Public Finances and Fiscal Policy in the Baltic States 1991–2015

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Abstract

This paper discusses the developments in public finances and fiscal policy in the Baltic states since the countries regained independence in 1991. The Baltic states have relatively small public sectors and maintain a limited role for government, in part reflecting the market-oriented economic model emerging from the transition process. The fiscal stance has generally been prudent but Estonia stands out for having an essentially balanced budget every year. The fiscal policy stance exhibits limited counter-cyclicality and has even been pro-cyclical at times, including during the pre-crisis boom. The upshot is that a number of key challenges remain for fiscal policy-making in the Baltic states.

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1. Introduction

This paper examines the fiscal policy and public finances of the Baltic states – Estonia, Latvia and Lithuania – since the countries regained independence in 1991. The countries share many economic, structural and institutional characteristics but their fiscal policies and the resulting fiscal performances exhibit substantial differences. This paper records and compares developments in the three countries and identifies challenges for their fiscal policy in the future.

Events after the global financial crisis have underscored the importance of public finances and fiscal policy for economic stability and welfare. The crisis strained budgets and caused severe tension between the need for counter-cyclical policies and the need for budget consolidation. Many countries, particularly those in the periphery of Europe, lost access to commercial debt markets and had to seek international financial assistance.

The Baltic states make a particularly interesting case for the study of fiscal policy and budget performance. The countries implemented market-oriented reforms, where the role of government was relatively small. They have seen numerous challenges from the economic reform process, external shocks and disproportionate business cycles. There are substantial differences between the fiscal policies in the three Baltic states, and performance has differed across the countries. Indeed, one of the countries, Latvia, was among those seeking international financial assistance.

The literature analysing fiscal policy is surely almost boundless. There are, however, only a few studies which seek to shed light on developments in the Baltic states. Pautola (1997) discusses fiscal policy in the Baltic states in the early phase of transition and a number of studies include fiscal policy in broader discussions of economic transition (OECD 2000, Leinela and Sutela, 1994). Several studies have considered the striking fiscal measures taken in the Baltic states in the wake of the global financial crisis (Blanchard et al., 2013, Staehr, 2013; Raudla and Kattel, 2011, 2013). This paper is the first to provide a broad and comparative perspective on fiscal policy and public finances in the Baltic states over 25 years, combining descriptive and narrative analyses.

The rest of the paper is organised as follows. Section 2 discusses the role of government and the size of the public sector in the Baltic states. Section 3 reviews the key measures of fiscal performance in the countries. Section 4 discusses the cyclical response of fiscal policy in the Baltic states. Section 5 considers two key events following the global financial crisis, the lending programme to the Latvian government starting in 2008 and the fiscal retrenchment in Estonia in 2009. Finally, Section 6 summarises, and identifies some challenges for fiscal policy in the Baltic states.

2. The Role of Government

The Baltic states were fully integrated in the Soviet economy until they regained independence in 1991. The system of central planning, price controls and the state ownership of the means of production meant that the government played an almost exclusive role in the Baltic economies. After regaining independence in 1991, the Baltic states set out to transform the political and economic systems they had inherited from the Soviet Union.[1] The transition process was

[1] Gorbachev's reforms in the late 1980s meant economic decision-making became decentralised. The Baltic states used the opportunity to allow small private firms known as cooperatives, to privatise small companies and to change the tax systems so that they relied on income and consumption taxes instead of the Soviet turnover taxes.

complicated by the need to build up independent public administration and institutions, establish national sovereignty, and engage in nation building. At the same time production volumes collapsed and inflation reached extreme levels (Leinela and Sutela, 1994; OECD 2000, ch. 2).

The governments in all three Baltic states chose transition paths which led to a strong market orientation and a rapid reduction of the role of the government in the economy (OECD 2000, ch. 1). The policies were rooted in a great faith in private enterprise, the importance of economic incentives, and a sceptical view of the ability of government to manage the economy (Mygind, 1997; Bohle and Greskovits, 2012, ch. 3). This view implies that government should be limited to core activities and the provision of a basic social safety net; it may also imply a preference for simple and rules-based policies.

The reforms in the Baltic states set these countries apart from other transition countries, including those in Central Europe, where the government was generally given a greater role in coordinating and managing the economy (Bohle and Greskovits, 2012; Buchen, 2007). Within the Baltic states, Estonia stands out as the most market oriented, as witnessed by the character and the speed of the reforms. This policy was driven by a strong ideological anchoring and grave doubts about the incentives and administrative capability of government (Laar, 2002; Buchen, 2007).

The key reforms in the Baltic states were the extensive privatisation programmes, which took very different forms across the three countries but nevertheless resulted in most means of production, including housing, getting private owners. Meanwhile, private de novo firms entered at a rapid rate. The structural reforms needed to establish the framework for the private sector were largely completed by the mid-1990s although the implementation often lagged behind the formal adoption of laws and regulations. From the mid-1990s, the Baltic states exhibited market economies with the role of government in many ways resembling the model seen in Western Europe (OECD 2000; Korhonen, 2001).

