



## The Eurozone Enlargement: The New Member States and Fiscal Policy

Georgi Angelov

- ***Prudent fiscal policy is a basic requirement of the Stability and Growth Pact and the Maastricht criteria;***
- ***NMS have relatively low government debts levels with Estonia and Bulgaria clear leaders. The two countries are also best in long-term fiscal policy in the region;***
- ***Most NMS are under excessive deficit procedure and some have programs with IMF;***
- ***The acceptance of Estonia into the Eurozone in 2010 is a natural result from the fiscal stability, but Bulgaria missed the opportunity to enter ERMII despite good long-term fiscal credentials.***

Prudent fiscal policy is a basic requirement of the Stability and Growth Pact, because without it the Eurozone stability cannot last long. The fiscal problems of Greece just confirmed this understanding. The fiscal policy is also among the most important of the Maastricht criteria for adopting the euro. This provides grounds to turn our attention to the budgets of the new member states of the EU, especially those which are still not members of the Eurozone.

The Stability and Growth Pact sets two limitations on fiscal policy:

- The annual budget deficit should be lower than 3% of GDP;
- The government debt should be under 60% of GDP.

In case of breaching any of the above requirements, the European Commission starts excessive deficit procedures against the given country. The goal is to urge the country to correct the situation and penalties can be imposed.

The Maastricht criteria, which should be met in order for a member state to join the Eurozone are five:

- Budget deficit no higher than 3% of GDP;
- Government debt no higher than 60% of GDP;
- The long term interest rates on the public debt should not exceed with more than 2 percentage points the rate in the three EU countries with best price stability;
- Price stability;
- Stability of the national currency exchange rate.

In practice, the first two criteria of Maastricht are the same fiscal requirements as those of the Stability and Growth Pact.

The third criterion – about the long term interest rate on the government debt – is to a large extent related to the fiscal policy, e.g. more prudent fiscal policy brings about lower interest rates and vice versa.

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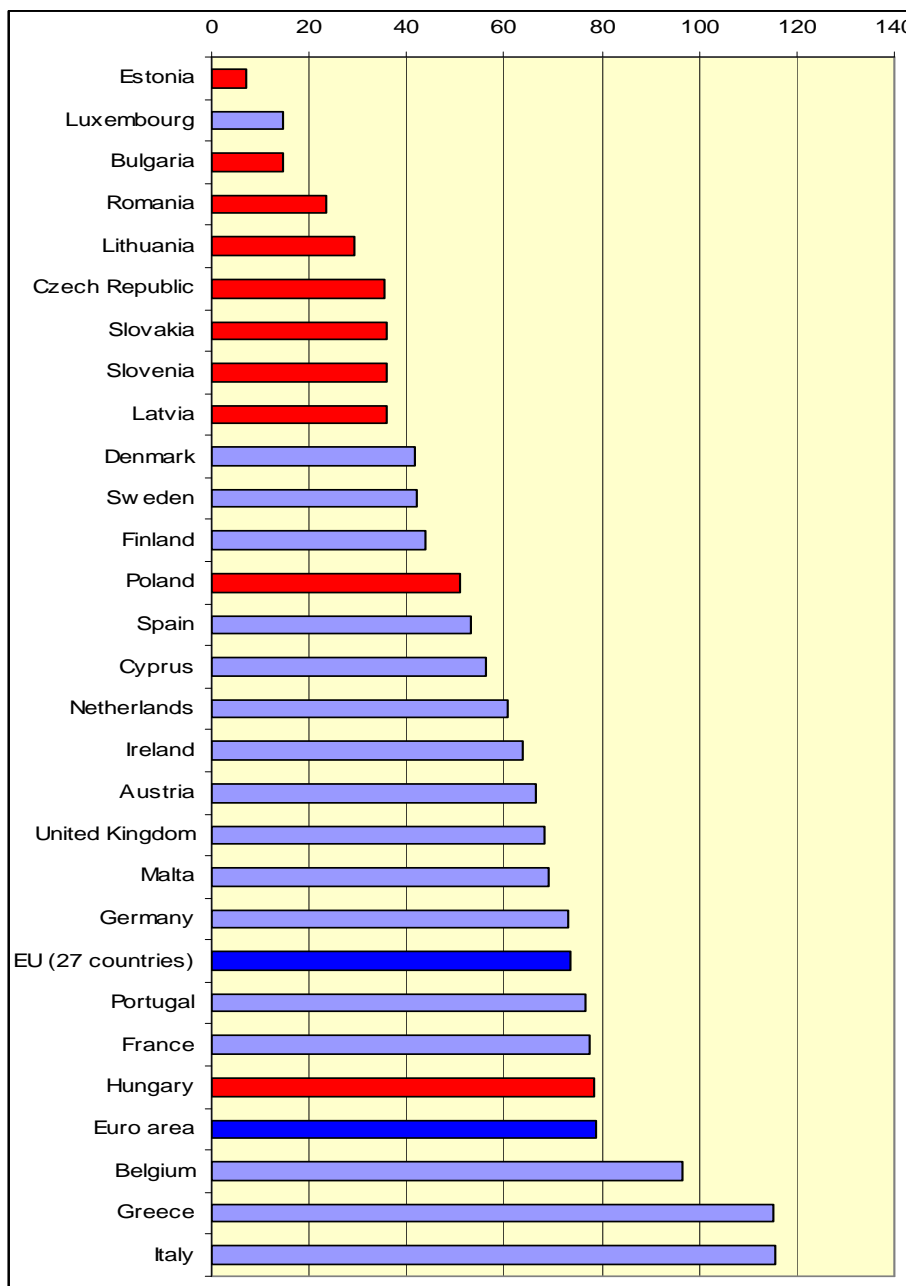
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**Government debt in the new member states**

