Chapter 3

Promoting Fiscal Restraint in Central European Accession Countries

Annex

Introduction

In its Spring submission, Global Insight concentrated on reviewing key policy challenges facing the governments of the 10 accession countries. We identified two major challenges:

- The need for fiscal restraint in the run-up to membership in the Economic and Monetary Union (EMU);
- The relative role of monetary and fiscal policies and the independence of the central bank.

Based on this preliminary analysis and additional research, we have determined that the developments in the area of public finance and the need to sharply reduce budget deficits in the next several years constitute by far the biggest challenge for accession countries. This challenge is of particular importance for the largest economies in the group, as in their case, the build-up in government spending over the last several years resulted in a public finance position that is not sustainable in the longer term. Moreover, their fiscal situation threatens to prevent the economies not only from meeting the Maastricht criteria, but also from reaching their growth potential. In this paper we expand our analysis of the fiscal position of the accession countries and discuss likely scenarios of developments. In order to keep the study manageable, while providing the most comprehensive review of issues involved, we concentrate on analyzing the situation prevalent in the three largest EU-accession economies: Poland, the Czech Republic and Hungary (called CE-3 throughout the remainder of this report). These three economies accounted for 78% of the GDP of all accession countries in 2002 and were (with the exception of Malta) by far the furthest from meeting the Maastricht criterion for fiscal budget deficit levels. We first review the developments in the fiscal position of the CE-3 countries in the last few years, providing detailed discussions on 2002 and 2003 budgets. We then move to review the pre-accession economic programs adopted by the three governments over the last several months, placing special emphasis on the public finance aspects of the programs. Subsequently, we outline several scenarios of developments in the public finance positions of the CE-3 countries for the years 2003-2006.

It is important to note that while difficulties in keeping deficits under control are common for all three economies, the underlying causes of these problems and suggested solutions may well vary among the countries. These specific differences are discussed in detail in this paper.

Background

The fiscal balances of the three Central European candidates for EU membership—Poland, Hungary, and the Czech Republic—have deteriorated considerably over the last two years. The reasons for the widening of state and consolidated budget deficits have differed among the countries. Some of the excessive increases in expenditures stemmed from outlays related to the implementation of pension, health care, and educational reforms. In addition, the economic slowdown across the region that hit in late 2001 and early 2002 kept tax revenues below expectations and resulted in short-term liquidity problems. Finally, the governments in Hungary and the Czech Republic introduced extensive fiscal packages to stimulate their struggling economies through large-scale investment and current spending programs.

In addition to short-term factors worsening deficits in the region, regional budgets are suffering as well from the effects of past short-term decisions taken without proper assessment of their long-term consequences. This applies in particular to Poland and Hungary, where the previous and

current governments competed in offering entitlements to large portions of the population without taking into account the impact of future demands on public funds. In Poland, these took the form of indexation of wages and retirement and disability payments. In Hungary, the entitlements were part of a pre- and post-election spending spree that resulted in a one-off 52% rise in wages of the public sector employees. In the Czech Republic, the lack of proper supervision of the banking system in the early 1990s and the indirect method of dealing with the "bad loan" problems still haunts the national government.

In many cases, decisions to increase fiscal spending from already high levels were made with the full understanding that the resulting build-up of deficits and, in consequence, of net public debt would put meeting the Maastricht criterion--a public finance deficit no larger than 3.0%-of-GDP in the course of the next several years--out of reach. The argument used by some of the policy-makers in the region (some of whom continue to support this view) is that while reductions in the budget deficits should ultimately be undertaken to meet the criterion, this process should not ignore the developments in the real economy. In brief, if the movement toward greater fiscal restraint threatens to bring about a significant slowdown in economic growth, such a restrictive policy should be reviewed and adjusted as appropriate. Notably, the governments of the three largest accession countries, Poland, the Czech Republic and Hungary, stated recently that while accession to the EMU and the adoption of the euro in the shortest time possible would be desirable, their policies with respect to budgets will be more balanced and take into account a variety of factors.

Such an approach could, however, bring unwanted results. The policy of increasing government spending purportedly to prop up growth in the economy may well serve to hide the sad truth that most of the monies spent are used ineffectively and on programs that, in the end, do not bring the desired results. The evidence suggests that most of the increase in spending has not necessarily been directed towards investment, but rather ended up expanding already excessive entitlement programs. In addition, it is likely that such policies may in almost all cases, amid an environment in which fighting inflation remains the top priority of local central bankers, lead to unnecessarily high interest rates. This, in turn, actually serves to depress domestic private investment.

Although the fiscal positions of the accession countries have clearly been affected by an economic slowdown that can be at least partially linked to the weakness of the global economy, the widening of the budget deficits was due mostly to excessive spending rather than to an unanticipated shortfall in budgetary revenues. In many of the largest accession countries, the large share of fixed costs in the budget, mostly related to social spending, limits room for maneuvering by the governments. Sometimes, the only hope left is for much stronger growth that would boost tax revenues and close the budget gap. Moreover, the willingness of national governments to reduce deficits is countered by the need to maintain at least the appearance of an intact social safety net to avoid defeat at the polls at the hands of a disenchanted electorate.

Budgetary Medium-Term Planning – The Weakest Element of the Current Policy Environment

In addition to attempting to use fiscal policy as a tool to prop up growth in struggling economies as well as please the electorate with increased social spending, one of the major inherent weaknesses of public finance planning in Central Europe is its short-term horizon. While the so-called medium-term economic plans are being published, the truth is that budgets have been and, in some cases, still are prepared just for the following year. Such an approach makes it very difficult for policy-makers to assess the long-term effects of their budgeting decisions. In addition, it also makes the influence of political and social interest groups on the budget planning

process that much more important. The governments refer to these as "social considerations" in designing the budget. The belief is quite widespread that stricter reductions are not necessary in the short-term as it will be up to the next government in power to take care of the fiscal consequences of current actions.

Some attempts at providing a more extended view of the budgetary policy making process have been undertaken, but only quite recently. For example, in the Czech Republic the new Act on Budgetary Rules requires individual ministries and extra-budgetary funds to present three-year projections of expenditures. Each new draft law now also is to be accompanied by an assessment of its impact on the budget in a perspective of three-years. This is, however, an exception to the rule. For example, the first serious attempt at capping expenditure levels proposed by the former Polish finance minister Marek Belka during the preparation of the 2002 draft budget was flatly rejected by his successor as an unnecessary constraint. Under this concept, dubbed "inflation plus 1%" and envisaged to anchor public finances in periods of slow growth, the government does not target a specific amount for the state budget deficit, but rather concentrates on restricting growth in expenditures. The deficit is treated as a residual and fluctuates depending on the collection of budget revenues. This system could have proven particularly useful in the short-term to stabilize the expenditure side of the budget. In the long-term, however, major expenditure cuts might still be needed to bring the deficits down to considerably lower levels.

