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Fiscal performance of the EU8+2 countries in the course of their integration process[*]

The economic performance of Eastern EU member states and their success of being involved in the Single European Market are greatly affected by their fiscal and reform policy in the preparation period prior to their accession to the EU and the EMU. This study gives an overview of this process in order to find the reasons for the success and failure of the fiscal policies in the EU8+2 countries between 1999 and 2006.

GENERAL FISCAL POLICY FEATURES OF THE CEE REGION

Following the political transformation in Central and Eastern European countries between 1989 and 1992, the need arose to transform their system of economic organisation as well. From this aspect, all the countries surveyed here started the transition to market economy with roughly identical backgrounds, and they had to face similar problems in economic policy. Former Soviet Bloc fiscal systems ran the following structural faults in Eastern European countries when economic transformation started there:

❶ The state budget, the budget of state-owned corporates, and the financial reserves of the central bank were not separated clearly.

❷ The budget institutions played a subordinated role. The manoeuvring room of fiscal planning was *ab ovo* defined by output planning.

❸ The taxation system preferred certain taxpayer groups to others at a considerable rate, therefore the principle of neutrality did not apply.

❹ State-owned and private companies were considered differently.

❺ State-owned corporates represented easy revenues for public finance because of a weak information asymmetry between the managements of state-owned companies and the tax authority (ensuring an easy control over information flow), and state-owned corporations had their accounts with the central bank. Consequently, they were a hidden source of taxes that were unperceivable to the players of the economy. (Bönker, 2006)

❻ As an additional burden, the financing mechanisms of social distribution systems were unsuitable to fend off any relative decrease in the number of contribution payers against that of welfare beneficiaries.

❼ However, there was a major difference: Bulgaria, Hungary, and Poland inherited substantial public debts from the command economy regime, while the other countries started

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with marginal public debts, which allowed them to employ soft fiscal limitations during the economic transition in the 1990s.

Numerous scopes can be mentioned here, from education finance to the headcount of central administration staff to privatisation of state-owned corporations where in-depth changes should have been made in every EU8+2 county either because of the economic transition or changes in global economy and technological environment. The process of restructuring the Communist regime's pension and health care system represented the two biggest expenditure items in each country, which, however, have been postponed for years because of their heavy impact on a wide scale of the population. In health care, excessive demand caused by moral risks originating from free access to health services, and the complete lack of a savings-type design in the pension system had to be eliminated.

Reform of social benefit systems

Except for the Czech Republic, each EU8+2 country implemented the three-pillar pension system, which means that certain older but still active age groups and also other age groups that had been pensioners when the reforms were rolled out are paid pension from the imposing-distributing pension system. Its coverage at any given time is provided by part of the pension contributions paid by active employers. The second pillar is the mandatory private pension fund where membership has been mandatory for fresh recruits or employers who were born after a certain date. The essence of this design is the capital cover, which means the future value of savings, calculated by life annuity, will be the basis of a pension upon retirement. These savings providers are at the same time contribution payers, therefore a tension is evident in the budget that contribution payments have to be divided between the state-managed pension fund and private pension funds, whereas pensions are to be financed exclusively by the state-managed pension funds for a good many years after the implementation of the reforms. The difference between the imposing-distributing pension system and the capital cover design is that contribution payment in the former design as per law is the defined cash-flow, whereas in the latter scheme contribution payment is the fixed part while the allowance itself is subject to the total of savings and yields.

The third pillar is represented by voluntary private pension fund savings. Its significance is to encourage higher-income groups to save more. In Poland, for example, the third pillar includes an automatic life insurance (Wagner, 2005).

The two-pillar system in the Czech Republic does not consider implementing a capital cover design but maintains a mandatory and a voluntary imposing-distributing pension fund system. *(See Table 1 below)*.

Any loss of revenues for the state-managed fund stemming from re-allocation between pension funds could be supplemented by the government via tax revenues and loans, which causes temporary excess deficit in the national budget. This temporary structural deficit is considered by the Stability and Growth Pact in that revenue losses caused by pension reforms shall not be accounted by the end of 2008 when calculating excessive budget deficit. At the same time, countries have gradually raised retirement age to dampen the deficit impacts. The increase of life expectancy will most likely force European countries to extend retirement age in the long run to somewhere between 65 and 70 years of age. For example, *Csillag* and *Mihályi* (2006) suggest retirement age in Hungary be raised to 65 years before 2012.

As for health care, former Communist countries inherited a system where citizens were eligible for unlimited health care services free of charge. These expenditures are covered by personal income tax and various contributions paid

Table 1

PENSION REFORM IN EU8+2

Country	Capital cover implementation year	Retirement age, female/male, yrs
Bulgaria	2003	57.5/62*
Czech Republic	not implemented	53–57/60
Estonia	1997	63
Poland	1998	60/65
Latvia	1998	61/62
Lithuania	2004	60/62.5
Hungary	1998	62/62
Romania	2005	58/63
Slovakia	2005	62/62
Slovenia	1999	58–63/58–65

Note: When intervals are given, they are subject to the number of children in the case of women, and to payment duration for both sexes

* 60/63 from 2009

Source: Wagner, 2005; Radula and Staehr, 2003; Benkovskis, 2006; EUROSTAT: government homepages, www.ssa.gov

by the employers. This system runs several core financial risks. First, the users (patients) are not faced with the costs in any form, living in the fiscal illusion of "all costs are always covered". Therefore, they are not encouraged to consider the interests of the financial community. And, consequently, they are not interested in knowing whether or not the cost calculation of their treatments are realistic. As a first step, central governments tried to tackle this problem by more stringent control. In order to lessen the demand-driven pressure on the system, a number of countries implemented dedicated patient care as in the UK and the United States.

Secondly, the funding institution inherited from the Communist regime operates neither as an insurer nor as a financial fund, because the treatments of all citizens are financed irrespective of payment or non-payment of contribution. Also, the institution is not forced to operate efficiently (in lack of stringent control of how it uses its funds) because the central budget guarantees cover for any deficit of the state-managed health care funds. Based on Western European countries' experience, some of the EU8+2 countries, Slovakia being the first among them in 2005, implemented appointment fees in health care in order to enhance the cost-sensitivity of service users on the one hand, and are also planning to introduce a multiple-insurer health care system with some involvement by private companies with some degree of competition in order to improve economic rationality and business cost-efficiency on the financing side.

