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World Bank EU-8 Quarterly Economic Report April 2004

EU-8

Foreword

This is the first report in a new World Bank series aimed at monitoring economic and reform developments in the eight Central European and Baltic EU accession countries (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia). The report is prepared by a team of Bank economists in the region, led by Thomas Laursen, Lead Economist for Central Europe and the Baltics.[1] Marcin Sasin, Country Economist for Poland, is the principal author of this first report.

The objective of these new quarterly reports is to provide regular updates on key economic developments and reform initiatives in this first "wave" of new EU accession countries. Focus will be on developments in the region, supplemented with country-specific highlights with each report paying particular attention to one or more countries. Also, the reports will be mainly concerned with macroeconomic developments and reform initiatives that have important medium-term implications, rather than have a short-term market-oriented focus. On the reform side, particular attention will be devoted to those areas in which the World Bank is directly or indirectly engaged, notably the fiscal and social sectors (including pensions, health, and education), infrastructure and energy, and finance. Each report will be complemented by an update on current Bank activities in the region. Further, each issue will contain a more detailed analysis of one or more topics relevant for medium-term sustainability. This first issue looks a public expenditure management in the EU-8 countries. In general, emphasis is on selectivity rather than comprehensiveness.

It is our hope that these reports will provide a valuable supplement to other regular reports produced at more or less frequent intervals, including by investment banks and other market participants, and in this way appeal to a broad audience of partners in the EU accession process, including government officials in the accession countries, official bilateral parties, the private sector, academia, NGOs, the media, and international organizations.

Since this is the first issue, we would very much welcome any comments and suggestions for improvement that readers may have. The aim is to publish the reports in the first week of the month following the end of a calendar-year quarter.

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[1] The views expressed in this report are those of authors and do not necessarily reflect official World Bank views.

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Highlights of the Report

The EU-8 countries will join the EU on May 1, 2004. This long-awaited event marks the irrevocable reintegration of these countries with the rest of Europe. However, it will be no panacea for these countries in their efforts to catch up to average European income levels as the experience of earlier accession/cohesion countries clearly demonstrates—success will depend mainly on the policies countries choose to pursue.

Recent economic and reform developments

- Political instability in the region has heightened as most countries continue to struggle with high unemployment and general voter dissatisfaction.
- Macroeconomic stability in the region remains characterized by a mixed picture: output growth is rapid in some countries (notably the Baltics) and slow in others (notably Czech Republic and Slovenia); inflation is low in most countries across the region, but remains significant in some countries (Slovenia, the Slovak Republic and Hungary); fiscal deficits are contained in some countries (the Baltics and Slovenia), but are a major concern in others (notably Poland, the Czech Republic, Hungary, and to a lesser extent the Slovak Republic). Current account deficits are high in some countries where domestic demand growth is high (notably the Baltics and Hungary), but low in others. No country stands out as a particularly strong performer on all counts.
- Growth appears to be picking up across the region on the backdrop of stronger demand conditions in key markets and buoyant consumption growth. Meanwhile, relatively weak investment growth raises questions about the sustainability of the recovery.
- High unemployment levels are slowly coming down in most of the fast growing countries (the Baltics and the Slovak Republic), but remain stubbornly high in Poland and is rising in the Czech Republic.
- There are some signs that inflation may be ticking up in some countries as output gaps narrow and credit expands rapidly, but upward pressures on the exchange rate in some countries is complicating the conduct of monetary policy.
- External current account deficits are reaching worrisome levels in the Baltic countries.
- Countries characterized by large fiscal deficits (notably the Visegrad countries) are trying to implement ambitious fiscal reform programs, but these are politically very sensitive as they generally address key social spending areas.
- Progress in other reform areas is uneven as countries have focused on adopting the Acquis Communautaire and political instability has increased.

Public expenditure management practices and reform options

- Notwithstanding significant benefits, EU accession will bring many fiscal challenges emerging from the need to provide counterpart financing to EU funds, make fiscal room for further investment in infrastructure, converge towards Maastricht criteria for EMU accession, and to reduce high levels of taxation to maintain competitiveness. EU accession will have a direct negative impact on budgets reflecting contributions to the EU budget and cofinancing requirements.
- While EU-8 countries have made significant progress in enhancing fiscal transparency, broader public expenditure management (PEM) reform—as expenditure policy reform—remains in its infancy in most countries. Proper PEM is a set of institutions that allocate public resources according to strategic priorities and ensure effectiveness and efficiency in provision of public services.
- This report argues that governments need to adopt credible programs to restructure spending while pursuing fiscal consolidation. To support such programs they need to upgrade their PEM systems, in particular introduce or strengthen Medium-Term Expenditure

Frameworks, performance orientation and program budgeting, and mechanisms to evaluate spending policies.

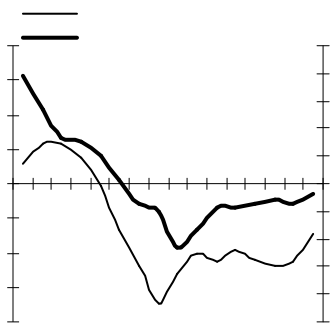
Stability at a glance

	Growth	Employment	Current Account	Inflation	Budget deficit	Debt	Political factors
Poland	+	—	+	+	—	—	—
Hungary	+/—	+	+/—	+/—	—	—	+/—
Czech R.	—	+/—	+/—	+	—	+/—	—
Slovak R.	+	—	+	+/—	+/—	—	—
Slovenia	—	+	+	—	+	+	+
Lithuania	+	+/—	+/—	+	+	+	+/—
Latvia	+	+/—	—	+/—	+	+	+/—
Estonia	+	+/—	—	+	+	+	+

Staff assessment

EXTERNAL ENVIRONMENT

The global growth outlook is broadly positive. Recent indicators confirm that the world recovery is well underway, led by the U.S. and Asia. It is reflected in recuperating domestic demand and improvement in worldwide trade flows. The recovery has a rather broad base across regions and sectors and is helped by unusually expansionary macroeconomic policies, both fiscal and monetary. In the EU, economic activity, although still very weak, seems to be bottoming out: Euro-area growth was 0.4% q/q in 2003q3 and 0.3% q/q in 2003q4, but business and consumer sentiment surveys suggest some uncertainty regarding the prospects for a further recovery in 2004. The strengthening of the Euro against the dollar is putting some pressure on competitiveness both in Europe and in countries whose currencies are pegged to the Euro, including the currency boards of Estonia and Lithuania in the EU-8.



Emerging market debt spreads at record lows. The beginning of 2004 was marked by a further improvement in emerging market credit conditions, with the EMBI+ spread in January testing the lowest levels ever (halving from over 700 bps to 380 bps in just one year). This has been facilitated by low international interest rates and improving fundamentals in emerging markets. Howver, these favorable conditions might be gradually reversing. In the first quarter of 2004 spreads widened back to 440 on a perceived possibility of a change in the bias of the Fed's monetary policy. Indeed, the approaching US tightening cycle can send not only emerging market debt yields but also spreads higher: there is evidence that the higher the international interest rate, the higher the likelihood of financial and currency crises. On the other hand, emerging markets are now much better equipped to handle such developments: they pursue better policies, hold higher international reserves, and generally maintain flexible exchange rate regimes. Thus, provided confidence is sustained, the demand for emerging market debt instruments should remain relatively stable and strong.

