

ALTERNATIVE FISCAL RULES FOR THE NEW EU MEMBER STATES

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1. Introduction

The fiscal regime of the new member states that joined the European Union on 1-5-2004 is dictated by the so-called Stability and Growth Pact (SGP, Amsterdam 1997, amended in March 2005) by virtue of EU membership and, for EMU candidates such as all new EU members are supposed to become soon after EU membership, by the Maastricht Treaty (1991). This paper illustrates such a dual fiscal regime (section 2) and stresses its almost perverse nature: in practice, though not in principle, the Maastricht conditions to be satisfied in the year before EMU entry is assessed are significantly harder than the standard SGP conditions applicable before that year and after EMU entry, thus representing a pointless and unnecessary hurdle. Quite independently of the appropriateness or otherwise of the fiscal constraints involved, the year-long pre-EMU fiscal regime and the SGP regime should be unified, in order not to delay unreasonably and unnecessarily both fiscal consolidation and the introduction of the euro in central eastern Europe (section 3).

Sections 4-7 discuss the fiscal difficulties of most of the new member states: the structural nature of current fiscal deficits (section 4); the commitment to relatively low (and mostly indirect) taxation, and the diffusion of the “flat tax” throughout the area (section 5); the relatively high cost of servicing public debt, in spite of its relatively small size, due to high interest rates and, more generally, the cost of failure to coordinate monetary and fiscal policy (section 6); last but not least, the fiscal shock of EU entry, due to additional net claims on government budgets in spite of positive net transfers to the economy as a whole (section 7).

Section 8 discusses the shortcomings that have been attributed to the SGP by its critics, and their relevance to the special conditions of central-eastern European economies, namely: the neglect of the size of public debt, and of the share of public investment; the failure to co-ordinate, within the Euro-area, both the

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fiscal policy of member countries, and the overall fiscal stance of the euro-area with ECB monetary policy; the inappropriateness of SGP rules to the principle of “subsidiarity” that shapes EU policy. While the March 2005 reform has softened the SGP fiscal deficit constraint to take some of these factors into consideration, there is still considerable uncertainty and indeterminacy in the EU authorities’ discretionary powers to deal with them, and the Maastricht conditions remain still as rigid as in their original formulation.

The implications of this overall picture are likely delays in both fiscal consolidation and the introduction of the euro in many of the new eastern member states – unless they can get away with either cosmetic measures such as those pioneered by Italy and other member states, basically playing with quasi-fiscal assets and liabilities, or unilateral euroisation as in Montenegro and Kosovo - two options which are neither likely nor desirable (section 9).

The paper concludes by recommending 1) the unification of the fiscal deficit requirements of EU membership and EMU entry, and 2) the formal non-discretionary modification of the fiscal deficit rules applicable to both EU membership and EMU entry in the same directions of the March 2005 reform of the SGP; 3) the relaxation of fiscal constraints for individual countries as long as the overall fiscal stance of the entire euro-area meets the criteria set for each country.

2. The fiscal regime of new and old EU members

By virtue of the Maastricht Treaty, EMU membership requires, *in the year prior to EU authorities’ assessment of a candidate country’s convergence*, the satisfaction of both a stock and a flow fiscal condition, namely a maximum 60% ratio of public debt to GDP, and a maximum public deficit of 3% of GDP - unless these ratios are judged to be close to being satisfied and are falling at a sufficiently fast rate towards their ceilings.

The debt stock condition traditionally has been interpreted most leniently in the case of Belgium, Italy, Ireland and Greece, which vastly exceeded 60% of GDP both at the time of their EMU accession and to date (Italy’s debt started rising again in 2005, towards 110% of GDP). *In any case all present eastern and central European members of the EU satisfy the 60% ceiling on public debt as a percentage of GDP.* Table 1, using national statistics, gives Hungary in 2004 as exceeding the ceiling by only 0.5%; according to Eurostat, which is what counts for the verification of the criterion, all countries are under the 60%

ceiling (with the most indebted, Hungary, at 59.9% in 2004; see table 5). The presence of *quasi-fiscal net liabilities (i.e. future, often contingent, and extra-budgetary net liabilities, difficult to assess)* make the picture less comfortable than it seems, but this is no obstacle to the fulfillment of the condition.

The flow constraint, of 3% maximum fiscal deficit as a share of GDP, on the contrary has been interpreted rather strictly *as a condition for EMU entry*, and is going to be difficult to satisfy in several the new eastern and central European member states (for a discussion of the difficulties see section 4 below). These countries' *own statistics* (table 1) are encouraging. Estonia and Bulgaria in 2004 have run a budgetary surplus of 1.7% of GDP, though smaller in 2005 (at respectively 0.4% and 1.0%) and forecast at zero in 2006. Latvia, Lithuania and Romania were under the ceiling in 2004 and forecast to stay there for the following two years. The Czech republic was right on target in 2004 but has exceeded the ceiling in 2005 and 2006 (4.3% and 3.8%); Hungary, Poland and Croatia are above well above the limit (5.4, 4.7, 4.9 respectively in 2004) and staying there in the following two years. The situation is worse by *western conventions*; the EBRD Transition Report 2005, using also statistical information from the IMF, the World Bank and Eurostat and for 2005 their own projections, considers four out of eight new eastern members as failing the fiscal test in the last five years: the Czech Republic, Hungary, Poland and Slovakia, as well as Croatia among the candidates (see table 2). Exactly the same picture is confirmed by the European Central Bank, on the basis of Eurostat, European Commission and their own data (see table 3). Differences in the measurement of debt and deficit are due to the treatment of items such as pension debt, cash and accrual accounting, government guarantees and the like (on statistical conventions and methodologies see the ECB Report on convergence, 2004). Unfortunately those four countries out of eight represent 90% of the central eastern European new members population and an even higher proportion of their joint income.

All the other Maastricht conditions for EMU membership are either satisfied by the new members or are well within reach. We have already noted that the debt stock condition is amply satisfied in all new eastern and central European member states. The +/- 15% band for exchange rate fluctuations is wide enough to allow likely real revaluations and nominal devaluations over the two years of statutory ERM-II membership; Table 1 gives only Romania as having needed, over the last three years, a slightly higher band to accommodate its maximum divergence (16.2%) from the average nominal exchange rate with respect to the euro over that period – had this rate been chosen as the ERM II parity.

