

Lithuanian Fiscal Reform 1999-2002

- yet another example of an expansionary fiscal contraction?

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Agenda

1. Expansionary fiscal contractions – an overview
2. Macro economic background – the Lithuanian case
3. Fiscal reform – the reaction to the crisis
4. The results – what happened?
5. Conclusion and perspectives

Expansionary fiscal contractions - 1

- The "Expansionary fiscal contractions" hypothesis (EFC) is the observation that a *tightening* of fiscal policy under certain circumstances can lead to an expansion of growth – contrary to the predictions of orthodox keynesian theory
- Best known examples of EFC are Denmark and Ireland (See among others Giavazzi and Pagano (1990))
- The literature traditionally has focused in developed economies, but the EFC literature on emerging and converging markets is growing (See for example Purfield (2002) for a recent example)
- The literature widely confirms the existence of numerous cases of EFC – both in developed and emerging/converging economies

Expansionary fiscal contractions - 2

- The theoretical research on EFC is less conclusive than the empirical literature
- A number of competing theories of EFC exists. These theories are not necessarily mutually exclusive, but rather supplement each other
- Broadly speaking there are two lines of EFC theories – demand side based theories and supply side based theories
- Often the EFC theories are outlines of theory rather than strict theories – there is clearly room for new research in this area

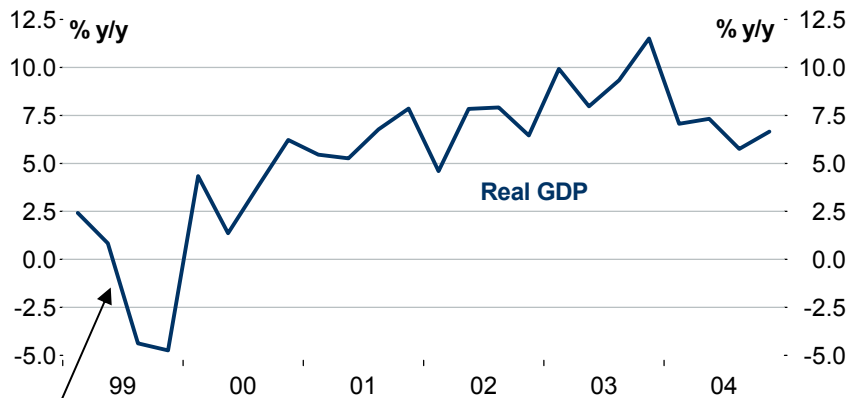
Expansionary fiscal contractions - 3

- The **demand side** based theories has especially been inspired by the early known empirical examples of EFC – especially the Danish case (1982-86) where a fiscal tightening lead to a boom in especially private consumption
- The demand side based theories stresses the importance of *Ricardian* effects and hence *expectations*
- Giavazzi and Pagano argued – along the lines of the Ricardian equivalence theorem - that forward looking consumers and investors would increase consumption and investment if they expected expenditures to be cut and hence the public deficit to be reduced (and therefore lowering the tax burden in the future)
- Blanchard (1990) and Bertola and Drazen (1993) argued that these Ricardian effects are most likely to be relevant in a situation with an unsustainable development in public debt.

Expansionary fiscal contractions - 4

- Alesina and Perotti (1995, 1997) not only expanded the empirical research on EFC greatly, but they also expanded the theoretical understanding of the EFC phenomenon by stressing **supply side** effects of fiscal consolidation
- AP's research leads to the following main conclusions:
 - **Persistent** rather **temporary** fiscal adjustments are more likely to be successful
 - Cuts in public consumption (especially public sector wage costs) and in transfers and subsidies are likely to lead to success than tax hikes (and cuts in public investment). Hence, the **composition** of the fiscal composition is (very) important
 - The **size** of the fiscal adjustment is *not* necessary all that important – it is much more important that the fiscal adjustment is **credible**

Macro economic background – the Lithuanian case

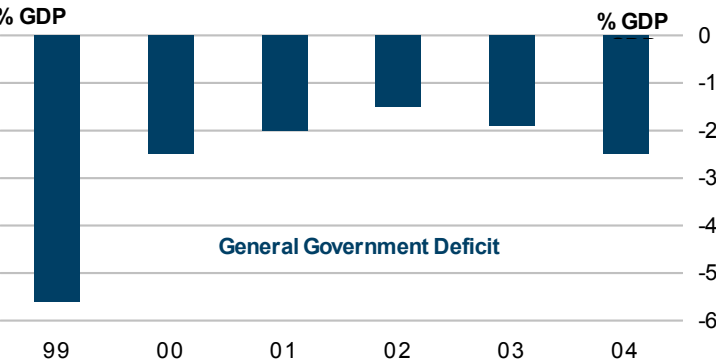


- The Russian crisis sent Lithuania growth plummeting in 1998-99. **GDP growth** fell from 7.3% y/y in 1998 to -1.9% y/y in 1999
- **Private consumption** slowed to 2.1% y/y in 1999 from 4.0% y/y in 1998
- **Investment** dropped by around 10% in both 1999 and 2000.
- Both the **public deficit** and the **current account** situation worsened markedly with the public deficit hitting 8½% in 1999 and the current account deficit peaking at more than 11% of GDP also in 1999
- Unlike in many other EFC cases **inflation** remained low before, during and after the crisis – primarily due to Lithuania's credible currency board arrangement

What hurts!

Fiscal reform 1

– the overall picture

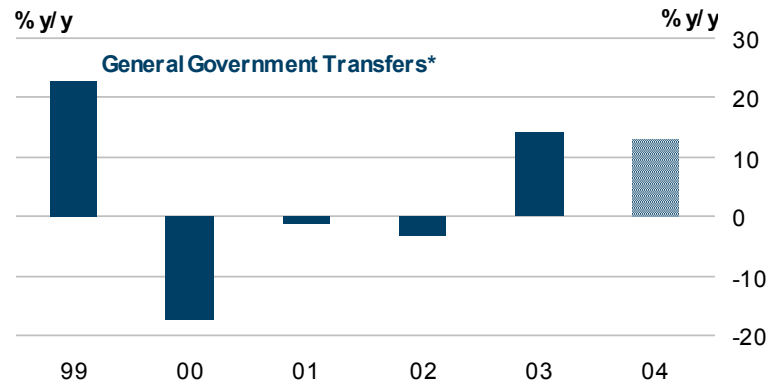


- The 2000-budget was planned to reduce the public deficit by 1.8% of GDP. However, the actual drop in the deficit was much larger with the deficit falling from just over 4% of GDP (as an average) in 1999 to less than 1% of GDP in 2000. The drop in the
- The tightening clearly allowed the “guidelines” in the EFC literature – given that adjustment nearly exclusively was done by cuts in expenditures rather than through tax hikes
- Expenditures on social benefits and transfers fell by 3% from 1999 to 2000, while government subsidies was slashed by more than 20% from 1999 to 2000
- Public sector wage growth basically came to halt in 2000-2001
- Tax revenues *fell* to 30.1% of GDP in 2000 from 32.1% of GDP in 1999

