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**Malgorzata Antczak**

**Do Acceding Countries Need Higher Fiscal Deficits?**

*Warsaw, November 2003*

Materials published here have a working paper character. They can be subject to further publication. The views and opinions expressed here reflect the author(s) point of view and not necessarily those of the CASE.

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## Abstract

The paper outlines the probable fiscal consequences of the accession process for the candidate countries and presents specific, fiscally sensitive aspects of *acquis communautaire* adoption. Apart from membership contribution fees, enlargement-related expenditures, never financed from the budget before, may additionally influence a public expenditure increase and a further deterioration of fiscal deficit to a level exceeding current values. To estimate the future **net fiscal positions** of acceding countries, the paper calculates the **net financial position** of each acceding country as a net gain from the negotiated EU transfers. The net financial position illustrates the net effect of the transfer flow to a given acceding country (including the government sector and other beneficiaries of the EU assistance) and from that country into the EU budget. The net fiscal position represents the net effect of accession on the government sector with the consideration of EU transfer flows to that sector, accession-related expenditures from the budget, as well as the positive fiscal effects of accession. The paper discusses the crucial issue in assessing the net fiscal position in the AC-10, namely the fact that negotiated transfers barely cover the latest and major budget obligations.

## Introduction<sup>1</sup>

The legislation of the EU does not directly regulate budget procedure in the new Member States. However, acceding countries need to take on board various new and important budgetary and financial provisions. After accession, the acceding countries will face additional pressures to increase expenditures associated with EU integration. This pressure, furthermore, is likely to outweigh financial benefits (from EU transfers, for example), especially in the early stages of their membership.

New financial provisions require the establishment and implementation of budgets based on the following two principles: one, that the annual budgetary deficits of the government sector (central budget and local governments) do not exceed 3 percent of GDP; two, that over the medium-term perspective, the general government sector revenues and expenditures should be kept close to balance or in surplus<sup>2</sup>. These requirements are in line with both the Maastricht criteria and Stability and Growth Pact which is binding on all Member States.

The main objective of this paper is to outline the likely key fiscal consequences of candidate countries' accession. One should bear in mind that there are many uncertainties as to the future fiscal stance of the new Member States and that the actual costs of accession are not easy to estimate.

A number of Pre-Accession Economic Programs, most of which came into existence in 2002, are somewhat short on concrete policy commitments that could credibly underpin medium-term fiscal consolidation. Most do not stress to a sufficient extent the efforts required to correct existing imbalances or to meet the potential costs of structural reform. Moreover, the National Development Plans (published at the beginning of 2003 and reviewed in July 2003 by the European Commission) fail to tackle in any detailed way the financial consequences of implementing the necessary structural reforms and other enlargement-related expenditures<sup>3</sup>.

After the Copenhagen Summit in December 2002, some significant uncertainties about the size of net gains from negotiated transfers to the acceding countries persist. Two issues with regard to future fiscal positions are crucial: one, it is still not decided how much of the transfers may fuel the general government (and how much will be directed to other recipients of EU assistance); two, it is not yet known how much of the transfers it will be possible to absorb in practice. A modest absorption of EU financial sources threatens not only the budget, but the whole

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<sup>1</sup> The author is grateful for their comments to Pawel Samecki from the National Bank of Poland and Sandor Richter from the WIIW (Vienna Institute for International Economic Studies).

<sup>2</sup> Avoidance of excessive government deficits and adherence to the relevant provisions of the Stability and Growth Pact are also required (Art. 104, title VII of the EC Treaty and the other EMU acquis).

<sup>3</sup> In a further follow-up, in its comprehensive monitoring report into structural reform to be published in November 2003, and in its Lisbon reports for the Spring European Council, the European Commission is invited to devote particular attention to the most urgent challenges identified in the report. Enlargement will be a special subject in the Economic Policy Committee (EPC) Annual Report on Structural Reforms in 2004.

economy as well. Moreover, it is very important to distinguish between planned and actual transfers. Commitment appropriations and payment appropriations are both planning categories.

In order to estimate the future **net fiscal positions** of acceding countries, this paper calculates the **net financial position** of each acceding country (as a net gain from negotiated EU transfers). The net financial position illustrates the net effect of the flow of transfers to a given acceding country (including the government sector and all other beneficiaries of EU assistance) and from that country into the EU budget. The net fiscal position represents the net effect of accession on the government sector, taking into consideration EU transfer flows to the government sector, accession-related expenditures coming out of the state budgets, as well as some positive fiscal effects of accession.

Enlargement-related expenditures are consequences of the adoption of specific, fiscally sensitive, *acquis communautaire* in the fields such as environmental protection, infrastructure, public administration reform, etc. Apart from the membership contribution fee, these expenses (which have never been financed from the budget before) can additionally influence public expenditure increases and the deterioration in the fiscal deficit to a level exceeding current values. The crucial issue in assessing the net fiscal position in the AC-10 is that the negotiated transfers cover the latest and most major budget obligations to a very limited extent, as will be presented in this paper.

## The starting fiscal positions of acceding countries

Most of the acceding countries arrive at the point of EU accession carrying unstable fiscal positions and accompanied by slowing economic growth rates (see the recent examples of Poland and Hungary). Most of the applicants have high and rising fiscal deficits (in some cases chronically so). As Coricelli and Ercolani (2002) demonstrate, most of the applicants' budget deficits are both structural and cyclical in their character. Fiscal positions in transition economies are very vulnerable to changes in real GDP growth. Furthermore, because of the higher volatility of output and the high level of public investment (including expenditure related to EU accession) in these countries, the risk of surpassing the 3 percent of GDP limit is that much higher.

General government balances continue to be negative in most candidate countries. For the AC-10 group as a whole, aggregate general government deficits (in ESA 95 terms) reached 5.3 percent of their GDP in 2002<sup>4</sup>, mainly due to the sharp increase in the Hungarian deficit<sup>5</sup>. These aggregate deficits are expected to fall to 4.4 percent of GDP in 2004, though differences between

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<sup>4</sup> Weighted average, using GDP converted at market exchange rates, according to Table 1. The April 2003 notifications (European Commission, 2003c) show that the average general government deficit for the ten acceding countries (also in ESA 95 terms) deteriorated from 3.8% of GDP in 2001 to 4.7% of GDP in 2002 and is planned to improve only very slightly to 4.2% of GDP in 2003.

