Center for Social & Economic Research

Fiscal Consolidation in Central Europe in Preparation for Accession to the European Union

by

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1. Introduction

The European Union eastern enlargement is a realistic, politically and historically determined task. Both the governments of countries having association agreements with the EU and the European Commission have expressed a desire to draft programs that will enable these states to join the EU in the future. Some fundamental directions of strategies of preparation for accession to the Union were indicated by the EU Copenhagen Summit and reinforced by the White Paper on “Preparations of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union” (Commission of the European Communities, 1995).

The economic policy elements of this program are still unclear, vaguely expressed in the EU documents. Central European countries (CEC's) will have to undergo modification of economic policy laws and a significant transformation of monetary and fiscal policies along with changes in their economic structures. The EU will have to make policy adjustments in the process of preparations for the eastern enlargement as well. At minimum, the EU will have to reform the common agricultural policy (CAP) and revise the structural funds (SF) program in order to minimize the overall cost of accession of CEC's.

This paper focuses on adjustments in fiscal policy in five CEC's whose accession seems to be politically most feasible, and who have expressed the strongest desire to join the Union. They include: Poland, the Czech Republic, Slovakia, Hungary, and Slovenia. Fiscal consolidation in these countries is very critical in the process of preparations for accession to the EU. These countries will have to undergo major reforms of tax laws and they have to further develop efficient institutions of government revenue collection. The governments will have to significantly alter their major expenditure positions as well. These CEC's are all implementing the program of transformation from central planning and state ownership into deregulated, competitive economic structures with private ownership. The ultimate goal of this transformation is minimization of state ownership, state financing and state regulatory interference with business to reasonable levels comparable to modern economies of industrial nations. In essence, this transformation shall be based on a sizable contraction of the state sector to ensure compatibility with the fiscal and regulatory system of the EU

nations and to narrow the efficiency gap between the West and the East. Consequently, the task of their fiscal convergence shall be very ambitious. Because the ongoing economic transformation is so closely tied to the contraction of the government intervention with business in CEC's, it is proposed that at the end of the pre-accession period the candidate countries of Central Europe shall not exceed a 3 per cent budget deficit-to-GDP ratio, right at the level consistent with the Maastricht convergence criteria for inclusion in the European Monetary System. Moreover, even a tighter criterion of no more than 2 per cent shall be recommended for CEC's since a 3 per cent annul deficit in relation to GDP is still quite significant. However, a tighter deviation from the Maastricht convergence criteria will be politically unjust, it may send a discriminatory message to the candidate countries. The fiscal convergence criterion required in preparations for accession to the EU shall be constitutionally guaranteed in CEC's and simultaneously announced to the public as a criterion of a "balanced budget" national economic strategy. At the same time, a 60 per cent maximum allowed ratio of public debt-to-GDP shall be applied as a supplementary fiscal convergence measure.

The remaining convergence criteria shall address both the monetary convergence requirements and the scope of institutional and structural reforms. Specifically, the private sector shall contribute at least two-thirds of the candidate countries GDP, which would set a benchmark for privatization and structural adjustment. The economic restructuring, infrastructural investment and a formation of market economy institutions (a competitive banking system, a growing private small business sector, etc.) shall not be facilitated through government expenditures. Rather, these institutions and structural changes ought to be predominantly financed with bank credit and, to a limited extent, with external saving. The monetary sources of financing structural adjustments are generally more efficient than government direct subsidies or tax credits. Because such financing requires an extensive availability of domestic credit, monetary policy in the program of preparations for accession of CEC's to the EU cannot be excessively tight and it shall not be based on an exchange-rate target (Orlowski, 1995b). Therefore, the monetary convergence target for the Central European candidates for accession to the EU ought to be somewhat more lenient than the Maastricht criterion. If the CEC's are to be admitted in the mid-2000s, their annual inflation

target shall be set at the level not exceeding 5 per cent. A rigorous control over fiscal spending and improved tax revenues will play a critical role in achieving this target as well.

