The levels of public deficits in new member States are more worrying than it looks but a tax rate increase is no solution—the case of Slovakia

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Deficit spending has become the prevailing rule in the European Union in 2009. While 8 countries operated with surplus in 2008, there was none in 2009 and more than 16 countries generated deficit exceeding 5% of their GDP. Slovak republic is not exception to that rule, though, with relatively low debt of 35.4% GDP, it does not attract as much attention as countries around the Mediterranean Sea or Ireland. Nevertheless, the 7.9% deficit of Slovak public finance system in 2009 is instructive for other reasons.

The economic growth has been there one of the strongest in the EU over the period 2004-2008 and growth came with soaring tax revenues. This growth itself was the by-product of several important reforms, especially the tax reform. It was based on real investments, not on speculation on real estate markets or inflated construction sector. Hence, the government was in a position to relatively easily fulfil the criteria for the introduction of the euro.

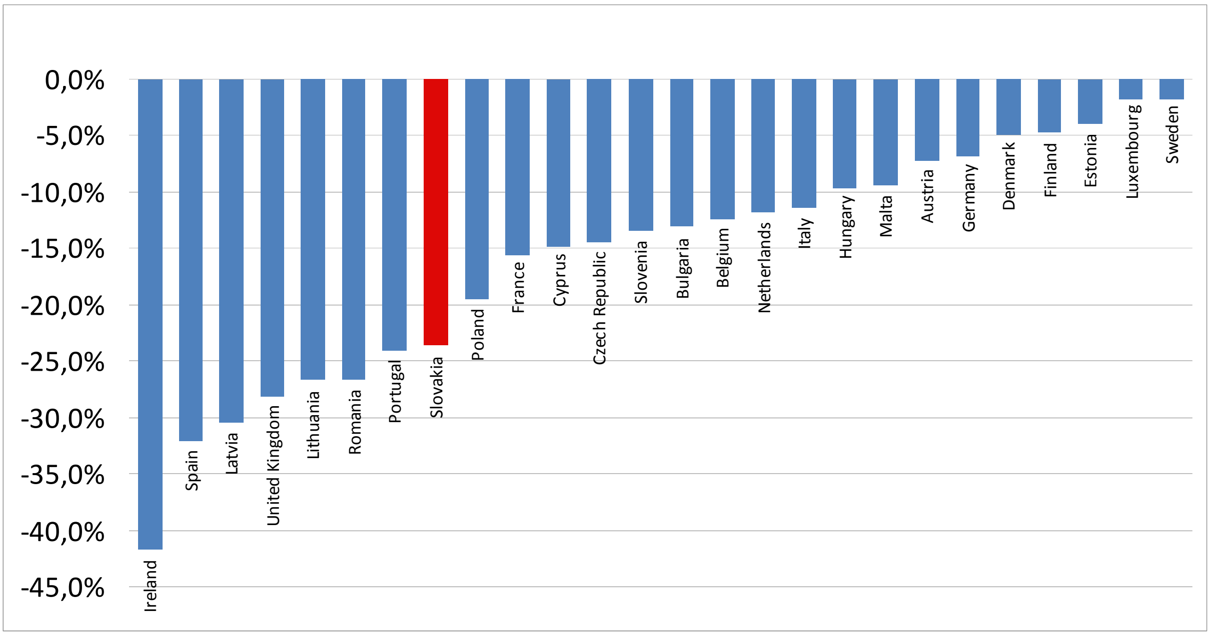
These facts prompt a question: how is that possible that such strong growth of economy and tax revenues can turn so quickly into gigantic public deficit even though Slovak government didn't need to spend a cent to rescue financial sector?

A good understanding of the situation prior to 2009 is helpful to address that question and point to the most desirable fiscal policy for the immediate future.

Gigantic deficit

The ratio of public deficit to GDP might be good enough for some international comparisons, but it does not convey very meaningful information. Not only is it dependent on the evolution of GDP (which in good times diminishes the size and impact of deficits); it also does not say much about the ability of government to deal with deficits. For this reason it is preferable to refer to the share of deficit to total government revenues that better describes the state of public finances.