Fiscal phases of integration process

The first phase of economic and economic policy transition was finalised between 1995 and 1999, in which period each EU8+2 country had to undergo considerable fiscal adjustment programs either because of internal tensions in their national finance systems or because of international financial crises. The former was the case in Central European countries mostly, and the latter, in the Baltic states typically, as an aftermath of the financial crisis in Russia in 1998. From fiscal aspects, the profit of this period for nearly all these countries was, by achieving fiscal equilibrium, a chance for governments to establish a sustainable economic policy and to launch medium-term reforms in the financing systems of social subsidies (and social

investments) that accounted for large expenditures in their central budget. Some governments used this chance, others did not. Inherited from the command economy regime, the lack of transparency was regarded by the IBRD (2004) as a number of blind spots in the fiscal framework, because budgeting and policies were completely separated and there was no medium-term planning. In addition, there existed a large number of off-budget funds, and the number of conditional obligations was also high, task- and performance-oriented financing was nonexistent, cash-flow and debt management was fragmented, and the budget was completely input-oriented. Certain components reappear in analyses made of some of these countries between 2004 and 2007, indicating that the transformation of state finance systems had not been completed. *(See Chart 1)*.

Fiscal adjustments made in the first phase created a stable starting point for each EU8+2 country. It's not its direct impacts that's relevant in 2007, but the question whether how the national governments profited from this stable basis and what they did in the pre-accession period and in the first years of their EU status. It is best to regard this period as two separate stages, because EU membership means stricter fiscal obligations, as these countries pledged economic policy convergence in their Treaty of EU Accession.

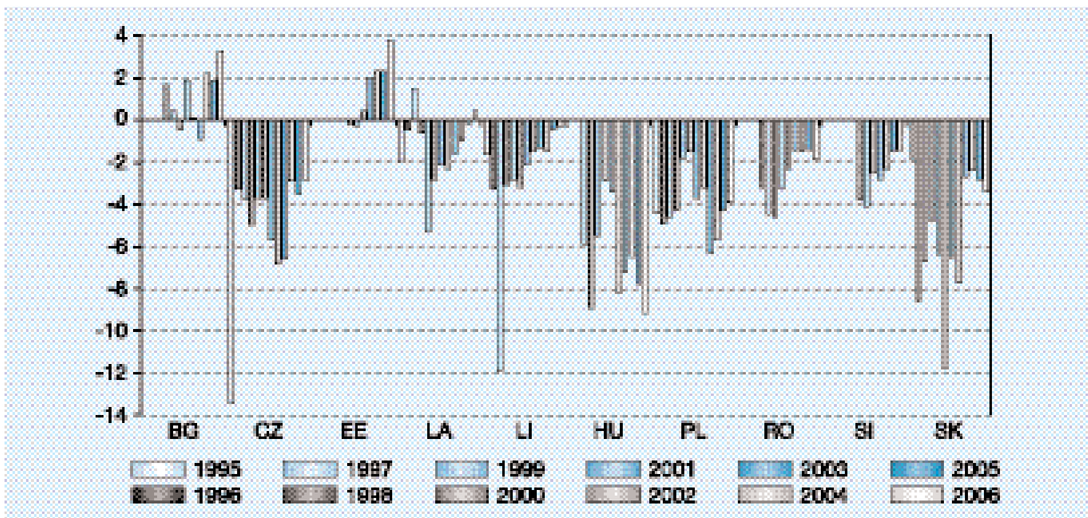
Accordingly, the second phase of the economic policy transition lasted roughly from 1999 to 2004, and to 2007 in the case of Romania and Bulgaria. In this period, EU aspirant countries had the chance to start the process of making their public finance system of expenditures and revenues sustainable in the medium term on the basis of the balance-creating results of the previous period without budget obligations, even allowing themselves to run growing fiscal imbalance in the first years. In other words, they had the opportunity to create the basis for long-term fiscal equilibrium.

Phase two saw the end of the large wave of privatisation which had been part of the transition process to market economy. Consequently,

Chart 1

NET PUBLIC FINANCE BALANCE OF EU8+2 COUNTRIES, 1995–2006

[percentage of GDP (central budget + municipalities + social security funds)]



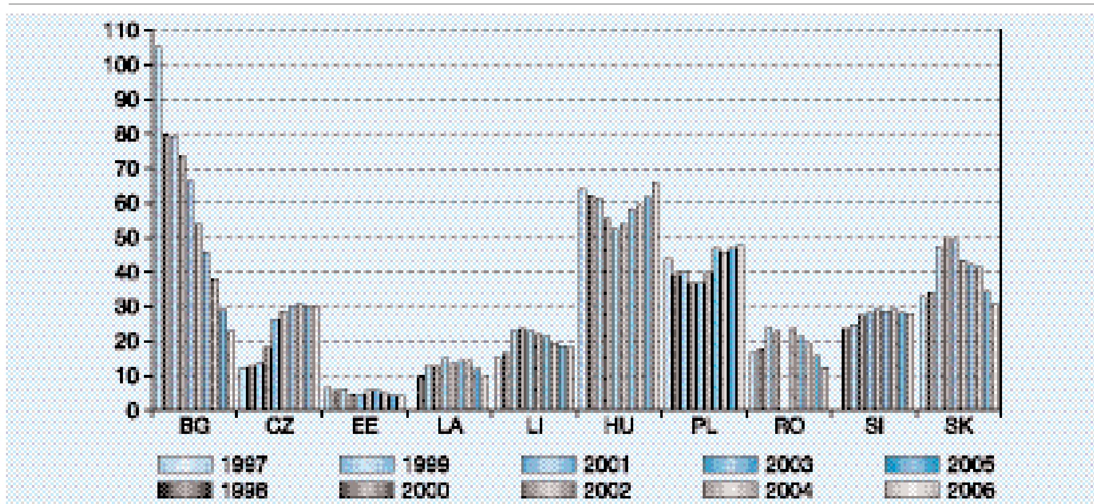
Note: BG = Bulgaria, CZ = Czech Republic, EE = Estonia, LA = Latvia, LI = Lithuania, HU = Hungary, PL = Poland, RO = Romania, SI = Slovenia, SK = Slovakia

Source: EUROSTAT

Chart 2

PUBLIC DEBT IN EU8+2 COUNTRIES, 1997–2006

(percentage of GDP)



Source: EUROSTAT

large sums from selling state-owned corporations could no longer offset annual deficits and increasing public debts. Therefore, *De Novellis* and *Parlato* (2005) recommend increasing tax revenues in the post-privatisation period if the central budget had a deficit in the privatisation stage. And it does not necessarily require a tax hike. The objective can be attained by cutting back tax allowances or by widening the tax base, as was the case in Slovakia, or in the Baltic States where tax rates were reduced. *(See Chart 2)*

The third phase, when community expectations regarding convergence are to be met, starts with 2004 (and 2007 in the case of Romania and Bulgaria). However, EU membership meant additional challenges for economic policies beyond limitations to excessive fiscal deficit. The governments had to contribute to the community budget and also to projects funded by community grants (Köhler-Töglhofer et al., 2003).