The scope of this study is limited to the examination of general issues of a necessary fiscal convergence in CEC's, along with political and economic constraints of fiscal reform. This analysis is supplementary and in essence not contradictory to the emerging literature on the issues of the EU eastern enlargement (Baldwin, 1994; DeCrombrugghe, Minton-Beddoes and Sachs, 1995; Orlowski, 1995a, and 1995b). Problems of constraints to cuts in government spending stemming mainly from the expensive social safety nets are addressed in Section 2 of this study. Recommended directions of tax reform are presented in Section 3. An open and honest dialogue between fiscal authorities and the public is very critical for enhancing credibility of policy makers and for social understanding and support for a sometimes painful fiscal contraction. Section 4 examines the need for social consultation and for a full public disclosure of fiscal policies in CEC's. The concluding Section 5 identifies some areas of improvements in the budgetary process in these countries that would make it compatible with the EU laws and with the incumbent members practices.

This study has a postulatory nature and it is not aimed at empirically investigating components of budget revenues and expenditures in CEC's and their recent changes. Empirical studies of fiscal policies in transforming economies of Central Europe have been relatively comprehensive and exhaustive. Among them are studies by: Tanzi (ed., 1991); Dabrowski (ed., 1993); Mizsei (ed., 1994); Campbell and Owsiak (eds., 1994); Barbone and Marchetti (1995).

2. The Descending Role of the Public Sector

The pre-reform fiscal system in transforming economies of Central Europe was characterized by a very high share of the public sector revenues and spending in the economy. The government not only owned and regulated the economic system, but also financed most of the economic activity. Specifically, in 1989 the share of government expenditures in GDP ranged from 49 per cent in Poland, 61 per cent in Hungary, to 72 per cent in the former Czechoslovakia (International Monetary Fund, 1994, p. 82). These were significantly higher than the corresponding ratios among members of the European

Community at the same time, ranging from the lowest 39 per cent for Spain to the highest 59 per cent in Denmark (Kornai, 1992).

The main direction of fiscal consolidation in the first stage of the economic transformation in CEC's was to significantly cut the degree of government direct financing of the economy. The reduction of the public sector involvement with the economy was completed with the construction of modern budgetary institutions in CEC's, namely, the formation of the effective tax administration and expenditure-control agencies. But the fiscal reform process has not been smooth. There has been a reduction in the real values of tax revenues in the early stage of transformation (Barbone and Marchetti, 1995). The initial deep decline in real GDP was a key contributing factor to the longer-than-expected drop in real tax revenues. However, the reduction in taxable income is not the only factor contributing to diminishing tax revenues. The prolonged corrective inflation and the weakening fiscal discipline of firms negatively affected tax collection as well. The corrective inflation shocks induced by price deregulation and trade liberalization reduced real tax revenues. High, anticipated inflation provided incentives to deferred tax payments (Olivera-Tanzi Effect) and expanded collection lags (Campbell, 1994; Orlowski, 1994).

The first near-hyperinflation shock in Poland and Czechoslovakia led, however, to a temporary improvement in business profits and tax collection, since many enterprises quickly revalued inventory gains and applied lagged adjustments of depreciation allowances. But these gains disappeared when inflation was reduced to “moderate”, double-digit monthly levels and real profits declined. A further deterioration of tax collection shall be attributed to widespread under-reporting practices by deregulated enterprises since the authority could not quickly replace the previous command system of profit monitoring with a new, effective system (Tanzi, 1993; Barbone and Marchetti, 1995). In the beginning of the reform program in Poland the authorities applied excessive loopholes that contributed to the reduction of tax revenues as well. Furthermore, the role of turnover taxes, which were a key source of government revenues in the past system, was significantly diminished. They became replaced later with value-added taxes (VAT) instituted first by Hungary, and later by Czechoslovakia in 1992 and in Poland in 1993. VAT is supposed to ensure a better tax collection since it is levied instantly on consumer goods and services at explicit rates. CEC's

have also expanded ad valorem excise taxes and have broadened the personal income tax base as necessary steps toward improving tax collectability.

Government expenditures fell in terms of their share in GDP as well in the first phase of the economic transformation. Their share in GDP varied in 1989 from 48.9 per cent in Poland to 72.3 per cent in the former Czechoslovakia. The presently available data (1994) shown in Table 1 reflect a significant reduction of the share of government expenditures in GDP. This reduction is attributable to cuts in subsidies to state-owned enterprises and in other positions of government financing of the national economy due to advancing privatization and deregulation programs.