<sup>5</sup> Data presented in this section are provided by European Commission (2003a, 2003c). Further analysis shows the deficit increases as a consequence of membership-related expenditure increases, something not considered by the Commission.

the countries are important. According to official European Commission sources, the deficits for of Estonia, Lithuania and Slovenia are expected to be lower than 2 percent in 2003, while the Czech, Maltese and Slovak deficits are expected to reach more than 5 percent of GDP in 2003. For the 10 acceding countries as a whole the forecast foresees deficits of at least 3 percent in 6 countries in 2003, and the same in 2004. Nevertheless, except for Estonia and Lithuania, the forecasts point to a trend towards somewhat lower deficits over the forecast horizon, with particularly remarkable improvements in Hungary and the Slovak Republic.

**Table 1. General government balance (as a percentage of GDP), forecast for candidate countries (CC-13)**

	2001	2002	2003	2004	2005*
Cyprus	-3	-3.5	-4	-3.5	-0.3
Czech Republic	-5.5	-6.5	-6.3	-5.9	-5.5
Estonia	0.5	1.3	-0.5	-0.6	0.0
Hungary	-4.2	-9.1	-4.9	-3.7	-2.5
Latvia	-1.9	-2.5	-2.9	-2.6	-2.0
Lithuania	-2.3	-1.8	-1.9	-2	-1.5
Malta	-7	-6.1	-5.2	-4.1	-3.1
Poland	-3.1	-4.2	-4.2	-4	-2.2
Slovakia	-5.4	-7.7	-5.3	-3.8	-2.6
Slovenia	-2.5	-1.8	-1.5	-1.2	-0.8
Acceding countries (AC-10)	-3.7	-5.3	-4.4	-3.9	-
Bulgaria	0.4	-0.7	-0.6	-0.5	0.0
Romania	-3.3	-2.6	-2.7	-2.7	-2.4
Turkey	-28.9	-13.7	-9.8	-6.9	-0.5
Candidate countries (CC-13)	-12.4	-7.1	-5.7	-4.7	-

Notes :

- aggregate across countries weighted using GDP converted at market exchange rates
- government deficits not yet comparable across countries
- attempts have been made to use a definition as close as possible to general government net lending

\* Data for 2005 comes from the earlier source: Evaluation of the 2002 pre-accession economic programs of candidate countries, European Commission (2002b). Data for 2005 is not, in fact, a forecast (of independent forecasting institution) but the declaration of a political will (or rather wishful thinking, as the further analysis shows) of each government preparing pre-accession economic program.

Source: European Commission (2002b, 2003a)

General government deficits in most of the larger countries are increasing, for various reasons: the effects of the economic slowdown, anti-cyclical loosening of fiscal policy, loosening before elections in some countries, social expenditure increases, transition-related expenditures on enterprise or banking restructuring, for example, as well as greater accuracy in measurements due to more transparent fiscal accounting of expenditures and revenues. However, despite the increasing transparency in public finances, the deficits presented here are neither fully comparable



across countries, nor yet fully in line with EU definitions. As the harmonization of statistics progresses, significant revisions of general government deficits are still possible<sup>6</sup>.

The presented forecasts for fiscal deficits do not take into consideration the actual impact of EU transfers or the costs of accession. The amount of commitments for payments is defined by the Copenhagen Summit (see Table 2), but the actual usage of EU financial sources and real payments from the EU budget is still unknown and strongly depends on the individual absorption capacities of applicants. The majority of enlargement-related costs are supposed to be assumed by state budgets, while transfers will be channeled not only to the state budgets. Taking these two factors into account, alongside the lower absorption of funds, EU fund allocation may be lower than expected and the fiscal position of the EU candidates could deteriorate further in the first two years after accession.

## **The impact of EU transfers on the New Member States**

At its meeting in Berlin on March 24-25, 1999, the European Council confirmed that enlargement is an historic priority for the European Union, and that the accession negotiations would continue “each in accordance with its own rhythm and as rapidly as possible”. In the framework of Agenda 2000, the Berlin European Council adopted new financial perspectives for the Union in the context of enlargement, covering the period 2000-2006. These perspectives make financial provision both for pre-accession expenditure and post-accession transfers from the new Member States to join the EU as of May 1, 2004. On the basis of the Berlin decisions, the total financial package agreed by EU leaders on December 12-13, 2002 at the Copenhagen European Council meeting concluded negotiations with ten countries (Estonia, Latvia, Lithuania, Poland, the Czech Republic, the Slovak Republic, Hungary, Slovenia, Cyprus and Malta).

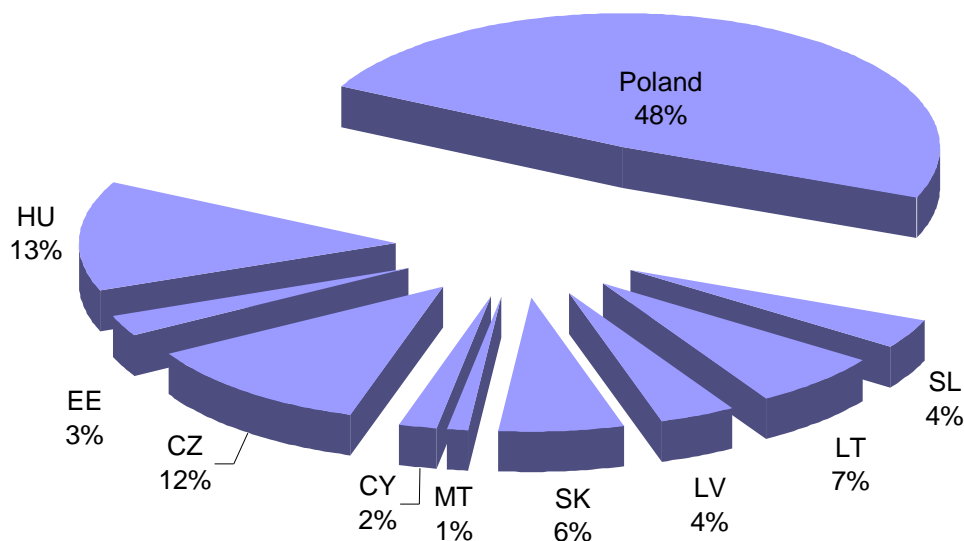
The Copenhagen Summit agreed the financial framework for enlargement, with nearly € 41 billion in terms of commitments (€ 25 billion foreseen for payments) for the period 2004-2006 (see Table 2). As has been widely reported, negotiations on the financial package were a tough nut to crack. Along with Malta, Poland was reported to have held on to the very end to improve its side of the financial package, with a deal only achieved in the final hours of hard negotiations in Copenhagen. It is very important to distinguish between planned and actual transfers, however. Commitment appropriations and payment appropriations are both planning categories. The former category, commitment appropriations, represents resources available in a given year. Actual expenditures in individual projects need not necessarily start or end in that year. The second category, payment appropriations, is expenditures earmarked in a given year for on-going projects.

