

# Lithuanian fiscal reform 1999-2002

- yet another example of an expansionary fiscal contraction?

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## **Abstract**

The Russian crisis sent shock waves through the Lithuanian economy in 1998/99 and both the budget deficit and the current account deficit increased dramatically. The Lithuanian government reacted to the crisis by tightening fiscal policy significantly – especially through cuts in public expenditure rather than through tax hikes. The fiscal adjustment closely followed the advice of the IMF. Contrary to the predictions of traditional Keynesian theory, growth picked up significantly from 2000 onwards. Hence, the Lithuanian case seems to provide yet another example of an expansionary fiscal contraction (EFC). Private consumption, investments and exports drove the Lithuanian recovery. It seems like supply-side factors – especially wage moderation following a public wage freeze and a cut in social benefits and transfers – helped spur both investments and exports. This channel seems to have been more important than the Ricardian channel that is normally cited in the EFC literature.

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## **1. Introduction**

The past 15 years has seen research on so-called expansionary fiscal contractions (EFC) grow rapidly. The literature on EFC mainly seems to indicate that fiscal policy, under certain conditions, can have non-Keynesian effects.

Orthodox Keynesian theory would stipulate that a tightening of fiscal policy would lead to a slowdown in economic growth. Keynesian theory would also stipulate that a tightening of fiscal policy leads to a slowdown in private consumption growth. However, a number of “episodes” seem to contradict the Keynesian orthodoxy. The literature on EFC has traditionally pointed to two examples of EFC – the Danish and Irish fiscal reforms during the 1980s. Both the Danish and Irish examples provide evidence that a tightening of fiscal policy does not have to lead to a slowdown in growth, but rather can, in some cases, actually lead to an acceleration of economic growth.

On the back of the Russian crisis, Lithuanian growth plummeted in 1998-99 and public finances deteriorated considerably. In this situation the Lithuanian government – under pressure from the IMF among others – implemented serious fiscal reforms that cut the budget deficit by more than 3% points of GDP from 1999 to 2000. Traditional Keynesian theory would have predicted that such a significant tightening of fiscal policy would have led to a serious slowdown in economic growth. However, this was not the case in Lithuania, rather than falling further into recession, the Lithuanian economy quickly gained momentum and the five years following the initial tightening of fiscal policy seemed to provide yet another example of an expansionary fiscal contraction, with the economy booming after the fiscal consolidation. This paper looks at the Lithuanian fiscal reforms since 1999 and examines to what extent the subsequent economic expansion was in fact an example of an expansionary fiscal contraction.

## **2. Expansionary fiscal contractions – a brief look at the literature**

The idea that fiscal contractions could in fact lead to economic expansion started to seriously circulate in the early 1990s. While the incidence of EFC has been numerous and growing over the years there has been little consensus on a coherent theory that could explain the EFC phenomenon. The first outline of a theory was presented by Giavazzi and Pagano (1990). They termed the EFC

phenomenon the “German view”<sup>2</sup>. Giavazzi and Pagano argued that forward-looking consumers and investors will expect future tax cuts if expenditures are reduced, and this will lead to an increase in consumption forthwith, thereby offsetting the negative (direct) growth effects of a tighter fiscal policy. This view is basically similar to the traditional Ricardian equivalence theory, which states that changes in public savings will not affect net total savings in the economy because higher (lower) public savings will be offset one-to-one by lower (higher) private savings. Hence, the German view – like traditional Keynesian theory – emphasises demand-side effects rather than supply-side effects.

The “German view” continues to be the predominant theory explaining the EFC phenomenon, but since Giavazzi and Pagano first presented their theory the literature on the subject has grown dramatically and has been refined. Blanchard (1990), and later Bertola and Drazen (1993) suggested that if fiscal consolidation is postponed, it would mean the consolidation – that sooner or later would have to be undertaken - would have to be larger than otherwise would have been the case. Therefore, if the debt dynamics are unexpectedly improved today then that would be expansionary. The Blanchard-Bertola-Drazen (BBD) kind of EFC model would therefore also emphasise the importance of the initial public debt situation and of expectations. BBD models would therefore indicate that the effects of a fiscal contraction on GDP, consumption and investment growth are critically dependent on the initial debt situation and, further, that a fiscal contraction would more likely be expansionary if public debt were on an unsustainable path than on a sustainable path.