Fiscal reform 2

– the expenditure side

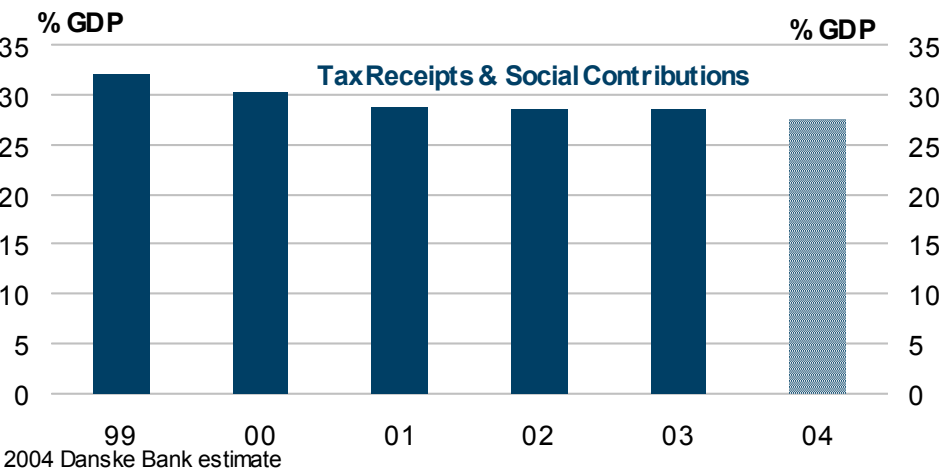
The 2000-budget – following the textbook:



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 subsidies, Social Benefits, Other Current Transfers and Capital Transfers

- Freeze of state government wage bill
- Elimination of civil service bonus payment
- A partial hiring freeze in the civil service
- Reduction in agricultural and transport subsidies and an abolition of VAT reimbursement on energy consumption
- Cutback in public investment
- Reduction of government purchases of “non-essential” goods and services
- A streamlining of state government institutions and extra-budgetary funds
- Postponement of restitution of land and property

Fiscal reform 3 – the tax side



The tax initiatives in the 2000-budget:

1. Hikes in energy taxes and excise taxes on tobacco
2. Broadening of the tax base for personal and corporate income tax by removing “privileges” – for example a removal of the special (low) tax rate for authors
3. Strengthening of the tax administration to combat tax fraud
4. The corporate income tax was cut from

...needless to say the net result was lower taxes!

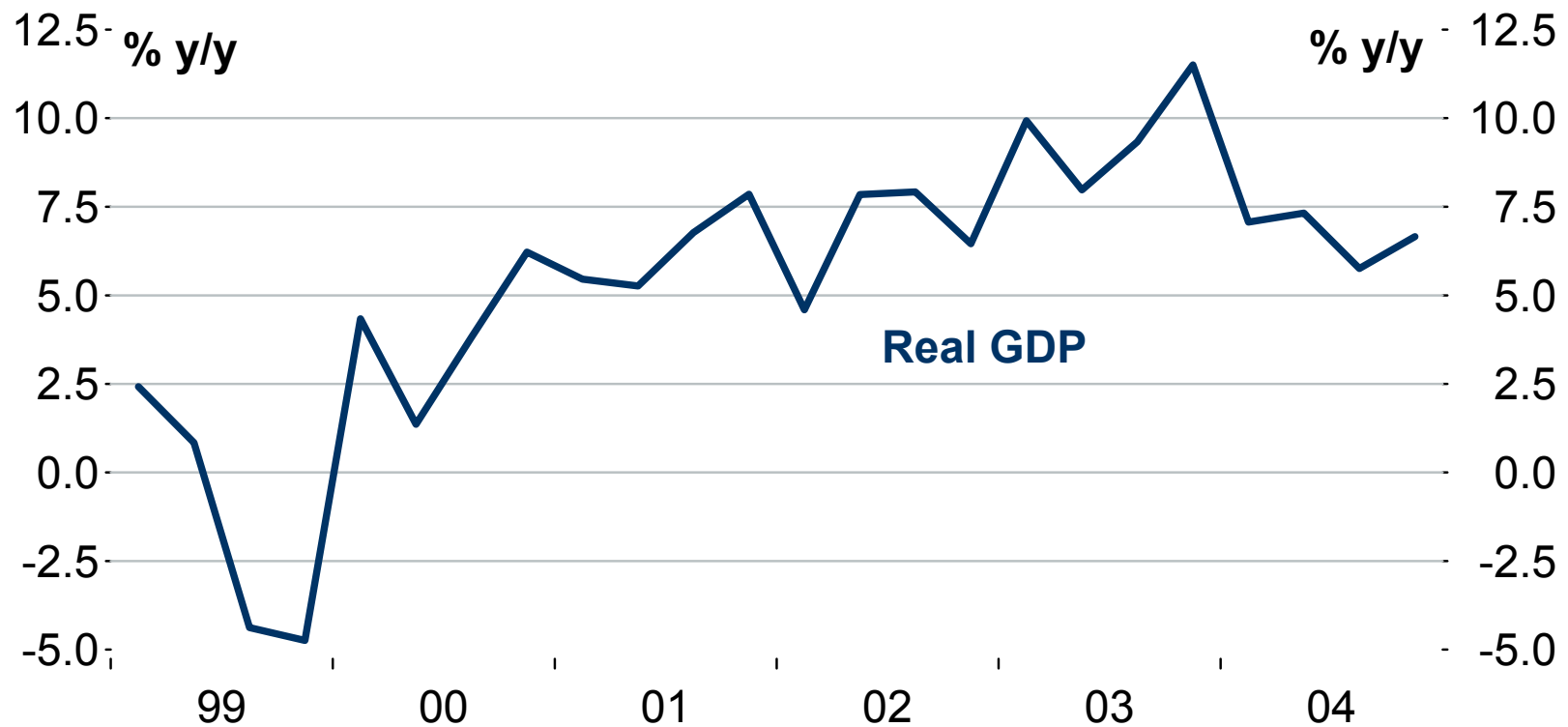
Fiscal reform 4

- the politics of it

- Numerous Lithuanian governments have benefited from IMF's "Golden straitjacket"
- The economic program closely followed the the advise of IMF – expenditure cuts and avoiding tax hikes
- The reforms were highly unpopular and during the process Prime Minister Vagnorius resigned (mid-1999).
- The his successor Prime Minister Paksas of the conservative Homeland Union Party adopted Vagnorius' economic austerity package more or less unchanged
- IMF finally approved a standby-agreement in February 2000

