The state of public finance in the EU acceding countries

Upon their accession to the European Union on 1 May 2004, the ten new member states will also take over the EU's fiscal policy framework, in particular the provisions on budgetary discipline. Although nine acceding countries are currently below the debt ceiling of 60% of gross domestic product (GDP) laid down in the Maastricht Treaty, the acceding countries' budget deficits are for the most part still well above the ceiling of 3% of GDP. The fiscal policy situation varies considerably across the individual acceding countries: whilst it appears to be relatively favourable in the Baltic states and in Slovenia, the other countries still have to make considerable progress towards consolidation.

This article outlines the current situation of public budgets in the acceding countries and examines aspects of the long-term sustainability of their fiscal position. The combination of structural reforms and continuing high economic growth may help to lastingly solve the acceding countries' budgetary problems, some of which are quite considerable. In this respect, the fiscal effects of accession, above all the financial linkage to the EU budget, are likely to have positive consequences. However, they cannot be precisely gauged at present.

Adoption of the fiscal policy framework

Duties of the new EU member states

Following accession to the European Union on 1 May 2004, the ten new member states will, in principle, have the same contractual rights and duties as the existing member states. They will, therefore, be incorporated into the EU's fiscal policy framework, which in particular contains the obligation to avoid excessive government deficits (Article 104 (1) of the Treaty establishing the European Community). For member states which have not yet joined the monetary union (such as Denmark, Sweden and the United Kingdom at present), however, continued violation of this requirement will not entail sanctions. The further requirements to be complied with, which are laid down in the Stability and Growth Pact (SGP), notably include the obligation to achieve a budgetary position in the medium term which is close to balance or in surplus. Moreover, convergence programmes are to be submitted for the purpose of budgetary surveillance. These are to be updated annually and are to outline the measures planned to achieve the budgetary targets. As the precursor to the convergence programmes, the acceding countries submitted programmes in preparation for EU accession (Pre-accession Economic Programmes or "PEPs" for short) to the European Commission for the second time in August 2002. They are part of the pre-accession fiscal surveillance procedure, which was initiated in spring 2001. The aim is to strengthen the technical, statistical, institutional and analytical capacities within each country as well as to promote the economic dialogue with the EU member states.[1] Instead of filing notifications on their deficit and debt levels on a compulsory twice-yearly basis as the EU member states do, the acceding countries have hitherto submitted reports annually on 1 April.[2]

Fiscal convergence criteria

The acceding countries will not join the euro area until they meet all the convergence criteria. These include a sustainable government financial position, which will be apparent from a situation without an excessive deficit (Art 121 (1) of the Treaty establishing the European Community). As a rule, this requires a maximum deficit ratio of 3% and a maximum debt ratio of 60%. Sound public finance is, therefore, an essential prerequisite for participation in monetary union. This is even more important when seen in the light of other factors. Thus fiscal discipline is not only crucial for ensuring stable prices but is also important for achieving a sustainable current account balance.

Compliance with the Maastricht criteria

Deficit ratios

Last year, the deficit ratios of the acceding countries – except for the Baltic states and Slovenia – exceeded the 3% ceiling (see the chart on page 23).[3] The deficit ratio was par-

1 See European Commission, Public Finances in EMU-2002, Part V.
2 The European Commission has not yet published the results of the notifications of 1 April 2003. The figures given in this article are based on publications by national institutions, on publicly available European Commission sources and on the Bundesbank's own estimates.
3 The European System of Accounts 1995 is the EU's methodological basis for the values to be reported under the fiscal surveillance procedure. The corresponding statistical reporting systems are still under construction in the acceding countries. Despite constant improvements, the reported deficit and debt ratios are subject to major revision (although this is also partly the case for existing member states).

ticularly high in Hungary (9.1%) and in the Slovak Republic (7.2%). Marked differences are apparent in the developments in the various countries in recent years.

Favourable development in the Baltic states and Slovenia

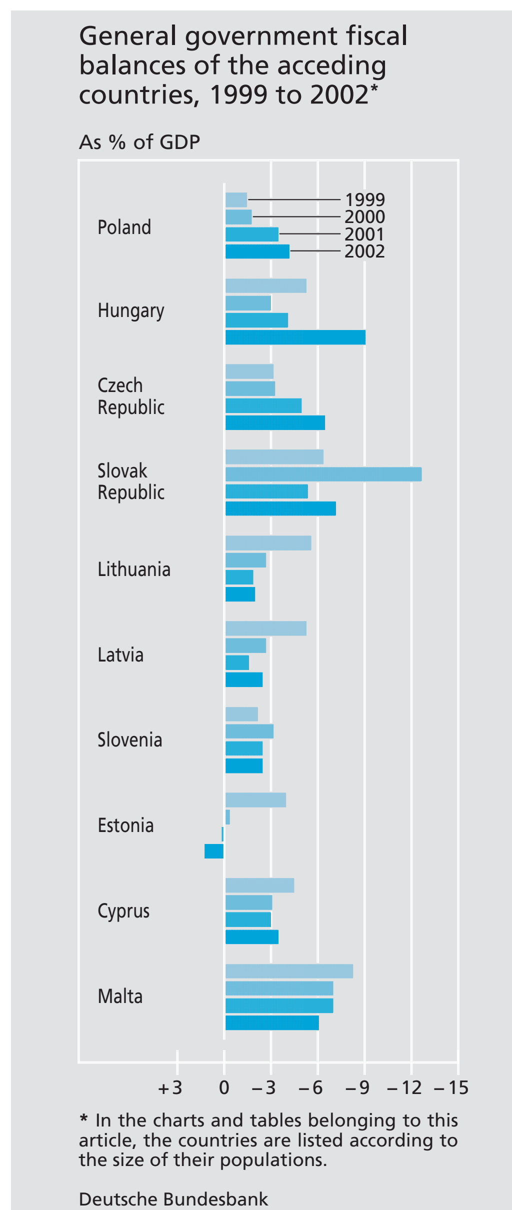
The Baltic states, whose deficits had increased significantly in 1999 – in particular owing to the crisis in Russia – made considerable progress towards consolidation in the subsequent years. Estonia actually recorded a general government surplus of 1.3% of GDP in 2002. This was attributable not least to high real economic growth (around 6% in the Baltic states in 2002 compared with 2½% on average for the acceding countries as a whole). This favourable development shows that – contrary to occasionally expressed fears – fulfilment of the provisions of the Maastricht Treaty and the SGP certainly is compatible with a high economic growth rate. The budgetary situation in Slovenia is also relatively favourable. The deficit in 2002 was well below 3% of GDP, whereas it had slightly exceeded this level in 2000.

