Executive Summary

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Transparency and sustainability of budgetary policy in the new EU member states

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Abstract

The principles of budgetary completeness and transparency are indispensable elements of fiscal surveillance in the European Union. Within this context, this study deals with the leading question to which extent budgetary policy in the ten new EU member states (NMS) can be regarded as transparent and sustainable. A variety of institutional and quantitative methods (among others analyses of fiscal forecast quality, stock flow adjustments, consolidation structure and a simulation of the EU budgetary system) is applied.

In the assessment of current budgetary trends, the employed criteria consistently underline the fact that the Baltic countries and Slovenia find themselves in a relatively stable fiscal situation. In contrast to that, Hungary ranks low on the scale with its chronic deficits, its poor record for sticking to consolidation announcements and an unfavourable consolidation structure.

In the next decades the demographic development will change significantly the age structure of the population in the European Community. Detailed cross-section analyses and case studies of pension and health systems in selected countries (Poland, Slovakia, Czech Republic, Cyprus and Hungary) indicate that further structural reforms are required in order to limit sustainability risks.

The study of possible fields of budgetary intransparencies hints towards Hungary as the country which most likely is the most acute problem case in this respect. For several countries, particularly sensitive fields with a potential for blurring official fiscal data are government guarantees, capital injections as hidden subsidies and, in future increasingly, instruments to mobilize private sector resources for infrastructure projects in the context of PPP.

The simulation of the EU financial framework in the period 2007-2013 clarifies that the NMS with the exception of Cyprus and Malta can count on net-inflows via the EU budget which could reach a significant macroeconomic magnitude of three or, in some cases, even above four percent of GNI.

The study concludes with recommendations for improving fiscal transparency. Among others an ex ante approach for an early settlement of statistically contentious issues is suggested. This approach should assist member states already in the process of drafting a budget.

Part A Introduction

The principles of budgetary completeness and transparency are indispensable elements of fiscal surveillance in the European Union. Within this context, this study deals with the leading question to which extent budgetary policy in the ten new EU member states (NMS) can be regarded as transparent and sustainable. In comparative and case study analyses the short- and long-run sustainability of public finance in the NMS is assessed and it is scrutinized to which extent intransparencies limit the meaningfulness of official budget data.

Besides extensive institutional analyses quantitative tools are applied (among others with regard to fiscal forecast quality, consolidation structure and stock-flow-adjustments). In addition, the study has benefited from numerous interviews with experts from international organizations (European Commission, European Central Bank, International Monetary Funds), rating agencies, academia and national institutions within the NMS. It should be stressed, however, that those interviewees do not bear any responsibility for this study's conclusions.

Part B Budgetary developments in the NMS

It is the purpose of part B's synoptic look at budgetary policy in the NMS to assess the extent to which, currently, individual countries are on a stable fiscal track.

Looking backwards at deficit and debt developments some peculiarities compared to the old member countries' experiences emerge: Budgetary performance of NMS has been very volatile in recent years, it has been markedly influenced by one-off effects and it has only weakly been influenced by cyclical developments. Budgets have been favored by initially low debt level, by a comfortable development of tax revenues and by a significant decrease of interest rates. However, the overall picture of the ten NMS is highly heterogeneous. Countries such as Hungary, Cyprus or Malta with constantly high deficits in recent years contrast to the Baltic states and Slovenia with a stable situation of low deficits or even constant surpluses (Estonia).

Following the insights of the public finance literature with regard to the characteristics of sustainable consolidation policies, the budgetary experience of NMS is analysed also in a qualitative way. The results hint towards favourable consolidation profiles in the Czech Republic and Cyprus due to the consolidation focus on non-investment expenditures. Contrary to that the Hungarian consolidation profile of the years 2003/04 with its focus on investment cuts does not appear very promising.

The empirical assessment of the NMS's budgetary forecasting reliability shows that these countries in general still have deficient fiscal information, control and forecasting instruments. Deficit, expenditure and revenue forecasts of Hungary, Cyprus and Malta tend to have errors above average. Estonia tends to produce imprecise forecasts, as well, albeit with a different sign: Surpluses regularly materialize on a higher level than projected before.

The picture being painted by the recently updated convergence programmes is a positive one in general, supported by high (but not unrealistic) growth assumptions. However, not all projections seem to be backed up by equally specified budgetary measures. Particular scepticism appears to be justified with regard to the Hungarian convergence programme, but other programmes as well may be overly optimistic compared to the Commission's projections.

