Two Years after EU Accession: Risks and Challenges to New Member States

Economic Sphere

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Executive Summary

The EU enlargement of 2004 did not produce the same economic results in all new Member States: some scored remarkable economic achievements, and others were less successful. Estonia, the rest of the Baltic States and Slovakia were success stories – not only thanks to a harmonisation of their laws and policies with the EU. The underlying reason for their success was their ability to identify their own interest and to pursue policies leading to a larger growth of their economies. Countries like Hungary and Poland do not enjoy the same success because of flaws in microeconomic policy (including the business environment), a reluctance to carry out reforms, which is complemented by an imprudent macroeconomic policy, resulting in high unemployment and slow growth of income and the economy.

The preparation for participation in the Euro-zone is closely related to the implementation of economic reforms and achieving flexibility and competitiveness of the economy. Accordingly, those countries that implement a more reform-minded economic policy and that prepare their economies for participation faster will be able to adopt the euro at an earlier stage.

Bulgaria can "borrow" several important things from Estonia's experience:

- In respect of macroeconomic policy, this country has so far followed the Estonian model very accurately, including a currency board arrangement, a balanced budget and a diminishing public debt.
- An added effort is needed for improvement of the business environment in Bulgaria, and this includes not just copying others' experience but also resourcefulness and innovation in national economic policy.

Bulgaria can tap the following experience of economic policy in Slovakia after 2002, which created prerequisites for fast economic growth:

- The possibility to carry out, within a short span of time, a radical tax reform improving the business environment
- The reforms of the labour market, social systems and education in Slovakia are also of interest to Bulgaria, considering the certain lag in these spheres in this country.
- Economic reforms come ever less as a result of external pressure and ever more as a result of domestic political will.

Poland's failure story is a challenge to Bulgaria in the following aspects:

- Deterioration of macroeconomic policy: budget balance, public debt, government expenditures, must be avoided at all costs.
- Reforms of the labour market and of the welfare system should not lag behind. The same applies to the relinquishment by the State of a direct control of the economy.

In the economic sphere in the first year of its EU membership, Hungary showed the worst results among the eight new Member States. The lessons to Bulgaria:

1. Without an improvement of the business environment and reduction of taxation, prosperity is difficult to achieve.
2. The trap of worsening the budget balance and admitting a budget deficit should be avoided. Regardless of the purpose, this would have a negative effect.
3. An administrative intervention in the market, including the labour market, affects adversely economic development.

In a word, in order to follow the good examples and to avoid the bad ones, Bulgaria should maintain a prudent macroeconomic policy, improve its business environment and reduce and simplify taxation, refrain from intervention in the markets and keep up the pace of reforms in the labour market and public services. This requires the presence of domestic political will, since ever fewer important reforms will be carried out under external pressure.

Regarding the adoption of the euro, Bulgaria stands to gain more if it follows a strategy of early entry into the Euro-zone. To make this happen, the country must keep the existing level of the exchange rate of the lev against the euro until joining the Euro-zone. An improvement can and must be sought in the following main areas:

- Competition in sectors producing non-tradable goods and services. Ensuring a high degree of competition in all economic sectors is an essential precondition for maintaining competitiveness, for meeting the price stability criterion, and for increasing the prosperity of the entire society.
- Low economic activity rate in the Bulgarian economy. Labour market policy must seek to create incentives to labour market participation rather than to claiming passively benefits from the State.
- The regulatory and educational policy in this country, as well as the policy in respect of the investment environment. They must be oriented to improve the incentives to investment in physical and human capital and to enhancement of productivity in the economy. The higher rates of growth of labour productivity can assure a higher growth of income without generating inflationary pressures on the economy.

1. Economic Development of the EU and the New Member States: an Overview

Eight countries of Eastern Europe joined the EU in 2004. They are unique since not only had they to reach the same end point of political and economic reforms (harmonisation with Community law), but their starting point as communist dictatorships with planned economies was similar, too. Nevertheless, their reforms and economic performance followed a country-specific course.

To a large extent, the "success" in the economic development of the countries of Eastern Europe was measured by the pace of "catching up" with the West. That had its political dimension: the post-socialism transition was viewed as "recovery," i.e. convergence to the non-communist economies. The economic argument, though, was just as valid: integration into a larger market of higher level of income was expected to trigger a natural process of convergence, equalisation of productivity and pay for work. Hence, the level of income benchmarked against the EU average was among the most frequently used indicators of the economies of the future members. In turn, converging with the income of "Old Europe" implied faster average GDP growth. These two indicators describe best the behaviour of the economies, which is why we use them as a point of departure in assessing the "success" or "failure" of each country's transition. An economy needs two principal growth factors: labour and capital; we therefore compare the level of labour market participation and the level of investments. When people in an economy work more and entrepreneurs invest a larger share of income, this makes possible future growth and prosperity. Finally, these decisions depend on a number of incentives of which a large part is predetermined by government policies: from budget decisions to administrative procedures for doing business.

To put it in a nutshell, economic development in recent years has distinguished the "achievers" from the "laggards" in reforms. The Baltic States, and especially Estonia, showed the fastest economic growth. Slovakia recovered its growth after a decade of stagnation. Estonia and Slovakia rapidly reduced their public debt, whereas the Czech Republic and Hungary increased it. In recent years, Hungary and Poland have had the worst business environment and the least free economy. Investments are most active in Estonia, Latvia and Lithuania, whereas capital formation is substantially lower in Hungary, Lithuania and Poland. While all other countries achieve labour market participation near the average for the old Member States, Poland and Hungary demonstrate a rigid labour market with low employment.

In this report, we have picked two examples of reform "achievers", Estonia and Slovakia, and two countries which have yielded more disappointing results in recent years, Hungary and Poland. Estonia has been cited as a role model of bold reforms in the mid-1990s, but Slovakia made a U-turn in economic policy in the late 1990s. Since the Baltic States have a similar reform history in many respects, why we selected one of them which, as everybody agree, has made the largest progress since 1991. Estonia managed to increase its income at the fastest pace during the last ten years, and it kept its lead after 2003 (unlike Hungary). This is the only country with a budget surplus for the 2003-2005 period which, in turn, enabled it to cut its public debt by over 20 per cent for those three years. And, what is probably most important, Estonia has the freest economy according to a number of international studies. For its part, Slovakia is a good example of a fast and decisive reversal, after years of side-tracked or lacking reforms until 1998. After 2003, Slovakia has been converging with the EU income at the fastest growth rate after that in the Baltic States. Investments in recent years have been most vigorous, and the Government has been parallelly reducing the public debt. This change also lent a practical dimension to the results of the radical tax reforms in recent years.

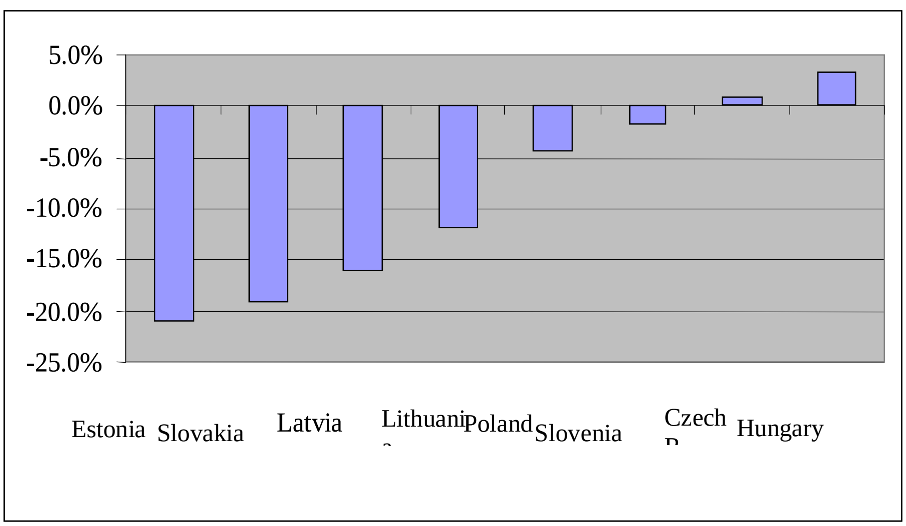
Change of per capita GDP as percentage of EU average

	1997-2006	**2003-2006**
Estonia	**69%**	**27%**
Latvia	58%	27%
Lithuania	48%	17%
Slovakia	25%	13%
Slovenia	18%	8%
Czech Republic	10%	8%
Poland	**16%**	**9%**
Hungary	**28%**	**5%**

Source: Eurostat

Hungary and Poland were among the pioneers in private business liberalisation back before 1990. They launched the pro-market reforms earlier, but their governments lost the will to carry them through, and in recent years they have had bad public finances and a hostile environment for work and investment. The two countries have the least conducive environment to doing business according to the World Bank, and their economies are the least free (along with Slovenia). Only there, the public debt has been increasing over the last three years, whereas all the rest have managed to reduce it by a narrower or wider margin. People have the worst incentives to work: employment is the lowest, and investments, as a GDP share, lag behind all the rest (except Lithuania). It is not accidental that after 2003 Hungary and Poland have been the slowest in converging with the EU average income.