Of course, the EU8+2 countries are net beneficiaries of the community budget, but only if they provide 25 to 50 per cent of co-funding to use their allocated subsidies. It is beneficial to join the European Union with a national budget that lacks structural deficit factors and is able to create equilibrium or even a surplus, because otherwise either the co-finance obligation or the convergence criteria will be lacking (Gáspár, 2002). *(See Table 2)*

Significance of political cycles in the fiscal policy of EU8+2 countries

Analyses by the IBRD (2007) and *Staehr* (2007) establish that the fiscal policies of the EU8+2 countries typically go against the current economic cycle. In the year 2006 for example, their fiscal balances deteriorated on a wide scale despite a more powerful economic growth in the region and an increase in their tax revenues. Presumably, the national economies of most Eastern EU members are overheated because of fiscal reasons, indicating economic risks *(See Table 3)*.

Fiscal positions

Based on main fiscal policy characteristics, the EU8+2 countries can be divided into two groups. The first group contains countries with

Table 2

EURO ADOPTION TARGET DATE IN EU8+2

Countries	Accession to ERM-2	Euro adoption target date
Bulgaria	mid 2007	2010
Czech Republic**	2008 or 2009 (2007 initially, but delayed)	2010
Estonia	2004. June	2009 (2007 initially)
Poland	No target date	No target date
Latvia	June 2004	2009
Lithuania	June 2004	2009 (2007 initially)
Hungary	2008*	2010
Romania	2012*	2014
Slovakia	January 2005	2009
Slovenia	June 2004	1 January 2007 (achieved)

*= planned accession to ERM-2

** Source: Ministry of Finance of the Czech Republic & the Czech National Bank (2006)

Source: national convergence programs

comparatively stable fiscal positions, relatively low public debt ratios compared to GDP, and low government spending: Namely, the three Baltic States; Slovakia and Bulgaria, as they are finally catching up with some delay; and Romania, although with strong reservations. Although there is a high rate of redistribution of finances by the government in Slovenia, the country has been able to maintain a stable fiscal position and implemented fiscal and monetary convergence, therefore – from the aspect of the efficiency of its fiscal policy when equilibrium creation is regarded as such – it should not be listed in an individual group *(See Chart 1)*. The

Table 3

COMPOSITION AND STABILITY OF EU8+2 GOVERNMENTS, 2000–2007

Countries	Typical number of coalition parties	Notes
Bulgaria	3	
Chech Republic	3	Long stalemate in Parliament in 2006-2007
Estonia	3	March 2007 elections ousted government
Poland	3	Unstable coalition; one of the coalition parties left the government in July 2007 the cabinet became minority, general elections probably in October 2007
Latvia	3	
Lithuania	4	A three-party minority government was ruling for a short while in 2006
Hungary	2	Very low popularity from mid-2006 because of powerful consolidation
Romania	3	Unsteady coalition, a party left the coalition in 2007
Slovakia	3	The coalition lost the elections in 2006 after implementing reforms and creating fiscal equilibrium. Promising less tight a budget, the opposition won the elections to form a coalition
Slovenia	4	General election in 2008

Source: IBRD, 2006b; IBRD, 2007

countries of the second group – including the Czech Republic, Poland, and Hungary – have weak fiscal positions, sizeable public debts, and considerable redistribution levels.

Some of the countries – Slovakia, Romania, and the Baltic States – have implemented flat taxes. According to *Árendás et al.,* (2006), flat taxes are fair when they reflect the socially approved level of public contribution, and at the same time are efficient and progress-safeguarding when they eliminate tax allowances and preferences, and are also simple, which ensures a higher degree of transparency and predictability for taxpayers. This latter feature is what provides a country with an edge in the tax competition that has developed among Eastern EU member states, because it can retain the volume of revenues by widening the tax base by offering certain foreign investors simpler and lower taxes.

EASTERN EU COUNTRIES PIONEERING IN THE CREATION OF FISCAL EQUILIBRIUM

Leading the pack are Estonia, Latvia, Lithuania, Slovenia, and Slovakia, and – considering their three-year lag in the European integration process – Bulgaria and Romania. Fiscal convergence is not an issue in this group. Basically, some risks have been evident regarding price stability, but mostly on the back of global economy developments and convergence. On the one hand, energy prices were rising very dynamically in the first years of the 21st century, and on the other hand there is a serious lag behind EU15 prices and wages – with the exception of Slovenia – but economic convergence inevitably calls for rises in these scopes, too. Evidently, successful convergence requires an economic policy mixture to ensure monetary convergence for these countries. (Festiè and Bekő, 2006, page 82). This is the reason for a large number of criticisms and suggestions on the part of international organisations (the IBRD, the OECD) regarding the fiscal policies of the Baltic States, Slovakia, and even Slovenia even though they are basically in balanced positions, because price levels are partially subject to the structure of government consumption as well as to the taxation and subsidy system which influences consumption and investment decisions of corporations and households.

The forerunner – Slovenia

Considering the positions of the EU8+2 countries in 2007, Slovenia seems to have applied the most efficient economic policy blend, meeting the convergence criteria by the end of 2005 and adopting the euro on 1 January 2007. However, the country had to face the very same fiscal and structural problems as the other countries. True, it had the advantage over the Baltic States of its initial price level being closer to that of the EU15 – even though it is not a fiscal issue basically – therefore convergence impacts manifested themselves at a lesser extent in price convergence. Slovenia had to manage financing problems stemming from its imposing-distributing pension system and rising public wages like any other EU8+2 country. In the course of the transition to market economy in the 1990s, a lot of vulnerable spots developed in its budget. Expenditures for public wages showed a constantly increasing trend, unemployment benefits and advance retirement pensions represented an increasing expenditure in social spending both in relative in absolute terms, subsidies granted for enterprises expanded, and the subsequent budget deficits called for increasing public debt repayment obligations (Cvikl and Gaspari, 2004). Based on statistical figures collated by *Roter* (2003, pages 132 to 134), public wages accounted for 22 per cent of expenditures in 2001, social benefits amounted to 40 per cent and pensions represented 30 per

cent. These figures clearly show that the ratio of cyclical budget component was marginal in the Slovenian central budget, thus the balance-creating effect of automatic stabilisers could not come into play, which means the deficit came about for structural reasons mostly. In the pre-accession period this inflexibility had to be addressed and changed (Cvikl and Gaspari, 2004). It was a very important realisation for a country on the threshold of monetary integration, because the implementation of the common currency and common monetary policy meant that fiscal adjustments would be the only tool left for economic policy to adapt to changes in global economy.