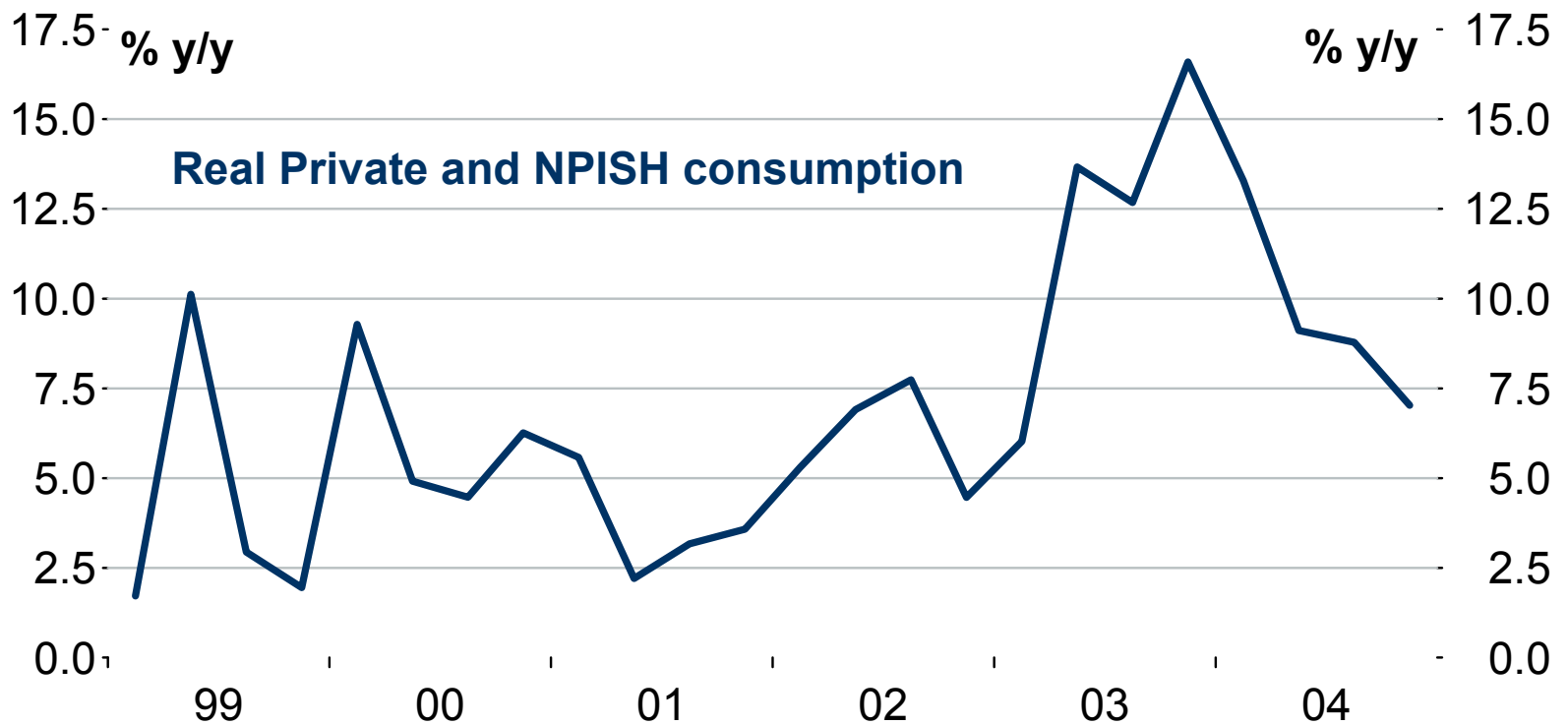
The results 1

- Boom, boom



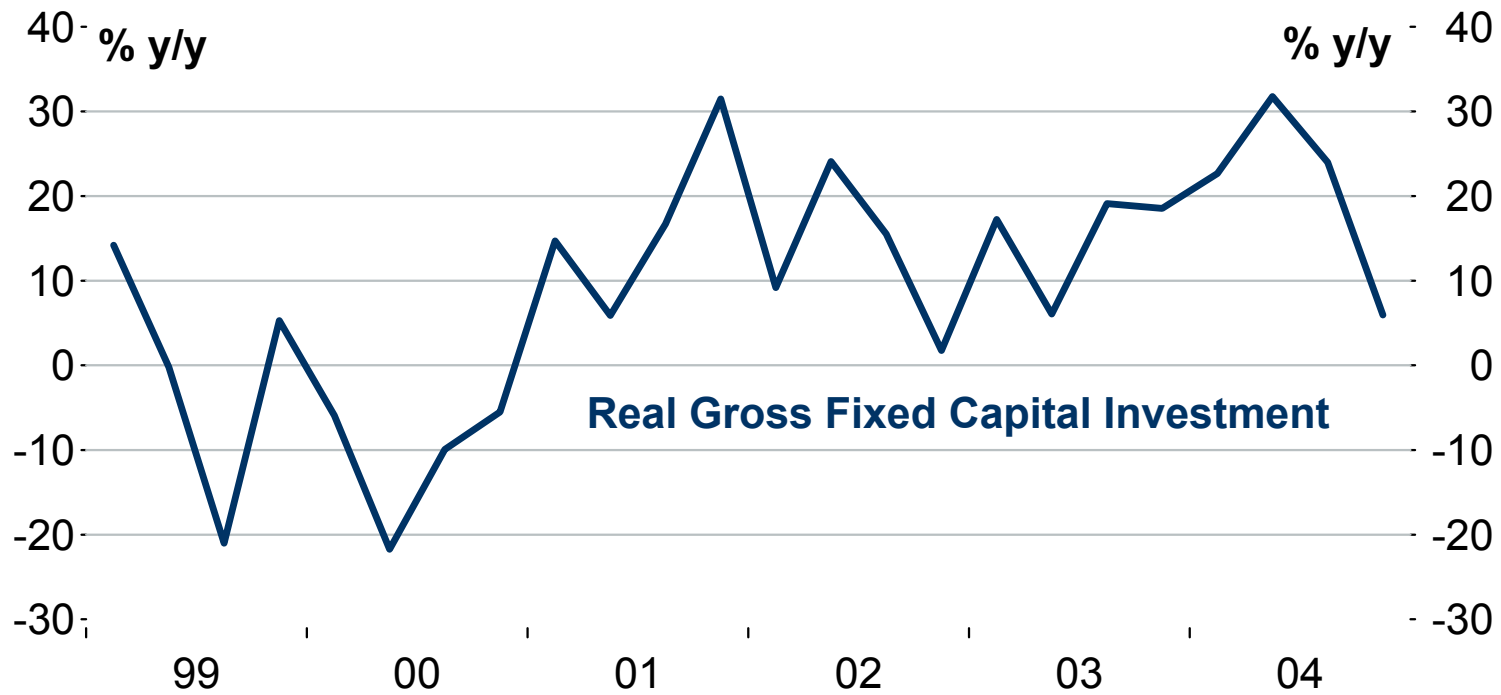
The results 2

- Semi-ricardian consumption boom