The high share of fixed (legally-mandated) expenditures in total budgetary spending is another important constraint for policy-makers. As a result of past policy decisions and adopted laws, this share has been steadily increasing over the last several years. To use the example of the Czech Republic, the cumulative rate of growth in socially-related spending (pensions, disability payments and public sector wages) far exceeded this for other categories of expenditures (see Table below) and contributed to a steady rise of those expenditures in the total.

Table 1: Dynamics of Public Expenditure in the Czech Republic 1995-2001

	Expenditure growth 1995-2001 in %	Weight in total expenditures 2001
Total general government expenditure	54.5	100.0
Of which: Social security and social care	95.1	33.9
Health care	58.8	15.9
Education	28.8	10.1
Defense services	29.0	8.8
Transportation and communication	59.4	8.0
Housing and community services	47.6	6.5
General public services	5.0	5.9
Other economic affairs or services	83.5	5.9
Recreational and cultural services	70.6	2.5
Agriculture, forestry, fisheries	112.4	2.4

Source: Pre-Accession Economic Program, August 2003, the Czech Republic

This structure of expenditures is not that much different for Poland and Hungary. It also implies that short of either freezing these fixed expenditures in real terms, or outright cutting them through drastic reforms of entitlement programs (which are both planned for the next several years), the only area of public spending where the governments still enjoy some flexibility are expenditures incurred by governmental departments and agencies. In these cases, with budget revenues dependent on tax collections that, in turn, reflect the pace of economic growth, the safest way to reduce expenditures gradually and without a dampening of economic growth is the implementation of a system of medium-term expenditure ceilings. Such ceilings, usually applied

for periods of between three and five years, set the maximum amounts of spending for all levels of expenditures that are relatively fixed and can be predicted. These ceilings apply to spending by all branches of the government including off-budgetary funds. The ceilings can then be reviewed every three to five years, and the spending levels monitored regularly to determine the availability of funds within the preset budget.

The British experience could be considered a good guideline in application of such maximum spending targets. In 1998, the U.K. government announced a new process for the planning and controlling of future public expenditures. Beginning in the 1999–2000 budget, the country's public spending has been regulated by the Total Managed Expenditure (TME) system. The TME included two major components, Annually Managed Expenditure (AME) and Departmental Expenditure Limits (DEL). The AME was home to a small number of large programs, whose expenditures are demand-led, volatile, and large in relation to the department. Such programs included: benefits, housing subsidies, EU funding for the Common Agricultural Policy, public service pensions, and the lottery. The AME projections were reviewed semi-annually.

The DEL consisted of the bulk of the expenditure programs managed by individual ministries and departments. The government, abandoning annual spending reviews of these programs, initiated a Comprehensive Spending Review (CSR) where strict, multi-year spending limits for each department were set for 1999-2000, 2000-01, and 2001-02. Another CSR was held in 2002, establishing limits for 2003-04, 2004-05, and 2005-06. The spending teams of the Treasury's Public Service Directorate, in consultation with individual departments, draw up the three-year limits. Spending limits for each department were strict, with increases only in exceptional cases, drawing additional funds from the DEL reserve only after a review from the Treasury. Departments are allowed, however, to carry over any unused funds from one year to the next. Within the limit, each department is allowed to allocate its own resources and chart its own decisions.

Departmental spending is clearly delineated between current and capital spending, with DELs separated between resource and capital. The capital DEL includes spending on fixed assets, giving loans, and buying shares. Resource DEL, then encompasses the rest of spending, including the operating costs of the departments, purchasing of services, grants and subsidies to the private sector, and non-cash items such as depreciation. In return for flexibility within departments for resource allocation, the departments had to sign three-year performance contracts, or Public Service Agreements, with specific output and result targets. The new TSE was designed to free departments from the bureaucracy of annual budgets and focus on strategic planning and results.

Public Finance in the Pre-Accession Economic Programs

The absence of a transparent medium-term budget plan and clear planning guidelines makes forecasting budget deficits in CE-3 very difficult. While in all cases, the budget deficit level of 3.0% of GDP is a generally accepted target for the medium-term, it is almost impossible to follow the progress in nominal convergence to this target. With a complete lack of a legally or even organizationally defined schedule, the only source of information on the government's medium-term plans with respect to public finances is information included in the Pre-Accession Economic Program filed on an annual basis by candidate country governments with the European Commission. An updated set of these reports was submitted to the Commission in Brussels in late August of this year. The picture transpiring from these plans is not very promising. Moreover, the

reports and conclusions included therein are in no way binding on the governments to undertake specific actions. Rather they should be viewed as a general framework for nominal convergence with the EU set-criteria. The experience of the last two years teaches us that the commitment of the CE-3 governments to stick to the published guidelines is illusory. The assumptions and the result vary substantially between the annual documents. Therefore, there is no guarantee that the plan won't be changed again. Nevertheless, these reports warrant a closer look.

With the exception of Hungary, where the government is planning to undertake a massive reduction in government spending to bring the deficit down from 9.2% of GDP in 2002 to just under 3.0% of GDP in 2006, the other two countries seem to take a much more liberal approach to budget expenditure management. As such, the target date of meeting the 3.0% of GDP level is seriously postponed from the original plans, to 2007 in Poland and 2008 or even 2009 in the Czech Republic.

The **Polish** government now seems resigned to the fact that the public finance deficit is likely to expand substantially in 2004 before accelerating economic growth permits a reduction in the gap in the subsequent years. Calculated according to the ESA-95 methodology, the public finance gap is set to rise from close to 4.1% this year to 5.0% in 2004 before declining gradually to 4.0% in 2005 and below 3.4% of GDP in 2006. While the rise in 2004 reflects the unwillingness of the government to face reality and cut expenditures already next year, the forecast for the subsequent years is even more questionable, mostly due to two factors. First, the assumed growth of 5.0% in both 2004 and 2005 and 5.6% in 2006 exceeds even the most optimistic consensus forecasts. Second, the first year of planned reduction falls in 2005, an election year. It is therefore, hard to imagine that the government's resolve to cut expenditures will be strong enough to outweigh political considerations. The plan provides little information in terms of identification of areas where cuts or realignments will be introduced. This type of information will not be available until the full medium-term economic program is announced in late September.

Table 2: Poland -- Fiscal Developments (Central government budget, percentage of GDP)

	2002	2003	2004	2005	2006
Budget revenues	42.1	43.1	42.9	42.2	42.1
Budget expenditures	45.9	47.2	47.9	46.2	45.5
Deficit (ESA-95)	-3.8	-4.1	-5.0	-4.0	-3.4
Deficit (Current Polish Methodology)	-6.0	-6.1	-5.8	-4.8	-4.0

Source: Ministry of Finance: Pre-Accession Economic Program of Poland, August 2003

Even without the detailed program at hand, its is safe to assume that the government will attempt to identify several categories of expenditures where rationalization of spending and the introduction of even small adjustment to existing regulations could result in major savings for the government.

First and foremost, large savings are potentially available within the inefficient social security scheme for farmers (KRUS). Currently farmers are not required to contribute to the program, while they receive regular retirement benefits. The introduction of a system of nominal farmer's contributions could reduce the expenditures by as much as 12 billion zlotys.