In addition to a cutback in spending, modifications were implemented in the taxation system. Introduced in 1999 only, the VAT rates of 19 and 8 per cent were raised in 2002 to 20 and 8.5 per cent, respectively. Also, the tax base was widened by trimming tax allowances, which in turn allowed the government to reduce the rates of personal income tax (IBRD, 2004). A EUR 500 million income from privatisation in the banking sector in 2002 meant a major step in reducing public debt. Also, two-year budgeting was introduced, on the basis of which the budget for the two subsequent years are planned and approved. Of course, the budget for the second year is always re-discussed in the preceding year, so planning and debating the budget cannot be avoided, but this time the manoeuvring space to make amendments is very tight (Kraan and Wehner, 2005).

Wide-scale political and social consensus supporting medium-term objectives and reforms played an eminent role in Slovenia's success, allowing a cautious implementation of reforms by pursuing a gradual economic policy since 1997 (Šušteršiè, 2004). However, this opportunity is no longer available to countries that failed to launch in-depth changes in finance systems related to public finance between 1999 and 2004, because they would now lose precious time in the process of monetary integration. This would mean a disadvantage in economic convergence, too, because they could not benefit from the advantages offered by the common currency, while this opportunity has been available to some of their competitors since 2007 (Slovenia) and perhaps from 2009 (Slovakia, Estonia, Latvia, Lithuania).

The political consensus has not shut opposition parties out of power in Slovenia, for it was the opposition that came to power after the general election in October 2004.

Minimalist state, fiscal discipline – the Baltic States

In the Baltic States, one of the components of the legacy from the disintegrating Soviet Union was an extremely low level of public debt – roughly 5 per cent of GDP, which would have meant almost limitless fiscal opportunities in the foreseeable horizon for policy decision-makers. However, the governments of the Baltic States – wisely – used this chance not to go for fiscal laxity or vote-generating subsidies but, in an example-setting manner among all the EU8+2 countries, to restructure their finance system of social benefits and to accumulate primary budget surplus. Economic growth and welfare improvement here are based on FDI influx. These countries are competing in the period between 2006 and 2011 to see which one of them offers the lowest combined ratio of income tax (labour tax) and corporate tax in the European Union. Apparently, Slovenia seems to be the most successful in the convergence process because of adopting the euro on 1 January 2007, the only one in this group to do so. However, the Baltic States missed the deadline merely because of the inflation criteria. But they have the largest manoeuvring room in their budgets among the EU27 countries in terms of fiscal balance and public debt. International

reports – such as the ones issued by the IBRD (2007), Deutsche Bank (2006a), the IMF, the EBRD, and the European Commission – underline external imbalance as the main risk factor. This, however, is applicable to all ten countries but shows a deteriorating trend in the Baltic States. *(See Charts 3 and 4)*

The Baltic States differ from the other EU8+2 countries also in that CIS countries have a larger proportion in their exports and imports, thus their economic growth is less dependant on the single European market.

The IBRD (2007) underlines that the economy of the Baltic States is considerably overheated, also evident in their increasing trend of core inflation. Putting forward a solution, the report basically suggests that the Baltic government should abandon fiscal easing via tax cuts and proceed in the area of labour market liberalisation.

Estonia and Lithuania was going to implement the euro in 2007 initially, but it has officially been delayed until 2009 because of failing to meet the price stability criteria. Fiscal policy seems to be all right in the Baltic states as far as the euro adoption is concerned – for Latvia boasts a similar equilibrium as Lithuania, and Estonia has been producing budget surplus, as it has been underlined repeatedly – and they need to improve their inflation positions only. The effects of an upswing in FDI and the inflation effect of economic convergence also contributed to higher-than-expected inflation figures.

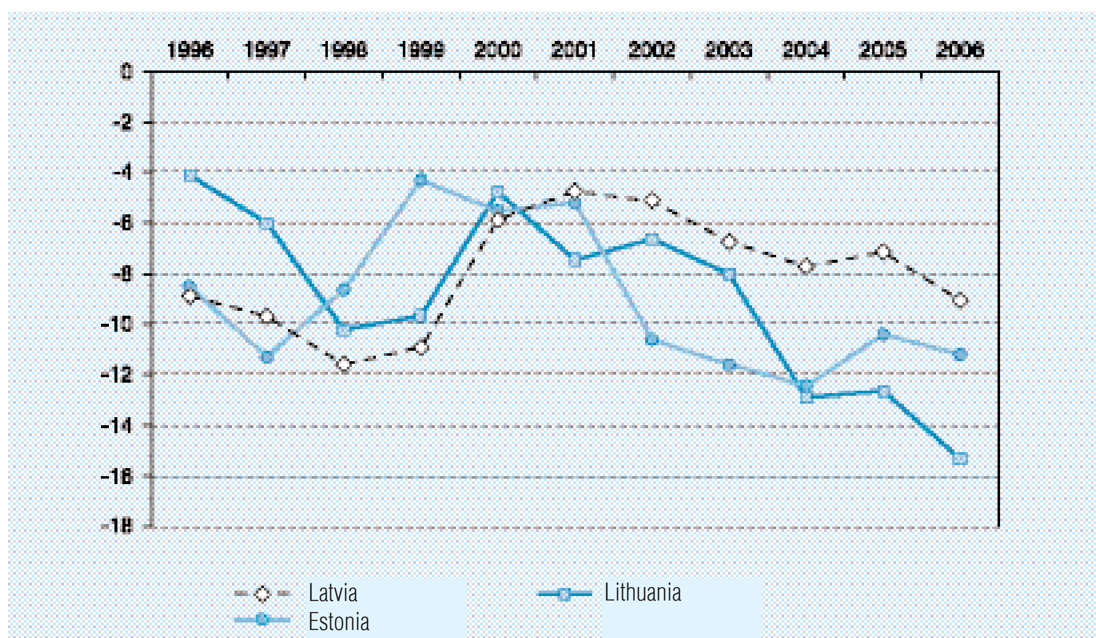
At the same time the reduction in the flat-rate personal income tax jeopardises price stability, if not fiscal balance, because the income available to be spent by corporations or households expands *(See Chart 5)*.