The chapter is complemented by a synoptic survey of budgetary policy in the NMS including the economic and political environment. Besides fiscal indicators and data for the economic situation the survey includes important dates (election years, target dates for the fulfilment of the 3-percent-criterion in the context of the excessive deficit procedure, target years Euro zone accession) in order to identify fiscal years where particular incentives for cosmetic operations may exist.

Generally, the analyses executed and a number of expert interviews hint towards a substantial institutional backlog compared to the (in this regard in no way perfect) old members.

Consistently, the employed measures and criteria underline the fact that the Baltic countries and Slovenia find themselves in a stable fiscal situation. In contrast to that, Hungary ranks low on the scale with its chronic deficits, its poor record for sticking to consolidation announcements and an unfavourable consolidation structure. The further budgetary perspective of Poland presents itself relatively unclear and it remains to be seen whether the new Polish government will indeed undertake serious consolidation efforts. At the same time both the Czech and Slovak Republic were able to improve their performance where, however, in the case of the Czech Republic some more question marks apply whether the current favourable development is rather a cyclical than a structural phenomenon.

The Southern European Malta and Cyprus which used to have chronic deficits in recent year and, hence, have experienced a deteriorating rating are now undertaking substantial consolidation efforts targeting at an introduction of the Euro in the year 2008.

Part C Fiscal risks and structural reforms of social security systems

The budgetary effects of structural reforms of social security systems can be divided into short- term and medium and long-term effects. A reason, why there could be a trade-off between reforms and budgetary objectives in the short-term is the fact that the reforms have direct budgetary costs. This is the case of pension reforms that introduce a funded pillar classified outside the government sector (Poland, Slovakia and Hungary) and temporarily increase the budget deficit. However, within the framework of the reformed stability and growth pact, over the first five years after the implementation of such a reform, the deficit figures can be degressively corrected for the net costs of the pension reforms.

The long-term fiscal implications of structural reforms have to be seen in the context of the demographic development that in the next decades will change significantly the age structure of the population in the European Community. Starting from a more favourable position now, some of the NMS (Czech Republic, Slovenia and Slovak Republic) will experience an even more pronounced process of population ageing than the EU-15. While the average old-age dependency ratio of the EU-15 is predicted to double by 2050, it is projected to more than double in Cyprus, the Czech Republic, and Slovenia and even to triple in Slovakia.

The biggest impact of the demographic development will be felt within the pension systems as the ratio of contributors to pensioners deteriorates. But also health systems face growing pressure, as expenditures for health care and long-term care will rise in an ageing society. This increases the burden on the budget and poses an enormous challenge to the long-term sustainability of public finances. Without radical structural reforms public debt threatens to explode in the medium- and long-term.

The results of long-run budgetary projections carried out at EU-level and by the Member states vary among the NMS. Whereas in the Czech Republic, Slovenia and Cyprus age-related budget expenditures will rise by up to 9.2 percentage points of GDP, they are projected to rise in the other NMS in the range of 0.5 to 2.6 percentage points of GDP. The biggest increases will take place between 2020 and 2050, while in the EU-15 the peak will be between 2010 and 2030.

Still missing in the projections in most of the NMS are the expenditures for education and the unemployment benefits. However, these expenditures are supposed to decline only slightly with ageing societies and growing employment rates.

Based on these long-term budget projections of age-related expenditures, the Commission assesses the sustainability of public finances in the member states. Sustainability is assumed if the debt ratio does not exceed 60% of GDP. The debt to GDP ratio is extrapolated assuming a constant tax burden and constant non-age related primary expenditures throughout the projection period. A ”baseline” scenario presumes that Member States actually achieve the medium term budget targets laid down in their convergence programmes (these indicate a substantial consolidation of public finances for all of them; only the Czech Republic foresees the general government deficit still above the 3% reference value). A ”2004 position” scenario differs from the baseline scenario only in starting from the actual budget data of 2004 instead of taking granted the medium term projections. This rather mechanical projection should not be taken as a forecast of likely debt levels. Instead, the indicators at best provide an indication of the timing and scale of emerging budgetary challenges that could occur on the basis of the ”no policy change” assumption.

Findings from the quantitative assessment of the Commission and from the convergence programmes 2004 and 2005 can be summarised as follows:

For most NMS debt levels are projected to decrease or remain constant in the coming 10-15 years. This trend would, however, start to reverse once the budgetary impact of ageing starts to take hold.

Even assuming that the NMS achieve their medium-term budget targets, there is a high risk of unsustainable public finances in some of the NMS (Poland, Czech Republic, Hungary, Slovenia, Cyprus and Malta). Based on a more favourable demographic trend and implemented reforms of the pension systems there is a lower risk for the sustainability of public finances in the Baltic States. In the Slovak Republic further parametric reforms of the pension system are necessary.