Persistently high or rising deficit ratios in Poland and Hungary, ...

By contrast, the budget deficit ratio in Poland – which is by far the most populous acceding country – increased in 2002 for the third year in succession to just over 4%. A sharp increase in expenditure was accompanied by a disappointing revenue trend due to a marked slowdown in the pace of economic growth. Hungary managed to reduce its deficit ratio to 3% by 2000, but then saw it rise dramatically, above all on account of a surge in expenditure. At 9.1%, it had the highest deficit ratio of all the acceding countries in 2002. Much of the jump in the deficit was attributable to exceptional factors, such as the statistical incorporation of off-budget special funds showing large deficits. Moreover, there were major increases in public sector wages and pension benefits, which the government elected last year had promised to implement if it gained office.

General government fiscal balances of the acceding countries, 1999 to 2002*

As % of GDP



* In the charts and tables belonging to this article, the countries are listed according to the size of their populations.

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... the Czech Republic and the Slovak Republic ...

The Czech Republic and especially the Slovak Republic also recorded high deficit ratios in 2002 in excess of the 3% ceiling (6.5% and

7.2% respectively). The budgetary position in both countries has for some years been considerably burdened by restructuring measures designed to tackle profound crises in the banking sector.[4] The measures are being financed largely by privatisation proceeds, which are not reflected in the deficits as defined in the national accounts, although they are reducing the government gross debt.

... as well as Cyprus and Malta

The two Mediterranean countries Cyprus and Malta are very much economically dependent on tourism. The negative developments in this sector owing to international crises affected public finance above all through shortfalls in tax revenue, especially in Cyprus. Owing to weak growth in 2002, the deficit ratio in Cyprus – which along with Slovenia generates the highest per capita income of all the acceding countries (see table on page 32) – increased from 3% to 3.5%. Although the budget deficit in Malta has declined sharply in recent years, it still amounted to around 6% of GDP in 2002.

Planned deficit reduction ...

According to the medium-term plans set out in the PEPs, all of the acceding countries except for the Czech Republic and Malta aim to achieve a deficit ratio which is below the 3% ceiling by 2005 (see table on page 25). This implies an ambitious consolidation policy for the "high-deficit countries" Hungary, the Slovak Republic and Malta (which plans a reduction to 3.1%). The plans in these countries envisage a reduction in the deficit ratio of more than 2 percentage points in comparison with the goals specified in the PEPs for 2002. However, in these countries in particular the actual deficit in 2002 was substantially higher than anticipated, which means that considerably greater consolidation efforts will be required in order to reach the 3% ceiling. The problem is compounded by the fact that the average real growth rates assumed for the period from 2002 to 2005 were, as things stand today – measured in terms of the European Commission's expectations – overly optimistic, above all in the case of Hungary.

The consolidation task is easier for Poland in that the deficit reduction can commence from a far lower level. In this country, the sluggishness of economic activity over the past two years (with annual real GDP growth at around 1%) constitutes a particular problem. Much the same is true for Cyprus. The Baltic states and Slovenia, where the deficit ratio is already below 3%, should focus their plans on achieving a balanced budget in the medium term. The Czech Republic is the only high-deficit country which is not planning to sizeably reduce its deficit, which is envisaged to amount to 5½% of GDP in 2005.

... above all through spending cuts

The necessary consolidation measures are even more ambitious in that they are to be implemented predominantly on the expenditure side. There is only limited scope on the revenue side in view of the existing levy burden. Furthermore, several acceding countries are endeavouring to introduce attractive tax regimes with low tax rates; despite the positive supply-side effects expected in the medium to long term, this is likely to lead to revenue shortfalls in the short run. The Slovak

4 According to the Czech central bank, the relevant cumulative costs for the Czech Republic amount to around 20% of GDP.

Medium-term budget plans of the acceding countries

	Realised/planned fiscal balances (as % of GDP)							Annual average real GDP growth in %			
	2002		2003		2004		2005	2002		2003-05	2003-04
Country	PEP [1]	Actual [2]	PEP [1]	COM [3]	PEP [1]	COM [3]	PEP [1]	PEP [1]	Actual [2]	PEP [1]	COM [3]
Poland	– 4.1	– 4.2	– 3.6	– 4.2	– 3.3	– 4.0	– 2.2	1.0	1.3	4.5	3.1
Hungary	– 5.7	– 9.1	– 4.5	– 4.9	– 3.0	– 3.7	– 2.5	4.0	3.3	4.8	3.9
Czech Republic	– 6.4	– 6.5	– 6.0	– 6.3	– 5.7	– 5.9	– 5.5	3.0	2.0	3.9	3.4
Slovak Republic	– 4.6	– 7.2	– 4.1	– 5.3	– 3.1	– 3.8	– 2.6	3.6	4.4	4.6	4.1
Lithuania	– 1.9	– 2.0	– 1.7	– 1.9	– 1.6	– 2.0	– 1.5	5.5	5.9	5.0	4.8
Latvia	– 1.8	– 2.5	– 2.5	– 2.9	– 2.2	– 2.6	– 2.0	5.0	6.1	5.7	5.8
Slovenia	– 1.8	– 2.5	– 1.3	– 1.5	– 1.0	– 1.2	– 0.8	3.3	3.0	4.4	3.6
Estonia	– 0.2	1.3	0.0	– 0.5	0.0	– 0.6	0.0	4.3	5.6	5.8	5,0
Cyprus	– 2.6	– 3.5	– 1.9	– 4.0	– 0.6	– 3.5	– 0.3	2.8	2.0	4.6	2.9
Malta	– 5.2	– 6.1	– 4.6	– 5.2	– 3.9	– 4.1	– 3.1	3.3	3.0	3.5	3.4

1 PEP: Pre-accession Economic Programmes. — **2** Actual: actual value for 2002. — **3** COM: spring forecast of the European Commission.