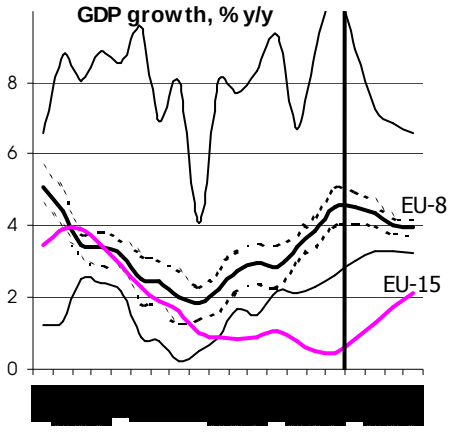
New 2007-2013 EU budget proposal preserves regional aid. The European Commission is in the process of preparing the next EU budget for years 2007-13. Despite calls from the largest

contributors to limit the size of the budget, it is expected to be drafted according to current policies, i.e. at the level of about 1.26% of EU's GDP. This is good news for the EU-8 countries who will be major recipients of structural and cohesion funds: out of the total envelope of 336 bn Euro of regional aid over 2007-13, the EU-8 countries will be allocated almost 140 bn (i.e. about 40%). However, the extent to which these countries will be able to effectively absorb these funds depends crucially on whether they can strengthen administrative and technical capacity to prepare quality projects eligible for funding.

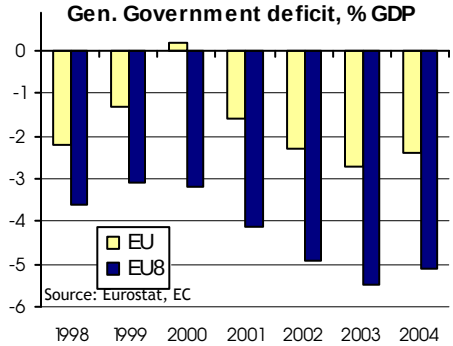
Eurostat has decided to exclude second pillar pension funds from government accounts. This means that contributions and benefits under fully funded, defined contribution schemes cannot be recorded as government revenue or expenditure and thus do not have an impact on the government balance. Similarly, government debt held by new pension funds cannot be netted out in the consolidation of government accounts. With part of contributions diverted to the new scheme, and the PAYG scheme continuing to be responsible for all pension payments during the transition period, the implication will be higher fiscal deficits (under ESA95) in countries that have adopted such pension reforms and somewhat ironically make it more difficult for these countries to meet the fiscal requirements for Euro adoption. However, Eurostat's ruling is generic, and may be altered on a case-by-case basis depending on country circumstances during forthcoming discussions between the EU and the individual countries.

EU-8 OVERVIEW OF EU-8

Political instability has increased. Political instability in the region has increased further in the run-up to EU accession on May 1, 2004 as most countries struggle with high unemployment and low credibility of government policies. Fragile coalition governments (whether formal or informal) are balancing on the edge of or below parliamentary majority in Poland, the Czech Republic, Latvia, and the Slovak Republic as supporting deputies come or more often go. In Poland, Prime Minister Miller announced his resignation effective May 2 on the backdrop of the SLD party's very weak standings in opinion polls and the defection of a group of party deputies; in Hungary the Finance Minister was replaced; and in the Slovak Republic the Deputy Prime Minister and Minister of Finance was subjected to a no-confidence vote (but survived). In Latvia, the Prime Minister was exchanged, and in Lithuania the President is undergoing impeachment proceedings. Elections to the European Parliament in June may lead to further shake-ups and political instability, with early Parliamentary elections in some countries a distinct possibility. Political instability is generally slowing the reform pace.



EU-8 average (bold), +/- 1 std (dashed), min/max and EU average (red). Source: National CSOs, Eurostat



Growth is picking up. Most EU-8 countries are experiencing rapid export growth, and in some countries domestic demand—especially public and private consumption—is being fueled by expansionary fiscal policies and/or rapid real wage growth (Hungary, Poland, Czech Republic). The Baltic countries continue to lead the pack with very high growth rates (8-9% y/y in Latvia and Lithuania). Growth has also strengthened markedly in Poland, albeit partly reflecting a cyclical recovery from the slump in 2001-02. However, stronger growth has generally not been associated with a reduction of fiscal imbalances (in particular Poland) or external imbalances (in particular the Baltic countries). Also, unemployment

remains stubbornly high in most countries, especially Poland and the Slovak Republic. Slovenia and Hungary are exceptions.

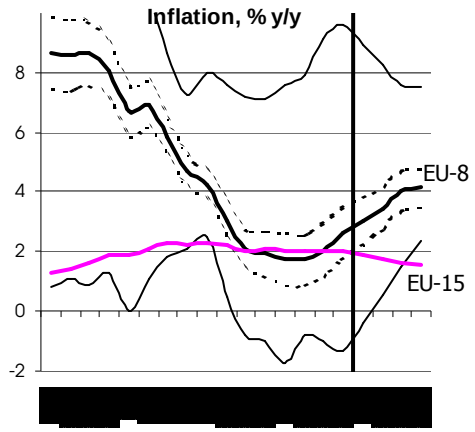
Large fiscal imbalances remain the major concern in the Visegrad countries. In Poland, the 2004 budget is providing a sizeable fiscal stimulus despite the improved growth environment, and large deficits are leading to a rapid increase in public debt. Hungary and the Czech Republic are also struggling with sizeable fiscal deficits that are proving difficult to bring under control. The Slovak Republic, on the other hand, has made significant progress in addressing its fiscal imbalances. Most countries have adopted informal medium-term fiscal targets aimed at converging to levels needed for Euro adoption (see targets in table below), but in general these targets are not sufficiently underpinned by concrete fiscal reform plans and measures. In Poland, an important step has been taken with government approval of a fiscal reform plan (the Hausner plan) aimed at rationalizing social expenditure and including a number of administrative measures, which—if fully implemented—could save around 1.5-2 percent of GDP annually by 2007 (see below for further detail). However, critical pieces of legislation remain to be approved by a divided Parliament. In Hungary, a fiscal reform plan launched by the new Finance Minister Draskovics is being implemented, with envisaged savings in the order of 1 percent of GDP already in 2004. Draskovics has indicated that the government's objective is to lower deficits by at least ½ percent of GDP each year from 2005, with larger reductions in expenditures. In the Czech Republic, the government secured approval of a fiscal package projected to save over 2 percent of GDP annually. This package—as in Hungary—is focused mainly on administrative savings, while reforms of key social spending programs remain on hold.

Surging external current account deficits are becoming worrisome in the Baltic countries. Current account deficits are now in double digits in Estonia, and close to 10% in Latvia and Lithuania. With FDI down across the region, these rising deficits are increasingly being financed by debt. The widening external imbalances are being driven by consumption-related imports and real appreciation of local currencies (especially Estonia and Lithuania whose currencies are pegged to Euro). However, net external debt still remains relatively low in these countries.