The risk of unsustainable public finances increases considerably if Member States do not achieve their medium-term targets. In this case, the debt levels are projected to grow far above the reference value. This is especially true for countries with high current budget deficits (Czech Republic, Hungary, Cyprus and Malta) and countries with strongly increasing age-related expenditures (Czech Republic, Slovenia and Cyprus). This underlines the importance of the medium term budgetary consolidation for long-term sustainability. A new projection, carried out by the Economic Policy Committee in January 2006, shows significant higher budgetary expenditures for pensions in Cyprus, Hungary, and Slovenia. Accordingly and all other assumptions kept equal, a even higher -than described above- debt level can be expected in these countries.

More detailed analyses of pension and health care systems in selected countries (Poland, Slovak Republic, Czech Republic, Cyprus and Hungary) demonstrate the need of further structural reforms in order to diminish fiscal risks. Lower public social expenditures are not per se synonymous with a loss of quality of public services. The results of a study of European Central Bank show that the expenditure efficiency across New Member States is rather low. Especially in the health sector and education there is wide scope by efficiency increase to keep expenditures constant or even to lower public expenditures without reducing the quality of offered services.

Part D Transparency, contingent liabilities and off-budget funds

This chapter deals with the question to which extent the official budgetary figures of the NMS present a comprehensive and transparent picture of the current state of public finance.

First of all, a digression covers the matters of fact which have led to significant intransparencies in the case of Greece. Besides insights into potential fields of “budgetary cosmetics” this case study concludes that fiscal surveillance under the responsibility of the Commission and

Eurostat critically depends on the support of independent, competent and integer statistical authorities in the member countries.

In the following, the discrepancies between the evolution of the debt level and the accumulated deficts are looked into. High and constant stock-flow-adjustments (SFA) may have harmless explanations but they could also serve as an indicator for cosmetic operations. High and positive SFA can be observed in Estonia, Slovenia and Cyprus. The decomposition clarifies that these SFA have been mainly driven by the impact of exchange rate changes on the value of public debt (Slovenia) and the accumulation of financial assets (Estonia and Cyprus). As a result, no suspicious facts for intransparencies emerge.

The core part of this chapter is devoted to the possible variety of fiscal intransparencies. Fiscal rules, such as the Maastricht criteria, should foster stability and sustainability of fiscal policy. However, they may also elicit opportunistic government behavior. The use of creative accounting to improve fiscal results is amply documented for many current EMU countries in the run-up to the Euro. Although the accrual system covers cost and liabilities more comprehensively than the cash-based system, it also entails ambiguities with scope for creative accounting. In the last years Eurostat took action and clarified in a series of rulings several issues of ESA recording.

The intentions of fiscal measures should be fiscal efficiency, the distribution of risks, and the management of liquidity. But measures might also be taken to present flattering fiscal accounts. Amongst others the following areas are prone to creative accounting: delineation of the general government sector, contingent liabilities, capital injections and one-off measures. These areas as well as transparency in general are analyzed in detail for the Czech Republic, Slovakia, Poland and Hungary in this chapter.

Quasi-fiscal activities of public corporations including central banks distort the scope of state activity as well as the fiscal performance. One criterion to delineate the state from the public or private sector is assumption of risk. A sufficient transfer of risk is the requirement for PPP or securitization schemes to be accepted as transactions outside the government. In future NMS are likely to use these complex finance schemes more often, not least to co-finance the transfers from EU´s structural funds.

Contingent liabilities can partly substitute budget expenditure and debts. State guarantees work similar to subsidies but avoid cash expenditures. Implicit liabilities, which occur if, for moral or political reasons, the state tends to support large corporations on the brink, are not shown in the debt figures.

Different from capital transfers, financial transactions, as revenue from privatization, do not affect the budget figures in ESA accounting. Therefore, governments might be tempted to classify capital transfers as financial transaction to conceal budget expenditures. In Poland some cases of capital injections and tax expenditure border on hidden subsidies. Losses of central banks, as in the Slovak Republic, might also trigger capital injections in future.

Greece is on record as omitting military expenditures from their budget. No systemic distortions can be seen in the reporting of military expenditures in the NMS, although data of Cyprus are highly volatile. Except for Cyprus, defense expenditures in the NMS are below the 2 percent target agreed with NATO. Recently Hungary and the Czech Republic had to correct their military expenditures. Despite long term payment agreements they had to record the complete sale of military goods at time of delivery.