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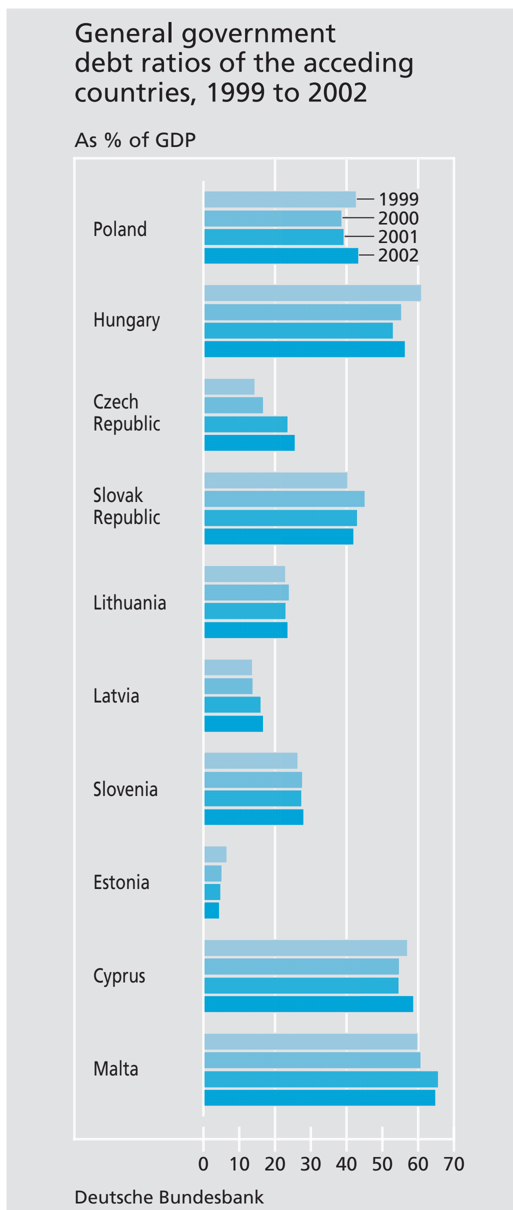
government recently decided to introduce a flat-rate income tax of 19% for both individuals and corporate entities as of 2004, although this is to be counter-financed by an increase in excise taxes. A "flat tax" is also being discussed in Poland.

Determinants of debt

In principle, government debt is a reflection of past budget balances. However, other determinants are also of considerable significance, especially for the new member states. Privatisation transactions, which play a major role there, are shown in the national accounts as not affecting the deficit, although they do have a dampening impact on the gross debt. On the other hand, the assumption of debt, for example in the wake of restructuring the banking system, or the allocation of enterprises to the government sector push up the national debt without this necessarily being reflected as an increase in the deficit as defined in the national accounts. However, these so-called financial transactions will probably diminish in the years to come as, in particular, the potential for selling enterprises is shrinking constantly. Fluctuations in the debt ratio are also caused by valuation adjustments wherever the government debt has been incurred in foreign currency. In Poland, the appreciation of the zloty in 2001 was a major reason why the increase in indebtedness was smaller than the general government fiscal balance had suggested it would be. In 2002, the devaluation of the zloty had the opposite effect on the debt level. The acceding countries show a mixed picture with regard to borrowing in foreign currency. The low level of government debt in the Baltic



states is denominated primarily in foreign currency, while the Czech Republic has for some time issued bonds only in the domestic currency.

Debt ratio

The acceding countries' debt ratios present a much more favourable picture than do their deficit ratios. Except for Malta, all of the countries are below the 60% limit – some of them considerably so (see chart on this page), although Hungary and Cyprus are only just below this level. As in the case of the budget deficits, the Baltic countries, which did not have any debt when their independence was re-established, are at the lower end of the spectrum. Whilst all of the other countries showed more or less constant debt ratios in the last four years, the debt ratio in the Czech Republic has increased sharply, above all as a result of the aforementioned determinants that are of no relevance for the deficit ratio.

Fiscal sustainability endangered in some cases

Uncertainties of medium-term plans

Although the evolution of the deficit and debt ratios projected in the respective countries' medium-term financial plans for the years ahead provides important indications of possible progress towards convergence, the projected development – as in the current EU countries – is strongly dependent on the underlying macroeconomic assumptions and on anticipated but often not yet adopted fiscal projects. The available plans should therefore be supplemented with more fundamental considerations on whether the present fiscal situation in the acceding countries is sustainable.

Definition of sustainability

The generally applicable principle is the so-called intertemporal government budget constraint, ie the requirement that future government revenue and expenditure, discounted to the present over an infinite time-horizon, must balance. However, the long-term requirement for government expenditure and revenue to match can be neutralised for par-

ticular periods or individual generations through borrowing. The degree of fiscal sustainability can therefore be derived from the level and expected development of a country's debt ratio.

Development of the debt ratio as an indicator

Clearly, a permanently rising debt ratio cannot be financed because, after it has reached a certain level, either the country's limited economic capability will prove an intractable obstacle or the political readiness to provide the necessary resources will be lacking. Accordingly, whether a country's fiscal and macroeconomic conditions are such that the general government debt ratio remains constant or converges towards a desired value is considered a general indicator of fiscal sustainability. A standard approach to answering this question is to simply extrapolate the status quo, which indeed can provide a certain indication of whether or not fiscal sustainability has been attained. This is, however, only a rough initial estimate as the current fiscal situation and the macroeconomic conditions can alter significantly in the future even without a change in policy. Thus demographic developments, in particular, can lead to considerable shifts in government revenue and expenditure ratios. Other variables such as interest rates and growth rates may also be subject to structural changes in the long term.

