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On the Road to the European Union – Some Remarks on Budgetary Performance in Transition Economies

Abstract

Accession to the EU is one of the biggest challenges for the CEECs in the coming years. Sound and sustainable public finances are crucial for the transformation towards a market economy to be continued (completed), as well as for the country's ability to comply with the membership requirements. As the long-term macroeconomic stability depends heavily on sound and sustainable fiscal balances, the structural reforms that will strengthen public finances should be a task of a highest priority for applicant countries.

The measurement of the budgetary position in transition economies presents important difficulties, as the quality and comparability of statistics is still poor, and as those less visible forms of fiscal deficit (i.e. the quasi-fiscal deficit and the contingent deferred fiscal deficit) are clearly linked with the postponements in structural reforms.

Furthermore, there is unquestioned interdependence between fiscal policy (budgetary aggregates) and the transition process (changes in macro- and microeconomic performance of the country). Indeed, one can hardly expect a successful balanced-budget policy during the entire journey from plan to market. To the extent that fiscal imbalances reflect the costs of necessary adjustments, they may be temporarily justified (as 'transitional' deficits). Thus, the most difficult issue in designing and implementing fiscal policy during transition is choosing a proper balance between the need to achieve macroeconomic stability (which require fiscal discipline) and the need to pursue structural, market-oriented (and fiscally costly) reforms. In practice, in the short run, this can lead to conflicts between quality and quantity of fiscal adjustment.

When the quality of fiscal adjustment is poor, the current 'good' quantities are not the evidence of sound public finances. Slow progress in structural reforms, which is not fully reflected in current budgetary aggregates, poses a risk of future fiscal imbalances and constitutes a threat to macroeconomic stabilization and sustainable growth. Therefore, further progress in restructuring the economy and reducing the role that the state plays in production and resource allocation remain the main challenges for sustainable fiscal position in transition economies.

The current levels of government spending in the relatively poor transition countries are much too excessive. The need to finance high government spending (strongly dominated by current transfers) makes impossible the reduction of the overall heavy fiscal burden on the economy. Such a burden creates a strong barrier to fast growth and leads to the development of the underground economy.

With this unfavourable current situation any pressure on the expenditure side will deteriorate fiscal position. Such pressures will derive from the continuous progress in structural reform as well as from the process of the preparation to accession.

As discussed in this paper, the budget deficit, as usually measured, has important shortcomings as an indicator of sound and sustainable public finances in transition economies. But this does not mean that fiscal imbalances are the matter of irrelevance. Instead, the medium term reform programs should address the need to reduce the fiscal deficit, but this goal can be achieved only by reshaping government expenditure with priorities given to productive activities (such as investment in infrastructure and in human capital), together with reducing the size of public spending.

Keywords: budget, deficit, European Union, fiscal policy

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1 Introduction

Integration into the European Union is one of the biggest challenges for transition economies in the coming years. Sound and sustainable public finances are crucial for the transformation towards a market economy to be continued (completed), as well as for the country's ability to comply with the membership requirements.

The paper reviews the EU membership criteria and addresses these fiscal issues, which deserve special attention during the process of transition and preparation for accession. In particular, the relevance of 'traditional' fiscal aggregates as the indicators of budgetary position during the way to a market economy, the structure of government expenditure and revenue in three applicant countries, as well as the prospects for long-run sustainability of public finances in transition economies are discussed.

2 Eastern enlargement of the European Union

Between March 1994 and June 1996 ten Central and Eastern European Countries (CEECs) submitted their application for membership of the European Union (EU).[1] On July 15 1997, the European Commission, in response to the request of the European Council, presented the opinion *(avis)* on the preparation of each of the applicant country to join the Union. The accession applications were examined by the Commission according to the political and economic criteria laid down by the conclusions of the European Council's Copenhagen Summit in June 1993.[2] According to these conclusions, *'accession will take place as soon as a country is able to assume the obligations of membership by satisfying the economic and political conditions.* The membership requirements[3] were spelled out as follows:

- *'stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities'* – the political criteria;
- *'the existence of functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the Union'* – the economic criteria;
- *'the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union'* – i.e. the ability to adopt and effectively implement the *acquis communautaire,* as expressed in the Treaty on EU, the secondary legislation, and the policies of the Union.

The so-called Copenhagen criteria, in their economic scope, are quite broad, unclear and subject to different interpretations. The opinions on the preparation for accession prepared by the European Commission have clarified this picture somehow, though they seem to be rather descriptive, and their conclusions arbitrary. In these conclusions, as well as in 'Agenda 2000' communication[4], the Commission states that none of the CEECs fully satisfies all the membership criteria; nine countries satisfy the political conditions,

[1] Applications were submitted by: Hungary (31.03.1994), Poland (05.04.1994), Romania (22.06.1995), Slovakia (27.06.1995), Latvia (27.10.1995), Estonia (24.11.1995), Lithuania (08.12.1995), Bulgaria (14.12.1995), the Czech Republic (17.01.1996), and Slovenia (10.06.1996).

[2] See European Council (1993).

[3] For the discussion on the formal requirements for accession and the past enlargement practice applied by the Union see Nicolaides and Close (1995), Nicolaides and Boean (1997), and Daviddi and Ilzkovitz (1997). For the critical discussion of the Copenhagen criteria see Inotai (1994, 1995); according to this author, 'the Copenhagen decision in fact constitutes an act of discrimination against the transitional countries' – as no economic conditions for entering the EU were applied in the past enlargements.

[4] 'Agenda 2000' (see European Commission, 1997) constitutes the Commission's response to requests from the European Council's meeting in Madrid in December 1995. It contains the broad outlook for the development of the Union and its policies beyond the turn of the century, the impact of enlargement on the Union, and the future financial framework for the period 2000–2006, taking account of the prospect of an enlarged Union.

while 'certain countries have made sufficient progress towards satisfying the economic conditions and those related to the other obligations of membership'[5]. In the light of its analysis, the Commission recommended that accession negotiations should be opened with five countries, i.e. with Hungary, Poland, Estonia, the Czech Republic and Slovenia.[6] For all the applicant countries the Commission proposed a reinforced pre-accession strategy in a framework of the Accession Partnership, a new pre-accession funding, and a European Conference to examine common foreign policy and justice and internal security affairs.

The final decision on the opening of accession negotiations (which should start early in 1998) is supposed to be taken during Luxembourg European Council on December 12–13. It is not possible to foresee countries which will be chosen for the first round of negotiations; such a decision, as well as the whole issue of eastward enlargement of the EU, has a very strong political dimension.[7] For many political reasons it can not be excluded that negotiations would be open simultaneously with all the applicant countries, given that thereafter the actual negotiations would be differentiated with account being taken of the Commission's opinion (which indicates, on a country by country basis, the conditions that still need to be met).[8]

Eastward enlargement of the EU is unique in that sense that it involves the largest number of candidate countries which, in addition, lag significantly in development. But it is also unique in the sense of the EU preparation for enlargement. The 'fourth', often overlooked Copenhagen 'criterion', concerns the EU side of the enlargement story, as it points to the '*Union's capacity to absorb new members as an important consideration in the general interest of both the Union and the candidate countries.*'[9]

The assessment of this capacity must take into account that the EU has expanded and deepened its integration without a clear concept for the overall structure of the Union, without adjusting its institutions and decision-making procedures. Furthermore, the next enlargement will come at a critical moment in the evolution of the Union (the introduction of a single currency in 1999). Finally, there is also the crucial problem of the so-called 'sensitive issues' (the CAP and structural funding), which are usually regarded as an obstacle on the road to the enlarged Union. In fact, these issues are sensitive for the existing Union itself[10], and the need of reforms, especially in the area of agricultural policy, is obvious even without any enlargement.

Since the Intergovernmental Conference

[5] European Commission (1997, Vol. I, p. 69).

[6] Slovakia, although 'could satisfy the economic criteria in a medium term', has been judged not ready for accession negotiations because its failure to meet the political criteria.

[7] As Baldwin (1995, p. 475) states: 'High politics is clearly the strongest force behind the EU's decision to enlarge eastward'. Although political considerations have been important for every previous enlargement of the EU (as Csaba (1996, p. 5) points out, 'any such step has invariably been an act of high policy'), this feature is indeed particularly relevant for the eastward enlargement. For the uniqueness of this 'special' enlargement see for example: Eatwell et all (1997), Baldwin (1994), Guggenbuhl (1995), Bofinger (1995).

[8] See *Euro-east*, No. 58, September 1997.

[9] The pre-accession strategy has been criticized for focusing on criteria for the CEECs rather than on necessary changes on the EU side; see for example Inotai (1995).

[10] As Nuti notices, '*CAP is a chunk of Comecon in the middle of the European Union. There are many strong similarities: multiple exchange rates, in the guise of green currencies; countervailing levies equalizing the position of domestic and international producers; large, costly, centrally administered inventories; export subsidies; massive budgetary transfers, which for CAP amount to nearly 60 per cent of the European Union budget*'; see 'Round Table on Eastwards Enlargement of the EU' (1996, p. 509).