The new member states take the first places in the ranking of countries with relatively low levels of government debts. Of the ten countries with lowest debt in the EU, eight are new member states. Estonia, Luxemburg and Bulgaria have the lowest level of public debt among all EU member states and **Estonia and Bulgaria are the leaders** among the new member states.

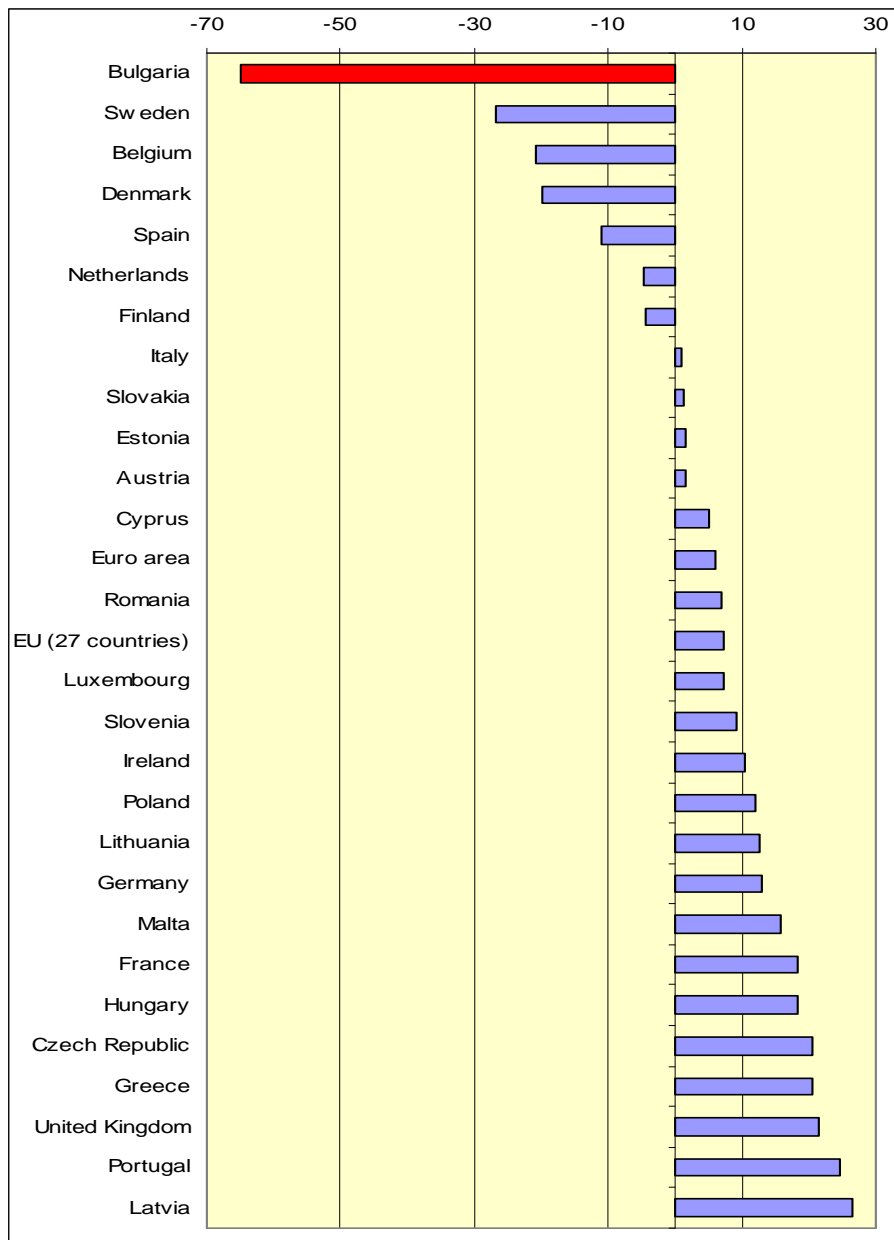
**Government Debt, % of GDP, 2009 (Eurostat data)**



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In relation to the debt position, Bulgaria is once again the uncontested leader with the biggest decrease of the government debt – since 1998 the debt has diminished by nearly 70% of GDP. This is a particularly significant achievement having in mind that most of the countries in the EU have increased their public debts for the same period. Bulgaria is a testimony that a country with a huge government debt can just in a decade transform itself into a country with a low debt. If one is looking for a good example to apply in Greece, the model is not in Western Europe but in neighboring Bulgaria.