There are, however, serious impediments to a further reduction of government expenditures. The most painful among them is an extremely expensive maintenance of social safety nets. High shares of pensioners and excessive unemployment are the main reasons for the expensive social insurance systems. CEC's face the problem of fast growing ratios of pensioners to currently employed members of the labor force. In 1992, these ratios reached 67 per cent in Slovakia, 64 per cent in Hungary, 61 per cent in the Czech Republic, and 57 per cent in Poland (International Monetary Fund, 1994, p. 65). These levels are certainly very high by international comparisons. Furthermore, CEC's pension recipients have obtained generous compensation from government sources. The ratio of the average pension to earnings in 1992 reached 75 per cent in Poland, 49 per cent in both states of the former Czechoslovakia and 45 per cent in Hungary (Roxin and Hoos, 1995). CEC's governments have been quite generous with providing decent levels of pension benefits, in part due to legislative loopholes, such as: the lax eligibility criteria and the limited supervision over the system (Orlowski, 1995a).

The expensive social insurance systems in CEC's impose a serious burden on government expenditures and force the authorities to finance them with high taxes. In order to reduce the magnitude of these transfer payments, CEC's shall intensify privatization and securitization of pension funds. Further legislative solutions are critical to resolve this urgent problem.

The second expensive burden on general expenditures in most of the CEC's is the coverage of unemployment benefits. Unemployment rates in the region are still excessive, although

they have shown recently a declining tendency with the notable exception of Slovenia. These rates for 1994 and 1995 are shown in Table 2. Unemployment programs are financed mostly by government sources in these states and the duration of benefits varied at the end of 1994 between 6 months in the Czech and the Slovak Republics and 12 months in Hungary and Poland. In addition, the Czech Republic has a generous system of retraining grants and social aid for an unlimited period of time after the expiration of unemployment benefits. Social aid is available in Hungary and Poland provides retraining grants but no social aid (Roxin and Hoos, 1995). These benefits are generally consistent with social policies of the EU members and match the requirements of the EU 1989 Social Charter (Treaty on the European Union, 1992, pp. 197-201).

In the context of the future admission of CEC's to the EU, the rules of harmonization and extension of social security benefits across the EU are playing a critical role. The European Commission has established four principles of social security systems (Commission of the European Communities, 1995, Annex, p. 71):

1. Application of a single social security legislation (protecting migrant workers from social security contributions in more than one state).
2. Equality of treatment (granting the migrant workers comparable benefits and subjecting them equal obligations across the EU).
3. Retention of acquired rights (to pensions and other benefits).
4. Aggregation of periods of insurance and benefits.

These rules combined together with low wages and salaries in CEC's in comparison to EU nations will provide strong incentives for workers to migrate to the West, in spite of pervasive sociological, geographic and institutional immobilities of labor within the Union[1]. Strong incentives for CEC's workers and pensioners to migrate to the West will exist if the rules of equalization of benefits are extended in the future to Central European entrants to the Union.

Furthermore, the income equalization mechanism built into the EU Structural Funds cannot be extended into CEC's in the present form of this program. Currently, each member state of

the EU whose income per capita is less than 75 per cent of the Union average may apply for compensating transfers from the EU SF's. Since per capita incomes in CEC's are a small fraction of the incumbent members levels, the resources for the income equilibrating mechanism would have to be enormous after admission of these countries to the EU. The needs will certainly exceed the SF budget in the present form. The ongoing EU intergovernmental conference (IGC) will have to resolve this issue by applying special, somewhat discriminatory standards of the income equilibrating mechanism to the Central European candidates.

In sum, social costs of transformation and preparations for accession to the EU add to high levels of government expenditures in CEC's. The authorities in these countries have been able to cut subsidies to enterprises over the past five years, but increasing costs of social safety contribute to a prolonged fiscal crisis in the region. As indicated in Table 1, the share of social security expenditures in GDP ranges from approximately 4 per cent in Hungary, to 12 per cent in the Czech Republic, although in the latter case these expenditures are actually self-financed by compensating social security contributions to the general government budget. Within the next several years of preparations for accession to the Union, CEC's governments will face the problem of fixidity or indexation of real values and the off-budget treatment of several other components of government spending as well. National defense and education can be identified as critical items that cannot be subject to spending cuts. Their share in GDP varies approximately between 3 and 4 per cent in CEC's for each category, which corresponds to comparable levels in developed industrial nations.