Change in the amount of public debt as percentage of GDP, 2003-2005



Source: Eurostat

After the enlargement in 2004, the economic indicators of the European Union have improved. In 2002-2003, the average economic growth of the old Member States was 1.1 per cent annually, the rate doubled for the 2004-2006 period, reaching 2.8 per cent in 2006. The budget indicators of the old Member States as a whole improved as well after the enlargement, with the budget deficit decreasing by one-fifth, from 3 per cent to 2.3 per cent.

Inflation in the EU was steady at 2-2.2 per cent. In the new Member States, inflation moved in a country-specific direction: it dropped in Slovakia, Slovenia and Cyprus and rose in the other new entrants. Such variable inflation in the short term is nothing new and surprising for the new Member States, and for a number of the old ones as well. In 2006, inflation in the new members was relatively low, between 2 and 4 per cent, and just Latvia had over 6 per cent. Unemployment in the EU (in both the EU-15 and the EU-10) started to decline after peaking in 2003 and 2004. Employment increased, topping 65 per cent in the old Member States.

After enlargement, business investments in the EU also pushed themselves off their 2003 bottom. In terms of the number of company bankruptcies in the new Member States, Eurostat provides detailed information only about Slovakia: the proportion of bankrupt companies there fell from almost 10-12 per cent for the 2001-2003 period to nearly 7 per cent in the first year of EU membership.

2. The Success Stories

2.1. Estonia

Undoubtedly, in the economic sphere Estonia is the best example among the eight new Member States. Over the last ten years, the country has increased its per capita income as a percentage of the EU average, by as much as 70 per cent. For the first three years of EU membership, the growth was 27 per cent. By comparison, the growth was 5 per cent in Hungary and 9 per cent in Poland, i.e. several fold lower. Economic growth in Estonia reached nearly 12 per cent in 2006, the highest rate among all EU Member States, both new and old, and one of the world's highest.

Estonia traditionally shows relatively high levels of investment by the standards of the region, and after EU entry these levels have been higher than any of the other seven former socialist countries. Employment, too, is high at a little over 70 per cent, nearly 10 percentage points ahead of Hungary. Since joining the EU, Estonia has seen its unemployment halve, reaching some 5 per cent in 2006, the lowest level among the new Member States and one of the lowest for the entire EU. Labour productivity has been growing at a higher rate than in any of the other new Member States.

Business environment

In 2007, Estonia was ranked as the world's 12th freest economy according to the Index of Economic Freedom of The Heritage Foundation and *The Wall Street Journal*. In terms of economic freedom, the country is ranked fifth in Europe and fourth in the European Union and first among the new Member States. Estonia is also first among the new Member States according to the other economic freedom index, published by The Fraser Institute, Canada.

According to the World Bank, Estonia ranks 17th in the ease of doing business, and of the new Member States only Lithuania is ranked higher, 16th. Estonia's highest ranking is in international trade, 6th in the world. Ranked by the cost to obtain operational licensed and permits, the Baltic State is the world's 13th least expensive in this respect. The country also scores high in enforcing contacts and in registering property.

Structural reforms

Some of the more important reforms carried out in Estonia:[1]

- In 1994, Estonia introduced a flat tax: a relatively low uniform rate of taxation of personal and corporate income. At that time, nobody in Europe had ever heard about a flat tax, but its introduction in Estonia proved such a success that in just ten years that policy spread to a quarter of the countries in Europe.
- A cut of taxation made Estonia a country with relatively low taxes. The flat rate introduced in 1994 was 26 per cent, and for several years now it has been reduced annually, to reach 20 per in 2009.
- Estonia privatised its state-owned companies: the privatisation was quick but also effective and transparent.
- In 2000, Estonia introduced zero tax on reinvested profit: that reform encouraged investment and economic growth to such an extent that just two years after it was launched, national budget revenue from profits tax already exceeded the revenues before the introduction of the zero rate.
- Estonia removed barriers to international trade: it is one of the few countries in the world that has abolished all customs duties. This is exceedingly favourable for the fast growth of trade and the economy.
- Government spending is transparent: as yet another unique achievement, Estonia has made information on all public expenditures available on the Internet. This transparency is a strong anti-corruption factor and improves the effectiveness of public spending.
- Electronic government: use of information technology in administration makes life a lot easier for Estonians, reduces the corruption risk and improves the productivity of civil servants. As from 2001, tax returns can easily be completed and submitted online. As from 2000, the municipal parking tax can be paid by mobile phone.
- A number of other reforms which ensure a high competitiveness of the economy.

Macroeconomic policy

In 1992 Estonia introduced a currency board arrangement, anchoring the local currency to the Deutsche Mark with full backing of the money supply by forex reserves. This ended hyperinflation and macroeconomic instability and provided a basis for economic growth. This monetary system is still in force, and will stay that way until adoption of the euro.

Estonia traditionally avoids budget deficits, and has been posting substantial state budget surpluses since 2002, which increased slightly after EU entry. The public debt is near zero, at levels of some 3-4 per cent of GDP in 2006, a tenth of the level in Poland, Hungary or the countries of Western Europe. State budget expenditures in Estonia stand at some 36 per cent of GDP, and only Lithuania has a lower reallocation through the budget among the new Member States.

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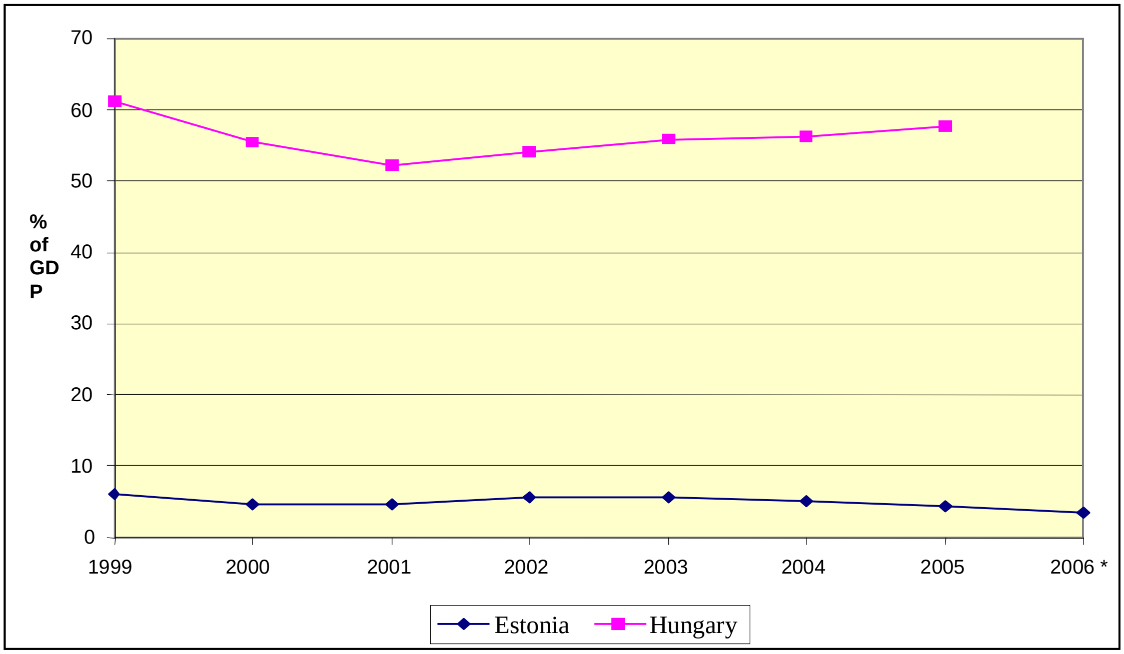
[1] A number of the economic reforms in Estonia are associated with the name of Mart Laar, twice prime minister of the country. Despite being a historian and aged just 32 when he headed the government for the first time in 1992, he launched major structural reforms in the economy, which had a serious impact on development.