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<sup>6</sup> It should be noted that public finance statistics are not yet fully comparable across countries, and are not yet in line with EU definitions. In the framework of the Pre-accession Fiscal Surveillance Procedure, work is being done to improve the quality and comparability of general government accounts. As this work progresses, significant revisions to general government deficits are possible. In Slovakia, for example, government support for bank restructuring has not yet been accounted for, according to EU definitions.

This sum, however, is still a far from actually disbursed resources, which are, to a large extent, dependent on the success/failure rate of appropriations for co-financed projects.

**Figure 1. Total transfer allocations in 2004-2006, in percent**



Source: European Commission (2002a), own calculations

Transfers from the EU budget reach the target countries through a variety of channels. One group of transfers is non-project-related and payment appropriations can be taken as real future disbursements. This group consists of direct payments, market interventions in agriculture, internal actions (such as existing policies, institution building, or the Schengen facility fund), additional expenditures (e.g. nuclear safety), temporary budgetary compensation, or a special cash flow facility fund. The other group consists of project-related transfers where the sum to be disbursed in a given year is determined by the amount of EU co-financing successfully secured for individual projects. This group includes transfers from the Structural Fund and the Cohesion Fund, rural development, as well as the residuals from the pre-accession aid. Project-related transfers require national co-financing<sup>7</sup>, thus are in this sense, “expensive” compared to the first group of transfers, which do not call for national co-financing. The attempt to increase non-project-related transfers for Poland and the Czech Republic during the negotiations (as less risky and less expensive) was successful<sup>8</sup>.

<sup>7</sup> The typical amounts are 25% for the transfers from the SF, 15% from the CF and 20% for rural development.

<sup>8</sup> Poland’s special deal was the reallocation of € 1 billion from structural activities (expensive and risky types of transfers), partly to: a) unconditional lump-sum payments; and partly to: b) project-related payments, without co-financing. The purpose of the deal was to reduce the budget deficit, which would result from having to top up direct payments to Polish farmers. The Czech Republic managed to secure a similar deal for EUR 100 million.

**Table 2. Copenhagen agreed a financial framework for enlargement - Total commitment appropriations 2004-2006\* for the 10 new Member States (€ millions, 1999 prices)**

	POL	HU	CZ	SLK	SLV	EST	LET	LIT	CY	MAL	TOTAL
<i>Agriculture</i>	4636	1483	1120	628	401	254	725	401	115	28	9791
CAP	2093	949	638	276	151	120	291	110	49	4	4682
Rural development	2543	534	482	352	250	134	434	291	66	24	5110
<i>Structural actions **</i>	11369	2847	2328	1560	405	618	1366	1036	101	79	21747
<i>Internal policies</i>	1817	559	419	329	222	127	539	175	48	20	4256
Existing policies											2642
Institution building											380
Schengen facility	280	148	0	48	107	69	136	71	0	0	859
Nuclear safety	0	0	0	90	0	0	285	0	0	0	375
<i>Special cash-flow facility (cash advance)</i>	1443	211	358	86	101	22	47	26	38	66	2398
<i>Temporary budgetary compensation (cash adv.)</i>	0	0	389	0	131	0	0	0	300	166	986
Total Commitments (without administration)	19265	5100	4614	2603	1260	1021	2678	1638	602	359	40851
<i>Administration (estimation)</i>	789	209	188,9	106,6	51,6	41,8	109,7	67,1	24,6	14,7	1673
The share of the payments ***	48.6%	13.1%	12.0%	6.3%	3.6%	2.6%	6.7%	4.0%	1.8%	1.1%	100%

Source: European Commission (2002a), own calculations

\* - Where appropriate, allocations by country are shown. For the Schengen facility, nuclear safety, special cash-flow facility and temporary budgetary compensation, these amounts are fixed. For structural actions and rural development, these amounts are indicative. Allocations by country for agricultural market measures, direct payments, existing internal policies, institution building cannot be definitively fixed at this stage

\*\* - Includes € 38 millions of non-allocated technical assistance.

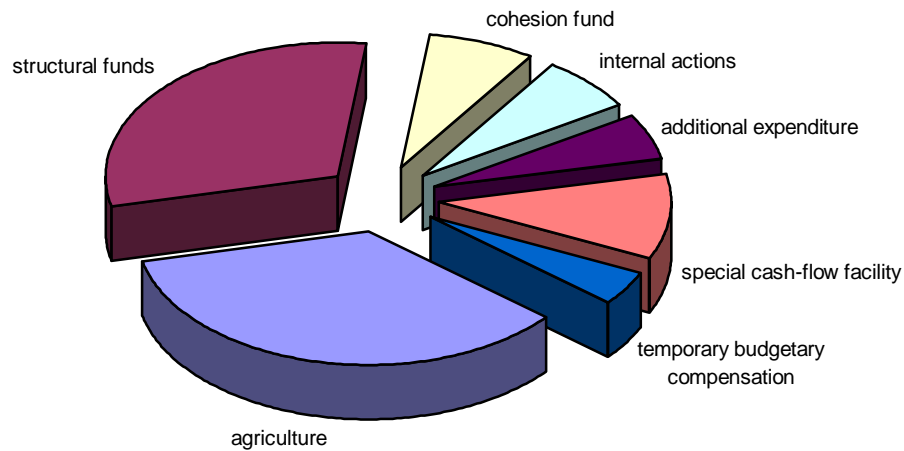
\*\*\* - The share of the payments does not include administration commitments estimation.

The main stream of investment and support financing is covered by three key funds (agriculture support, Structural Fund and Cohesion Fund). These key funds constitute more than 70 percent of total funds in Hungary, Latvia, Slovakia, Estonia, Poland and Lithuania. In the Czech Republic and Slovenia, the share of these key funds is smaller, at 66 percent and 55 percent, respectively. Due to higher fiscal deficits, Malta, Cyprus, Slovenia, and the Czech Republic negotiated special lump sum payments. This was the reason for different structures of transfers in these countries.