Similar to the situation in the Czech Republic, Poland features one of the most developed system of disability payments that is, due to obvious abuses, one of the most expensive in Europe if not the world. The determination of possible areas of savings within the system would require close

cooperation between several branches of the government, but is likely to be met with strong opposition on the part of the current beneficiaries of the system.

On the expenditures side, the program might suggests implementation of tighter controls over spending in special funds and independent agencies of the state treasury as well as organizational changes in the state administration of funds. Among others, 9 of the 20 special funds could be incorporated into the state budget. Furthermore, an additional 58 separate special accounts could also be included in the budget. These represent accounts maintained outside the government budget that allow budgetary units to offer payments of bonuses to employees. The total amount of those funds is estimated at 4.6 billion zlotys in 2003. Most of these funds are at the disposal of the Ministry of Finance (29.1% of total funds), Ministry of Treasury (27.7%), Interior Ministry (21.9%), and Ministry of Education (9.9%).

In its review of the current situation of public finances in the **Czech Republic**, contained in the pre-accession program, the government openly admits that the situation has deteriorated to such a degree that the lack of any sensible reform in the nearest future creates a risk of the general budget deficit reaching 8-9% of GDP during 2004-2006. This is mostly due to a persistent tendency for expenditures to grow in real terms. In addition to staggering costs of the Ceska konsolidacni agentura (CKA), the increases in general expenditure levels are mostly due to growing social expenditures. Social security and the so-called social assistance expenditures have been the fastest growing category of spending. For example, during 1999-2001, total budget expenditures rose cumulatively by 54.5%, while those on social security and social care almost doubled in the same period. This expenditure is essentially crowding out all remaining types of expenditure. In addition, the government resorted to discretionary spending starting in 1999 to prop up the economy coming out of a bout of post-transition recession.

Table 3: Czech Republic -- Fiscal Deficits (ESA-95, general government, percentage of GDP)

	2002	2003	2004	2005	2006
General government deficit	-6.7	-7.6	-5.9	-4.8	-4.0
Central government deficit	-6.7	-7.3	-5.3	-4.3	-3.6
Local government deficit	0.1	-0.2	-0.5	-0.4	-0.4
Social security funds	-0.1	-0.1	0.0	0.0	0.0

Source: Pre-Accession Economic Program, August 2003

In light of the above problems, the Czech government has adopted a medium-term fiscal framework based on the baseline macroeconomic forecast that assumes a gradual acceleration of economic growth in the years 2003-2006. It is also assumed that the budget this year will not exceed 7.6% of GDP, and that the trend toward a growing deficit will be reversed starting in 2004. The framework also assumes that the public finance deficit will be reduced to 4.0% of GDP by 2006 and below 3.0% not later than in 2008.

Proposed fiscal reforms are very gradual compared to those suggested in Hungary and even Poland. The reform is to consist of a combination of measures on both the revenue and the expenditure sides of the general government budgets including a reform of the pension system, as well as cutting sickness benefits.

A gradual reform of the current pay-as-you-go pension system is one of the cornerstones of the adjustment process. According to the presented plan, in 2004-2006, pensions will be annually

increased only by the minimum amount required by law (CPI plus one-third of the annual increase in real average wages). From the point of view of long-term sustainability of the pension system the most significant change involves a further increase in the retirement age (63 years for both women and men). However, financial effects of this change will not be felt until 2008.

In the area of sickness benefits, the aim of the reform would be to reduce the abuse of the current system and cut the current excessive level of redistribution and reduce the average length and frequency of sick leave. The main change will be the transfer of the obligation to pay the sickness benefits in the firs two weeks of the sick leave from the state to the employer. This will be adequately compensated for by lower employer contribution rates. But even with these reforms in place, positive effects will not be felt until 2006.

The more immediate savings could be generated by limiting growth of government's wage bill. This could be achieved by first capping the number of government employees at 2003 levels, and then, gradually reducing this number over time. The plan envisages a reduction in the government administration headcount by 6% in the years 2004-2006. As of January 2005, the sales of workers in the public administration will remain frozen throughout 2004-2006.

With regard to budgets of extra-budgetary funds, their accounting and conditions for their activities will be made increasingly compatible with the conditions that apply to the state budget. This will contribute not only to an increased transparency, but also their inclusion in medium-term expenditure frameworks. The National Property Fund should be closes as early as 2005, while the Czech Debt Consolidation Agency by 2007.

With a stated goal of joining the Economic and Monetary Union at the earliest possible date, the fulfillment of convergence criteria, including that of the budget deficit- and public debt-to-GDP ratios place high on the **Hungarian** government's agenda. The government forecasts that following a 4.8% of GDP budget deficit in 2003, the deficit would be then cut by 1 percentage point of GDP in each of the subsequent two years, thus dropping to 2.8% of GDP in 2005. It will be then reduced to 2.5% in 2006. The program rests on the assumption that the reduction during 2003, from 9.2% of GDP to 4.8% of GDP, indeed materializes. This in turn will require, meeting the 3.5% GDP growth target, as well as continuation of better than expected tax collection, in particular with respect to VAT and corporate and simplified enterprise taxes. The plan also assumes that the trend of budget deficit underperformance on the part of the local governments would hold this year, reducing the impact of this category on the general budget deficit. In light of the risk inherent in such a rather optimistic forecast, the Hungarian government is ready to admit that an overshooting of this year's target is likely. The excessive spending might be combined with an unexpected reduction in tax revenues not only in 2003, but also next year. According to the plan, if the deficit in 2004 runs the risk of exceeding the target, expenditures will be cut to implement necessary corrections.

Table 4: Hungary -- Fiscal Developments (General government, percentage of GDP)

	2002	2003	2004	2005	2006
Budget revenues*	44.5	43.0	44.5	44-44.5	43.5
Budget expenditures*	53.7	47.8	48.3	47.0	46.0
Deficit	9.2	4.8	3.8	2.8	2.5
* of which: EU transfers	0.2	0.4	0.5-1.0	1.0	1.0

Source: Pre-Accession Economic Program of Hungary, August 2003

In the period 2003-2006, the overall public debt-to-GDP ratio is expected to fluctuate between 54% of GDP and 57-58%. The risk of the public debt exceeding 60% of GDP is rather remote, even under the most unfavorable circumstances. The real key to viability of the plan will be its implementation in 2004. As the government admits, previous commitments render it impossible to reduce the growth in budget expenditures below the aggregate growth in the economy. The reduction in the deficit will thus depend almost exclusively on increased revenue collection.

Starting with the budget act of 2004, the government will initiate the process of a three-year framework budget act by the parliament. Arguably the most important aspect of budget management, expenditure controls are covered with the minimum amount of detail in the pre-accession program. The government assumes that due to previous commitments, the expenditures of the general government will increase considerably. The reduction in deficit will, however, necessitate a reduction in growth in expenditures, which in turn will require a change in their structure.

