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Agnieszka Alińska

University SGH in Warsaw
Collegium of Socio-Economics
e-mail: aalin@sgh.waw.pl
phone: 22 564 86 76

Fiscal Sustainability and Financial Stability – Challenges and Experiences during a Time of Financial Crisis*

Abstract. *The public finance sector is an element of the economic system which increasingly feels the negative impact of the current financial crisis and has been paying dearly for it. Therefore, developing and implementing an appropriate strategy in the field of fiscal policy, and preserving the stability of the public finance system becomes a challenge for many governments and public institutions in the whole world. The purpose of this article is to present the substance, role, and importance of fiscal sustainability and financial stability in a changing financial and economic environment due to the financial crisis. The author attempts to prove that in the post-crisis reality fiscal sustainability is one of the elements of financial stability, which in turn is the basis for long-term economic growth and obtaining social benefits. Policy makers and representatives of the public should, first and foremost, strive to maintain financial stability, including financial stability in the public sector.*

Keywords: *public finance, fiscal sustainability, financial crisis*

Introduction

In times of crisis, due to market consequences, an increasing role in the financial and economic system is attributed to public institutions and assessment in the area of public finance. The public finance sector is one of the elements of the economic system which increasingly feels the negative impact of the financial crisis;

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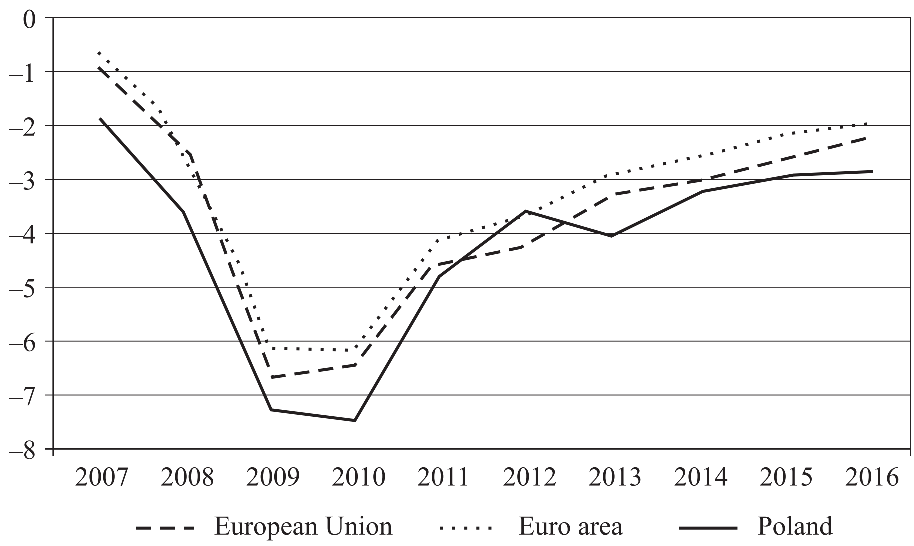
it has become the sector that has paid most dearly for the current crisis. Therefore, developing and implementing appropriate strategies in the field of fiscal policy and preserving the stability of the public financial system becomes a challenge for many governments and public institutions all around the world. Experiences drawn on from the global financial crisis show that the stability of the public financie system requires the use of appropriate instruments within the framework of fiscal policy including, in particular, the observance of the fiscal rules adopted at the European and national levels. These types of behaviours are the basis, not only for obtaining positive results in the state of public finance, but above all, for achieving optimal values, desired behaviours, and the development of entities from the field of the real economy. This, in turn, leads to improved living conditions for society, positive economic growth, and maintaining long-term stability of the market financial system as well.

The purpose of this article is to present the substance, role, and importance of fiscal sustainability and financial stability in a changing financial and economic environment due to the financial crisis. The author attempts to prove that in the post-crisis reality, fiscal sustainability is one of the elements of financial stability which, in turn, is the basis for long-term economic growth and obtaining social benefits. Policy makers and public authorities should, first and foremost, strive to maintain financial stability, including financial stability in the public sector. The presentation of issues related to financial stability is the basis for obtaining positive effects in the sphere of the real economy, and especially for achieving inclusive growth, and thus, will contribute to obtaining positive effects in terms of fiscal sustainability.