The largest share of the Copenhagen financial package was designated to finance structural actions in the new Member States. Some € 22 billion has been set aside for this purpose over the three years 2004-2006, one-third of which will be for the Cohesion Fund and internal actions and two-thirds for Structural Funds. EU financial assistance from Structural and Cohesion funds is

project-based, that is, it is only paid on the basis of approved projects that are implemented in AC-10, if and when they are carried out<sup>9</sup>.

**Figure 2. Structure of the transfers' allocations in AC-10 in 2004-2006**



Source: European Commission (2002a), own calculations

Note: Pre-accession aid is excluded from the analyses while it was negotiated earlier and guaranteed

## Co-financing

The project-related transfers (SF, CF, rural development, as well as pre-accession assistance) require national co-financing. Other groups of non-project-related transfers do not. Total project-related transfers amount to € 18.5 billion. The typical amounts for project co-financing are 25 percent from transfers from the SF, 15 percent from the CF, 20 percent for rural development and 30-40 percent for pre-accession assistance, depending on the project type.

Total maximum required co-financing of project-related transfers in AC-10 in 2004-2006 amounts to over € 4 billion. A part of this sum will significantly burden the state budgets and local governments who will implement projects that have not previously been financed from their budgets (mainly new environmental projects and transport infrastructure).

Investment project co-financing can be also credited from the European Investment Bank (EIB) and other international financial institutions, such as: the European Bank for Reconstruction and Development (EBRD), the International Bank for Reconstruction and Development (IBRD), the International Finance Corporation (IFC), the Nordic Investment Bank (NIB), the Nordic Environment Finance Corporation (NEFCO) and the Council of Europe Development Bank.

In January 2000, the EIB's Board of Governors approved an extension of the EIB's pre-accession facility for lending to the candidate countries of up to € 8.5 billion over a period of three

<sup>9</sup> However, in order to ensure that even on a cash flow basis the AC-10 remain in a net beneficiary position, all of the AC-10 will receive additional cash flow lump sum payments and some of the AC-10 will receive temporary budgetary compensation.

and a half years. The international institutions' pre-accession support covers priority investment in all the candidate countries, in particular those projects that facilitate the adoption of the *acquis communautaire* and strengthening integration with the EU. The financing covers all sectors and focuses on environmental protection, the development of transport, telecommunication and energy links, industrial competitiveness and regional development.

Cooperation with the EIB, the EBRD and other institutions has resulted in the joint co-financing of a substantial number of projects in accession countries since 1998.

At the project level, the exchange of information is carried out at a very early stage in the procedure of project identification in order to select possible proposals for co-financing.

## The financial contributions of the new Member States

All candidate countries, on joining the EU, will be required – as EU countries - to pay their annual contribution to the common EU budget. This is made up of a contribution in the form of payments of a part of VAT revenues collected in AC-10, customs duties collected on non-EU imports and an additional contribution based on the country's Gross National Product (GNP). Additionally, each EU country also contributes to a rebate that is granted to the United Kingdom on its budgetary contribution<sup>10</sup> (known as 'the UK Rebate' or "the British rebate").

Most of the acceding countries (only AC-8) must pay an equal contribution equivalent to 1.27 percent of annual GDP in 2005 and 2006. Malta and Cyprus are obliged to pay a higher membership contribution (1.5 percent of GDP), while their transfer structures are different than the AC-8. Postponing the accession date from January 1 to May 1, 2004 will reduce by one third the annual contributions in 2004 to the level of 0.85 percent of GDP in AC-8 and to 1 percent of GDP in the island countries.

The total agreed contributions to the EU budget by all new entrants (AC-10) in 2004 amounted to € 4 billion; total financial contributions amounted to over € 16 billion during the first three years after accession (at 2004 prices).

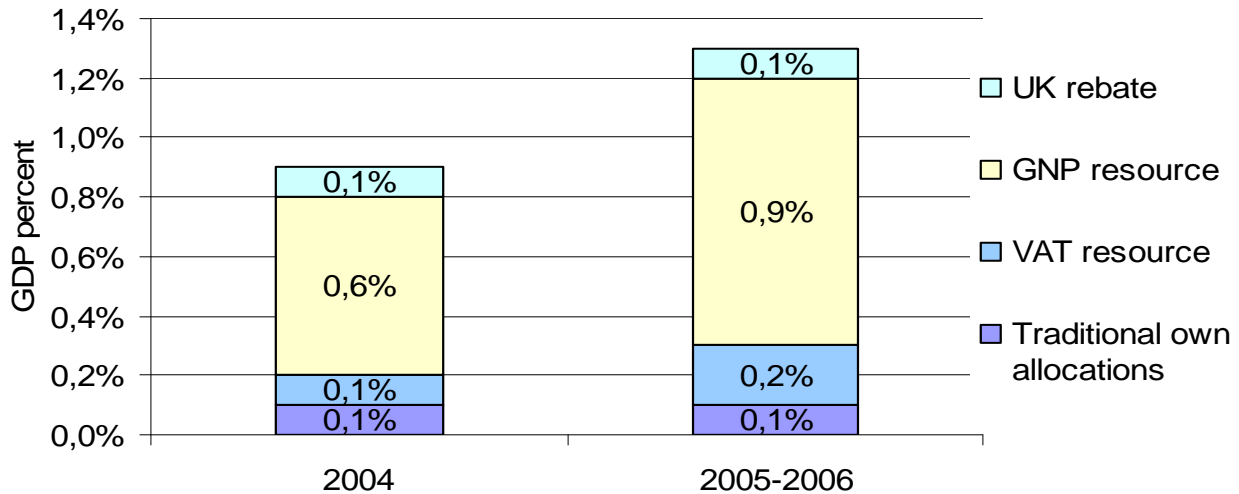
The full contribution to the EU budget comes from state budgets. The most important component of the membership contribution fee is GNP resources (67 percent of the contribution will be taken from own resources of state budgets). Ten percent of applicants' budgetary contributions will come from customs duties and agricultural levies (another name for this component is 'traditional own allocations'). Twelve percent will be taken from countries' VAT resources, over three years. As a part of the budgetary contribution, acceding countries will also have to pay the UK rebate. This is part of sharing the burden generated by a 75 percent reduction

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<sup>10</sup> The British rebate was negotiated by the former Prime Minister Margaret Thatcher in 1984 in Fontainebleau as a way of reducing the difference between money paid by Britain into the EU and its receipts from EU payouts. Britain gained less than other EU members like France, Spain, and the Former East Germany from the Common Agricultural Policy. Thanks to payments from CAP subsidy system, France is a net beneficiary, while Britain is a net contributor. According to official statement of the UK, it is estimated that without the abatement provided by the rebate, the UK would be paying 3 times more than France. After enlargement of the EU to include 10 new member states, UK and French contributions will be similar.

granted to Germany, the Netherlands, Austria and Sweden from their normal financing share. The total agreed part of the UK rebate to be paid by acceding countries amounted to € 1.5 billion<sup>11</sup>.