Public debt: Estonia and Hungary



Conclusion and lessons to Bulgaria

Estonia registered a phenomenal economic growth, which in recent years surpassed the rate of Ireland, Europe's fastest growing economy in the 1990s. Thus, Estonia has gradually emerged as the new economic miracle in the European Union, followed closely by the two other Baltic States, Lithuania and Latvia.

The Estonian success story is rooted in the following policies:

4. Prudent macroeconomic policy: thanks to a stable exchange rate, a balanced budget, a low and diminishing public debt, there are favourable conditions for economic development at the macroeconomic level.

5. Improvement of the business environment: in most new Member States the business environment has improved, but few of them approximate the levels achieved by Estonia.

6. Low tax burden: the declining flat tax on corporate and personal income, along with the zero rate of taxation of reinvested profit and the relatively low VAT rate, ensure a tax burden on the economy that is low by the standards of the region.

7. Fast and unique reforms: if there is anything exclusive about Estonia, it is that the country is invariably at the forefront of launching new reformer economic policies. From the introduction of a flat tax and a zero tax on reinvested profit, through the adoption of a currency board environment and to the launch of e-government, the country has always been a pioneer and a leader. Estonia never waits to see what the other countries would do: on the contrary, everybody learn from Estonia's successful policies.

Bulgaria can “borrow” several important things from Estonia’s experience:

- In respect of macroeconomic policy, this country follows very accurately the Estonian model, including a currency board arrangement, a balanced budget and a diminishing public debt. This must continue after admission to the EU as well.
- The big difference from Estonia is the insufficient improvement of the business environment in Bulgaria. An added effort is needed in this aspect of the reform, and this includes not just copying others’ experience but also resourcefulness and innovation in national economic policy.

2.2. Slovakia

In the mid-1990s Slovakia reported a low economic growth and high unemployment, a picture similar to the one in Bulgaria until 1997. Understandably, the country scored low in almost all economic freedoms. Eight years later, growth topped 6 per cent (forecast at 6.7 per cent for 2006). In early 2007, The Heritage Foundation ranked Slovakia as the world’s 40th freest economy, and in its reports for 2005 and 2006, the World Bank described Slovakia as the leading reformer in streamlining the procedures for starting a business. This progress resulted from a series of reforms carried out between 1998 and 2006, and in particular in the 2003-2004 period.

Economic freedom in Slovakia, 1999-2007 (100 = most free, 0 = repressed)

	2007	1999	Change
Economic Freedom	68.4	51.6	16.8
Business Freedom	71	50	21
Trade Freedom	76.6	68	8.6
Fiscal Freedom	93	68.7	24.3
Freedom from Government	60.8	3.9	56.9
Monetary Freedom	76.7	74	2.7
Investment Freedom	70	50	20
Financial Freedom	80	50	30
Property Rights	50	50	0
Freedom from Corruption	43	50	-7
Labour Freedom	62.5	-	-

Note: Data refer to the year before publication of the Index

Source: WSJ/Heritage Foundation, 2007 Index of Economic Freedom

The first term in office of Dzurinda’s reformer Cabinet

After 1998, the right-of-centre cabinet of Mikulas Dzurinda launched a number of stabilising and pro-market changes in economic policy. Among those that had mostly stabilising macroeconomic effect, we must mention the following:

- introduction of stricter fiscal restraints and control over the budget deficit and the public debt;

- deregulation of the financial sector and privatisation of state-owned banks;
- initial deregulation of the so-called "network" industries: energy, telecommunications, followed by reforms in the state intervention in pricing;
- liberalisation of capital transactions and investment regulations.

The shared element of these changes is the role of EU accession negotiations. These are spheres in which the EU directives require revisions of national legislation if a country wishes to join the Union. In this sense, we can find that in carrying out these changes the Slovak Government followed pre-set targets, and that manoeuvring room for local decisions was relatively limited.

The reforms since 2003

The second term in office of the right-of-centre cabinet began with a new reform package. These were rather "micro" or "structural" reforms, i.e. reforms intended to improve business operation and increase incentives to work and investments. The reforms focussed on tax policy, which was complemented by reforms in retirement and health insurance. Parallel to that, labour legislation was radically reformed, and regulations related to business start-up were partially revised.

The tax reform introduced as from 1 January 2004 included the following more important steps:

The VAT, corporate income and personal income tax rates are all a flat 19 per cent. Before that change, there were two VAT rates (14 and 20 per cent), corporation tax was 25 per cent (40 per cent until 1999), and personal income was taxed between 10 and 38 per cent. As a result, the effective taxation of corporations decreased, and the average effective taxation of financing dropped from 22.1 per cent to 16.7 per cent. Only four OECD countries (Lithuania, Latvia, Ireland and Cyprus) apply lower taxation, according to a study of the German ZEW Institute.[2].

In the short term, the reform had a neutral effect on the budget: in other words, aggregate revenue from the three taxes remained unchanged for 2003 and 2004 (at some 18 per cent of GDP). The relative weight, however, shifted from direct to indirect taxation.

Almost all tax reliefs and preferences were abolished for attainment of two objectives: simplicity of taxes administration and reduction of market distortions. Inheritance tax and dividend tax were eliminated as well. In practice, there is no double taxation in Slovakia, which encourages business self-financing rather than debt-financing.

The reforms in retirement and health insurance are similar to the framework set up in Bulgaria. Arguably, Slovakia closed the gap in these spheres without doing anything substantially different from the rest of the East European countries. Nevertheless, the total social insurance burden was lightened by 2.4 percentage points in 2004. Also, supplementary insurance at private, capital-accumulating funds helped the formation and channelling of investments in the economy.

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[2] Jacobs, O.H., H. Spengel, M. Finkenzeller and M. Roche (2003, 2004): "Company Taxation in the New EU Member States", First and Second Edition, Ernst and Young and ZEW, Mannheim/Frankfurt.

Labour market policies are based on two principles: reduced regulatory intervention in industrial relations and increased incentives to work through rollback of welfare benefits. In the first place, as part of the pension reform, the retirement age was gradually increased from 60 (men) and 58 (women) to 62 for both sexes. The combination of lower direct taxes on work and curtailed entitlement to welfare benefits led to a reduction of the effective tax on re-employment (the amount of lost benefits plus taxation upon recruitment), which encouraged a higher labour market participation. Parallel to that, the Government encourages the long-term unemployed to start work by a bonus (about a quarter of the minimum wage), above all through municipal employment programmes. The combined impact of these incentives leads to a heightening of labour supply by the long-term unemployed even for the lowest paid positions.

At the same time, labour legislation underwent substantial revisions. A possibility for work under renewable fixed-term contracts was introduced. The working week can be extended to 48 hours. The annual limits on overtime were relaxed from 150 to 400 hours. Trade unions' role in intervention in employee-employer relations was restricted: their consent is no longer required for the dismissal of a worker, nor for introduction of flexible working hours within up to four months. In collective dismissals, trade unions merely have to be notified but their authorisation is no longer required, unlike the practice until 2003. The amount of severance pay for redundancy has been decreased. According to a World Bank study[3] of 2006 (citing 2003 figures), Slovakia was the world's 8th most flexible economy in terms of hiring of workers.