1. Assessment of the situation in the Polish public finance sector in comparison to the EU

The state of public finance is reflected primarily in the level of budgetary deficit and public debt of the general government sector [cf. Alińska 2016b; Kosycarz 2015]. Poland is one of a few European Union states which takes effective measures to keep the budget deficit below 3% of its GDP. Since 2012, in comparison to other EU countries and the Eurozone, Poland has generated a budget deficit value which is above average. At the end of 2015, the value of the budget deficit amounted to 3.0% in Poland and the Euro area countries averaged 2.17%. However, in the last decade, periods can be seen where the general government sector deficit was far in excess of the reference value (3% of GDP). In this situation, the European Commission introduced the excessive deficit procedure. Poland was covered by this deficit program from 2004 to 2007, and from 2009 to 2015.

Chart 1. The general government balance as a % of GDP between 2007-2015 and a projection for 2016 (ESA 2010)



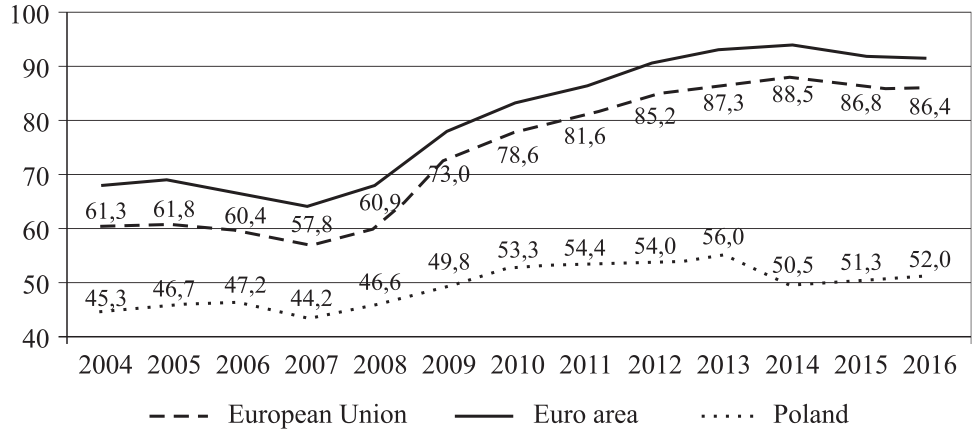
Source: European Commission, http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm [access: 10.10.2016].

Analysis of public debt in Poland compared to the EU and the euro area indicates that Poland meets the values set out in the Maastricht criteria (60% of GDP). Taking care of the sustainability of public finances, Poland introduced several provisions limiting the value of public debt. E.g. a provision on the maximum level of public debt is already in the Constitution, Art. 216(5), as well as, other fiscal rules which involve numerous financial consequences if not followed [Alińska & Kosycarz in press].

Since the economic crisis, public debt has continued to increase, both nominally and in relation to the GDP. In 2014, a significant decrease in the public debt in Poland resulted from a one-time shift of assets from open pension funds to the Social Insurance Institution (ZUS). This was not associated with any changes in fiscal policy, but only with a sovereign decision of the government. Existing debt affects the amount of current flows required to service it and, therefore, may be important for the ability of the country to fulfil its obligations within the scope of satisfying its liabilities, as well as, it may determine the ability to incur new liabilities. The size of the debt also affects the perception of the credibility of a given country by investors. A country that has a low cost of issuing new debt may borrow with greater ease and lower costs than a country for which the marginal cost of debt is higher.