Alesina and Perotti (1995, 1997) stress the importance of expectations for the outcome of fiscal tightening. They argue that to be expansionary, fiscal tightening has to be perceived as *permanent* rather than *temporary* and that this would be more likely if the consolidation of public finances took place through expenditure cuts rather than through tax hikes. Furthermore, Alesina and Perotti stress that expenditure cuts are more likely to succeed, not because they reduce the public deficit by more than tax hikes, but because they lead to higher growth. Hence, Alesina and Perotti stress not only demand-side effects, but equally importantly, supply-side effects.

The empirical literature on EFC in general tends to confirm a number of cases where tighter fiscal policy has led to an increase in growth. However, the literature is less clear on the mechanisms that

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<sup>2</sup> Today, this term could seem somewhat ironic, given the state of public finances in Germany and the prevailing political-economic views among key German policy-makers, who seem to be advocating traditional Keynesian policies more rigorously than ever.

generate EFC. Furthermore, the literature generally confirms that expenditure cuts rather than tax hikes are more likely to lead to a sustained improvement in public finances and to higher growth.

The empirical literature also exams the importance of the size of fiscal adjustment. Here the results are less than clear cut. Even though one could posit that a large fiscal adjustment would be more credible than a small fiscal adjustment, it is very hard to find strong empirical support for this in the literature.

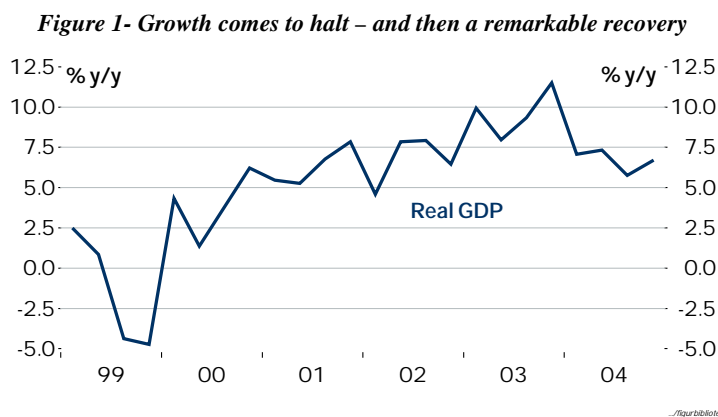
To sum up, the literature in general focuses on four key elements to explain the EFC phenomena. First, the *expectations* of investors, consumers, unions, etc. at the time of fiscal adjustment. Second, the *composition* of the fiscal adjustment between transfers, public consumption and investments on the one side, and taxes on the other side. Third, the literature stresses the importance of the *circumstances* under which the fiscal adjustment is undertaken. And finally, the literature points to the importance of the *size and persistence* of the fiscal adjustment.

One should add to these four elements the importance of other non-fiscal policy initiatives that have typically been enacted during the period of the fiscal adjustment. A notable example is the Danish fiscal adjustment from 1982-86. During this episode a hard currency reform was implemented and capital flows were significantly liberalised. Furthermore, the Danish government implemented strong price and income policies. Some have argued – inter alia Christensen (1987) – that, in particular, the hard currency reform, where the Danish government committed itself to a strict fixed exchange rate policy, was the main reason for a significant drop in both nominal and real interest rates, and that it was actually this easing of monetary conditions that lead to the strong recovery in the Danish economy from 1982 to 1986 rather than the tightening of fiscal policy. However, one should also note that the implementation of a hard currency policy would probably have failed had it not been underpinned by significant fiscal tightening.

Most of the empirical literature on EFC has focused on developed economies, but a growing volume of literature is now focusing on emerging markets and transitional economies. Notable examples include Cheasty and Davis (1996), Gavin and Perotti (1997), and Purfield (2002). The empirical literature on EFC in emerging markets and transitional economies generally confirms the results from the studies of developed economies.

### 3. Macroeconomic background

In 1998-99, economic growth came to a halt in Lithuania on the back of the Russian crisis. GDP growth fell from 7.3% y/y in 1998 to -1.9% y/y in 1999 and the country faced a severe economic, political and social crisis, with the budget deficit hitting 8.5% of GDP and a current account deficit of 11.2% of GDP.



