CENTER FOR SOCIAL & ECONOMIC RESEARCH

The State of Public Finance in Post-socialist, Central European Economies

a Comparison with the European Union Countries

by

Urszula Kosterna

Translation by Jolanta Byliniak-Kozłowska

Warsaw, April 1996

Materials published in these series have a working papers character. They can be subject to further publication. The views and opinions expressed here reflect Authors' point of view and not necessarily those of CASE .

We acknowledge the support of the ***Ford Foundation***, which made this publication possible. (grant No: 930-1199)

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ISBN 83-86296-75-5

CASE - **Center for Social & Economic Research**
00-585 Warszawa, Bagatela 14
tel (48-22) 628 09 12, (48-22) 629 43 83; fax (48-22) 628 65 81

Contents:

On December 16, 1991 Poland signed an Association Agreement with the European Communities[1] which came into force on February 1, 1994. The remaining countries of the Wyshegrad Group (Hungary, and the Czech and Slovak Republics) also signed such agreements with the European Union. It is interesting, both from the perspective of these countries' potential membership in the European Union, as well as the necessity of creating fiscal systems complying with market economy requirements, to compare the budgetary position of these countries with the state of public finances in the Community's countries.

1. Introduction - Conditions Affecting the State of Public Finances in The Countries of the Wyshegrad Group and the European Union

1.1. Situation in the Wyshegrad Group Countries

In post-socialist Central European countries which have launched the process of economic system transformation into market-oriented structures, the difficulties in balancing the state budget (pressure to increase the budget deficit) - see Table 1 - became a serious threat to economic stabilization efforts. At the same time, they significantly limited decision- making possibilities in the field of macro-economic policy.

There exists a comprehensive body of literature devoted to the reasons for the rise and existence of fiscal tensions during the course of implementing the pro-market transformation process. In most cases, two stages of fiscal crisis can be distinguished: (i) an initial fiscal crisis observed from the very beginning of the transformation process during the collapse of the centrally planned economic system, and (ii) a secondary fiscal crisis emerging under a new institutional and legal economic framework, after carrying out basic reforms.[2]

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[1] The European Union has been in existence since November 1, 1993 and has emerged following the entry into force of the Maastricht Treaty (the Treaty on European Union signed on February 7, 1992). This constitutes the next stage of European integration, which was initiated with the following treaties: the Paris Treaty (1951) setting up the European Coal and Steel Community (ECSC), and the Rome Treaties which established the European Economic Community (EEC) and the European Atomic Energy Community (Euroatom). The Maastricht Treaty has changed the EEC into the Economic Community. The European Union, by contrast to all three Communities which it consists of, is not an entity subject to an international law, therefore all agreements are signed not with the European Union but with the Communities. Generally, the name "European Union" applies to the European Communities or the European Community. Currently (since January 1995), there are 15 member-states of the European Union: Austria, Belgium, Denmark, Finland, France, Greece, Spain, Holland, Ireland, Luxembourg, Germany, Portugal, Sweden, Great Britain and Italy. The EFTA countries are associated with the Union (Switzerland, Norway, and Island); Malta, Cyprus, Turkey (and Yugoslavia in the past) have been enjoying the status of associated states. The Wyshegrad Group countries (Poland, Hungary, the Czech Republic and Slovakia) as well as Bulgaria and Rumania have signed with the Communities the association agreements (called the European Agreements) determining the principles for cooperation and trade, and creating the framework of political dialogue. To learn more about the European Union see Lewandowska (1995) and Komar (1993).

[2] To learn more about the conditions which allowed the initial and secondary crises to occur, see Dąbrowski, Mizsei, Rostowski (1995, p.187-297).

Table 1. Revenues, expenditures and government budget balance in Wyshegrad Group countries in relation to nominal GDP (in %).

	1989	1990	1991	1992	1993	1994	Change 1989-1994
Poland							
Revenues	34.4	47.3	42.6	45.1	47.6	45.8	+11.4
Expenditures	39.9	43.6	48.9	51.8	49.9	48.7	+8.8
Balance	-5.5	+3.7	-6.4	-6.6	-2.3	-2.9	+2.6
Hungary							
Revenues	59.1	57.9	52.2	56.1	54.7	52.3	-6.8
Expenditures	60.5	57.2	54.3	61.6	62.7	58.8	-1.7
Balance	-1.3	0.5	-2.2	-5.5	-8.0	-6.5	-5.2
Czechoslovakia							
Revenues	42.8	42.4	35.3				
Expenditures	42.4	41.2	37.0				
Balance	+0.4	+1.2	-1.7				
Czech Republic							
Revenues				47.4	49.8	48.8	
Expenditures				47.9	48.5	49.7	
Balance				-0.5	+1.4	-0.9	
Slovak Republic							
Revenues				50.7	48.0	50.7	
Expenditures				63.8	55.6	53.6	
Balance				-13.1	-7.6	-2.8	

Source: World Bank Statistics; *MultiQuery Database: A Tool for Cross-Country Comparison.* Prepared by Nancy Vandycke under the Supervision of Luca Barbone. Spring 1995 Update - March 15, 1995.

The causes of difficulties in balancing the state budget can be attributed both to the revenue side and the fiscal side. These are:

- Decrease in total production and in Gross Domestic Product[3] (GDP) ("transformation" recession). The size of government revenues and expenditures depends, to some extent, on the level of economic activity (the effect of the so-called "automatic

[3] Several methodological difficulties arise when embracing, for statistical purposes, economies undergoing the process of systemic transformation. The existing (inherited from centrally planned) systems of social accounting were adjusted to factor in the phenomenon occurring in the state sector, not in the private one, the share of which has been steadily growing. Another fact of significant importance is that under a socialist economy there were reasons to overestimate recorded production size, while the process of change creates incentives to underestimate it (tax reasons). It must be taken into account that standard statistical data allow an analysis only of quantitative changes, not qualitative (i.e. production structure, the variety of products offered, etc.) which the process of pro-market transformation is accompanied by. Because of this, the analysis of economies undergoing the process of economic transformation based on official statistics and estimations must always contain an element of uncertainty and margin of error. See: *Gospodarka Polski* ...(1993) and Balcerowicz and Gelb (1995, p. 4-6).

stabilizers" for the economy[4]). Thus, a deep recession must have been accompanied by a deterioration in the state of public finances;

- Privatization and changes in the ownership structure of the industrial sector, as a result of the decline in the share of the large state enterprise sector (which have suffered the most during the recession) constituting the traditional taxation base for centrally planned economies;

- Diminishing of the traditional taxation base not being compensated by an increase in tax proceeds from other sectors. It is affected both by the relative ease in evading taxes for some types of economic activity being conducted and whose role increases in the economies studied (e.g. small retail trade, services for the population), and by the organizational ineffectiveness of tax administration;

- Impact of "corrective inflation" on tax proceeds (Tanzi effect)[5];

- Emergence of so-called social costs of transformation exerting pressure on growth in state budget expenditures (primarily the central budget) in the form of unemployment benefits and different forms of social assistance;

- Increase in expenses related to the servicing of growing public debt under a policy of positive real interest rates.

The influence of the above-mentioned factors on the state of the budget in specific countries was differentiated according to their respective economic positions at the dawn of the transformation process[6], as well as to the depth and pace of reforms being carried out. Part of those factors seem to be immanently linked with the transformation process, thus the fiscal crisis (especially the initial one) can be considered to be an unavoidable cost of it. Such an approach, however, cannot conceal the need to continue the fiscal system's restructuring, which requires a clear vision of its final (desired) shape. It is necessary from

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[4] See: Muller and Price (1984).

[5] The term "corrective inflation" has been borrowed from Sachs's and Larrain's document (1993, p.759). It marks an inflationary phenomena which emerges after conducting radical economic reforms, including price liberalization and initiating the process of centrally planned economic transformation into a market system. The greater inflation is, the stronger is its influence on the level of budgetary receipts. The Tanzi effect marks a decrease in real receipts derived from direct taxes under high inflation conditions. These taxes are being paid with some delay in relation to the moment of earning the taxable incomes, therefore, in real terms, their nominal value is being depreciated. It is worth emphasizing that the drop in tax proceeds is recorded despite an increase in enterprise effectiveness (thus an increase in the tax base), caused by inflation as well. The corrective inflation, therefore, through the Tanzi effect, can be conducive to "corrective budget deficit" which - in the absence of sufficiently developed financial markets - is mainly financed by the printing of money. It may lead to a vicious circle - the creation of inflation and deficit. Thus, if hyperinflation exists, it is necessary to coordinate monetary and fiscal policy - slowing down the pace of price rises (thus radical monetary reforms) is an obligatory condition to balance the budget while a condition for a balanced budget (thus fiscal restriction) is the need for price stabilization. See: Orlowski (1994, p. 283-286) and Łaski, Podkaminer (1995, p.14-24).