National defense expenditures cannot be cut mainly for the reason of the growing political uncertainty in the region enforced by rhetoric of several political factions in Moscow and because of the necessary preparations of CEC's military sectors for accession to NATO. The claims of rebuilding the former Soviet Union are frequently launched by virtually all the political parties engaged in Russia's presidential election campaign at the present time. They definitely add to the needs for development of national defense for precautionary reasons among CEC's. Moreover, the political rationale of the NATO membership is cohesive with political and economic reasons for the EU eastern enlargement. Central European armies

need to be trained and upgraded to the NATO standards. This restructuring will be largely financed by internal budgetary sources in these countries.

Education and human capital investment will be a serious constraint to the program of fiscal consolidation. The majority of students in CEC's attend public schools and universities which provided the only source of education in the previous system. Students enjoy extensive benefits in the form of full tuition coverage, free textbooks, subsidized meals, transportation discounts, etc. in these countries. These benefits will be very difficult to cut. Rather, they shall be essentially maintained in the future since in the social perception in CEC's education has become a public good. Nevertheless, the increasing number of successful private schools and universities that are gradually emerging in the region may provide a significant relief to the inflexibility of public spending on education. Some countries, most notably Poland, have a long tradition of catholic education. Therefore, the predominant Roman Catholic Church and other religious institutions and organizations shall assume a more active role in developing the national education system in Central Europe.

In the process of fiscal consolidation essential for a pre-accession strategy, subsidies to enterprises are the main area of cuts in government spending among the EU candidate countries. Central European fiscal authorities have already advanced in this area. Barbone and Marchetti (1995) prove that cuts in subsidies among CEC's in the period between 1986 and 1992 amounted to 11 - 19 per cent of GDP. This was more than the expansion of the share of income transfers to households in GDP ranging from 4 to 11 per cent at the same time. But the cuts in subsidies have not fully eliminated “soft budget constraints” to enterprises. As Schaffer (1995) argues, there has been a significant transmission of cuts in subsidies into tax arrears among various state-owned enterprises in the region. Consequently, cuts in subsidies alone have not yet resolved the symptoms of the fiscal crisis induced by activities of public enterprises. Further privatization efforts and improvements in tax efficiency and discipline are needed to alleviate pressures of these enterprises on CEC's fiscal deficits.

3. Methods of Improvements in Tax Revenues

Tax revenues compose a significant share of GDP in CEC's. In the period 1986-1988 they constituted close to 50 per cent of the GDP in the region (Barbone and Marchetti, 1995). More recently, their GDP shares declined to the lowest 28 per cent for Hungary, while Slovenia still maintained a high 48 per cent share, as reflected by Table 1. This decline is consistent with the process of economic deregulation and transition to a market economy. It brings the role of the public sector closer to the one established among the EU incumbent members.

The declining tax revenues in the first stage of the economic transformation can be attributed to a combination of desirable factors, such as the diminishing role of turnover taxes, unavoidable factors, such as falling taxable incomes during the first three years of transformation, and undesirable developments. Among the latest, a critical role is played by overtaxation, or excessive marginal taxes and absolute income and profit taxes. Excessive marginal taxes promote the development of underground economies - rising unreported incomes to tax authorities - due to high opportunity costs of tax payments. Moreover, high profit taxes urge international companies to apply transfer pricing practices in the sense of underreporting incomes in high-taxed and overreporting incomes in low-taxed economies. More detailed studies of these practices in CEC's are needed. However, a scattered empirical evidence reported in business periodicals in Central Europe suggests that transfer pricing practices are quite pervasive. They are mostly applied by a number of multinational corporations engaged in foreign direct investment in the region.

It can be further argued that in the presence of high marginal income and profit taxes newly privatized firms and individual taxpayers find strong incentives for tax evasion. Consequently, the new tax base, which is based on private individuals and firms, is very weak. Declining real tax revenues in the region are also hurt by a prolonged chronic inflation, that is, inflation stemming from automatic indexation of prices and wages. If inflation in the region continues to persevere, incentives to defer tax payments will be also strong. This problem is especially relevant for Hungary and Poland where the CPI-based inflation in 1995 ended at 29.0 and 21.4 per cent respectively. In the initial stage of

transformation, the evidence supporting the Olivera-Tanzi effect was not too strong since the near-hyperinflation in Poland or in Czechoslovakia had a character of one-time, self-correcting shocks (Orlowski, 1994). The Olivera-Tanzi effect becomes normally stronger when inflation assumes a chronic, long-lasting character stemming from automatic indexation of wages and prices[2]. Such inflation is normally anticipated by firms and individuals who then plan to defer tax payments as well.