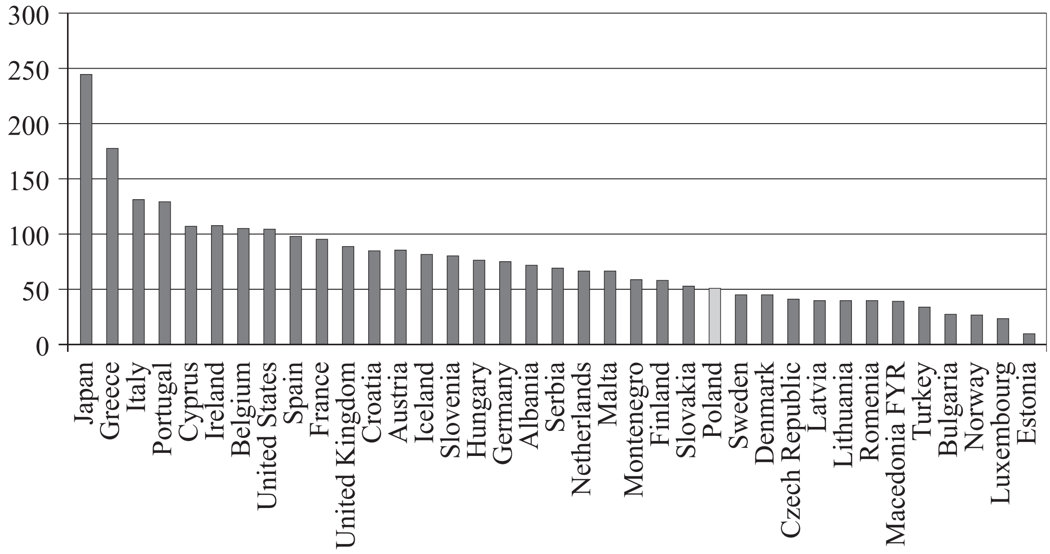
Compared to other EU countries, Poland shows a relatively low level of public debt, which results mainly from strict legislation in the public sector, the eco-

Chart 2. General government debt as a % of GDP (ESA 2010)



Source: European Commission, http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm [access: 10.10.2016].

Chart 3. Consolidated gross debt for general governments in 2014 (ESA 2010)

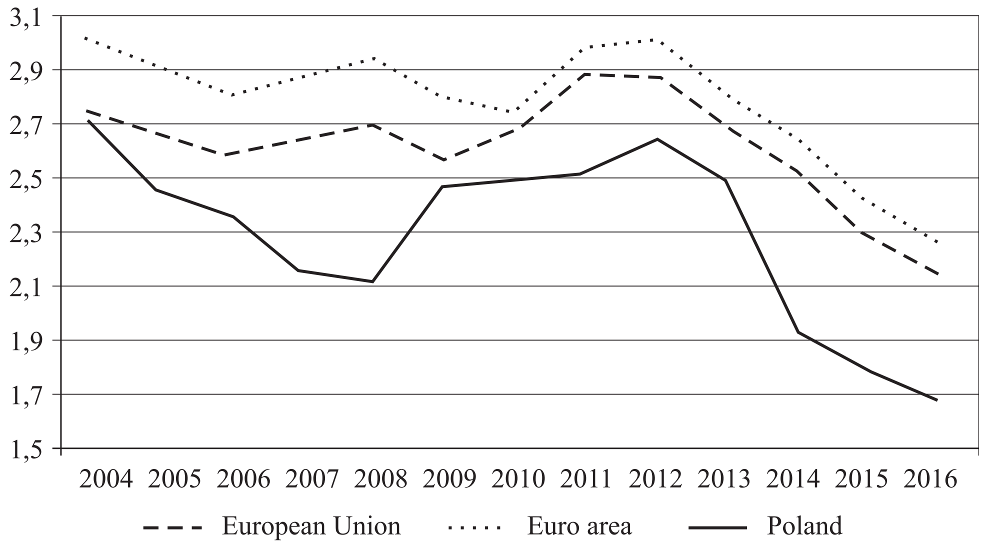


Source: European Commission, http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm [access: 10.10.2016].

nomic policy of the country, and the impact of the financial crisis on the state of the real economy.