[6] See: Balcerowicz (1994); Balcerowicz and Gelb (1995).

the viewpoint of i) the long-term nature of the transformation process in this sphere of the economy[7], and ii) changes in the macro-economic conditions affecting fiscal policy[8].

Table 2. Revenues, expenditures and government budget balance in 12 European Union countries in relation to nominal GDP (in %).

	1960	1965	1970	1975	1980	1985	1990	1995
Belgium								
Revenues	27.9	31.3	39.1	45.4	48.8	52.6	48.8	50.2
Expenditures	30.7	32.7	41.7	50.9	58.1	61.3	54.2	54.9
Balance	-2.9	-1.6	-2.6	-5.5	-9.3	-8.8	-5.4	-4.7
Denmark								
Revenues	27.9	31.2	46.1	45.7	51.5	56.0	55.9	57.1
Expenditures	24.8	29.9	42.0	47.0	54.8	58.1	57.4	60.1
Balance	+3.1	+1.3	+4.1	-1.4	-3.3	-2.0	-1.5	-3.0
France								
Revenues	34.9	38.4	39.0	41.4	46.5	49.9	49.0	49.4
Expenditures	34.6	38.4	38.1	43.8	46.6	52.7	50.6	54.3
Balance	+0.4	0.0	+0.9	-2.4	0.0	-2.9	-1.6	-4.9
Greece								
Revenues	21.1	23.7	26.8	22.6	25.2	28.5	32.9	37.1
Expenditures	...	...	...	...	27.6	40.2	46.8	50.3
Balance	...	...	...	...	-2.4	-11.7	-14.0	-13.3
Spain								
Revenues	...	...	22.1	24.4	29.9	35.2	39.5	40.9
Expenditures	...	...	21.4	24.4	32.5	42.2	43.5	46.9
Balance	...	...	+0.7	0.0	-2.6	-6.9	-3.9	-6.0
Holland								
Revenues	33.9	37.3	41.2	48.7	52.5	54.4	49.9	49.6
Expenditures	33.7	38.7	42.4	51.5	56.5	58.0	55.0	53.2
Balance	+0.2	-1.4	-1.2	-2.9	-4.0	-3.6	-5.1	-3.5
Ireland								
Revenues	24.8	27.9	32.1	33.3	36.5	41.1	37.9	37.2
Expenditures	28.0	33.1	36.2	45.4	48.8	52.0	40.0	39.2
Balance	-3.2	-5.1	-4.1	-12.2	-12.2	-10.8	-2.2	-2.0
Luxembourg								
Revenues	31.0	33.5	36.4	49.9	55.1	58.1	...	53.6
Expenditures	29.1	31.6	33.2	48.7	55.6	50.9	...	52.0
Balance	+2.0	+1.8	+3.0	+1.1	-0.5	+7.2	+5.9	+1.6
Germany[a)]								
Revenues	35.5	36.1	38.7	43.1	45.1	46.0	43.3	46.9
Expenditures	32.5	36.7	38.5	48.6	48.0	47.2	45.3	49.3
Balance	+3.0	-0.6	+0.2	-5.6	-2.9	-1.2	-2.1	-2.4
Portugal								
Revenues	19.1	21.7	26.0	27.7	30.9	33.4	34.0	38.0

[7] Vito Tanzi shows that the time required to effectively introduce pro-market reforms is different for separate sectors of the economy. The process of reforming public finances is one of the longest lasting processes - according to the author it is impossible to complete this within one decade; see: Tanzi (1993, p. 1-3).

[8] Those conditions determine both the amount and the structure of the tax base as well as state budget expense needs.

	1960	1965	1970	1975	1980	1985	1990	1995
Expenditures	18.5	21.5	23.2	31.9	...	43.5	38.8	43.7
Balance	+0.6	+0.3	+2.8	-4.1	...	-10.1	-5.0	-5.8
Great Britain								
Revenues	29.9	33.0	39.8	40.0	39.7	41.3	38.8	37.5
Expenditures	32.2	35.9	37.3	44.7	43.2	44.1	40.3	42.1
Balance	-2.2	-2.9	+2.5	-4.7	-3.5	-2.8	-1.5	-4.6
Italy								
Revenues	28.8	30.1	28.8	28.5	33.3	38.3	42.2	44.9
Expenditures	30.1	34.3	32.1	39.1	41.9	50.9	53.2	53.6
Balance	-1.1	-3.8	-3.3	-10.6	-8.6	-12.6	-10.9	-8.6

a) Till 1990 data refer to Federal Republic of Germany, for 1995 to Germany after unification

Source: *Annual Economic Report for 1995*, European Economy No. 59, 1995.

1.2. The European Union Countries

Within the past three decades some noticeable changes have taken place in the economic policy of countries with developed market economies, and in the perception of the role of fiscal policy[9]. From the viewpoint of the state of public finances, in the EU member-states four periods can be distinguished[10] (see Table 2):

- The 1960s, characterized by public sector expansion, resulted in a rapidly increasing relationship both of budget expenditure and receipts to GDP. The growing role in the economy being played by the public sector reflected a general belief that the State should be involved in market processes, as well as the feeling about the effectiveness and usefulness of pursuing an active stabilization policy. In connection with realizing the idea of the "welfare state", an increase in government expenditure has mostly resulted from growth in expenses of a social nature;

- The years of the 1970s until the beginning of the 1980s -were a period in which the budgetary position worsened. Steady growth in budget expenditure as a percentage of GDP was not compensated with an increase in revenues, even though the level of tax rates and social insurance contributions were raised. As a result, an increase in budget deficits, exceptionally big in the second half of 1970s, was noted. During this period, public debt as a percentage of GDP, showing a slight downturn tendency between 1960-1975, soared. A deterioration of the state of public finances state was due not only to discretional activities within the framework of fiscal policy but also to a slower pace of economic development and rising unemployment;

- The 1980s - there was a tendency for public finances to be restored. The change in the direction of fiscal policy was dictated by anxiety about the negative impact of an overaly large public sector [11] and the excessive share of this sector in the

[9] See: Chouraqui (1988, p.1-8) and Kosterna (1995, p.34-41).

[10] See: de Haan, Sterks and de Kam (1994, p.29-34).

[11] A sector, the size of which - according to representatives of liberal conceptions - has reached the level endangering long-term possibilities for economic growth, and at the same time making more difficult the effective control to be kept over it. This can be described with a quote from Harris "*the private sector is a part of the economy*

redistribution of national production. Moreover, in many countries the state budget deficit became difficult to control, at least partially due to excessively optimistic estimates of the potential pace of production growth. This resulted in the transformation of "cyclical" deficits into structural ones. The persisting deficits have restricted decision-making possibilities in the field of fiscal policy - the budget was becoming more and more "stiff", mainly because of the increasing share of public debt service costs and transfer expenses. The change in fiscal policy direction has also resulted in extending its timeframe - there has been a generally accepted view that it is necessary to formulate the fiscal objectives for a longer period of time (the adoption of so-called medium-term financial strategies)[12]. New priorities of fiscal policy therefore became:

a) restraining the growth of public debt, which raises concern about the appearance of a vicious circle, in the form of increasing public debt and budget deficit, exerting upward pressure on interest rates. This pressure, unfavourable from the viewpoint of economic development supply-side mechanisms, has been reinforced by the restrictive character of monetary policy carried out after 1979;

b) reducing public expenditure in comparison to GDP, which would permit a decrease in the tax burden of the economy;

c) change in the structure of budget expenditures and receipts. The purpose of tax system reforms has been mainly to extend the tax base while at the same time lowering the marginal tax rates. Reforms concerning the expenditure side of the state budget were to consist mostly in reducing the share of subsidies and transfer payments.