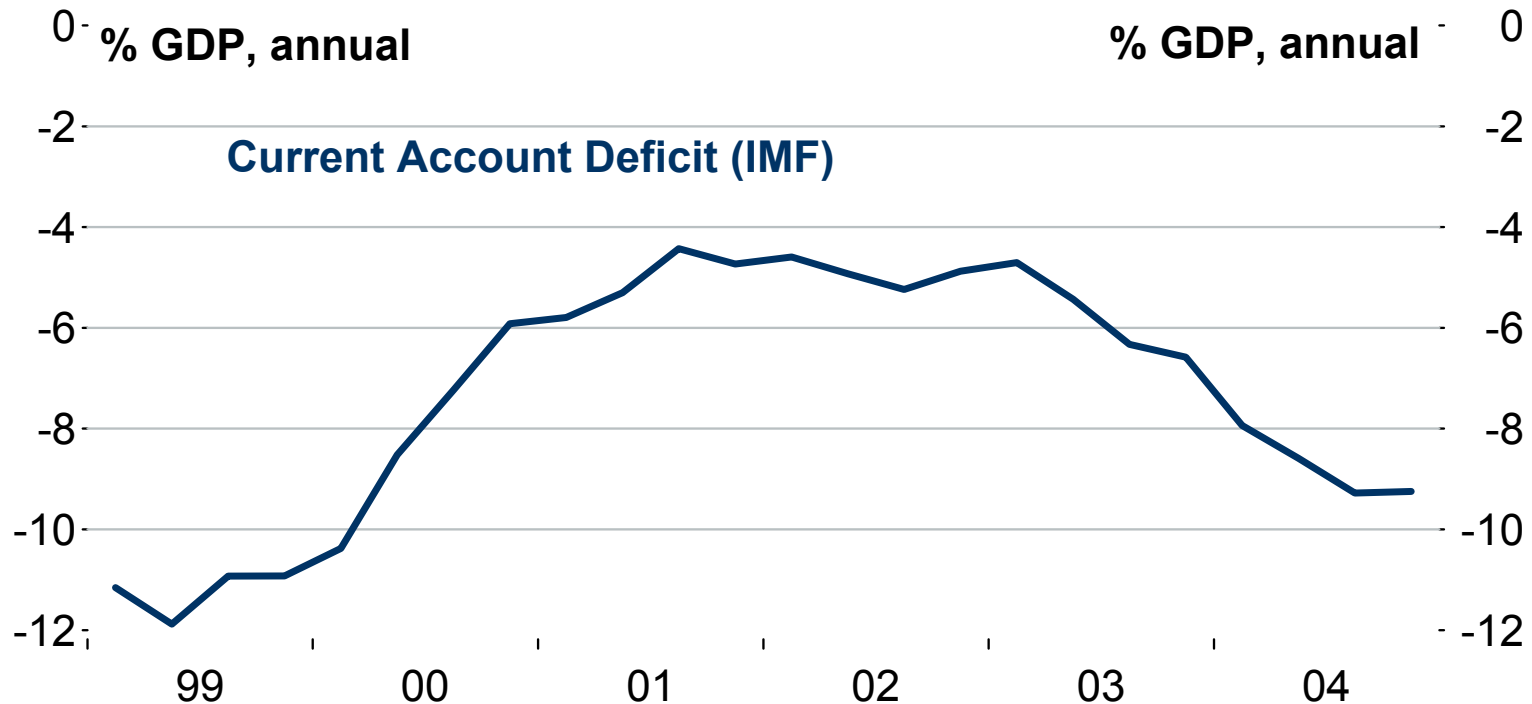


The results 3

- Investments full speed a ahead

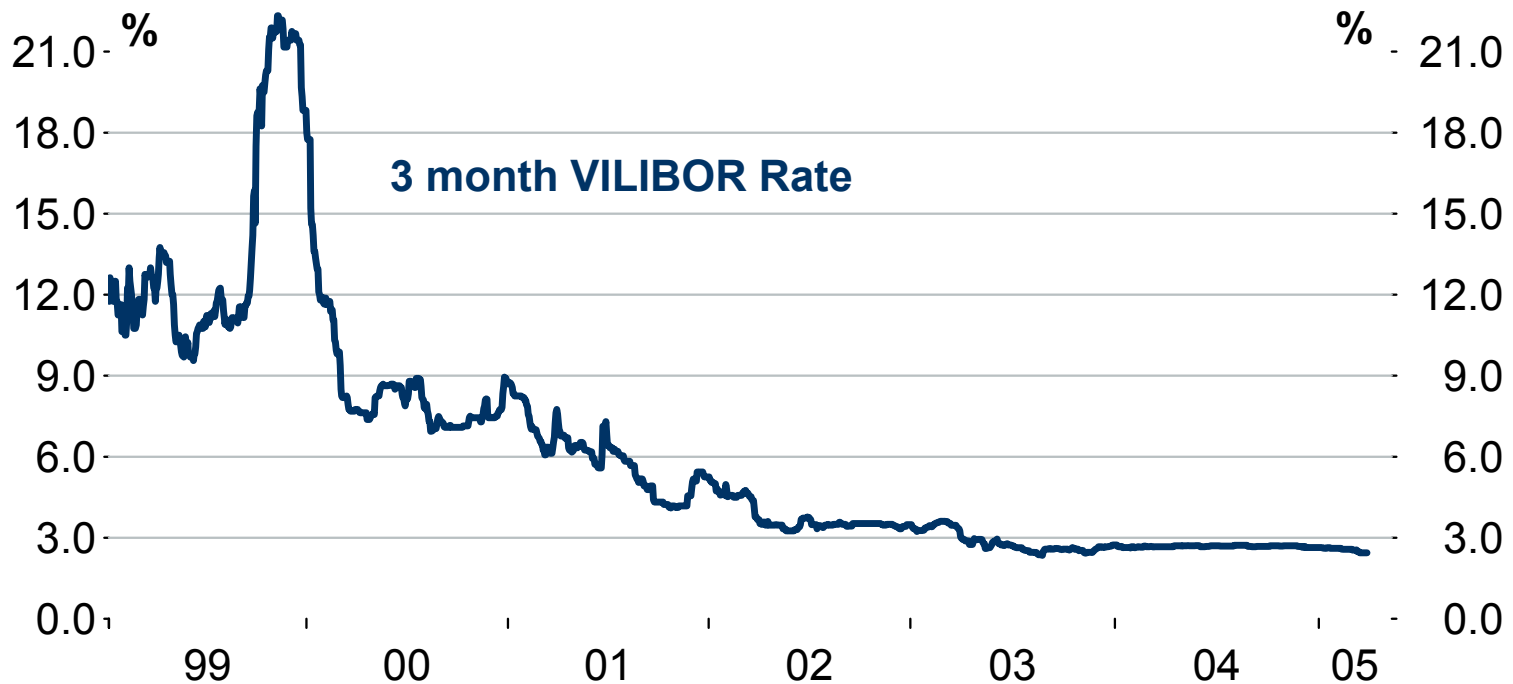


The results 4 - Amazing!