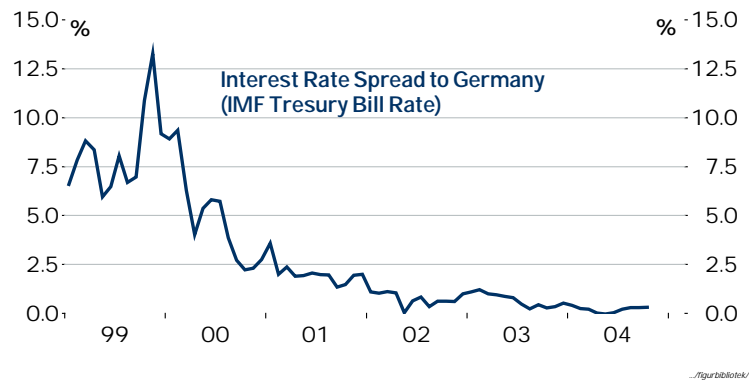
Despite the severe crisis, private consumption held up fairly well with private consumption slowing from 4.0% y/y in 1998 to 2.1% y/y. However, private investment plummeted nearly 10% y/y in both 1999 and 2000.

However, unlike in many other examples in the EFC literature, inflation remained more or less under control before, during and after the crisis, with inflation averaging less than 2% for 1999-2004. The low inflation can largely be attributed to the successful operation of a currency board in Lithuania during the entire period<sup>3</sup>.

Even though inflation remained in check, interest rates spiked dramatically towards the end of 1999. By New Year, the 3-month VILIBOR rate stood at more than 21%, and the rate spread vis-à-vis Germany had widened to more than 13%.

<sup>3</sup> Until the beginning of 2002 the Lithuanian central bank pegged the Lithuanian Litas against the dollar and hereafter against the euro.

Figure 2- Losing faith – and regaining it



#### 4. Textbook fiscal reform

The severe deterioration of, especially, public finances and the current account situation forced the Lithuanian government to seriously tighten fiscal policy, with the support of a standby agreement with the IMF.

Fiscal policy was tightened first through the revised budget in 1999 and then further and much more importantly in the budget of 2000. The adjustment of fiscal policy was a clear-cut EFC “textbook” tightening of fiscal policy. Hence, transfers, subsidies and public consumption were drastically slashed, while the Lithuanian government did not to any significant extent rely on tax hikes to improve public finances. The fiscal adjustment generally reflected the demands of the IMF, which made the approval of a standby-agreement dependent on sizeable cuts in public expenditures.

The role of the IMF should not be underestimated. The IMF clearly recommended that the fiscal adjustment needed was substantial and that the government should rely on expenditure cuts rather than on tax hikes. The Lithuanian government followed these recommendations closely. It should be noted that Prime Minister Vagnorius resigned in mid-1999 amidst public dissatisfaction with economic policy. However, despite the political uncertainty and the clear unpopularity of the (planned) fiscal measures, the new government under the leadership of conservative Homeland Union Party chief, Rolandas Paksas, adopted the outgoing government’s economic program more or less in its entirety. This should obviously be seen in the light of the IMF demands. The IMF finally approved the standby agreement with Lithuanian in February 2000 – after the Lithuanian parliament, the Seimas, had passed the 2000 budget.

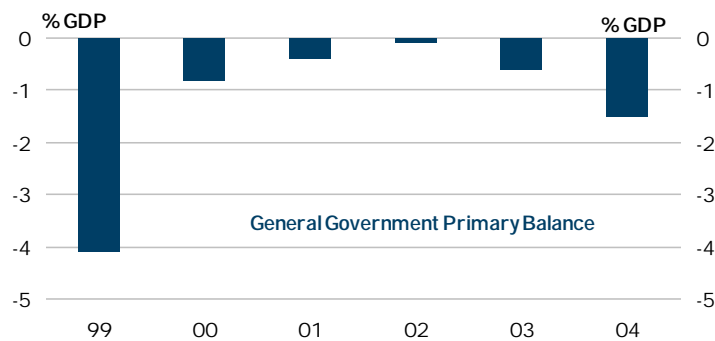
The key elements of the 2000 budget were:

- 1) A freeze of the state government wage bill and extra-budgetary funds
- 2) Elimination of civil service bonus payments
- 3) A partial hiring freeze in the civil service
- 4) Reduction in agricultural and transport subsidies and an abolition of VAT reimbursement on energy consumption
- 5) Cutback in public investments
- 6) Reduction of government purchases of “non-essential” goods and services
- 7) A streamlining of state government institutions and extra-budgetary funds
- 8) Postponement of restitution payments for land and property

The 2000 budget was planned to reduce the public deficit by 1.8% of GDP, primarily through expenditure cuts. Even though this is by any measure a substantial tightening of fiscal policy, the realised improvement in the budget was in fact even greater. The budget deficit fell from more than 5% of GDP in 1999 to just above 2% of GDP in 2000. The improvement in the primary deficit was even more impressive, with the primary deficit declining from just over 4% of GDP in 1999 to less 1% of GDP in 2000.

Expenditure on social benefits and transfers fell by 3% from 1999 to 2000 – and this was in a situation where unemployment rose from 14.1% in 1999 to 16.4% in 2000. Furthermore, government subsidies were cut by more than 20% from 1999 to 2000. However, as subsidies constitute a much smaller share of the government budget, this was less important than the cut in social benefits and transfers vis-à-vis the improvement in public finances.

Figure 3- Visible fiscal consolidation!



The government wage freeze also had dramatic effects, with both public and private wage growth coming more or less to a halt in 2000-2001.

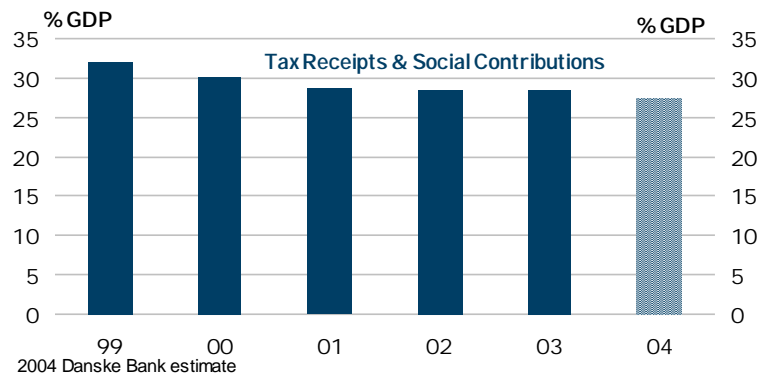
In addition to the direct expenditure measures, a number of measures were put in place to increase the transparency and management of public finances. For example, quarterly ceilings were introduced on the general government fiscal deficit and on the government's net lending to off-budget institutions and companies that received government support. Furthermore, steps were taken to limit off-budget spending of privatisation proceeds, through the establishment of a *Fiscal Reserve Fund* to administer the investment of privatisation flows<sup>4</sup>.

While public expenditure was cut dramatically in Lithuania as part of the fiscal consolidation, the Lithuanian government – with a very few exceptions – did not rely on taxes to improve public finances. The only tax increases that were implemented were hikes in energy taxes and excise taxes on tobacco. Also, both the corporate and the personal income tax bases were broadened by removing some special “privileges” in the tax system; for example, for authors<sup>5</sup>. In addition, the tax administration was strengthened to combat tax fraud. At the same time, corporate income tax was slashed from 29% to 24%. The net effect of the changes in the tax system was in fact that tax revenues fell from 32.1% of GDP to 30.1% of GDP in 2000 (and have continued to fall ever since).

<sup>4</sup> In 1998-99 off-budget spending surged as the government spent large amounts of the privation revenues.

<sup>5</sup> Until the implementation of the 2000 budget, authors had an income tax rate of 13% whilst others paid 20%.

Figure 4 - Taxes on the decline



The work on fiscal consolidation and reform continued in 2001 and 2002, with public expenditures continuing to decline and the budget situation improving. However, a notable change has been observed in 2003 and 2004, when budgetary discipline was greatly relaxed in the run-up to the parliamentary and presidential elections in 2004.