The presented objectives of fiscal policy adopted in the 1980s have not, however, been achieved. The intention to reduce budget deficits and the level of fiscal redistribution, and to lower public debt in relation GDP failed. Furthermore, structural changes in respect to state expenditures, which had taken place within the discussed period, were also adverse - in most countries there was an increase in the share of transfer expenses and expenses which financed public consumption, but at the same time the share of investment expenditures declined (see Table A1 - Appendix). The main reason for the difficulties in fulfilling the aims of fiscal policy was public pressure to increase government expenditures, primarily those related to enforcing the idea of a "Welfare State"[13] due to the necessity of restraining the growth of internal indebtedness, which in turn forced an increase in fiscal obligations in the economy.

- The first half of the 1990s - saw a noticeable deterioration in the state of public finances, which was reflected - in many countries - by an increase in the budget

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being controlled by the government, and the public sector is a part being controlled by nobody; quote see: Wojtyna (1990, p.147).

[12] See: Chouraqui, Price (1994).

[13] See: Oxley and Martin (1991).

deficit and in state budget expenditures as a percentage of GDP. In EU countries, a stoppage in the process of budget consolidation[14], and in the reduction of state budget expenditures relative to GDP, has been undoubtedly associated with the adverse impact of the cyclical factor; all declarations made by fiscal authorities have shown the intention to counteract the influence of automatic stabilizers on the state of the budget.[15].

The objectives of fiscal policy outlined in the previous decades have not changed in the beginning of the 1990s, but due to the adoption of the Maastricht Treaty provisions, they have been formally defined and treated as one of the conditions necessary to continue the process of building the Community. Within the course of the II stage of Economic and Monetary Union, begun on January 1, 1994, further convergence of economic policy and the conditions under which economies of the member-states operate, is required. This was reflected in formulating the so-called convergence criteria (the Maastricht Treaty criteria). With respect to fiscal policy these are:

- the annual state budget deficit cannot exceed 3% of GDP[16],
- gross public debt cannot exceed 60% of GDP.

In a further part of this study a comparison is presented of the enforcement of the aforementioned criteria by the EU member-states with the fiscal situation of the Wyshegrad Group countries.

2. State Budget Balance, the Size of Public Debt

Despite the over ten-year efforts aiming at equilibrating the state budget balance and decreasing the relation of public debt to GDP, most countries of the European Union do not meet the convergence criteria determined under the Maastricht Treaty (see Table 3). Both the average state budget deficit for 12 EU countries (6% of GDP in 1993; 5.6% of GDP in 1994) and the average size of public debt in those countries (66.1% of GDP in 1993; 68.8% of GDP in 1994) exceed the limits (accounting for 3% and 60% of GDP, respectively). The situation in individual countries diverges.[17], however in 1994 the economies of only three

[14] i.e. reducing the difference between the size of budget expenditures and receipts.

[15] Only in Denmark, France and at the beginning of decade in Great Britain, were attempts undertaken to emerge from the recession with help of discretionary activities of fiscal policy. It is worth noticing that the restrictive character of fiscal policy forced by the need to halt the growth of deficits during periods of slower economic development operates "pro-cyclically", thus affects the extension of the process of overcoming the recession. This is one aspect of the previously-mentioned, reduced decision-making possibilities within the framework of fiscal policy, when the desired, (from the economic perspective), softer shape of fiscal policy cannot be implemented. This dilemma of the EU countries' economic policy at the beginning of the 1990s is to a large degree a consequence of making only partial use of the conditions conducive to economic expansion in the second half of the 1980s, and of an excessive relaxation of the fiscal situation, which resulted in a smaller than possible reduction of deficits; see: Kosterna (1995, p.69-70).

[16] With no permission to finance the deficit by printing money.

[17] A review of the fiscal situation in 11 EU countries is contained in the Appendix.

countries (Luxembourg, Ireland and Germany) met the criterion concerning the relationship between the deficit and GDP. In the remaining countries the deficit exceeds the limit, and major budgetary difficulties are faced by Italy and Greece.

The relation of public debt to GDP is also divergent within the group of countries examined. The convergence criterion (public debt below 60% of GDP) is met by four countries (Luxembourg, France, Great Britain, Germany), while in two - Spain and Portugal - public debt relative to GDP slightly exceeds the limit. The most complex situation is in Belgium, Italy and Greece where the value of public debt exceeds 120% of GDP. It is worth stressing that even in countries with a relatively low ratio of public debt to GDP, this ratio increased over the period 1989-1994. The main cause of this rise was a persistent budget deficit (continued debt accumulation) as well as a reduction in the pace of economic growth (lower than expected value of nominal GDP).

Table 3. The fulfilment of Maastricht fiscal criteria by European Union and Wyshegrad Group countries in 1993 and 1994[a].

1993			1994		
State	Government budget balance (% GDP)	Gross public debt (% GDP)	Country	Government budget balance (% GDP)	Gross public debt (% GDP)
Luxembourg	+1.1	7.8	Luxembourg	+1.3	9.2
Ireland	-2.5	96.1	Ireland	-2.4	89.0
Holland	-3.3	81.4	Germany	-2.9	51.0
Germany	-3.3	48.1	Holland	-3.8	78.9
Denmark	-4.4	79.5	Denmark	-4.3	78.0
France	-5.8	45.8	Belgium	-5.5	140.1
Belgium	-6.6	138.9	France	-5.6	50.4
Portugal	-7.2	66.9	Portugal	-6.2	70.4
Spain	-7.5	59.8	G. Britain	-6.3	50.4
G. Britain	-7.7	48.3	Spain	-7.0	63.5
Italy	-9.5	118.6	Italy	-9.6	123.7
Greece	-13.3	115.2	Greece	-14.1	121.3
EU 12	**-6.0**	**66.1**	**EU 12**	**-5.6**	**68.8**
Czech Republic[b]	+1.4	16.5	Czech Republic	-0.9	15.4
Poland	-2.3	85.1	Poland	-2.9	65.8
Slovak Republic[b]	-7.6	30.0	Slovak Republic	-2.8	35.7
Hungary	-8.0	84.5	Hungary	-6.5	...

a) The states of both groups of countries have been presented according to the state of their government budget balance in 1993 and 1994.

b) In the case of the Czech and Slovak Republics in 1993 - the value of public debt of January 1, 1993.

Source: EU countries: *Annual Economic Report for 1995*, European Economy No. 59, 1995, Wyshegrad Group countries: World Bank Statistics; *MultiQuery Database: A Tool for Cross-Country Comparison.* Prepared by Nancy Vandycke under the Supervision of Luca Barbone. Spring 1995 Update - March 15, 1995, Adamec (1995), Bratkowski(1995).

In 1994, the convergence criteria referred to in the Maastricht Treaty were met by two of the Wyshegrad Group countries, namely by the Czech and the Slovak Republics. Poland's budget deficit approximates the limit equal to 3% of GDP, while the public deficit slightly exceeds 60% of GDP, providing a slightly better picture than the average value in 12 EU countries. In Hungary both limits are substantially exceeded.

One should maintain caution in comparing the data between both groups of countries. The size of public debt in EU countries is being determined in accordance with criteria formalized under the Maastricht Treaty. It can be assumed that in the case of the Wyshegrad Group countries where such criteria do not exist, the entire value of state obligations is not taken into account, and thus the value of public indebtedness captured by the statistic data could be underestimated.

Furthermore, the assessment of the Wyshegrad Group countries' situation, from the viewpoint of the fiscal convergence criteria referred to in the Maastricht Treaty, must take into account the specific character of economic structures in transition, when a market economy infrastructure is only being created (the institutional framework and coordinating systems). Certain factors should be taken into consideration. These are:

- the level of financial market development, determining the possibilities to finance the budget deficit by nonmonetary means. Under the Maastricht Treaty the size of the budget deficit amounting to 3% of GDP has been recognized as a "safe" level, while budget deficit financing by money creation has been simultaneously forbidden. This "safe" level value was defined for economies possessing a permanent market structure, where the level of money and capital market development enables the non-banking private sector to absorb newly issued Treasury bills and Treasury bonds[18] . The situation in post-socialist countries is quite different - financial markets are in the creation stage - therefore, even a slight budget deficit must be perceived as a threat to the process of price stabilization[19]. This is of particular importance given the fact that the level of inflation in these countries considerably exceeds 3% annually (defined in the Maastricht Treaty)[20];

- a "safe" level of the deficit must be determined not only in relation to GDP but also with regard to the degree of economy monetization (velocity of money circulation); this provides an indication of the potential absorptive power of the financial markets and of the potential inflationary effects of the deficit. The relation of monetary

[18] 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 the secondary expansion of money occurs, but when 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: Kosterna (1995, p.89-93) and *Budget Financing and Monetary Control* (1982).