In the year before the consideration of EMU membership inflation and nominal interest rates are or can be brought under their ceilings respectively of 1.5% and 2% above the reference values provided by the average of the three least inflating EU members (even though *it defies logic why convergence should not be referred to an EMU average rather than to the best three performers, moreover including non-EMU-members*)². Table 1 shows that in 2004 the inflation reference value was either satisfied or sufficiently close to being satisfied by the new member states, all with one-digit inflation (except Romania at 11.9%, whose rate however has been falling to 9% in 2005 and 7.2% in 2006 forecasts). Long-term interest rates, measured by the rate on ten year government bonds, is everywhere one-digit and sufficiently close to the reference value (actually lower than that in the Czech Republic); moreover to a very great extent the interest rate is an administered price decided by the national Central Bank, that could at a pinch, if it wished, shorten the gap with the Maastricht target value. Both for inflation and interest rates the comparison with the so-called Club Med countries (Spain, Portugal, Italy and Greece) two years before their entry into the euro area is encouraging (Gros, 2002). It should also be remembered that both criteria are compulsory only in the year preceding EMU admission, without constraints for the preceding and the following period (e.g. see Ireland's high inflation after EMU entry; high inflation may still be undesirable but is no longer subject to a mandatory constraint). *Of all the Maastricht conditions for entering EMU the fiscal deficit constraint can be regarded as the hardest to satisfy.*

In principle the SGP deficit condition, which applies to all EU members regardless of their status vis-à-vis EMU, is stricter than the Maastricht condition applicable to EMU candidates, as it involves an average balanced budget over the cycle *as well as* a Maastricht-style 3% ceiling at any time. In the Treaty there are only minor qualifications to the ceiling, which can be exceeded in case of a grave recession of over 2% GDP decline or, with Ecofin permission, of a GDP decline between 2% and 0.75%. Excess deficits must be eliminated within a year, failing which discretionary penalties are applicable, subject to the decision of the Economic and Financial Committee (Ecofin), consisting in an interest-free deposit convertible into a fine in case of failure to observe the 3% constraint for two consecutive years, at the discretion of the Council. This deposit is calculated as 0.2% of GDP plus 1/10 of the excess deficit over 3%,

² See Buiter 2005, who argues that only traded goods inflation should be taken into account, in order to accommodate the currency real revaluation induced by the Balassa-Samuelson effect.

up to a maximum fine of 0.5% of GDP. This general principle, however, is subject to four important qualifications:

First, the 3% constraint has been systematically violated by various recidivist EU and EMU old members – 4 years in succession by Germany, 3 by Italy and France, not to mention Greece's fulfillment of the constraint only thanks to acknowledged falsification of national accounts – without the application of any penalties; the same applies to the non-EMU-member UK for the last two years.

Second, the 3% ceiling has been considerably softened by the March 2005 reform, which benefits both old and new members. That reform extended the time period allowed for bringing back the excessive deficit under the limit, from one to two years (plus another two years in case of unforeseen negative events); by allowing deficits higher than 3% in case of protracted low growth or stagnation (instead of the original grave or significant recession mentioned above). The March 2005 SGP reform also considers the difference between public deficit and public investment expenditure, and a long list of factors is introduced to allow a “modest, exceptional and temporary” excess deficit. These factors include expenditure on innovation, research and development; the impact of structural reforms and in particular that of pensions; contributions for international solidarity; the costs of European unification (and German unification). Finally, low-debt countries with a high growth potential are allowed an average deficit of 1% over the cycle instead of zero.

Third, the penalties applicable to EU old members in case of non-compliance, though mild and so far disregarded, are not applicable to the new EU members; they can continue to exceed the 3% deficit ceiling until a year before they wish to be considered for EMU membership.

Fourth, the new EU members are – again in theory, i.e. subject to an Ecofin decision – exposed to a much more severe maximum penalty than an interest-free deposit of 0.5% of GDP, namely the suspension of transfers from cohesion and structural funds from the EU budget, which average about 2% of the recipients' GDP but can be as much as their ceiling of 4%. The interest-free deposits involves, at the ECB current interest rate of 2.25%, a yearly interest loss of around 2.25% of 0.5% or 0.1125 per thousand of GDP, raised to a maximum fine of 0.5% of GDP in case of repeated violation. The maximum penalty applicable to new EU members is a devastating yearly loss of 2%-4% of GDP; therefore it is of the order of 178 to 355 times (2% or 4%/0.01125%) larger than that theoretically applicable to existing members incurring excessive deficit. One of the offending new members, Hungary, has been threatened with

such a suspension, but so far the threat has remained idle. Indeed, in view of the exceedingly lenient treatment of old EU members, the application of such an inordinately disproportionate penalty to new members totally lacks credibility.

3. An unreasonable hurdle

This state of affairs is undesirable in two respects:

- 1) a tough but erratic and non credible treatment of fiscal laxity is worse than a milder but certain penalty, for both old and new members; and
- 2) the only incentive for fiscal restraint for new EU members comes from the requirements of EMU membership and, therefore, a fiscal squeeze to satisfy the 3% deficit constraint in the year prior to EMU is a *significant marginal cost of EMU membership, which therefore is likely to delay it unduly*. It would be better for the same fiscal stance – preferably in the milder version of the GSP ceiling – to be required of new members regardless of whether or not they are nearing their EMU membership. The budget deficit constraint, now tougher when associated with EMU entry, would then be milder and a condition of EU membership, and would cease to be a specific additional hurdle for entering the euro area. New members would have every interest to prepare themselves to consolidate their fiscal position at the time of EU membership (whose advantages are perceived as far greater than those of EMU) and to rush to satisfy the other, and much easier, Maastricht conditions, for they would have nothing to lose from accelerating euro adoption except their high interest rates.

Originally the purpose of the GSP was that of tightening fiscal discipline, by extending to all EU members, *before and after EMU membership*, the 3% per cent ceiling applied to EMU candidates temporarily before joining the euro. Indeed the GSP purpose was that of hardening the fiscal constraint by adding the zero average deficit condition over the cycle. It is typical of the EU that GSP implementation should have actually established a fiscal regime more lenient than that immediately preceding EMU membership. It is extraordinary that the March 2005 softening of the fiscal deficit constraint should apply to all EU members – including EMU members – but not to new members for the purpose of meeting the Maastricht fiscal conditions for euro introduction. It is as if, before joining a club for athletes capable of jumping over 2 metres, candidates had to jump over 2.20 metres.

The current uncertainty on fiscal rules and applicable penalties, which today encourages the continued fiscal incontinence of the new EU members and candidates and delays the introduction of the euro, is not at all the consequence of specific decisions taken by EU authorities, or of a reasoned debate, but the collateral effect of the manoeuvres, the manipulation and conflicts which have ended up by protecting French-German interests and – in the perspective of pre-announced fiscal disasters of 2005 and 2006 – Italian interests.