Chart 1: Public deficit to total government revenues ratio, 2009



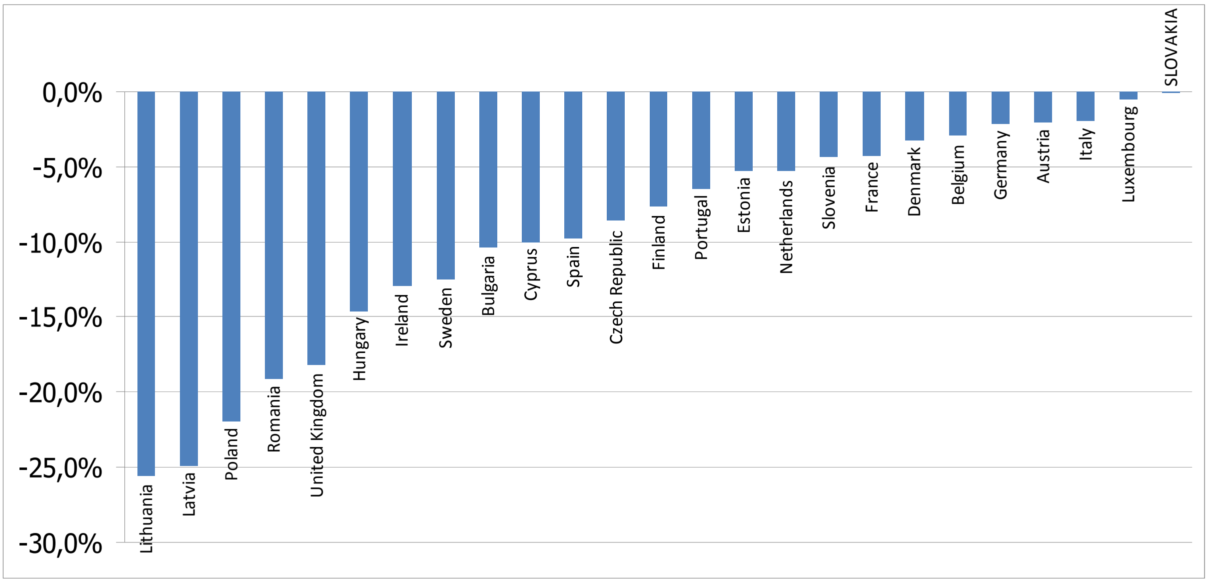
Source: Eurostat database

Simply said, this ratio shows that, if Slovakia wishes to balance its budget, the public sector would have to either raise its income by 23% or to substantially decrease expenditures. In both cases the target is just too much and this justifies that the deficit be seen as gigantic. In fact, the situation is even worse, when revenues from the European Union budget are discounted, since such revenues cannot be raised or influenced by national governments. Among new member countries these European funds represent from 4% to as much as 20% of total revenues (in comparison, the non-weighted average for old member states is 1.9%,). Discounting for EU funds, the above mentioned ratio would worsen to 25%[1] in the case of Slovakia.

Some might object that, typically, the decrease of economic performance hits negatively the revenues of public sector and therefore that the deficits are simply the results of lower tax revenues. But this does not describe the Slovakian reality. Yes, in 2009 the drop of GDP in Slovakia exceeded EU average and reached 4.9%, but interestingly the Slovak public sector has been the only one that didn't suffer a fall in public revenues as the following chart shows[2] (and this stabilization of public revenues was obtained without any significant income from privatization):

[1] For Lithuania, the ratio would increase from 26.6% to 33.1%.
[2] Malta has been excluded from the chart to achieve higher transparency of data (the drop in revenues reached 56%). For the same reason, Malta has been excluded also from other charts.

Chart 2: Drop in total government revenues without EU funds in 2008-2009



that allows them to withdraw from needed structural reforms and from debate on relevance of specific public expenses.

A statement often surfaces from media reports according to which the costs of deficit reduction should be split between public sector and taxpayers in a 2:1 ratio or something similar. Usual argument to support such division is the need to treat the deficit as soon as possible, so that the debt burden of future generations will not be that high. And increased tax rates are precisely expected to speed up that adjustment. This is the taxpayers part. But, assuming that treating the deficit solely through spending cuts would take longer by a third, what would be the consequences? Would public debt grow too fast? Probably not in the case of Slovakia that has public debt at 35% of GDP and current debt service below 5%[4] of total government revenues.[5] Despite this, the government uses the Greek scenario as a threat to justify tax raises. But the unseen is again forgotten: the negative consequences of any tax increase. Taking those other effects into account, the question then becomes whether it is worth paying for earlier 3% public deficit with slower economic recovery or higher price level?

Naturally, this is not to mean that any public deficit is acceptable. But the obsession with cutting deficits is dangerous where it leads to overall increase of tax load *and most importantly sustained increase of share of government spending*.

[4] It is worth to mention, that membership in monetary union helps to hide the seriousness of fiscal problems for small and less developed economies, as the government can borrow for lower rates than it would with its own currency.

[5] The demand for new Slovak bonds during the year 2009 – the year of fiscal irresponsibility - significantly exceeded supply, and the premium paid by Slovak taxpayer belonged to lowest among CEE countries.