(IGC)[11] has made rather modest progress toward more efficient Union's structures[12], the future shape of the Union and its capacity to absorb new members are hardly predictable.[13] On the other hand, the applicant countries' initial enthusiasm for joining the EU may cool down during the long lasting negotiation process, with growing consciousness of costs of accession and with limited access to the agriculture and structural funds.[14]

In the light of all these uncertainties, the attempts to specify the extent, timing and conditions for accession must be considered hazardous. Despite, however, all the difficulties on the road to the enlarged Union, a clear, credible and complete strategy for enlargement, concerning both the EU and the applicant countries, is required. Such a strategy will make possible a deeper economic and political integration to continue during the pre-accession period. A deadlock in the accession process would be harmful for the CEECs, as well as for the Union and the whole Europe.[15]

3 Transition and accession

Following dramatic changes at the turn of the decade, the CEEC's have initiated the process of progressive economic and political integration with the EU; subsequently, by signing the European Agreements, they have declared their intentions to become the members of the Union. As a consequence, they have structured their transformation programs in anticipation of eventual membership in the EU. The transition process in these countries is therefore very closely related to the process of the preparation for accession.[16] The broad goal is identical – the ability to run a healthy, market economy, adjusted, however, to the EU standards. To reach this goal, the whole economic structure of the country must be reshaped. This includes the redefinition of the role and scope of the public sector during and after transition, widespread privatization, the overall reform of public finances, and the creation of financial markets. Financial markets will make possible both the efficient mobilization of private savings and their most efficient allocation, with the leading

[11] This IGC commenced in March 1996 in Turin and concluded in June 1997 in Amsterdam. Its purpose was to revise the Treaty of European Union (the Maastricht Treaty) by the provision of internal reforms, which would deepen integration, improve the Union's capacity for action and prepare the ground for next enlargement. For more about expectations toward the IGG see Brabant (1996); for a comprehensive analysis of challenges facing the EU see a study of Ludlow (1997).

[12] This concerns primarily the poor progress in decision-making procedures; in 'Agenda 2000' the European Commission is calling for the new EU IGC, as soon as possible after 2000, to agree on the introduction of qualified majority voting, and to reform the composition and functioning of the institutions.

[13] As Ludlow states: *'The European Union is currently in the throes of a crisis of self-confidence which can only be compared with the worst days of Euro-pessimism and Eurosclerosis in the early 1980s'* (Ludlow, 1997, p. 1). For stages of the EU integration see Jovanovic (1997).

[14] In 'Agenda 2000', the European Commission suggests a ceiling on annual transfers from the Structural and Cohesion Funds of 4 % of a member state's GDP. Such a ceiling, in the Commission's view, would help avoid *'major problems with regard to absorption'*. It may be argued, however, that the Commission's formula would provide extra aid on relatively rich countries, making the 'catching up' process more difficult for those poorer.

[15] The EU eastern enlargement is consistent with the concept of a larger Europe without barriers, stemming from the vision of Jean Monet, Konrad Adenauer, Jacques Delors, and the authors of the Treaty of Rome and the Maastricht Treaty. In other words, enlargement ought to be seen as a key pillar in the European post-Cold War architecture.

[16] This identity could have facilitated and speeded up the process of transformation. With the broad acceptance of the idea of joining the EU (especially at first stages of transition), some socially difficult and thus politically unpopular reforms (e.g. of social security system) might have been undertaken more easily, as steps required for accession. Unfortunately, this opportunity has been largely wasted. This can be partially explained by, as described by Nuti, *'the EU's lukewarm attitude and lack-lustre performance towards enlargement'* (see 'Round Table on Eastwards Enlargement of the EU', 1996, pp. 503–511).

role in resource allocation being played by the private sector. Thus financial liberalization together with the creation and development of institutions, instruments and procedures, is the core of building a stable market economy.

The same applies to the prospect of accession to the EU. The Copenhagen economic eligibility criteria for the transition countries' membership of the EU are indeed general[17] enough to indicate that the capacity of countries to conduct economic policies implied by EU membership, the overall degree of "marketization" of their economies, and the existence of sound macroeconomic balances, are the most important issues.

Therefore, a sufficient progress in transition is a prerequisite for accession. But no one should expect the completion of transition before joining the EU – in fact, accession to the EU ought to be seen as a milestone on the way towards a mature, established market economy, as a framework for the successful continuation of the transformation.

In that sense that the transition process is supposed to be continued after the accession, it can be said that the conditions for transition go beyond the conditions for accession. On the other hand, the conditions for accession go beyond the conditions for transition.[18] This is because of the fact, that transition economies are supposed to create not only a market economy, but the economy adjusted to the EU standards. According to the Copenhagen criteria, any new members of the EU is expected to be able to adopt the whole of the *acquis communautaire*[19] at the time of entry or soon afterwards. As the Union is more integrated, this requirement is much higher compared with previous accession (new obligations have arisen regarding the Single Market, common foreign and security policy, EMU and justice and home affairs); it is also higher while compared with requirements of some of the current members states (new members will not be allowed to opt out on EMU and the social chapter). Furthermore, as the Union is in a dynamic phase of integration, new obligations are expected to arise. Thus the *acquis* is a moving target, whose final shape is partly unknown as yet – for example, in the area of exchange rate policy it is not possible to define precisely the requirements for new members because this will depend on the future exchange rate arrangements between the member states participating in the euro area and the non-participating member states.

Although the declared objective of the Union is that the new members adopt, implement and enforce the whole of the *acquis* upon accession, because of the specificity of CEECs as transition economies, and regarding the EU's experience with previous enlargement[20], there will be some scope to negotiate transition arrangements (periods)[21], but not derogations, according to the European Commission's standpoint in 'Agenda 2000'.

From the viewpoint of the applicant countries, adoption of the *acquis* should be perceived as the instrument to create the conditions under which the benefits of integration with the EU may be obtained. In many areas early adoption of the *acquis* will reduce legal, policy and regulatory uncertainty and will encourage domestic and foreign investment, which help strengthen the growth potential of the economy. At the same

[17] More precise requirements are expected to be defined within the accession negotiations between the EU and individual applicants.

[18] See V. Glasmacher and N. Stern in: 'Round Table on Eastwards Enlargement of the EU' (1996, pp. 497–502).

[19] The *acquis communautaire* includes:
- the principles and political objectives of the founding Treaties and subsequent amendments,
- legislation adopted pursuant to the Treaties, and the case law of the Court of Justice,
- declarations and resolutions adopted within the Community framework,
- international agreements and agreements concluded by member states among themselves, relating to Community activities.

The text containing the *acquis* has been estimated to run to more than 15,000 pages. See Nicolaides and Boean (1997).

[20] No country that joined the EU in the past complied fully with the *acquis* at the time of its entry.

[21] It does not concern the measures necessary for the extension of the Single Market, which, according to 'Agenda 2000' document, should be applied immediately.

time, increased competition will speed up structural reforms, restructuring and modernization processes in the economy, as well as will encourage further reallocation of resources. In other words, the approximation and harmonization of legislation will stimulate and enforce the transition processes.

There are, however, some aspects of the *acquis,* whose quick adoption by the CEECs is not feasible (environmental protection) or not desirable (the Common Agricultural Policy). In both areas a transition period for new member countries is envisaged by the European Commission in 'Agenda 2000' documents. It should be noted that applying the CAP in its present form to the acceding countries would be obviously not desirable for the EU. It would stimulate surplus production that could not be sold on third markets (WTO constraints on subsidized exports), and it would cost, according to the Commission's estimates, around 11 billion ECU per year with direct payments to farmers representing close to 2/3 of this sum. On the other hand, substantial rises in agricultural prices and direct transfers to farmers would have a negative impact on acceding countries, as it would create income disparities leading to social tensions. Moreover, as direct payments within the EU are intended to compensate farmers for cuts in guaranteed prices, and as farmers in acceding countries will experience price increases, not cuts, such payments would be not justified. Therefore, the Commission suggests a reorientation of CAP with less focus on price support and more on income support as well as on rural development and structural reforms in acceding countries.

The country's ability to adhere to the aims of the European Monetary Union (EMU) is one of the Copenhagen accession criteria. This criterion should be understood as an ability to maintain sufficient macroeconomic stability in the long run. In other words, it is the requirement to possess the macroeconomic structure that can support price stability on a permanent basis. As the structural reforms in transition countries are not completed yet, the changes in qualities, more than in quantities, are better indicator of the progress towards well-functioning market economy. This is exactly why the economic convergence criteria of EMU (Maastricht criteria) are not the accession criteria and why they are not relevant as the main benchmarks for the assessment of transition (candidate) countries' 'readiness' to join the EU.

On the other hand, since membership of the EU implies acceptance of the goal of EMU, the convergence criteria should be seen as 'key points of reference for stability oriented macroeconomic policies'.[22]

Meeting the Copenhagen accession criteria is a great challenge facing applicant countries. As already mentioned, the country's ability to comply with the membership requirements will be measured primarily by the existence of policies (instruments and procedures) and institutions conducive to fast and sustainable growth, rather then by fixed numerical criteria.

As the long-term macroeconomic stability depends heavily on sound and sustainable fiscal balances, the structural reforms that will strengthen public finances should be a task of a highest priority for applicant countries. This strengthening of public finances is a key condition for attaining price stability on a permanent basis, but it is also the main vehicle to help improve domestic (public and private) saving, which are crucial for investment and for sustaining fast economic growth.

The main features of budgetary performance during transition, as well as the main fiscal challenges faced by the Czech Republic, Poland and Hungary, i.e. by the three of five CEECs judged by the European Commission ready for starting accession negotiations, are discussed below.

4 Fiscal aggregates and their relevance during transition

Before starting the analysis of fiscal performance in the three applicant economies, it is necessary to address two crucial issues. The first is the availability, quality and comparability of statistical data, which describe government accounts in post-socialist countries. The second issue relates to the specific features of economies under transition – in such economies 'traditional' fiscal measures are neither good indicators of current soundness of public finances nor can they serve as the only base

[22] This statement is included in each opinion prepared by the European Commission.

for future budgetary projections.

Proper measuring of government fiscal activity depends crucially on a proper definition of the term 'government'. The most common approach is that of general government, which includes central, state, provincial, local and other lower-tier government institutions, as well as off-budget agencies such as the social security funds or privatization funds.

Within the European Community, in order to ensure the correctness and effectiveness of the excessive deficit procedure the concepts of the government budget deficit and government debt have been precisely defined, and the adjustment procedures aimed at the transformation of budgetary aggregates in individual countries' public accounts into aggregates relevant for these agreed definitions, have been prepared. In the case of transition countries, the position of local and regional government budgets as well as of social security funds is still difficult to assess. In addition, taking into account the strong incentives for officials to present a favorable picture of the economic performance of their country, one may suspect that the government budget deficit and the value of public debt captured by the official statistical data could be underestimated.