From corrupt autocracy to forerunner of reforms – Slovakia

Slovakia underwent radical changes in fiscal terms in the preparation period preceding the

Chart 3

BALANCE OF PAYMENTS IN THE BALTIC STATES

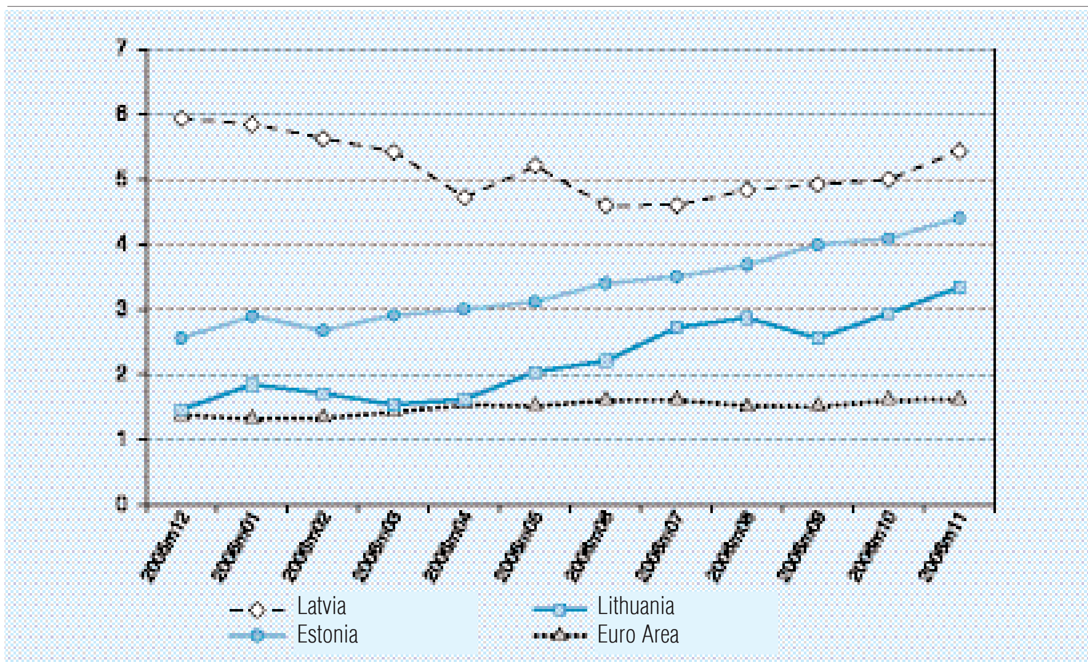


Source: IBRD, 2007

Chart 4

CORE INFLATION IN THE BALTIC STATES

(CPI excluding energy and unprocessed food)



Source: IBRD, 2007

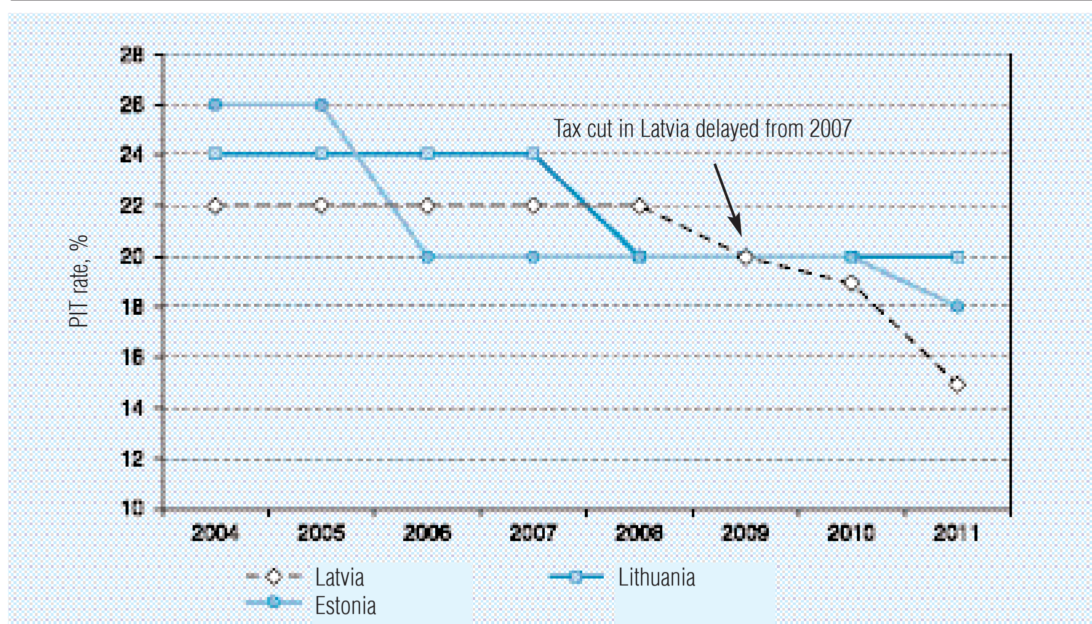
EU enlargement. Before 1998, the Meciar administration pursued a loyalty-based policy that disregarded the importance of fiscal discipline (Mathernová and Renèko, 2006). Doing so was easy for Slovakia because it had started in 1992 as a country with a low level of public debt, which ensured manoeuvring space to relax fiscal conditions in the medium term. Elected to power in 1998 and running two terms, the Dzurinda administration, however, set completely new economic objectives, based on the principle of fiscal equilibrium and market rationale. Not only a fast-paced EU accession was targeted but the euro adoption at the earliest date possible was also decided in order to allow Slovakia to benefit fully from the advantages in competitiveness and convergence offered by the Single European Market.

Governing the country between 1998 and 2002, the first Dzurinda cabinet launched a three-pillar reform based on fiscal stabilisation, structural reforms in the corporate sector, reforms in state institutions, most notable among them the curbing of corruption (Mathernová and Renèko, 2006)

In the second term of the Dzurinda administration, from 2002 to 2006, really radical changes were made in budget-related areas, such as the transformation of the pension system into a three-pillar capital cover design; cutting back social benefits; labour market liberalisation; implementation of a multi-insurer model and appointment fee in health care. On the revenues side, the taxation system was simplified considerably. On the one hand, a single and uniform rate for VAT, PIT and corporate tax was introduced, and on the other hand the majority of tax allowances were eliminated along with a reduction in the number of tax types by discontinuing the duties on real estates, donations, and inheritance (Mathernová and Renèko, 2006; Árendás et al., 2006).

Chart 5

PIT REDUCTION PLANS IN THE BALTIC STATES



Source: IBRD, 2006b; IBRD, 2007

The advantage of the taxation system in Slovakia does not lie in the single tax rate, but in its simplicity; elimination of tax allowances; a wider tax base; transparency of the revenues side of public finance; and implementing a lower tax rate for capital income than for PIT, encouraging savings and investments.

One of the main objectives of the Slovakian tax reform was not to let tax revenues decrease. In addition to reducing tax rates and widening the tax base, cautious underestimation of PIT revenues also ensured fiscal balance. In the scope of corporate tax, sustainability was supported by increasing pre-tax earnings, thus tax evasion grew scarcer despite a lowered tax rate (Árendás et al, 2006).

By using "ready-made" scenarios already in use by other countries, Slovakia managed to benefit from the situation where no structural or financial reforms had been started until 1998. In order to make progress in business environment convergence, however, it could not opt for a gradual reform, shock therapy was the only reasonable option. By implementing this program, Slovakia turned its position around, and since the EU accession it has set the example for other Central European countries that have been dragging their feet in reform implementation. The second Dzurinda administration managed to continue the reforms even when it had lost its majority in Parliament for a while in 2004. True, eventually it lost the elections in 2005. And the Fico government has been more or less in favour of retrogression and fiscal easing.