**Figure 3. Structure of the membership contribution fees in AC-8 in 2004 and 2005-2006, as a percentage of GDP**



Source: European Commission (2002a), AMECO database, own calculations

The membership contribution fee is supposed to be paid to the EU budget in monthly installments, at the beginning of each month starting from May 2004. This obligation was imposed in order to assure regular payments, as well as to avoid temporary liquidity problems in state budgets. However, one unfavorable aspect for the acceding countries of this payment system must be considered. There is a time lag between the contribution fee to the EU budget (paid up-front) and incoming transfers (ex-post reimbursement of incurred expenses). A transitional period may be needed because new Member States will contribute fully to the EU budget, but at the same time will not participate fully in all EU policies from the first day of membership and therefore will not benefit from the full EU system of subsidies from the start. This applies, for instance, to the EU agricultural subsidy, which is partly paid retrospectively. Starting from May 2004, relatively poor new EU countries will have to contribute fully to the EU budget, but will not receive a large part of the agricultural subsidy until the following year – probably in 2005 (Poland is one of them). Thus, there is a risk of covering some additional expenses from the state budgets, especially in the first year or two years after accession.

<sup>11</sup> The rest of the rebate will be financed by Germany, Austria, the Netherlands and Sweden. In 2001, the whole British rebate amounted to £2.8 billion, in 2002, £2 billion, and in 2003 £3 billion. In 2001, the whole British rebate amounted to £2.8 billion, in 2002, £2 billion, and in 2003 £3 billion.

## **Cost-benefit analysis of accession – net financial positions of the new Member States**

EU transfers and the membership contributions are the most important factors influencing new members' financial position after accession. This category is fully measurable and an accountable base (assuming the possible absorption rate of project-related transfers) for assessment of future net fiscal positions does exist.

The net project-related transfers (diminished by necessary co-financing) amounted to € 14.3 billion in 2004-2006 (in 1999 prices). The non-project related transfers (including budget liquidity support) amounted to € 9.4 billion. Own resources, i.e. the new members' contribution to the EU budget, will amount to approximately € 14.7 billion (1999 prices). The sum of these figures, as well as the estimated success/failure rate for the project-related transfers, provide a basis for the calculation of the net financial position the ten new members can expect as a group.

During the first three years of membership, AC-10 will get from the EU only € 9 billion more than they will pay (under the key assumption of full transfer absorption). This will make the new members net beneficiaries only in the case of absorption above 37 percent of project-related transfers (weighted average minimum absorption rate for AC-10, see Table 4). In the case of lower absorption, the group will be a net contributor.

The limited institutional capacities of the new members may be an important obstacle to absorbing EU structural funds, especially at the beginning of the accession process. This will obviously result in deeper fiscal deficits in state budgets than paying full membership contribution fees. In the case of wasting opportunities to use the full amount of the EU transfers, the state budgets will obtain fewer financial sources to finance investment. This way, EU transfer absorption capacity becomes a crucial issue for the future fiscal stance of the acceding countries.

During the 2000-2002 period, the actual usage of structural assistance granted under the ISPA (financial resources on transport infrastructure and environmental protection) was very small. Poland, Slovakia, and the Czech Republic, with a rate of ISPA funds absorption of 9-10 percent, did not use the opportunity to benefit fully from the funds allocated to them. Slovenia, Lithuania, Estonia and Hungary, with rates of 13-19 percent, were better prepared to absorb and benefit from the ISPA funds. The investment in transport infrastructure (highways, bridges, and transport solutions in urban areas) is one of the most important and visible advantages accession will bring to the average citizen. But that chance was lost, second - and possibly - chance for infrastructure improvement may be Cohesion Fund transfers. It is difficult to say what absorption of transfers will be, but with such a modest usage of the project-related funds, the net transfers to the budget will without much doubt be smaller, bringing in turn deterioration in the fiscal deficit.

**Table 3. Pre-accession ISPA fund allocations and absorption in 2000-2002, € millions**

	<b>ISPA allocations</b>	<b>Usage of the ISPA funds</b>	<b>Absorption rate (percent)</b>
Poland	2053	203.0	9.9
Slovakia	279	28.0	10.0
Latvia	277	27.9	10.0
Czech Republic	349	37.4	10.7
Hungary	547	68.1	12.4
Estonia	121	17.7	14.6
Lithuania	252	42.7	16.9
Slovenia	70.4	13.4	19.0

Source: European Commission (2002f)

In order to estimate the acceding countries' net financial positions on acceding to the EU, the minimum absorption rate for each country was calculated. The rate ( $x$ ) is the minimum level of project-related transfers engaged in domestic structural reforms in 2004-2006 sufficient to retain a positive net financial position in terms of EU transfers after budget support receipts and EU membership payments are taken into account.

$$x = \frac{\text{EU membership contribution} - \text{non-project-related transfers} - \text{budget support}^*}{\text{project-related transfers} - \text{co-financing}}$$

\* - budget support = temporary budgetary compensation + special cash flow facility,



**Table 4. The net financial position of the new members under various project-related fund absorptions in 2004-2006, as a percentage of GDP. Minimum absorption rate of project-related transfers, in percent**

	Net financial position under various transfers' absorption. GDP percent				Minimum absorption rate (x)
	100%	75%	50%	30%	
Estonia	1.7	1.2	0,8	0,4	6
Lithuania	2.1	1.6	1,1	0,7	7
Latvia	2.2	1.6	0,9	0,4	14
Poland	0.8	0.5	0.2	-0,1	35
Slovakia	0.6	0.3	0,0	-0,2	46
Hungary	0.4	0.2	0,0	-0,2	51
Slovenia	0.2	0.0	-0,1	-0,2	70
Czech Republic	0.1	0.0	-0,1	-0,3	75
Weighted average minimum rate of absorption in AC-10					37
Weighted average minimum rate of absorption in AC-8 (AC-10 minus island countries)					25

Source: European Commission (2002a), AMECO database, own calculations

As indicated in Table 4, the net position of individual members within the group may vary considerably depending on the negotiated amount of transfers and transfer absorption, also taking into account each country's starting fiscal position.