The general government concept does not include state enterprise sector. In transition countries, however, as long as privatization is not sufficiently completed, one might argue that state-owned enterprises continue to carry out many fiscal functions that in market economies are financed through the government budget, for example providing to their workers medical care, kindergarten facilities, various forms of welfare assistance, as well as unemployment insurance through hoarding of workers.[23]

The concept of general government has been criticized as too narrow approach in the context of financial activity of the government. As emphasized by Buiter (1997), the relevant definition of the government is that of *sovereign*. In such a concept, all agencies that can levy taxes or issue legal tender have to be included; this means that the term 'government' should embrace not only general government, but central bank as well. The reason for consolidation of government and central bank accounts arises from the ability of the government to shift outlays and receipts from general government budget to the central bank, giving rise to the quasi-fiscal deficit of the central bank.[24] Quasi-fiscal operations (outlays and receipts) of the central bank (and other public financial institutions) must be seen as a hidden form of subsidies and taxes of the general government sector.

Hiding government deficits in the central bank account can be done, for example, by subsidized (via negative real interest rates) central bank credits directed to specific sectors or by central bank losses associated with the purchase and sale of foreign exchange in a multiply exchange rate system; such quasi-fiscal subsidies have been widely experienced in countries of the former Soviet Union and Romania. A good and quite common example of tax-equivalent central bank activity is offered by the imposition on commercial bank of reserve requirements that oblige them to hold central bank liabilities with below market rates of interest.[25]

The need to consolidate the central bank and government accounts was particularly relevant in the case of Hungary's system of public finances, where until 1996, the external debt was held by the central bank[26] – consequently, external debt service did not appear as a fiscal cost on government accounts.

[23] See Tanzi (1993).

[24] For a detailed discussion on the quasi-fiscal operations of the central bank and other public financial institutions see study of Mackenzie and Stella (1996) and Mackenzie (1994). For examples of such activities in transition economies see also Buiter (1997) and Dabrowski (1996).

[25] The form of quasi-fiscal central bank activity, both tax- and expenditure-equivalent was introduced in Poland in 1992. The new banking law stipulated that the National Bank of Poland should remunerate banks for their obligatory reserves; however, the income thus generated should be used for agricultural restructuring through the establishment of a Fund for Farm Restructuring and Debt Relief. The fund received an amount equal to 0.1 per cent of GDP in 1994.

[26] Since the beginning of 1996, a centralized treasury has been in operation, and the extra-budgetary funds are being incorporated into the central budget. These measures should markedly improve a poor transparency of public finances in Hungary.

While the concept of the consolidation of the general government and central bank accounts enables the quasi-fiscal operation to be embraced, the picture of government financial activities may still be incomplete. This is because of the 'contingent deferred fiscal deficit' described by Buiter as follows: '*A contingent deferred fiscal deficit arises when the central bank or some other general government agency are known to be willing and able to engage in a future bail out of a state enterprise (or private enterprise with continued political clout) either directly or by bailing out a commercial bank that has made a nonperforming loan to the enterprise in question*'.[27] The most important problem with deferred fiscal deficit is that it is hardly visible and very difficult to assess: until the (expected) bailout transfer actually happens, nothing would be recorded in the general government or central bank accounts. The examples of such operations can be found within the area of government assistance in resolving banking sector problems.[28] During 1990s, the recapitalization of state-owned banks by issuing public debt occurred in Poland (1993–94) and in Hungary (1992–94). The principal of the recapitalization debt instruments was excluded from the budget,[29] though the interest payments were included. As they were incorporated in the budget, thus the operation was not quasi-fiscal in nature. However, recapitalization could be seen as a form of partial compensation to state-owned banks for lending to public sector enterprises on preferential terms (to keep them afloat). To the extent that such loans had a subsidy element, they entailed a contingent deferred fiscal deficit.

There is also an important issue of various contingent liabilities of the government. They include, for example, loan guarantees, export credit guarantees or foreign exchange guarantees. As a rule, the less advanced the overall reforms, the greater weight of these liabilities. This can be illustrated by loan guarantees provided to inefficient state enterprises. On the one hand, if these guarantees are exercised, they will bring about budgetary costs. On the other, they distort the allocation of credit in favor of state sector, thus reducing the production and investment of private enterprises.

The protection of inefficient state-owned sector through quasi-fiscal government activities (the tolerance of systemic non-payment should be also included) adds to the problem of the banking sector's nonperforming ('bad') loans. This problem is common to most transition economies, and it has not been solved yet,[30] which means the necessity to consider the costs that the budget is going to bear for this in the future.

One must also take into account the expenditure arrears, which are not reported in the government budget balance (while prepared on a cash basis) and which constitute a hidden form of budget deficit. This problem is particularly acute in Poland, where in 1994 and 1995 substantial arrears built up; at the end of 1995 the stock of expenditure arrears reached 0.8 % of GDP.[31] Such hidden forms of government liabilities must be taken into account in future fiscal projections.

Some important conclusions can be drawn against that background. First, that the level of (conventional) budget deficit itself, with the omission of different quasi-fiscal activities and contingent liabilities of the government, cannot serve as the only base for estimating the size of future public debt. Second, that those less visible forms of fiscal deficit, i.e. the quasi-fiscal deficit and the contingent deferred fiscal deficit, are clearly linked with the postponements in structural reforms. For a proper assessment of fiscal position of the government, such forms have to be abandoned or absorbed into the government budget, as

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[27] Buiter (1997, p. 11).

[28] For a detailed discussion on fiscal aspects of government assistance in bank restructuring see Daniel (1997).

[29] This example makes it clear that the changes in public debt may occur irrespectively of the size of budget deficit.

[30] In 1994, the share of bad loans in total assets of the banks amounted to 20.1 % in the Czech Republic, to 11 % in Hungary, and to 9.8 % in Poland; as a percentage of GDP, the bad loans amounted to 30.4 % in the Czech Republic, to 7.9 % in Hungary, and to 3.2 % in Poland; see Anderson et al. (1996, p. 59).

[31] These expenditure arrears were concentrated in education and health care.

explicit budgetary operations.[32] Third, the contingent liabilities of the government, with the inclusion of the implicit pension debt, should be valuated,[33] despite the problem of choosing proper discount rate in the calculation of their present value.

Apart from the measurement problems, the assessment of the transition countries' fiscal situation involves some crucial issues, related to the nature of transition itself. These are discussed below.

The reform of public finances is perceived as one of the longest lasting processes within the transformation (Tanzi, 1993a), and there is an unquestioned interdependence between fiscal policy (budgetary aggregates) and the transition process (changes in macro- and microeconomic performance of the country). Indeed, one can hardly expect a successful balanced-budget policy during the entire journey from plan to market. To the extent that fiscal imbalances reflect the costs of necessary adjustments, they may be temporarily justified (as 'transitional' deficits). Additionally, the advancement in structural reforms is supposed to improve future budgetary position. Therefore the assessment of the situation of public finances in transition countries must take into account the progress toward the creation of a market-based, relatively stable and growth-generating economic system.

It has been widely argued[34] that the adoption of too tight fiscal criteria could slow down the process of reforms. On the other hand, the gap between government expenditure and government revenue could generate serious inflationary problems. The possibilities of financing the budget deficit by non-monetary means[35] are determined by the level of financial market development together with the size of private savings. In post-socialist economies both limited private savings and underdeveloped financial markets may be a barrier to non-monetary deficit financing. Therefore, a budget deficit, which is small by the standards of developed market economies, may be a serious threat to the process of price stabilization in transition economies;[36] the influence of the existing (and anticipated) budget deficit on inflationary expectations should also be taken into account.

On the other hand, the 'unpleasant monetarist arithmetic' of Sargent and Wallace (1981) shows that bond financing does not necessarily protect against inflation in the longer time horizon. If the government fight inflation at the expense of raising the real stock of public debt, the future monetary expansion and larger inflation may be the outcome. The reason is that larger debt and interest payments create the need for seigniorage. Here, the example of Hungary seems to be appropriate. Despite relatively thin financial markets, Hungary succeeded in obtaining nonbank financing of the budget deficit, but in so doing graduated into a vicious spiral of increasing debt, further deficits, and higher interest rates.

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[32] Tanzi (1993).

[33] Such a practice takes place in New Zealand, where the government is legally bound to present a comprehensive public sector balance sheet which includes explicit valuation of the more standard contingent claims and liabilities.

[34] See for example Tanzi (1993) and Coricelli (1997).

[35] Non-monetary financing the fiscal deficit required that treasury bonds are being sold to the non-banking private sector. Then, both the monetary base and broadly-defined money supply are not being changed. Under conditions when the deficit is financed by the central bank, an increase in the monetary base and overall money supply occurs, but when treasury bonds are being sold to commercial banks (having free cash reserves) an increase in broadly-understood money supply takes place despite the fact that the monetary base does not expand. To receive more information on the monetary effects of deficit financing see *Budget Financing and Monetary Control,* 1982.

[36] This is of particular importance given the fact that the level of inflation in these countries considerably exceeds the levels seen among the EU countries. In 1996, the inflation rate (average yearly increase in the consumer price index) amounted to 20.0 % in Poland, 23.7 % in Hungary, and 8.8 % in the Czech Republic. Among EU countries, the highest price rise in 1996 was recorded in Greece (8.2 %); in other countries inflation varied between 0.6 % (in Finland) and 3.9 % (in Italy). The average inflation rate for the EU amounted in 1996 to 2.5 %.