Country	Exchange rate arrangement	Intended/ likely entry to ERM2	EMU
Poland	Pure float	2007-08	2009-10
Hungary	Peg to Euro	"No rush"	2009-10
Czech R.	Managed float	2007-08	2009-10
Slovak R.	Managed float		2008-09
Slovenia	Tightly managed float	2005	2007
Lithuania	Currency board Euro	2005	2007
Latvia	Peg to SDR	2005	2008
Estonia	Currency board Euro	a.s.a.p.	2006

Source: WB Staff assessment, National Plans for Euro adoption

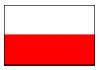
Inflation appears to be ticking up. As demand is recovering and excess capacity gradually declining, there are signs that core inflation across the region may be ticking up, especially in the Slovak Republic and Hungary (and to a lesser extent the Czech Republic) where large increases in administered prices and indirect taxes are leading to high CPI inflation that may be spilling over to core prices. Buoyant demand is also putting upward pressure on prices in the Baltic countries, especially Latvia. Central banks across the region are on the alert, although Hungary (and the Slovak Republic) surprisingly reduced interest rates on the backdrop of upward pressure on their currencies.



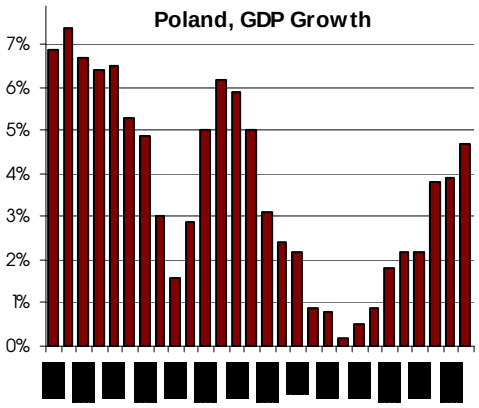
The World Bank is working on a framework to strengthen support to the EU-8 accession countries. While EU accession does not affect countries' eligibility for borrowing from the World Bank, the Bank is adjusting its assistance

framework in order to be more relevant to the development of these countries after they join the EU. This fits the ongoing efforts to reframe and scale-up the Bank's support to middle income countries.

The new approach emphasizes the need for support to capacity building to facilitate the integration process, especially as it relates to effective and full utilization of structural funds. In some sectors and countries, it foresees financial support linked to co-financing of EU funds or related expenditure priorities. The World Bank also intends to simplify its procedures and rely more on countries' own systems, introduce new more flexible lending instruments, and enhance cooperation with the EC and the main European financial institutions (such as the EIB).



POLAND



Political turmoil intensifies. With polls showing very little support for the government led by the Democratic Left Alliance (SLD), a group of 34 SLD deputies led by Parliamentary speaker Borowski defected from the party, and Prime Minister Miller announced his intention to resign effective May 2 (he had already been forced to step down as leader of the SLP). Mr. Borowski formed a new Social Democratic Party, but has declared his conditional support for the government's fiscal reform plan (see below). Marek Belka, Finance Minister in Mr. Miller's government in 2001-2002, has been given the task of trying to form a new government, but it remains uncertain if he will obtain the necessary support from Parliament.

Growth accelerates. Growth picked up toward the end of 2003, with real GDP growing by 3.7% for the year as a whole. Soaring industrial production in early 2004 points to a further recovery this year. However, the recovery has so far been led by exports, with investment growth in 2003 still in the red. Also, it has so far been jobless growth, with unemployment continuing to rise and now above 20 percent: firms appear to be reluctant to engage in new investment and hiring in a relatively volatile political, economic, and investment environment. Thus, the ongoing recovery is to a significant extent cyclical and unlikely to be sustained in the absence of a renewal of the reform momentum (in particular fiscal reform and restructuring/privatization of state enterprises).

The fiscal austerity plan remains the key item on the reform agenda. After a long public debate, the government in January approved a controversial fiscal austerity plan (called the "Hausner plan" after its main author—the Deputy Prime Minister and Minister of Economy). The plan focuses on rationalizing social expenditures (consistent with the recommendations of the World Bank in its Public Expenditure and Institutional Review—January 2003), including changes to indexation rules for social benefits, the farmers pension system, and the disability pension scheme. It also includes a number of administrative measures on both the revenue and expenditure side of the budget. Overall, the plan — if fully realized — could yield savings of around 1.5-2 percent annually of GDP by 2007 (see table). The cabinet has already sent the first related legislation to Parliament. Remaining legislation is expected to go to Parliament during the second quarter of 2004. Most of the changes should take effect from January 2005. The plan is an important step in reforming public finances and addressing the unfavorable debt dynamics, but more is likely to be needed to ensure that public finances are placed solidly on a sustainable path. The fiscal deficit in 2004 is likely to exceed 8 percent of GDP and public debt (including the expected value of outstanding guarantees, approx. 1.5% of GDP) to exceed 55 percent of GDP by end-2004.

Poland: Implication of the government economic program ("Hausner plan")

% of GDP	2003	2004	2005	2006	2007
No policy change scenario					
Gen. Government balance[1]	-6.5	-8.2	-7.2	-6.5	-6.1
Public debt /GDP ratio[2]	50.5	54.9	59.3	61.9	63.9
Hausner plan					
Total fiscal improvement, o/w		0.0	1.6	2.0	1.8
social cuts		0.0	0.9	1.3	1.1
administrative cuts and tax hike		0.0	0.7	0.7	0.7
Hausner plan fully implemented scenario					
Gen. Government balance[1]	-6.5	-8.2	-5.6	-4.5	-4.3
Public debt/GDP ratio[2]	50.5	54.9	57.7	58.2	58.4

Source: MoF, MoELSP, and World Bank Staff projections.
1) incl. off-budget recurrent expenditures.
2) Excluding expected value of guarantees.

Monetary policy remains credible. The replacement of Monetary Policy Council members in the first quarter of 2004 has not so far been associated with the feared shift to a more dovish monetary policy. The new MPC rushed to reassure markets by mentioning the possibility of a switch to tightening-bias (from current neutral), and Poland's monetary policy is expected to remain one of the most credible among the EU-8. Inflation is targeted to remain in the range of 2½ +/-1 percent over the medium term, in the context of a pure float. However, recent government indications that it would sell proceeds from external borrowing in the market appears to be at odds with this policy and good practice.

The World Bank on March 31 approved two new operations for Poland: a roads maintenance project (Euro 100 mn) and a hard coal reform social mitigation project (Euro 160 mn). These loans follow a long period of Bank engagement in these areas in Poland. The Bank also completed a Living Standards Assessment for Poland in collaboration with local authorities and think tanks. The report found a rise in poverty during recent years (from 13% in 1998 to 16% in 2002) despite positive growth during this period. Growth failed to produce new jobs mainly because of labor market imperfections, skill mismatches, and a high tax wedge. While generous social transfers played an important role in poverty mitigation, they are poorly targeted and tend to be associated with the creation of inactivity traps thus sustaining people at low income levels.

HUNGARY

The political situation remains relative stable. A new Finance Minister, Tibor Draskovics, assumed office in February, and has already pushed through cabinet a fiscal austerity package

totaling HUF155bn (0.8% of GDP) to be implemented in 2004. However, the ruling coalition led by the Socialist Party (MSZP) appears to be losing ground to the opposition Fidesz.

Growth is picking up and becoming more broad-based. Output expansion in 2003 was led by consumption fueled by rapid wage increases and fiscal expansion. Growth accelerated to 3.5 percent in 2003q4, with some shift from domestic to external demand, and buoyant industrial production in early 2004 suggests that growth in 2004 could be sustained at around this rate. Meanwhile, the current account deficit has started to decline, after having deteriorated markedly to almost 9 percent of GDP in 2003. The downward trend in inflation was reversed in 2003, and inflation remains significantly above end-2004 targets (3-5 percent).