In transfer terms, one can clearly see who are the beneficiaries and who are the losers. The biggest beneficiaries of EU assistance are the Baltic States. The negotiated amounts of transfers and their structure provided a very low estimated minimum absorption rate for the Baltic States (from 6 percent in Estonia to 14 percent in Latvia). This allows them to keep the net beneficiary position even under low structural (and other expensive) investments. However, without the implementation of investment projects, the effect of accession on the economy as a whole may be limited and economic growth reduced. With an absorption rate of 75 percent of the project-related transfers, the net position of the Baltics is the strongest among the AC-10, estimated at 1.6 percent of GDP in Lithuania and Latvia and of 1.2 percent of GDP in Estonia.

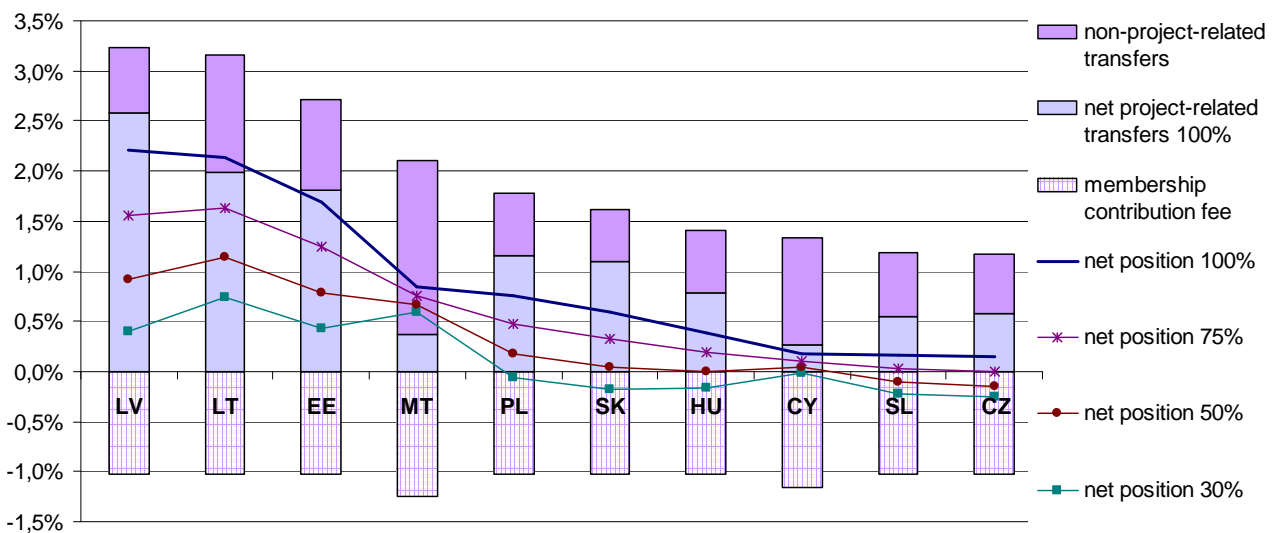
Slovakia and Poland, with the minimum absorption rates of 46 and 35 percent, respectively, belong to the second sub-group of beneficiaries in terms of transfers. Their net financial positions are located at the medium level of the whole group. With absorption rates of 75 percent of the project-related transfers, the net position of Poland is estimated at a level of 0.5 percent of GDP and Slovakia at 0.3 percent of GDP.

Countries benefiting least in terms of GDP are Slovenia, the Czech Republic and Hungary. Their net positions in terms of GDP are the weakest among the AC-10 group. With absorption rates of 75 percent of the project-related transfers, the net position of the countries from this group is estimated at a minor level in Slovenia and Hungary. The Czech Republic's net position is insignificant at this level of transfer absorption. Hungary will have a positive financial net position

only if that country is able to use more than half (51 percent) of the project-related transfers (in the case of the Czech Republic 75 percent, and Slovenia 70 percent). After accession, higher fiscal deficit is likely to be observed in these countries. In order to avoid it, the countries should use the EU's help as much as they can. The benefits of accession in terms of GDP are the weakest among this group.

The main conclusion stemming from this analysis is that accession countries should aim to concentrate their efforts on maximum absorption of EU transfers so as to assure sustainable growth after accession (in the case of countries with more favorable amounts and fund structures) and to support their net fiscal positions (in the case of countries with less favorable amounts and fund structures).

**Figure 4. Net positions of AC-10 in 2004-2006, as a percentage of GDP. Lines – net financial positions under various project-related transfer absorption rates**



Source: European Commission (2002a), AMECO database, own calculations

## Net fiscal positions in acceding countries<sup>12</sup>

As analyzed in the preceding body of this paper, the national net financial position resulting from negotiations is an important determinant of the future fiscal position of accession countries. The usage of funds also influences the size of deficits and the scope of economic advantages stemming from accession (among others: private sector expansion, FDI inflow, labor market development and economic growth). Any fiscal deficits which may occur in AC-10 at the beginning of membership may stem primarily from the above-described factors as well as from other direct and indirect enlargement-related factors (mainly on the expenditure side).

A substantial additional fiscal burden on state budgets will be imposed upon accession. There are few substantive estimates in the literature on the impact of structural reforms (which will be partially financed from state budgets and EU transfers) on the public finances. In August 2002, each candidate country submitted to the Commission its own National Development Plan, updates of their Pre-accession Economic Programs, submitted in 2001, presenting country strategy and reform implementation to increase country capacity to compete on the common EU market. The latest European Commission assessment of the National Development Plans suggests a lack of sufficient information on the implementation of structural reforms and very weak estimation of their costs or impact on budgets.