The Soviet system of central planning and administration used the official banking system for budgetary control and when this system was abolished an entirely new system of budgeting and fiscal management was needed (Martinez-Vazquez and Boex, 2001). These complicated administrative reforms took place at a time of collapsing output and extreme inflation while numerous other economic and institutional reforms were being implemented (Tanzi and Tsibouris, 2000). The Baltic states, with their clear orientation towards reform, received advice and administrative support from other countries and international organisations, including the World Bank and the IMF.

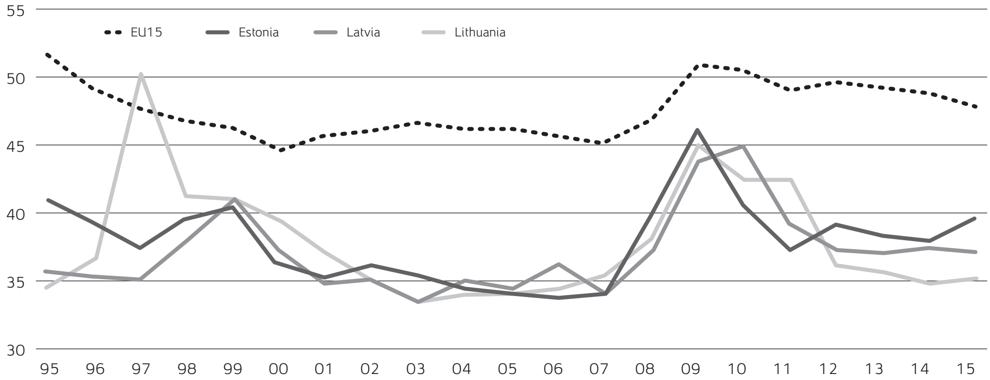
The governments in the Baltic states have a number of features that set them apart from their peers in Western Europe. One key difference is the amount of government spending relative to GDP, often referred to as the size of government. In the early transition phase 1992–1994, government spending in the Baltic states was already around 10 percentage points below the average level in the EU15, the Western European EU countries.[2] This outcome in large part reflects the desire of policy-makers in the Baltic states to limit the scope and size of government as discussed above.

The public sector in the Baltic states has remained at a relatively modest size since the early transition phase. Figure 1 shows the total government spending as a percentage of GDP for

[2] Cheasty and Davis (1996, p. 21) report general government expenditures for 1992, 1993 and 1994 using data from national authorities and IMF staff estimates. The spending amounted to 33.6, 40.6 and 39.9 per cent of GDP in Estonia; 29.0, 35.8 and 41.2 per cent of GDP in Latvia; and 31.3, 33.3 and 29.3 per cent of GDP in Lithuania.

1995–2015 for the three Baltic states and the EU15. The data are for the general government, which includes government entities at all levels, and are consolidated across the entities. The Baltic states have a centralised administration, which implies that the general government data by and large reflect developments at the level of the central government.

Figure 1: General Government Spending in the Baltic States and the EU15, per cent of GDP

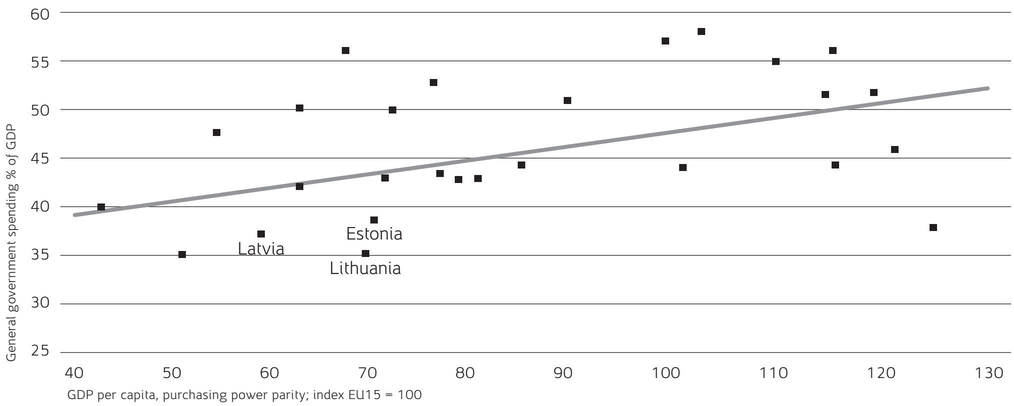


Source: Ameco (2016, code: *UUTG*)

The peak for Lithuania in 1997 was caused by a one-off measure where compensation was given to savers who had lost their savings during the extreme inflation at the beginning of the 1990s. Spending as a percentage of GDP increased markedly in all three countries at the outbreak of the global financial crisis, in large part because of the large declines in GDP, but it declined rapidly as a percentage of GDP after the crisis because of a resurgence in GDP growth combined with spending cuts (Raudla and Kattel, 2013). Towards the end of the sample, spending as a percentage of GDP is lower in Lithuania than in Estonia and Latvia; this is in large part the result of the Lithuanian economy exhibiting higher rates of economic growth after the global financial crisis.