[19] The influence of the existing (and anticipated) budgetary deficit on the nature of inflationary expectations should be taken into account.

[20] In 1994, the inflation rate (consumer price index - CPI) amounted to 32.2% in Poland, 18.8% in Hungary, 10% in the Czech Republic and 13.5% in the Slovak Republic. Among 12 EU countries, the highest price rise was recorded in Greece (10.8%), Portugal (5.5%), Spain (4.9%) and Italy (4.0% of GDP). In other countries the inflation was between 1.7% (in France) and 2.8% (in Ireland).

resources (broadly-defined) to GDP - in 1994 - is shown below (income velocity of money circulation is given in parentheses)[21].

Poland:	35.5% (2.8); domestic currency: 25.4% (3.9),
Hungary:	50.0% (2.0); domestic currency: 41.3% (2.4),
the Czech Republic:	78.8% (1.3); domestic currency: 73.4% (1.4),
the Slovak Republic:	69.8% (1.4); domestic currency: 60.1% (1.7).

In EU countries the relation of money supply to GDP in 1991 varied widely, and in individual countries was as follows:

Belgium: 57.1% (1.8), Denmark: 60.7% (1.6), France: 78.5% (1.3), Greece: 82.8% (1.2), Spain: 74.3% (1.3), Holland: 88.0% (1.1), Ireland: 48.2% (2.1), Germany: 70.3% (1.4), Portugal: 82.8% (1.2), Great Britain: 81.5% (1.2), Italy: 77.5% (1.3).

In the Czech and Slovak Republics, the degree of economic monetization is comparable with that observed in EU countries. A slightly worse situation is noted in Hungary, and the worst of all in Poland. It is worth noting that in Poland, the share of currency deposits in total money resources is the largest within the group of post-socialist countries being analyzed (the greatest extend of the economy's "dollarization"). If one assumes that in order to measure the inflationary effects of a money supply increase, the relation of domestic currency resources to GDP is more essential, then Poland's situation becomes even more complex. In Poland, the aforementioned relation is twice as low as in EU countries. With such a low degree of economic monetization, the 3% criterion of the deficit's relation to GDP becomes inadequate - its "permissible" or "safe" level - from a monetary point of view - is much lower.

- State demand for finance is determined not only by the size of the deficit but also by the existence of other types of obligations of a "non-fiscal" character, which are in fact substitutes for government expenditure (in Poland, e.g. restructuring bonds for Treasury-owned banks). Thus, the value of the budget deficit itself cannot serve as a base for estimating the value of public debt being issued, and projecting its future servicing costs.
- The problem of limited private savings in post-socialist economies, which may be a barrier to non-monetary deficit financing.

[21] Own calculation based on the World Bank Statistics; *MultiQuery Database: A Tool for Cross-Country Comparison.* Prepared by Nancy Vandycke under the supervision of Luca Barbone. Spring 1995 Update - March 15, 1995; *World Tables 1993.*

- The problem of the possible emergence of the crowding-out effect[22] in economies in transition. This issue is not being evaluated equally when considering 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 so-called "bad debts" as a percentage of bank assets, and the poor financial standing of enterprises. One may argue that the lack of reliable borrowers, rather than state competition for financial market resources,[23] 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 to sound 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 and reduce inflationary pressure in the economy (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 State. Although in the short run, credit for the State solves the problem of the need for banks to invest deposits received, the current (and expected future) borrowing needs of the public sector can contribute to reducing the banks' interest in financing the economy. This situation seems to be, therefore, an expression of the specific type of crowding out effect - of the *ex ante* kind - of credit to the economy by credit to the State[24].

- The impact of the banking sector's "bad debts" on the future budgetary position and the size of the public debt. The problem of banks' bad credit portfolio has not yet been solved[25], which means the necessity to consider the costs that the budget is going to bear for this in the future.

- A short history of internal debt accumulation, given the strong dynamics of this process (and which creates upward pressure on the size of future deficits) - increases the debt-servicing cost portion of government expenditure, causing them to become fixed portions of this expenditure. It should be added that the marginal cost of public debt service in post-socialist countries exceeds its average cost, which results from

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[22] This concerns the financial crowding out (indirect), the merit of which is to lower private expenses as a result of the State assuming the public debt for budget deficit financing. The competition between the private sector and the State for limited credit leads to an increase in interest rates, which "crowds out private expenses" of the market in favour of government expenditures. It should be noticed that apart from a possible financial crowding out in post-socialist economies, a direct crowding out - being a relic of the previously existing system - also widely occurs. It takes place when the State, through its expenditure, provides the private sector with goods and services perceived as substitutes for possible private expenditures (educational, health service expenditures, etc.,). A direct crowding out is conditioned by this substitution whereas it does not depend on the way in which the budget deficit is financed. To learn more about the taxonomy of the crowding-out effect, see: Buiter (1977, 1985), Chouraqui (1988) and Kosterna (1985, p.106-125).

[23] See: Oblath and Valentinyi (1995, p.248-253).

[24] It should be added, however, that the evaluation of such a type of crowding-out should not be unequivocally negative. Financing the State by the banking system makes possible the maintenance of hard budget limits for enterprises, counteracting at the same time a deepening of the bad debt problem in the economy.

[25] To find out more about the activities carried out within the Wyshegrad Group countries aimed at the banking sector recovery, see: Dąbrowski, Mizsei and Rostowski (1995, p.299-300).

changes in the structure of indebtedness, in the form of a fall in the share of "old" debt in favour of debt being assumed at market costs.

Due to the specific conditions - mentioned above - affecting the budgetary position of economies experiencing market structure creation, the fiscal criteria referred to in the Maastricht Treaty cannot be treated, like in the EU countries, as the limits which determine "safe" levels of budget deficit and public debt. Among the Wyshegrad Group countries the most unfavourable situation is faced by Poland and Hungary. Adopting, however, the thesis that these budgetary difficulties are a result of the pace and depth of reforms being carried out, a deterioration of the state of public finances in the Czech and Slovak Republics, where the process of microeconomic restructuring seems to be delayed in comparison with the remaining two countries[26], can be expected.

3. The Scope of Fiscal Re-distribution

The centrally planned economies were characterized by a very wide scope of budgetary re-distribution[27]. This was a derivative of the philosophy of the functioning of a "command-and-distribute" economy, in which the means of production means were primarily State-owned, and prices were subject to administrative control. All decisions concerning production, consumption, and the allocation of resources were mostly centrallized. Implementing the allocative function of the State consisted in directing the resources to industrial sectors of key importance. At the same time, a method of internal (intra-industrial) subsidizing of certain types of manufacturing (desired from the planning point of view) was applied. The re-distributive function (a stipulation for a socially equitable income distribution) was being exercised (at least theoretically) through State allocation of grants-in-aid to housing, communication, health care, education and basic consumption goods, as well as through an expanded system of social insurance. The rates of money wages of people employed in the public sector were low and insignificantly differentiated. These individuals, however, received a number of non-cash fringe benefits (such as access to cheaper, subsidized goods and services - institutional apartments <i.e. apartments built by an institution for its employees>, institutional shops, holidays organized and partially or fully financed by the institution, etc.,).

In the process of the pro-market transformation of the economy, a reduction in the State's role[28], both in respect to its direct participation in the economic process and the magnitude of the redistribution of Gross National Product, (which will make possible the

[26] This issue is of controversial character, and in particular with regard to the Czech economy. Against initial sceptical opinions (concerning, for example, coupon privatization) exposing the shortcoming of microeconomic restructuring (see: Klacek and Hrncir, 1995) the effects of reforms seem to have turned out in the Czech Republic better than expected, to which the inflow of foreign capital has probably contributed.

[27] For more information on the role of public finance in centrally planned economies, see: Chand and Lorie (1992) as well as Barbone and Marchetti (1994).