Late up-and-comers – Bulgaria and Romania

Bulgaria has pursued a policy of stringent fiscal discipline. In fact, it had no other options, because, following the example of the Baltic States, it had opted for Currency Board as its foreign exchange rate regime, which eliminates room for monetary manoeuvring.

Bulgaria managed to reduce its fiscal deficit primarily by cutting back quasi-budget expenditures, eliminating direct budget funding through the central bank and tightening its revenue policy, just like Romania did (IBRD, 2007, page 41). In a report regarding these countries (and also the Baltic States), Deutsche Bank (2006b) warned about an imbalance in their balance of payments.

Another common feature in Romania and Bulgaria, corruption has continued to be a severe and unresolved problem that greatly undermines the efficiency of their government institutions. Public administration is in need of modernisation also in this respect (IBRD, 2007, page 43).

According to Romania's convergence program, budget expenditures will rise to 39.8 per cent of GDP by 2009 from 33.6 per cent of GDP recorded in 2005, and fiscal discipline will also be laxer than in other countries regarded as forerunners, which seriously questions the country's classification as a converging economy. But as planned tax revenues are converging to expenditures and fiscal policy does not jeopardise any of the two convergence criteria in public finance according to the country's convergence program, budget deficit will not likely to exceed 3 per cent of GDP by 2009 and public debt is not expected to go past the 60-percent mark, also in terms of GDP. However, the considerable deterioration in fiscal balance, as projected by the Romanian government, is seen as an unfavourable development.

Romania's country risk, stemming from its fiscal policy, has been increased further by the decision to stop privatisation in the banking sector and energy industry (Romgaz, Petrom) in 2007, and a decision was made to inject state funds into CEC Bank instead of selling it.

Both countries have devised different euro adoption strategies: Bulgaria set the target date at 2010, while Romania intends to adopt the common European currency in 2014. Bulgaria, as mentioned above, has copied the strategy of the Baltic States by applying a Currency Board and entering the ERM-2 in the middle of 2007. Romania, on the other hand, intends to ensure a firm basis for monetary and fiscal convergence by improving its economic performance to the EU average first. However, both plans should be taken with a pinch of salt even though it is not fiscal policy that represents the core risk. Bulgaria has the lowest level of both prices and wages in the European Union, and these levels are not much higher in Romania. At the same time, their GDP and domestic consumption both are increasing dynamically. Also, both plan to achieve convergence by a very intensive FDI influx. This represents a positive impact on the one hand, because it means both countries have started on the convergence path, but, on the other hand, inflation pressure, a side-effect known as the Balassa-Samuelson effect which has thwarted the integration plans of the Baltic States, will be evident at a greater extent. This in turn jeopardises the inflation criteria. And in the case of Romania, the fiscal government seems to amplify this inflation effect by its increasing need for deficit financing from foreign exchange sources (Convergence programs, IBRD, 2007). Scrutinising the example of the Baltic States and the Visegrád Four [Czech Republic, Hungary, Poland, and Slovakia; V4], it is evident that unfulfilled objectives cause loss of credibility, which in turn renders certain short-term economic policy efforts that have been made so far useless.

In its report, the IBRD states (2007, page 43) that *"the consolidation of government institutions has been slower than expected"*, which makes it harder not only to curb public administration expenditures but to obtain community grants at an efficient rate, preferably 100 per cent.

COUNTRIES FALLING BEHIND IN CREATING FISCAL BALANCE

Prior to the EU accession, fiscal policymakers were not in an easy position. Germany, the biggest external market of the Visegrád Four, was struggling with economic slowdown. This slump in demand made a mark also on the tax revenues of these countries. Their fiscal imbalance was further magnified by policymakers' decision to respond to unfavourable economic cycle by launching discretional fiscal easing. Government terms were nearing the election phase, and structural factors – such as the bank consolidation in the Czech Republic and the unresolved pension and health care finance system in each of the countries surveyed – caused expenditures to increase.(Gáspár, 2002).

Creating balance cautiously – Poland and the Czech Republic

Poland's economic policy had to face the fact in 2001 that its medium-term budget plan was unsustainable. In detail:

- the costs of pension reform had been underestimated, thus the deficit rate of the pension fund was bigger than expected;
- on the back of the decentralisation reform, a much higher number of municipalities were created than expected previously;
- 35 to 41 per cent of PIT revenues had to be spent on financing the deficit of the health care fund *(see Chart 6/b);*
- the expansion of domestic trade slowed down, and VAT revenues fell behind plans;
- within the reform of the education system, pay rise was effected for public employees;
- starting from 2001, the ratio of expenditures fixed for the short term increased *(see Chart 6/a)*. As a consequence, the trend of public debt turned around in 2001 from decline to increase.

Referring to a critical economic situation, the Polish government decided to postpone the implementation of the reforms, and made only minor adjustments in 2002 to restore its credibility. On the other hand, the cabinet introduced a cap on expenditures, according to which they could not exceed the level measured in the previous year by more than 1 per cent. And in 2004, a limitation that public debt must not exceed 60 per cent of GDP was enshrined in the constitution. As the pace of economic growth had remained permanently at a low level between 1 and 2 per cent, just like in the Czech Republic, structural reforms were postponed until after the EU accession, for the next government term. In addition, the rule of expenditure cap was violated in 2003 (Golik and Jêdrzejovicz, 2003). Privatisation objectives were not met, either.

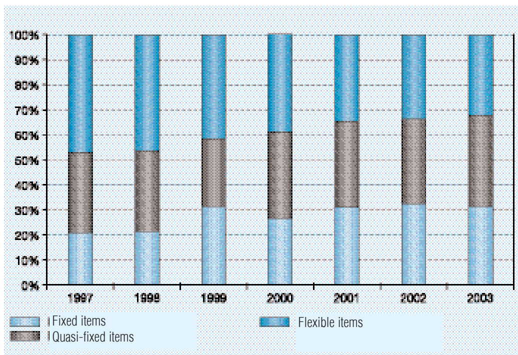
To restore fiscal discipline, the Hausner Plan was launched in 2004 before the election that would bring the downfall for the government. However, this program could not have eliminated the country's excessive fiscal deficit before 2007 *(see Table 4)*.

After the adjustments in 1996, budget deficit and public debt in the Czech Republic again set out on a rising trend. The gap between tax revenues and primary expenditures opened increasingly wider between 1999 and 2003 *(see Chart 7)*. A conclusion was reached by *Matalík* and *Slavik* (2003) that increasing public debt represents the greatest country risk in the medium term. The Czech public debt nearly doubled between 1998 and 2002, propelled primarily by structural problems stemming from pension system and health care finance, as well as employment and wage policy in the public sector.