As a rule, government spending as a percentage of GDP tends to be larger in high-income countries than in countries with lower per capita income. This is also the case in the EU. Figure 2 shows the general government spending and the income level in 27 EU countries in 2013–2015, but the overall picture is the same irrespective of the time sample chosen. Government spending as a percentage of GDP is substantially below the linear regression line for the Baltic states; the size of government is smaller in the Baltic states than may be expected given the income level of the countries.

Figure 2: GDP Per Capita and General Government Spending in 27 EU Countries, Averages for 2013–15



Note: Luxembourg is not included.
Source: Author's calculations, Eurostat (2016, codes: *UUTG, HVGDPR*)

The Baltic states differed from other transition countries in that they rapidly reduced the size of government and redefined its scope from the outset of transition. Gupta et al. (2003) argue that the size of government remained excessive in many transition countries while the scope was not made fully compatible with the transpiring market economies. These criticisms are clearly less relevant for the Baltic states.

The overall market-oriented reforms in the Baltic states also implied high-powered economic incentives afforded by government. One area where this is clear was the introduction of flat personal income taxes, which allow a tax-free deduction and taxation of the remaining income at a fixed percentage. Estonia introduced the flat tax system in 1994, followed by Lithuania the same year and Latvia the following year. Flat tax systems may simplify administration and provide incentives for work and enterprise. Staehr (2009) finds, however, from Estonian data that the incentive effects are modest for high-income earners, while low-income earners face a comparatively high tax rate.

The Baltic states inherited basic welfare states, with free or largely free child care, education and health care and with tolerable disability benefits and old-age pension systems. The transition reforms generally retained these provisions of welfare services, in some cases by transferring the services from the workplace to state-run systems. The Baltic states also introduced new systems for unemployment insurance and cash benefits for the needy.

The generosity of the welfare states developed in the early stages of the transition process was relatively modest. Cornelius and Weder (1996) find, for instance, using data for 1994 that the re-distributional effects of the Baltic tax and welfare systems were very limited. Põder and Kerem (2011) find that the Baltic welfare systems are characterised by a high degree of *commodification*, where individuals have the right to payments or services without means testing, but payments or services are limited and offer modest protection.

In conclusion, policymakers in the Baltic states have generally favoured market-oriented policies since the countries regained independence in 1991, with a relatively limited role for government. This is witnessed by a range of policies regarding privatisation, taxation and social policy, and by small governments. The key skeleton of the welfare state has nevertheless been preserved, with largely free education, universal health care, unemployment benefits and state-provided old-age and disability pensions.

3. Public Finances

This section discusses and compares the developments in public finances in the Baltic states with particular emphasis on the two decades from 1995 to 2015. As discussed previously, the early transition was complicated by dramatic output declines as central planning was abolished, trade links were disrupted and inflation reached extreme levels. In one respect, however, the Baltic states set out in a favourable position as there was virtually no government debt in the Baltic states as of 1991. As the legal successor of the Soviet Union, Russia took over essentially all the external assets and liabilities of the Union and this "zero option" meant that the governments of the Baltic states started the transition with virtually no government debt.

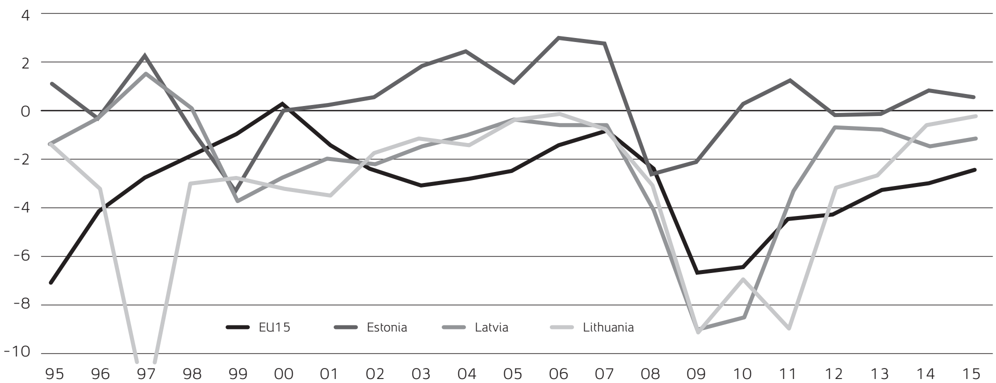
Estonia adopted a prudent fiscal stance from the beginning with a basically balanced budget from 1992. Latvia saw some fiscal slippage in 1994 while Lithuania ran sizeable deficits starting from 1993.[3] These developments are in large part tied to the exchange rate policies of the countries and the development of a market for government bonds.

Estonia introduced its own currency, the *kroon*, in 1992 and tied it to the German mark using a currency board (Staehr, 2015b). A law prohibited the central bank from financing budget deficits and this law was widely, though incorrectly, interpreted as prohibiting budget deficits. Estonia did not establish a market for government bonds and has never done so, and this clearly limits the options for financing budget deficits.