**Change in debt position, % of GDP, 1998-2009 (Eurostat data)**

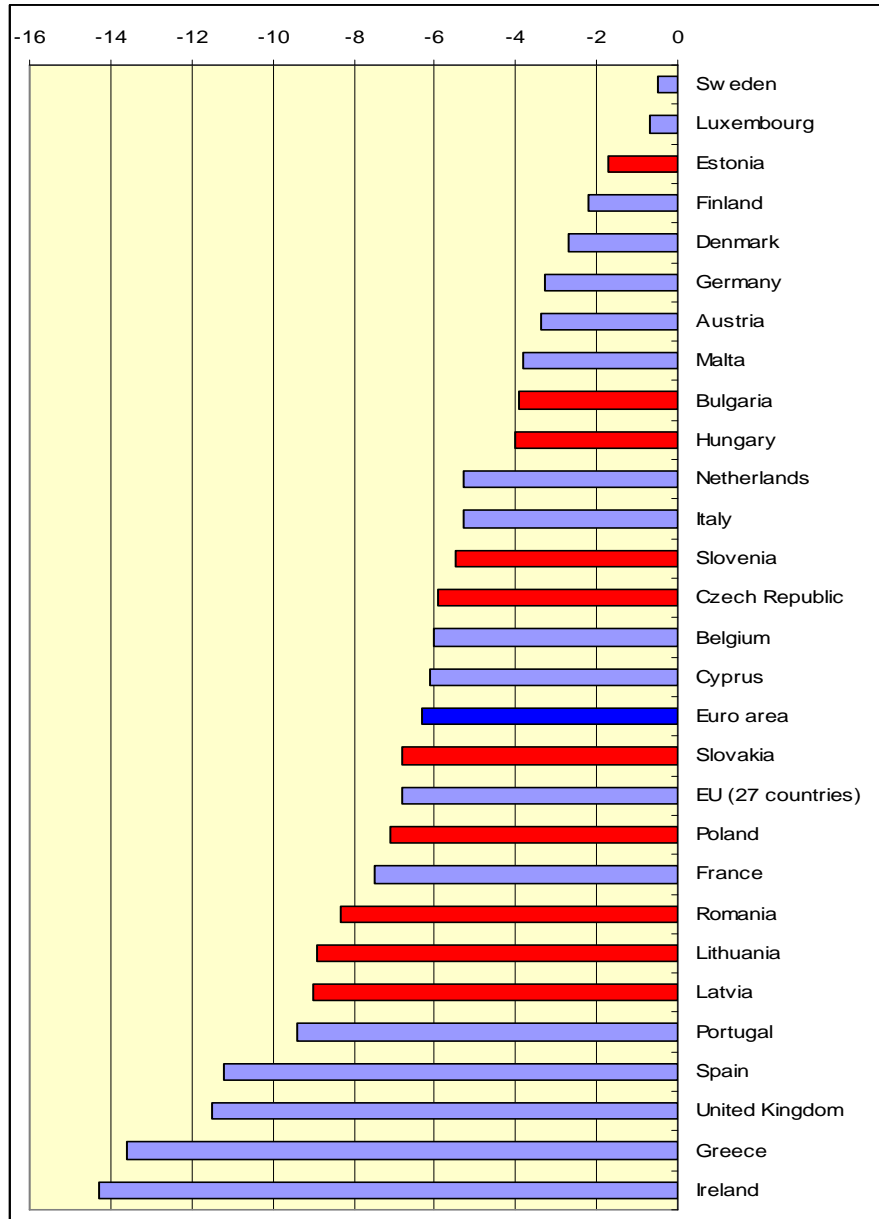


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**Budget deficit in the new member states**

In regard to the budget deficit the situation in 2009 is more diverse - half of the ten new member states have a deficit lower than those of the Eurozone average and the other half have a