[28] It is a kind of state "metainterventionism" - the State acts in full consciousness to self-limit the role it plays in the economy and to reintroduce market mechanisms; to find out more about the controversies around the term "state interventionism" see: Wojtyna (1990, p.16-26).

transfer of decisions concerning the allocation and the value, as well as the structure, of consumption, from the state sector to the private sector) is necessary. To this point the results are not satisfactory. The relation of budget receipts to GDP in all countries of the Wyshegrad Group (see Table 4) was, in 1993, higher than the average recorded for the EU countries. In addition, it should be emphasized that the situation in the EU countries cannot be treated as a model - as previously shown, the level of budgetary re-distribution taking place in these countries is estimated as excessive, and one specific fiscal policy aim (being pursued without success) since the beginning of the 1980's has been to reduce it.

Furthermore, it is important to focus attention on the differences in the level of economic development and wealth of the countries of the Wyshegrad Group and the European Union. An observation of developed market economies points to the existence of a long-term upward tendency in the size of the public sector, often described as Wagner's right[29] (hypothesis) according to which state expenses grow at a faster pace than economic growth. The causes of this phenomenon are not completely known[30], and the attempts to explain it mostly focus on political, social and institutional conditions affecting the increase in state expenditures. Wagner assumed that an increase in state expenditure together with an increase in society's wealth encountered the barrier of social acceptance of the level of taxation. The difficulties in balancing the State budget in developed market economies, observed over the last 15 years, seem to be proof of the existence of this barrier.

[29] Put into words in the 1880s.

[30] For a review of the concepts explaining the phenomenon of public sector growth, see: Wojtyna (1990, p.147-153).

Table 4. The size of budgetary re-distribution versus GDP level in 12 European Union and 4 Wyshegrad Group countries in 1993.

Country	GDP per capita a)	Budget expenditures in relation to GDP (%)	Budget revenues in relation to GDP (%)
Belgium	21650	56.0	49.4
Denmark	26730	62.0	57.6
France	22490	55.4	49.6
Greece	7390	48.0	34.6
Spain	13590	49.3	41.8
Holland	20950	56.8	53.5
Ireland	13000	41.2	38.7
Luxembourg	37320	53.5	54.6
Germany	23560	49.7	46.4
Portugal	9130	44.2	37.0
G. Britain	18060	43.5	35.8
Italy	19840	56.2	46.7
EU 12		**51.3**	**45.5**
Poland	2260	48.7	45.8
Hungary	3350	58.8	52.3
Czech Republic	2710	49.7	48.8
Slovak Republic	1950	53.6	50.7

a) in US dollars, current prices

Source: World Development Report 1995. Workers in an Integrating World, s. 163 and 228; Annual Economic Report for 1995, European Economy No. 59, 1995; World Bank Statistics; MultiQuery Database: A Tool for Cross-Country Comparison. Prepared by Nancy Vandycke under the Supervision of Luca Barbone. Spring 1995 Update - March 15.

The level of wealth in post-socialist countries examined, as measured by the size of GNP *per capita*, is several times lower than the level recorded in the EU countries. Therefore, fiscal re-distribution observed in relatively poor countries must be considered excessive. A determination of the optimal size of re-distribution would always be arbitrary, since it is connected with the ongoing debate on the role of the State in the economy.

Utilizing, however, the experience of European countries possessing long-term market economic structures, one may conclude that the level of fiscal re-distribution in post-socialist countries should amount to 30% - 40% of GDP[31]. Such values were observed in countries of the European Union in the years 1950 and 1960, i.e. over the period when the level of GDP per capita was comparable with the level that is currently being achieved in the Wyshegrad Group countries[32]. It indicates the necessity to continue activities aimed at reducing State expenditures, which would ease the fiscal burden of these economies.

[31] See: Wierzba (1993) and Gomułka (1995).

[32] It must be noticed, however, that West European countries, where the evolution of public finances has led to an excessive budgetary re-distribution and the crisis of the Welfare State, do not have to serve as a pattern for post-socialist countries. According to Prof. J. Sachs, the acceleration of the pace of economic growth - necessary to decrease the distance between these countries 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 re-distribution level is much lower than in European countries (state expenditures in Hong Kong account for 14% of GDP, in Korea 17%).

4. The Structure of Budgetary Revenues and Expenses

Given the excessive degree of fiscal burden in post-socialist economies, it is interesting to compare the structure of budgetary revenues of these countries with the structure observed in the countries of the European Community (Table 5).

The existing structure of budgetary revenues within EU member-states constitutes, on one hand, the result of the multi-year 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 these systems' harmonization - the process accompanying the creation of a single economic system. Since the beginning of the 1980s, activities were undertaken, the purpose of which was to reform national fiscal systems by reducing their complexity, so that they would have as little impact as possible on the rationality of economic decision-making, and more fairly distribute among society the financial obligations of the state. At the same time, the ongoing process of integrating separate national economies within the European Union - 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 favourable taxation conditions.

The existence of the common market primarily requires the harmonization of VAT systems. Among the EU countries, VAT was most recently introduced (in the 1980's) in Greece, Portugal and Spain. Currently, the method of determining the tax base for VAT has already been unified. Since January, 1993, pursuant to a European Council decision, a minimum VAT rate equal to 15% is obligatory; the minimal rates for the main excise taxes have also been defined. Competitive conditions since the time when tax limitations were abolished (since 1993) are resulting in attempts being made in individual countries to improve their budgetary positions through an increase in VAT rates, attempts which have outlived their usefulness. Despite the fact that no decisions concerning harmonization of tax systems (systems of personal income and enterprise profit taxes; as well as the system of social insurance) have yet been made, a declining tendency (within Community countries a tendency to equalize rates) in the rates of those taxes has been observed since the beginning of the 1980s[33].

[33] In order to prevent budgetary losses, activities were also implemented which attempted to extend the tax base, primarily through limiting various allowances.

Table 5. Government budget current revenues in relation to GDP (in %) in 11 European Union (1993) and 4 Wyshegrad Group countries (1994).

	Belgium	Denmark	France	Greece	Spain
Total current revenues	50.6	57.3	48.9	38.4	41.7
1. Taxes	29.6	47.7	23.6	24.5	22.2
1.1. Direct taxes	16.9	30.5	9.1	5.8	11.9
Enterprise income tax	3.0	2.1	2.0	1.7	2.7
Natural person income tax a)	13.6	26.0	6.0	4.0	8.1
1.2. Indirect taxes	12.7	17.2	14.5	18.7	10.3
VAT a)	7.2	9.7	7.9	8.5	5.4
2. Social insurance premiums	19.0	2.8	21.4	11.1	14.4
3. Other current revenues	2.0	6.7	3.9	2.8	5.1
	Holland	Ireland	Germany	Portugal	G. Britain
Total current revenues	53.7	40.0	47.1	36.9	35.8
1. Taxes	29.8	31.9	24.8	21.9	27.4
1.1. Direct taxes	16.9	16.1	11.7	9.0	11.6
Enterprise income tax a)	3.5	1.3	1.7	3.2	4.0
Natural person income tax a)	9.7	11.9	10.6	6.3	10.4
1.2. Indirect taxes	12.9	15.8	13.1	12.9	15.8
VAT a)	7.5	8.1	6.4	6.8	6.0
2. Social insurance premiums	18.9	5.7	19.1	10.2	6.1
3. Other current revenues	4.9	2.4	3.2	4.7	2.3
	Italy	Poland	Hungary	Czech Rep. b)	Slovak Rep.
Total current revenues	46.7	44.9	50.9	49.0	50.7
1. Taxes	28.0	29.1	29.4	28.5	29.1
1.1. Direct taxes	16.1	12.9	9.2	10.9	11.4
Enterprise income tax a)	4.0	3.3	1.9	7.7	8.0
Natural person income tax a)	10.4	9.6	7.3	3.2	3.4
1.2. Indirect taxes	11.9	16.2	20.2	17.6	17.7
VAT a)	6.1	12.4	7.7	7.6	9.3
2. Social insurance premiums	15.3	10.3	12.4	15.4	11.9
3. Other current revenues	3.4	5.5	9.1	5.1	9.5

a) Data for European Union countries for 1991. b) Data for the Czech Republic for 1993

Source: European Union countries: Italianer and Ohly (1994), de Haan, Sterks and de Kam (1994); Wyshegrad Group countries: World Bank Statistics; *MultiQuery Database: A Tool for Cross-Country Comparison.* Prepared by Nancy Vandycke under the Supervision of Luca Barbone. Spring 1995 Update - March 15.