Scenarios

Given the past experiences with fiscal laxity in Central Europe, one needs to view the macroeconomic growth assumptions and the resulting forecasts of budgetary performance presented in the Pre-Accession programs and the already published or soon to be published medium-term economic programs with a grain of salt. Growth figures, although plausible under the most favorable sets of circumstances, are usually adjusted upwards to fit a politically acceptable spending plan in terms of the budget deficit-to-GDP and public debt-to-GDP ratios. The budget figures themselves also incorporate a number of rather broad assumptions on the revenue side to present a smooth process of nominal convergence with the EU's criteria. As a result, the baseline figures presented in the programs should be viewed as the optimistic scenarios of developments, where a chance of an actual undershooting is rather minimal, and even further restricted by the ability of the government to find "socially justifiable" methods of spending the excess funds available.

The range of possible negative outcomes in terms of the deficit-to-GDP ratio is considerably skewed towards the early years of the forecast period. This results from the widespread perceptions among the political elites that only the final-year target is set firmly, while the interim annual targets could be adjusted upwards by increasing expenditures to satisfy social demands and positioning themselves in preparation for parliamentary elections. Even though a later adjustment would have to be considerably more radical on the expenditure side, and may actually involve a sharp rise of taxes, the governing elites are willing to accept short-term risk for political gain.

Among the three country official scenarios presented below, the Hungarian approach is clearly the most radical in terms of timing and severity of expenditure cuts in the first several years. It is also the plan that brings the deficit to target levels of below 3.0% of GDP in the shortest amount of time. On the other hand, the Czech government's baseline seems overly pessimistic with respect to growth prospects for the Czech economy. This does not change the opinion, however, that the fiscal problems in this country are by far the most severe.

While the government scenario could be described as relatively optimistic, at least three other scenarios can be developed. The results of the scenarios on the budget bottom line are presented in the attached tables. Below we provide a brief review of the assumptions and results.

The "Official" Scenario

This scenario reflects the official governments' outlook as of mid-2003 of the most likely growth path for the relevant economies. These forecasts usually assume that:

- The actual accession to the EU in May 2004 does not result in a dramatic change in the development of key macroeconomic parameters, but will only enhance the trends already present during the pre-accession period.
- Growth within the EU is expected to be quite weak in 2003 and 2004, followed by a substantial acceleration in 2005/2006, with the majority of risks still on the downside. Growth in the EU accelerates from near zero this year to slightly above trend 2.8-3.0% by 2005. Commodity markets are assumed to stabilize with the price of oil not exceeding $24 per barrel.
- Gradual acceleration of growth takes place in 2004-2006 with growth oscillating between 2% and 4% in the Czech Republic, 3.5-5.0% in Hungary and 5.0-5.6% in Poland.
- Growth in household consumption is conditional upon stable growth in real wages. Moderation in wage increases provides for a sufficient lag in growth of average wages relative to labor productivity growth.
- Investment starts growing faster following the accession, due to transfer of modern technologies and creation of new more modern export capacities. Contribution of net trade should be neutral over the next several years.
- The external sectors stabilize with current accounts remaining manageable in the years 2003-2006.

The official scenario produces a decline in ESA-95 calculated budget deficit in the years 2004-2006 in Hungary. The public deficits in Poland and the Czech Republic increase temporarily in 2004, but then decline in the latter years, due in part to austerity measures, but mostly due to an acceleration of economic growth in the period. The adjustment is much more gradual in the Czech case

<u>The Baseline Scenario</u>

This scenario reflects our current assessment of the economic outlook for the CE-3 economies and our view of the most likely scenario of fiscal adjustments in the coming years. This scenario is *de facto* roughly based on similar assumptions in terms of the kind of spending cuts and revenue adjustments as those used in the government scenario, but is stripped of the overly optimistic assumption as to the governments' ability to cut spending radically in the current political and social environment. It also reflects the differences in the projected growth trend between the official scenario and our own forecasts. Specifically, it rejects the following assumption in individual country cases: in Hungary – the belief that the budgets of local governments will be balanced in 2003 and beyond, despite past evidence of excessive spending that leads to higher deficits that are reported in the last months of the year and as such can not be properly incorporated in the baseline general government budget projection. Additional spending on wages for teachers and the effects of the one-off increase on wages of public sector employees are also included. Also, slightly reduced revenues are stemming from the introduction of cuts in personal income taxes, a move that the government promised, but than tried to withdraw. The cumulative difference in the deficit in Hungary relative to the government baseline scenario is equal to 0.4% of GDP in 2003 and 0.5-1.0% of GDP in 2004-2005.

In the case of Poland, we assume that the budget deficit in 2003 will be implemented in line with the original budget law. However, several expenditure items will not be included in the official numbers, and as a result will have to be treated as additional expenditures in 2004. The assumed public sector deficit is closer to 5.5% of GDP under the ESA-95 methodology, and significantly exceeds 6.5% under the old system of reporting. This is a major loosening of fiscal policy when

compared with 2003 and could have negative consequences on the outlook for the remaining years of the forecast period. Starting in 2004, our "baseline scenario" assumes lower rates of growth in the economy. While the results for the first half of 2003, would indicate that the Polish economy entered a path of fast accelerating growth, specific risk areas still exist and should constrained growth in outer years. Slower growth in household consumption and corporate profits is also expected bring less tax revenues. The need to support inefficient social programs further widens the deficits in 2004-2005. Deficits in the latter years get back in line with the forecast, but growth still fails to reach the projected 5.6% annual rate, staying instead in the 4.0%-4.5% range.

In the Czech Republic, the realistic scenario is actually the closest to the official government approach with slightly stronger-than-assumed economic growth matched by higher spending in the earlier years. In general, we believe that the Czech official program is the most conservative and closest to reality.

The "Expansion/Austerity" Scenario

This hypothetical scenario follows in general the growth pattern for the three economies developed under the "baseline scenario". This time, we assume, however, that the need to boost growth in the next two year (mostly due to political considerations related to upcoming parliamentary elections), results in higher spending in the initial period of the forecast. Specifically, the governments are successful in implementing the revenue side measures, such as planned reduction in personal and corporate income taxes, while failing to a) implement on time medium-term expenditure frameworks for all categories of flexible budget spending, b) pass through the respective parliaments measures aimed at reforming the excessive social spending on pension benefits, sickness benefits, c) wage growth in the public sector continues to exceed planned limits due to the opposition on the part of trade unions.

The resulting overshooting of the deficit, when compared with the official scenario, is then "corrected" in the years 2005-2006. This is achieved through application of very restrictive spending policies that effectively freeze most of the expenditure categories in nominal terms at the previous year's levels. This scenario has an unwelcome effect of dampening growth potential in the latter years of the forecast. It also results in the practice of artificial reductions in spending or even a need to increase taxes temporarily to meet the deficit and public debt criteria. Another negative effect of such an approach would involve elements of creative accounting aimed at reducing the transparency of government spending and delaying necessary spending to future years in order to meet certain targets and criteria. The application of such a short-view approach to public deficits will only cumulate the problems, by postponing the actual reform into the future. Under this scenario, real economic convergence is delayed. Growth in the private sector is constrained by more aggressive monetary tightening at the least opportune of times. Finally, the financial markets punish the country's government by raising the yields on government's domestic currency- and foreign currency- denominated debt.