The costs of reform implementation are connected to the adoption of some specific *acquis communautaire*, particularly in fiscally sensitive areas, such as environmental protection, infrastructure, transportation, public administration, social policy, external border control, etc. Adoption of EU standards and regulations - contained in 31 chapters under negotiation between the European Commission and the governments of the accession countries – imposes a major adjustment burden on both the public and private sectors of the accession countries. The cost of compliance for governments is particularly heavy in the areas of environmental protection (air and water quality, waste management) and transportation infrastructure (road construction and upgrading of railroads). The additional infrastructure expenditures may require up to 1.5 percent of GDP annually in additional budgetary outlays<sup>13</sup>, which is even more than the financial contribution to the EU budget. As indicated, expenditures may be partially offset by Cohesion Fund transfers. In any event, the estimates are subject to a considerable margin of uncertainty, as they depend on the time-frame of implementation agreed upon with the EU.

A second important accession-related cost is public administration reform, which can be partially offset by transfers from the additional expenditure category. In order to develop the appropriate capacity of those institutions responsible for managing the funds, applicants should provide approximately one additional percent of GDP from public sources.

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<sup>12</sup> Due to different transfer structures in Malta and Cyprus these island countries are excluded from further analysis.

<sup>13</sup> On the basis of estimates by the World Bank (1997, 1999) for Estonia, Hungary and Poland.

There are also some positive fiscal effects of accession. The most important is the possible reduction or elimination of some budgetary expenditure as a result of EU transfers (eg. agriculture support). Under the CAP, it is envisaged that the traditional crop-specific price subsidy program will be replaced by income-support transfers to agricultural producers. Uncertainty about the timing and scope of this reform (some of the particularities are known only for Poland) is compounded by uncertainty concerning the reduction of agricultural protection scheduled under the Doha (Millennium) Round. Allocations under the reformed CAP will also depend on the recognition of existing agricultural subsidies in eligible accession countries on the eve of accession.

In any event, the magnitude of these transfers will be primarily determined by the overall size of the agricultural sector in each country (very high in Poland and low in Estonia). While most CAP transfers are channeled directly to eligible producers in the private sector, they would to some extent act as a substitute for some farm subsidies. The phase-out of farm subsidies, along with non-farm subsidies slated for elimination under EU standards on state aid and competition, could lead to significant budgetary savings of around 1 percent of GDP or more in some accession countries<sup>14</sup>.

Another positive fiscal aspect of accession would be additional revenues from indirect-tax harmonization. Member countries are obliged to harmonize the statutory base of VAT and excises and observe minimum statutory rates. The EU average standard VAT rate is 19.7 percent, while in AC-8 it is 20.8 percent<sup>15</sup>. While VAT rates in most accession countries are significantly above the minimum rates (15 percent standard rate, 5 percent reduced rate), their excises on energy and fuel tend to be below the minimum rates. VAT rates in none of the accession countries are below the described minimum. Some of the countries also provide significant exemptions from VAT and they are expected to be abolished. Consequently, after accession, the new members should recoup, on average, revenues of around 0.5 percent of GDP mainly from a broadening of their VAT base, higher excise duties and eco-taxes.

As regards tax revenues, accession should lead to the removal of customs duties on imports from EU members and assumption of a common external tariff (at 5.5 percent rate) on non-EU imports. However, in low tariff countries (such as, for example Estonia, with a near zero rate), this would result in a small gain. Depending on the country tariff rates, realignment of customs duties will result in mixed effects, from -0.5 percent of GDP in Hungary, Poland, the Czech Republic and Slovenia to +0.5 percent of GDP in Estonia.

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<sup>14</sup> According to the Kopits & Szekely (2002) estimate, the phase-out of production subsidies in Poland will bring 2 percent of GDP savings on subsidies, mainly currently directed to farmers.

<sup>15</sup> On the basis of Dobrinsky, (2002) and own calculations

**Table 5. Direct fiscal effects of accession and net fiscal positions on accession in AC-8 on average in 2004-2006, as a percentage of GDP**

	CZ	EE	HU	PL	SL	LT	LV	SK
<i>Fiscal effects of EU transfers</i>								
<b>1. Fiscal effects of EU transfers</b>	-0.6	-0.2	-0.7	-0.5	-0.5	0.1	0.0	-0.6
Membership contribution	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Special cash-flow facility	0.2	0.1	0.1	0.2	0.1	0.1	0.1	0.1
Temporary budgetary compensation	0.2	0.0	0.0	0.0	0.2	0.0	0.0	0.0
Net CF transfers (15% of co-financing)	0.1	0.3	0.1	0.1	0.1	0.3	0.4	0.1
Internal actions	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.1
Additional expenditures	0.0	0.4	0.1	0.1	0.2	0.7	0.3	0.2
<i>Other direct fiscal effects of accession</i>								
<b>2. Other fiscal effects of accession</b>	-2.5	-2.0	-1.5	-1.3	-1.3	-2.0	-2.0	-2.3
Infrastructure expenditures	-1.5	-1.5	-1.5	-1.5	-1.0	-1.5	-1.5	-1.5
Reform of public administration	-1.5	-1.5	-1.0	-1.5	-1.0	-1.5	-1.5	-1.5
Phase-out of production subsidies	1.0	0.3	1.5	2.0	1.0	0.3	0.3	1.0
Realignment of custom duties	-0.5	0.3	-0.5	-0.5	-0.5	0.3	0.3	-0.3
Tax harmonization	0.0	0.5	0.0	0.3	0.3	0.5	0.5	0.0
<b>Total net fiscal position (1+2)</b>	<b>-3.1</b>	<b>-2.3</b>	<b>-2.2</b>	<b>-1.8</b>	<b>-1.7</b>	<b>-2.0</b>	<b>-2.1</b>	<b>-2.9</b>

Source: Kopits, Szekely (2002), own calculations

In view of the diversity of effects across accession countries, as well as uncertainty as to the timing and size of indirect effects, it is difficult to provide a comprehensive picture of the fiscal costs-benefits of accession. The estimated net fiscal position of the individual applicant countries is provided in Table 5. There are two main groups of direct fiscal effects of accession influencing the future fiscal stance on acceding countries. The first group represents the fiscal effects of EU transfers which are directly channeled to the government sector and membership fee. The special cash flow facility, temporary budgetary compensation, net CF transfers (diminished by 15% of co-financing), internal actions, additional expenditure and membership contributions give a net fiscal gain on negotiated transfers of from -0.6 percent of GDP in the Czech Republic to + 0.1 percent of GDP in Lithuania. The second group of direct fiscal effects consists of the following components: infrastructure expenditures, public administration reform, phase-out of production subsidies, realignment of custom duties and tax harmonization. The fiscal effect of the second group was stronger than in the first group and amounted to direct fiscal effects ranging from -2.5 percent of GDP in the Czech Republic to -1.3 percent GDP in Poland and Slovenia.

