Fiscal rules in CEE – fiscal masochism or necessary clean up?

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- **New fiscal rules in EU six-pack to benefit CEE5 countries and reduce risk of self-defeating austerity**
- **No need for CEE countries to raise taxes if they stick to growth-friendly policies and cap real increase of expenditures below 1%**
- **CEE5 countries expected to leave Excessive Deficit Procedure by end-2014; threat of temporary suspension of EU funds is a strong motivating factor**
- **Local debt brake rules to increase CEE governments' fiscal responsibility and complement structural benchmarks**

Erste Group's research report "Fiscal rules in CEE", released today, finds that CEE5 countries (Czech Republic, Hungary, Poland, Romania and Slovakia) should benefit from the six-pack fiscal rules introduced on the EU level in 2011. The six-pack emphasizes structural benchmarks, which take into account cyclical developments and as such are less harmful for growth than the previously used nominal targets. "The new structural criteria give CEE5 countries more breathing space during the economic downturn and thus reduce the risk of self-defeating austerity. The rules also efficiently protect public finances from overspending during 'good years', which was the main cause of increased fiscal deficits in CEE5 before," explains Juraj Kotian, Head of CEE Macro/FI Research at Erste Group.

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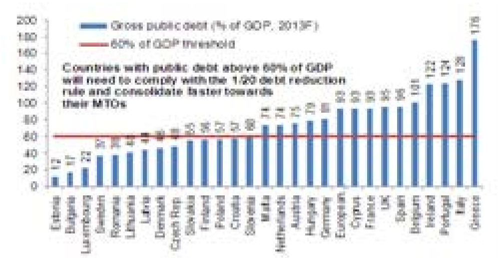
No need for CEE countries to raise taxes if they stick to growth-friendly policies and cap real increase of expenditures below 1%

Countries such as the Czech Republic, Poland, Slovakia and Romania have a higher growth potential and lower debt levels than the other EU members, so they can afford a higher increase of expenditures. "Many EU countries will need to raise taxes if they want to preserve the current level of expenditures. By contrast, CEE countries do not need to go for higher taxes, provided that they keep their economic policy growth-friendly and cap the increase of expenditure below 1% in real terms. They also benefit from a wide room for manoeuvre for the deduction of costs related to healthcare, pension and labour market reforms and smoothing investment expenditures. This should incentivize them to pursue growth-focused economic policies," adds Kotian.



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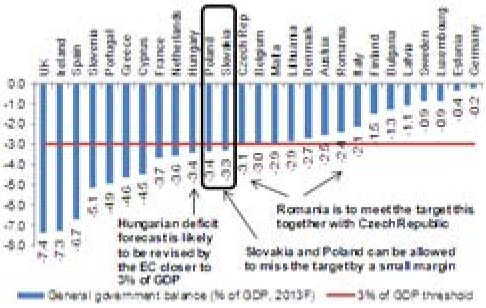
CEE5 countries expected to leave Excessive Deficit Procedure by end-2014; threat of temporary suspension of EU funds is a strong motivating factor

All CEE countries are currently in the Excessive Deficit Procedure (EDP) (together with other 11 Euro Area members) and are still committed to meeting the nominal 3% of GDP deficit target before quitting the EDP. This is the only stage at which the Czech Republic, Hungary, Poland and Romania could be confronted with financial punishment. Kotian explains: "The threat of temporary suspension of cohesion fund financing, which averaged about 0.7% of GDP in CEE5 in 2012, is a strong motivating factor for CEE5 countries to leave the EDP procedure. We expect them to do so in the next two years, taking into consideration that some of them may request a one-year extension, invoking the recession in the Euro Area as a legitimate escape clause."



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Hungary can quit the EDP this summer, unless the EC puts into its Spring Forecasts deficits above 3% of GDP for 2013-14. Given the much better fiscal development over the last year, the only potential risk is that the EC forecast on the fiscal deficit for 2014 edges above 3% of GDP under a scenario of no policy change and some temporary measures running out. In order to rule out this risk, Hungary may announce some more durable consolidation measures in 2Q.

The Czech Republic and **Romania** are expected to meet their EDP deadline based on data for 2013, so they can formally quit the EDP in summer 2014. In the case of the Czech Republic, it could be a close call, due to the deficit being close to the 3% of GDP threshold.

It will be a challenge for **Slovakia** and **Poland** to bring their deficits below 3% of GDP this year, as required by their EDP. These countries can adopt additional measures, but more ambitious consolidation in times of already weak growth could be 'too harsh' and would be in conflict with the intentions of the recently adopted framework. However, Poland and Slovakia can deduct part of their transition costs related to pension reform in order to meet the 3% deficit target by 2013 or use the explicit escape clause which says that special circumstances like severe economic downturn or unusual events which are outside of control of the country can be used for an extension of the EDP deadline for the purposes of correction. Thus, in the worst case we expect the EDP to be extended by one year without any problems.

Local debt brake rules to increase CEE governments' fiscal responsibility and complement structural benchmarks
Once CEE5 countries meet their 3% deficit target, they have to continue the consolidation in structural terms, according to benchmarks outlined in the six-pack. However, after quitting the EDP, non-Euro Area countries do not face the risk of any financial punishment for non-compliance with the structural rules, which creates a potential window for fiscal loosening. "Local debt brake rules, albeit not always compatible with the new structural benchmarks, are extremely important once CEE5 countries quit the EDP. They make politicians accountable to the public and increase their awareness about fiscal responsibility, probably more than 'externally-set' EU rules. The debt brake rules could be seen as complementary to structural benchmarks and partially substitute the debt reduction rule from the six-pack and fiscal compact," concludes Kotian. While Euro Area countries with public debt of about 60% of GDP have to reduce their excessive debt, according to the debt reduction rule, the local debt brakes in CEE prevent the debt from growing to the 60% of GDP level.

CEE Special Report [pdf; 335.1 KB]