The "Fiscal Prudence" Scenario

This most desirable approach to fiscal management is also the least likely in terms of implementation. It requires a disciplined approach to reforms and political will to implement changes in legislation to reduce mandatory spending. This approach effectively freezes most of the social spending, such as pension and disability benefits at the levels of the current year, leads to a reduction in the number of recipients of some of these benefits, implements cuts in the public sector workforce of up to 10-15% of the current levels. In addition such a prudent, albeit not necessarily politically-viable approach, would result in setting up a system of medium-term limits

on expenditures that can be managed on the central government level and an almost complete elimination of other categories of expenditures by incorporation of off-budgetary funds into the main budget, as well as a program of annual savings on the ministerial level with respect to variable expenditures. The approach towards the revenue side of the budget incorporates among others an assumption of lower inflows from corporate income and personal income taxes due to a reduction of rates for both tax categories by on average 5%. In the latter years of the forecast the loss of revenue due to reduction in taxes is compensated by broadening of the tax base, and extra revenues due to improved financial situation of enterprises and households. The reductions in corporate and personal income tax rates are matched with a selective application of increased VAT and excise taxes.

APPENDIX I – Results of Fiscal Scenarios for CE-3 Economies

POLAND - Fiscal Scenarios

(according to ESA-95 methodology)

	2003	2004	2005	2006
OFFICIAL SCENARIO				
GDP (annual growth in %)	**3.0**	**5.0**	**5.0**	**5.6**
General budget revenues (% of GDP)	43.1	42.9	42.2	42.1
General budget expenditures (% of GDP)	47.2	47.9	46.2	45.5
General budget balance (% of GDP)	**-4.1**	**-5.0**	**-4.0**	**-3.4**
BASELINE SCENARIO				
GDP (annual growth in %)	**3.0**	**3.9**	**4.3**	**4.0**
General budget revenues (% of GDP)	43.2	43.4	43.1	43.0
General budget expenditures (% of GDP)	47.3	48.9	47.6	47.0
General budget balance (% of GDP)	**-4.1**	**-5.5**	**-4.5**	**-4.0**
EXPANSION/AUSTERITY SCENARIO				
GDP (annual growth in %)	**3.0**	**3.9**	**4.3**	**3.8**
General budget revenues (% of GDP)	43.2	43.3	43.1	43.2
General budget expenditures (% of GDP)	47.3	49.2	47.9	47.0
General budget balance (% of GDP)	**-4.1**	**-5.8**	**-4.8**	**-3.8**
FISCAL PRUDENCE SCENARIO				
GDP (annual growth in %)	**3.0**	**3.9**	**4.4**	**4.2**
General budget revenues (% of GDP)	43.2	43.2	43.0	42.9
General budget expenditures (% of GDP)	47.3	48.3	47.5	46.7
General budget balance (% of GDP)	**-4.1**	**-5.1**	**-4.5**	**-3.8**

CZECH REPUBLIC - Fiscal scenarios

(according to ESA-95 methodology)

	2003	2004	2005	2006
OFFICIAL SCENARIO				
GDP (annual growth in %)	**2.4**	**2.8**	**3.2**	**3.6**
General budget revenues (% of GDP)	42.4	43.8	43.4	42.8
General budget expenditures (% of GDP)	50.0	49.7	48.2	46.8
General budget balance (% of GDP)	**-7.6**	**-5.9**	**-4.8**	**-4.0**
BASELINE SCENARIO				
GDP (annual growth in %)	**2.5**	**3.5**	**4.1**	**4.4**
General budget revenues (% of GDP)	42.1	43.5	43.1	42.5
General budget expenditures (% of GDP)	50.4	49.3	47.7	46.5
General budget balance (% of GDP)	**-8.3**	**-5.8**	**-4.6**	**-4.0**
EXPANSION/AUSTERITY SCENARIO				
GDP (annual growth in %)	**2.5**	**3.5**	**4.1**	**3.8**
General budget revenues (% of GDP)	42.1	43.5	43.0	42.6
General budget expenditures (% of GDP)	50.4	49.6	47.8	46.4
General budget balance (% of GDP)	**-8.3**	**-6.1**	**-4.8**	**-3.8**
FISCAL PRUDENCE SCENARIO				
GDP (annual growth in %)	**2.5**	**3.5**	**4.1**	**4.4**
General budget revenues (% of GDP)	42.1	43.5	43.1	42.5
General budget expenditures (% of GDP)	50.1	48.9	47.6	46.3
General budget balance (% of GDP)	**-8.0**	**-5.4**	**-4.5**	**-3.8**

HUNGARY - Fiscal scenarios

(according to ESA-95 methodology)

	2003	2004	2005	2006
OFFICIAL SCENARIO				
GDP (annual growth in %)	**3.5**	**3.5**	**4.0-4.5**	**4.5-5.0**
General budget revenues (% of GDP)	43.0	44.5	44-44.5	43.5
General budget expenditures (% of GDP)	47.8	48.3	47.0	46.0
General budget balance (% of GDP)	**-4.8**	**-3.8**	**-2.8**	**-2.5**
BASELINE SCENARIO				
GDP (annual growth in %)	**3.2**	**3.9**	**4.0**	**4.0**
General budget revenues (% of GDP)	43.1	43.8	43.5	42.8
General budget expenditures (% of GDP)	48.3	48.2	47.5	46.6
General budget balance (% of GDP)	**-5.2**	**-4.4**	**-4.0**	**-3.8**
EXPANSION/AUSTERITY SCENARIO				
GDP (annual growth in %)	**3.2**	**3.9**	**4.0**	**3.6**
General budget revenues (% of GDP)	43.0	43.4	43.0	43.5
General budget expenditures (% of GDP)	48.4	48.5	47.4	47.3
General budget balance (% of GDP)	**-5.4**	**-5.1**	**-4.4**	**-3.8**
FISCAL PRUDENCE SCENARIO				
GDP (annual growth in %)	**3.2**	**3.9**	**4.1**	**4.0**
General budget revenues (% of GDP)	43.1	43.4	43.2	43.0
General budget expenditures (% of GDP)	48.3	47.7	46.4	46.0
General budget balance (% of GDP)	**-5.2**	**-4.3**	**-3.2**	**-3.0**

APPENDIX II: Country Case Studies – Fiscal Policies in Poland, the Czech Republic and Hungary in 2001-2003

Country Case Studies

Poland

Public finances and the implementation of lax fiscal policy have been the weakest elements of Poland's economic policy mix since the mid-1990s. Following the early years of so-called "shock-therapy," the boom years of 1994-1997 coincided with the implementation of rather loose fiscal policy under the leadership of then-Deputy Prime Minister and Minister of Finance Grzegorz Kolodko. Despite registering annual growth rates in excess of 6.0%, the Polish SLD-PSL coalition government failed to markedly reduce the absolute scale of the budget deficit, boasting instead about gradually reducing the deficit as a percentage of GDP. That led to overheating of the economy and widened the current account deficit to a degree that necessitated a radical cooling-off program implemented by the central bank with the use of high real interest rates.