By all means, personal income tax rates reaching the current peak level of 48 per cent in Hungary and in Poland and corporate profit taxes of 45 per cent are excessive. Their cuts, in the presence of rising taxable incomes, would contribute to higher tax revenue collection by governments. As the economic transformation proceeds, the emerging CEC's private sectors will consolidate their competitive position in the European economy. Under such circumstances, the negative spending multiplier and the negative tax multiplier seem to have a strong validity among CEC's. More specifically, in the second stage of the economic transformation cuts in government spending and lower tax rates will both contribute to an accelerated GDP growth, contrary to the keynesian arguments of a positive spending multiplier effect raised, among others, by Nuti and Portes (1993) or by Laski and Gabrisch (1994)[3].

Lower taxes may boost taxable income and improve tax revenues not only by reducing incentives toward an underground economy, or to transfer pricing. They will also create a more favorable environment for direct investment, thus generating a long-term growth of taxable income. Moreover, lower capital gains taxes coupled with reduced capital controls that will have to be a part of the program of preparations for accession to the EU, may help to develop and to strengthen domestic equity and fixed income security markets. Under such conditions, corporations will obtain more capital for their growth and governments will be able to finance deficits by the public debt creation, not by an accommodative monetary policy. These changes will help to reduce pressures on chronic inflation which is normally enforced in the presence of large deficits financed by money creation.

High tax rates trigger the transmission mechanism of subsidy cuts into tax arrears examined by Schaffer (1995). In the presence of excessive tax rates, public enterprises hurt by lower subsidies will gain more revenues by not paying high taxes. If tax rates were lowered, their

revenues from tax arrears would be automatically weakened and so would incentives for tax deferrals or evasion. In other words, the opportunity cost of tax arrears would become unattractively low.

The policy of low taxation is further justified by the need to protect still fragile small private businesses emerging in Central Europe. Governments of CEC's have a special obligation to preserve the entrepreneurial spirit of small business owners that erupted with the change of the system. Excessive taxation would generate doubts among new entrepreneurs about the efficiency of a market economy.

Key elements of tax reforms in CEC's have been largely completed during the first phase of the economic transformation. All of the CEC's have introduced and expanded VATs and strengthened the role of personal income taxes. At the same time, turnover taxes have been gradually reduced (Barbone and Marchetti, 1995). These changes have helped to bring their taxation systems closer to the EU. While preparing for accession to the EU, the Central European candidates will have to introduce uniform import tariffs and will have to eliminate barriers to trade with the EU members. The greater openness to Western products is likely to bring a number of goods heavily subsidized by EU members (Gros and Steinherr, 1991) that would be a questionable solution for the EU candidates. Therefore, it is imperative that the EU incumbent members undertake efforts to lower the scale of subsidization of their exports to increasingly open economies of CEC's and, at the same time, grant a wider market access to Central European exports. As a result of such desirable changes in the structure of trade policy instruments, CEC's governments will experience a further reduction of revenues from import duties. They may partially alleviate this loss by adhering to the World Trade Organization and the Uruguay Round Final Act requirement of tariffication of existing non-tariff barriers (NTB's) to trade. Converting some highly restrictive NTB's (quotas, product health and technical restrictions, etc.) into tariffs may bring more revenue to government budgets, at least in a short period of time.

In the process of negotiations with the EU on conditions for accession, CEC's governments may consider bringing up the issue of temporary tariffs consistent with the "infant industry" protection argument. Such tariffs have been advocated for transforming economies of Central Europe by Corden (1992). However, although the "infant industry" protection with

tariffs may be a part of the program of preparations for the EU accession, some procedures for their future dismantling shall be included in a post-accession strategy.