The greatest divergence in the amount of budgetary revenues within EU countries concerns social insurance premiums, the highest share of which is observed in France (21.4% of GDP), with the lowest in Denmark (2.8% of GDP). In Denmark, however, a majority of social contributions is financed directly out of tax proceeds - therefore it has the highest ratio within the EU of the size of direct tax proceeds (above 30% of GDP). The differentiation in the value of social insurance premiums collected results from variations existing within the systems of their financing, as well as from differences in the degree to which the State fulfills its welfare functions.

The countries of the Wyshegrad Group have introduced taxation systems compatible with the European Community Directives[34]. Data contained in Table 5 point to an apparent similarity of the budget revenue structure in both groups of countries. Indirect taxes assume the largest share of budget revenues generated in post-socialist economies, which should be positively assessed[35], both from the viewpoint of ease of collection (they do not require a tax authority as efficient as in the case of income taxes) and from the perspective of how they affect allocation decisions and the propensity to save.

The share of social insurance premiums in the Wyshegrad Group countries' budgetary revenues does not diverge from the proportions observed in the EU countries. However, the fact that the division of obligatory premiums between employers and employees constitutes a general principle adopted in the western countries is important to point out. To this point the insurance premiums are paid, in Poland, exclusively by employers. It suggests that apart from taxes, employers must pay very high (48% together with a 3% premium for the Unemployment Fund) quasi-taxes on wages, which radically changes the evaluation of the levels of fiscal burden in the economy. Such a situation creates strong incentives to escape to the gray area of the economy, which brings budgetary losses.

Given the existing degree of tax burden in post-socialist countries which is excessive in relation to their level of development and (wealth), there is no possibility to increase budgetary revenues through an increase in tax rates. Some reserves are likely to lie in facilitating more efficient work of the tax authority. although this alone does not seem to be enough to restore balance to the state budget. Achieving this balance requires cuts in state expenditures.

Table 6 provides data on the structure of budgetary expenses in the countries analyzed. They indicate that post-socialist countries, in their short history of reintroducing market mechanisms, did not manage to avoid the trap in which western economies happen to be in - the trap of the welfare State.[36] State expenses - almost exclusively current expenses - are financing widely understandable consumption. The successes in radically eliminating

[34] Hungary was the first country to introduce personal income tax and VAT - in 1988. In the Czech and Slovak Republics the aforementioned taxes were introduced in 1993, and in Poland personal income tax was implemented in 1992 while VAT in July 1993. In 1995, the tax rates were the following:

* on enterprise profits: Poland 40%, Hungary 36%, the Czech Republic 41% and the Slovak Republic 42%;
* on natural person income: Poland 21-45%, Hungary 20-44%, the Czech Republic 15-43%, the Slovak Republic 15-42%;
* VAT: Poland 22 & 7%, Hungary 25 & 10%, the Czech Republic 22 & 5%, the Slovak Republic 25 & 6%.

[35] See: Wierzba (1993) and Gotz-Kozierkiewicz (1993).

[36] 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;* quote see: Kornacki (1996).

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 was lower than what was possible to achieve under the circumstances of social approval for the reforms. The most unfavorable situation is faced by Poland and Hungary. In both countries, due to errors made in social policy (a delay in social insurance system reform), State expenses are primarily composed of social spending, with a huge share taken up by pension benefits. In the countries of former Czechoslovakia the situation seems to be slightly better, although the level of state expenses is much too excessive in relation to the level of economic development[37].

Table 6. Government budget expenditures in relation to GDP (in %) in 11 European Union (1993) and 4 Wyshegrad Group countries (1994).

	Belgium	Denmark	France	Greece	Spain
Total government expenditures	57.7	61.9	54.7	54.7	48.9
1. Current expenditures	55.4	58.9	51.0	51.7	43.6
- current transfers	28.9	25.3	28.1	15.7	21.6
- public debt service	11.1	7.6	3.7	16.2	4.8
2. Capital expenditures a)	2.3	3.0	3.6	3.0	5.3
	Holland	Ireland	Germany	Portugal	G. Britain
Total government expenditures	56.6	42.3	50.4	43.9	43.5
1. Current expenditures	53.6	40.7	46.2	39.7	40.8
- current transfers	32.8	17.6	22.8	15.7	16.0
- public debt service	6.3	6.8	3.4	6.7	2.9
2. Capital expenditures a)	3.0	1.6	4.2	4.2	2.7
	Italy	Poland	Hungary	Czech Rep. b)	Slovak Rep.
Total government expenditures	56.2	48.7	58.8	48.5	53.6
1. Current expenditures	52.6	45.6	53.5	41.8	48.3
- current transfers	22.9	21.5	24.3	19.3	21.8
- public debt service	12.0	4.4	6.8	1.6	4.4
2. Capital expenditures a)	3.6	3.1	5.2	6.7	5.2

a) Investment expenditures and net capital transfers are included in capital expenditures of European Union countries.
b) Data for the Czech Republic for 1993.
Source: European Union countries: Italianer and Ohly (1994), Wyshegrad Group countries: World Bank Statistics; *MultiQuery Database: A Tool for Cross-Country Comparison.* Prepared by Nancy Vandycke under the Supervision of Luca Barbone. Spring 1995 Update - March 15.

5. Summary

- Specific conditions affecting the budgetary position of economies in pro-market transition result that fiscal criteria referred to in the Maastricht Treaty cannot be

[37] It is worth adding that the effectiveness of state expenses in post-socialist countries is considered less than in the majority of economies having a permanent market structure; see: Fakin and de Crombrugghe (1995).

treated, in the case of these countries, as the limits which determine a safe level of budgetary deficit and public debt;

- The scope of budgetary re-distribution in relatively poor post-socialist countries is too excessive;
- The structure of budgetary revenues in Wyshegrad Group countries approximates the structure existing in EU countries; in both groups of countries there are barriers to increasing tax rates;
- The structure of budgetary expenses in post-socialist countries, with a large share of the expenses going towards financing public consumption, indicates consolidation of the fiscal crisis in a form of a welfare State crisis;
- The recovery of public finances in these countries requires a radical cut in state expenses, of which a necessary condition is the reform of the social insurance system and a greater market orientation within the social services sphere.

Appendix: A Review of the Fiscal Situation in EU Countries

(based on materials of the European Commission)

BELGIUM

The main cause of fiscal difficulties in this country (in 1994, gross public debt exceeded 140% of GDP) lies, according to observers, in a social insurance system which operates on a consultation basis between the government and social partners. Although this system is assumed to be financed with contributions, nevertheless, in practice, the assurance of fixed payments requires considerable subsidy from the central budget, which hinders the ability of balance the state budget and increases public debt.

The possibilities for growth in budgetary revenues are limited (taking competitiveness into account); only excise tax rates are lower in comparison with other EU countries. Limited progress is possible by making the system of tax collection more effective and extending the tax base. It is necessary to reduce state expenses in order to balance the budget. A reduction of tax administration operating costs and making health care system more market-oriented are included among the sources of savings as well. As far as social insurance is concerned, the elimination of the possibility of early retirement and lowering unemployment expenses are also considered to be sources of saving. The limitation of subsidies for enterprises primarily associated with pension and health insurance funds in the coal industry and the railways can also be treated as a kind of reserve.

DENMARK

In the beginning of the 1980s public debt increased rapidly, from 39.9% of GDP in 1980 to 79.8% of GDP in 1984. The main cause of this was a large growth in the public sector employment level, as well as development of State social programs. The adoption of a restrictive trend in fiscal policy led to a reduction in the relation of public debt to GDP, to a level equal to 66.4% in 1989. This was, however, a short-term success - since the end of the 1980s, expenditures have been rising. There has been an increase in expenditures for family benefits. Because of a reduction in working hours, the level of employment (and wages) has grown in the public sector. The expenses of local authorities have also increased. The necessity to protect the environment has caused an increase in state investment expenditures. As a result, in 1994 state budgetary expenses reached 62.5% of GDP while public debt amounted to 78% of GDP. In light of the fact that the fiscal burden of the Danish economy is the largest within the EU countries (in 1994, budgetary revenues accounted for 58.3% of GDP) the only way to consolidate the budget is to reduce budgetary expenses, mainly those related to the social insurance system and fulfillment by the State of its "welfare" functions; it is consider to be of great importance to reduce unemployment benefits (both through decreasing the benefits' level and shortening the time within which they are received by unemployed people). According to experts there are additional possibilities for reductions in defence, educational, cultural and housing spending;

furthermore, it is postulated to diminish subsidies (being relatively high in comparison with other countries) channelled primarily to the public transportation sector and construction associations.