## 5. Textbook reforms lead to textbook results

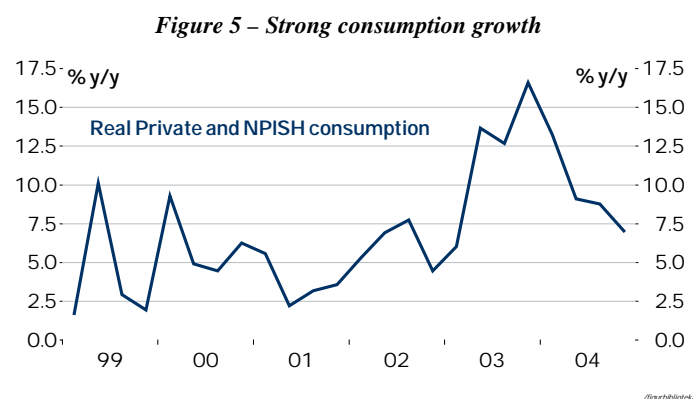
The Lithuanian fiscal reforms, 1999-2002, in many ways stuck to the EFC “textbook” in the sense that the reforms were chiefly based on expenditure cuts rather than tax hikes. Hence, the Lithuanian government clearly followed the lead given by, for example, Alesina’s and Perotti’s research (1995, 1997) that showed that especially fiscal consolidation based on cuts in public sector wages and transfers would be more likely to succeed. The question is then, of course, if this textbook reform also led to a textbook outcome?

Looking at GDP growth, it is obvious that the tightening of fiscal policy from 2000 onwards did not lead to a slowdown in economic growth, as traditional Keynesian theory would have predicted. In fact, GDP growth picked up significantly from 2000 to 2004. Hence, the Lithuanian fiscal consolidation can be described as an EFC episode. However, this does not in itself enlighten us about the mechanisms that generated the boom in GDP growth.

Traditionally, the literature has – as mentioned above – pointed towards a Ricardian explanation for EFC. In other words, that fiscal consolidation – contrary to traditional Keynesian theory – will lead to a consumption boom. The Lithuanian case seems (at least partially) to fit the Ricardian explanation of EFC, in the sense that private consumption did not slow down in 2000, but rather

picked up – especially in the first half of 2000. Private consumption growth topped 4½% in 2000 – up from 2.1% in 1999. Thus private consumption outpaced GDP growth and was the main driver of growth in 2000 (along with exports, which also surged strongly). However, private consumption only grew by around 2% in 2001 but then picked up again in 2002, when wage growth finally started to gain traction again.

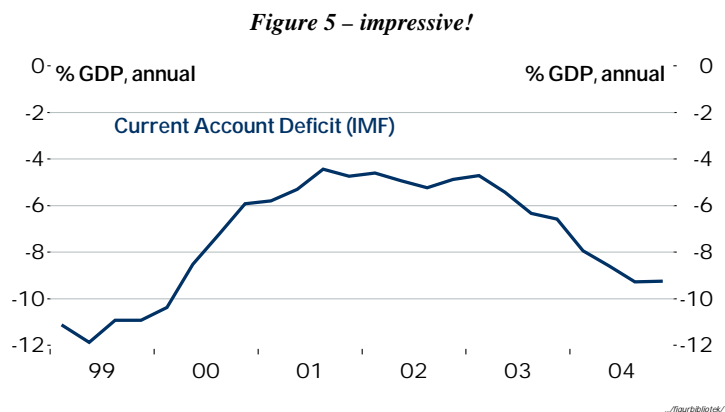
Naturally, one can always debate whether the fairly strong growth in Lithuanian private consumption, 2000-2002, was driven by purely expectational and Ricardian effects on the back of a credible tightening of fiscal policy, or whether other factors – such as the declining interest rates – contributed to the strong consumption growth. However, it can be concluded that even if the Lithuanian case does not necessarily provide strong evidence *for* a Ricardian-based EFC theory, it does provide evidence *against* orthodox Keynesian fiscal theory that stipulates that a tightening of fiscal policy will lead to a slowdown in private consumption growth.