4. Difficulties of fiscal consolidation

Until their post-socialist transition of the early 'nineties, the new eastern and central European EU member states and candidates had a large government budget accounting for at least a half of their GDP (or net material income, in their unusual accounting conventions of Marxian origin that neglected so-called non-material services). Turnover taxes at variable ad-hoc rates were fixed ex-post so as to siphon off enterprise profits, unless needed for planned reinvestment, into the state budget for redistribution to finance additional investment and other expenditures. Personal income taxes were not levied, being wrongly regarded as an accounting duplication instead of an instrument of income re-distribution. Social expenditure was often undertaken and financed directly by state enterprises (providing housing, schools, hospitals, shops restaurants and hotels, holiday resorts). Small budgetary surpluses were customary, but there was a much larger web of quasi-fiscal accounts involving the entire economy, concealing additional government liabilities. Also there was usually a large scale, endemic, monetary overhang due to administered prices set below equilibrium and the ensuing repressed inflation; such an overhang was a hidden public debt and its increase was a hidden deficit; the overhang vanished with the first bout of inflation that accompanied price liberalization.

With the post-socialist transition budgetary income is initially swollen by state enterprise paper profits due to inflation and domestic currency devaluation, while unemployment rises rapidly but does not represent a significant cost; an initial surplus arises. Then government revenues are reduced by recession, while privatization provides some capital revenue initially but subsequently reduces company transfers to the budget. Personal income tax and VAT are introduced. State enterprises before or after privatisation are stripped of their social functions, which become a claim on government expenditure or a private cost. A safety net for the unemployed and the poor, whose incidence in the population rises fast, swells public expenditure (Kolodko 1993a).

The transformation of the pension system from Pay As You Go (PAYG, or redistribution, or defined benefits system) to a funded pension system (or capitalization, or defined contribution system), combined with population ageing and with the early retirement of workers expelled from unprofitable enterprises and sectors, begins to weigh heavily on the budget (although PAYG pension liabilities should not be regarded entirely as a net claim on the government budget, see the pensions chapter in Eatwell et al. 2000). Privatization makes a low (in view of mass privatization, of other underpriced sales such as Russian loans for shares swaps, of privileged sales to employees and managers) and only temporary contribution to government revenues (though in Poland some of the privatization revenues have been earmarked to finance the cost of pension reform).

Tables 2-4 give EBRD data on general government balances in 1993-2005, and revenues and expenditure for the years 1998-1994. There are significant differences between countries and, for the same country in different years but there seems to have been a certain rigidity in the shares of both government revenues and expenditures. Latvia and Lithuania were able to lower the share of government revenues steadily, while Slovakia did the same but raised it again in 2005, and Slovenia actually raised it over the period considered (Table 3). A similar pattern applies to government expenditures (Table 4). Coricelli (2005) highlights the presence of two distinct patterns, namely low deficits in small countries and high deficits in larger countries.

There is widespread agreement that at the time of accession budget deficits tended to be structural rather than cyclical (Dabrowski et al., 2005; Vinhas de Souza and Borbely 2003; for Coricelli and Ercolani 2000 both components are present). A considerable rigidity of public expenditure has been inherited from the past, due to extensive price indexation, cross links between incomes in various sectors and groups (e.g. wages and pensions), pre-fixed percentages of certain expenditures in GDP (e.g. 2% of GDP earmarked for Poland's defense). In Poland 14 state institutions literally determine their own budget every year, with the Finance Minister acting simply in a notary role; Parliament can cut those budgets but it usually diverts expenditure savings thus the obtained towards other uses of its own, rather than towards deficit reduction. Rigidity is also due to multiple level budgets, and populist policies (for a growth oriented fiscal programme see Kolodko 1993b and 1996; a general restructuring of the fiscal system was attempted in Poland in 2001-2002, see Kolodko 2005).

A similar rigidity exists on the side of government revenues, especially in consideration of the increasing diffusion of hyper-liberal fiscal policies, based on the adoption of low tax rates and above all a uniform (i.e. non-progressive) and low “flat tax”.

5. Tax structure and rates

The hyper-liberal approach that has permeated post-communist transition strategies has been extended to fiscal policy. There is a generalized belief that the size of the state and therefore of government budget should be reduced, that lower tax rates yield higher government revenues (Laffer’s curve), that income taxes and in particular taxes on corporate income (TCI) should be simple and low, lowering the tax basis, tax rates and their progressiveness (witness the competitive diffusion of the flat tax). The fall in tax rates has been accompanied by a less than proportionate fall in government revenues, but – contrary to the Laffer conjecture – a fall nevertheless (Quitzeau 2006).

By comparison with Germany, with an effective average tax burden on business of 38%, or with the other EU members (averaging 28.5%), central and eastern European members average 19.5% (Quitzeau 2006). This is often regarded as unfair tax competition, so much so that Mr Schroeder and other leaders of old EU member states have suggested cutting out new members from Cohesion Funds (Coricelli 2005). However the EU Code of Conduct does not set minimum tax rates and therefore the new members are not contravening any rule. Conversely, indirect taxes are on average higher than in the old EU countries (See Table 6 for a comparison).

The notion of a single flat tax goes back to the French Physiocrats as a tax on land, but in modern times it was mainly introduced as a fiscal incentive in dependent territories (1940 in Jersey, 1960 in Hong Kong and Guernsey); it was developed in the USA in the 1980s but was not really implemented on a large scale until the 1990s in central eastern Europe. It was first introduced in the Baltic countries in 1994-95, followed by Russia (2001), Slovakia and Ukraine (2004), Georgia and Romania (2005), see Table 7. There have been similar proposals in Slovenia, the Czech Republic, Croatia, Bulgaria and Hungary. In Poland a flat rate of 18% was proposed by the outgoing government in 2005; a 15% flat tax (personal, corporate and indirect) was in the 2005 election programme of the runner-up PO (Civic Platform) party; a flat tax was also advocated by Finance Minister Zyta Gilowska in 2006 but is unlikely to be implemented in the current legislature. Recently older EU members have also

been discussing it, like Greece and notably Germany, where the proposal to unify tax at a 25% rate was hotly debated in the 2005 elections and almost cost Mrs Merkel her Chancellorship. Its attraction remains mostly that of a fiscal incentive aimed at promoting investment, including foreign direct investment (FDI), apart from the greater ease of administration – at the cost of making much harder the satisfaction of fiscal constraints.