Latvia introduced the *lat* in 1993 and linked the currency to the SDR through a traditional but tightly fixed exchange rate system, and the first government bonds were placed on the market in December 1993. Lithuania introduced its currency, the *litas*, in 1993 and after some instability linked it to the US dollar through a currency board in 1994. The country started issuing government bonds in July 1994 (Martinez-Vazquez and Boex, 2001).

Estonia pursued very cautious or prudent fiscal policies from the beginning of the transition process, while Latvia and Lithuania occasionally had sizeable budget deficits. This broad picture from early transition was still in place at the end of the sample period in 2015. Figure 3 shows the headline budget balance as a percentage of GDP for the three Baltic states and, for reference, the EU15 for 1995–2015.

Figure 3: General Government Fiscal Balance 1995–2015, Per Cent of GDP



Sources: Ameco (2016, code: *UBLG*)

[3] Tanzi and Tsibouris (2000, p. 24) report data on the general government fiscal balance on a cash basis using data from national authorities and IMF staff estimates. The fiscal balance for the years 1992–1994 was -0.2, -0.7 and 1.3 per cent of GDP for Estonia; -0.8, 0.6 and -4.0 per cent of GDP for Latvia; and 0.5, -5.3 and -4.8 per cent of GDP for Lithuania.

In Estonia the fiscal balance oscillated around zero throughout the two decades except in 1999 and 2008–2009 when there were relatively small deficits and in 2003–2007, when there were modest surpluses during the boom. Latvia and Lithuania typically ran budget deficits and immediately after the outbreak of the global financial crisis they had very large deficits. Lithuania exhibited a particularly large deficit in 1997 due to the compensation of savers as mentioned in Section 2.

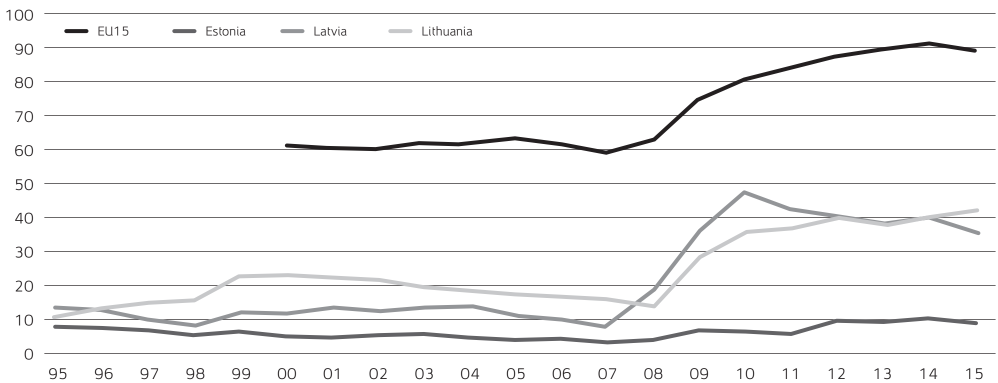
It is reasonable to presume that there was greater prudence in Estonia than in the other Baltic states because of the early currency reform and the absence of a domestic market for government debt, which left the country effectively excluded from international borrowing for a long time. The early establishment of government bond markets in Latvia and Lithuania meant that budget deficits could be financed in these markets and this might have had feedback effects on their fiscal policies.

The Baltic states have unusually strong business cycles (Martin, 2010). The countries experienced a prolonged boom through 2000–2007 and deep recessions with very large output declines following the global financial crisis. It is notable that Latvia and Lithuania had very large deficits immediately after the global financial crisis, while the deficits in Estonia were moderate; see also the discussion in Section 5.

The Baltic states joined the EU in 2004, which affected their public finances in different ways. Membership meant that the countries would receive funding from the common agricultural policy and the cohesion policy and pay various contributions to the EU budget; parts of these flows are accounted for in the general government budget. Membership also meant the Baltic states had to adhere to the Stability and Growth Pact (SGP). The pact underwent changes in 2005 and 2011, but the most notable consequence was that budget deficits had to stay within 3 per cent of GDP except under extraordinary circumstances. The SGP probably had very little impact on the budget policies in the Baltic states, as revenue was plentiful during the pre-crisis boom while Latvia and Lithuania evidently broke the 3 per cent ceiling during the global financial crisis, but so did most other EU countries.

While measures of the annual fiscal balance reveal important information on the fiscal stance at any given time, government gross debt may equally be of importance for fiscal sustainability. Figure 4 shows the consolidated government debt for 1995–2015.