In most of the countries studied the main problem in the effective implementation of fiscal policy are not problems with balancing the budget, but the need to incur expenses related to debt servicing. In recent years, the costs of public debt

Chart 4. General government interest as a % of GDP (ESA 2010)



Source: European Commission, http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm [access: 10.10.2016].

servicing have been the highest in Hungary (4.6% of GDP in 2013, and 4.1% of GDP in 2014).

In summary, the assessment of the situation in the public finance sector in Poland compared to other EU countries and the Euro Area indicates that the financial and economic crisis, which most European countries face, has not affected the public sector in Poland to a significant degree. Both the value of the budget deficit and the public debt remain at safe levels. Convergence criteria from the Maastricht may serve as an example of international rules, specifying the maximum size of the public finances deficit in EU Member States at 3% of the GDP, and public debt at 60% of the GDP. While Polish examples of national fiscal rules include the following: the public debt limit (from Art. 216 sec. 5 of the Constitution of the Republic of Poland), set at the level of 3/5 of the annual GDP, or also the so-called prudence limits (from Art. 86 of the Public Finance Act), obliging government and local government authorities to take specific and diverse recovery actions in situations of exceeding certain levels of association between the state public debt in relation to the GDP, i.e. prudence limits of 55% and 60% of the GDP. Non-standard restrictions introduced in the form of national fiscal rules have a large part in this area of management of the public funds. Usually a fiscal rule is expressed as the maximum level of a numerical index or the target or desired value, expressed in relation to GDP or in nominal value. The fiscal rule can also apply to procedures of creating a budget or a certain model, best practices, or regulations for increasing the transparency and predictability of fiscal policy

[Próchnicki 2013: 30; Schaechter, Kinda, Budina & Weber 2012: 5]. In praxis, on the subject there are four main types of fiscal rules: (I) the debt rule, (II) the budget balance rule, (III) the expenditure rule, and (IV) the revenue rule [Marchewka-Bartkowiak 2010: 4-6].

The specificity of the public financial system lies also in the fact that in contrast to the market system it is subject to parliamentary (social) scrutiny. Budgetary procedures, fiscal rules, and instruments of fiscal policy are discussed, evaluated, and implemented by the Sejm, as the supreme body of state control. Therefore, the analysis of issues related to the maintenance of the stability of the public finance system should be carried out in terms of:

– regulatory issues,
– economic and financial issues.

In terms of regulatory issues, attention should be drawn to two essential aspects of the issues at stake:

– regulations at the EU level, which are required to be implemented within the Polish legal system,
– national regulations.