Sustainability as defined in European legislation

European legislation has provided a political definition of sustainability. The provision in the Maastricht Treaty limiting the deficit and the debt ratios to, as a rule, a maximum of 3% and 60%, respectively, as well as the further-going objective set out in the SGP of achieving a budgetary position that is at least close to balance in the medium term contribute substantially to permanently ensuring fiscal sustainability. This averts the danger of a sovereign default. The possibility that monetary policymakers or other member states have to intervene in order to contain the negative spill-over of unsound public finance or even a solvency crisis was a major reason why the fiscal discipline requirement was enshrined in the Maastricht Treaty.

Overall pattern of debt dynamics

As shown in the synoptic table on page 28, the development of the debt ratio is dependent not only on the primary balance, (ie the difference between revenue and expenditure excluding interest payments), but also on the rate of macroeconomic growth and the interest rate level. When analysing this overall pattern of debt dynamics, the actual primary balance is often compared with the primary balance that would be needed to stabilise the current debt ratio or to reach a specified target within a certain period. The difference between the two balances (expressed as a percentage of GDP) is termed the "primary budget gap" and shows to what extent revenue and expenditure, which in principle can be altered by policy measures, have to be adjusted in order to attain the desired debt path. Analyses of the overall pattern of debt dynamics played a major role, too, in assessing the fiscal convergence of the current euro-area countries in 1998. [5]

5 For details, see: Convergence Report of the European Monetary Institute of 25 March 1998, in: Deutscher Bundestag, Drucksache 13/10250, p 241 ff as well as the Opinion Concerning Convergence in the European Union published by the Central Bank Council of the Deutsche Bundesbank on 26 March 1998, ibid, p 757 ff.

The debt ratio and its determinants

The government debt at the end of a period t (B_t) results from the debt level at the end of the previous period (B_{t-1}) plus the deficit in the current period (D_t). The deficit is derived from the interest paid on the debt of the previous period (B_{t-1} i, where i is the average effective interest rate paid on the government debt) less the primary balance (S_t):

$$B_t = B_{t-1} + D_t = B_{t-1} + B_{t-1}\, i - S_t.$$

If there is a primary surplus, a part of the government's interest payments is financed from government revenue. In terms of GDP, the above budget equation reads as follows:

$$b_t = b_{t-1} \frac{1+i}{1+g} - s_t.$$

In this equation, b_t (b_{t-1}) is the share of GDP represented by government debt in period t (t–1), s_t is the primary balance in relation to GDP in period t and g is the nominal GDP growth rate. For the change in the debt-to-GDP ratio ($\Delta b_t = b_t - b_{t-1}$), this gives us:

$$\Delta b_t = b_{t-1} \frac{i-g}{1+g} - s_t.$$

The development of the debt ratio is negatively dependent on the primary balance and positively dependent on the growth-adjusted interest payment on the previous period's debt ratio. The "growth-adjusted interest rate" $[(i-g)/(1+g)]$contains the

nominal interest rate effect: $\frac{i}{1+g}$,

real growth effect: $\frac{n}{1+g}$,
where n = real GDP growth, and the

GDP deflator effect: $\frac{\pi}{1+g}$,
where π = GDP deflator.

If the debt ratio is to be stabilised at its current level, ie $\Delta b_t \doteq 0$, the primary balance ratio (s_t*) is as follows:

$$s_t^* = b_{t-1} \frac{i-g}{1+g}.$$

The difference between the current primary balance and the primary balance needed to stabilise the debt ratio (both expressed as ratios) is termed the "primary budget gap"(s_{BI}):

$$s_{BI} \equiv s_t - s_t^* = s_t - b_{t-1} \frac{i-g}{1+g}.$$

It is an indicator of the degree of consolidation required to stabilise the debt ratio under the assumed macroeconomic conditions.

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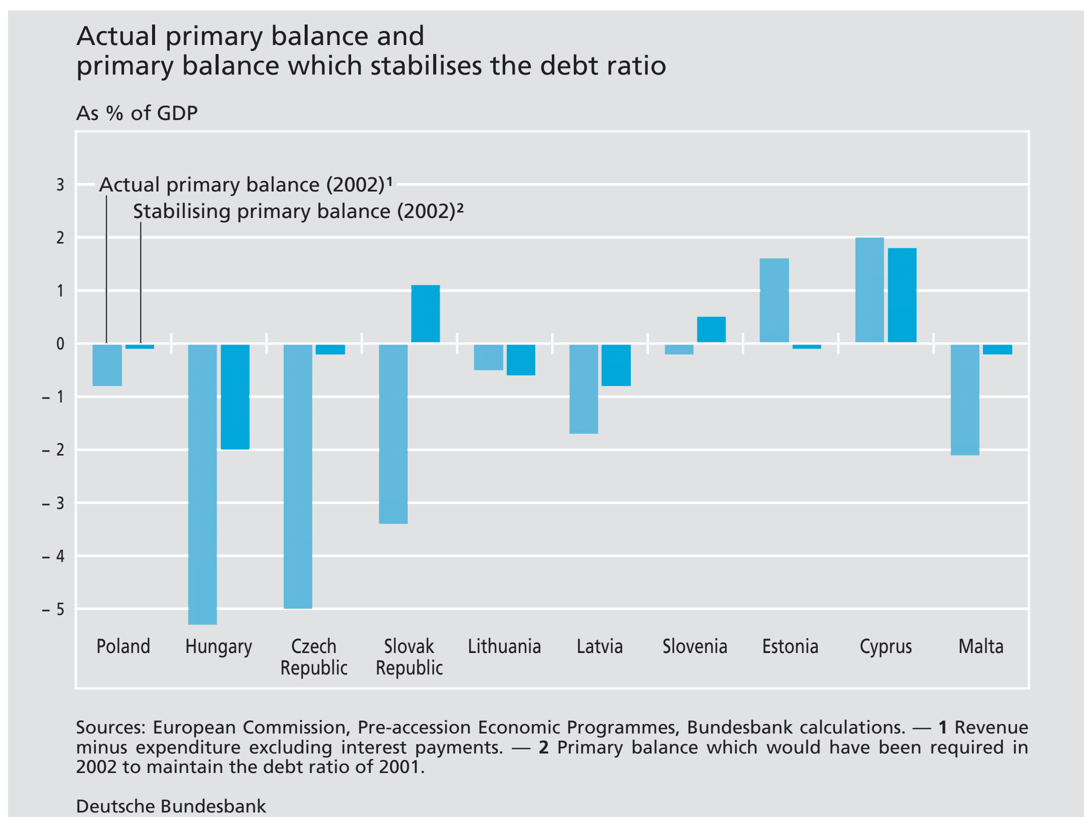
Hypothetical development under the present national conditions ...