However, Chart 7 indicates a similarly growing gap in Hungary and Poland between 2000 and 2003. But, whereas some correction was made in Poland and the Czech Republic from 2004 onwards, in Hungary the gap not only

Chart 6/a

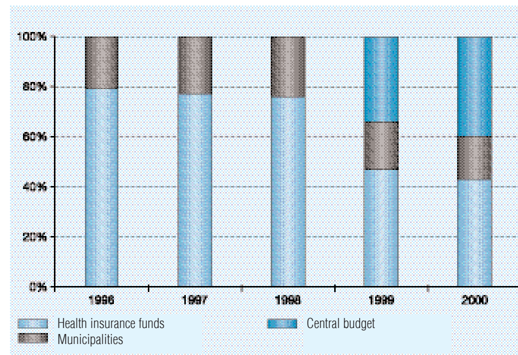
EXPENDITURE STRUCTURE OF POLAND'S CENTRAL BUDGET FROM THE ASPECT OF FLEXIBILITY, 1997–2003



Source: Golik and Jêdrzejovicz, 2003, Table 7

Chart 6/b

DISTRIBUTION OF POLAND'S PIT REVENUES IN PERCENTAGE



Source: Golik and Jêdrzejovicz, 2003, Table 4

increased but expenditures also started rising – the temporary decrease from 2002 to 2003 was only seeming, because it was only the disappearance of one-off extra expenditures that occurred in the election year of 2002 – and tax revenues had not followed expenditures until taxes were raised in 2006.

In the case of the Czech Republic, the EU accession acted as a disciplinary force from fiscal aspects. As a result of the consolidation launched in 2004, budget deficit dropped to 3.0 per cent in that year. However, a significant increase in tax revenues on the back of livelier economic growth also contributed to this achievement (ONB, 2005). At this point, however, a political stalemate that was going to last years was developing. As the first blow, the ruling coalition lost its majority in parliament in 2004, then the early elections resulted in a tie of 100 MPs for both political formations with no passage between them.

Due to the stalemate, restructuring in the funding of the pension and health care system was postponed until the middle of 2006 on account of an uncertain political background (IBRD, 2004; IBRD, 2006b), and entry to the ERM-2, planned for 2007, was also put off. The government had been focusing only on tax reforms since 2004, reducing VAT and corporate tax rates, and also reducing the minimum timeframe of depreciation, which decreased corporate pre-tax profits, and, consequently, the amounts they paid in corporate tax. On the expenditures side, the cabinet attempted to save public administration costs only, which, predictably, could not ensure sustainability.

Table 4

ESTIMATED IMPACT OF THE HAUSNER PLAN ON POLAND'S PUBLIC FINANCE DEFICIT,

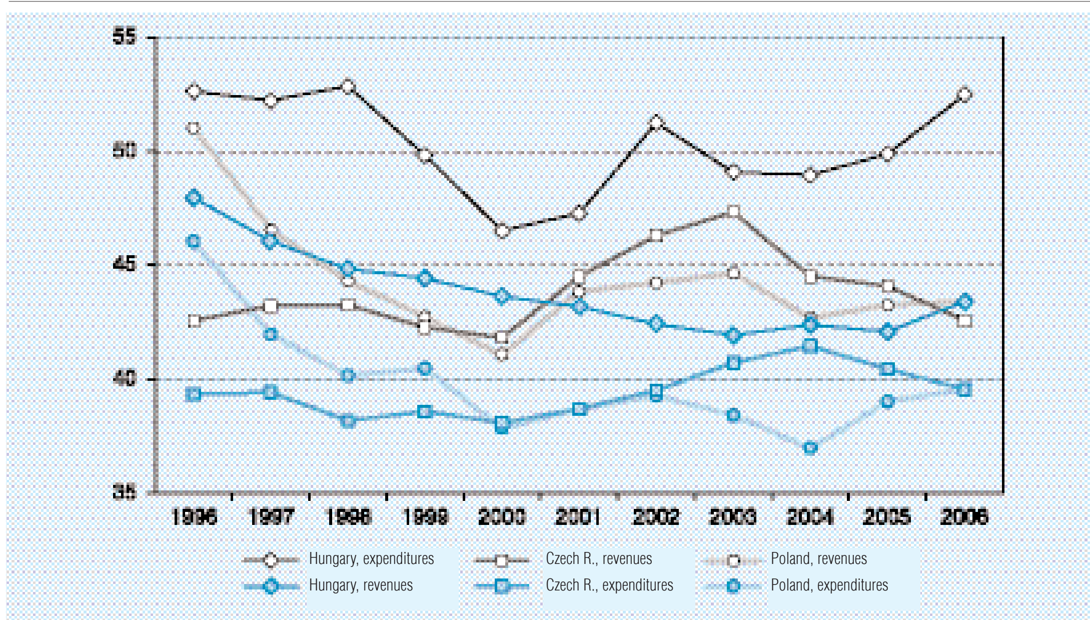
(percentage of GDP)

	2004	2005	2006	2007
With no changes	–8.2	–7.2	–6.5	–6.1
With the Hausner Plan	–8.2	–5.6	–4.5	–4.1

Source: IBRD, 2004, page 6

Chart 7

GROWING GAP BETWEEN REVENUES AND EXPENDITURES IN THE BUDGETS OF THE CZECH REPUBLIC, HUNGARY, AND POLAND, THE REASON FOR THEIR DEFICITS; 1996–2006



Source: EUROSTAT

The price of delaying action – Hungary

Orbán and *Szapáry* (2006) establish in their study that the Hungarian economic policy eased fiscal discipline in 2001 and 2002 in spite of apparently favourable economic conditions, making discretionary measures such as a wage rise in the public sector, increasing transfers, indexing pensions, and tax cuts. Austerity was postponed in 2003 and 2004 again, which means the usual trend of political cycles did not apply. Negative economic effects impacted the Hungarian economy; however, the cabinet planned additional easing within the tax program, which was cancelled subsequently.