On balance, accession appears to have an unfavorable direct net effect on applicants' general governments of up to minus 3 percent of GDP (see Table 5).

The calculation of net fiscal position is based on the following three important assumptions:

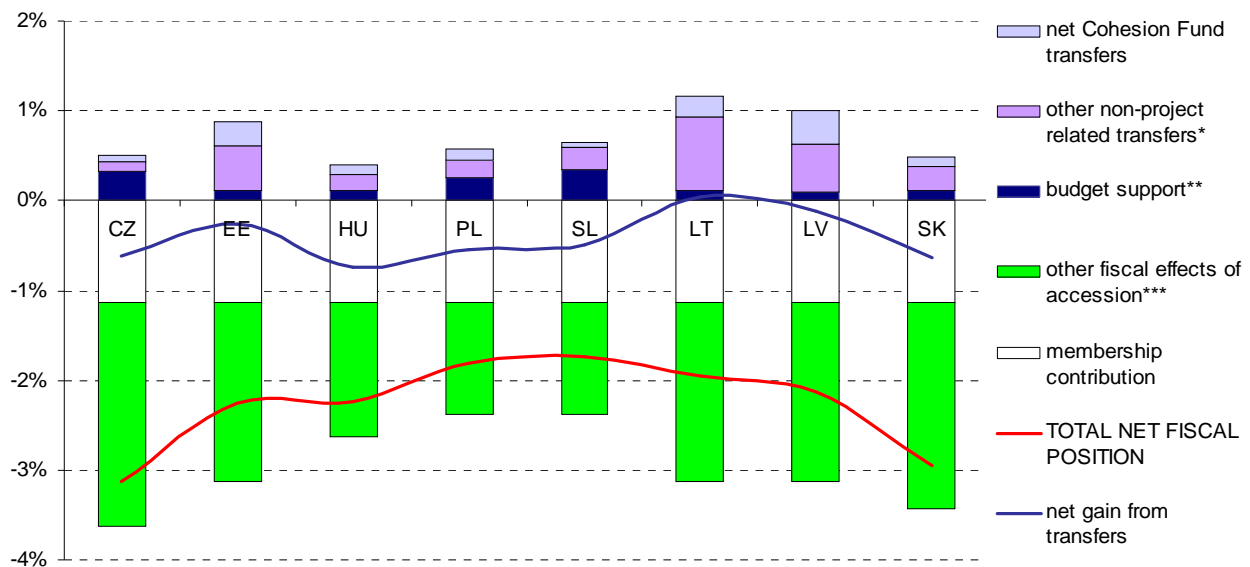
1. the accession countries will use the **full amounts** of project-related EU transfers channeled to the government sector,
2. these funds will substitute one for one for other government expenditures, and
3. all of the transfers and payments are presented in the national financial system<sup>16</sup>.

In the case of lower absorption or lower substitution, negative net financial results imply further deterioration in the net fiscal positions of acceding countries.

The increased deficits of accession countries are likely to be partly compensated over time by favorable indirect fiscal effects.

Fiscal deficit increases impose additional restrictions on the new Member States and may postpone their accession to the Euro zone.

**Figure 5. Direct fiscal effects of accession and net fiscal position upon accession in AC-8, in 2004-2006, as a percentage of GDP**



Source: Kopits, Szekely (2002), own calculations

Notes: \* - these non-project related transfers which are channeled through the public sector,

\*\* - budget support = temporary budgetary compensation + special cash flow facility,

\*\*\* - other fiscal effects of accession: infrastructure expenditures, reform of public administration, phase-out of production subsidies, realignment of custom duties, tax harmonization

<sup>16</sup> The calculated deficit increases are of maximum values, what means that all of the transfers and payments are presented in the national financial system. There are still uncertainties about transfer classification as the above- or under-the-line items in particular national budgets. If some of the payments are classified as under-the-line items in the budget it will not be visible in the budget result.

## Conclusions

Net fiscal gains on negotiated EU transfers are only one aspect of the multiple implications of EU accession for the new members' budgets. The costs of complying with the *acquis* (especially in additional infrastructure and environmental protection), phasing out production subsidies, tax harmonization, and, finally, reducing risk premiums in financing will have deeper repercussions than membership contribution payments for the prospective new members' state budgets. The impact of all the direct fiscal effects of accession is estimated to mean fiscal deficits deteriorating by up to 3 percent of GDP in the first few years after accession, what can be a serious reason for the delays in Euro zone accession. In the longer-run, some positive indirect fiscal aspects may start to play a role.

The current fiscal status (in terms of low budget deficits) of the Baltic States is the strongest among the group. The minimum absorption rates for these countries were also estimated at very low levels. Due to strong net fiscal gains on negotiated transfers (which are to cover the necessary expenditure on infrastructure) and low levels of current fiscal deficits, their estimated net fiscal positions are the strongest in the group.

Some applicant countries, especially those with the highest current fiscal deficits within the group (the Czech Republic and Hungary) may expect serious difficulties keeping their fiscal deficits under control after accession. The estimated fiscal effects on state budgets confirm their weak fiscal prospects. It is even more important for them as the calculated minimum absorption rates in these countries are also the highest in the group.

As was illustrated earlier in this paper, EU fund absorption became a crucial issue only in the case of determining the net financial positions of new Member States. As EU transfers cover accession-related expenditure to a very limited extent, the absorption rate of the EU funds is less important to the calculation of the net fiscal position. Starting fiscal positions are more important than the absorption rate for each acceding country, though the Baltic States seem to have a favorable stance in both respects.

The advantages of membership, however, are not equivalent to the net financial or net fiscal positions of the new Member States. Gains from the new wave of foreign direct investment, decreasing transaction costs of trade, transport, industrial co-operation and simplifying of international co-operation procedures, and the opportunities offered by the free access to the European single market (not to mention the political and security aspects and the modernization of the institutional and legal system following acceptance of the *acquis communautaire*), are much more important than temporary fiscal imbalances. Possible non-enlargement would entail considerable costs for the ten applicant countries in terms of the opportunities they would lose of achieving higher GDP growth rates and structural change.

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