If one assumes that the interest rate level and nominal GDP growth remained unaltered in the individual acceding countries on average from 1999 to 2002, considerable differences are apparent in most of the countries between the primary balance needed to stabilise the debt ratio and the actual primary balance (see chart on page 29). The Czech Republic, Hungary and the Slovak Republic would need to improve their budgetary position by more than 3% of GDP in order to stabilise their debt ratios. Conversely, Lithuania, Estonia and Cyprus already show "positive primary budget gaps" under status quo conditions.

The development of the debt ratio presents a similar picture if no consolidation is assumed, ie if the primary balance for 2002 remains unaltered (see table on page 30). If the average GDP growth for the period from 1999 to 2002 is taken as a basis, the debt ratio in the aforementioned countries with large primary budget gaps would, in some cases, rise well above the 60% ceiling by 2015. By contrast, Estonia could build up net wealth.

... and under EMU conditions

However, it cannot be assumed that the present macroeconomic conditions in the acceding countries – which, in contrast to the current euro-area countries, are mostly characterised by relatively high growth rates and interest rate levels – will remain unchanged during the adjustment process. Instead, convergence with the "old EMU" level is to be expected in the medium to long term. In a second scenario, therefore, the average for all the current member countries from 1999 to 2002 is used as a rough approximation for



Actual primary balance and primary balance which stabilises the debt ratio

Sources: European Commission, Pre-accession Economic Programmes, Bundesbank calculations. — **1** Revenue minus expenditure excluding interest payments. — **2** Primary balance which would have been required in 2002 to maintain the debt ratio of 2001.

the new member states with regard to overall economic growth and the interest rate level.

If, applying these macroeconomic constraints, unchanged primary balances are assumed in the acceding countries from 2002, the debt ratio in four countries (the Slovak Republic, Slovenia, Estonia and Cyprus) would develop more favourably up to 2015 than if the national interest rate level and the average GDP growth rate for the period from 1999 to 2002 are extrapolated. Cyprus' debt ratio would actually decrease significantly. The main reason for the more favourable development is that the current situation in these countries is characterised by a relatively high rate of interest on government debt in relation to overall economic growth. However, this ratio is, as a rule, much more favourable under EMU conditions, which means that these countries would gain particularly from the expected convergence.

By contrast, the remaining six acceding countries would face a more rapidly growing debt ratio under the EMU scenario. This – given the across-the-board negative primary balances – is due to the less favourable interest rate/growth constellations: at present, the GDP growth rates are higher than the interest rates, whereas the opposite would be the case in the EMU scenario. All in all, the projections show no clear trend in the transition to EMU conditions. The debt ratios would develop less favourably in most of the acceding countries. By contrast, there would be a marked improvement in some countries. It is to be expected, however, that the interest

Development of debt ratios with varying interest rate and growth assumptions

As % of GDP

Country	Current scenario [1]			EMU scenario [2]		
	2005	2010	2015	2005	2010	2015
Poland	45.4	49.0	52.5	46.3	51.5	56.8
Hungary	65.6	78.9	89.8	73.2	101.7	131.0
Czech Republic	39.7	62.5	84.1	41.0	67.3	94.2
Slovak Republic	55.7	81.3	110.3	52.8	71.2	90.1
Lithuania	23.2	22.6	22.1	25.5	28.6	31.8
Latvia	19.2	22.4	24.8	22.2	31.3	40.6
Slovenia	30.2	34.1	38.4	29.0	30.7	32.5
Estonia	– 0.6	– 8.2	– 15.2	– 0.4	– 8.4	– 16.7
Cyprus	58.5	58.0	57.4	53.5	44.7	35.7
Malta	70.7	80.3	89.8	72.2	84.5	97.2

Sources: European Commission, European Central Bank, Pre-accession Economic Programmes, Bundesbank calculations. — **1** Extrapolation of the primary balance ratios estimated for 2002, the average effective interest rates for 2002 approximated using the deficit ratio, primary balance ratio and debt ratio, and the average nominal GDP growth rates in the period from 1999 to 2002. — **2** In contrast to the current scenario, the average yield on ten-year government bonds in the euro area (1999 to 2002: around 5%) and the average GDP growth rate in the euro-area countries (1999 to 2002: around 4½%) were used as a basis here.

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rate level will approach the euro-area average relatively quickly in the process of convergence, while growth rates are likely to remain considerably higher over the longer term. In this respect, the EMU scenario described here presents an overly unfavourable picture of the development of the debt ratios.

Exemption from Stability and Growth Pact rules not advisable

Exemption from balanced budget requirement for acceding countries…

EU legislation, which is oriented towards a sustainable public finance position, is often criticised for being too inflexible. Against this background, there have been occasional calls, subject to certain conditions, to relax the fiscal discipline requirement for the acceding countries – at least for a certain time. These advocates of relaxing the rules argue that a certain structural deficit would be tolerable as, given the low debt ratio in most of the new member states and the high nominal economic growth, the 60% ceiling is unlikely to be breached even in the longer term. Furthermore, they argue that the acceding countries need to vastly expand their infrastructures, especially in the public domain, and that this could be debt-financed, at least in part.

… not warranted by legal or political…

There are legal reasons but also other important arguments for not allowing exemptions from the Pact. The SGP provides uniform,

transparent and comprehensible rules.[6] A relaxation of the rules in individual cases would run counter to these fundamental principles and would compromise, in particular, the confidence placed in the ongoing validity of these rules and consequently in a sound fiscal policy in the future. Given that fiscal and economic policies remain largely a matter of national sovereignty, this would lead to a blurring of responsibilities. Special treatment in applying the SGP would undermine the credibility of the legislative framework and should be rejected.

... or economic reasons, ...