The OECD (2006) underlined institutional and planning mistakes as well, in particular on the part of the Ministry of Finance which regularly overestimated economic growth, expenditure caps and tax reduction possibilities between 2000 and 2006. This is why a gap between expenditures and revenues, even wider than in the Czech Republic, developed, resulting in an increase in expenditures to 51.2 per cent of GDP from 48.8 per cent between 2000 and 2006 while tax revenues dropped to 44.4 per cent from 46 per cent of GDP (ESA 95, OECD, 2006, page 261)

In the years between 1999 and 2006, Hungary was impacted most among all EU8+2 countries in 2001 and 2002 by upcoming general elections. According to a survey made by the OECD (2006, pages 261 to 264), the following increase in expenditures was effected: Price subsidies by 30 per cent, local investments by 44 per cent, public wage expenditures by 23 per cent. This latter item was caused by a 1.5-percent increase in headcount in the public sector and a 50-percent pay rise for public servants. The situation was further exacerbated by the fact that the depreciation pressure, stemming from the ill-conceived devaluation of the forint's median rate in 2003, caused additional

GDP loss. Pressed by 9.2 per cent of deficit in 2002 and 7.2 per cent in 2003, the government finally made steps to reduce expenditures – including a cutback on the interest subsidy for housing loans, and the blocking of residual funds reserved from the preceding years, but these were far from sufficient to restore balance and arrest galloping public debt.

Neither did a community obligation, namely the Convergence Program of 2004, represent any disciplinary force. The financial government did not take this public plan for the medium term seriously, so much so that two convergence programs were submitted to the European Commission. Neither was approved.

The original convergence program of 2004 targeted the euro adoption for 2007, which did not seem achievable even back in 2004 and was completely irresolute in light of inflation and budget forecasts for 2007. Submitted in 2006, the third version excepted the convergence criteria to be met by the end of 2009. Drawing from pervious experience, this means 1 January 2011 as the earliest date for euro adoption if and when each and every prediction described by the government in the 2006 convergence program comes true.

In 2004, Hungary managed to push inflation down to 5.4 per cent, but then came the procedure by the European Commission EUROSTAT that forced Hungary, and others, in 2005 to abandon the practice of putting certain expenditures off the budget, most notably the expenditures related to investments made by way of *public-private partnerships* which were accounted in the books of Magyar Fejlesztési Bank [Hungarian Development Bank] instead of in public finances. Consequently, the actual deficit in terms of GDP was 6.1 per cent in 2006 instead of 3.6 per cent planned.

Substantial increase in expenditures and tax cuts were to be expected in 2006, an election year, even though the deficit target should have been 4.7 per cent in line with the Budget Act, which, however, had to be raised by 0.3 per cent due to the EUROSTAT resolution to adjust the figure for Gripen fighters procurement. Submitted and approved in 2005 then cancelled in 2006, the law on tax reduction would have increased the deficit by 4 per cent of GDP (OECD, 2006, page 267). Even without it, the government "managed" to record 9.2 per cent of deficit in 2006.

The solution, summarised on the back of the conclusions reached by Orbán and Szapáry (2006), is as follows:

- adjustment processes shall be irreversible, which means the taxation and benefit systems shall be reconstructed;
- activity rate shall be increased, which would make a positive impact on the budget balance as well. But this requires a system of social benefits that encourages employment;
- financing health care system shall be made sustainable, retirement age should be raised;
- transparency and controllability of the municipal finance system shall be improved;
- transparency of the central budget shall be ensured. Primarily the practice of putting certain items off-budget shall be abandoned, as Hungary has been warned by the European Commission;
- fiscal rules shall be put into legislation in order to enhance disciplinary force.

The weakest fiscal point in Hungary between 2000 and 2006 was an *"excessive role played by one-off measures"*, or discretionary steps, and also *"by non-specified savings"*, such as overexaggerated expectations for prime rate cuts and for an increase in tax revenues and GDP. In fact, hardly any progress has been made in the scope of structural reforms that could have eliminated the structural reasons of the deficit (OECD, 2006, page 267). Statutes or other legislation regarding budget caps are also lacking.

Instead, the medium-term "commitment" manifests itself in the form of a convergence program the government tends to rewrite each year, as the current practice indicates.

EXPECTED FISCAL POLICY DEVELOPMENTS BETWEEN 2007 AND 2009

Based on their convergence programs, Poland and the Czech Republic will meet the 3-percent deficit requirement, and Hungary might also get close, but analysts have every reason to be sceptical. The year 2006 saw the fiscal balance of Poland and Bulgaria alone improve, but one has to add that Estonia has for years achieved budget surpluses, and meeting the public finance criteria in Latvia, Lithuania, and Slovakia would not be an issue when considering the Maastricht criteria exclusively. Yet the IBRD, the IMF, and the European Commission warn against undisciplined laxity within the 3-percent deficit limit in terms of GDP because it may represent the beginning of an additional imbalance – and likely to result in an increase in country risks – but could also threaten price stability as the government demand is financed by loans at an increasing rate. As it was the case in Estonia and Lithuania, the euro adoption in both countries suffered a delay solely because of falling a couple of tenths of a percentage point shy of the price stability requirement.

Based on IBRD expectations (2007, pages 29 and 30), increasing revenues[1] and reducing expenditures[2] in Hungary will allow the government to shift from a heavy deficit towards fiscal balance. Based on improving fiscal balance, the governments in Slovakia and the Czech Republic are targeting an increase in social expenditures, which in turn will enhance economic boom.

Although Bulgaria is planning a budget surplus, the rate of corporate tax has been lowered to 10 per cent from 15 per cent, and the decrease in social expenditures planned for 2007 has been postponed. The government intends to offset this decline in revenues by increasing excise tax. Overall, budget surplus is likely to be achieved.

Estonia continues to be a country with budget surplus. Lithuania is expected to fully eliminate its budget deficit by 2009. The Latvian government, observing fiscal discipline, had to delay the tax cuts planned for 2007 until 2009.

Substantial cutback in revenues are typically expected of governments with a high ratio of financial redistribution, including Hungary, Poland, and Slovenia. In this regard, the Czech Republic remains to be an exception. Countries with low expenditure levels draw a mixed picture. In Estonia, fiscal discipline is expected to improve, but Lithuania, Bulgaria, Romania, and Slovakia will most likely see an increase in expenditures in terms of GDP. In countries with projected reduction of expenditures, social spending is the main area where cutbacks are expected to be made.

The Baltic States and Slovakia target 2009 for euro adoption, which means they have to meet the criteria by the end of 2007. There are no clear euro target dates in the Czech Republic, Poland, or Hungary, but their current convergence programs indicate full achievement of convergence requirements in 2010 or 2011. Bulgaria has set a target date of 2011, with the only possible obstacle being excess inflation on the back of convergence effects. Romania intends to adopt the European currency in 2014, which seems doubtful, because the current structure of the country's central budget indicates an improbability to meet the three-percent budget deficit criteria.

The IBRD (2004) basically recommends the EU8+2 countries to apply medium-term planning, program-based finance, and expenditure decision assessment mechanisms by all means.

Notes

1 VAT increase, extra tax, increase in social security contribution

2 Streamlining in public employee headcount, expansion of e-government, more rigorous control of treatment and medicine prescriptions, transfer of part of the costs to users, reform in the pension system, reform in funding the education system, better distribution of social benefits

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