In the nineties the Czech and Slovak Republic run large hidden deficits. In the beginning of the transformation so-called consolidation agencies took over bad debts from the banking system. Only at the end of the nineties the countries started to report these deficits and debts in their official statistics. This explains today´s high share of state guarantees in GDP in both of the countries.

In recent years the Czech Republic and Slovakia made strenuous efforts to cut their contingent liabilities. To do so they record the total sum of guarantees as debts even though only a part of the guarantee is due. This procedure reduces future risks for the budget. State guarantees will, however, figure less prominent in future because direct subsidies and private credits will adopt their function as the financial sector in the countries matures.

The Czech, the Slovak Republic as well as Poland face several disputes over investment treaties which might result in higher liabilities. In addition, cases of litigation concerning ecological damages might come up in all countries considered.

Despite the low share of local in total government debts, the fiscal risk of sub-national entities might rise as fiscal decentralization proceeds as in Slovakia. Local governments will gain responsibility for managing the rising investment in infrastructure.

Last year Hungary was severely criticized by national and international institutions for excessive creative accounting. Eurostat required adjustments concerning the 13th month pay of public servants and the recording of the redemption of the value added tax. The largest correction of the budget was triggered by Eurostat´s veto against the recording of budget revenues arising from a PPP based scheme. The Hungarian budget deficit had to be increased significantly as the sale of roads was classified as an inside government dealing.

Part E The impact of EU transfers

In this part, the fiscal consequences of EU accession are assessed from the perspective of the NMS. These consequences are not unimportant for the overall study’s key question since they may be of relevance for the medium-term fiscal perspective in these countries and the possible existence of overlooked budgetary risks and chances.

In a first step, different possible fiscal effects of EU membership are discussed qualitatively and on the basis of estimates originating from the relevant literature. Here, not only direct effects related to own resources payments and EU policies (above all agricultural and structural policies) are taken account of but also indirect effects like co-financing requirements and costs of adjustment towards the acquis communautaire.

Employing a simulation model of the EU budget developed by the ZEW the net balances of the NMS are quantified which can be expected based on the agreement of the European Concil in December 2005 on the new financial framework. The results suggest that all these countries with the exception of Cyprus and Malta will experience net inflows via the EU budgetary system. These inflows will reach magnitudes of three percent of GNI and for some countries even above four percent.

Part F Conclusions

In the coming years the following trends are relevant with regard to the prospects for fiscal transparency in the NMS:

– Budgetary transparency of the NMS has been improved over the recent year. Apart from possible limitations mentioned above with regard to Hungary the study does not indicate far reaching manipulations of budgetary data. This may also be due to the fact that surveillance e.g. by Eurostat has been intensified as a consequence of uncovered abuses in Western Europe. Given the imminent Euro qualification procedures, however, measures of budgetary cosmetics cannot be excluded at least for countries with deficit and debt levels close to the critical values as defined by the convergence criteria.

– Within the convergence criteria legal guarantees are required to safeguard the independence of the national central bank. This will have a positive impact on transparency since independent central banks tend to play the role of a guardian over fiscal policy.

– Independent from temporary Euro accession incentives the issue of effective budgetary control of local and sub-national federal layers in the NMS will become increasingly important due to the ongoing decentralization of infrastructural decisions.

– With regard to financial instruments it is to be awaited that the NMS will employ more ambitious constructions (PPP, securitizations) as they have become standard in some EU-15 countries.

– Parallel to increasing capital market based finance the control executed by private rating agencies will gain importance. This control, as well, would be impaired by blurred fiscal data.

The following fields offer starting points for improving budgetary transparency:

- In order to improve the communication during the compilation of the budget and to improve the control of budget execution by national institutions (court of audit, central bank, etc.) the transition of national accounting systems to accrual based systems in line with ESA95 is required as soon as possible.
- Fiscal surveillance in the EU should put more weight on the scrutiny of multi-annual fiscal performance instead of focussing on single year data. This medium-term view would reduce incentives to shift deficits between periods.
- A broad service should be provided by European Commission/Eurostat in order to discuss statistical problems already when budgets are being drafted. The ex post assessment of budgetary specificities practiced so far (with lags extending over years in some cases) should be supplemented by ex ante assessments. Thus national budgetary policy could be assisted to avoid undue accuses of cosmetic operations.
- A priority is the further evolution of national statistical offices toward independent and self-confident institutions. The European Statistics Code of Practice defining principles such as independence and impartiality of statistical authorities which has been recommended by the Commission is a promising initiative which should be supported emphatically.