6. Interest rates and monetary/fiscal policy coordination

Transition economies, including new EU members, delegate the conduct of monetary policy entirely to an independent Central Bank; those countries that have a Currency Board are no exception, in that such Board is equally independent from the government. Central Bank independence is indeed one of the conditions of EU and EMU membership. As it is often the case in other fields, such independence reaches a degree much higher than in equivalent institutions in market economies. Central Banks in transition economies have been modeled on the super-independent Bundesbank model, instead of other modern independent Central Banks like the Bank of England, the Central Bank of New Zealand or of Japan, characterised by greater built-in co-ordination with fiscal policy. Indeed they have often been given even greater independence from the government than the Bundesbank; at the same time they have sometimes taken on a political role of opposition to the government instead of being above political parties.

This exceptionally high degree of independence makes co-ordination of fiscal policy with monetary policy particularly difficult, or simply absent. Lack of fiscal/monetary co-operation can be costly, as it is known to lead to higher interest rates, stronger exchange rates and higher government deficits than otherwise would be the case – a circumstance which makes harder the achievement of EU and EMU fiscal constraints. Interest rates tend to be higher than justified by inflation and exchange rate trends, and are imposed out of single-minded, often exaggerated concern about inflationary trends. Such high interest rates discourage productive investment (including FDI) but attract financial capital flows and drive up the exchange rate, sometimes to unsustainable rates.

An example is Hungary in 2003: ambitious inflation targeting required a strong forint, which led to speculative pressures to appreciate. When it became clear that the unsustainable fiscal position would require an adjustment in the

opposite direction and the ambitious inflation reduction targets were lowered, the opposite occurred with a speculative outflow of capital (Coricelli 2005).

Capital inflows lead to increases in the quantity of money; the Central Bank then is forced to sterilise such increases with open market operations that are normally loss-making, for the Bank effectively borrows back from the public some of the money issued through reserve acquisition, at an interest rate greater than earned on its reserves. This is a quasi-fiscal liability that appears in the government budget only under the guise of lesser transfers from the Central Bank balance sheet than otherwise would occur, but it can be very substantial, of the order of 1-3 percentage points of GDP, paradoxically worsening the fiscal deficit that the Bank usually demands that should be reduced. Central Banks also sometimes conceal resources in the folds of their balance sheets.

One of the main advantages of introducing the euro is precisely the enfranchisement of domestic governments from their own Central Banks.

7. The fiscal shock of EU accession

A totally unexpected implication of EU accession is a non negligible fiscal shock to a new member's government budget.

Net transfers to the new members from the EU budget (smaller than originally expected but still positive and significant) in each country will accrue to the economy at large – including the private sector, farmers in particular; local authorities, various extra-budgetary funds – and only in a small proportion to the government budget which will contribute the costs of membership. Such costs are a share of VAT, a tax on GDP levied ex-post to balance the EU budget, loss of custom duties; contributions to EIB (while contributions to the ECB capital and reserves are the responsibility of the Central Bank) and to the European Development Fund, the Research Fund of Coal and Steel, a contribution to the British rebate (sic!). Moreover, charges are paid in full from the start, while benefits are introduced gradually and are in great part conditional on the new members' absorption capacity. The budget will also bear much of the cost of co-financing projects only partly funded by the EU conditionally on domestic support, and the burden of pre-financing transfers from structural funds. There are also additional costs deriving from membership (meeting environmental standards, etc.), most of which are a charge on the budget.

Thus accession itself involves a fiscal shock, initially expected to be of the order of magnitude of up to over 3-4 per cent of GDP (“for unchanged policies”, Kopits and Szekely 2002), then estimated to be smaller but still significant, averaging 1.2% of GDP and ranging from 0.3% for Latvia to 2.6% of GDP for the Czech Republic (see table 8, from Antczak 2003). Dabrowski et al. (2005) simulate alternative scenarios depending on GDP growth rate and timing of EMU entry; they advocate fiscal consolidation in order to reap early benefits from euro introduction, and to avoid the cumulative costs of postponing consolidation; but the likely outcome of the fiscal shock of accession and of the other difficulties discussed above is a delay of euro introduction precisely to postpone the costs of fiscal consolidation.

8. The general shortcomings of fiscal targets

The principle of fiscal austerity as the foundation of a sound single currency was asserted by the Delors Report of 1989 (advocating “stringent rules”), and by the *One Market, One Money* Report (EC-1990) without much of a debate or articulation of the arguments backing it. The principle has been strongly criticized by the economics profession; already before the Treaty was signed or even drafted, by Buiter and Kletzer 1991, and after: see Bofinger 2003, Eichengreen 2003, Eijffinger 2003; Hefeker 2003; Buiter et al., 1993, Buiter 2005, to name but a few.

Bofinger (2003) stresses that “there is absolutely no evidence of a systematic correlation between the size of fiscal deficits and national inflation rates. If anything, the opposite seems to be true”; he regards the deficit problems of a number of member countries as caused by below average economic growth (during the first four years of EMU). The SGP pays no attention to the need for a flexible fiscal policy in order to compensate for overly restrictive (or indeed expansionary) monetary policy. The “excessive deficits” procedure encourages a pro-cyclical fiscal policy. Eichengreen (2003) shifts emphasis from numerical thresholds to fiscal procedures. “The 3 per cent reference value is arbitrary. It has no basis in economic logic. It bears no relationship to the sustainability of public debts, which is presumably the underlying concern that the pact is designed to address”. “[S]ometimes deficits in excess of 3 per cent are part of the solution rather than part of the problem, for instance when the economy running them is in an exceptional recession”. Eijffinger (2003) notes the asymmetric inflexibility of the SGP, the lack of incentives to comply, the neglect of the overall fiscal stance of the area, the focus on short term

commitments to the detriment of structural reform, the neglect of the actual debt/GDP ratio.

Buiter (2005) argues that the March 2005 reform of the SGP “effectively killed it”, but that “the death of the Pact is not a tragedy”. Individual states are well advised to ensure fiscal-financial sustainability, and therefore to adopt prudential rules for their public debts and deficits, but the case for supranational imposition, monitoring and enforcement of public deficit and debt rules “is weak, except in one respect” – which is not addressed by the Pact – namely the presence of effective demand cross-border spillovers. “The Pact is not designed to ensure coordinated fiscal policy in the E(M)U, let alone coordinated monetary and fiscal policy in the E(M)U”. Nor is there anything to ensure that the E(M)U-wide fiscal stance and fiscal-monetary mix is appropriate given economic developments in the rest of the world and the policy mix in the other key national and regional economies (Buiter 2005). Last but not least, Buiter argues that the Pact fails to observe the principle of “subsidiarity” that permeates EU policies, in that it rules on matters that ought to remain national preserve, while it does not address issues of international coordination where a supranational approach would have been desirable.