FRANCE

In 1991, when the Agreement on the European Union was being prepared, France was one of three countries (besides Luxembourg and Great Britain) which had met both fiscal convergence criteria. Since then, the situation has worsened. The public debt (which increased from 35.5% of GDP in 1991 to 50.4% of GDP in 1994) has remained below the limit, while the budget deficit, amounting to 5.6% of GDP in 1994, significantly exceeds this limit (in 1991 it accounted for 2.25% of GDP). Such an evolution in the budgetary position is, in great part, a consequence of cyclical economic factors (a reduction in the level of economic activity). It is important, however, to take some steps of a structural character in order to balance the budget in the long-run. As far as budgetary revenues are concerned there are some opportunities for increasing excise and income tax proceeds; according to experts, reserves lie in the growth of social insurance contributions. However, the events of 1995 reveal that these reserves are extremely difficult to put into operation; the only advice for an inefficient state system of social insurance seems to be to increase its market orientation. This purpose, however, due to existing social conditions is very difficult to realize. As far as budgetary expenses are concerned, reduction of personal expenses in the public sector is being recommended.

GREECE

The last 15 years have been a period of steady deterioration of the fiscal situation in Greece. It is worth noticing that since 1985, the budgetary deficit, which in 1980 accounted for 2.4% of GDP, has continued (except for 1987) to exceed 10% of GDP; in 1994 it was equal to 14.1% of GDP. Finally, due to the accumulation of annual deficits, Greece's public debt has risen from 28.8% of GDP in 1980 to 121.3% of GDP in 1994). The existence of political business cycle (accompanied by increases in state spending and decreases in tax rates in pre-election periods) and the strong engagement of the State in the economy (nationalization of main industrial branches) as well as growth of public administration, are listed among the causes of such a fiscal situation. The upward pressure on public sector salaries and the growth in expenses connected with the State performing its "welfare" functions are the main reasons why it is impossible to check the growth in budgetary expenses (from 27.6% of GDP in 1980 to 49.9% of GDP in 1994). The Greek economy has also faced other phenomenon, namely tax payment evasion. Facilitation of tax administration activity, mainly the activities aimed at reducing the scope of the State's function in the economy, are recognized to be one of the solutions leading to consolidating the budget and halting the growth of internal indebtedness; it seems to be necessary, however, to introduce strict budget cuts for state enterprises. Privatization of a portion of these enterprises could contribute to a reduction in the size of the public debt.

SPAIN

The state of public finances in Spain is connected with the political events of the second half of the 1970s. The overthrow of Franco's dictatorship, the return of democracy, the liberalization of political life and the willingness to prevent social confrontation have constituted a strong stimuli for development of the welfare State function. Despite the change in the direction of fiscal policy which aimed to limit the State's participation in the economy in 1980's, the public debt has exhibited a growing tendency - in 1980 it amounted to 17.5% of GDP while in 1994 it reached a level equal to 63.5% of GDP, thus the level exceeding the limits provided under the Maastricht Treaty; since 1990, the size of the budget deficit has been exceeding the limit of 3% of GDP.

The problem of balancing the budget and checking the growth of internal debt cannot be solved through an increase in taxation levels (aspects of competitiveness); it is emphasized, however, that when there is a tendency to evade taxes, an improvement in methods of tax collection could bring fruitful results in the form of a growth in budgetary revenues. The purpose of budgetary consolidation cannot, however, be achieved without diminishing government expenditure which requires, according to experts, carrying out deep structural reforms in public social services and the social insurance system. The currently existing structures do not prevent the appearance of several abuses, primarily those related to retiring pensions, disability benefits, unemployment benefits and health care expenses.

HOLLAND

In Holland, the post-war period was characterized by a gradual expansion of the functions and institutions of the welfare State, which was reflected by a strong increase both in government spending (in particular, in transfers for households) and in the taxation level. In the second half of the 1960s the scope of fiscal re-distribution recorded in Holland was the highest among EU countries. During the period of 1962-1980, only in one year (1973) a budget deficit was not recorded. Those phenomena have resulted in a situation that as the chief trend of macroeconomic policy was being changed at the beginning of the 1980s, radical activities were adopted which were aimed at reducing the growth of government expenditures, and also improving the budget through an increase in revenues (increase in social insurance contributions, VAT rates, excise and income tax rates). As a consequence, the state budget deficit was scaled down from 7.1% of GDP in 1982 to 2.9% of GDP in 1991. Due to the existence of the cyclical factor, in the succeeding years the deficit increased - in 1994 it accounted for 3.8% of GDP. Gross public debt notably exceeds the limit of 60% of GDP - in 1994 it amounted to 78.9% of GDP, however it is characterized by substantial stability (within 1974-1986 the average size of debt accounted for 73.5% of GDP). A continuation in the recovery of public finances under the conditions of a broad scope of fiscal re-distribution (in 1994, budgetary revenues amounted to 52.1% of GDP) depends on further decreases in government expenditures. Like in other EU countries, this refers mainly to social insurance and the functions of the welfare state (the excessive generosity of the State and the possibility for abuses in the sphere of granting sickness benefits and disability benefits are singled out here).

IRELAND

The evolution of the fiscal position in Ireland can serve as an example of success in pursuing the strategy of public finance recovery. In 1992, the budget deficit amounted to 13.2 of GDP, in 1986 10.6% of GDP (within 1974-1986, its average value was 10.5% of GDP). Therefore, the traditions of deficit spending were strongly established, which was reflected in the size of public debt - within the 1974-1986 it averaged 116% of GDP. In 1987, the programme for recovery of state finances (*Programme for National Recovery)* was prepared and implemented. Government expenditures were cut - among other ways, through a price freeze in the public sector together with establishing limits for increases in employment. It is worth noticing that treatment in hospitals has been provided against partial payment. An increase in budgetary revenues has been achieved thanks to the suspension of the indexation of tax intervals, the announcement of tax amnesty, as well as improvement in tax collection methods. The strong position of the market (the positive impact of cyclical factors) was conducive to the success in realizing the programme. As a result, the budget deficit was lowered to 1.7% of GDP in 1989; in succeeding years, due to recession, it slightly increased, but did not exceed the level of 2.5% of GDP between 1990-1995. It is worth noticing that such a strong reduction of the deficit has occurred without any increase in the scope of fiscal re-distribution - the relation of budgetary revenues to GDP fell from 41.2% of GDP in 1986 to 38.5% of GDP in 1991. Together with budget consolidation, a reduction of the relation of public debt to GDP - from 116% in 1986 to 89% in 1994 - took place. This value, however, is still higher than the limit provided for under the Maastricht Treaty. The perspectives for balancing the budget and further reducing the internal debt ratio are, according to observers, promising. There are some possibilities, on the budgetary revenue side, to increase income tax proceeds from enterprises (a rate rise and increase in the tax base) and from natural persons (reduction of numerous allowances and exemptions). A continuation of a restrictive wage policy in the public sector can also contribute to spending reductions.

GERMANY

In 1994, Germany met both fiscal convergence criteria, although the state of public finances over the last few years has deteriorated, partially owing to the recession of the early 1990s, but primarily due to the implications of the unification process. The necessity to increase financing for new Lands in the form of investment in infrastructure, replenishment of local authorities' budgets and an increase in social benefits (arising from the growth in unemployment) have resulted in an increase in the relation of budgetary expenditure to GDP financed by an increased fiscal burden to the economy. As a result, in 1994 the level of fiscal re-distribution in Germany reached its historical peak - budgetary revenues amounted to 46.6% of GDP, while expenditures were 49.4% of GDP. Since 1991, the budgetary deficit has been fluctuating around the 3% GDP limit (exceeding it in 1991 and 1993 by 0.3% of GDP); due to an accumulation of annual deficits, gross public debt went up from 41.5% in 1991 to 51% of GDP in 1994 (59.45% of GDP in 1995). The perspectives for balancing the budget in Germany seem to be relatively far from being implementable, which means basic difficulties with maintaining the size of public debt below 60% of GDP. The currently existing fiscal burden on the economy, as well as aspects of international competitiveness, act as barriers to further tax increases (according to experts, small reserves lie in the possibility to increase VAT and excise rates). As far as budgetary expenses are concerned, it is postulated to reduce the expenses in public social services, through decreasing the employment level in the public sector and introducing a firmer wage discipline; in order to lower health care expenses it is necessary to make this sector more market-oriented.