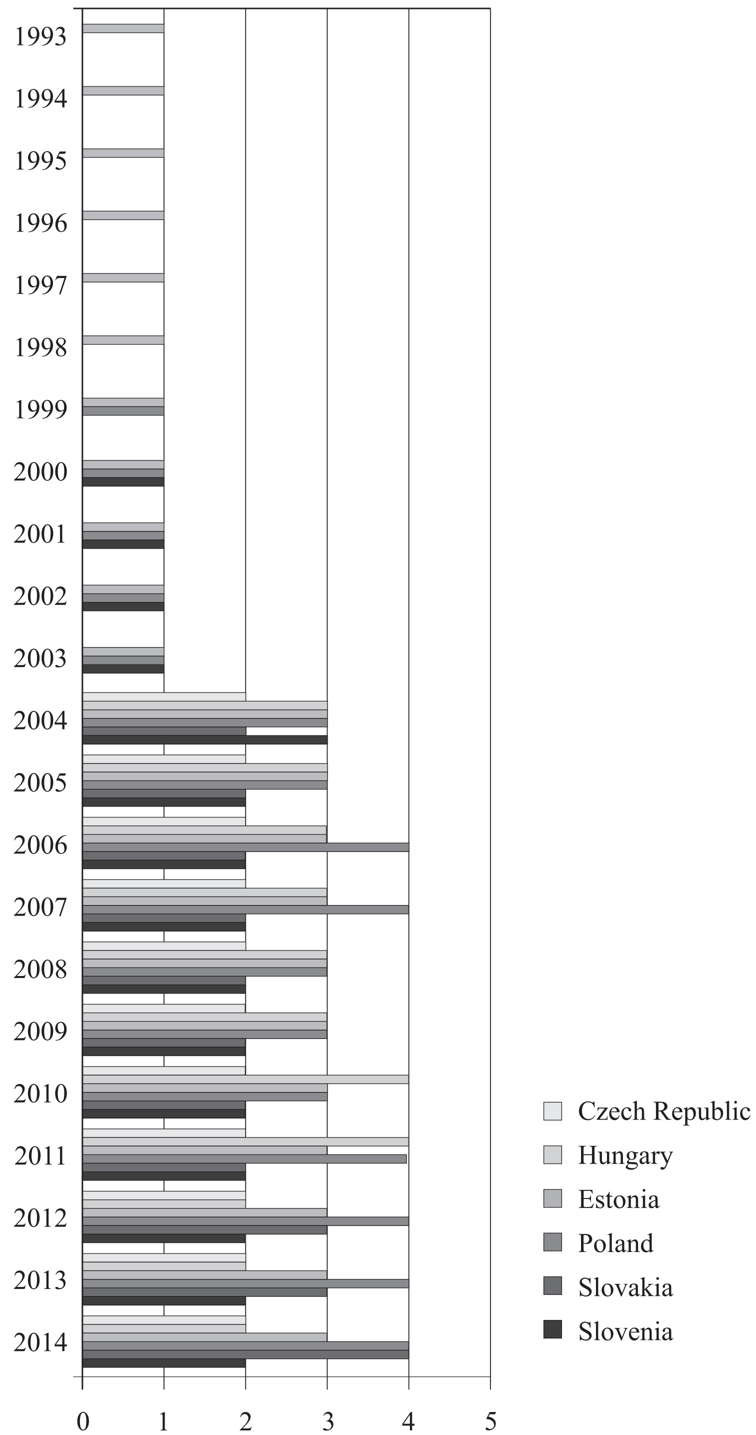
Among the European legal framework of the EU relating to the public finance sector, in terms of relevance of the introduced solutions these deserve special mention:

– six-pack (2011), consisting of five Regulations and one Directive, the aim of which was to introduce greater macroeconomic surveillance,
– two-pack (2013), consisting of two Regulations, the aim of which was to further strengthen macroeconomic surveillance [Dziemianowicz & Kargol-Wasiluk 2015: 154].

At the national level, regulatory solutions for the management of public funds have been defined in the highest legal act which is the Constitution of the Republic of Poland [Art. 216(5)], as well as, in the Public Finance Act and other extraordinance regulations, such as fiscal rules. Poland belongs to countries in which the number and scope of fiscal rules are one of the largest. Generally, in the early 90s there were only 13 fiscal rules in force across the EU. In 2010, the entire EU had 70 numerical fiscal rules, and the countries of Central and Eastern Europe had 16. Among the countries of Central and Eastern Europe, at the end of 2014, the most advanced framework disciplining fiscal policy was in force in Poland and Slovakia.

It should be noted that on one hand, fiscal rules protect against uncontrolled formation of the deficit and public debt, but on the other hand however, their excessive number and stringency may result in restrictions on the conduct of fiscal policy in a changing and unstable socio-economic environment, including times of economic crises. This is why fiscal rules in the financial or economic system should be used with caution during a period of turbulence, and during a downturn,

Chart 5. The number of numerical fiscal rules in selected countries of Central and Eastern Europe between 1993-2014



Source: author's own study based on data from www.imf.org/external/datamapper/FiscalRules/map/map.htm [access: 23.05.2016].

solutions of this type are often referred to as sub-optimal. Fiscal policies that are too restrictive, aimed at fiscal consolidation, may result in a reduction in economic growth and a decline in GDP. As a result of the persistence of such a situation, the opposite effect can be achieved, i.e. an increase in the debt to GDP ratio in the long term.

2. Fiscal sustainability versus financial stability in the public sector

Measures taken by institutions in the public finance sector, in terms of maintaining the stability of the financial system, must be considered in both a narrow and broad sense [Alińska 2016a].