The economic policy agenda is focused on fiscal reforms. The general government deficit was close to 6 percent of GDP in 2003 (ESA95). The revised budget for 2004 foresees a deficit of 4.6 percent of GDP, including savings proposed by Finance Minister Draskovics. These savings are expected to come mainly from reducing government operational costs, including the wage bill, but are unlikely to be sufficient to achieve the deficit target. There is scope for further rationalization of social spending, in particular health care, as well as public sector employment and subsidies.

Monetary policy continues to focus on both inflation and the exchange rate. The National Bank of Hungary surprisingly reduced interest rates in March on the backdrop of a rapidly appreciating exchange rate, while inflation is edging up and prospects for fiscal consolidation remain uncertain.

The World Bank has no major active programs in Hungary, but still provides limited technical assistance and support for institution building and environmental improvements.

CZECH REPUBLIC

The political situation remains fragile. The ruling coalition lost its formal parliamentary majority with the departure of 2 MPs from one of the junior parties. On the wave of resistance to the fiscal austerity package, public support for the government has dropped to an all time low, while the main opposition party remains the most popular.

Growth rebounded in 2003, but remains sluggish. 2003 witnessed a consumption led recovery fueled by large real wage increases. Growth is likely to become more balanced in 2004, but unlikely to exceed around 3 percent. Meanwhile, unemployment is rising and now exceeds 10 percent.

The fiscal reform agenda still looms large. Efforts so far have focused on tax reforms, including a reduction of the top VAT rate from 22 to 19 percent combined with a shift of several items from the preferential to the standard rate, a lowering of the corporate tax rate, and a shortening of the allowed depreciation period. Overall, the tax reform is expected to be revenue neutral, although the tax burden is likely to rise slightly in the short term. Meanwhile, expenditure cuts have been achieved mainly through administrative savings, raising doubts about the sustainability of the adjustment although the government's not very ambitious goal of reducing the fiscal deficit to 4% of GDP by 2006 should be feasible (the official deficit in 2003 amounted to 5.6 percent of GDP, but according to Eurostat methodology the deficit was 12.9% of GDP owing to its inclusion of all guarantees against which claims had been made in 2003; similarly, public debt calculated by Eurostat reached 37.6% of GDP last year compared to the official government figure of 23% reflecting debts of the Czech Consolidation Agency, railways, and other government guarantees). The high tax burden and high indirect labor costs remain key obstacles to faster output growth.

Monetary policy is anchored on medium-term inflation targets. The CNB announced that it would be aiming for an inflation rate of 3 percent over the medium term; current inflation is below this limit.

The World Bank has limited engagement in the Czech Republic, but is currently providing technical support for bankruptcy/insolvency reform.

SLOVAK REPUBLIC

The political situation remains fragile. Support for the minority government led by Prime Minister Dzurinda was further undermined by the recent resignation of Ivan Simko from SDKU. Deputy Prime Minister and Finance Minister Mikloš survived a no-confidence vote in March. Presidential elections were held on April 3 with former Prime Minister Meciar surprisingly receiving the most votes, although not enough to win in the first round. A referendum on early elections the same day did not result in adequate support for this.

Buoyant growth is continuing and unemployment easing. Output growth is sustained at around 4 percent per year, and this is slowly beginning to reduce the very high unemployment rate which nevertheless remains at over 16 percent. Growth has been led by exports, and the current account deficit was reduced sharply in 2003. Meanwhile, core inflation remains low, although large increases in administrative prices and indirect taxes are keeping CPI inflation high. South Korean car maker Hyundai decided to locate its investment of EUR700m in the Slovak Republic. Tax reform and cheap labor were cited as the main reasons behind this decision. The country is becoming a top producer of cars per capita.

The Slovak Republic has emerged as one of the leading reformers in the region. The fiscal deficit in 2003 came in at only 3.6 percent of GDP (ESA 95), well below plans and expectations (although owing mainly to better performance of off-budget accounts). Major tax reforms aimed at lowering the tax burden as well as expenditure reforms (focused on rationalizing the social security system) were introduced in the context of the 2004 budget. In addition to major reforms of the health care system, a pension reform with the introduction of a second, fully-funded pillar is being implemented. The government targets a fiscal deficit of 3.9 percent of GDP in 2004 and should be well on track for meeting its objective of reducing the deficit to 3 percent of GDP by 2006. The OECD generally praised government reforms in its recent Economic Survey on the country.

The World Bank is currently organizing consultations on the Country Partnership Strategy (CPS) for the Slovak Republic for the period 2004–2006. A legal and judicial reform project and a social fund project are under preparation. Also, support for public finance management and social benefits and health reforms is continuing. Further, a new Living Standards Assessment is being initiated.

SLOVENIA

Political situation remains stable. There is broad political and social consensus on the main medium-term economic objectives and directions for reform, but the ruling party is under some pressure.

Growth has picked up and inflation slowed. Domestic demand rebounded strongly in 2003 after three slow years, but growth was held down by weak external demand. Inflation also eased as the output gap widened, increases in administered prices and indirect taxes were limited, the fiscal stance was tightened, and exchange rate depreciation slowed. However, wage moderation contributed little to disinflation.

Slovenia continues a prudent fiscal policy. Slovenia has long followed a prudent fiscal policy and the rolling two-year budget for 2004-05 suggests that this will be continued. The government is implementing a major tax reform, including a range of cuts to individual income taxes and a broadening of the tax base. The net effect of these changes is likely to be a slight reduction in revenue. The decline in revenues has been matched by significant savings on the expenditure side, notably in the social sectors. However, there is scope for further rationalization.

There has been some progress in addressing excessive indexation. Public-sector trade unions have accepted slower wage growth in 2004-05 and a partial de-indexation of their wages in return for additional pension insurance. Similar negotiations are under way now between the government and the largest private-sector unions. However, rigidities persist in the indexation of untargeted social transfers.

Slovenia "graduated" from the World Bank. Based on mutual recognition that Slovenia is now well prepared to manage its remaining development challenges, its graduation from World Bank assistance was celebrated on March 17 marking a successful transition from borrower to possible donor. Slovenia will still be eligible for limited technical assistance over the next 2-3 years. The Bank still has two active projects: a Real Estate Registration Modernization and a Health Sector Management Project, both of which will close by mid-2005.

LITHUANIA

Political uncertainty hightened. Following a recent unfavorable Constitutional Court ruling, Parliament voted to impeach the President. The impeachment proceedings have been associated with a slowdown of the general legislative process.

Rapid growth is continuing, but the current account deficit widening. Lithuania remains the leader among EU-8 countries in terms of real GDP growth rates, which amounted to around 9% in 2003. Growth has been driven by exports but increasingly also domestic demand, and as a result the external current account deficit widened significantly (to about 7% of GDP in 2003). High growth has begun to make a dent in the high unemployment rate (which has declined from 17% in 2001 to 12% in 2003). Fiscal policy remains prudent (aimed at balance over the medium term), and prices remain stable.

Progress on structural reforms has been mixed. The main areas where further efforts are needed is the health sector, energy and transportation sectors, agriculture, and in the efficiency of social safety nets.

The World Bank is in the process of finalizing its Country Partnership Strategy for Lithuania for 2004-2006. The Bank has ongoing projects in the social sector, including health and education, municipal development, and port rehabilitation, and provides technical assistance in a number

of areas, including health, education, rural development, telecommunications, civil service reform, and strategic planning in municipalities.