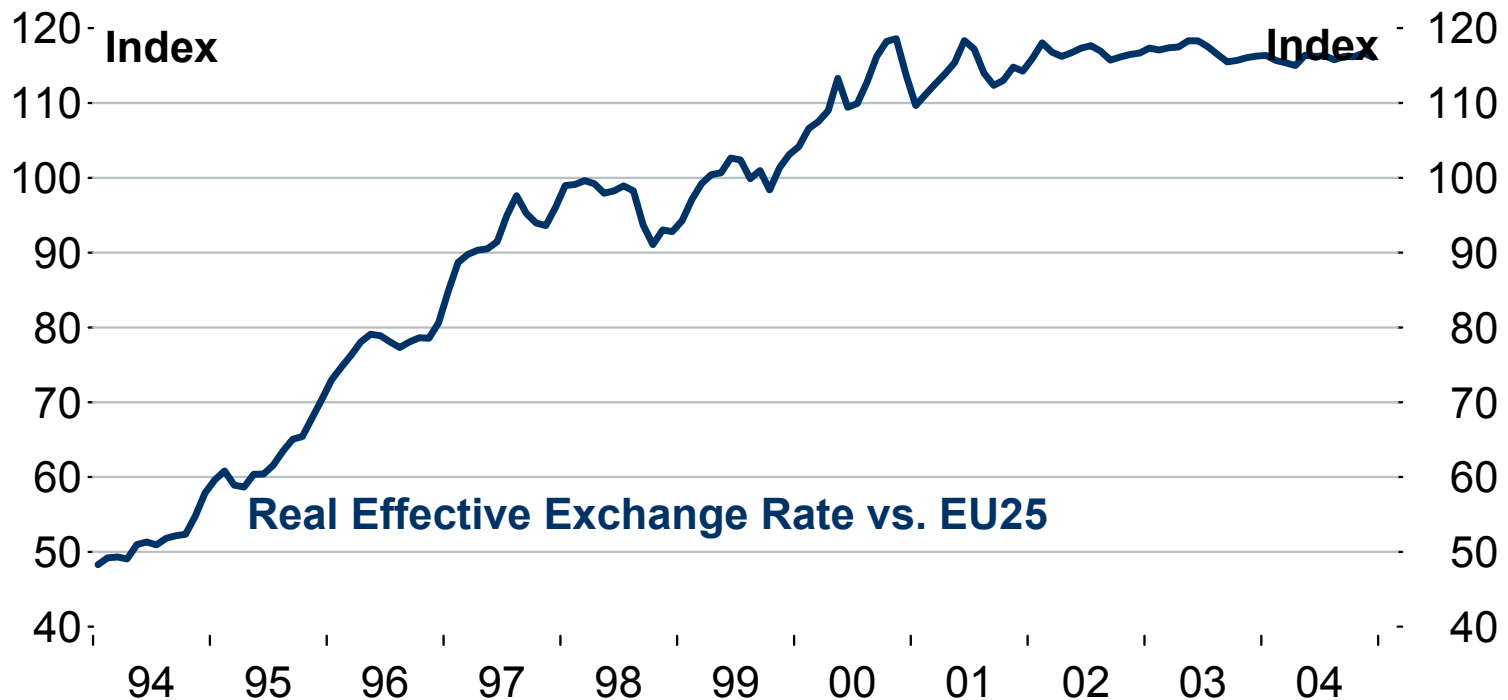
The results 5

- Was it this that did it? Probably not



The results 6

- This is a better explanation



Conclusions

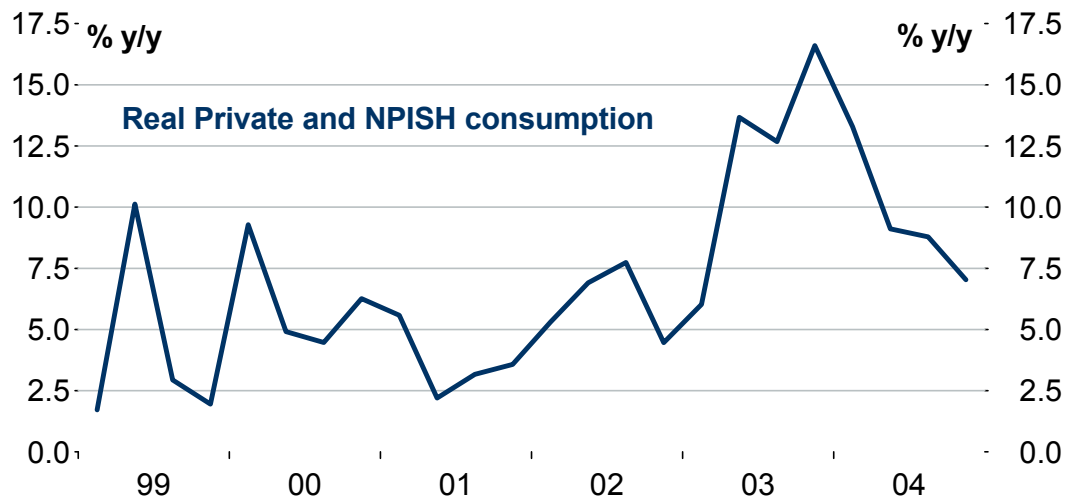
- The Lithuanian fiscal adjustment 1999-2002 was clearly yet another case of an expansionary fiscal contraction
- Contrary to previous for example the Danish case (1982-86) demand effects (Ricardian effects) seem to have been less important, while supply side effect – driven by the cuts in social benefits and transfers – were much more important
- The Lithuanian case clearly demonstrates that a fiscal tightening do not have to lead to a slowdown in growth. This seems highly relevant to the continued discussions about relaxing the Stability and Growth Pact within the EU