In the years immediately following the parliamentary election that brought to power the center-right AWS-UW coalition and the return to the finance ministry of the author of the original shock therapy, Leszek Balcerowicz, again ushered in some degree of fiscal prudence to Poland's economic policies. The general government deficit was reduced to 2.1% of GDP by the year 2000 and seemed destined to remain under control in the nearest future. Unfortunately, after the departure of the UW from the ruling coalition, the plummeting popularity of the AWS government and its labor union roots led to a spending spree and passage of a number of laws that have proven seriously detrimental to the health of Poland's public finances for the years to come. A young, Western-educated Minister of Finance, Jaroslaw Bauc, brought to determine the extent of the damage done, concluded that in the absence of a whole series of reforms, the public sector deficit might loom as large as 11% of GDP by 2003. While his predictions were later determined to be overly pessimistic, the reality caught up with the policy-makers, forcing a more serious reconsideration of the situation.

Following a disastrous fiscal performance in 2001, when the radical shortfall in revenues, combined with minimal cuts in expenditures resulted in a major widening of the deficit, the 2002 budget in its version presented by the finance minister, Marek Belka who represented the newly elected SLD-UP government, was a major step in taking control over developments in Poland's government finances. Given only six weeks to present a comprehensive budget draft for 2002, Belka put together a document, which was intended to establish a basis for reforming public finances over the next several years. The document was based on very realistic, even conservative, assumptions. Its only major weakness was the fact that it did not transparently address the issue of budget obligations inherited from past several years. In particular, the document did not present a solution for dealing with the amounts owed by the Social Security Fund (ZUS) to the private pension funds, estimated at around 6 billion zlotys. Otherwise, the budget was a much-needed step in the right direction that temporarily calmed investors' concerns about the government's control over public finances.

Under this budget plan, the level of the budget deficit was to be determined by the government's success in collecting budget revenues. For 2002, Minister Belka assumed that, following the implementation of changes to tax regulations he proposed, budget revenues would reach 143.97 billion zlotys, allowing the budget deficit to remain under 40 billion zlotys, or 5.3% of GDP,

according to the Polish methodology. The size of the budget deficit could not be changed unless a revision to the budget was passed by the Parliament. Any shortfall in budget revenues was to be matched by a corresponding reduction in expenditures. The data on budget performance in 2002 were very encouraging. According to these data, the budget deficit, at 39,412 million zlotys, fell somewhat short of the annual target of a 40-billion-zloty deficit. This positive result was mainly due to better-than-expected collection of corporate income taxes (108.3% of the annual target) and revenues from other budgetary agencies, mostly increased customs tariffs. Most budget expenditures met the targets set earlier. Financing of public debt was less than expected, at 96.1% of the plan for the domestic portion of the debt, and 95.9% for the external debt.

Instead of building on Belka's plan and moving ahead with further restructuring of expenditures, his successor as minister of finance and former holder of this post, Grzegorz Kolodko, prepared the 2003 budget in record time in late Summer 2002. The document's format, although named "a budget of stabilization and development", followed roughly the same assumptions as the budget for 2002, although the rule of limiting expenditures was dropped. The revenues were estimated at 155.7 billion zlotys and expenditures at 194.4 billion zlotys, 8.5% and 6.3%, respectively, more than in 2002 in nominal terms, despite very low inflation. The budget deficit was planned at 38.7 billion zlotys, marginally less than the actual deficit reported for 2002. However, a number of actual spending items were not included in the expenditure count, remaining instead below the line. The government also assumed that privatization revenues, at 9 billion zlotys, would substantially exceed the collections from that source in the preceding year.

According to preliminary data from the Ministry of Finance, Poland's central government budget deficit reached 61.5% of the annual plan after the first six months of 2003. The deficit amounted to 23.8 billion zlotys. Revenues came in at 71.9 billion zlotys (46.2% of the annual plan) and expenditures at 95.7 billion zlotys (49.2% of the plan). Despite the higher deficit, the budget implementation in 2003 has been proceeding according to schedule. State spending remains in check, while inflows of revenues have slowed, mostly due to lower inflows from corporate and personal income taxes. On the other hand, revenues from indirect taxes reached 46.3% of the total annual target. Also in June, the budget received a full transfer of the profit from the National Bank of Poland in the amount of 4.6 billion zlotys. Privatization has so far generated only 1.168 billion zlotys, only 3 million zlotys more than in the first five months of the year (15.8% of the annual plan).

While the 2003 budget seems on target, although much higher in terms of percent of GDP than might have been the case were expenditure controls put in place, the future of Poland's public finances is by no means secure. There are several reasons for this. First and foremost, the current ruling coalition, nearing an all-time low in terms of popularity and facing another parliamentary vote in 2005, is not willing to reduce spending in the most socially-sensitive categories. These include, among others, the inefficient social security scheme for farmers (KRUS) (currently farmers are not required to contribute to the program, while they receive regular retirement benefits), a number of off-budgetary government agencies and funds, as well as a disability payments system that is, due to obvious abuses, one of the most expensive in Europe if not the world. Second, the need to boost growth following two years of mediocre performance makes it that much more difficult to increase taxes. So far, the ministry of finance has scrapped the previous plan to reduce personal income tax rates and proceeded with increases in VAT and excise tax rates, actions that are necessary to align Polish tax regulations with the EU norms. Finally, weaker than expected revenues from privatization of state property mean that a larger portion of the deficit needs to be financed by issuance of government securities, at a higher cost, as yields rise.

The situation calls for radical measures. However, these have not been forthcoming. Quite to the contrary, the final format of the budget for 2003 became a point of disagreement between then-finance minister Kolodko and the new Deputy Prime Minister Jerzy Hausner that led to the resignation of the former earlier this year.

Kolodko spent his last two months in office presenting the outline of his plan of reform of public finances to all parties. The recent version of his program, although still not very progressive, incorporated a number of substantial changes to the original assumptions, and was given a fairly lukewarm reception by employers, trade unions, tax payers, opposition parties and, most importantly, members of the cabinet. This version of the program differed in some crucial points from the original plan. Kolodko lowered his GDP growth forecast from 3.5% to 3.0%. Furthermore, he adjusted his program to incorporate some of the ideas promoted by Hausner. These adjustments included, notably, a reduction in the corporate income tax rate from 27% to 19%, effective in 2004. Even in light of the compromise offered by Kolodko, however, Hausner continued to criticize the package, claiming that it still kept the tax burden "too high." Specifically, he questioned the need to introduce a 19% tax on capital gains next year, the effects of liquidation of all tax breaks and exemptions, and the lack of clearly defined tax-free income allowances for the poor. Hausner also questioned the Ministry of Finance's resolve in dealing with the rising debt of government funds and agencies, such as the Labor Fund. What Hausner has not discussed is the impact his proposals, if implemented, would have on the budget's bottom line. According to rough estimates, Kolodko's adjusted plan still included "a financing gap" of close to 12 billion zlotys to be covered partially through a release of the zloty revaluation reserve, a move that is not going to be approved by the current management of the National Bank of Poland. Kolodko also removed from the budget 10 billion zlotys in past-due transfers owed to private pension funds by the Social Security Fund (ZUS), arguing that privatization revenues will finance the shortfall next year. As a result, the budget showed a deficit of only 38.7 billion zlotys or 3.9% of GDP (4.6% using the EU's ESA-95 methodology).