LATVIA

Political instability continues. In February, the government of Prime Minister Einar Repse resigned after Latvia First Party left the coalition , and a new three-party minority government headed by Indulis Emsis took office. Nevertheless, the policy agenda remains broadly unchanged.

Latvia continues to enjoy buoyant growth. Real GDP expanded by close to 8% in 2003. However, inflation has started to pick up and is now running at around 4 percent compared to only 1% a year ago (in part, this reflects adjustment of administered prices and indirect taxes). The fiscal situation remains under control; the deficit of 1.8 percent of GDP in 2003 was significantly better than projected reflecting buoyant tax revenues (despite cuts in corporate and social taxes) and lower than budgeted spending across a number of areas. The 2004 budget implies an unchanged fiscal stance. The external current account deficit, which reached 9% of GDP in 2003, is the main current challenge, especially as this is no longer being fully financed by FDI.

Reforms have come a long way, but significant challenges remain. In particular, public sector reforms need to be continued and deepened as do anti-corruption efforts. Social welfare benefits need to be better targeted, civil service reforms should be continued, and control of local government expenditures should be enhanced.

The World Bank is supporting social sector reforms, including health, education, and housing, as well as public administration reform and waste management. It has recently completed a Country Economic Memorandum focused on the labor market issues. The study highlights the key problems Latvia is facing in developing a flexible labor market and proposes possible solutions.

ESTONIA

The political situation has calmed down. The ruling coalition agreed to postpone controversial income tax cuts until 2005. This will have a positive impact on the budgetary balance in 2004, although the fiscal position remains strong.

Growth remains satisfactory, but the surging current account deficit is worrisome. The Estonian economy continues to grow at a healthy rate of around 4-5%. However, the current account deficit has reached worrisome levels of 15 percent of GDP as the real exchange rate continues to appreciate and import demand is expanding briskly. Fiscal policy is generally prudent, although it would be desirable to aim for balance over the medium term rather than on an annual basis. Unemployment is down, but remains high.

Estonia has come a long way with reforms. In part reflecting the advanced stage of reforms, the reform pace appears to have slowed somewhat. While Estonia has undertaken far-reaching reforms in both pensions and health, further reforms are needed to ensure longer-term sustainability of the health care system. Further, important challenges remain in streamling

the structure of local governments, liberalizing the energy sector, and enhancing further flexibility in the labor market.

The World Bank has no active projects in Estonia.

Public Expenditure Management reform in EU-8 countries

Background

Notwithstanding significant benefits, accession will bring many challenges, including not least in the fiscal area. Fiscal challenges emerge because EU-8 countries have to provide counterpart financing to EU funds, make room for further investment in infrastructure, struggle towards meeting Maastricht criteria for EMU accession[2] and cut down already high levels of taxation to maintain overall competitiveness. This implies that the burden of adjustment will have to fall mainly on the expenditure side of the budget, although most countries have already converged towards "appropriate" levels of public expenditures (Figure 1).

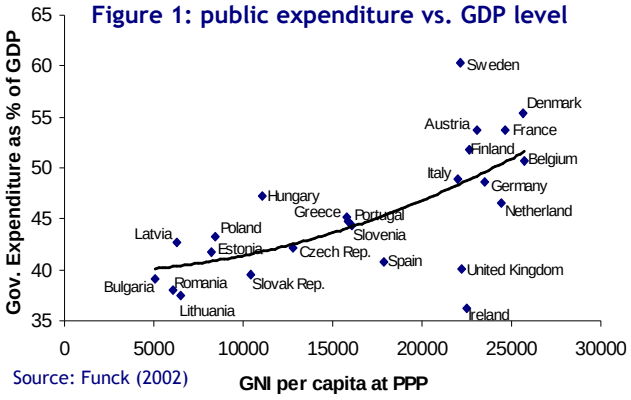
Most EU-8 countries recognized this early on by presenting medium-term fiscal strategies envisaging improvements in budget balances and cutting back taxation levels, so as to effectively bring down public expenditure by an average of 2.5 percent of GDP over the period 2000-04. However, these strategies mostly failed (particularly in Poland, the Czech Republic, and Hungary).

Table 1: Fiscal discipline in EU-8 countries

Country	2004 balance foreseen in 2001 PEP	Expected 2004 deficit
Poland	-2.2	-5.7
Hungary	-2.0	-5.1
Czech Republic	-4.3	-6.2
Slovak Republic	-2.5	-3.9
Slovenia	-0.4	-1.5
Lithuania	-1.4	-2.5
Latvia	-0.7	-2.0
Estonia	-0.4	1.0

Source: Eurostat, General Government deficit [ESA95], 2001 Preaccession Economic Programs

Figure 1: public expenditure vs. GDP level



Source: Funck (2002)

Although a high cost of reforms (Poland: hard coal and pension reform; the Czech and Slovak Republic: banking system restructuring) and slower than expected growth in several countries played an important role in this regard, poor fiscal management including uncontrolled increases in social spending were at the root of the problems.

Good public expenditure management requires that[3]:

(i) the country can make meaningful choices between policies based on priorities and objectives established through coordination and informed consensus among interested parties;

(ii) these priorities can be embedded in action programs;

(iii) the selected programs can be effectively and efficiently implemented;

(iv) reliable feedback is generated following the evaluation of policies to permit corrective action where needed.

The true test for the system is whether the discipline and progress towards objectives can be maintained through bad times, when revenues drop and economic or political adversity generates fiscal pressure. While all countries in the region have come a long way with "first generation" PEM reforms, "second generation" reforms are generally lagging. More importantly, the political system is not geared to generate the policy tradeoffs around which concerted government action can rally public opinion. Recent development suggest that many EU-8 countries have difficulties in formulating sustainable fiscal programs, implementing

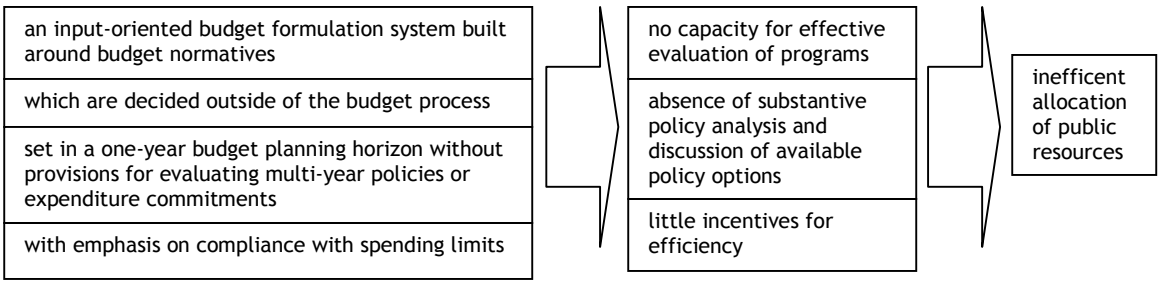
[2] An upper limit for the fiscal deficit of 3 percent of GDP (the Stability and Growth Pact calls for a balanced budget over the medium term).

[3] See Box 1 for formal principles and objectives of PEM.

realistic fiscal policies and in controlling budget execution in practice. Therefore, acceleration of public expenditure management reform is a prerequisite for effective restructuring of their public expenditure. However, PEM reform must begin with a political commitment to face and agree on tradeoffs. Technical improvements in PEM systems are a necessary but far from sufficient condition for achieving a reorientation of public spending priorities.