PORTUGAL

As in the case of Spain, Portugal's budgetary position is being associated with the consequences of political events of the 1970s. After the April revolution of 1974, the State has strongly engaged in the expansion of the system of public social services, developing at the same time its welfare-related functions. This concerned the systems of education, health care and social benefits, since in these areas Portugal was far behind the remaining European countries. In 1975, a significant portion of industry was nationalized. The effect was a rapid growth in state budgetary expenses which doubled their value from 23.3% of GDP in 1973 to 46.6% of GDP in 1984. A simultaneous increase in budgetary revenues over that period (from 24.9% of GDP to 34.6% of GDP) was insufficient to prevent a growing budget deficit which in 1984 reached 12% of GDP. In the second half of the 1980s, while the position of the market was favourable, an improvement of the budgetary position was noted (in 1989, the deficit amounted to 3.4% of GDP). Nevertheless, in the early 1990s the deficit showed an upward trend. Balancing the budget through an increase in revenues seems to be extremely difficult. In Portugal, the relation of budgetary revenues to GDP is relatively low in comparison with other EU countries, however the scope of fiscal re-distribution should be viewed against the wealth level of a given economy. Portugal is a relatively poor country (a similar situation is noted in Greece - see Table 4) which marks the earlier emergence of a barrier to the further growth of taxation. Beside the possibility of increasing certain excise tax rates, the only reserves noted on the revenue side lie, according to experts, in expanding the taxation basis and improving tax collection. An introduction of partial payment for health care and education services would also benefit the budget. Finally, a wider scope of privatization activities would reduce the value of the State's current debt needs, contributing at the same time to an increase in economic efficiency.

GREAT BRITAIN

Until the end of 1970, the macroeconomic policy of Great Britain was carried out in compliance with the idea of functional finances, the essence of which was to steer the size of total demand (mainly with fiscal instruments) in order to achieve desired production and employment targets. After the political elite had changed, the goals of this policy were radically modified in 1979 - the fight against inflation and the limitation of the State's role through privatization, liberalization and deregulation became top priorities. The fiscal restriction have brought about distinct effects - i.e. the state budget deficit which between the years 1971-1980 on average amounted to 3.2% of GDP (1981 4.05% of GDP), was significantly reduced through the 1980s - in 1988 even a slight surplus was registered (equal to 0.1% of GDP). The scope of fiscal re-distribution decreased - between 1981-1989 the relation of budgetary revenues to GDP fell, from 41.7% to 38.6% but also expenditures, from 45.7% to 38.6%. The public debt decreased from 55.7% of GDP in 1984 to 35.3% of GDP in 1990. Since 1989, however, the fiscal situation in Great Britain has been deteriorating - in 1993 the budget closed with a deficit of 7.7% of GDP. It was undoubtedly connected with the functioning of the cyclical factor under a reduced level of economic activity. Taking into account the opinion of the OECD Secretariat[38] according to which the cyclical factor is responsible for half of the British budget deficit at most, this would mean that it is important to take restrictive steps under fiscal policy in order to bring the size of the deficit below 3% of GDP.

ITALY

In the history of the Italian economy, since 1960 the state budget has always ended with a deficit. Between 1961-1970, the deficit amounted to, on average, 2.3% of GDP, between 1971-1980 7.6% of GDP, and between 1981-1990 11.2% of GDP. Public debt exceeded the value of GDP in 1991. In 1994, the deficit accounted for 9.6% of GDP, and public debt 123.7% of GDP. According to European Commission experts, radical, deep and real changes in the structures of national authority leading to the removal of ties of interest and reforms of administrative apparatus are a necessity to improve the budgetary position. Budgetary revenues are reduced by the frequently occurring phenomenon of tax evasion; thus the tax burden carried by entities which pay the taxes is considered excessive. A growth in tax rates can not, therefore, result in increased budgetary receipts (Laffer's curve). It is not necessary to improve the activity of tax administration. As regards budgetary expenses, it is of great importance to reform public social services and the social insurance system in order to eliminate waste, abuses and corruption.

[38] See: OECD Economic Outlook, no 53 (June 1993).

Table A1. Changes in the structure of the type of government expenditures in European Union countries in decade of 1980 (in % of GDP).

	Belgium			Denmark		
	1979	1990	Change	1979	1990	Change
Total current expenditures	53.3	52.6	-0.6	48.9	55.3	6.5
consumer's	17.6	14.2	-3.4	25.0	24.7	-0.3
subsidies	4.5	2.9	-1.6	3.2	3.0	-0.3
social insurance and other transfers	25.9	24.8	-1.1	17.1	20.5	3.3
public debt service	5.3	10.7	5.5	3.5	7.2	3.7
Investment ependitures	3.6	1.3	-2.3	3.8	2.0	-1.8
Net capital transfers and other net trasfers[a)]	1.2	0.7	-0.5	0.6	0.3	-0.3
Total	58.1	54.7	-3.4	53.2	57.6	4.4
	France			Greece		
	1979	1990	Change	1979	1990	Change
Total current expenditures	41.4	46.6	5.2	29.7	51.0	21.1
consumer's	17.6	18.3	0.7	16.3	21.9	5.5
subsidies	2.0	1.6	-0.3	2.3	1.8	-0.5
social insurance and other transfers	20.4	23.5	3.1	8.9	16.1	7.2
public debt service	1.4	3.1	1.7	2.2	11.2	9.0
Investment expenditures	3.1	3.3	0.2	3.2	2.9	-0.3
Net capital transfers and other net transfers[a)]	0.5	0.3	-0.2	0.0	0.0	0.0
Total	45.0	50.2	5.2	32.9	53.9	21.0
	Spain			Holland		
	1980	1990	Change	1979	1990	Change
Total current expenditures	29.3	35.5	6.1	51.3	52.3	1.0
consumer's	12.5	14.2	1.6	18.1	14.9	-3.2
subsidies	2.0	1.6	-0.5	1.3	1.6	0.3
social insurance and other transfers	14.0	16.1	2.1	27.6	29.1	1.5
public debt service	0.7	3.6	2.9	4.2	6.7	2.5
Investment expenditures	1.8	4.7	2.9	3.1	2.3	-0.8
Net capital transfers and other net transfers[a)]	1.4	1.3	-0.1	1.5	1.8	0.3
Total	32.5	41.5	9.0	55.8	56.3	0.4

	Ireland			Germany		
	1979	1990	Change	1979	1990	Change
Total current expenditures	41.6	43.5	1.8	42.4	42.3	0.0
consumer's	18.1	14.6	-3.5	19.6	18.5	-1.1
subsidies	3.8	4.4	0.6	2.2	1.9	-0.3
social insurance and other transfers	14.0	16.4	2.4	18.9	19.3	0.4
public debt service	5.8	8.0	2.2	1.7	2.6	1.0
Investment expenditures	4.2	1.3	-2.9	3.2	2.3	-1.0
Net capital transfers and other net transfers[a)]	1.1	0.0	-1.0	2.0	1.2	-0.7
Total	46.8	44.5	-2.3	47.6	45.8	-1.8
	Portugal			**Great Britain**		
	1979	1990	Change	1979	1990	Change
Toal current expenditures	31.2	40.2	9.1	39.2	38.1	-1.1
consumer's	13.9	19.7	5.9	19.7	20.0	0.3
subsydies	4.5	1.5	-3.0	2.4	1.1	-1.3
social insurance and other transfers	10.0	10.5	0.5	12.8	13.7	0.9
public debt service	2.9	8.6	5.8	4.4	3.4	-1.0
Investment expenditure	3.8	3.4	-0.4	2.6	2.1	-0.5
Net capital transfers and other net transfers[a)]	1.2	-1.0	-2.3	0.7	-2.9	-3.6
Total	36.2	42.7	6.5	42.5	42.9	0.3

	Italy		
	1980	1990	Change
Total current expenditures	37.7	48.3	10.6
consumer's	14.7	17.4	2.7
subsydies	2.9	2.2	-0.6
social insurance and other transfers	14.8	18.9	4.1
public debt service	5.3	9.7	4.4
Investment expenditure	3.2	3.5	0.4
Net capital transfers and other net transfers[a)]	0.9	1.4	0.5
Total	41.7	53.2	11.5

a) purchase of land and concealed assets

Source: Oxley, Martin (1991, s. 158-159).

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