Ultimately, the quantitative fiscal constraints introduced by the Maastricht Treaty rest on two justifications, rooted in the economic conditions prevailing at the time. The first is that, as noted by Buiter et al.(1993), a 3% deficit stabilizes a public debt of 60% of GDP for an economy growing at 5% nominal growth rate (2% real plus 3% inflation), which were the average EEC parameters at the time of the Maastricht Treaty. A ratio of 60% of GDP has come to be regarded as a prudential limit to public debt. UK Chancellor Gordon Brown set a stricter ceiling of 40%, which he then promptly exceeded; the Polish constitution imposes fiscal restrictions at a debt/GDP ratio of 50%, and even stricter provisions at 55%, equally a straightjacket.

The second justification was that 3% happened to correspond to the historical ratio of public investment over GDP in Germany at the time of the Treaty, and this became a loose target/wish/forecast for the rest of the area; a “golden rule” argument regards public investment as neutral from the viewpoint of sustainability (Creel 2003).

A third argument can be raised to support fiscal constraints in general as “non-Keynesian growth factors” (Giavazzi and Pagano 1990), due to the impact of fiscal consolidation on expectations of less crowding out, lower interest rates

and their direct impact on investment and indirect impact on consumption through wealth effects.

The first argument – fiscal convergence of the debt/GDP ratio for economies growing at 5% and running an average 3% deficit – would naturally recommend the easing of fiscal constraints, at least during a slowdown or recession, for countries that have a lower than 60% debt/GDP ratio, and/or that over time grow at average nominal rates well in excess of 5% like the new members, and a parallel tightening of fiscal constraints for slow growers like the old members of the EU. Several authors have even advocated replacing the SGP deficit constraints with a debt ratio constraint (e.g. Pisani-Ferry 2002, Calmfors and Corsetti 2003), although the pace at which the debt constraint is being approached is not irrelevant for the macroeconomic balance of the area.

The second argument (allowing a deficit over 3% to the extent of the share of public investment in GDP) should also lead to a relaxation of the fiscal constraint for the new eastern members, engaged in greater public investment as part of their catching up with the rest of Europe. At any rate that part of public investment which could potentially be privatized (for instance, a motorway or a railway) should be totally deducible from whatever constraint is otherwise set.

The March 2005 reform of the so-called Stability and Growth Pact goes some way in both these directions, allowing countries to put forward a case for more sustained deficit on the ground of “fast growth and low-debt”, and of large public investment, but the discretionary nature of possible allowances makes them unpredictable and therefore largely ineffective.

The third argument, i.e. the alleged growth impact of fiscal consolidation, is not supported by convincing evidence. The results have been challenged as a “data artifact” and more recent evidence does not support the argument (Vinhas de Souza and Borbely 2003). The impact of lower interest rates on wealth and consumption is a debatable Pigou effect; when it takes the form of lower interest rates *expectations* it is even more doubtful. Besides, lower interest rates have a negative effect on incomes that is bound to reduce or possibly even offset the wealth effect. Government policy is not pre-committed with certainty over an indefinite period; economic agents would be well justified to expect fiscal consolidation to lead to subsequent fiscal dilapidation by the next government, rather than to permanently lower interest rates. Permanent fixed policy constraints neglect that decisions are taken continuously here and now for a short time horizon, only to be reconsidered and revised at any time later, and are subject to instant and short term constraints. The ultimate constraint,

whether for households, firms or governments, is the inter-temporal constraint on the present value of their revenues and expenditures; the inter-temporal optimization of their economic decisions may very well depart from considerations of long term sustainability of unchanged policies, especially in the presence of unique, infrequent and temporary challenges such as the change of economic system or the economic and monetary integration into a wider area.

From these criticisms it follows that there are no reasons why the once-and-for-all fiscal shock of EU accession should be included in the measurement of the deficit for the purpose of satisfying SGP or Maastricht criteria. A regime of deliberately low and non progressive tax rates, on the contrary, might be penalized by curtailing access to structural and cohesion funds. Emphasis might be placed not only on the need for central bank independence, but also on the need to coordinate fiscal and monetary policy for the sake of fiscal discipline. And fast growing countries, with low debt ratios and large scale public investment, do not need the 3% fiscal constraint in order to achieve sustainability.

9. Fiscal cosmesis, unilateral or delayed euroisation?

Fiscal consolidation in the new EU member states is unlikely to take place through the acceleration of GDP growth rates, which are already high, forecast in 2006 at between 4% in Poland and over 6.5% in the Baltics (Deutsche Bank 2006). Consolidation would require unpopular measures of expenditure reduction and/or greater fiscal pressure, a reform of public finance implementing de-indexation, reorganization and control, and greater coordination between monetary and fiscal policy. These are measures which, by their technical and political nature, at best will be diluted over time. The implication of this overall picture is a very likely delay in the introduction of the euro in a number of the new eastern member states.

One of the alternatives is feasible but most undesirable, namely the use of cosmetic measures to achieve a purely delusory fiscal consolidation. This consists in the adoption of “creative” accounting measures, such as the securitisation of deferred and contingent state revenues, and other manipulations of quasi-fiscal assets and liabilities, pioneered by the Italian Treasury. These provisions leave completely unchanged the net wealth of the state, if properly accounted; therefore they are not a real solution but, unless Eurostat rules are tightened, they might provide a way out.

The second way of avoiding a postponement of euro introduction is feasible in theory through *unilateral* euroisation (Coricelli 2002, Nuti 2002) but this is either late or unacceptable to the EU, and anyway is no panacea. The euro could be – to most intents and purposes – be introduced unilaterally by establishing a Currency Board linking the domestic currency irrevocably to the euro at a fixed exchange rate;³ Estonia, Latvia and Bulgaria have been allowed to do it long before they became EU members; it has also been done in Bosnia and Herzegovina, but such an option is no longer open to new members, arguably even if not yet ERM-II members.

The euro could also be introduced unilaterally through the total formal replacement of the domestic currency by euros, as long as the National Bank had enough reserves to implement it. Kosovo and Montenegro have done it, but the ECB and other EU authorities have explicitly forbidden this course of action to any state that is a EU member or candidate (Kosovo and Montenegro arguably are not even states).