In a narrow sense, the stability of the public finance system is identified as activities focused on the conduct of fiscal sustainability. The result of such activities is the maintenance of the budget deficit and public debt at a level lower than the one required in the Maastricht criteria. This means that the concept of fiscal sustainability is closely linked to fiscal policy (generating a budget surplus or deficit), and the value and/or the dynamics of public debt. In literature, there are usually three approaches to distinguish fiscal sustainability: in the first approach, fiscal balance is related to solvency (i.e. the ability to service current debt);according to the second approach, sustainable fiscal policy provides an adequate (required) ratio of debt to GDP; the third approach takes into account both the solvency and the limiting of public debt growth [Krejdl 2006; Keliuotytė-Staniulėnienė 2015].

More broadly, the stability of the public financial system refers to the activities in the long, multi-faceted term, serving not only the assessment of the state of finances in the public sector, but also assessing their impact on social behaviour and the state of the real economy. According to the International Federation of Accountants (IFAC) [2015], there are three dimensions indicated of long-term financial sustainability of the public sector. They are identified in the following areas of activity:

– the possibility of collecting public revenues,
– shaping the optimum value of public debt,
– the provision of services in the public sector.

A more detailed and highly accurate description of the stability of the public finance system is suggested by experts from the OECD [2009: 8]. They point out that the sustainability of public finance should be based on the following four essential criteria:

– accountability and the capacity of governments to finance existing and future obligations and liabilities;

– the ability of governments to sustain economic growth over an extended period of time;

– fairness and the capacity of the government to provide net financial benefits to future generations that are not less than the net benefits provided to current generations;

– the maintenance of a tax system at a stable level, without increasing the tax burdens in the future.

The stability of the financial system should be assessed in terms of not only the current state, but from the perspective of at least one financial or economic cycle. This view of the changes and an assessment of the financial crisis impact on the public sector can create a basis for identifying indicators and values considered important from this point of view. As emphasized by V. Rutkauskas [2015: 73] the increase in debt can hardly be assessed as a measure of risk in itself. The existing liabilities have a risk potential which evolves when the debtors' abilities to repay financial liabilities are deteriorating. The situation becomes even worse when there are no suitable assets (financial and/or real) which could be used in order to meet obligations. In turn, deterioration of a debtor's financial standing, through direct and indirect channels, will make the financial standing of creditors worse due to expected losses. The consequences of one debtor's default for its obligations will affect a number of participants in the whole economy, dragging down both financial stability and fiscal sustainability.

Considering the stability of the public financial system, one must also pay attention to the need to implement basic functions by the public sector, i.e. allocative, redistributive, and stabilisation, in addition to preventing long-term imbalances in public finances. This is possible to achieve by creating an effective system of public expenditure and income to the public finance sector. There is also significance to the level of fiscalism, measured by the share of income to the public finance and public expenditure sector in relation to the GDP, but also to the structure of public duties and expenses.

3. Trends and challenges in maintaining stability in the public finance system in the context of lessons learned from the financial crisis

In the context of lessons learned from the financial crisis of 2007 onwards, action should be taken to develop and implement fiscal policy that will take into account the current state of public finance, the situation and needs in the field of the real economy, and social expectations. Thus in the post-crisis period, anti-crisis fiscal policy should be developed and implemented [Alińska 2015]. It should be equated with the need to take action in the public finance sector and with the use of available fiscal instruments so as to:

– reduce the effects of the current financial crisis,
– prevent the emergence of problems within the financial system in the future,
– strive to maintain long-term fiscal sustainability,
– ensure long-term and stable economic growth of the country based on the principles developed in the inclusive growth strategy.

Actions taken by individual Member States in the field of public finance were primarily aimed at maintaining stability in the financial system and to ensure permanent, long-term, and sustainable economic growth at the national level.