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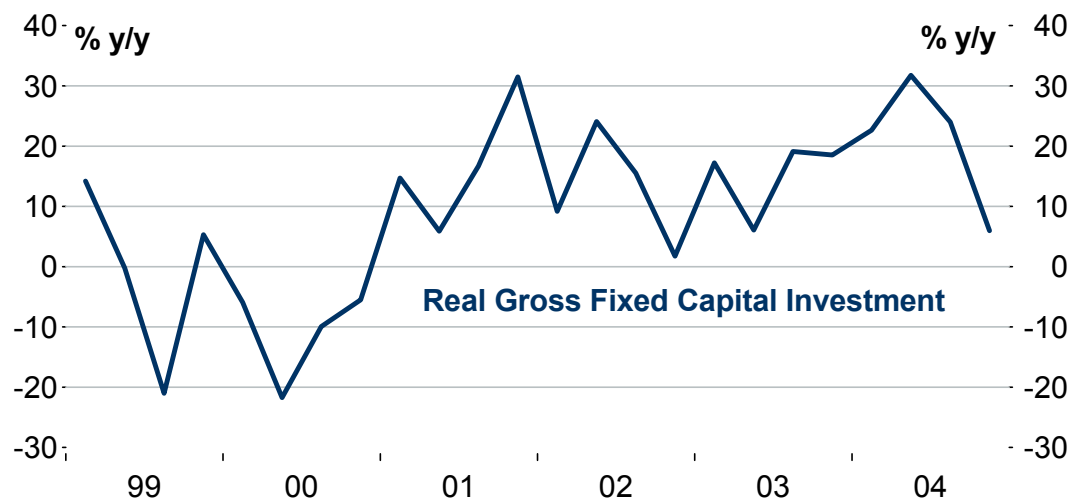
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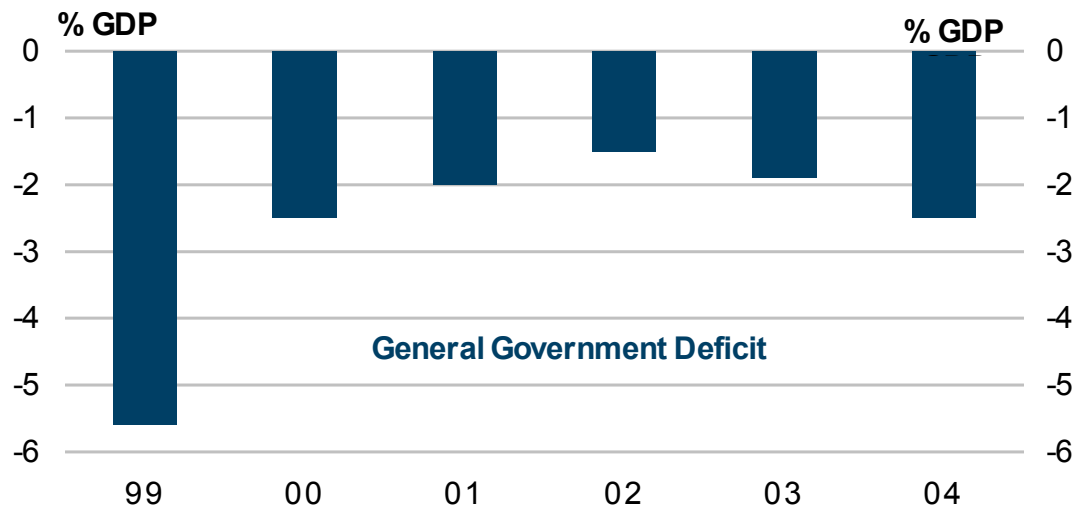
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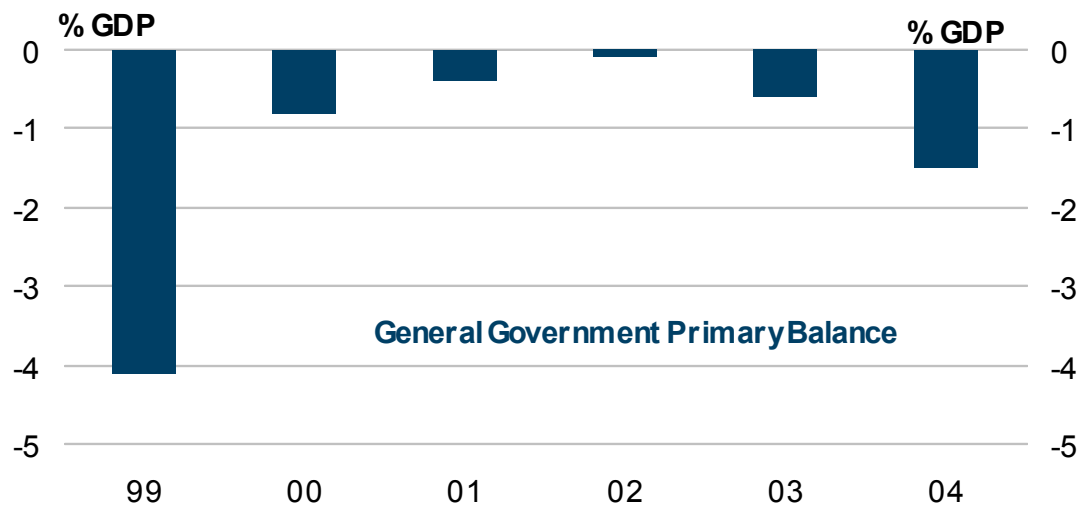


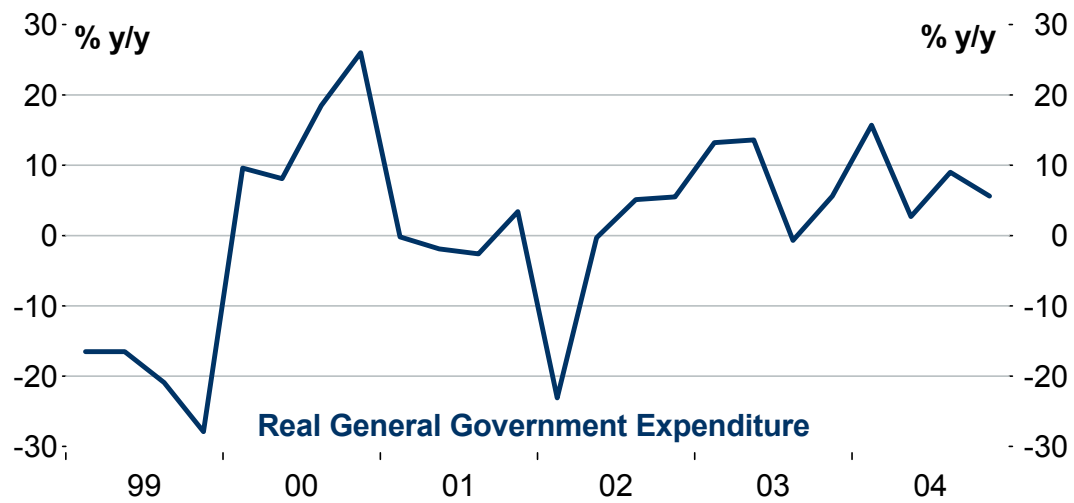
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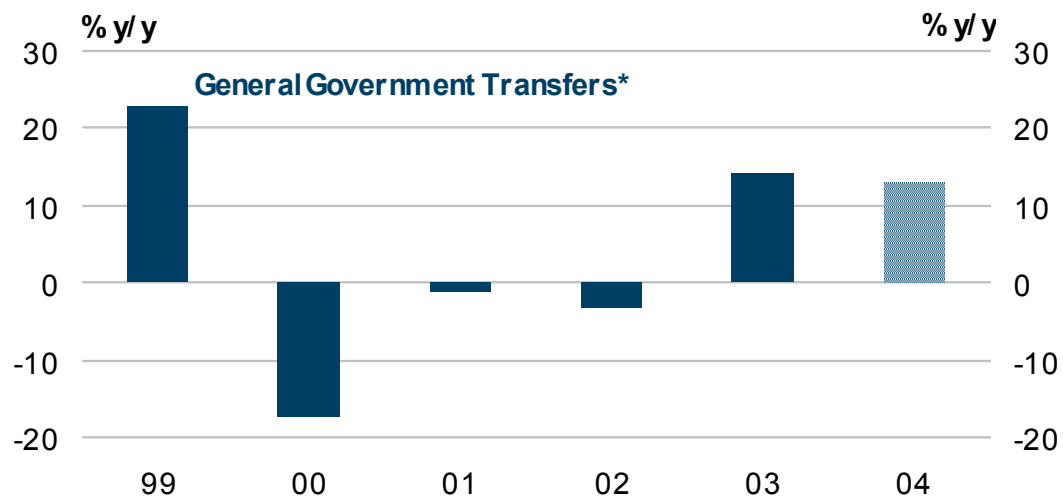
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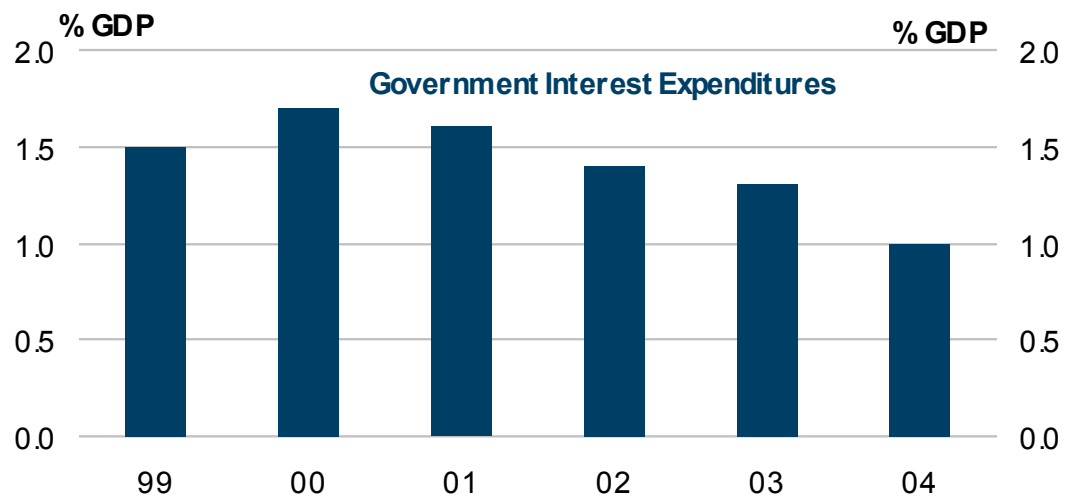