Furthermore, there are also economic arguments against granting the acceding countries special treatment. The SGP's medium-term budgetary objective is intended, amongst other things, to ensure that the 3% ceiling laid down in the Maastricht Treaty can be maintained even during periods of economic weakness (safety margin for cyclical fluctuations). Almost all of the acceding countries have small open economies whose dynamic growth in recent years has been principally characterised by substantial foreign direct investment and the possibility of virtually unhindered exports to the EU. External shocks are likely to lead to relatively severe output fluctuations and, given the sensitivity of public finance to cyclical fluctuations – which is not very different from the situation in the current EU member states[7] – to the triggering of the automatic stabilisers. It therefore follows that the safety margin for maintaining the 3% ceiling should at least not be curtailed.

... especially as major demographic strains lie ahead ...

Furthermore, although the budgetary consequences of the demographic change in the acceding countries are likely to become noticeable somewhat later, they will in principle be similar to those in the current EU countries. The birth rates (children per female) are considerably lower than those required to keep the population at a constant level and (apart from in Malta and Cyprus) are also below the EU average of just under 1.5.[8] Although the age structure is generally still more favourable than in the EU (in the sense of a lower average age), this does not affect the long-term trend towards an ageing and declining population. A rapidly increasing level of indebtedness in the coming years would make it very difficult to cope with these problems in terms of fiscal policy.

However, some of the acceding countries have already adopted far-reaching reform measures in order to limit the additional burdens of unfunded statutory pension and health systems. Extensive reforms have been set in train in Poland and Hungary. Besides partly decoupling pension adjustments from wage growth, these reforms also include the introduction of a funded pension component. By contrast, there is still a considerable need for action, for example, in the Czech Republic, although further reforms, such as decoup-

6 Their positive effects on fiscal discipline have already been emphasised, eg with regard to the three Baltic states. See study by A M Kutan and N Pautola-Mol (2002), *Integration of the Baltic States into the EU and Institutions of Fiscal Convergence,* Bank of Finland, Discussion Paper No 1.
7 See F Coricelli and V Ercolani (2002), *Cyclical and Structural Deficits on the Road to Accession: Fiscal Rules for an Enlarged European Union,* CEPR Discussion Paper, No 3672.
8 Data for 2001. At 1.1, the birth rate in the Czech Republic is the lowest of all the acceding countries.

Key statistical indicators for the acceding countries

Country	Area in thousands of km² 2002	Population in millions 2002	Per capita GDP in purchasing power standards EU 15 = 100 2002	Real GDP growth in % 2002	Agricultural sector's share of gross value added in % 2001	Unemployment rate in % 2002	Increase in the consumer price index in % 2002
Poland	312.7	38.6	39	1.3	3.8	20.0	1.9
Hungary	93.0	10.2	57	3.3	4.3	5.8	5.3
Czech Republic	78.9	10.1	60	2.0	4.2	7.3	1.4
Slovak Republic	49.0	5.4	47	4.4	4.6	18.5	3.3
Lithuania	65.3	3.5	39	5.9	7.1	16.9	0.3
Latvia	64.6	2.3	35	6.1	4.7	12.3	1.9
Slovenia	20.3	2.0	74	3.0	3.1	6.4	7.5
Estonia	45.2	1.4	41	5.6	5.8	10.3	3.6
Cyprus [3]	9.3	0.7	74	2.0	4.0	3.3	2.8
Malta	0.3	0.4	[4] 55	3.0	2.4	6.9	2.2

Country	Interest rate: Money market [1] in % 2002	Interest rate: Bonds [2] in % 2001	General government fiscal balance as % of GDP 2002	General government debt level as % of GDP 2002	Current account balance as % of GDP 2002	Trade with EU, share of total exports in % 2001	Trade with EU, share of total imports in % 2001
Poland	9.0	10.7	– 4.2	43.3	– 3.6	69.2	61.4
Hungary	9.2	9.1	– 9.1	56.4	– 4.1	74.2	57.8
Czech Republic	3.5	5.6	– 6.5	25.6	– 3.1	69.0	61.8
Slovak Republic	7.8	7.9	– 7.2	41.9	– 8.2	60.0	49.9
Lithuania	3.7	7.3	– 2.0	23.6	– 4.4	50.2	44.4
Latvia	3.3	7.6	– 2.5	16.8	– 7.8	61.2	52.6
Slovenia	8.0	[5] –	– 2.5	28.0	1.8	62.2	67.6
Estonia	3.4	[5] –	1.3	4.4	– 12.3	69.5	56.5
Cyprus [3]	4.4	7.0	– 3.5	58.7	– 5.3	49.5	50.8
Malta	4.0	5.5	– 6.1	64.9	– 4.7	44.6	63.0

Sources: Eurostat, European Commission, Bundesbank estimates. — **1** Interest rate for three-month funds. — **2** Yields on medium-term government bonds. Poland: yields on long-term government bonds. — **3** Territory controlled by government (area: total area). — **4** 1999. — **5** No data.

