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Public Debt and Economic Welfare in Central and Eastern Europe

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Abstract

The purpose of this paper is to analyze the relationship between fiscal policy, public debt and economic welfare in post-transition economies of Central and Eastern Europe. The paper builds theoretical and empirical models that highlight the specific relationship between market-oriented reforms, public debt, and economic growth. The post-transition economy can be defined as an economy that began with the process of transformation from centrally planned to market based economic system in early 1990s, but it continued to display economic distortions of previous system to present days. As a part of their transition, these countries have been advised to reduce the role of government in the economy and to continue with reductions of public debt to successfully join the European Monetary Union. Our analysis presents new evidence on questions: when is public debt excessive, what is the relationship between debt and growth, and why the post-transition economies may have different relationships between debt and growth than other countries? The hypothesis is that the debt-growth relationship is non-linear, that is, public debt may enhance economic growth when debts levels are low and decrease growth when debt levels are high. After a certain threshold, debt becomes unsustainable, and the probability of public debt crisis increases. The unique nature of post-transition economies provides the opportunity to further test the channels and mechanisms that affect the threshold after which debt becomes too excessive and harmful to economic welfare.

Keywords: fiscal policy; growth; model; post-transition; threshold