The crowding-out[37] issue should also be considered, with special attention given to the specific situation of the banking sector in post-socialist countries. The banks are pursuing a very cautious credit policy due to a large share of 'bad debts' in their portfolios, and the poor financial standing of enterprises. One may argue that the lack of reliable borrowers, rather than government competition for financial market resources, constitutes a barrier to transforming private sector savings into credit for the economy. In other words, it is assumed here that the savings existing in the economy would be unutilized (i.e. they would not be transformed into private investment); the existence of a budget deficit allows for their utilization and sustains total demand. Those arguments, however, do not seem convincing. On one hand it can be presumed that a balanced budget would lead to lower interest rates (nominal and real), which in turn would improve the financial standing of enterprises increasing the circle of potential borrowers. The second aspect of this issue refers to the conditions under which the banking sector operates and its relations with the government. Although in the short run credit for the government solves the problem of investing existing bank assets, the current (and expected future) borrowing needs of the public sector can contribute to reducing the banks' interest in financing the economy (a specific type of *ex ante* crowding out effect).

It should be added, however, that the assessment of such a crowding-out effect in the first stages of transition process should not be entirely negative. Financing the government by the banking system makes possible the maintenance of hard budget constraints for enterprises by giving banks alternative assets in which to invest, thus counteracting a deepening of the bad debt problem. Taking a longer time perspective, however, such a crowding out must be viewed as counterproductive.

Thus, the most difficult issue in designing and implementing fiscal policy during transition is choosing a proper balance between the need to achieve macroeconomic stability (which require fiscal discipline) and the need to pursue structural, market-oriented (and sometimes fiscally costly) reforms. In practice, in the short run, this can lead to conflicts between quality and quantity of fiscal adjustment.[38]

Due to the aforementioned specific conditions of transition economies, 'low' budget deficit and public debts, as they are currently officially recorded (see Table 1), do not necessarily mean sound public finances.

Taking a longer time horizon, the sustainability of fiscal position is crucial. Sustainable fiscal position means that the public debt to GDP ratios converge to some tolerable level. With the assumptions about seigniorage revenues (which depend on assumed inflation), about the real interest rate and the real rate of growth as well as with the assumed debt-to-GDP target, one can calculate the sustainable primary deficit. Once such 'financeable' primary deficit is computed, it can be compared with the actual one.

[37] This concerns financial (indirect) crowding out, the merit of which is absorption of private saving for financing the fiscal deficit and public debt. The competition between the private sector and the government for limited private savings leads to an increase in interest rates, which 'crowds out' private investments in favor of government expenditures. It should be noted that apart from possible financial crowding out, direct crowding out – being a relict of the previously existing system – also frequently occurs. This takes place when the government, through its expenditure, provides the private sector with goods and services perceived as substitutes for possible private expenditures (educational, health service expenditures, etc.). Direct crowding out does not depend on the way in which the budget deficit is financed. For more about the taxonomy of the crowding-out effect, see Buiter (1977, 1985) and Chouraqui (1988).

[38] See Kopits and Offerdal (1994).

Table 1 **Government budget balance and foreign debt in transition countries, percentage share of GDP**

	Government budget balance				Gross foreign debt
	1993	1994	1995	1996	1996
Czech Republic	1.4	0.5	-0.8	-0.5	39
Hungary	-6.8	-8.2	-6.5	-3.5	62
Poland	-2.9	-2.0	-3.5	-2.6	32

Sources: EBRD (1997), European Commission (1997a, 1997b, and 1997c).

Recently, Budina and Wijnbergen (1997), following Buiter's (1997) approach, found the fiscal policy in the Czech Republic and Poland sustainable, while Hungary's fiscal position was assessed as 'borderline case'; however, taking into account the recent fiscal adjustment measures, Hungary's fiscal position could be assessed as sustainable.

Budina and Wijnbergen found also, that countries with sustainable public finances were not only more successful with their inflation stabilization programs, but also experienced an earlier and faster recovery of economic growth. Thus, contrary to widespread fears, countries that adopted tight fiscal policies have not had to pay for that with reduced growth.

It must be kept in mind that the calculation of sustainable primary deficit allows for the assessment of the sustainability of current fiscal position. But what really matters is not actual (current) deficit, but expected future deficits. This issue is of particular importance in transition economies. When the quality of fiscal adjustment is poor, the current good quantities are not the evidence of sound public finances. Slow progress in structural reforms, which is not fully reflected in current budgetary aggregates, poses a risk of future fiscal imbalances and constitutes a threat to macroeconomic stabilization and sustainable growth. Therefore, further progress in restructuring the economy and reducing the role that the state plays in production and resource allocation remain the main challenges for sustainable fiscal position in transition economies.

5 The role and size of the government

One of the main features of centrally planned economies was a very wide scope of budgetary redistribution[39] – a consequence of the philosophy of a "command-and-distribute" economy in which the means of production were almost exclusively state-owned and prices were subject to administrative control. Therefore, market mechanisms did not exist and did not play any role in decision-making processes concerning production, consumption and the allocation of resources; these decisions were mostly centralized. Implementing the allocative function of the state consisted of redirecting existing resources to key industrial sectors (according to the preferences of the central planner). At the same time, a method of internal (intra-industrial) subsidization of certain types of manufacturing favoured by the central authorities was applied. The redistributive function (the mechanism for achieving an equitable income distribution) was exercised, at least theoretically, through government subsidies and transfers to housing, public transport, health care, education and basic goods, as well as through an expanded system of social security. Therefore, apart from wages, which were insignificantly differentiated within the government sector, individuals received via their employer a number of non-wage benefits including access to subsidized goods and services: housing (i.e., flats built by an institution for its employees), institutional shops, holidays organized

[39] See for example: Chand and Lorie (1992); Barbone and Marchetti (1995).

and partially or fully financed by the institution, etc. Such non-wage benefits composed a large portion of the total compensation package.

The process of a pro-market transformation of the economy requires that the boundaries between the government and non-government (private) sector are clearly delineated. This process requires also a reduction in the role of the state, with respect both to its direct participation in the economic process and to the scope of the redistribution of the gross national product.[40] This ought to make possible the transfer of decisions concerning the allocation of resources and the size and structure of consumption from the government to the private sector. Such a process can be described as a kind of a state "meta-interventionism", where the state deliberately acts to restrain its role in economic life and to reintroduce market mechanisms.

The relative size of government is usually measured as the ratio of government expenditure and revenue to GDP. It is estimated that these ratios are close to 50 per cent of GDP in the Czech Republic and Poland, and around 55 per cent in Hungary.

Thus, transition countries continue to maintain relatively high levels of government spending (and revenue) as a share of GDP. A determination of the optimal size of budgetary redistribution would always be arbitrary, since it is linked to the debate on the state's role in the economy. There is, however, a measure, which indicates to some extent the potential of the economy to maintain a large government – the level of economic development and wealth. The observation of developed market economies in historical perspective points to the tendency of growth in the size of the public sector. This is often described as Wagner's law, according to which government expenditure increases at a faster pace than economic growth.

The causes of this phenomenon are not definitely known, and the attempts to explain it mostly focus on political, social and institutional conditions affecting the increase in government expenditure. Despite the reasons of the growth in spending, it is obvious that in a cross-country comparison a higher level of development enables the maintenance of a larger government.

From the point of view of the future eastern enlargement of the European Union, it is interesting to compare the level of budgetary redistribution in applicant countries with the level seen in EU countries. (Table 2).

The ratio of budget revenue to GDP in three applicant countries is higher than the average recorded for EU countries; transition economies, however, lag significantly in development. The level of wealth in post-socialist countries, as measured by the level of per capita GNP (current exchange rate method), is several times lower than that recorded in EU countries. Therefore, fiscal redistribution observed in relatively poor post-socialist countries must be considered excessive. Following the experience of European countries with long-lasting market structures, it could be concluded that the level of fiscal redistribution in post-socialist countries should amount at most to 30 to 40 per cent of GDP. Such levels were observed in EU countries in the 1950s and 1960s, i.e. over the period during which levels of per capita GDP were comparable with those currently observed in (more advanced) transition economies.

Per capita GDP reported at current exchange rates can be argued to be misleadingly low in transition countries, but this concerns the poorest EU countries as well. Thus per capita GDP data based on purchasing power parity (PPP) does not really change the picture. The levels of wealth in three applicant countries still do not reach those in the poorest EU countries where, however, the scope of fiscal redistribution is much lower than the average for 15 EU countries. This points to the need to continue reducing government expenditure, which would ease the fiscal burden of transition economies.

In addition, it should be emphasized that the situation in EU countries cannot be treated as a model – the level of budgetary redistribution taking place in these countries is estimated as ex-

[40] See Tanzi (1993, 1993a).

Table 2 **The size of budgetary redistribution versus GDP level in European Union and applicant countries in 1995**

Country	GNP per capita (ECU, current exchange rate method)	GDP per capita (ECU, purchasing power parity method)	General government expenditures, share of GDP (%)[a]	General government current receipts, share of GDP (%)[a]
Austria	22180	19320	53.0	49.1
Belgium	20310	19340	53.7	50.3
Denmark	25260	19960	60.3	58.8
Finland	18720	16550	58.3	55.7
France	20200	18520	54.5	50.4
Germany	22600	19070	49.3	45.6
Greece	8360	11320	44.7	37.3
Ireland	10920	13230	36.5	35.6
Italy	14250	17770	52.7	45.9
Luxembourg	32370	29140	43.6	45.4
Netherlands	19570	18390	50.8	48.4
Portugal	7770	11620	44.0	39.9
Spain	10920	13230	44.6	40.1
Sweden	19970	17390	66.2	62.6
United Kingdom	14410	16580	42.1	37.7
EU 15	17260	17260	50.3	46.1
Czech Republic	3490	9410	50.4	49.6
Hungary	3340	6310	56.1	49.6
Poland	2360	5320	49.0	47.1

[a] Estimates for EU, 1996; for applicant countries, 1995.
Sources: *European Economy* No. 64, 1997; EBRD (1997), European Commission (1997).

cessive[41], and one specific fiscal policy aim (being pursued without success) since the beginning of the 1980s has been to reduce this level. West European countries, where the evolution of public finances has led to an excessive budgetary redistribution and crises of the welfare state, do not have to serve as a pattern for post-socialist countries to follow. According to Sachs and Warner (1996), the acceleration of the pace of economic growth – necessary to narrow the economic gap between CEECs and the countries of developed market economies – is possible while patterning upon the experience of non-European economies characterized by the fastest pace of growth over the last ten years (Hong Kong, Singapore, Malaysia, Taiwan, South Korea, Thailand, Chile, Mauritius). In all these countries the budgetary redistribution level is much lower than in EU countries (government expenditures in Hong Kong account for 14 % of GDP, in Korea 17 %).[42] Apart from the issues of the quality of government spending and the effectiveness of government sector, high level of bud-

[41] The size of public sector in Western European countries – according to liberal opinion – has reached a level endangering long-term possibilities for economic growth, and at the same time has made more difficult the exercise of effective control over it. This has been described by Harris as follows: "the private sector is a part of the economy being controlled by the government, and the public sector is a part being controlled by nobody" (quoted in Wojtyna, 1990, p. 147).