Some EFC theories stress the importance of investment. In the Lithuanian case, however, investment seems to have played a less clear role in the sense that investment did not expand in 2000, but rather continued to fall. In fact, investment fell by nearly 10% in 2000. However, investment started picking up in mid-2000 and accelerated strongly in both 2001 and 2002. This delayed pick-up in investment might also be due to the fact that Lithuania’s standby-agreement with the IMF was not approved until February 2000. This might have led some investors to wait-and-see before initiating new investments – which would not have been unnatural, given the uncertain political situation, especially throughout 1999. The delayed pick-up in investment seems to indicate that the impact on investment from the fiscal consolidation did not necessarily work through a pure expectational channel, but rather through what we might term a Alesina-Perrotti channel (AP

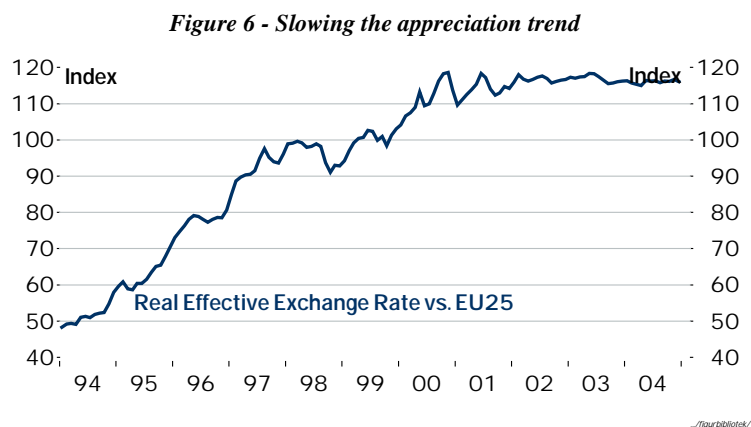
channel). A channel where fiscal tightening in the form of a public sector wage-freeze and a cut in social benefits and transfers leads to a slowdown in private sector wage growth, which improves the profitability of investments. However, one cannot ignore that other factors might have been at work. Especially the cut in the corporate income tax rate from 29% to 24% no doubt played an important role in re-energising investment growth.

One aspect of the Lithuanian case stands out in particular, and that is the massive boom in Lithuanian exports in 2000 and thereafter. In other cases of EFC, a consumption- and investment-driven recovery in growth has led to a deterioration in the current account situation – for example in the often-cited Danish EFC case 1982-86. In fact, the current account situation improved dramatically from 1999 to 2002 in Lithuania (see graph 5).



In the wake of the Russian crisis, Lithuanian exports to Russia and other former Soviet countries fell dramatically. However, Lithuanian companies were largely able to re-direct their exports from the eastern markets to the western markets – especially to EU countries, despite the weak growth in the European economy. In both 2000 and 2001, Lithuanian exports strongly outpaced imports. Exports grew by 12.9% in 2000 and 20.8% in 2001. Also here the AP channel seems to have been the main driver. Hence, the significant slowdown in wage growth in 2000 and 2001 undoubtedly helped spur Lithuanian competitiveness and thereby support export growth. In this connection it is also worth noting that the (long-term) appreciation trend in the real effective exchange rate slowed down significantly following the fiscal consolidation. Furthermore, it should be noted that this slowdown in the appreciation rate was not due to a weakening of the nominal exchange rate. In fact, the Litas actually kept appreciating in nominal terms from 2000 to 2004. The main driver of the

slowdown in the real effective exchange rate was the marked slowdown in inflation that went hand-in-hand with the slowdown in wage growth.



## 6. Conclusion

The Lithuanian fiscal adjustment, 1999-2002, seems indeed to be yet another example of an expansionary fiscal contraction and further confirms that a tightening of fiscal policy does not necessarily have to lead to a slowdown in GDP growth through a slowdown in private consumption. In fact, a tightening of fiscal policy can, as the Lithuanian case clearly demonstrates, lead to an acceleration of growth, through higher private consumption and investment growth, *and* higher export growth.

Contrary to other cases of EFC, the Lithuanian case seems to have been primarily driven not by an expectational channel working through the demand side of the economy on consumption and investment (even though this was also partly the case), but rather through supply-side factors, where a tighter fiscal policy induced wage moderation that in turn spurred investments and exports.

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