higher than average deficit. **Estonia has the lowest deficit among the new member states** and is holding the third place in the entire EU. The next after Estonia among the new member states is **Bulgaria and after that Hungary**. Only Estonia meets the deficit requirement for a deficit under 3% of GDP.

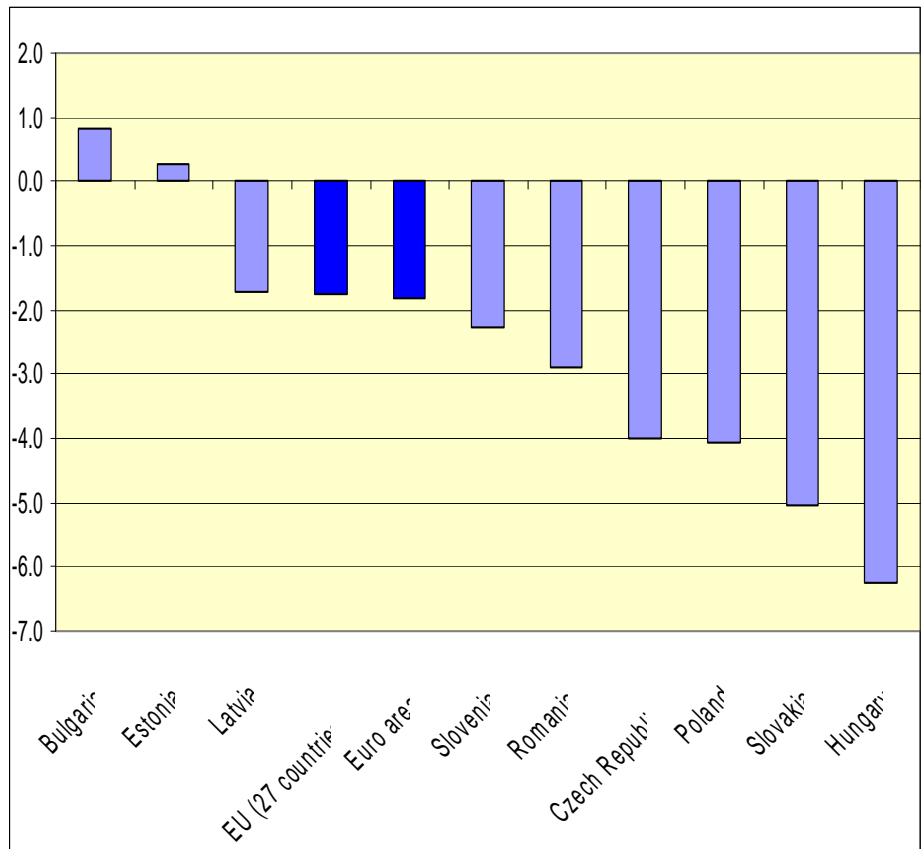
**Budget deficit, % of GDP, 2009 (Eurostat data)**