[42] A lot of research suggests a negative correlation between the level of fiscal redistribution and the rate of economic growth. Allowing for the level of GDP per capita, it has been estimated that an additional 10 percentage points in the government expenditures GDP ratio is associated with a 1 percentage point lower growth rate. See Balcerowicz and Gelb (1995), p. 30, quoting from Easterly and Rebelo (1993).

getary redistribution reduces income inequality, having a potentially negative impact on national saving and investment.

High levels of domestic saving are crucial for sustaining rapid economic growth. In 1995 the gross domestic saving rate in transition economies was 18 % of GDP (EBRD, 1996), lower than the average world saving rate (23 % of GDP), and much lower than in the case of the rapidly growing East Asian economies (35 % of GDP). Promoting domestic saving in transition countries calls for slimmer government. On the one hand, lower budgetary spending would improve the balance of the budget and reduce government dissaving (or increase its savings). On the other hand, and this is of much greater importance, curtailing government spending would stimulate household savings, which play a dominant role in wealth accumulation in a market economy. In centrally planned economies household savings were very low because of the low incentives to save. Since social security benefits were provided by the government, individuals perceived no need to save for retirement or for a 'rainy day'. Shifting the burden of social security from the government to the private sector would increase incentives for private savings. At the same time this would have a positive impact on financial markets, stimulating the development of financial intermediaries (such as pension funds) and saving instruments. These arguments make the measures to reduce the scope of fiscal redistribution in transition economies even more necessary and urgent.

6 The composition of government expenditures and revenues

The most distinctive feature of changes in budgetary expenditures among transition countries is the sharp drop in subsidies.[43] Between 1989 and 1994, producer and consumer subsidies declined by 21.6 % of GDP in the Czech Republic, by 7.6 % of GDP in Hungary and by 10.7 % of GDP in Poland (Table 3). Consequently, reported budgetary costs of enterprise subsidies have almost disappeared in transition countries. In 1995 the budgetary subsidy to GDP ratio amounted to 1.8 % in Poland, 3,4 % in the Czech Republic and 3.5 % in Hungary.

It must be noted, however, that focusing only on reported budgetary subsidies in the assessment of the scope of government intervention in the economy, and from the viewpoint of the introduction of hard budget constraints to enterprises, can be misleading. It is a common feature of transition economies that the sharp reduction in direct producer subsidies had been accompanied by increases in tax arrears, as well as by increases in non-performing loans in the banking sector.[44]

Cuts in subsidies for products have been often transmitted into increased expenditure on transfers. Therefore, cuts in subsidies alone can not be perceived as evidence of sounder public finances and as a measure of success in reintroducing market rules. On the one hand, cuts in subsidies have not alleviated pressures on budget deficit (tax arrears – revenue losses, and increased transfers); on the other, they have not fully eliminated soft budget constraints to enterprises. Whereas the former phenomenon is connected to fiscal adjustment itself, the latter means the postponement in necessary enterprise restructuring, the crucial step in pro-market transformation. It is worth noting that this concerns primarily large state-owned enterprises. In the case of Poland, for example, over a third of arrears on social security contributions at the end of 1995 originated with coalmines.

The most expensive burden on general government expenditure in transition economies is the maintenance of a social safety net system, with pensions as its most costly component. In 1995, current transfers absorbed some 20 % of GDP, with levels varying from 18.8 % of GDP in Hungary to 21.0 % of GDP in Poland.[45]

[43] Successful pro-market transformation of the economy requires, among other things, price liberalization and the reduction of price distortions. Typically, there is a strong connection between price liberalization and the decline in government spending on subsidies. When prices are allowed to reach market-determined levels, which cover the producers', costs, subsidies become unnecessary. Thus progress with price liberalization is reflected in a decrease in subsidies.

[44] See Schaffer (1995), Orlowski (1996).

[45] *MultiQuery Database* (1996).

Table 3 **General government expenditures in applicant countries. Percentage share of GDP**

	1989	1990	1991	1992	1993	1994
Czech Republic [a]						
Total expenditures	**72.3**	**61.5**	**57.1**	**47.5**	**49.4**	**50.7**
• Goods and services	25.2	24.6	24.4	20.2	24.0	25.1
• Interest payments	–	0.2	0.5	1.0	1.6	1.4
• Social security benefits	13.6	13.6	16.1	14.0	13.8	13.7
• Subsidies	25.0	16.2	7.7	5.0	3.9	3.4
• Capital expenditures	**8.5**	**6.9**	**8.4**	**7.3**	**6.7**	**7.1**
Hungary						
Total expenditures	**60.9**	**57.0**	**56.9**	**60.7**	**62.5**	**62.0**
• Goods and services	20.5	18.7	18.5	18.8	20.3	18.3
• Interest payments	4.5	5.4	5.9	5.5	5.0	6.8
• Social security benefits	14.4	15.7	18.2	18.3	18.1	17.6
• Subsidies	12.1	9.5	7.4	5.5	4.3	4.5
• Other current expenditures	2.9	3.1	1.2	4.8	7.9	8.2
• Capital expenditures	**6.6**	**4.6**	**5.8**	**7.7**	**6.9**	**6.6**
Poland						
Total expenditures	**48.8**	**39.8**	**48.0**	**50.6**	**50.6**	**48.7**
• Goods and services	10.3	10.3	13.1	12.7	12.4	10.4
• Interest payments	–	0.4	1.6	3.2	3.4	4.2
• Social security benefits	11.2	10.6	17.3	18.7	19.5	20.7
• Subsidies	12.9	7.3	5.1	3.2	2.2	2.2
• Other current expenditures	11.1	8.4	7.2	9.3	9.7	8.2
• Capital expenditures	**3.3**	**2.8**	**3.7**	**3.4**	**3.3**	**3.1**

[a] data for 1989, 1990, 1991 refer to former Czechoslovakia;
Source: International Monetary Fund (1996, p. 81).

Transition countries inherited from the socialist system an extensive social welfare system, generally comprising a pay-as-you-go (unfunded) state pension scheme, sick pay, generous maternity benefits and family allowances, retraining/labour funds, as well as specific welfare schemes. The social benefits paid were not related to the social security contributions, and the pension system was unfunded; general budget revenues provided the major source of financing the entire social security system. At the beginning of the transition process, the former centrally planned economies were faced with the necessity of replacing this inefficient system by social safety net structures suited to the requirement of a market economy. The need for implementation of cost-effective social safety nets was reinforced by the expected social costs of transformation exerting pressure on growth in government expenditures in the form of unemployment benefits and various forms of social assistance.

The high level of pension benefits is one of the most important reasons for the expensive social security systems in transition economies. This is the outcome of both unfavourable demographic trends, and changes in the pensions systems, which have taken place during a pro-market transformation. The high share of old age and disability pensioners are partly the result of early retirement's schemes and lax eligibility criteria, introduced as a surrogate for outright lay-offs. Additionally, in most Central European countries, statutory regulations on indexation of pension benefits were introduced. Between 1989 and 1994, the replacement ratio (the ratio of average pension benefit to average wage) decreased by more than 6 percentage points in the Czech Republic and Hungary. Different processes have taken place in Poland, where the replacement ratio increased during transition period by as much as 20 percentage points. In 1994, the ratio of average gross pension to average wage amounted to 73 % in Poland, 57 % in Hungary and 44 % in the Czech

Table 4 **The replacement ratios in major industrial and applicant countries in 1995**

	Replacement ratio (%)
Major industrial countries	37.5
Canada	29.2
France	60.1
Germany	52.0
Italy	53.9
Japan	19.6
Sweden	39.0
United Kingdom	17.5
United States	38.5
Transition countries	
Czech Republic	44.0
Hungary	57.0
Poland	73.0

Sources: Chand and Jaeger (1996), Golinowska (1996).

Republic.[46] It seems obvious that pensions recipients in Poland obtain excessively generous compensation from the government (see table 4). Such a situation reflects unfair tendency in income redistribution to the advantage of pensioners.

The budgetary burden of pensions in these three CEECs ranged in 1995 from 9.1 % of GDP in the Czech Republic to 14.6 % of GDP in Poland.[47] These ratios are high by international standards – the average for OECD countries amounted to 9.2 % of GDP, while the averages for countries of comparable per capita income in Latin America and East Asia amounted to 2.0 % and 1.9 % of GDP, respectively.