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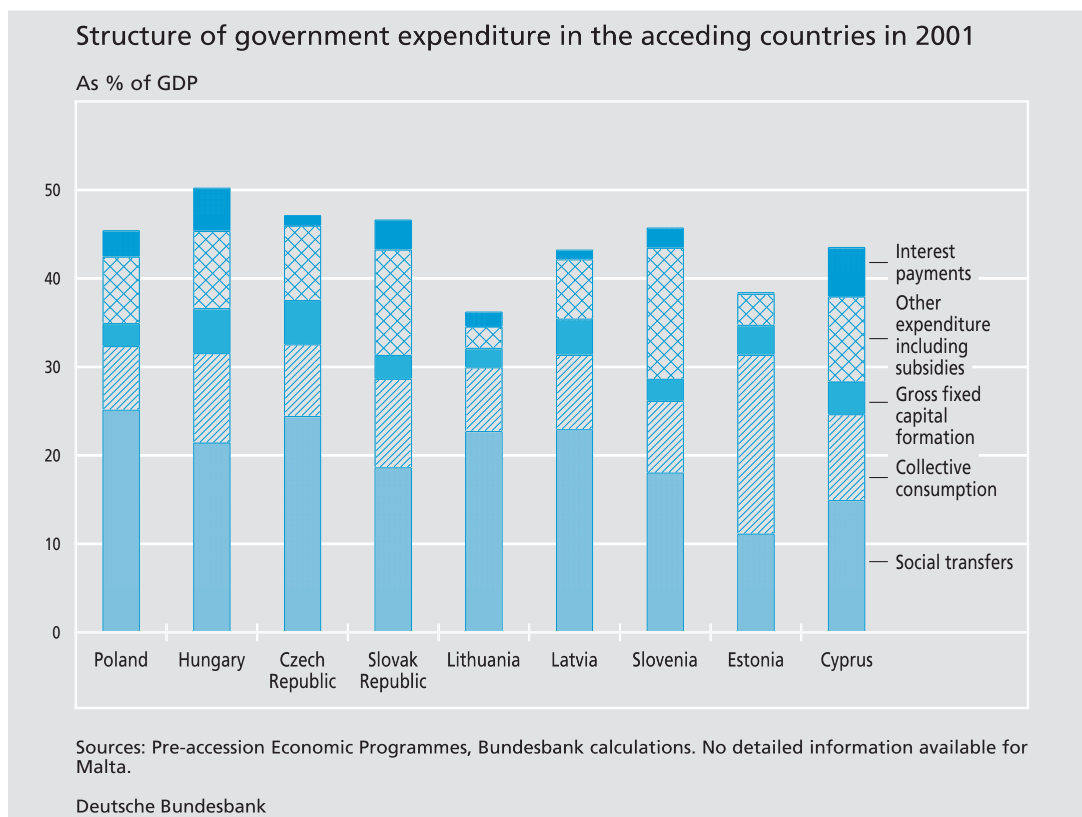

ling pensions from wage developments, are also being considered there.

... and the government expenditure ratio is already very high

As far as financing the substantial investment requirements is concerned, the structure and size of the government budgets in the acceding countries suggest that it would be wiser to shift the emphasis of expenditure from consumption to investment rather than to opt for a deficit-boosting increase in overall expenditure (see chart on page 34). The average government expenditure ratio in the new member states in 2001 exceeded 46% and thus virtually matched the EU level (47%), although the government expenditure ratio typically correlates positively with a country's level of economic development – and per capita GDP in the acceding countries (measured in purchasing power standards) is only 45% of the EU level. There are also only minor differences between the acceding countries and the EU average with regard to the structure of government expenditure, especially the large share of social transfers. Moreover, it should be borne in mind that the extensive cofinancing of investment by the EU limits the acceding countries' additional financing requirements for developing their infrastructure.

The fiscal effects of accession

Effect of accession on expenditure ...

Accession to the EU will affect public finance in the acceding countries in many different ways, mainly owing to the financial linkage to the EU budget. Other budgetary aspects also

need to be taken into account, however.[9] On the expenditure side, the new member countries will firstly have to contribute around 1% of their GDP towards financing the EU budget. Furthermore, additional expenditure will be required to comply with the EU's legal standards, for example in the field of environmental protection. On the other hand, the EU's agricultural subsidies will replace the corresponding national payments. Moreover, subsidies in other areas will also have to be abolished if they conflict with the EU's rules on state aid.

... and revenue in the national budgets

As the sizeable agricultural subsidies flow from the EU budget directly to the beneficiaries, transfers from the Structural Funds and the Cohesion Fund are the most important items of government revenue from EU resources. However, these payments are governed by the cofinancing principle, which limits the subsidy from the Structural Funds to, as a rule, 75% of the investment volume. In addition, the principle of additionality is applied, whereby ongoing investment projects are excluded from assistance. The maximum amount available from structural assistance measures is limited to 4% of the recipient country's GDP. The extent to which this ceiling is actually reached depends on the absorption capacity, ie not only must a country have sufficient projects which fulfil the eligibility criteria, it must also develop administrative capacities to implement the programmes. The very limited use which the acceding countries have made so far of pre-accession aid, which they receive through the PHARE (institution building), ISPA (environmental and transport projects) and SAPARD (structural measures for the agricultural sector) programmes, is an indication of deficiencies in this area. It is thus to be expected that the funding possibilities will be exhausted only gradually.

Furthermore, additional revenue will be generated through the need to harmonise certain indirect taxes, especially in the energy sector. By contrast, revenue shortfalls will result from the adoption of the EU's tariff regime.

Indirect fiscal effects

These direct revenue and expenditure effects will be accompanied by indirect fiscal effects if accession to the EU *per se* boosts economic growth, thus leading to higher tax receipts. Lower interest costs for servicing the government debt as a result of reduced risk premia should also be mentioned. However, the expected accession to the EU and even the introduction of the euro have already been partly factored into interest rates on the capital markets.

Arrangements up to 2006

When assessing the extent of the aforementioned payment streams and the resulting strains or relief for the acceding countries' fiscal positions, a distinction should be made between the short and the long term. Before concluding the accession negotiations, the European Summit in Copenhagen agreed in December 2002 on a corresponding adjustment of the financial perspective up to 2006, covering the period from 2004 to 2006, which lays down binding expenditure limits

9 For details see: P Backé (2002), Fiscal Effects of EU Membership for Central European and Baltic EU Accession Countries in *Focus on Transition,* No 2/2002, Oesterreichische Nationalbank, pp 151-164.

The financing of enlargement

Agreement on the integration of the acceding countries into the EU's financial operations was a major political prerequisite for the signing of the accession treaties. Following lengthy negotiations, a corresponding decision was reached at the European Summit in Copenhagen in December 2002 and enshrined in the Act of Accession signed in Athens on 16 April. On 9 April, the European Parliament adopted a decision for the necessary adjustment of the financial perspective which lays down the EU's binding expenditure ceilings for the period from 2000 to 2006.

