measures related to COVID-19, which according to estimates amounted to 0.7% of GDP in 2022, will contribute to reducing the deficit in 2023. The EC projects that the budget deficit will rise to 5.0% of GDP in 2023, and in 2024, it will still remain above the reference value of 3% of GDP, amounting to 3.7% of GDP. It should also be noted that corrections related to payment deadlines and the implementation of military investments are expected to increase the public debt ratio, which is projected to reach 53% of GDP by 2024.

Conclusions

Despite the general trend of improving budget deficits in EU countries, many states, especially in Central Europe, still have high deficits exceeding 3% of GDP. In Central European countries, which are characterized by a lower level of economic development compared to Western EU countries, a stronger expansion of fiscal policy may be justified in situations of significant growth slowdown and high unemployment. The projected unemployment levels in 2023 in most Central European countries are low enough to favour the restoration of stability in the public finance sector. According to the EC economic forecasts for 2023, the largest budget deficits among the group of Central European countries will occur in Slovakia and Poland. Slovakia, despite the rapid increase in the budget deficit in 2023, will maintain the public debt-to-GDP ratio below 60%. In Poland, the high budget deficit results from costs related to the energy crisis, assistance for refugees from Ukraine as well as increased expenditure on defence and healthcare. It is projected that the deficit will exceed 5% of GDP in 2023, and in 2024, it will still be higher than the Maastricht Treaty reference value of 3%. Meanwhile, the public debt ratio is expected to increase to 53% of GDP by 2024.