There is very little difference between these two unilateral moves to introduce the euro, and between them and full EMU membership. Currency Board and currency replacement differ 1) in the form of seigniorage which for a Currency Board takes the form of interest on its reserves that back the domestic currency, and in the case of domestic currency replacement by euro are lost completely for the money in circulation; and 2) the symbol of monetary sovereignty, preserved by a Currency Board and lost with domestic currency conversion. The features that the two forms of unilateral euroisation have in common seem more important, and represent differences with respect to euro multilateral adoption: 1) loss of monetary policy, whereas EMU members participate in the formation of policy in the entire euroarea; 2) loss of a Lender of Last Resort, except to the limited extent of excess foreign reserves (though there seem to be ambiguity about the ECB role as LLR). This last feature makes a country

³ The Currency Board can be a new institution or possibly the old Central Bank now subject to the operational constraints of a Currency Board, namely issuing domestic currency exclusively as a counterpart of foreign currency at the fixed rate established with the reference currency or basket (and at current cross rates of other currencies with respect to it); supplying foreign currency on request at the same rates, and not lending to the government (in Estonia there is also a provision for a balanced budget). The country's currency could be new or continue to be the old domestic currency as long as it was fully covered by the Board's reserves. Credibility of the fixed exchange rate rests on the associated monetary and fiscal policies.

vulnerable to a liquidity crisis, when foreign currency demand exceeds M2, which it very well might. In that case a financial collapse is likely to ensue, of the kind experienced by Argentina in 2002.⁴ *All that unilateral euroisation does is to transform a given probability of a financial crisis into a smaller probability of a larger crisis.* Both alternatives are no panacea and, while it is unreasonable for the EU to allow Currency Boards and to forbid domestic currency replacement by the euro, it would have been more cautious to disallow or discourage both.

If we regard painful fiscal consolidation as unlikely, seeing that it can be avoided by delaying the introduction of the euro; if we regard cosmetic fiscal consolidation as a placebo, and unilateral euroisation as a potentially risky option, then the only way to enable the new members to reap the benefits of euro introduction is a re-consideration of EU fiscal rules, intended to soften the fiscal constraint in the run up to the euro.

10. Conclusions

The introduction of the euro in the central eastern new EU members, and the considerable net benefits expected of it (greater trade and investment integration, lower inflation and interest rates) are likely to be delayed by the tightening of fiscal constraints in the year preceding the assessment of their EMU accession. Such tightening was not the result of a deliberate, reasoned decision, but it just happened as a result of collusion among EU larger and older members faced with a fiscal crisis of their own. Being either members of EMU already, or – like the UK – not intending to join, they were not concerned with the adverse implications of introducing a significant marginal cost of euro introduction for the New Members. As a result euro introduction is bound to be a much slower and harder process than it might have been expected.

In order to avoid or reduce such delay, three measures should be considered:

1) the unification of the fiscal deficit requirements of EU membership and of EMU entry, in order to eliminate the unreasonable, substantial though temporary hurdle of a specific marginal cost of introducing the euro, and

⁴ The collapse of Argentina's Currency Board arrangement at a dollar/peso 1:1 parity is due to a combination of adverse factors, from the earlier dollar revaluation which did not extend to Argentina's trade partners to the increasing government debt, large scale capital flight and panic phenomena (see Calvo et al. 2003).

2) the formal non-discretionary modification of the fiscal deficit rules applicable to both EU membership and EMU entry in the same directions of the March 2005 reform of the SGP, which at the moment do not extend to EMU entry. This requires a relaxation of the fiscal constraint – before during and after the EMU accession process – quantitatively predictable, to take into account at least of the size of public debt (after due consideration for quasi-fiscal positions in both debt and deficits), public investment at least in privatisable assets, actual growth rates, the once-and-for-all initial cost of EU accession.

3) the relaxation of the fiscal constraint for individual countries as long as the overall fiscal position of the entire euro-area meets the criteria set for each country.

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Table 1. New EU members and candidates from central & eastern Europe

	EMU Convergence				Nominal exchange rates		
	Inflation 2004/2003 % *	Interest rate 10 years [♦] (last)	Fiscal balance %GDP [♥] 2004	Public debt %GDP [♥] 2004	Exchange rate max. deviation against parity [♠] (2 years)	1 Euro in national currency	Exchange rate regime
<i>Reference</i>							
<i>Value</i>	2.5	5.5	-3.0	60.0	+/- 15%	last	
Czech Republic	2.8	3.4	-3.0	36.8	-7.0	28.8	Managed float (Euro)
Estonia	3.0	2.6	1.7	5.5	-0.4	15.6	Currency Board (Euro) + ERM II
Hungary	6.8	6.5	-5.4	60.5	-7.6	249.9	Target zone (Euro)
Latvia	6.2	2.2	-1.2	14.7	-4.6	0.7	ERM II
Lithuania	1.2	6.4	-2.5	19.7	-0.2	3.45	Currency Board (Euro) + ERM II
Poland	3.6	4.8	-4.7	46.7	-13.9	3.77	Float
Slovakia	7.5	2.5	-3.3	43.5	-2.8	37.4	ERM II
Slovenia	3.6	3.2	-1.4	26.0	-6.2	239.5	ERM II
<i>Candidates</i>							
Bulgaria	6.1	3.3	1.7	40.9	-5.5	1.96	Currency Board (Euro)
Croatia	2.1	3.1	-4.9	55.8	-8.6	7.39	Managed float (Euro)
Romania	11.9	3.3	-1.1	38.6	-16.2	3.6	Managed float (Euro)

* Year on year, per cent. .

♦ If available; shorter maturities for Bulgaria, Croatia, Estonia, Latvia, Lithuania, Romania, Slovakia and Slovenia.

♥ Definitions can deviate from Eurostat.