The Government also took a number of steps to reduce *administrative barriers to business*. They include both direct costs (fees) and indirect costs (time) for business start-up and operation. In the first place, Slovakia removed company registration from the court, turning the commercial register into a fully administrative process. As a result, the time it takes to start a business was cut by three-quarters (from 98 days in 2002 to 25 days in 2004). The minimum capital requirement for a business start-up was lowered as well. Each company now has just a single identification number. A law established time limits within which the administration must issue the required operational licences and permits. The 3 per cent tax on transfer of immovable property was scrapped, which eased the mobility of assets. Claims enforcement procedures and loan collateral regulations were revised in such a way that the time for enforcement was reduced by three-quarters. According to the latest edition of the Index of Economic Freedom[4], for 2007, Slovakia's Business Freedom score soared 21 percentage points, from 50 to 71 per cent.

Slovakia: Selected business environment indicators

	2002	2004
Days to start a business	98	25
Minimum capital for start-up (% of per capita GDP)	112	41
Flexibility of hiring (index, 0 = most flexible, 100 = most rigid)	61	10

Source: World Bank, Doing Business in 2004-2006

3 World Bank, Doing Business in 2005, Washington DC, 2005

4 WSJ/Heritage Foundation, 2007 Index of Economic Freedom, Washington DC, 2007

Conclusion

The economic policy in Slovakia after 2002, which created prerequisites for fast economic growth, can be summed up by the following regularities:

1. Radical change of the tax system, with two targets: simplified administration of taxes and substantial reduction of direct taxation. Combined with the elimination of a number of taxes, this reform turned Slovakia into one of the most hospitable destinations for establishment of business and investments in the EU.

2. The reforms in the sphere of welfare benefits and the labour market focussed on an increase of the incentives to work. The combination of these policies with a tax environment favourable for new investments makes possible the achievement of fast economic growth and increase in employment. In addition, we must note that Slovakia did not restrict access to its labour market for workers from the rest of the EU countries, and thus encouraged labour mobility.

3. Parallel to these two principal areas of reform, the Government launched a number of other reforms as well: a change of the model of retirement and health insurance, simplification and reduction of administrative barriers to business, fiscal decentralisation in financing education. From a political point of view, this was a signal to the investor community that the government took its reform intentions seriously.

4. Each of these reforms resulted from a national political decision. EU membership did not dictate and did not encourage any of these changes, as evident from a number of studies, some of the EU Member States have heavy income taxation and a strongly restrictive labour market. Insofar as macroeconomic stabilisation in most post-communist countries was supported from the outside: by the IMF, the World Bank and, later on, the EU, on account of the future adoption of the euro, Slovakia's pro-market reforms of 2003-2004 are a product of national policy. They were carried out in a period when EU membership was no longer under a question mark, but the Slovak Government demonstrated a will to turn its country into a good place for doing business within the common market. They also indicate the relatively high priority which pro-market measures have in making policy and the efforts to enlist domestic support, at the expense of other decisions like, say, regarding the allocation of EU funds, farm subsidies or the income of public-financed sphere employees.

The lessons to Bulgaria:

- The Slovak experience is indicative regarding the possibility to carry out, within a short span of time, a radical tax reform improving the business environment: something that Bulgaria needs as well.
- The reforms of the labour market, social systems and education in Slovakia are also of interest to Bulgaria, considering the certain lag in these spheres in this country.
- Economic reforms come ever less as a result of external pressure and ever more as a result of domestic political will.

3. The Failure Stories

3.1. Poland

At the start of the market transition, Poland was a fast and resolute reformer, lifting a large part of the controls on prices of goods and services and allowing private business starts. After the mid-1990s, however, the pace of pro-market reforms slackened and fiscal discipline relaxed.

Since 2000, the country's economy has been reporting a growing public debt and large budget deficits, combined with a growth of public expenditures and a slow-down of growth. Capital formation has stagnated at one of the lowest levels in the "New Europe" countries. Labour market is stagnant, showing low participation levels and high unemployment.

Fiscal policy

Poland's public finances are in a relatively bad condition, judging from the amount of the budget deficit throughout the period since 1990. For 1997-2005, the deficit averaged 3.3 per cent of GDP, and it deteriorated visibly after 2000, when it averaged 3.6 per cent of GDP. Public debt, after a decline to 36.8 per cent of GDP in 2000, rebounded to reach 44 per cent in 2003. The existence of deficits, however, was not the result of a lowering of the tax burden but of a steady increase in spending, which exceeds 42 per cent of GDP.

The structure of expenditures is turning into another barrier to investment and growth in the private sector. Social expenditures reached 43 per cent of total expenditures in 2003-2004, compared to 33-35 per cent in the other ten countries that joined the EU in 2004. For 2004-2005, budget subsidies practically doubled, with Poland ranking fourth among the OECD countries in the level of State aid (after Malta, Cyprus and Finland, and close to the levels in Hungary). The expenditures on civil servants did not decrease either nominally or relatively, as a result of the governments' hesitancy to downsize public sector employment.

The only positive move in tax policy was a gradual reduction of corporation tax, from 40 per cent in 1998 to 19 per cent in 2005. At the same time, however, dividends attract an additional 19 per cent tax, which makes the effective taxation of income from entrepreneurship much higher than the region's average. Taxation of personal income is lagging behind progressively (after the failure of the proposed reform in 1999, vetoed by the President, which would have introduced 22 per cent flat taxes for all sources of income), and the maximum rate is 40 per cent. The aggregate social insurance contribution reaches 43 per cent of the wage.

Poland is also late introducing programme budgeting, a mechanism guaranteeing better transparency of public finance planning, as well as an instrument to eliminate ineffective government programmes.

At the macrolevel, the lavish government expenditures lead to two expected effects, having a strong adverse impact on economic growth. On the other hand, the incentives to labour market participation dwindle, with Poland already having the lowest employment rate after Bulgaria and Hungary. Unlike these two countries, however, where participation has been steadily increasing in recent years, the downward trend in Poland persists. On the other hand, high government expenditures, combined with other factors, limit investment opportunities. The overall rate of capital formation in Poland since the end of the 1990s has levelled at some 18-19 per cent of GDP, and the rate of investments in the private sector has dropped from over 21 per cent in 2000 to under 15 per cent in 2004.

Labour market and social policies

In the early and the mid-1990s, Poland's labour market developed as expected: the public sector shed jobs, while the emerging private sector absorbed the labour supply. Between 1992 and 1998, public sector employees decreased by 4 per cent on an average annual basis, and private sector employees increased by 3.7 per cent. Between 1998 and 2004, however, the public sector shrank by an average annual of some 7 per cent, while private sector employment did not grow appreciably.

All this shows that the labour market is insufficiently flexible. True, after a series of revisions of labour legislation, Poland is not among the most restrictive economies in respect of labour freedom. At the same time, however, it applies some of the heaviest restrictions on collective dismissals in the EU. In addition, labour legislation prohibits the dismissal of employees within four years of retirement. At the same time, social policy is relatively generous and gives World Bank experts a reason to define Poland as a precocious welfare state. After the mid-1990s, when the first adverse effects of the economic transition made themselves felt, entitlement to various allowances and benefits was limited. But, parallel to that, the new pension system eased the access to early retirement and to disability benefits. By 2002, as many as 13 per cent of the working population were receiving disability benefits, the largest proportion in the OECD. After 1997, benefits for employees in pre-retirement age were also introduced, and some 500,000 availed themselves of this entitlement by 2002. Farmers are covered by a special system of social security, under which they pay minimum contributions but enjoy full rights. In practice, this turns into a practice of indirect subsidisation of low productive workers.

The Government, too, poses serious obstacles to market mobility. Through the support for farmers and the subsidies for the enterprise sector, the State maintains less productive activities which retain labour power. Additionally, privatisation slowed down after 1990s, and the enterprises which remained state-owned resist reduction of employment.

Through its intervention in the housing market, and especially through various restrictions on the freedom of landlord-tenant relations, the State provides another disincentive to labour mobility.