4. The Need for a Social Dialogue

A successful fiscal consolidation in preparations for accession to the EU will depend largely on the ability of finance ministers of CEC's to manage the policy formulation and implementation. The authorities must seek a wide public support for this policy, especially because it will be based on the reduction in the scale of direct government intervention in the economic system. The diminishing role of government patronage over the national economy will have to be accompanied by significant social costs. Specifically, public enterprises will no longer enjoy a subsidy protection. Instead, market competition will force them to be more productive and creative in terms of product development, pricing, marketing techniques, etc. A large share of CEC's societies who have been accustomed to receiving transfer payments will also have to face sacrifices brought by the program of fiscal consolidation. These social costs will require governments to provide a satisfactory explanation of future economic and political benefits related to the accession to the EU.

CEC's fiscal authorities will have to engage in an extensive social dialogue so that they can properly explain to members of their societies the underlying causes and the expected benefits of accession. Furthermore, they must show a strong commitment to preparations for accession and they have to make all possible efforts to strengthen the integration policy credibility. As an indication of the policy makers commitment to accession, deCrombrugghe, Minton-Beddoes and Sachs (1995) favor a fast-track completion of the integration process. It seems, however, that a speedy accession accompanied by radical changes in fiscal and monetary policies, all in the direction of contractionary policies, may backfire on the authorities in CEC's. A sudden imposition of social constraints through cuts in transfer payments, or restraints on domestic credit, especially at the time of active structural adjustments which this credit ought to facilitate, may generate a social shock and distrust (Orlowski, 1995b).

A strong policy commitment by the authorities can be better expressed by announcing a clear, long-term accession strategy. 'Under such circumstances, the social costs of the pre-accession strategy will be spread over time, but at least the societies will better comprehend the purposes and the directions of necessary adjustments for admission to the EU. Moreover, a long-term, well-designed and explicit strategy will help to better align social costs with benefits of these adjustments. On the contrary, a rapid accession accompanied by radical policy adjustments could generate immediate costs, while benefits in terms of growing incomes from trade creation with the EU and new areas of specialization within the expanded EU economic system will take several years to surface.

It shall be strongly emphasized that the commitment to the EU eastern enlargement shall not be expressed solely by CEC's governments. A similar commitment must be clearly states by the European Parliament and by the European Commission, more explicitly than it was presented in the Commission May 1995 “White Paper”. Otherwise, the program will not gain a sufficient social support. So far, despite several formal statements, such commitment on the part of EU authorities has not been adequately expressed.

CEC's governments will have to carefully and forcefully present future benefits of the accession strategy to their societies. Members of CEC's societies will understand and endorse the need to bear well-defined sacrifices related to the necessary fiscal consolidation if these policies are properly presented and explained to them. As emphasized by Tanzi (1993), the need for a social dialogue and a clear presentation of costs and benefits of fiscal consolidation have been critical for successful fiscal deficit reductions in most of the empirical cases.

An explicit identification of long-term benefits of fiscal consolidation and the overall accession strategy will be a challenge to CEC's especially because the future income transfers to CEC's from the EU budget are very questionable. The new EU members from Central Europe cannot expect to receive CAP subsidies and transfers from SF because, as stated before, these programs in their present form would require very large transfers to the new members which exceed financial resources of the Union. Therefore, if the CEC's societies do not see support for their agricultural sectors through CAP and do not gain an access to SF they may question viability of their states applications for accession. It shall be

explained to CEC's societies that they should not count on an extensive financial support for their agricultural sectors or on transfers from SF. When presenting the accession benefits, CEC's government shall emphasize future gains from economic restructuring and trade creation with the EU. The societies will then focus on long-term benefits and will not inflate their expectations of immediate gains from the EU accession. Needless to say, the CEC's governments shall be realistic in their accession strategy. They shall avoid excessive promises and unrealistic claims. Otherwise, their credibility will be undermined.

Because the fiscal authorities will have to demand from the public some social costs related to the accession strategy, they shall by all means avoid optimistic biases in their forecasts of the accession outcomes. Claiming significant benefits from the EU accession forecasted for a short period of time would undermine the policy makers credibility if such benefits could not be generated. Consequently, a cautious approach to anticipated accession outcomes is a much better solution. At least the societies will not feel misled that the promised benefits compensating their early sacrifices related to fiscal consolidation are not visible. A further improvement of the policy makers credibility can be also accomplished through a proper periodic monitoring and control system of costs and benefits of the accession and the post-accession strategy. Such a monitoring and control mechanism on the part of both the European Commission and CEC's governments will have to be built into the future EU eastern enlargement program.