♠ “Parity” here is understood as the average exchange rate of the last 3 years against the Euro, also for the currencies in the Exchange Rate Mechanism II (ERM II)

Table 2. General government balances (in per cent of GDP) 1993-2005

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
	<i>Estimate Projection</i>												
Central eastern Europe and the Baltic states													
Czech Republic	2.6	-1.2	-1.1	-1.6	-2.4	-4.2	-3.4	-4.5	-5.9	-6.8	-11.6	-3.3	-4.5
Estonia	na	1.2	-1.2	-1.5	2.0	-0.4	-4.0	-0.3	0.3	1.4	3.1	1.8	0.1
Hungary	-6.0	-7.5	-6.7	-5.0	-6.8	-8.0	-5.6	-3.0	-3.5	-8.5	-6.5	-5.4	-6.0
Latvia	na	-4.4	-3.6	-1.7	0.7	-0.7	-5.3	-2.7	-1.6	-2.7	-1.5	-0.8	-1.7
Lithuania	-5.3	-4.8	-4.2	-4.4	-1.1	-3.0	-5.6	-2.6	-2.1	-1.6	-1.9	-2.5	-2.6
Poland	-2.4	-2.2	-3.1	-3.3	-4.0	-2.1	-1.4	-1.9	-3.7	-3.3	-4.8	-3.9	-3.7
Slovak Republic	-5.7	-1.4	0.4	-1.3	-5.2	-5.0	-7.1	-12.3	-6.0	-5.7	-3.7	-3.3	-3.3
Slovenia	0.6	-0.2	-0.2	-0.2	-1.6	-2.2	-2.1	-3.4	-2.8	-2.4	-2.0	-1.9	-2.1
<i>Average</i> ¹	-2.7	-2.6	-2.5	-2.4	-2.3	-3.2	-4.3	-3.8	-3.2	-3.7	-3.6	-2.4	-3.0
SEE-3													
Bulgaria	-10.9	-5.7	-5.6	-10.3	-2.4	1.0	-0.9	-1.0	-0.9	-0.6	-0.4	1.8	1.0
Croatia	-0.8	1.2	-1.4	-1.0	-1.9	-1.0	-8.2	-6.5	-6.7	-5.0	-6.3	-4.9	-4.5
Romania	-0.4	-2.2	-2.5	-3.9	-4.5	-4.4	-2.1	-3.8	-3.5	-2.0	-2.0	-1.4	-1.0

Note: Data for 1993-2003 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2004 are preliminary actuals, mostly official government estimates. Data for 2005 represent EBRD projections.

¹ Unweighted average for the region.

From: EBRD, Transition Report 2005, November, p. 51.

Table 3. General government revenues (in per cent of GDP) 1993-2005

	1998	1999	2000	2001	2002	2003	2004 <i>Estimate</i>
Central eastern Europe and the Baltic states							
Czech Republic	36.1	36.4	36.3	36.8	37.6	38.6	38.6
Estonia	37.9	36.3	35.6	35.3	36.6	38.0	38.8
Hungary	44.2	44.4	44.6	44.3	44.1	43.9	44.6
Latvia	39.5	37.4	34.6	32.8	32.9	33.5	35.4
Lithuania	31.6	31.6	30.1	29.6	29.3	31.8	27.4
Poland	37.1	37.2	37.6	37.5	36.8	37.4	39.1
Slovak Republic	57.1	49.8	47.6	45.5	45.2	35.5	44.7
Slovenia	40.3	41.0	44.7	45.1	45.7	46.2	45.4
<i>Average</i> ¹	40.5	39.3	38.9	38.4	38.5	38.1	39.3
SEE-3							
Bulgaria	38.0	38.7	38.7	37.7	36.5	37.9	39.2
Croatia	45.6	48.4	46.2	44.0	44.5	46.3	47.1
Romania	27.9	30.7	31.2	30.1	29.7	30.0	28.9

Note: Data for 1998-2003 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2004 are preliminary actuals, mostly official government estimates.

¹ Unweighted average for the region.

From: EBRD, Transition Report 2005, November, p. 52.

Table 4. General government expenditure (in per cent of GDP) 1993-2005

	1998	1999	2000	2001	2002	2003	2004 <i>Estimate</i>
Central eastern Europe and the Baltic states							
Czech Republic	38.4	39.0	40.4	41.6	43.9	43.7	41.9
Estonia	38.2	40.3	36.2	34.9	35.5	35.6	37.1
Hungary	50.4	49.9	47.7	48.7	52.6	50.2	48.9
Latvia	40.2	41.0	37.2	34.9	35.7	35.0	36.2
Lithuania	36.9	39.6	33.0	31.1	30.8	31.7	32.2
Poland	40.1	40.3	41.0	43.0	43.4	44.2	44.6
Slovak Republic	60.8	56.9	59.9	51.5	50.9	39.2	48.0
Slovenia	41.7	41.9	48.2	47.9	48.1	48.2	47.7
<i>Average</i> ¹	43.3	43.6	43.0	41.7	42.6	41.0	42.1
SEE-3							
Bulgaria	37.0	39.6	39.7	38.6	37.2	38.4	37.5
Croatia	46.7	56.6	52.7	50.7	51.4	52.7	52.0
Romania	34.7	35.2	34.8	33.4	32.3	32.3	30.5

Note: Data for 1998-2003 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2004 are preliminary actuals, mostly official government estimates.

¹ Unweighted average for the region.

Source: EBRD, Transition Report 2005, November, p. 51

Table 5. ECB Economic Convergence Indicators (excluding the exchange rate)

		HICP Inflation [*]	Long-term interest rates [♦]	General government surplus (+) or deficit (-) [▼]	General government gross debt [▲]
Czech Republic	2002	1.4	4.9	-6.8	28.8
	2003	-0.1	4.1	-12.6	37.8
	2004	1.8	4.7	-5.0	37.9
Estonia	2002	3.6	.	1.4	5.3
	2003	1.4	.	3.1	5.3
	2004	2.0	.	0.3	4.8
Latvia	2002	2.0	5.4	-2.7	14.1
	2003	2.9	4.9	-1.5	14.4
	2004	4.9	5.0	-2.0	14.7
Lithuania	2002	0.4	6.1	-1.5	22.4
	2003	-1.1	5.3	-1.9	21.4
	2004	-0.2	4.7	-2.6	21.4
Hungary	2002	5.2	7.1	-9.2	57.2
	2003	4.7	6.8	-6.2	59.1
	2004	6.5	8.1	-5.5	59.9
Poland	2002	1.9	7.4	-3.6	41.1
	2003	0.7	5.8	-3.9	45.4
	2004	2.5	6.9	-5.6	47.2
Slovenia	2002	7.5	-	-2.4	29.5
	2003	5.7	6.4	-2.0	29.4
	2004	4.1	5.2	-2.3	30.8
Slovakia	2002	3.5	6.9	-5.7	43.3
	2003	8.5	5.0	-3.7	42.6
	2004	8.4	5.1	-3.9	44.5

Sources: ECB, Eurostat and European Commission.

From: ECB, Convergence Report, 2004, p.22. [NOTE: A new ECB Convergence Report is due in 2006.]