Considered in conjunction with the high rate of taxation of income from work (43.1 per cent, compared to 36.5 per cent for OECD for 2005), all these factors presuppose higher incentives to non-participation in the labour market.

Business environment

The latest OECD Economic Survey of Poland finds definite progress in the reduction of regulatory obstacles to doing business, including the adoption of the Law on Economic Activity which lifted a number of licensing and permit requirements. Nevertheless, the country has an environment that is least conducive to doing business. In the first place, the level of state property is particularly worrisome: it is symptomatic of the slow-down of privatisation in the mid-1990s. By a number of actions, the Government created a perception of a negative attitude to foreign investors, like the attempt to prevent the merger of two large commercial banks owned by merging banks in Europe. Several large banks, holding 20 per cent of the assets of the banking system, remain government-controlled, and the financial sector has the lowest level of foreign participation in Central Europe. The Polish Government has the worst reputation regarding the existence of corruption among all governments of OECD countries. Until recently the State restricted foreign investors' investments in immovable property, and foreigners are not yet allowed to purchase land. The latest OECD survey on product market regulations ranks Poland at the bottom of all indicators, behind the average scores of the OECD countries and, worse yet, behind the best examples.

Product market regulations in Poland and OECD

	Poland	OECD average	OECD best practice
Total business regulations	2.8	1.5	0.9
State participation in the economy	3.6	2.1	0.6
Obstacles to entrepreneurship	2.3	1.5	0.8
Obstacles to trade and investment	2.4	1.0	0.3
Sector regulations	4.1	1.6	0.3

Source: OECD, 2003

Conclusion

Economic policy in Poland ceased to support fast economic growth and the improvement of productivity at the end of the 1990s. The reasons lie largely in the lack of a will to carry on pro-market reforms that had started earlier, but also in purposeful efforts worsening the business environment.

1. Imprudent fiscal policy. The growth of public expenditures presupposes an increase of the deficit and the public debt. In turn, this diminishes investors' overall macroeconomic security and prevents more radical tax cuts. In addition, a large share of expenditures is channelled to support unproductive activities, both in the form of subsidies and as welfare benefits.

2. The rigid labour market is a substantial problem. The negative factors are both the subsidisation of state-owned enterprises and their employment and the number of restrictions on hiring and firing. Welfare benefits and the heavy tax and social-insurance burden create a strong disincentive to labour market participation. The special subsidies to farmers, which artificially maintain employment in the low-productive agriculture, make things even worse.

3. The level of government interference in business is considerable. The reasons are both the numerous administrative barriers and the government's attempts to control certain economic sectors and to restrict the freedom of foreign capital investments.

Lessons to Bulgaria:

- Deterioration of macroeconomic policy: budget balance, public debt, government expenditures, must be avoided at all costs.
- Reforms of the labour market and of the welfare system should not lag behind. The same applies to the relinquishment by the State of a direct control of the economy.

3.2. Hungary

During the last ten years, Hungary has achieved substantial economic progress, with per capita income growing by more than a quarter compared to the EU average. This success was based on the economic reforms implemented mainly in the 1990s, such as privatisation, liberalisation of commodity markets and the labour market, reduction of certain taxes. For the last ten years, the country has had annually a sustained positive economic growth, even though it is moderately high.

Despite this development in the right direction, Hungary is losing ground compared to the other former socialist countries of the first wave of enlargement. While in 1997 Hungary was the third richest country among the eight, leaving the rest far behind, in 2006 Hungary was already outran by Estonia and within two years will trail Slovakia as well (according to the Eurostat forecast). While ten years ago Estonia was a quarter poorer than Hungary, at present Estonia performs better in terms of income.

During the three years of EU membership of the eight new Member States, Hungary showed the worst growth of per capita income as a percentage of the Union's average. The growth during those three years was just 2.8 points, a mere 5 per cent, considering that Estonia's growth was over quintuple that level: 27 per cent. The first years of Hungary's EU membership were not as successful economically as they were for Estonia and the other fast-growing economies.

Business environment

Even though it is among the relatively free economies according to the Index of Economic Freedom of The Heritage Foundation and *The Wall Street Journal*, Hungary, ranked as the world's 44th freest economy, is less free than five of the other seven new Member States. In the ten specific economic freedoms, Hungary surpasses Estonia in just one.

In respect of the business environment in 2006, the World Bank ranked Hungary 66th, down six rungs from 2005. The country showed a decline in each of the ten indicators, with the exception of closing a business, where a certain improvement is observed.

Certain problems of the business environment in Hungary

		Estonia	**Hungary**
Doing business (rank)		17	66
Starting a business	Cost (% of per capita income)	5.1	20.9
	Minimum capital (% of per capita income)	34.3	74.2
Business licensing	Number of procedures	13	25
	Time (days)	117	212
	Cost (% of per capita income)	34.3	260
Registering property	Number of procedures	3	4
	Time (days)	51	78
	Cost (% of value of property)	0.7	11
Paying taxes	Number of payments	11	24

	Time (hours)	104	304
	Total tax burden (% of profit)	50.2	59.3
International trade	Number of export documents	5	6
	Time for export (days)	3	23
	Cost of export (USD per container)	640	922
	Number of import documents	6	10
	Time for import (days)	5	24
	Cost of import (USD per container)	640	1,137

Fiscal policy and labour market policy

The tax burden and its reallocation through the budget are among the highest in the region, with government expenditures approximating 50 per cent of GDP and revenues 43-45 per cent.

In the autumn of 2002, keeping a campaign promise, the new Socialist government raised the wages of most employees in the public-financed sphere by 50 per cent. At the same time, the minimum wage, too, was increased by as much as 90 per cent over a two-year period. The shock rise of public-sector wages led to an average 13 per cent increase of income in real terms, far above the growth of labour productivity. During the following year, the growth of income was halved and settled at levels below the one before the government's moves.

As a result of this policy, the budget deficit doubled, reaching 9 per cent of GDP, levels that Bulgaria experienced on the eve of its crisis in 1996. Private ownership of the economy, a stable banking system, relatively free markets and a stable banking system in Hungary helped the country avoid the Bulgarian scenario of the mid-1990s.

Nevertheless, the adverse effects of the shock rise of public-sector wages and of the minimum wage were serious: the budget deficit induced an increase in public debts, unemployment grew, especially among women, economic growth decelerated, and investments in the economy declined. Inflation advanced as well, just as interest rates, and exports fell for the first time in years. The Government's moves, which were supposed to increase income, actually led to an increase in poverty.

In 2004 the Government tried to take measures to cut the budget deficit, but the result was far from satisfactory: the decline was negligible. In 2005 the Government started to use accounting tricks to meet the budget deficit target, but these measures were rejected by Eurostat. Employment in the economy edged down from an already low rate of 50 per cent of the working-age population.

The situation deteriorated further before the elections, as the Government cut the VAT rate from 25 to 20 per cent (it decided to reverse the action after winning the elections) and increased public spending. In 2006, the International Monetary Fund expected a budget deficit of 11 per cent, which means that meeting the 3 per cent required under the Maastricht criteria would necessitate a reduction of government expenditures and/or increase of the already heavy tax burden by as much as 8 per cent of GDP. Economic growth for 2006 was expected to fall for a third year running.

Conclusion

In the economic sphere in the first year of its EU membership, Hungary showed the worst results among the eight new Member States. This was due to a gradual lag behind in respect of the business environment and to problems generated by an imprudent macroeconomic policy.

1. The low ranking in terms of economic freedom and doing business, along with high taxation, held back the potential of the economy.

2. The enormous budget deficit and its growth heightened investment risk, hiked interest rates, and impeded export.

3. The decreed rise of public-sector wages and of the minimum wage above labour productivity affected adversely unemployment, employment and income.

The lessons to Bulgaria:

- Without an improvement of the business environment and reduction of taxation, prosperity is difficult to achieve.
- The trap of worsening the budget balance and admitting a budget deficit should be avoided. Regardless of the purpose, this would have a negative effect.
- An administrative intervention in the market, including the labour market, affects adversely economic development.