For a number of reasons, fiscal policy pursued by the government does not always lead to the stabilisation of the public finance system and long-term economic growth. It is, therefore, not surprising that there are suggestions to appoint an independent opinion institution that would carry out fiscal policy and impose restrictions in this area or implement fiscal rule, for example in the form of a Fiscal Policy Council [Gołębiowski 2010]. Fiscal rules are instruments that, on one hand, prevent uncontrolled formation of deficit and public debt, and on the other hand, can be too stringent resulting in restrictions in the conduct of fiscal policy. This is particularly important in a situation of high volatility and instability of socio-economic conditions in the real economy and the financial system. A tendency to introduce new legislation in the field of the public finance discipline can be seen in many European countries. Between the years 2010-2014, restrictions were introduced (in Hungary, Poland, and Slovakia to name a few). At the beginning of the 1990s, Estonia introduced a numerical fiscal rule which disciplined the rules of public spending [Schaechter et al. 2012]. Assessment of the solutions within the scope of implementing fiscal rules and other restrictions on public spending reduction should be used primarily to implement a fiscal policy that should be used to maintain fiscal sustainability. Present legal, financial, and economic conditions caused by the effects of the financial crisis indicate the need for the implementation of counter-cyclical fiscal policy. At the same time, it should be noted that countries with stable public finances, having "fiscal space," which is the freedom to reduce fiscal burdens and increase expenditure, are not in danger of exceeding the deficit over the level of 3% of their GDP, and as a result cope better with periods of economic downturn or even a recession [Samojlik 2012].

Conclusions

Since 2007, Poland has been dealing with the global financial and economic crisis, which has had a significant impact on the state of public finance in many countries of the world. In the member states of the Euro Area there is a tendency to decline in fiscal revenue with a simultaneous increase in the total expenditure, in particular, those relating to the financing of current operations and covering primary expenses. In addition, problems related to the maintenance of stability in the financial sector have contributed to the increase in the value of the budget deficit and maintenance of public debt in most Member States of the EU at a level above the Maastricht criteria. In these circumstances, it is worth to consider the stability of public finance taking into account the following aspects:

– perception of the public finance system as a link of the national financial system, the operations of which should be strongly coordinated with the operations of the market financial system, and these two links together forming the basis for the socio-economic development of the country;

– distinction between issues related to the concept of public finance stability and fiscal sustainability;

– identification of the maintenance of stability in the essential components of the public financial system, i.e. government, local government, and insurance sectors;

– identification of internal (endogenous) factors and the estimation of the impact of conditions outside the public sector (exogenous) on the stability of the public financial system.

Consideration of issues related to the assessment of stability of the public financial system in the short-, mid-, and long-term.

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Równowaga fiskalna i stabilność finansowa – wyzwania i doświadczenia w dobie kryzysu finansowego

Streszczenie. *Sektor finansów publicznych jest jednym z elementów systemu gospodarczego, który w coraz większym stopniu odczuwa negatywne skutki globalnego kryzysu finansowego i staje się jednym z największych jego płatników. Dlatego istotnym jest, aby rządy i inne instytucje publiczne podjęły wysiłek opracowania i wdrożenia odpowiedniej strategii w zakresie polityki fiskalnej, której celem będzie zachowanie długoterminowej stabilności publicznego systemu finansowego i osiągnięcie innych celów makroekonomicznych. Celem niniejszego artykułu jest przedstawienie istoty, roli i znaczenia równowagi fiskalnej, jako elementu zachowania stabilności publicznego systemu finansowego w zmieniającym się, pokryzysowym środowisku finansowym i gospodarczym. Autorka zwraca uwagę na znaczenie, identyfikuje miejsce oraz rolę równowagi fiskalnej jako jednego z elementów stabilności finansowej w pokryzysowej rzeczywistości gospodarczej. Równowaga fiskalna i stabilność publicznego systemu finansowego stanowią podstawę do długofalowego wzrostu gospodarczego i świadczenia usług społecznych na odpowiednim poziomie. Politycy i przedstawiciele władz publicznych powinni dążyć i podejmować działania w zakresie utrzymania stabilności finansowej, w tym stabilności w sektorze finansów publicznych.*

Słowa kluczowe: *finanse publiczne, równowaga fiskalna, kryzys finansowy*