Figure 4: Gross General Government Debt 1995–2015, Per Cent of GDP

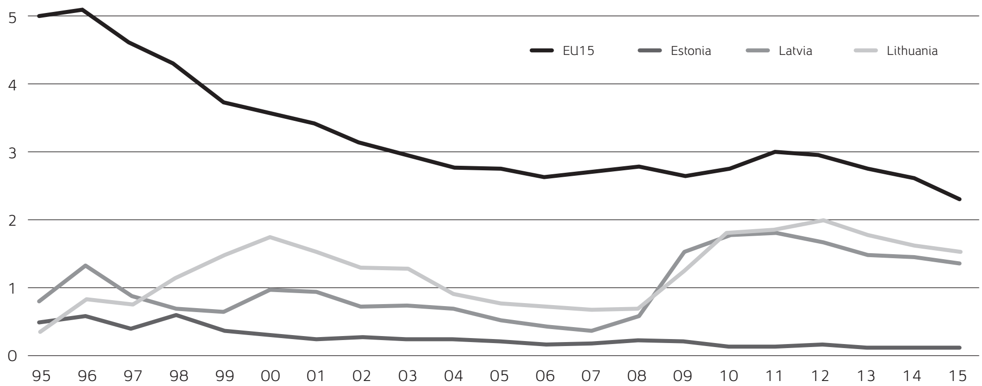


Note: No data available for EU15 1995–99.
Source: Ameco (2016, code: *UDGG*)

Government debt is relatively modest in the Baltic states, particularly in Estonia, which has the lowest debt-to-GDP ratio in the European Union. The large deficits in Latvia and Lithuania after the outbreak of the global financial crisis are clearly visible in their debt-to-GDP ratios. The overall debt ratios are clearly smaller than that of the EU15, and this also applies to Latvia and Lithuania. It should be kept in mind, however, that the Baltic states are small open economies with a historically very volatile macroeconomic environment, and this may limit the ability of the countries to sustain high levels of public debt (Reinhart et al., 2003).

Figure 5 shows the general government interest payments in the Baltic states and the EU15. The interest payments in the EU15 have declined substantially since 1995 but largely because of lower interest rates on debt, associated first with the introduction of the euro and later with the expansionary monetary policy pursued after the outbreak of the global financial crisis. The interest payments in the Baltic states have typically been relatively low compared to those in the EU15, but it is notable that the payments increased markedly in Latvia and Lithuania after the global financial crisis and the substantial increase in government debt.[4]

Figure 5: General Government Interest Payments 1995–2015, Per Cent of GDP



Note: No data available for EU15 1995–99.
Source: Ameco (2016, code: *UYIG*)

In conclusion, the Baltic states have generally pursued prudent fiscal policies since regaining independence. This is particularly pronounced in the case of Estonia, which has generally balanced its budget and has very little government debt. Latvia and Lithuania have pursued somewhat laxer fiscal policies and this was particularly prevalent after the outbreak of the global financial crisis. Fiscal slippages occurred in all three Baltic states during the pre-crisis boom as growth expectations appeared too optimistic.

5. Cyclical Response

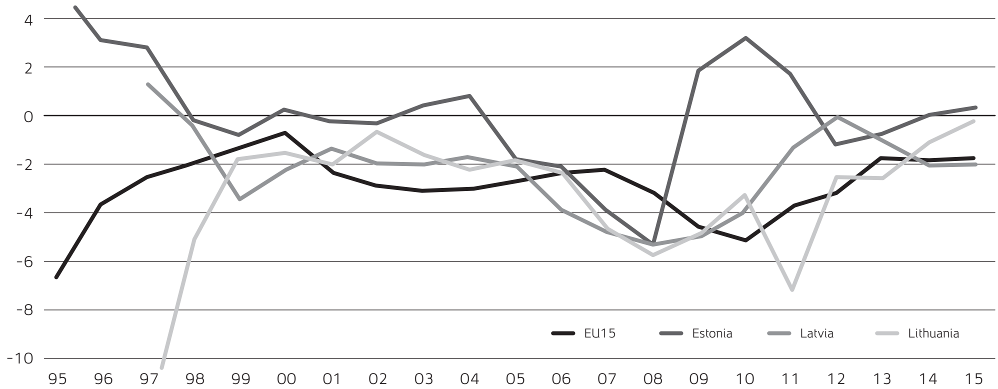
The Baltic states have seen unusually large business cycle fluctuations, as witnessed by downturns in 1999 after the Russian crisis, prolonged booms during the years 2000–2007,

[4] It is notable that whereas the large increase in the debt stock in Latvia and Lithuania brought about a proportional increase in interest payments, a similarly large increase in the debt stock in the EU15 did not lead to any major increase in interest payments, as interest rates on government debt declined rapidly in many EU15 countries.

exceptionally large output losses in 2008–2010, and finally a period of relatively subdued growth (Martin, 2010). The budget balance outcome discussed in Section 3 is, of course, in large part influenced by the business cycle stance in the countries.

The European Commission computes the cyclically adjusted budget balance, where the effect on the budget from the cyclical stance is removed. The effect of the cyclical stance is found by multiplying a measure of the output gap with a semi-elasticity depicting the sensitivity of the budget balance to the output gap. The computations are subject to numerous difficulties but may nevertheless provide a useful means for assessing the underlying fiscal performance (Larch and Turrini, 2009). Figure 6 shows the European Commission's estimates of the cyclically adjusted fiscal balance as a percentage of GDP for the Baltic states and the EU15.