Evaluation of PEM systems in the EU-8 and reform options

PEM systems in transition countries have had some common characteristics – a heritage of Soviet central planning system - as represented in the diagram below:



During the 1990s there was gradual progress in all countries, including introduction of modern budget laws (setting roles, procedures, and responsibilities), improvement in macroeconomic forecasting, enhanced transparency (including publication of budget documents on the internet), increased technical efficiency of accounting/reporting (through use of IT), etc. This significant progress was a natural consequence of modernization in addition to being a requirement for EU accession. However, it has generally been insufficient and relatively limited compared to other economy-wide institutional reforms. The reasons for this include: (i) a degree of complacency regarding fiscal policy on the backdrop of improvement in the overall macroeconomic environment; (ii) strong vested interests of politicians and budget (and off-budget!) managers in maintaining the status quo of weak discipline and oversight; (iii) underestimation of the complexity of public sector budget management, where efficient allocation of resources cannot any longer be achieved by even the most benevolent central-planner (minister).

There are several issues:

(i) Budget process: separation of policy formulation from budgeting, gaps in the accountability framework, and related budgetary incrementalism;

(ii) Short term planning horizon and lack of a Medium Term Expenditure Framework (MTEF);

(iii) Lack of comprehensiveness: fragmentation of the budget, existence of Extra-budgetary Funds (EBFs), focus on the central government only, contingent liabilities;

(iv) Lack of program budgeting, lack of performance orientation and inadequate audit; and

(v) Disintegrated cash and debt management.

The Process

In most EU-8 countries the policy process continues to proceed outside the budget process (Figure 2). The budget is primarily intended to allocate available funds to existing commitments and programs. There is little substantive policy analysis and discussion of options throughout the budget process. This is because the capacity is not always there, the communication between line Ministries is imperfect, and there is no evaluation of the effectiveness of programs on which to base allocation decisions. Moreover, the political process has no mechanism to force policy tradeoffs to be considered at a high level based on the main policy objectives of the Government.

In all EU-8 countries, the essence of budget making starts with budget entities preparing draft budgets and claiming resources from the Ministry of Finance (MoF). Each spending agency

applies for funding based on their own assessment of financial needs for existing personnel and facilities, and on established spending norms. This provides the basis for the Government's draft budget – the totals are determined in negotiations (if not outright fights) between line Ministries and the MoF.

After the budget totals have been approved, the only legal requirement for budget units is that they spend the money appropriated to them – unused surpluses lapse. Consequently, managers have little incentive to economize and enhance efficiency, let alone to question whether their own programs should be continued or reorganized. Instead, the natural tendency is to expand resources devoted to themselves. Even if managers wanted to economize, they rarely can because they lack operational autonomy and evaluation benchmarks/instruments. Their authority to reallocate funds between programs is very limited. Budgeting focuses on the amounts spent on the various inputs instead of outputs/outcomes produced.

Figure 2a: Current Disconnected Policy and Budget Process

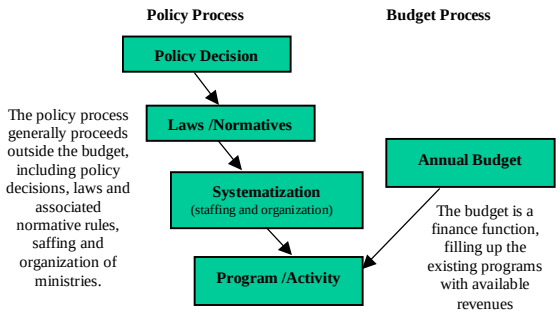
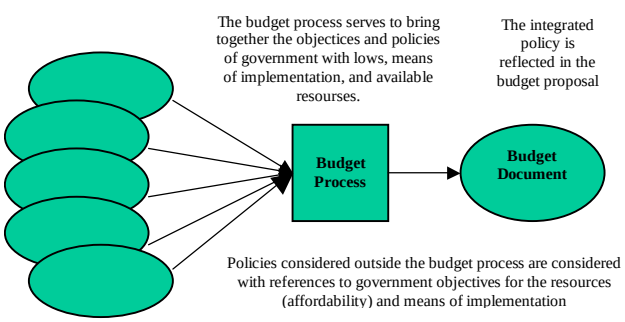


Figure 2b: Policy and Budget: Toward an Integrated Process



The described situation where outlays are continued, not necessarily because of any demonstrated need, but because they have been there during previous years is called "needs driven allocation" or "budgetary incrementalism" and is common to most EU-8 countries. It is distinctly out of step with the developments in other European countries.

To address this, some countries have moved beyond the introduction of a modern budget law. In Estonia, objectives and targets are set in a comprehensive fiscal framework, and in the Slovak Republic and Hungary, links between policies and budgeting are being strengthened.

More effort is needed so that budgeting becomes a vehicle for rationalizing policy, objectives, laws, and resources, with a view to achieving the most efficient expenditures for a given set of objectives. Integrating budgeting with policymaking requires a strong capacity at the center of government to define national priorities which are then embodied in cross-sectoral allocations consistent with the MTEF. Limits on total spending (in some cases sectoral spending as well) should be established before individual spending bids are considered. A strong Finance Ministry should be empowered to enforce the budget aggregates in bilateral negotiations with spending departments and in Cabinet discussions. Furthermore, ministers should be encouraged to reallocate within these limits based on evaluations of program effectiveness. Finally, the operational efficiency can be improved through strengthening the accountability of spending units (e.g. through external audit). Unit costs of programs could be progressively reduced to the pace of expected efficiency gains. Specifying budgeted outputs in advance, comparing actual outputs to the targets, and publishing this information would also help.

Medium Term Expenditure Framework

The process of budgetary decision-making in most EU-8 is very short term, i.e. a single fiscal year. At such a short horizon it is not possible to discuss and evaluate the links between economic objectives, policy options and tradeoffs, allocation of resources, and expected results. Realistic fiscal policies are developed only in the context of a (rolling) MTEF.

A starting point is to develop in the budget multi- (usually 3-4) year projections of macroeconomic indicators and related fiscal aggregates (revenues and expenditures). This is already being done in most countries. The estimates would be revised on an ongoing basis to include the effects of new policies and programs and changes in the economic parameters. Budgetary policies should then be formulated in the context of such a MTEF, i.e. the MTEF provides a credible, authoritative macro-fiscal envelope within which annual budget needs are assessed. This should give budget institutions a sustainable environment for program implementation and force policymakers/managers to measure the impact of present decisions on future budgets.

While all EU-8 countries prepare macroeconomic projections, many (including Poland, Lithuania, and the Czech Republic) don't treat them too seriously. Estonia and Slovenia have working rolling fiscal strategies, and Hungary has considered a three-year rolling framework but not yet implemented this. The Slovak Republic is trying to integrate its *Medium Term Financial Outlook* into the budgetary process.

Therefore, the credibility of macro forecasting needs to be strengthened. Also, fiscal aggregates should be better institutionalized (for example in a *Fiscal Policy Paper* discussed by Parliament). The MTEF—in order not to be merely a forecasting exercise—should be complemented with incentives to lengthen the time horizon of fiscal policy to include longer-term objectives and demographic developments, to strengthen tools for managing fiscal policy and financial planning, and to broaden the focus of fiscal policy towards the comprehensive general government.