4. Preparation for Adoption of the Euro

As is well known, the EU was last enlarged on 1 May 2004, with eight of the ten new Member States being post-communist countries with political, economic and social characteristics close to Bulgaria's. Community law existing at the time of the fifth enlargement of the EU does not allow the new Member States to invoke an opt-out clause for membership of the Economic and Monetary Union (EMU). This means that each of the new Member States has to determine the timeframe within which it will join the Euro-zone and will adopt the euro as its national currency.

Community law does not fix an express date for adoption of the euro, nor a period within which the convergence criteria must be met. Even though there is no expressly established time limit for joining the Euro-zone and adopting the euro, all new Member States have national plans describing the required steps and the timeframes within which they intend to introduce the single currency.

Acceding to the Economic and Monetary Union and adopting the single European currency implies ceding a country's monetary policy from the national central bank to the supra-national Eurosystem. In such case, the country's monetary policy is not guided solely by the state of the national economy but also by the state of the economies of the countries participating in the Euro-zone. In other words, membership of the Economic and Monetary Union presupposes exclusion of monetary policy from the national governments' set of instruments for formulation and implementation of their countries' economic policy. This is seen as the main disadvantage of a country joining a monetary union. The underlying assumption is that independent monetary policy can offset the rigidity of certain micro markets (labour, goods and services).

The potential advantages of a country's membership in an economic and monetary union can be sought in the following aspects:

- With the adoption of the single currency, the country will save on households' and companies' transaction costs because the national currency will no longer have to be exchanged in euro and vice versa.

- The single currency also eliminates the existing foreign-exchange risk, creating an added incentive to the influx of capital into the country. No matter how consistent and stable the monetary policy of the respective national bank may be, the existence of a national currency in itself generates a foreign-exchange risk, which makes investors seek a risk premium for foreign-exchange risk, as well as limit their exposures in the relevant national currency.

- Expressing the prices of goods and services in all Euro-zone countries in one and the same currency achieves greater comparability of prices, which limits retailers' capacity to influence the prices of goods and services and provides better protection to consumer interests.

- Joining an economic and monetary union leads to a reduction of nominal interest rates, both thanks to the elimination of the foreign-exchange risk and as a result of a reduction of the sovereign risk.

- The single currency will also provide an additional incentive to trade between the relevant economy and the countries participating in the monetary union, due to cutting of transaction costs and elimination of the foreign-exchange risk. Joining the economic and monetary union gives an impetus to the country's international trade.

- Joining the country to an economic and monetary union also results in greater flexibility of the relevant country's fiscal policy while observing the principles and rules of the Stability and Growth Pact.

- Joining the Economic and Monetary Union and applying the principles of free movement of goods, services, capital and persons eases the pressure on the relevant country's balance of payments. In practice, with the adoption of the euro as an official currency, most of the country's international trade will be transacted in national currency. This also has an impact on the international reserves, which the country has to maintain in order to service its external (public and private) debt and to carry on international commerce.

- The adoption of the single European currency and the adherence to a single monetary policy, oriented to achievement of price stability, creates conditions for additional deepening of financial intermediation in the country and fuller integration of the national financial market into the European financial market. This gives the private sector access to a far larger and diversified financial market, which will additionally ease the access of households and companies to loans.

The ten new EU Member States fall into two categories. One category comprises seven countries (Estonia, Lithuania, Slovenia, Cyprus, Malta and Slovakia)[5], which have already

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[5] Estonia, Lithuania and Slovenia joine ERM II on 27 June 2004, Latvia, Malta and Cyprus did so on 29 April 2005, and Slovakia followed suite on 25 November 2005. Estonia and Lithuania joined ERM II with a fixed exchange rate against the euro, which had been in force since the introduction of a currency board arrangement in those countries, in 1992 and 1994, respectively. Latvia, which has also adhered to a quasi currency board arrangement since regaining independence in the early 1990s, joined ERM II at the same level of the exchange rate. For details on the joining of those countries to ERM II, see www.ecb.int

joined the Exchange Rate Mechanism II (ERM II) and are planning to adopt the single currency within a short period of time. Slovenia managed to fulfil the Maastricht criteria and entered the Euro-zone on 1 January 2007. Lithuania and Estonia meet all criteria except price stability and postponed their participation for 2008. The rest of the countries also plan to join in 2008 or 2009, depending on their ability to fulfil the convergence criteria.

The second category of countries (Poland, the Czech Republic and Hungary) are economies with a floating exchange rate, following an independent monetary policy based on an inflation targeting regime. What is typical of these economies is that they were long unable to get their budget policy under control, which leads to high budget deficits and a growing government debt-to-GDP ratio[6]. In these economies, the inability to achieve financial consolidation and sustained reduction of the level of their budget deficits that would enable them to meet the Maastricht criteria explains why they are planning to adopt the single currency at a later stage, between 2010 and 2012.

The readiness of the new Member States to adopt the single currency should not be viewed only as an ability to meet certain nominal economic criteria. Participation in the monetary union must be regarded as an ability of national governments to restructure and liberalise their economies, so that they could be sufficiently flexible to develop successfully within the monetary union. The existence of an overcontrolled labour market, strictly regulated economic sectors, state intervention and lack of competition at the micro level sets the pace at which a country will be aspiring to adopt the single currency. From this point of view, we can regard participation in the Euro-zone as a test of the readiness to carry out economic reforms and liberalise a national economy.

Conclusions and lessons to Bulgaria

Regarding the strategy for participation in the Euro-zone, the experience of the new Member States showed that implementation of a policy of early accession stimulates the carrying out of microeconomic reforms and leads to a faster growth of income, which is the ultimate goal of any economic policy. To Bulgaria, which has a currency board arrangement just like Estonia and Lithuania, stands more to gain than to lose by opting for a policy of early entry into the Euro-zone.

Bulgaria must join the Exchange Rate Mechanism II as soon as possible after the country's accession to the EU at the existing level of the exchange rate of the lev against the euro and must declare a unilateral commitment to keep the currency board arrangement until entry into the Euro-zone (i.e. zero fluctuation of the exchange rate). At present, Bulgaria meets on a sustained basis all Maastricht criteria with the exception of price stability. With the existing monetary policy regime and a strongly conservative fiscal policy, microeconomic measures have to be taken in order to meet the price stability criterion. An improvement can and must be sought in the following main areas:

- Competition in sectors producing non-tradable goods and services. On the one hand, the lack of competition leads to a higher level of the prices of goods and services in these sectors, which affects directly the rates of inflation in the country, individuals' purchasing power and their perception of social development (production and distribution of electricity and heat are a case in point). On the other hand, the companies producing tradable goods often use, as an intermediate product, goods and services from the non-tradable sector,

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[6] For the last five years, Hungary's budget deficit has averaged 6%, Poland's 3.6%, and the Czech Republic's 5%.

which often affects their competitiveness on the international markets. Ensuring a high degree of competition in all economic sectors is an essential precondition for maintaining competitiveness, for meeting the price stability criterion, and for increasing the prosperity of the entire society.

- Data on the domestic labour market suggest a very low economic activity rate in the Bulgarian economy. This can be determined by a number of factors: the qualifications of the labour force and the incentives to retraining and training; the social policy, which must encourage economic activity and not lead to passive receipt of benefits from the State; the tax policy, which must encourage formal hiring instead of concealment of labour costs due to the existence of high taxes on labour. Households and companies determine their behaviour depending on the incentives created by the domestic environment, including the regulatory framework, and by the incentives defined by the international environment. Labour market policy must seek to create incentives to labour market participation rather than to claiming passively benefits from the State.

- The level of productivity in the Bulgarian economy is around 30 per cent of the level in the EU. The regulatory and education policy in this country, as well as the policy in respect of the investment environment, must be oriented to improvement of the incentives to investment in physical and human capital and to enhancement of productivity in the economy. The higher rates of growth of labour productivity can assure a higher growth of income without generating inflationary pressures on the economy.