*Estonia has the lowest deficit among the new member states and is holding the third place in the entire EU. The next after Estonia among the new member states is Bulgaria and after that Hungary.*

As 2009 is influenced by the crisis, we may look into a longer term perspective at the budget deficit in the new member states. The **absolute winners in Eastern Europe are Bulgaria and Estonia**, which have had systematic budget surpluses. The other countries in the region do not have any significant achievements – in most countries the budget deficits are higher than those in the Eurozone. Hungary has the worst fiscal record with an average budget deficit of over 6% in the period 1998-2008.

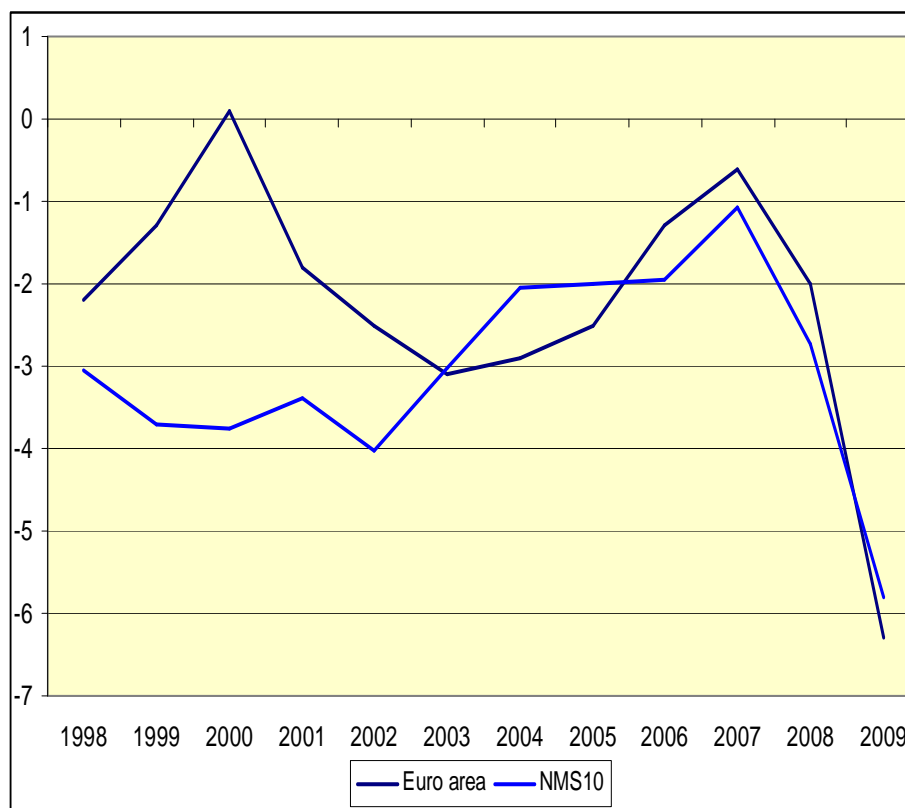
**Budget deficit, average for 1998-2008, % of GDP**