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*Subsidies, Social Benefits, Other Current Transfers and Capital Transfers

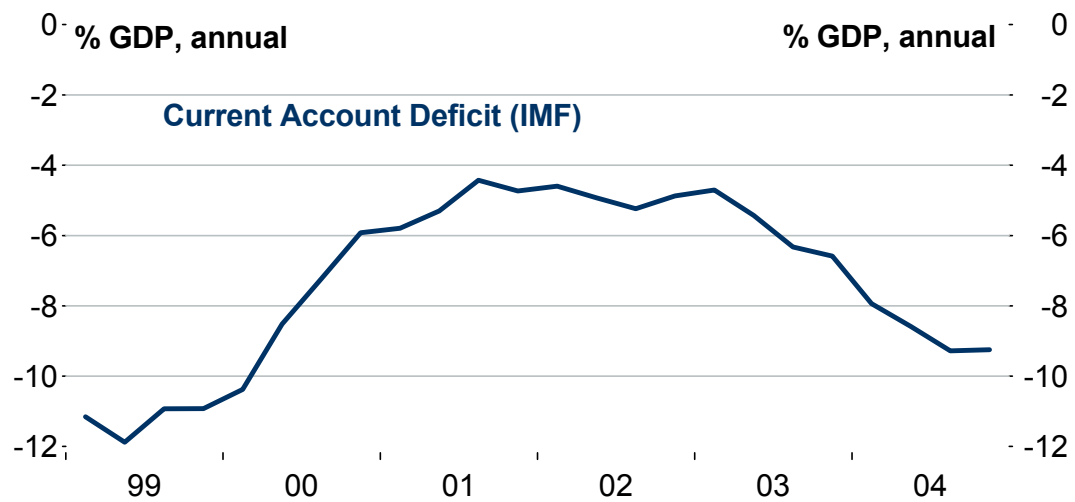




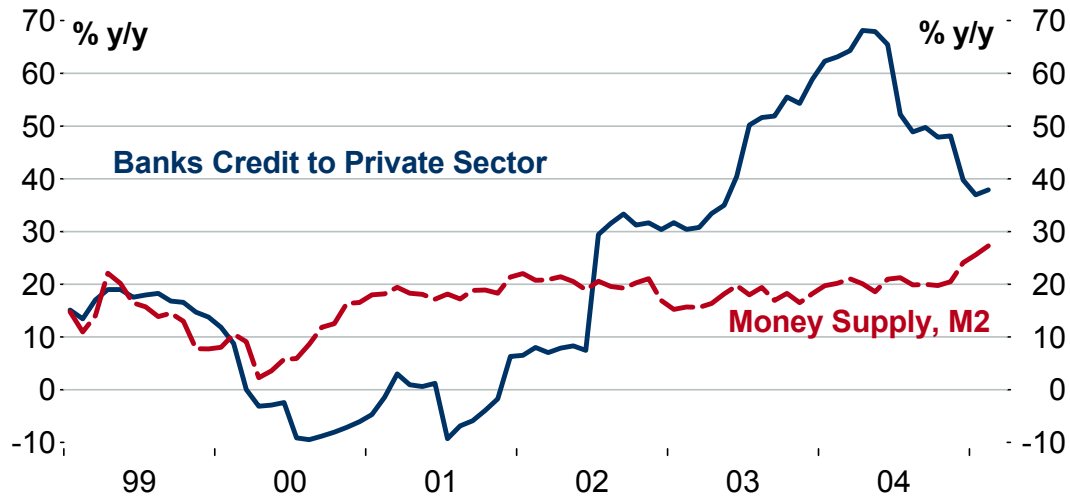
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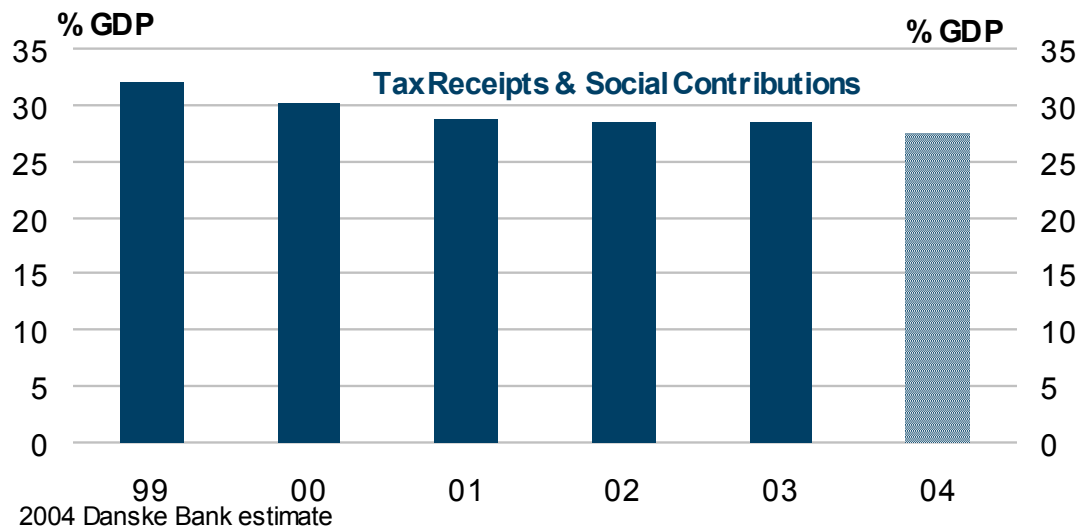
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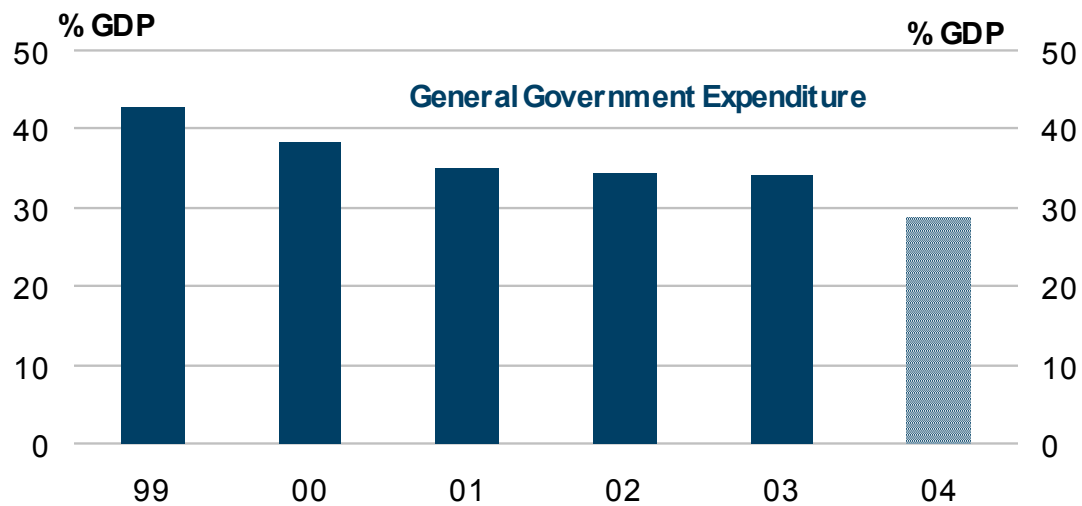