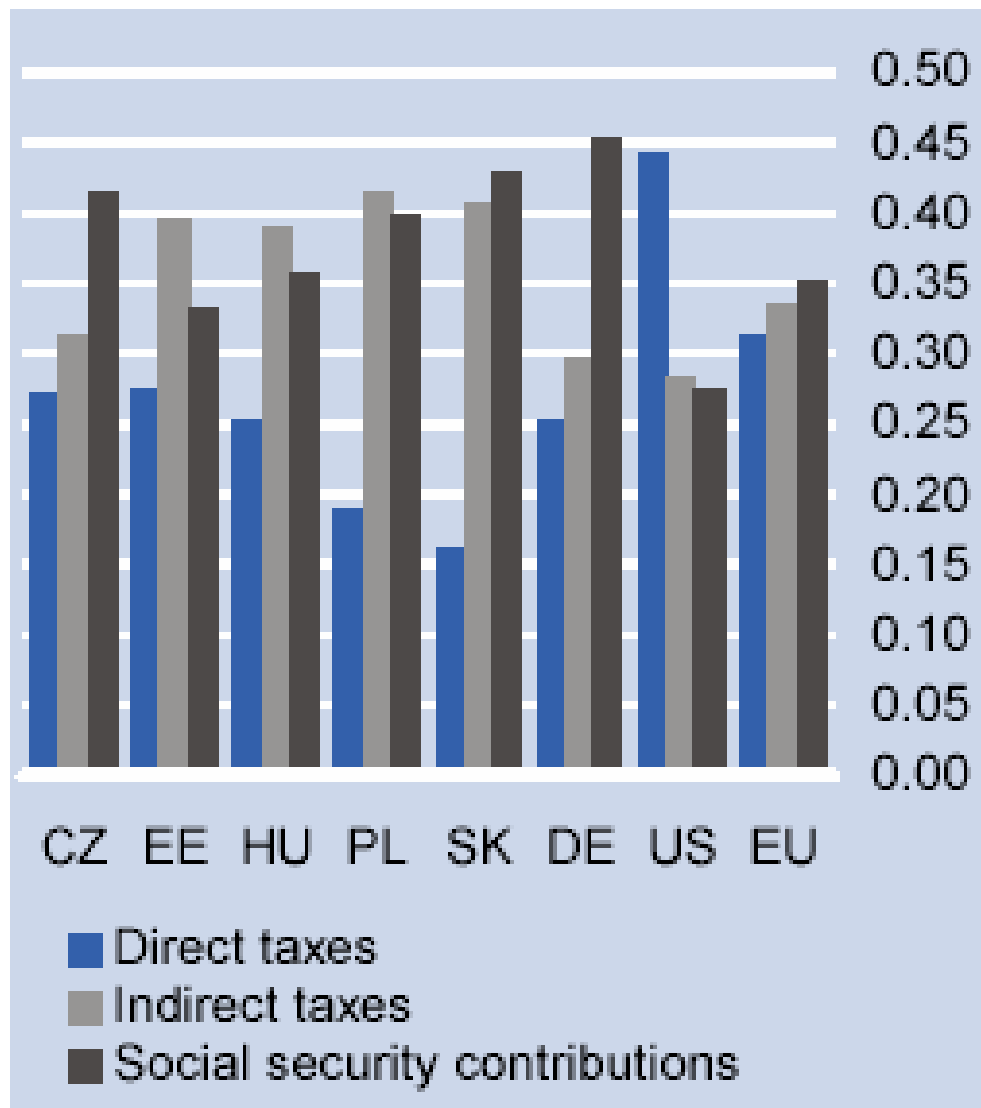
* Annual average percentage change. 2004 data refer to the period September 2003 to August 2004.

♦ In percentages, annual average. 2004 data refer to the period September 2003 to August 2004.

▼ As a percentage of GDP, European Commission Services projections for 2004.

▲ Reference value refers to the period between September 2003 to August 2004 for HICP inflation and long-term interest rates [and in the year 2003 for general government deficit and debt (sic)].

Table 6. Revenue Structure, 2004



Source: European Commission. From Quitzau 2006

Table 7. Flat tax rates (%) in central eastern Europe (implemented or under discussion)

Country	Year	PIT rate	PIT rates before the reform	CIT rate
Estonia	1994	24 [•]	16, 24, 33	24 [◇]
Lithuania	1994	33	Rates 18-33	15
Latvia	1995	25	Five rates 15-35	15
Slovakia	2004	19	Five rates 10-38 [▽]	19
Russia	2001	13	12-30	37
Ukraine	2004	13	10-40	25
Georgia	2005	12	12-20	20
Romania	2005	16	18-40	16
Slovenia	2007 [⊕]	20	Five rates 17-50	25
Czech Republic	after 2006 [∅]	15	Four rates 15-32	15

From: Schadler and Rosenberg 2005.

[•] The rate was introduced at 26 per cent, with a phased reduction to 20 percent by 2007.

[◇] Estonia subsequently reduced the CIT on retained profits to zero, with dividends taxed at the PIT

[▽] On average production earnings, the average PIT rate was about 20 percent

[⊕] Proposed by Council of advisors to the government.

[∅] Proposed by opposition party ODS.

Table 8: Total net fiscal effects of accession in NMS-8 [8 new member states], 2004-2006 (% of GDP), annual average

Item	CZ	EE	HU	PL	SL	LT	LV	SK	EU - 8
Net fiscal effects of EU transfer flows (1)	-0.1	1.0	-0.1	0.5	-0.0	1.6	1.8	0.3	0.6
Accession related expenditure (2)	-2.5	-2.0	-1.5	-1.3	-1.3	-2.0	-2.0	-2.3	-1.9
Infrastructure expenditures	-1.5	-1.5	-1.5	-1.5	-1.0	-1.5	-1.5	-1.5	-1.4
Reform of public administration	-1.5	-1.5	-1.0	-1.5	-1.0	-1.5	-1.5	-1.5	-1.4
Phasing out of production subsidies	1.0	0.3	1.5	2.0	1.0	0.3	0.3	1.0	0.9
Realignment of custom duties	-0.5	0.3	-0.5	-0.5	-0.5	0.3	0.3	-0.3	-0.2
Tax harmonisation	0.0	0.5	0.0	0.3	0.3	0.5	0.5	0.0	0.3
Total net fiscal effects of accession (1+2)	-2.6	-1.0	-1.6	-0.8	-1.3	-0.4	-0.3	-2.0	-1.2

Source: EC (2002), AMECO database, own calculations [Antczak 2003]. The net gain on EU transfers will look different if EU funds are not fully absorbed. From: Antczak 2003.