Figure 3: Fiscal policy becoming realistic through MTEF, case of Australia.

projected growth of expenditure

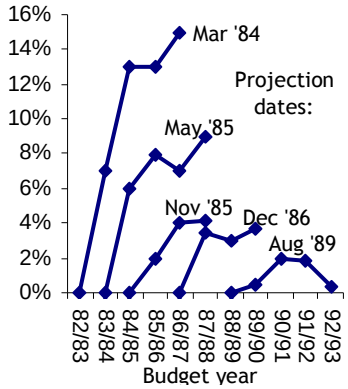


Figure 3 shows the potential of the MTEF tool.

Comprehensiveness

A clear and comprehensive picture of public finances is fundamental to its effective management. Incomplete information precludes appropriate decision-making. The scope of the government's budget should comprise the total operations of the government, including all instruments of fiscal policy. This is not happening in most EU-8 countries, principally for three reasons: a focus on a narrowly defined central (state) budget, operations of autonomous EBFs, and existence of contingent liabilities.

In EU-8 countries, the main fiscal aggregates (deficit, expenditure and revenue targets) are traditionally determined and communicated in terms of the central (state) budget. However, if one wants a comprehensive picture of fiscal policy, it is imperative to shift the focus in designing fiscal policy towards the Consolidated General Government (including all EBFs and ideally quasi-fiscal activities), building on international standards (such as ESA95 or GFS).

EBFs continue to be a plague of public finances in the EU-8 countries. Some of them were inherited from socialist times, some mushroomed during the transition period. The main problem with EBFs is not that they can run hidden deficits (transparency has recently improved greatly) but that they limit effective expenditure management. They hold separate bank accounts and borrow money at high interest rates. Further, EBFs are not uniformly subject to the same standards of budgetary oversight, reporting, auditing, and transparency.

EU-8 countries have tried to fight the proliferation of EBFs with mixed success. In the Czech Republic, progress has been uneven, and in Poland problems persist despite some improvement. Latvia and Slovenia have recently introduced a much stronger legal framework for EBFs. Hungary and the Slovak Republic bravely abolished most of them and incorporated their finances into the main budget.

The consolidation of EBFs should continue through a careful scrutiny of their relevance. Liquidated agencies should be transferred to a general budget activity. Those EBFs which are retained should be subject to the same transparency requirements as on-budget operations.

Quasi-fiscal activities - particularly the issue of guarantees and asset transfers – also deserve attention. The EU-8 have generally been treating guarantees as a substitute for budget expenditure. In the Slovak Republic and the Czech Republic (1994-1998), and in Poland (after 1999), guarantees were given recklessly. The cost of honoring them were in some cases as high as 2% of total expenditure. Although the situation in these countries has now been brought under stricter control (information on guarantees is shown in the annual budget document; in the Czech Republic parliamentary approval is needed to grant a guarantee; the Slovak Republic has also discontinued its practice of issuing new guarantees), new guarantees continue to be extended in some countries. Similarly, governments (e.g. Poland) are often wishing to transfer assets (e.g. stock of listed companies) in order to recapitalize a public enterprise or an agency. Giving away assets and extending guarantees is done outside the budget process and misrepresents the government's fiscal position. Therefore, better coverage of explicit and implicit contingent liabilities (if not discontinuation of these practices altogether) as well as development of a balance sheet of the public sector (with explanation on changes to the stock of public wealth) is recommended.

Performance orientation, program budgeting, and auditing

The budget classification in EU-8 countries is input-based illustrating the items on which money is spent (wages, pencils, etc.) but not revealing the purpose or destiny of the funds appropriated (programs). This framework provides that expenditures on inputs are met, but not for any performance evaluation and, hence, efficiency improvement.

Therefore, a program classification of spending is necessary in order to provide a link between the objectives of the unit and the purposes of the allocated funds. Programs are groupings of related activities that support a common objective. Given that programs frequently correspond to organizational units within ministries, initially the modification would be similar to a classification change. However, unlike a function (which is a general category determining a specific area of government activity) a budget program: (i) has clear goals and tasks; and (ii) has measurable benchmarks for the expected outcomes. Additionally: (iii) budget allocations should be approved on a program-by-program basis (instead of being approved in accordance with the functional classification); (iv) one entity is accountable for the implementation of each program; and accordingly (vi) should bear full responsibility for its implementation.

This approach allows the development of performance criteria to determine whether expected outcomes are achieved, effectiveness is satisfactory and volume of expenditures is met. As a result this framework should promote accountability and efficiency, ultimately improving the process of resource allocation.

Recently Estonia, the Slovak Republic and Slovenia have developed (pilot) program classifications aimed at the introduction of performance budgeting. The Czech Republic and Hungary are beginning to contemplate some outcome/performance indicators. In Lithuania and Latvia, the legal framework provides for a program approach, but it is not yet appropriately taken advantage of.

Audit is an important part of performance evaluation. The legal framework in all EU-8 countries provides for an independent external audit of the public budget conducted by a Supreme Audit Institution (SAI). However, there are at least three issues: first, the audit agency has a narrow technical approach emphasizing compliance with laws and the authorization of expenditures only, with attention to fault-finding rather than assessing relevance and efficiency of spending; second, the audit reports are not consistently taken up or considered either by the legislature or the MoF and as a result the value of the audit (stopping losses, ending bad practices) is largely unrealized; finally, modern concepts of internal control, where in the first instance the entity is responsible for its own control, are still not fully exploited.

Progress is gradually underway. Most EU-8 countries have introduced/strengthened internal audit procedures, and some countries (the Czech Republic, Slovenia, and Estonia) contemplate strengthening the "value-for-money" audit functionality of their Supreme Auditors.

State Treasury System

Some EU-8 countries maintain an inadequate integration of cash and debt management. For example, often funds are directly released into the accounts of the budget units. EBFs maintain their accounts with the commercial banks. Because cash resources, even when physically held by the units, belong to the whole government, the principle of cash unity has to be respected. This can be achieved by unifying accounts of state budget entities into a Single Treasury Account, with virtual sub-accounts for spending agencies. Additionally, a good State Treasury System, which also records commitments, i.e. a future obligation for the government, as they arise, provides for timely monitoring and control over government operations. Hungary has a very good Treasury system, and significant progress has been made in the Slovak Republic.

Conclusions

The technical side of PEM reform is a relatively cheap undertaking that can bring significant improvements when combined with a political commitment to focus on policy tradeoffs that will guide the allocation of public spending. Pressures to conform to Maastricht deficit targets and the need to reorient spending to absorb EU structural funds require governments to face policy tradeoffs in a medium term context. Political capital needs to be spent by the political leadership to rally public opinion to changed spending priorities. To support this political process, EU-8 countries will need to strengthen PEM systems. It is also important to keep in mind that the various parts of the PEM system are interlinked so that reforms should address them simultaneously. Unless broad political consensus on spending priorities can be established and PEM reforms pursued in an ambitious and comprehensive manner, good efforts to introduce future MTEFs risk becoming as irrelevant as past five year plans.

Box 1: Principles of good Public Expenditure Management

A proper public expenditure management system is a set of institutions that allocate public resources according to strategic priorities and ensure effectiveness and efficiency in the provision of public services. Budget rules should organize the budget process so that the fiscal aggregates are decided through competition among spending claimants. As long as competition is comprehensive (no extra-budgetary spending), fair (no earmarked funds), and authoritative (no improper expenditure), then the outcome is supposed to be the right one. If instead of competition, there is collusion (between claimants) or fragmentation (the various claims are decided sequentially), then the due process will not assure optimal outcomes.