It must be noted that the problem of social safety net system is not exclusively typical for the countries undergoing the radical transition from plan to market – the reform of failing pension systems tops the priority list of economic reforms around the world. As in the next 35 years (by 2030) the number of people over 60 years old will triple to 1.4 billion,[48] systems financed exclusively or partially on a PAYG basis[49] are in the urgent need of reform (they are particularly vulnerable to population aging). According to Kopits (1997), for at least five EU members (i.e. Belgium, France, Portugal, Spain, Sweden), the present value of net unfunded pension liabilities surpasses the value of GDP, reflecting a considerable additional burden on future generations. The picture would be worse upon adding an estimate of unfunded health-care liabilities.

According to the World Bank recommendations, the best way for most countries to meet their populations' need for income security is by setting up a three-pillar pension system, that includes the following elements: (i) a mandatory PAYG public pension system, scaled down and designed to provide an income floor for all pensioners, (ii) a mandatory privately managed and fully funded system, and (iii) voluntary system (funded and privately managed) to provide for additional saving and insurance. Such a system places greater

[46] See Golinowska (1996, pp. 20–22).

[47] EBRD (1996, p. 95). Fox (1994, 1995) indicates that the level of public expenditure on pensions in Poland as a proportion of GDP is the highest in Europe. According to Kopits (1997), however, Italy has the highest pensions expenditure, amounting to 15.6 % of GDP in 1994.

[48] World Bank (1994). For a discussion of public pension schemes in industrial countries and their need of reform see Chand and Jaeger (1996).

[49] Public pension systems in European Union countries are dominated by PAYG schemes. These model is supplemented in some countries (Denmark, France, the Netherlands, the United Kingdom) with compulsory private pension schemes.

emphasis on saving and is likely to have a positive impact on financial market development and economic growth.

Recently, steps towards the three-pillar structure of pension system were taken in Poland and Hungary. Although the transition towards a new system entails a temporary worse budgetary position, the costs of reforms should be seen as representing the transformation of implicit pension liabilities into explicit public debt.

The second burden on general expenditures in some of transition countries is the coverage of unemployment benefits, together with the financing of various active labour market policy (ALMP) schemes. Unemployment insurance schemes with benefits provided for a limited duration have been introduced as part of the transformation process; the expected serious imbalance in the labour market called for the need to protect and support the affected workers until the time when systemic changes began to take effect. Legal regulations on unemployment were adopted in Hungary in 1988, in Poland in 1989, and in Czechoslovakia in 1991. During the course of transition these regulations were amended frequently,[50] reflecting ongoing changes in the labour market. In Poland, where the unemployment insurance schemes initially introduced were extremely generous (unlimited duration of unemployment benefits, which were linked with individual's last earning), the eligibility rules were tightened, benefits were limited to one year and were de-linked from past earnings. In other transition countries, eligibility criteria introduced in the first phase of transition were relatively tight, and the size of allowances was rather modest.

Despite a favourable output performance, unemployment remains high in Poland, with registered jobless amounting to 14.9 % of the labour force in 1995 and 13.6 % in 1996. The high level of unemployment in Hungary (10.4 % in 1995, 10.5 % in 1996) can be attributed to a moderate pace of economic recovery. The Czech Republic has avoided serious problems of rising registered unemployment – within the period from 1989 to 1996 its highest rate, recorded in 1991, amounted to 4.1 % – this suggests that enterprise restructuring still has a long way to go. However, the rate in unemployment increased recently, from 3.9 % at the end of 1996 to 4.3 % in July 1997, as some large firms start to speed up restructuring.

The share of expenditures on labour market schemes (unemployment benefits and the expenditures on ALMP schemes) in GDP is the lowest in the Czech Republic (less than 0.5 % in 1994) and the highest in Hungary (3 %); these ratios are comparable to those seen in EU countries[51].

Special attention must be paid to public health care. The ratio of government expenditures on public health care to GDP have either increased (in the Czech Republic) or remained stable during the transition period. It must be stressed that these services are still financed primarily from the government budget – the role of the private sector is marginal. To raise the quality of medical services, overall reforms in this area are needed. Some steps towards more effective health care systems have been undertaken in Hungary and in the Czech Republics. The general idea of the reforms being introduced was to separate health insurance funds from the state budget or social insurance fund. This would permit the creation of a system partially of an insurance character, financed from contributions paid by employers and employees. Although such funds were set up, they neither markedly solved the financial problems of health care institutions nor increased the low effectiveness of public health care.[52] In practice, the existing financial problems of the health care sector led to the introduction of various charges and fees for patients, sometimes of informal character.

The levels of public spending on pensions and other social security programs in relation to GDP in three applicant countries are similar to those seen in the EU. However, as the share of labour income in GDP is lower in transition economies, the social security contributions rates are generally higher than among the EU(see table 5).

High social security payroll contributions

[50] See Boeri (1997).

[51] For example, in 1994 the share of unemployment benefits in GDP amounted to 0.6 % in Italy, 0.4 % in Greece, 2.3 % in France, 2.7 % in Germany, 2.8 % in Belgium, 3.5 % in Ireland, 4.1 % in Spain, and 5.5 % in Denmark; (Kopits, 1997).

[52] See Uldrichova (1996), Gyulavari and Nemenyi (1996).

increase considerably the cost of labour. This strengthens the incentive for tax evasion and has negative consequences for employment (lower formal hirings). The rates applied in transition economies[53] are well above the rates of EU countries.

In sum, government expenditures in transition countries are strongly dominated by current transfers, which still retain many features from the centrally planned economy era. Changing unfavourable spending patterns and diminishing the role of the state are obviously conditioned by a fundamental reform of social security and welfare system, aiming at the redirecting social demand in these areas from the government to the private sector.

Table 6 indicates, that post-socialist countries, in their short history of reintroducing market mechanisms, did not manage to avoid the trap in which the Western economies find themselves: the trap of the welfare State.[54] Government expenditures – almost exclusively current expenses – are financing private and public consumption. The success in a radical elimination of subsidies at the beginning of the transformation process have been accompanied by upward pressure on social spending. As a result, the reduction of overall state expenditures that occurred was small than was possible. Due to errors made in social policy (granting too many social privileges, an extensive system of social benefits indexation, a delay in fundamental social security system reform), government expenditures are primarily composed of social spending, with a huge share taken up by pension benefits. In all transition countries the level of government expenditures is much too excessive in relation to the level of economic development.[55] The expenditure patterns have converged towards the Western European levels, while the GDP gap remains wide. Government spending is high, but spending patterns cannot be alter as long as the fundamental reforms of social security expenditures are not carried out.

Successful economic transformation requires a fundamental reform of the revenue side of the budget. Within the inherited fiscal system, budget revenues were heavily dependent on levies paid by state-owned enterprises and on the turnover tax; taxes paid by households constituted only a marginal fraction of budget revenues. There were three main reasons for urgent changes in the tax system:

- the need to establish a system of general parametric profit taxation that would eliminate 'soft budget constraints' and support incentive-driven forces in the economy;
- the necessity of achieving universal and equal tax treatment of different sectors, commodities, and forms of ownership to ensure that resource allocation would be driven by undistorted market forces;
- adequate adjustment of individual income taxation in line with distributional objectives and institutional changes.

The tax reforms introduced in transition countries have followed West European revenue patterns. The previous turnover tax was replaced by consumption taxes – value-added tax (VAT) and specific excises. A personal income tax (PIT) was implemented to replace the previous range of taxes on income. VAT and PIT, together with corporate income tax and the payroll-based social security contributions, are the main channels of fiscal revenues.

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[53] In the Czech Republic, social security contributions are set at 12.5 % of gross wages for employees and 35 % for employers; in Hungary at 11.5 % and 50.1 % respectively. In Poland social security contributions are paid exclusively by employers, with the rate amounting to 48 % of gross wages.

[54] As early as in 1958, Prof. Wilhelm Ropke, one of the authors of the German economic success wrote: "A welfare State has a built-in inclination for further development that is impossible to be eliminated. Every now and again other sectors are being given mandatory assistance. Every now and again different groups of society become the subjects falling within the scope of that aid." Quoted in Koronacki (1996).

[55] It is worth adding that the effectiveness of government expenditures in post-socialist countries is considered to be much lower than in the majority of mature market economies. See Fakin and de Crombrugghe (1995).

Table 5 **Effective social security contribution rate[a] in 1994[b]**
(in per cent of gross compensation of employees, including contributions)

Transition economies	
Czech Republic [c]	36.4
Hungary	36.6
Poland [c]	32.4
European Union	
Austria	25.3
Belgium	29.2
Denmark[d]	7.7
Finland	31.4
France	38.5
Germany [c]	30.4
Greece	34.8
Ireland [c]	17.8
Italy	30.9
Luxembourg [c]	28.3
Netherlands	37.8
Portugal	20.7
Spain	29.7
Sweden	23.2
United Kingdom	11.6
East Asia	
Indonesia [c]	10.9
Japan	17.0
Korea [c]	8.8
Thailand [c]	4.8
United States	12.6

[a] Employer plus employee contributions, as a ratio of all-inclusive compensation of employees (including contributions).
[b] For Portugal, 1989; for Norway, 1991; and for Germany, Hungary, and the United States, 1993.
[c] Based on statutory rates.
[d] Denmark finances the social security system almost entirely with general tax revenue.
Source: Kopits (1997).

The main goal of implementing VAT was to extend the indirect tax base to services and imports and to enhance its neutrality by reducing the range of rates in comparison with the previous system. VAT was expected to reduce tax evasion as well.

The tax system reform has taken place during the overall macroeconomic adjustment process, under persisting inflationary pressures and with growing government expenditures, calling for sufficient fiscal capacity. Conflicting policy goals and targets have profoundly affected the development of tax structures; the main driving force of changes being implemented within the new system has been budgetary pressures.