The Ministry of Finance presented the first draft of the 2004 budget prepared by Deputy Prime Minister Jerzy Hausner and Minister of Finance Andrzej Raczko on July 22, 2003. This draft was then discussed and approved by the cabinet two days later and sent to the parliament for discussion and eventual approval in September. The document, presented for the first time in accordance with the EU's ESA-95 methodology, shows a budget deficit of 45.5 billion zlotys, on revenues of 152.7 billion zlotys and expenditures of 198.2 billion zlotys. In developing the budget assumptions, Minister Raczko introduced a number of major amendments to the original draft designed by his predecessor, Grzegorz Kolodko. First and foremost, the new draft assumes economic growth at 4.5-5.0%in 2004. Raczko also assumes moderately slower growth in private and public consumption and investment. The average annual exchange rate for the zloty is now estimated at 4.25 against the euro, compared to 4.15 in last assessment. More importantly, the Finance Ministry removed from budget revenues the 9 billion zlotys from the liquidation of the revaluation reserve at the National Bank of Poland that Kolodko insisted be included despite vocal opposition from the NBP. The official revenue estimates call for 150.0 billion zlotys in almost guaranteed inflows, with the remaining 2.7 billion zlotys expected to accrue due to "more efficient collection of taxes." On the expenditure side, Minister Raczko drastically reduced the spending levels that were requested by individual ministers (by almost 17 billion zlotys). On the other hand, 12 billion zlotys due in transfers to private pension funds are still not included in expenditures, in accordance with ESA-95, and will have to be financed by a combination of privatization receipts and debt issuance. Although the Ministry of Finance wants to raise the ceiling for foreign debt issuance to 15 million zlotys ($3.5 billion) next year, a substantial portion of these transfers will have to be financed by additional debt issuance on the domestic market. In summary, the new draft is clearly more transparent than the "virtual budget" suggested by

Kolodko, but it still offers a major loosening of fiscal policy next year. If implemented, the budget gap next year would bring the total public debt to above 55% of GDP, dangerously close to the 60% limit set in the constitution.

Czech Republic

The fiscal situation in the Czech Republic has to a large extent been negatively affected by the failed efforts to restructure the banking sector during the 1990s. In the end, the government decided to transfer the non-performing loans from commercial banks to the Konsolidacni banka, a loan restructuring agency. This permitted a serious clean-up of bank loan portfolios, but also left the budget with the financial burden of an agency that was likely to generate massive losses for a number of years that would have to be covered through budget subsidies. In their assessments of the situation of public finances over the years, both the World Bank and the OECD have warned the Czech government about the country's large budget deficits. They acknowledged early on, however, that the large projected consolidated deficit for 2001 was due to the high costs of bank restructuring, which should have peaked in 2001 and started to decline in years to come. The cleanup of the IPB bank alone, which was placed into forced administration and sold in Summer 2000 with government guarantees, boosted expenditures significantly in 2001. According to the Ministry of Finance, the cost of bailing out the financial sector was supposed to weigh on government finances until 2004 or 2005. But international financial institutions have also pointed to several additional areas where fiscal restructuring was necessary to bring budgets under control. Pensions represented one of the most significant problems in mandatory spending. Other areas for suggested reform included health care, education, housing, and transportation. It was ascertained that if budget deficits are not brought under control over the next several years, macroeconomic balance could be threatened, particularly once privatization revenues run out.

A January 2001 agreement between the largest Czech political parties, CSSD and ODS, called for a gradual reduction in state budget deficits over the next few years, with a deficit of 10 billion koruna in 2002 and a balanced budget by 2003. However, the CSSD was counting the bank restructuring losses from Ceska konsolidacni agentura (formerly Konsolidacni banka) below the line. When these expenses are included, the overall budget deficit is boosted considerably. Even discounting bank bailout expenses, budget deficits were higher than planned in 2001. The state budget deficit reached 67.7 billion koruna (3.1% of GDP), considerably more than the deficit that was finally approved of 49 billion koruna. Revenues reached 626.22 billion koruna, while expenditures totaled 693.92 billion koruna. Then-Finance Minister Jiri Rusnok stated that the privatization of 14 firms brought in revenues of 164 billion koruna for the National Property Fund in 2001. The proceeds from some of those sales did not arrive until 2002, however. Other privatization projects that were supposed to be completed in 2001 but faced delays included the telecommunications firm, Cesky Telecom, and the CEZ utility company, together with six electricity distributors. According to the Finance Ministry, the consolidated budget deficit for 2001 reached 52.2 billion koruna (2.4% of GDP). The deficit would have been considerably higher if it were not for income from extra-budgetary accounts. With privatization revenues excluded, the consolidated budget deficit jumped to 5.3% of GDP.

The Czech Republic's 2002 budget bill envisaged a deficit of 46.2 billion koruna, with revenues of 690.4 billion and expenditures of 736.6 billion koruna. Mandatory costs were projected to make up 52% of total budget expenditures, or 16.6% of GDP. In the absence of pension reform, 29.7% of the total state budget was set to go to pensions. Although the budget target was widely expected to be surpassed given the cabinet's lax fiscal approach, the state budget ended 2002 with an unexpectedly low preliminary deficit of 45.72 billion koruna (2.8% of GDP). Revenues reached 705.04 billion koruna in 2002, while expenditures totaled 750.76 billion koruna.

According to Finance Minister Bohuslav Sobotka, the better-than-expected results were achieved primarily because of an improvement in tax revenues, mainly from corporations. The deficit would have been considerably higher if privatization revenues and income from the repayment of Russia's Soviet-era debt were excluded, however. Of the total proceeds from the sale of Transgas, 20.6 billion koruna were transferred to the state budget in 2002, in addition to 17.2 billion koruna from Russia's debt repayment. Extraordinary revenues totaled 53.5 billion koruna in 2002. Excluding those one-off revenues, the deficit reached 99.2 billion koruna (4.4% of GDP).