The system has three key objectives:

(i) aggregate fiscal discipline – budget totals should be the result of explicit, enforced decisions; they should not merely accommodate spending demands. They should be consistent with a realistic macroeconomic framework, be sustainable over the medium-long term and brought in on target;

(ii) allocative efficiency — resource allocations should reflect government policies and priorities as well as the effectiveness of programs. The budget process should ensure reallocation from lower to higher priorities and from less to more effective programs;

(iii) technical efficiency — resources should be utilized efficiently and effectively towards to the purpose for which they have been allocated.

Additionally, the budget process is examined in terms of its:

- comprehensiveness: all revenue and expenditure, and all government agencies, are included in the budget and integrated into the public expenditure management system;
- accuracy: the budget should record actual transactions and flows;
- annuality: the budget covers a defined period of time, e.g., one year;
- authoritativeness: spending is carried out only as authorized by law;
- transparency: information on spending is publicly available, on a timely basis, in an understandable format.

These principles are necessary for the system to serve as an effective tool for formulating and implementing budget policies, evaluating budget outcomes, and holding agencies accountable for results.

References: This note is based on the following sources: **World Bank**: Public Expenditure Reviews: Poland [2003], Latvia [2002], Estonia [1997], Czech R.[2001], the Slovak Republic Budget Management Project Appraisal Document [2003], Schick A. [1998] *A Modern Approach to PEM*, Funck B. [2002] *Expenditure Policies Towards Accession*; **International Monetary Fund**: Fiscal Transparency modules of Reports on Observance of Standard and Codes: Poland [2001-03], Hungary [2001-03], Czech R. [1999-2003], the Slovak Republic [2002-03], Slovenia [2002], Lithuania [2002], Latvia [2001], Estonia [2001-02].

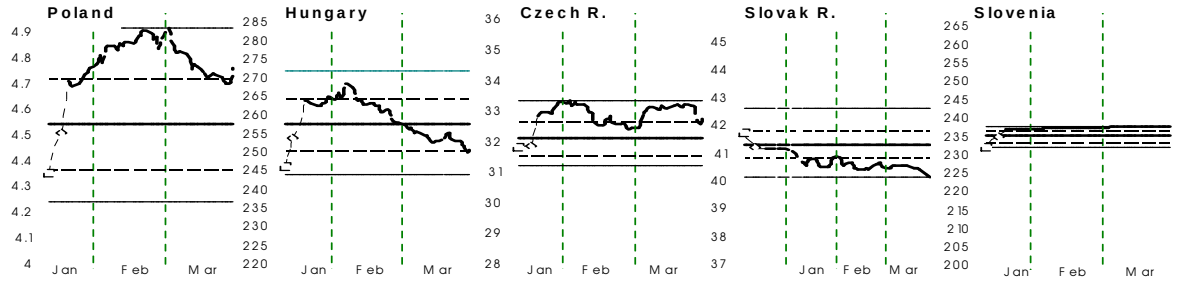
EU-8: Main Economic Indicators

2003	POL	HUN	CZK	SVK	SVN	LTU	LTV	EST
Population, mn	38.6	10.2	10.2	5.4	2.0	3.5	2.3	1.4
GDP per capita, US$[d]	5,228	7,755	8,097	5,811	10,170	4,978	4,265	5,863
CPI inflation, %y/y[a]	0.8	4.7	0.1	8.5	5.6	-1.2	2.9	1.3
GDP growth, %y/y[a]	3.7	2.9	2.9	4.2	2.3	8.9	7.5	4.8
Gen. government deficit, % of GDP[a]	-4.1[e]	-5.9	-12.9[f]	-3.6	-1.8	-1.7	-1.8	2.6
Current account deficit, % of GDP[a]	-2.0	-6.5	-6.5	-1.1	0.1	-6.9	-9.2	-15.0
Unemployment rate, % labor force[a]	19.7	5.9	7.8	17.4	6.7	12.4	10.6	10.0
interest rate, comm. LT lending[a]	5.8	10.5	5.1	7.5	10.2	5.4	5.2	5.4
Gen. government debt, % of GDP[bc]	45.1[e]	57.9	30.7[f]	45.1	27.4	23.3	16.7	5.4
External debt, % of GDP[d]	45.5	34.5	34.4	49.0	71.9	41.4	85.8	72.3
Ruling party/coal. (% support in polls)	bottom	medium-low	low	low	high	medium	low	medium-low

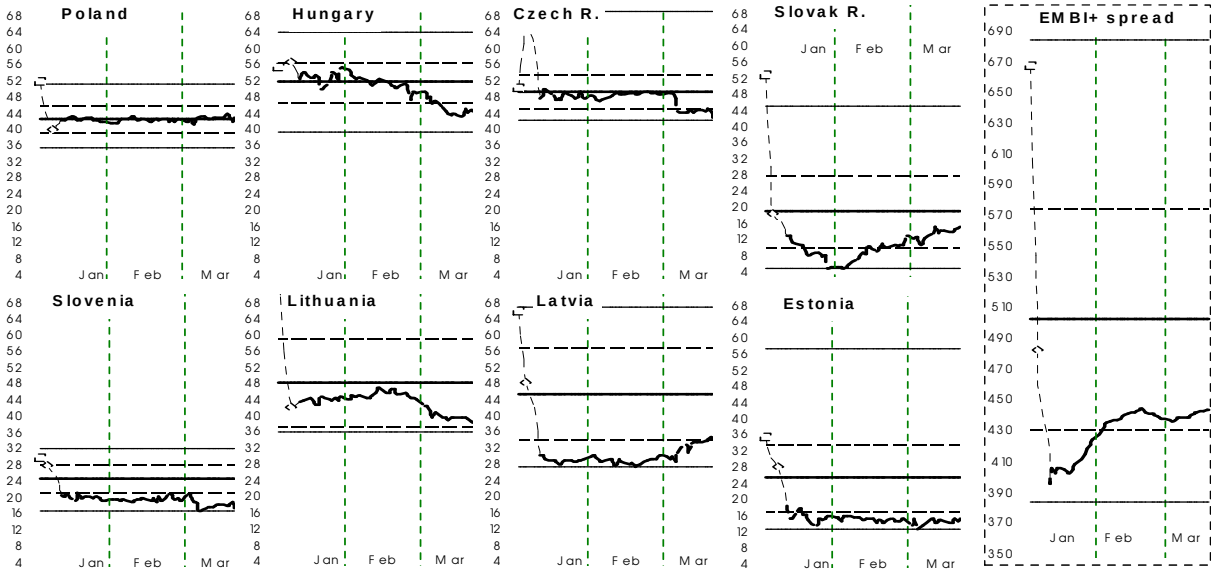
a-year average, b-year end, c-estimated, d-latest data, e - excludes open pension fund related debt and deficit (as reported by Eurostat), f –includes a guarantee-related deficit and debt of agencies (as reported by Eurostat)
Source: National Statistical Offices, World bank, EC, Eurostat, ECB, OECD, staff assessment

--- Short term stability indicators ---

Exchange rate, LCU/Euro



Eurobond spreads



Exchange rates source: ISI Emerging Markets (vertical axes span an approx. +/- 12% range). LTU, EST, LVA not shown (currency boards for LTU and EST; +/- 1% SDR peg for LVA).
Eurobond spreads source: Bloomberg (relative to comparator German bonds).
Vertical lines: 1y average (bold), 1y average +/- 1 st. deviation (dashed), and 1y min/max (thin line). Diamond: 6 months ago; square: 1 year ago.

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