5. Concluding Remarks: Modifications of the Budgetary Process

Fiscal policy formulation and implementation has undergone significant changes in the first stage of the economic transformation in CEC's. The program of preparations for accession to the European Union, which will dominate over the tasks in the second stage of the economic transformation, provides vast opportunities for further improvements of this policy. Although a number of modifications of the budgetary process shall be included in the pre-accession strategy, most of them are not exclusively related to the integration with

the EU. Rather, they are consistent with the logical evolution and modernization of fiscal policy in the process of the ongoing economic transformation.

Fiscal policy modifications in the program of preparations for the EU accession shall be tied to a strong priority assigned to the balanced budget over interests of regions and lobbying groups. The balanced budget concept shall be carefully redefined for CEC's and adjusted to the fiscal convergence criterion built into the pre-accession strategy. It would be desirable to enact a Constitutional obligation for CEC's governments to balance the budget. Moreover, a reasonable Constitutional limit on financing the deficit through money creation (as it exists in Germany) is strongly recommended for CEC's[4].

A Constitutional commitment to the balanced budget shall be further supported in CEC's by the legislation that would channel the ultimate responsibility for fiscal policy preparation and implementation to a single constituency, that is, a ministry of finance and a council of ministers (Dabrowski, 1993). Parliaments, as legislative branches of governments, shall not have a right to break constitutional laws by enacting a budget deficit expansion relative to the budget proposal submitted by the administrative branch of government. Parliamentary committees may work together with representatives of the administration on adjustments of individual expenditure and taxation items, but within the framework of the fiscal convergence target.

Fiscal policy makers must also improve their tools of economic analysis and income forecasting. A further evolution of forecasting models and methods is imperative for a prudent formulation of budgetary expenditures in nominal terms. GDP forecasts prepared by fiscal authorities may be more accurate once the economic growth assumes a more stable path on the upward section of the J-curve of real GDP growth, now evident for all the CEC's - candidates for the EU accession. Such forecasts are likely to improve the government budgetary process. Ministries of finance shall further strengthen the system of monitoring accuracy of their forecasts. Furthermore, a full coordination and compatibility of forecasting methods and models used by the finance ministry, branch ministries, and central strategic planning institutions is much desirable to ensure a better correspondence between expenditure and taxation positions in the general government budget. As a result of an

improved accuracy of national income forecasts, the guess work approach of economic analysts at finance ministries will be eliminated.

Such approach had to be partially applied at the beginning of the economic transformation when a major structural break in the economic system took place. Adaptive expectations and extrapolated trends became meaningless when the authorities in Poland or in the former Czechoslovakia applied respectively in 1990 and in 1991 a "shock therapy" approach to the economic reform. Under the conditions of high uncertainty of GDP and inflation that prevailed at the early stage of transformation, nominal values of many budgeted positions of government expenditures were likely to be overstated for precautionary reasons. Specifically, in the presence of high inflation, nominal values of spending requests from the government budget were highly inflated. A comprehensive policy of disinflation that ought to be an integral part of the EU accession strategy will help to make the budgetary process more realistic. Moreover, anticipating a declining path of inflation consistent with the task of fulfilling a monetary convergence criterion (for instance, no more than a 5 per cent CPI-based inflation for the year preceding a formal date of accession) the governments will be likely to reduce nominal values of budgeted expenditures. They will also lower the scale of adjustments in administrative prices of fuel, energy, transportation, etc., which by themselves always add to inflationary pressures. In essence, the accession program and the policy of disinflation will undeniably help to improve the fiscal discipline of CEC's governments.

Further improvements in fiscal policy shall concentrate on an extension of the policy time horizon, along with the means of reduction of the policy recognition and decision lags[5]. It is also imperative that fiscal policies in CEC's shall be rather based on stable, predetermined rules incorporated in parliamentary laws. Policy makers shall avoid excessive discretionary policy adjustments reacting to negligible, self-correcting economic disturbances. Specifically, they shall avoid increasing allocations of expenditures in the areas where they will be later very difficult to cut. The authorities may be dangerously inclined to do so if they, for example, just experienced a large inflow of revenues from a major wave of privatization. A discretionary approach to fiscal policy may hurt credibility of government authorities.