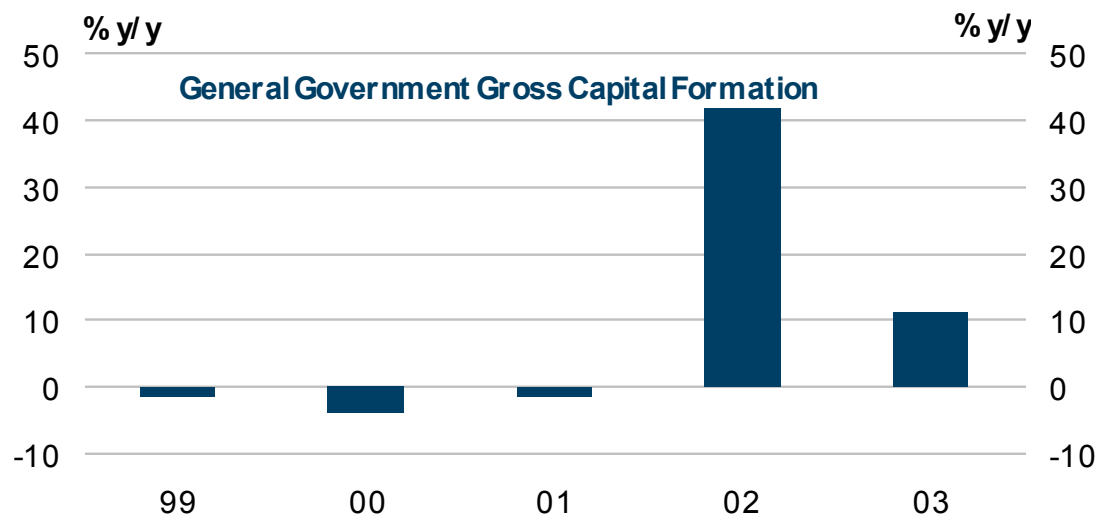
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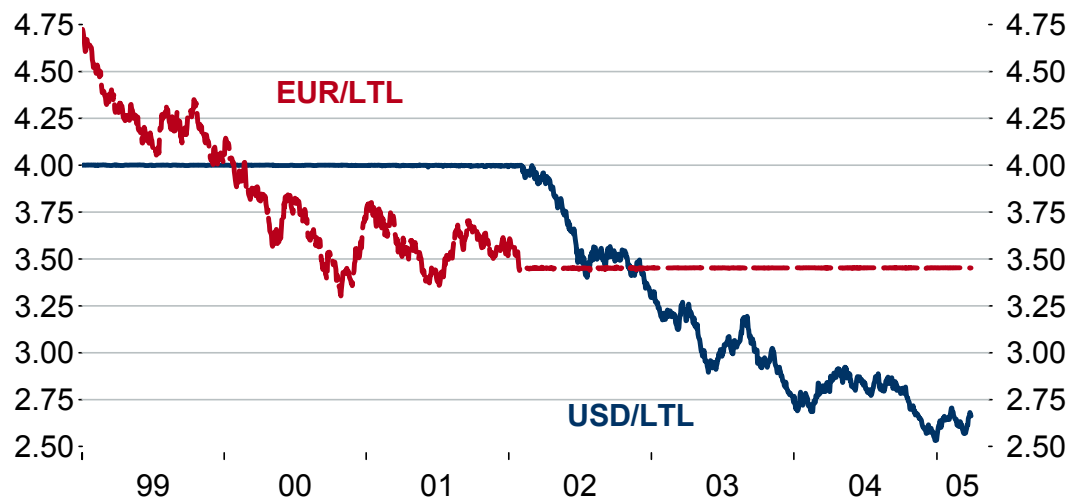


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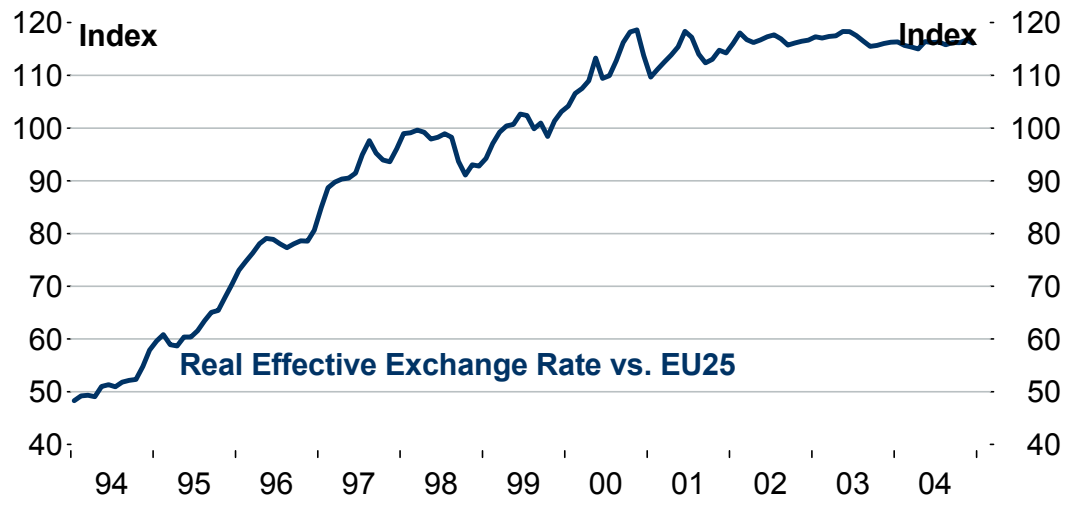








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