Figure 6: General Government Cyclically Adjusted Fiscal Balance 1995–2015, Per Cent of GDP



Note: No data available for Latvia and Lithuania 1995–96.
Source: Ameco (2016, code: *UBLGAP*)

The most noticeable differences between the headline budget balance and the cyclically adjusted balance are to be seen before and after the outbreak of the global financial crisis in 2008 (Rainer, 2010). During the pre-crisis boom the cyclically adjusted balance deteriorated in all three countries, reflecting the emergence of an increasingly large positive output gap without corresponding improvements in the headline budget balances. Indeed, all three countries implemented discretionary measures, including cuts in tax rates, which led to a deterioration of the underlying or cyclically adjusted fiscal balance.

The performance of the cyclically adjusted balance differs markedly across the three countries after the outbreak of the global financial crisis. As discussed in Subsection 5.2 Estonia tightened fiscal policy considerably in 2009 and this is clearly visible. The cyclically adjusted balances for Latvia and Lithuania were largely unchanged after the outbreak of the global financial crisis, suggesting that the relatively expansionary stance of before the crisis was maintained. The subsequent fiscal consolidation gained speed in Latvia in 2011 and somewhat later in Lithuania.

The deterioration of the cyclically adjusted budget balance in the years 2000-2007 may be interpreted as a sign of fiscal slippage in all three Baltic states during the boom. It should be noted, however, that Figure 4 shows ex post data computed using the output gap that can only be estimated reliably after a delay of several years. Real time computations of the cyclically adjusted budget balance are often very different from those obtained using *ex post* data (Cimadomo, 2016). This was indeed also the case for the Baltic states during the pre-crisis boom, as policymakers based their policies on real time data that showed no or very small positive output gaps, while the ex post data indicate large and increasing positive output gaps (Hansson and Randveer, 2013).

The difference between real time and ex post estimates of the cyclically adjusted fiscal balance was particularly pronounced at the height of the pre-crisis boom. Data from the European Commission's 2008 spring forecast showed the cyclically adjusted budget balance for Estonia to be 1.9 per cent of GDP in 2006 and 1.6 per cent of GDP in 2007 (European Commission 2008, p. 66). The corresponding ex post data from Ameco show the cyclically adjusted balance to be -2.2 per cent of GDP in 2006 and -3.9 per cent of GDP in 2007 (Ameco 2016, code: *UBLGAP*). There are corresponding but less pronounced differences between the real time and the ex post data on the cyclically adjusted balance for Latvia and Lithuania.

It appears that, for various reasons, the fiscal stance has at most been moderately counter-cyclical and even pro-cyclical in periods such as the pre-crisis boom. This conclusion is consistent with the relatively small size of government in the Baltic states, a feature that harks back to the early transition choices of the countries. It is also consistent with studies estimating fiscal reaction functions where the budget balance is explained by persistence, a measure of the cyclical stance and sometimes other variables such as the debt stock or dummies for particular events of particular interest. Staehr (2008) compares fiscal reaction functions for panels of Western European countries and CEE countries and finds less persistence and less counter-cyclicality in the budget balance of the CEE countries than in the Western European countries. This pattern does not seem to be have been affected by the global financial crisis (Baldi and Staehr, 2016).

5. Two Events

5.1. International Assistance to Latvia

The global financial crisis affected the three Baltic states disproportionately, with GDP declining dramatically, unemployment rising and the financial sectors coming under severe strain. Latvia was arguably the worst affected as a large domestically-owned bank encountered financing problems, eventually leading the authorities to nationalise the bank with ominous consequences for public finances.

Parex Bank was a fast-growing and expansionary bank, which financed a large part of its domestic lending through foreign borrowing. The bank found itself no longer able to borrow internationally when liquidity in financial markets dried up in the autumn of 2008, and it stood on the verge of bankruptcy. The Latvian government decided to nationalise and recapitalise the bank to maintain a degree of stability in the financial system. The amounts needed were substantial and the government was not able to borrow such sums from private markets, so instead it requested international financial assistance from the International Monetary Fund (IMF), the EU and neighbouring countries (Åslund and Dombrovskis, 2011).

The Latvian government agreed a loan package in February 2009 with total commitments of 7.5 billion euros. The bulk of the loan commitments came from the IMF and the EU, but the Nordic countries, the Czech Republic, Poland and Estonia also contributed. The loan made it possible to nationalise Parex and avoid excessive fiscal cutbacks in the early stages of the crisis.

The assistance programme was controversial, in part because the Latvian government insisted on retaining the fixed exchange rate of the *lat* against the euro, but also because the programme committed the government to fiscal consolidation at a time when incomes were falling and unemployment rising to unprecedented levels (Blanchard et al., 2013). Although some austerity measures had been implemented from the beginning of 2009, the bulk of the measures were decided in 2009 and came into effect the following year. Taxes were hiked, but most notable was the decision to reduce the government wage bill by 20 per cent. Output stabilised from the middle of 2010 and the economy grew rapidly in 2011 and 2012. Indeed, the Latvian government regained access to commercial credit markets in 2011 and in 2012 it repaid the international assistance loan before time.