The tasks of improving fiscal policy formulation and implementation are still enormous in transition economies of Central Europe. They will have to be addressed in the economic program for the second stage of the economic transformation. Some of the more general policy guidelines shall be also incorporated in the strategy of preparations for accession of these countries to the European Union.

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Endnotes

[1] At the end of 1995, the average USD monthly wages in CEC's ranged from the highest of 585 in Slovenia, 381 in the Czech Republic, 345 in Poland, 298 inHungary, to the lowest of 279 in Slovakia (Business Central Europe, March 1996, p. 73). They were 8 to 11 times lower than the EU average.

[2] As recently argued by Orlowski (1996) the role of chronic inflation in Poland has been recently considerably strengthened. This type of inflation can be primarily overcome with long-term oriented fiscal consolidation accompanied by a fairly restrictive and rules-based monetary policy.

[3] These neo-keynesian authors argue that cuts in spending lead to supply constraints that impede the GDP growth. They believe that the economic transformation will assume the L-curve path, that is, the economic recovery will not emerge as a result of the continuous fiscal consolidation.

[4] The call for a Constitutional ramification of fiscal policy in Poland is strongly presented by Dabrowski (1993).

[5] The fiscal policy recognition lag is the time required for policy makers to acknowledge a problem, a macroeconomic disturbance that would require corrective policy actions. The decision lag is the time required to formulate and to enact specific policies.

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Table 1: Selected Positions of General Government Revenues and Expenditures in Central Europe. Percentage Shares of GDP.

HUNGARY	1993	1994
Revenues	26.8	27.8
Excise taxes	4.2	3.8
Corporate income taxes	1.6	1.8
Import duties	3.3	3.5
VAT	7.6	7.8
Expenditures	32.5	35.3
Subsidies (to business and consumers)	2.3	3.0
Social security payments	3.9	4.7
National defense	3.8	3.8
Interest and debt repmnts.	5.3	8.4
Budget Balance	-5.7	-7.5
CZECH REPUBLIC	**1993**	**1994**
Revenues	39.3	37.6
Personal income taxes	7.9	6.8
Social security contr.	11.6	12.8
VAT	7.7	8.3
Excise taxes	4.1	4.4
Other taxes (include. corporate income taxes)	8.0	5.3
Expenditures	39.2	36.6
Education	3.9	2.7
Health	1.9	1.5
National defense	3.8	3.9
Social security payments	11.3	12.0
Interest on gov. debt	1.6	0.0
Subsidies to enterprises	5.3	5.2
Budget Balance	+0.1	+1.0
POLAND	**1993**	**1994**
Revenues	29.5	30.4
Turnover taxes	11.4	13.0
Corporate income taxes	4.1	3.3
Personal income taxes	7.7	8.3
Customs duties	2.8	2.4
VAT	3.6	3.4
Expenditures	32.3	33.2
Social security payments	6.7	6.9
Debt service	3.4	4.7
National defense	3.9	3.9
Public sector compensation	8.7	7.2
Budget Balance	-2.8	-2.8

Table 1 - continued

SLOVAKIA	1993	1994
Revenues	48.8	40.9
VAT	8.9	10.8
Excise taxes	5.0	6.2
Corporate income taxes	6.7	8.3
Personal income taxes	1.5	3.3
Social security taxes	13.2	7.0
Expenditures	56.3	47.6
Subsides to enterprises	5.6	4.7
Social security and welfare	18.5	n.a.
Debt service	3.9	7.0
Budget Balance	-7.5	-6.7
SLOVENIA	**1993**	**1994**
Revenues	47.8	48.2
Social insurance taxes	21.3	21.0
VAT	11.3	12.3
Expenditures	47.6	48.4
Health, pensions, disability	20.7	20.6
Other	4.9	4.7
Republic of Slovenia	22.1	22.9
Budget Balance	+0.2	-0.2

Data Source: Plan Econ.

Table 2: Unemployment Rates in Central European Countries (by the ILO definition)

End of:	Poland	Czech Rep.	Hungary	Slovakia	Slovenia
1994	16.0	3.2	11.0	14.8	14.2
1995	14.9	2.9	10.2	13.1	14.4

Data Source: Business Central Europe, March 1996, p. 73.