From 2004 to 2006, €41.4 billion in total will be available to the acceding countries in the expenditure categories agriculture, structural actions, internal policies and administration (these and all further details at 2004 prices). If a political settlement is reached on the Cyprus issue, €300 million in additional funds will be made available. Transfer payments will be provided within the limits of the expenditure ceilings agreed at the Berlin Summit in 1999, which were in fact slightly undershot even though, at that time, the calculation was based on enlargement by only six new members (see table on page 36). The aforementioned amount concerns commitment appropriations, of which only a part is actually likely to be paid out within the time-frame in question. As the new member countries will have to contribute to financing the EU's total expenditure – mostly in proportion to their gross national income – as soon as they join the EU on 1 May 2004, there was a risk that some of the acceding countries would have become net contributors to the EU budget and remained so for several years. In order to counter this, a new expenditure item entitled "Compensation" was created, from which lump-sum payments totalling €3.7 billion will be made to the acceding countries up to 2006. According to initial estimates, there could be a total net transfer of around €15 billion to the acceding countries from 2004 to 2006, which would correspond to 1% of their GDP in this period. This figure will probably increase continuously in subsequent years. Firstly, the actual number of drawdowns of appropriations will rise once action financed as part of structural assistance measures starts. Furthermore, direct payments to agricultural holdings will increase gradually from 25% of the comparable EU level in 2004 to 100% in 2013. However, at the moment it is virtually impossible to forecast whether and, if so, when the level of up to almost 5% of GDP recorded in the past for the existing net recipients in the EU will be reached. This will depend on both the absorption capacity of the new member states and the overall expenditure framework for the next financial perspective, which is still to be decided.

The reason given for the progressive introduction of direct payments to farmers over a ten-year period is that the immediate introduction of payments in full would leave the current structures unaltered and provide hardly any incentives for modernisation owing to the large income transfer. The new member states were able to negotiate an improvement for their agricultural producers in that they may considerably top up the direct payments with appropriations earmarked for rural development and national funds.

Almost two-fifths of the appropriations for "Internal policies" take the form of temporary financial assistance intended to help the acceding countries in implementing the Schengen *acquis,* in the field of nuclear safety and in building up administrative capacities. Upon accession, the countries in question will no longer have the option of new expenditure commitments as part of pre-accession aid. The ceiling for this expenditure category, which is to be renamed "Pre-accession strategy", will be maintained, however. In future, it will incorporate the expenditure for the accession countries Bulgaria and Romania as well as pre-accession aid for accession candidate Turkey. This expenditure is to be boosted significantly. In principle, this budgeted amount also provides scope to support further countries or rather possible future applicant countries.

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EU enlargement in the financial perspective (2000-06)

€ billion

Commitment appropriations	Current prices					2004 prices	
	2000	2001	2002	2003	2004	2005	2006
1. Agriculture	41.7	44.5	46.6	47.4	49.3	50.4	50.6
of which AC 1	–	–	–	–	2.1	4.1	4.6
2. Structural actions	32.7	32.7	33.6	34.0	41.0	41.7	42.9
of which AC 1	–	–	–	–	6.7	7.6	9.7
3. Internal policies	6.0	6.3	6.6	6.8	8.7	9.0	9.1
of which AC 1	–	–	–	–	1.6	1.6	1.5
4. External actions	4.6	4.7	4.9	5.0	5.1	5.1	5.1
5. Administration	4.6	4.8	5.0	5.2	6.0	6.2	6.3
of which AC 1	–	–	–	–	0.6	0.6	0.7
6. Reserves	0.9	0.9	0.7	0.4	0.4	0.4	0.4
7. Pre-accession strategy	3.2	3.2	3.3	3.4	3.5	3.5	3.5
8. Compensation for AC 1	–	–	–	–	1.4	1.3	1.0
Total appropriations for commitments	93.8	97.2	100.7	102.1	115.4	117.5	119.0
of which for enlargement	–	–	–	–	12.4	15.3	17.5
(ditto according to Berlin Summit decision of 1999)	–	–	6.9	9.8	12.8	15.7	18.5
Total appropriations for payments	91.3	94.7	100.1	102.8	111.4	112.3	114.7
Appropriations for payments as % of GNI 2	1.07	1.08	1.11	1.09	1.08	1.06	1.06
Own resources ceiling as % of GNI 2	1.24	1.24	1.24	1.24	1.24	1.24	1.24

1 AC: acceding countries. — **2** GNI: gross national income.

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for the EU budget. Lump-sum payments will ensure that the acceding countries do not become net contributors to the EU budget – which would otherwise have been the case, given the fact that payments from the Structural Funds will flow only gradually (see box on page 35).

Longer-term effects

Assuming that the EU's structural policy will remain largely unchanged after 2006, considerable assistance from the EU budget for investment projects in the acceding countries is to be expected in the medium to long term. The extent of this assistance will be defined in the next financial perspective, which will probably cover the financial years 2007 to 2013 and is likely to take into account the accession of Romania and Bulgaria. The question of how the available resources are to be distributed will doubtless be the subject of intense struggles during the consultation process. The new member states' claims must be satisfied within a parallelogram of forces in which, on the one hand, the net contributors are seeking to limit their financial burden and, on the other, the current principal beneficiaries of structural assistance are trying to retain their existing level of aid. The focus of structural assistance at present is on helping "regions whose development is lagging behind" (Objective 1 areas). This includes regions whose per capita GDP – expressed in purchasing power standards – is less than 75% of the EU average. As the per capita GDP of all the acceding countries falls significantly short of the EU average at both national and regional level, the EU's "new" average per capita GDP will be around 10% lower.

Owing to this statistical effect alone, a large number of the present Objective 1 areas would no longer be eligible for assistance.

Restructuring of agricultural subsidies

One financing possibility to support the convergence process of the new member states lies in reforming or reducing the agricultural subsidies, which account for almost half of the EU budget. The reform of the Common Agricultural Policy (CAP), which was initiated by the European Commission and has now been set in motion by a decision of the Council of Ministers, aims to decouple aid from actual production. It may be possible to avoid the existing cost-driving tendency towards overproduction by concentrating aid on direct payments unconnected with production levels or surface areas. At the moment, however, it is uncertain whether the reform now agreed upon in principle will not only potentially eliminate market-distorting effects but also provide significant relief for European tax payers. The agricultural subsidies have already been fixed at the 2006 level (with an annual 1% adjustment for inflation) up to 2013.