The Latvian assistance programme, and in particular the associated fiscal consolidation, has been widely debated. Indeed, Krugman (2013, p. 381) asserts that, "Latvia has become a symbol in the fiscal policy wars". Some see Latvia as vindication that austerity policies and improved competitiveness through an "internal devaluation" can successfully stabilise an economy and rekindle economic growth (Åslund and Dombrovskis, 2011). Krugman (2013) argues that more expansionary policies would have softened the downturn and possibly led to a stronger recovery.[5] Staehr (2013) argues that even if the austerity policy did not preclude a return to economic growth in Latvia, it would have been preferable to have implemented it during the pre-crisis boom. Finally, Blanchard et al. (2013) contend that whereas the austerity policies may have served Latvia well, there may not be many lessons here for other crisis countries since the Latvian crisis was characterised by many factors unique to the country.

Although there may be disagreements about the lessons from the austerity in Latvia, it is uncontroversial to conclude that the developments in Latvia underscored the close interconnection between public finances and financial sector developments. Rapid credit growth may contribute to booming growth and higher tax revenue and hence mask underlying fiscal problems, while problems in the financial sector may slow growth or necessitate bailouts that strain public finances. Latvia is a prime example of these close linkages between the financial sector and public finances.

Although the Latvian crisis was unique in its extent and repercussions, it is notable that the Baltic states have repeatedly faced serious banking sector problems with spill-overs to other parts of the economy (Hansson and Tombak, 1999). Problems in the financial sector can in a short time strain public finances and necessitate sweeping measures. The upshot is that the surveillance and regulation of the financial sector are key requirements for sustainable public finances. This is a challenge that the Baltic states share with most other developed and emerging market economies.

5.2. Fiscal Policy for Joining the Euro

As discussed in Section 3, Estonia has typically pursued a cautious fiscal policy and has essentially balanced its budget annually. The outbreak of the global financial crisis in 2008 evidently challenged this policy, with economic growth of -5.4 per cent in 2008 and -14.7 per cent in 2009. Such a deep recession will typically lead to a marked deterioration of the fiscal balance as revenues decline and social spending increases. Figure 3 in Section 3 shows, however, a modest deficit of 2.2 per cent of GDP in 2009 and a small surplus in 2010. This outcome was the result of an unprecedented tightening of fiscal policy in a crisis situation.

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[5] Győrffya (2015) focuses on the speed with which the reform measures were implemented and sees that as a decisive factor in the recovery of the Latvian economy.

The Baltic states joined the European Union in May 2004, and this meant they were obliged to adopt the euro as soon as possible. Membership of the euro area is predicated on the country satisfying the Maastricht convergence criteria, however. The country must have been in the Exchange Rate Mechanism ERM2 for two years, implying a stable exchange rate against the euro. Budget defects cannot exceed 3 per cent of GDP and the public debt must not be excessive. Finally, interest and inflation rates should be below certain reference values.

It was the objective of all three governments to enter the euro area as soon as possible (Buiter and Sibert, 2006). Estonia and Lithuania joined the ERM2 immediately after becoming EU members while Latvia joined the ERM2 in 2005. The three countries did, however, have problems in meeting one or more of the criteria, and this delayed the adoption of the euro.

Estonia had problems up to 2008 in satisfying the inflation criterion, as a booming economy exerted upward pressure on the inflation rate. In the middle of 2008, it appeared that satisfying the inflation criterion and gaining membership of the euro area was out of reach in the immediate future. This changed when the depth of the crisis became apparent during the second half of 2008. The deep recession would lead to lower inflation as demand declined and unemployment increased.

The Estonian government decided at the end of 2008 to exploit the opportunity afforded by the lower inflation it expected. The complication was of course that although the recession would be expected to lower inflation, it would also lead to a deterioration of public finances and to a violation of the deficit criterion. The government therefore implemented a comprehensive austerity policy from the beginning of 2009. The policy implied tax increases, the diversion of contributions from private pension funds to the public system, expenditure cuts and an extraordinary distribution of dividends from state-owned companies.6 The estimates of the total effect of the austerity policy on the budget balance vary somewhat; Staehr (2010) estimates the effect to be around 6.5 percentage points of GDP.

The bold policy of fiscal austerity was ultimately successful in the sense that the convergence reports published by the European Central Bank and the European Commission in the summer of 2010 asserted that Estonia satisfied all the convergence criteria. This opened the way for membership of the euro area and Estonia adopted the euro in January 2011. The economic impact of the switch from the domestic *kroon* to the euro was probably limited given that the *kroon* was fixed to the euro through a currency board, but the adoption of the euro sent important political signals and also removed a key challenge from the political agenda.

The other Baltic states, which also had problems satisfying the inflation criterion, effectively copied the Estonian policy of fiscal austerity during the period of low inflation following the global financial crisis. Latvia joined the euro area in January 2014 and Lithuania in January 2015.

The fiscal consolidations by the three Baltic states after the global financial crisis were somewhat unorthodox as the induced pro-cyclicality may have aggravated the crisis and brought unwarranted hardship to people (Staehr, 2013).[7] The consolidations, on the other hand, bear witness to the agile and proactive policymaking in the Baltic states that makes it possible to implement austerity policies that seem virtually impossible in other European countries adversely affected after the global financial crisis.[8] Raudla and Kattel (2011) discuss factors that may have

[6] It is notable that a great deal of the adjustment took place in the fourth quarter of 2009 when output had bottomed out and the extraordinary dividends were distributed.