The Hungarian VAT policy experience can serve as an example of difficulties in meeting different policy objectives in transition economies. In 1988, the standard VAT rate of 25 % was accompanied by the preferential rate of 15 % applied to most services. To reduce the social costs and inflationary pressures following the implementation of VAT, the zero rate was in force for most of the food products, fuels, pharmaceuticals, and public transport. Medical care, sports, culture, education, financial services, and public administration were VAT-exempted. In 1993, the government launched a large-scale revision which lowered the reduced rate to 6 % (from August 1993, 10 %). This rate covered a group of products and services, previously taxed at zero rate (e.g. food, public transport). The zero rate remained only for household energy and medicines. From January 1995 the preferential rate was increased to 12 %. Some products and services previously classified

Table 6 **General government expenditures in EU (1996) and applicant (1994) countries, percentage share of GDP**

	Government consumption[a)]	Current transfers to households[b)]	Current transfers to enterprises[c)]	Interest payments	Capital expenditure[d)]	Total expenditure
Czech Republic	25.1	13.7	3.4	1.4	7.1	50.7
Hungary	18.3	17.6	4.5	6.8	6.6	62.0
Poland	10.4	20.7	2.2	4.2	3.1	48.7
Austria	18.8	21.5	2.2	4.4	4.8	53.0
Belgium	14.7	24.9	2.8	8.6	1.9	53.7
Denmark	25.2	21.4	3.6	6.5	2.4	60.3
Finland	22.1	22.9	2.8	5.8	2.9	58.3
France	19.3	23.4	2.7	3.8	3.0	54.5
Germany	19.6	19.4	2.2	3.7	3.1	49.3
Greece[e)]	14.3	16.3	0.4	11.5	2.0	44.7
Ireland[e)]	14.1	13.7	4.3	4.8	1.8	36.5
Italy[e)]	16.4	19.7	1.5	10.8	3.5	52.7
Luxembourg	13.5	20.7	2.8	0.3	5.0	43.6
Netherlands	14.0	25.8	1.7	5.6	2.4	50.8
Portugal[e)]	18.2	...	0.7	4.9	3.5	44.0
Spain	16.1	15.5	2.8	5.3	3.5	44.6
Sweden[e)]	25.9	23.2	4.8	7.1	2.6	66.2
United Kingdom	20.9	13.6	1.2	3.7	2.0	42.1
EU 15	18.8	...	2.2	5.2	2.4	50.3

Note: For EU countries, net current transfers to the rest of the world are not included in the table. Their levels varied in 1996 between –2.2 % of GDP in Ireland and 1.6 % of GDP in Sweden. For Hungary and Poland, 'other current expenditures', as labeled by the IMF, are not included in the table. They amounted to 8.2 per cent of GDP in both countries.

[a)] For EU countries, compensation of employees and current purchases of goods and services are included. For applicant countries, these are figures labeled by the IMF as 'goods and services'.

[b)] For applicant countries, these are figures labeled by the IMF as 'social security benefits'.

[c)] For applicant countries, these are figures labeled by the IMF as 'subsidies'.

[d)] For EU countries, final capital expenditure and net capital transfers are included.

[e)] Subsidies paid by the EC institutions are not included in 'current transfers to enterprises'.

Sources: *European Economy* No. 64, 1997; International Monetary Fund (1996, p. 81).

into this category were reclassified and taxed at the standard rate.

From 1988 to 1992 the share of VAT revenues in Hungarian GDP decreased. The proportion of zero rate goods and services within the household's purchases reached the level of 44 % in 1991.[56] The revision of VAT rates in 1993 led to the increase of VAT to GDP ratio in 1993, but in 1994 and 1995 this share decreased again.

The lesson from Hungarian case is straightforward. First, although the introduction of VAT leads to a (once-only) price increase, the whole tax adjustment process should be carried out relatively quickly. A broad application of the zero and reduced rates erodes the principle of VAT neutrality and distorts consumer and producer decisions. Second, high tax rates do not bring about high budgetary revenues; in fact, they tend to diminish the tax collection capacity. In Hungary, the application and extension of high VAT rates led to a considerable tax evasion; according to some researchers, VAT avoidance seems to be the rule rather than the exception in some sectors of the Hungarian economy.

The situation in Poland and in the Czech Republic is similar. Commodities originally taxed

[56] Gyulavari and Nemenyi (1996, p 64).

at the zero turnover tax rate are still taxed at the reduced rate. At the same time, budgetary needs (pressures on expenditures) are the main cause of maintaining high – in comparison with the EU countries – standard rates of VAT (see Table A1 in Appendix).

The pattern of PIT among transition countries differs in details concerning deductions and exemptions. In general, PIT has a progressive structure of marginal rates. In 1996 these rates ranged from 0 % to 45 % in Poland, from 0 % to 48 % in Hungary, and from 15 % to 40 % in the Czech Republic.

Corporate income tax rates differ among applicant countries, varying in 1996 from 18 % for retained profits and 23 % for distributed profits in Hungary, 39 % in the Czech Republic, and to 40 % in Poland. In Hungary and in the Czech Republic, the rates were reduced between 1993 and 1996.

As a result of the reforms of the tax system, the patterns of government revenues changed considerably (see Table 7) and converged to the budget revenue structure in the EU (Table 8).

Due to the expansion of government expenditure, maintaining fiscal revenues has been a major challenge in all countries in transition. Despite the reforms within the tax system, government revenues have not significantly increased. Weak tax collection is undoubtedly connected with high tax rates, leading to tax arrears and numerous methods of tax evasion. These high tax rates are accompanied, however, by widespread exemptions and deductions. In addition, poor revenue performance can be attributed to weak tax administration.

In all these economies the need to finance high government spending determines tax policy, making impossible the reduction of tax rates and of the overall fiscal burden on the economy. The excessive burden of social security contribution is of particular importance, as it means that labor taxation converged to that found in EU countries with mature welfare systems. Indirect taxation is also high. Such a heavy fiscal burden on the transition economies creates a strong barrier to fast growth.

Given this excessive fiscal burden, there is no possibility of increasing budgetary revenues through an increase in tax rates. Some reserves are likely to lie in broadening tax bases and in more efficient tax administration, although these measures alone does not seem to be sufficient to restore fiscal balances in the medium and long term. The fundamental reforms of the expenditure side are required to develop sound public finances in transition countries.

7 Concluding Remarks

Accession to the EU is one of the biggest challenges for the CEECs in the coming years. EU membership will require that a country has a 'functioning market economy', has a capacity to cope with competitive pressures and market forces within the EU, and adheres to the aims of political, economic and monetary union.

Sound and sustainable public finances are crucial for the country's ability to comply with the membership requirements. Indeed, fiscal discipline is necessary in order to:

- attain price stability on a permanent basis;
- improve public saving and encourage private saving – the pre-condition for sustained, investment-led growth;
- prevent the crowding-out of private investment by government spending;
- prevent major imbalances (asymmetric shocks) that stem from persistent trade and current account deficits;
- create room for stabilization function of budgetary policy – a budget has to be flexible enough to handle real shocks in a counter cyclical way, since the use of independent monetary and exchange rate policies will be limited (or abandoned, after joining the euro area).

The assessment of the transition countries' public finances must go beyond the assessment of the budgetary balance, not only because of the measurement problems. The specificities of transition with the conflict (in the short-run) between quality and quantity of fiscal adjustment mean that the progress toward the creation of a market-based, relatively stable and growth-generating economic system must be taken into account.

Table 7 **General government revenues in applicant countries. Percentage share of GDP**

	1989	1990	1991	1992	1993	1994
Czech Republic[a]						
Total revenues	**69.5**	**61.1**	**55.0**	**48.3**	**50.4**	**51.2**
• Profit tax	11.0	12.2	13.7	10.6	7.7	6.2
• Wage tax and social security contribution	21.9	21.2	17.0	17.9	19.5	22.5
• VAT, excises, and custom duties	19.5	21.2	13.8	12.5	13.3	14.4
• Other taxes and nontax revenue	17.1	6.7	10.5	7.1	9.9	8.1
Hungary						
Total revenues	**59.6**	**57.9**	**53.9**	**53.9**	**55.8**	**53.3**
• Profit tax	8.1	8.2	5.6	2.5	2.0	2.0
• Wage tax and social security contribution	19.8	19.8	19.9	21.0	21.9	20.7
• VAT, excises, and custom duties	18.9	15.6	14.0	14.9	15.8	14.9
• Other taxes and nontax revenue	12.8	14.3	14.3	15.5	16.1	15.7
Poland						
Total revenues	**41.5**	**43.0**	**41.5**	**44.0**	**47.6**	**46.7**
• Profit tax	9.7	14.0	6.1	4.6	4.2	3.4
• Wage tax and social security contribution	10.8	10.4	15.9	18.2	19.0	18.6
• VAT, excises, and custom duties	8.9	6.9	9.5	11.3	14.2	14.8
• Other taxes and nontax revenue	12.1	11.7	10.0	9.9	10.1	9.9

[a] data for 1989, 1990, 1991 refer to former Czechoslovakia;
Source: International Monetary Fund (1996, p. 80).

Current fiscal position in the Czech Republic, in Poland and in Hungary may be assessed as sustainable. However, what really matters is not actual (current) deficit, but expected future deficits. Although it is not possible to foresee the details of future development of public finances in transition economies, some general features can be identified.

The current levels of government spending in these relatively poor countries are much too excessive. The need to finance high government spending (strongly dominated by current transfers) makes impossible the reduction of the overall heavy fiscal burden on the economy. Such a burden creates a strong barrier to fast growth and leads to the development of the underground economy.

With this unfavourable current situation any pressure on the expenditure side will deteriorate fiscal position. Such pressures can be easily identified: they will derive from the continuous progress in structural reform (enterprise restructuring, further consolidation of the financial system, pension and health-care reform) as well as from the process of the preparation to accession. As concerns the government expenditures involved by the structural reform, the bulk of them are expected to yield a high return in the form of reduced future losses (an example can be offered by coal sector restructuring in Poland). At the same time, the preparation for EU membership will require substantial investment in sectors such the environment, transport, agricultural infrastructure and rural society. This investment will place potentially heavy burden on the budget. The extent of this impact, however, will depend on the role played by the private sector in infrastructure development. Thus the progress in privatization and further deregulation is obviously consistent with the future consolidation of public finances.