Annex: Euro-zone Participation Criteria

The building of a stable and sustainable monetary union requires the achievement of a high degree of real and nominal convergence among the economies of the individual participating countries. Achieving nominal convergence is expressly stated as a precondition for joining the economic and monetary union, whereas real convergence is not specified in any document of the European Commission and the European Central Bank as a formal criterion for participation. Since achieving nominal and a real convergence are inter-related processes, it is practically impossible to achieve one type of convergence without attaining the other. Considering this interrelation, the real criteria of convergence, like per capita income as a percentage of the average level in the EU, price levels as a percentage of the EU average, level of financial intermediation, integration of international trade, convergence of business cycles, are informal criteria which must be attained so that the relevant economy could successfully integrate into the monetary union.

The conventional theory, developed in the 1960s by Mundell (1961), McKinnon (1963) and Kenen (1969), presupposes the achievement of specified preconditions so that the countries could represent an optimum currency area and form a sustained monetary union.[7]. These pre-set criteria include integration of commodity and financial markets (free movement of goods and capital), integration of the labour market and high labour mobility, synchronisation of business cycles, and a minimum level of co-ordination of fiscal policy and fiscal transfers.

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[7] See Mundell, R. (1961) "A theory of optimal currency areas", *American Economic Review*, Vol. 51, p. 657-665; McKinnon, R. (1963) "Optimum currency areas", *American Economic Review*, Vol. 53, p. 717-725; Kenen, P. (1969) "The theory of optimal currency areas: An eclectic view", in R. Mundell and A. Swoboda, eds. "Problems of international economy", Chicago University Press.

The more recent literature, based on the article of Frankel & Rose (1998)[8], shows that these criteria are actually endogenous, i.e. the formation of a monetary union itself leads to faster convergence and, hence, to ex-post fulfilment of the criteria of an optimum currency area.

The nominal convergence criteria, popularly know as Maastricht criteria, explicitly set five preconditions which each country must fulfil in order to be admitted to the EMU:

- Attainment of a stable basis of a rate of inflation, which must not exceed 1.5 per cent more than the average rate of inflation of the three Member States with the lowest inflation. Inflation is measured by the harmonised consumer price index, and this criterion must be met in the course of twelve months preceding the conduct of the assessment.

- Attainment of a nominal long-term interest rate which mist not exceed 2 per cent more than the rate in the three Member States with the lowest inflation. The yield of ten-year government securities is used as a reference interest rate, and this criterion must be met in the course of twelve months preceding the conduct of the assessment.

- Attainment of a budget deficit which must not exceed 3 per cent of GDP. This criterion must be met during the calendar year last preceding the conduct of the assessment. Even though the assessment is based only on the data on the year preceding the conduct of the assessment, attainment of a low budget deficit must be a sustained tendency because this criterion continues to apply even after joining the monetary union because it is embedded in the Stability and Growth Pact.

- Attainment of a ratio of gross government debt to GDP that must not exceed 60 per cent. This criterion must be fulfilled during the calendar year last preceding the conduct of the assessment.

- Maintaining a fixed exchange rate for a period of at least two years through participation in the Exchange Rate Mechanism (ERM II). The national currency may not be devalued during that two-year period. This criterion must be fulfilled at least two years before conduct of the assessment.

The overall assessment of the readiness of a country to join the economic and monetary union as a full member also takes into account the formal criteria of nominal convergence and alignment of national legislation related to the single currency, monetary policy and the statute of the central bank[9], as well as the informal criteria of real convergence (legal comparability). The moment of full accession to the Economic and Monetary Union is not entirely within the control of the relevant country's government. The positions of the European Commission and of the European Central Bank are set forth in the Convergence Reports, and the EU Council of Ministers has the final say.

5. Conclusion

The EU enlargement of 2004 did not produce the same results in all new Member States. Estonia, the rest of the Baltic States and Slovakia were successful not only thanks to a harmonisation of their laws and policies with the EU. The underlying reason for their success was their ability to identify their own interest and to pursue policies leading to a larger growth

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[8] Frankel, J. & Rose, A. (1998) "The Endogeneity of Optimum Currency Areas Criteria", *The Economic Journal*, vol. 108,№449, p. 1009-1025.

[9] On the alignment of national legislation in respect of the single currency, the monetary policy and the statute of the central bank, see ECB Convergence Report, May 2006. www.ecb.int

of their economies. Countries like Hungary and Poland do not enjoy the same success because of flaws in microeconomic policy (including the business environment), a reluctance to carry out reforms, which is complemented by an imprudent macroeconomic policy, resulting in high unemployment and slow growth of income and the economy.

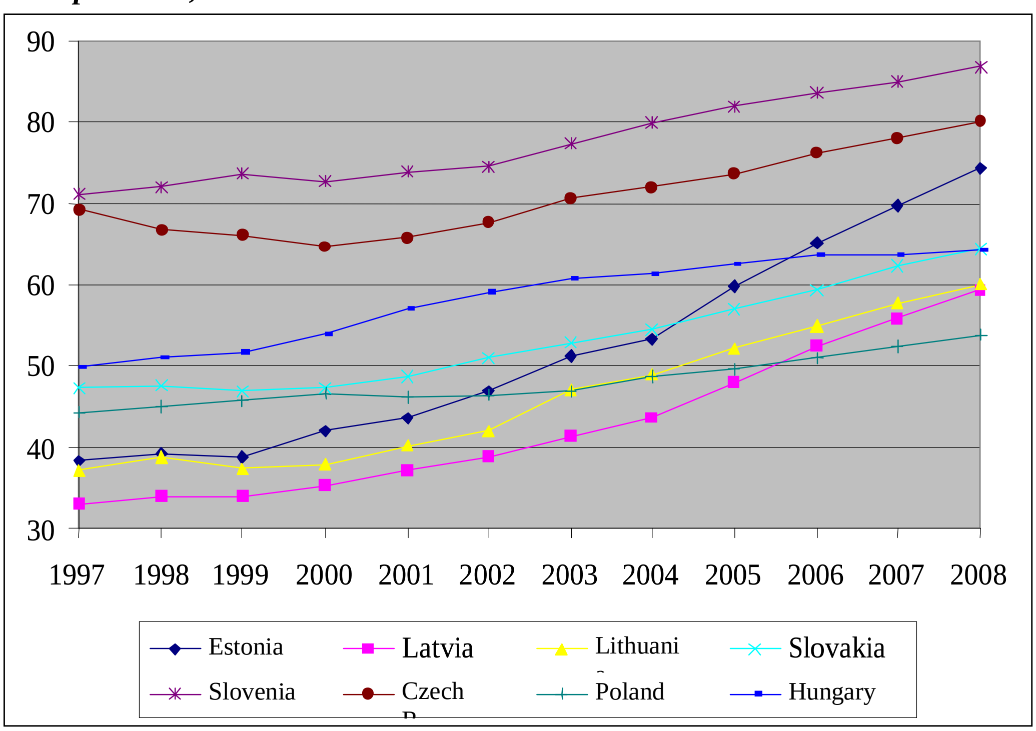
The preparation for participation in the Euro-zone involves the carrying out of economic reforms and achieving flexibility and competitiveness of the economy. Accordingly, those countries that implement a more reform-minded economic policy and that prepare their economies for participation faster will be able to adopt the euro at an earlier stage.

To follow the good examples and to avoid the bad ones, Bulgaria should maintain a prudent macroeconomic policy, improve its business environment and reduce and simplify taxation, refrain from intervention in the markets and keep up the pace of reforms in the labour market and public services. This requires the presence of domestic political will, since ever fewer important reforms will be carried out under external pressure.

Regarding the adoption of the euro, Bulgaria stands to gain more if it follows a strategy of early entry into the Euro-zone. To make this happen, the country must keep the existing level of the exchange rate of the lev against the euro until joining the Euro-zone. In addition, microeconomic reforms are required to promote competition, increase the flexibility of the labour market, and improve labour productivity.