[7] Figari et al. (2015) provide estimates of the distributional effects of fiscal consolidation in the EU countries.

[8] Raudla and Kattel (2013) find that a great deal of the fiscal consolidations in the Baltic states come from the spending side. It is often considered more difficult to gain political support for fiscal consolidations relying on spending cuts than for those relying on tax increases.

made the strict austerity measures politically feasible in Estonia and, by implication, also in Latvia and Lithuania. A key factor is the absence of organised societal players outside the parliamentary system, such as trade unions and grass roots movements.

6. Fiscal Policy Challenges

This paper has considered the fiscal policies and the resulting performance in the Baltic states from 1991 to 2015. It was argued that the developments to a large extent follow from the early transition, where all three countries pursued market-oriented reforms, with Estonia arguably the country most committed to limiting the role of government.

The countries have overall pursued prudent fiscal policies aided by high rates of economic growth and a less generous welfare state than typically seen in Western Europe. There are also key differences, in particular a fairly strict adherence to annually balanced budgets in Estonia while Latvia and Lithuania with a few exceptions have run budget deficits throughout the period considered. Lithuania, and to a lesser extent Latvia, also seem to have pursued more expansionary or counter-cyclical fiscal policies in the period after the global financial crisis. The different fiscal policies have left Latvia and Lithuania with a greater debt as a percentage of GDP than Estonia, although all three Baltic states are among those EU countries with the lowest debt-to-GDP ratios.

When compared with the fiscal performance in most EU countries from Western Europe and also many from Central and Eastern Europe, the Baltic states may be argued to have managed their public finances well during the last 25 years since they regained independence. The relative prudence has left the countries with comparatively small debt stocks and lean public sectors, which should reduce the risk of unsustainable debt dynamics and reduce the adjustment burden in the future. There are, nevertheless, a number of issues or challenges facing the Baltic states which deserve attention.

- The Baltic states are small and vulnerable to external shocks and do not have access to independent monetary policy. The fiscal policy exhibits very modest counter-cyclicality in the Baltic states, and appears in some periods to have been pro-cyclical, suggesting that fiscal policy has not helped to stabilise the business cycle to any major extent. It may be desirable to implement policies that would introduce a higher degree of counter-cyclicality, and at the least avoid a pro-cyclical discretionary policy. A large government with a larger tax intake and more spending might make public finances more counter-cyclical.
- Key challenges for fiscal policy emanate from the financial sector in the Baltic states. The sector might have aggravated business cycles through pro-cyclical lending policies. Worse, banking crises or bankruptcies of individual financial institutions have appeared with worrying regularity in these countries, often straining public finances. An important requirement for fiscal sustainability is therefore the effective surveillance and regulation of the financial sector so that adverse spill-over effects can be reduced as much as possible.
- The experience across Europe after the outbreak of the global financial crisis shows that government access to financing on commercial terms may vanish very fast and for a variety of reasons. The lesson is the importance of prudent and cautious debt management. Government debt must have maturities and currency compositions that limit exposure

to market sentiment. Precautionary financing agreements with financial institutions and international organisations may also contribute to enhanced stability. Finally, the performance of Estonia during the height of the crisis in 2009 shows that ample liquidity reserves may also provide protection against sudden sentiment shifts.

- A largely unresolved issue is whether there would be a way to use fiscal policy more actively in the pursuit of longer-term economic growth in the Baltic states. Gray et al. (2007) discuss a number of options for realigning fiscal policy with development goals such as economic growth and social development. Staehr (2015a) raises the question of whether the Baltic states have become caught in a middle income trap with low rates of economic growth after the global financial crisis. Investment in infrastructure, education, business development and social welfare might be ways to restart economic growth but these investments will in all likelihood require increased public spending.
- The European Union imposes a complex and evolving regulatory framework that seeks to ensure prudent fiscal policy-making in the individual EU countries. The Stability and Growth Pact has been revised several times, and the Macroeconomic Imbalance Procedure, the Fiscal Compact and other measures have been introduced since the global financial crisis. The Fiscal Compact makes the cyclically adjusted fiscal balance a key short-term policy objective and obliges countries to establish fiscal councils to monitor their fiscal performance (Kukk and Staehr, 2015). These measures may help buttress fiscal prudence, but it is crucial that countries take "ownership" of the regulatory framework and do not seek to circumvent or side-step the measures. These concerns are clearly also of relevance for the Baltic states.
- The list of challenges facing fiscal policy-making could arguably be extended. Moreover, while the challenges are in some respects smaller in the Baltic states than in many other EU countries, it may be argued that more is at stake in the Baltic states due to their economic and geopolitical vulnerabilities. It is safe to conclude that the management of public finances and devising of fiscal frameworks will remain key issues in policymaking in the Baltic states in years to come.

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