As discussed in this paper, the budget deficit, as usually measured, has important shortcomings as an indicator of sound and sustainable public finances in transition economies. But this does not mean that fiscal imbalances are the matter of irrelevance. Instead, the medium term reform pro-

Table 8 **General government current revenues in EU (1996) and applicant (1994) countries, percentage share of GDP**

	Indirect taxes [a]	Direct taxes [b]	Social security contributions	Other current receipts	Total current receipts
Czech Republic	14.4	6.2	22.5	8.1	51.2
Hungary	14.9	2.0	20.7	15.7	53.3
Poland	14.8	3.4	18.6	9.9	46.7
Austria	15.9	15.0	15.5	2.7	49.1
Belgium	12.7	18.2	17.6	1.8	50.3
Denmark	18.5	31.6	2.8	5.8	58.8
Finland	14.5	19.2	15.0	7.0	55.7
France [d]	15.4	9.9	21.3	3.8	50.4
Germany	12.8	10.4	19.8	2.6	45.6
Greece [c), d]	14.3	7.2	12.4	3.4	37.3
Ireland	14.8	14.4	4.6	1.8	35.6
Italy [c]	11.9	15.2	15.1	3.8	45.9
Luxembourg	16.7	15.1	11.8	1.9	45.4
Netherlands	13.3	13.2	18.2	3.7	48.4
Portugal [d]	14.3	10.1	11.7	3.8	39.9
Spain	10.7	11.5	13.7	4.3	40.1
Sweden	15.9	22.2	15.3	9.2	62.6
United Kingdom [d]	16.3	13.0	6.3	2.1	37.7
EU 15	13.9	12.8	16.0	3.4	46.1

[a] Taxes linked to imports and production..
[b] Current taxes on income and wealth
[c] Indirect taxes paid to EC institutions not included in 'indirect taxes'.
[d] Community charge (poll tax) included in 'indirect taxes'.
[d] Capital consumption not included in 'other current receipts'.
Sources: *European Economy* No. 64, 1997; International Monetary Fund (1996, p. 80).

grams should address the need to reduce the fiscal deficit, but this goal can be achieved only by reshaping government expenditure with priorities given to productive activities (such as investment in infrastructure and in human capital), together with reducing the size of public spending.

Therefore, reforming expenditure programs and further reducing the role that the state plays in production and resource allocation remains the main challenge for sustainable fiscal position in transition economies.

Appendix

Formal requirements for accession in the field of taxation and their compliance in applicant countries

The existing structure of budgetary revenues within EU member-states constitutes, on one hand, the result of the lengthy development of separate (national) fiscal systems under existing cultural differences and different conditions for socio-economic development, and on the other hand, the consequence of the process of the harmonization of these systems – the process accompanying the creation of the Single European Market. Since the beginning of the 1970s, measures have been taken to reform national fiscal systems by reducing their complexity. At the same time, the ongoing process of integrating separate national economies within the EU – under the conditions of removed barriers to the free movement of goods, services and factors of production between the countries – is contributing to an intensification of competition, and the introduction of more favorable taxation conditions.

All member states, as a condition of membership have a Value Added Tax (VAT), which implies an equal tax treatment of domestic and non-domestic (import) transactions. Introduction of VAT was coordinated by the European Commission in the early 1970s to replace the previous sales taxes of member states.

The current VAT arrangements in the EU were introduced with the removal of fiscal frontiers in 1993. The tax base of VAT is nearly fully harmonized across EU countries. From January 1993, the European Council adopted measures introducing minimum standard rate of 15 %. Member states may also set no more than two reduced VAT rates (of at least 5 %) on a specified list of goods and services. However, goods not on that list may be taxed at a reduced rate of not less than 12 % if they were taxed at a reduced rate in 1991, and certain goods taxed at less than 5 % in 1991 may continue to be taxed at those rates.

Despite these provisions, the patterns of VAT rates differ widely among EU countries (see Table A1).

Table A1 **VAT rates (%) in European Union and applicant countries**[a)]

	Reduced	Standard
Austria	10	20
Belgium	1, 6, 12	20.5
Denmark	–	25
Finland	9, 12	22
France	2.1, 5.5	18.6
Germany	7	15
Greece	4, 8	18
Ireland	0, 2.5, 12.5	21
Italy	4, 9, 13	19
Luxembourg	3, 6, 12	15
Netherlands	6	17.5
Portugal[b)]	5	16
Spain	3, 6	15
Sweden	12, 21	25
United Kingdom	0, 8	17.5
Czech Republic	5	22
Hungary	0, 12	25
Poland	0, 7	22

[a)] VAT rates in the EU at 1 July 1994, in applicant countries at 1 July 1997.
[b)] Lower rates apply in the autonomous regions of Portugal. Portugal has also higher (30 %) VAT rate.
Sources: for EU countries: Keen and Smith (1996), for applicant countries: European Commission (1997a, 1997b, 1997c).

The *acquis communautaire* in the area of VAT contains also transitional[57] arrangements for the taxation of transactions within the EU between taxable persons.

In the field of excise duties the *acquis* consists of harmonized tax structures and minimum rates of duty together with common rules on the holding and movement of harmonized excisable goods, including the use of warehouses.[58] Common excise duties are applicable to mineral oils, alcohol and alcoholic beverages, and manufactured tobacco.

Direct taxes are not harmonized at European Community level.[59] The direct taxation *acquis* mainly concerns some aspects of corporate taxes and capital duty. As the two company taxation Directives and the Arbitration Convention provide for mechanism, which applies on the basis of reciprocity, no respective provisions are expected to exist before accession.

Although the tax reforms introduced in transition countries have followed the EU revenue patterns[60], there are several discrepancies between the regimes applied in these countries and the requirements of the Community *acquis*. These, in the field of VAT, include in particular:[61]

- the application of the reduced VAT rate in all three analyzed countries is notably broader in scope compared to the Community legislation;

- in Poland and in the Czech Republic, VAT systems are in some respects discriminatory against imports. The legislation in both countries does not contain any provisions enabling tax to be refunded to taxable persons non-established within the country. In the Czech Republic, such foreign traders cannot be registered for VAT; in Poland, in turn, they have a legal right to register for VAT, in practice, however, this is a complicated procedure. Therefore, in both countries VAT represents an increased cost to foreign entrepreneurs;

- in Poland, although in principle imported goods are subject to the same level of VAT as similar domestically produced products, certain national products are zero-rated, whereas similar imported products are taxed at either the reduced or the standard VAT rate; such a treatment is discriminatory against import. Also, the tax on imported services is not deductible in Poland;[62] as a result such services bear an additional cost of 22 % when compared to similar domestically provided services;

- in Poland, in addition to VAT, a further lump sum 'VAT' is applied to the transport of goods and non-

[57] The current VAT regime in the EU is explicitly transitional. While a 'definitive' system was originally planned for 1997, the European Commission's proposals for that system (originally due by 1994), are still awaited. Such a long delay is due to the fact, that in a new regime a tolerable balance between two, mutually inconsistent objectives, has to be found. These objectives are: (i) preserving the maximum degree of autonomy for the member states in setting their tax rates; (ii) ensuring that VAT structures and administrative procedures do not impede the single market. For more on history and prospects of VAT in the EU see Keen and Smith (1996).

[58] See European Commission (1995).

[59] As taxation is explicitly excluded (by the unanimity requirement of art. 100 of the Treaty) from the majority principle normally applicable to internal market measures, the European Union made little progress on fiscal harmonization within the area of direct taxation.

[60] In Hungary, VAT was introduced in January 1988 and excise duty system entered into force from January 1992. In the Czech Republic VAT and excise duty systems were implemented in January 1993, while in Poland such systems were introduced in July 1993.

[61] See European Commission (1997a, 1997b, 1997c).

[62] In contrast, in the Czech Republic imported services are not liable to any VAT.

regular passenger transport services by vehicles non-registered within the country. Since the lump sum VAT is neither refundable nor has the Polish contractor the right to deduct this levy as input VAT, it increases the costs of transport services provided by non-Polish hauliers. The charge cannot be avoided by being registered for VAT in Poland;

- Hungary's definitions of goods and services are not identical with those contained in Community legislation. In Poland, in turn, the approach regarding exempt transactions differs considerably from that of the Community both in terms of scope and substance.

As regards excise duties, the main differences between the systems applied in applicant countries and that contained in Community legislation are as follows:

- in all three applicant countries, there exist no excise suspension systems where goods can move between authorized tax warehouses without payment of duty;

- in Poland and Hungary, excise duties are levied on a wide range of products including products other than those subject to common excise duties within the Community. Such duties could continue to apply after accession provided, however, that they would not give rise to border-crossing formalities in trade between national products and those originating from other member states;

- in Poland, there are separate tariffs for domestic and imported products which provide for a higher level of taxation on imported products than that imposed on similar domestically produced goods;

- in Hungary, ad valorem taxation[63] of spirits tends to exaggerate price differentials between products and can be seen as discriminatory against the more expensive imports in favor of local producers. Also, the systems of taxation of wine, tobacco and beer are not compatible with Community *acquis;*

- in the Czech Republic, differences between the rates of the excise duty levied on similar products could lead to distortion of competition between these products.

In sum, with the perspective of accession, all three candidate countries still need to adjust their VAT and excise duties legislation to the requirements of *acquis communautaire*. The most important issue is to comply with the Community principle of non-discrimination between national products and those originating from other member states.

[63] In Hungary, generally the duty is ad valorem in nature, with an additional specific duty for spirits, beers and cigarettes. Only mineral oils are charged on a purely specific basis. In the Czech Republic and Poland, the duty is specific in nature, though in Poland certain mineral oils and tobacco products are chargeable on ad valorem basis.

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