*Until 2003, the new member states (which at the time were still EU candidates) have had constant and substantially higher deficits than the Eurozone members. Since 2003 however, the deficits have synchronized and move into one direction – the improvement in the 2003-2007 period and the deterioration in the 2008-2009 period.*

The development of deficits, however, changes over time. Until 2003, the new member states (which at the time were still EU candidates) have had constant and substantially higher deficits than the Eurozone members. Since 2003 however, the deficits have synchronized and move into one direction – the improvement in the 2003-2007 period and the deterioration in the 2008-2009 period.

**Budget deficit: Euro area vs. NMS-10**



**The excessive deficit procedure and the agreements with the IMF in the new member states**

Estonia is the only country among the new member states against which there has never been opened an excessive deficit procedure. There is only one other such country in the entire EU – Sweden.

Hungary has been in an excessive deficit procedure since 2004 and most of the other new member states entered in such procedures in 2009. Bulgaria was the last to enter the excessive deficit procedure in July 2010 because of the unexpectedly high deficit of 3.9% of GDP in 2009 and 3.8% in 2010. Bulgaria has been given the shortest time limit – one year – to remove the excessive deficit while most of the other new member states have about three or four years to cope with the problem.

From the very start of the crisis – the winter of 2008 – Hungary, Romania and Latvia concluded agreements with the IMF and the European Commission. Poland concluded a “flexible” agreement with the IMF in 2009. In contrast to Greece and the other countries of the Eurozone, the new member states do not have particular problems in working with the IMF. On the opposite, they have long and successful traditions of relations with the IMF. However, until the IMF programs and excessive deficit procedures are ended, there is little chance of any of the countries to enter the ERMII or the Eurozone.

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**The fortunes of the leaders: Estonia and Bulgaria**

Concerning the fiscal indicators, Bulgaria and Estonia are the undisputable leaders in the region. They have the lowest government debt among the new member states; they are the only two countries, which have systematic budget surpluses; and they have the lowest deficits even in the crisis of 2009 and Bulgaria holds the record of highest reduction of the government debt.

From that point of view, **the acceptance of Estonia into the Eurozone in 2010 is a natural result** from the long term fiscal stability of the country, supported also by measures for budget stability in the crisis years in 2009-2010. The Estonian government made epochal efforts and reduced the budget deficit in 2009 by almost 10% of GDP in just one year. Without the fiscal measures, Estonia would have had double-digit budget deficit in 2009, while at the end of the year the registered deficit was only 1.7% of GDP

Looking at the long term fiscal policy, it would be natural to expect Bulgaria also to enter the ERMII (the so-called waiting room of the Eurozone) in 2010. Unfortunately however, the ERMII entry will not happen because the Bulgarian government exactly in 2010 made a series of decisions, which significantly increased the budget deficit. Thus, instead of achieving a balanced budget as planned, the government already aims at a deficit of 3.8% of GDP for 2010. This is the reason why the EC started an excessive budget deficit procedure against Bulgaria – and in the current situation it is much less likely for a country with an opened excessive budget deficit procedure to be accepted in the ERMII. **Bulgaria did not manage to capitalize on its long term fiscal prudence because of a brief moment of weakness in its 2010 budget policy.**

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The European Policy Initiative (EuPI) aims at stimulating and assisting new Member States from CEE to develop capacity for constructive co-authorship of common European policies at both government and civil society level. As a new priority area of the European Policies and Civic Participation Program of Open Society Institute – Sofia, EuPI will contribute to improving the capacity of new Member States to effectively impact common European policies through quality research, policy recommendations, networking and advocacy. The initiative operates in the ten new Member States from CEE through a network of experts and policy institutes.

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