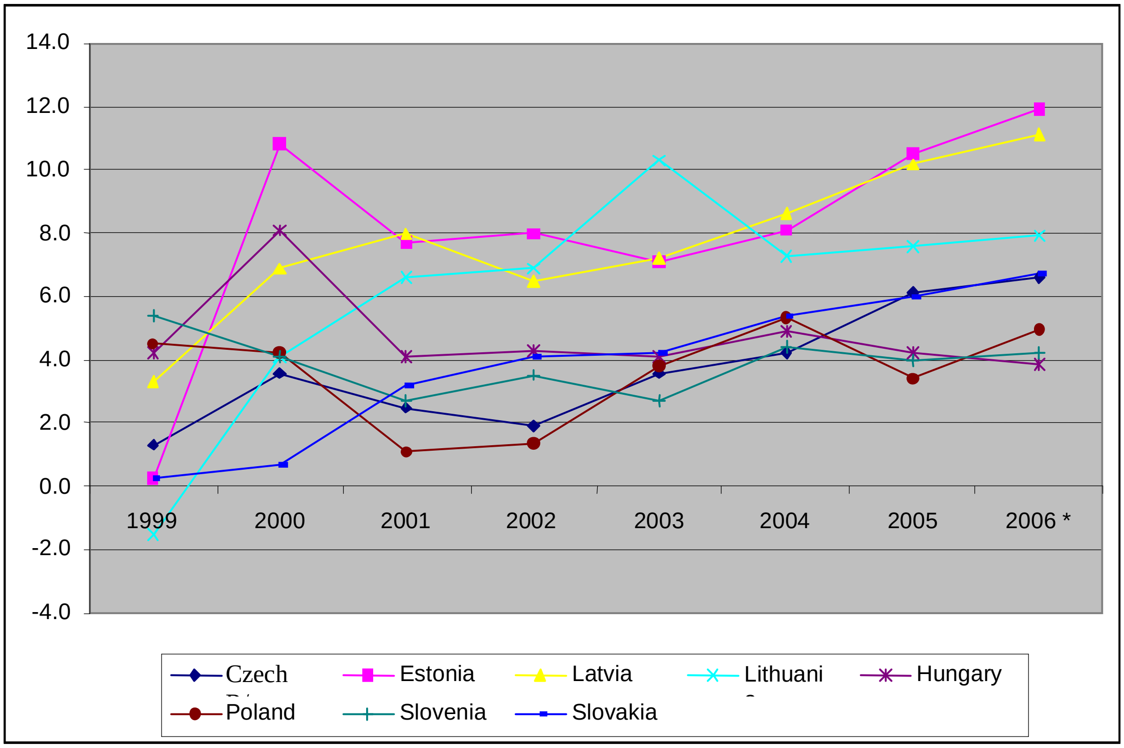
6. Annexes

Per capita GDP, EU-25 = 100



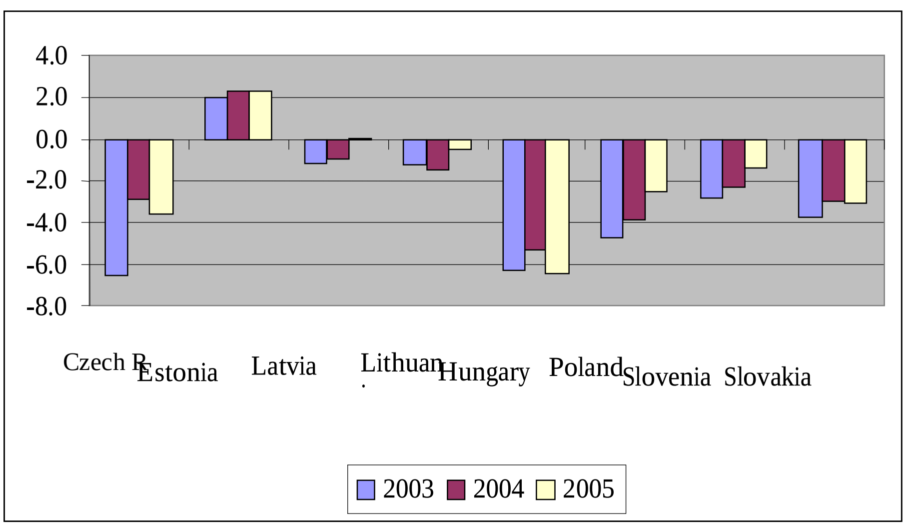
Source: Eurostat

Economic Growth, 1999 – 2006



Source: Eurostat

Budget balance, % of GDP



Source: Eurostat

Doing business: ranking worldwide

	2006	2005
Lithuania	16	15
Estonia	17	17
Latvia	24	31
Slovakia	36	34
Czech Republic	52	50
Slovenia	61	56
Hungary	66	60
Poland	75	74

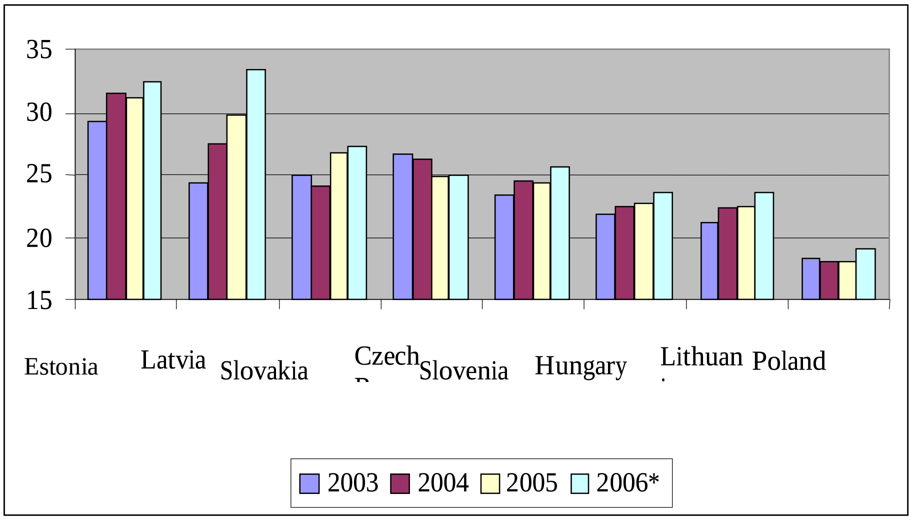
Source: World Bank

Economic freedom, 2007 (maximum: 100)

Estonia	78.13
Lithuania	72.00
Czech Republic	69.68
Slovakia	68.37
Latvia	68.21
Hungary	66.15
Slovenia	63.60
Poland	58.77

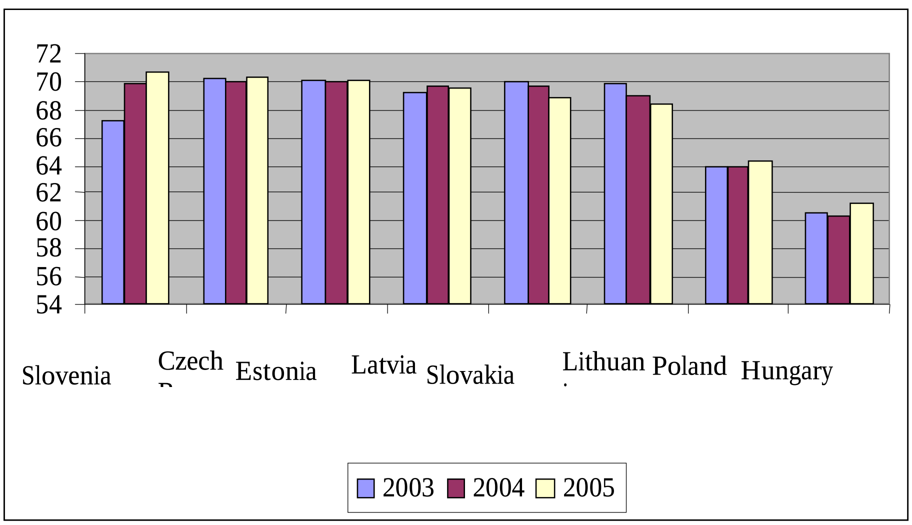
Source: The Heritage Foundation

Investments (gross fixed capital formation)



Source: Eurostat

Economic activity rate, population aged 15-64



Source: Eurostat

Growth of labour productivity