The Finance Ministry's initial draft state budget for 2003 counted on a deficit of 157.3 billion koruna. Of that amount, 60 billion koruna were to be used to cover debts relating to bank restructuring. While expenditures were projected to rise on mandatory items, such as pensions and social insurance, revenue totals were expected to fall as one-off revenue flows such as privatization income ceased to be included in the budget. The government approved its draft budget for 2003, with a gap of 111.3 billion koruna, which was 46 billion koruna less than in the Finance Ministry's original proposal. That included expenditures of 795.4 billion koruna and revenues of 684.1 billion koruna. The budget planned for GDP growth of 3.3%, inflation at 2.0%, and average unemployment of 9.9%. In order to reduce the deficit, the government made spending cuts of about 3.5 billion koruna, including 1.5 billion koruna at the Defense Ministry alone. The main reason for the lower deficit, however, was the delay in paying for losses from the bank bailout agency, Ceska konsolidacni agentura (CKA). The government decided that it would cover only losses for 2001 in 2003, totaling 18.6 billion koruna. Funds for covering damage from the August floods were expected to total 17 billion koruna. The implementation of the Czech state budget deficit proceeded roughly according to the plan reaching 62.1 billion cumulatively in the first seven months of this year, or around 56% of the annual deficit target of 111.3 billion koruna. Revenues totaled 394.7 billion koruna, while expenditures amounted to 456.9 billion.

Fiscal reform remains the key policy concern for the Czech Republic. If the government does not take serious reform measures, the budget deficit will continue to rise, endangering long-term growth. Deputy Finance Minister Eduard Janota recently speculated that unless radical changes were implemented, the state budget gap for 2004 could not be smaller than 140 billion koruna, while growing demands for public sector wage hikes may push the deficit even higher. In a meeting in May 2003, ruling coalition representatives agreed to reduce the public finance deficit to 4.0% of GDP by 2006—down from an estimated 6.7% in 2003—representing savings of 92 billion koruna over the next three years. The approved deficit target represented an improvement over last year's coalition agreement, which stipulated that the public finance deficit would be cut to 4.9–5.4% of GDP by 2006. Last December, Finance Minister Bohuslav Sobotka had offered two versions of public finance reform: one that would reduce the deficit to 4.9% of GDP by 2006 and a more radical scenario that would cut the deficit to 3.7% of GDP. Even with Sobotka's more radical plan, the cuts would not be as deep as recommended by non-governmental economic experts and the central bank. Within the government, one of the junior ruling parties, the Freedom Union, would like to bring the deficit to 3.1% of GDP by 2006.

After repeated delays, the Czech cabinet finally approved its preliminary blueprint for public finance reform in June 2003. According to the plan, the corporate income tax shall gradually be cut from 31% to 24% over the next three years. In order to compensate for the negative effects such a step will have on budget revenues, excise duties on cigarettes and alcohol will be raised. The government also agreed that it will not impose a uniform value-added tax rate, although most services and some goods will soon be taxed at the higher rate of 22%. While the real estate transfer tax will be cut from 5% to 3%, the coalition does not intend to introduce an inheritance tax. The retirement age will be raised to 63, and other aspects of pension reform will be approved in the future. Moreover, sickness benefits will be cut.

Excluding privatization revenues and losses connected with bank restructuring, the state budget gap is expected to reach 83 billion koruna in 2004, down from 92 billion koruna in the previous year. While the parliament was scheduled to begin discussions on certain aspects of the legislation on July 22, the government must submit its draft state budget for 2004 to the lower house by the end of September. The cabinet has not yet discussed its plans for budget cuts for individual ministries, an issue that is sure to be a struggle. In June, Finance Minister Bohuslav Sobotka surprised the other cabinet ministers when he proposed spending cuts that are more radical than expected, negatively affecting farmers, police, scientists, and the army. Critics pointed out that the reforms approved by the cabinet did not go far enough since they fail to include much-needed changes in the pension and social welfare systems. Moreover, the cabinet's plan to cut corporate income tax to 24% by 2006 is widely seen as insufficient, particularly given that the rate is being slashed to 18-19% in the other three Visegrad countries. On the other hand, the discussions on public finance reform have been met with protests from the labor unions, while Defense Minister Jaroslav Tvrdik resigned in May in protest over proposed budget cuts in the army. Prime Minister Vladimir Spidla pointed out that the reforms are inevitable and would be even more severe if the current coalition was replaced by the opposition Civic Democratic Party, which is now the most popular in the country. Although the parliament approved the bills in the first reading on July 24, their final approval this fall currently appears highly uncertain.

Public finance reform still requires the final approval of the parliament, which will certainly be complicated, given the leftist slant of some representatives of the Social Democrats (CSSD), the dominant party in the ruling coalition. Some CSSD members would prefer higher taxes to decreases in spending, arguing that radical budget cuts would make it difficult for the party to fulfill its pre-election promises, particularly in the area of social policy. In that light, the 2004 state budget law will be extremely difficult to approve and could mark a breaking point for the ruling coalition. Even if the government's proposals are eventually approved by the parliament and signed by the president, the public finance deficit is unlikely to fall below 3% of GDP until 2008, at the earliest.

Hungary

In 2000, Hungary adopted a two-year budget cycle. Hence, the government proposed and the Hungarian Parliament passed budgets for both 2001 and 2002 in fall 2000. Despite these good intentions, the government had to modify both budgets, increasing budgetary expenditures in both years. The government initially argued that better-than-expected tax revenues had made it possible to increase spending without expanding the fiscal deficit. The first revision of the two-year budget was announced in August 2001. The Hungarian government decided to spend an additional 284.6 billion forints in 2001 and 200.0 billion forints in 2002. The additional expenditures for 2001 included 47.1 billion forints for increased subsidies for pharmaceuticals, 67.1 billion forints to increase various pensions, and 25 billion forints to accelerate construction under the *Szechenyi* infrastructure program. The 200-billion-forint boost in 2002 was to be primarily spent on infrastructure projects. The government also planned to spend an additional 100 billion forints on highway construction. In addition, substantial sums were designated for mortgage interest rate subsidies. The government had been providing subsidized credits at interest rates of 8%; and these were to be reduced to 6% in 2002. These changes resulted in a 2.9% increase in expenditures in the consolidated budget in 2001, financed by an additional 3.1% increase in revenues. The officially reported figure of the public sector budget deficit was 3.3% of GDP in 2001, below the revised budget target of 3.4%. However, the Hungarian budget accounting system did not correspond to the EU standards, according to which the Hungarian 2001 deficit was as high as 5% of GDP. On paper, the 2002 budget looked fairly good, although

most observers believed it would be looser once off-budget expenditures were incorporated into the picture. The consolidated fiscal balance was budgeted to rise to 505 billion forints, from 493 billion in 2001, a very modest nominal increase. However, after eight months of the year, the consolidated fiscal deficit expanded to 756 billion forints. A further revision to the 2002 budget expanded the deficit to over 1.2 trillion forints; but even this assumption was proven wrong.

Hungary's cash-based consolidated budget deficit totaled 1.62 trillion forints in 2002 (9.6% of GDP, or 9.2% of GDP according to ESA-95 methodology), more than triple the 445-billion-forint deficit reported for 2001. In December 2002 alone, the deficit amounted to a shocking 615.8 billion forints. In addition, the deficit was not only much larger than the original annual target of 505 billion forints, but also larger than the revised figure of 1.22 trillion forints set in the final revision to the 2002 budget, which was approved in December. The widening of the deficit was entirely due to excessive spending. In fact, revenues exceeded the initial target by 3.1%.

Hungary's fiscal performance in the first four months of 2003 was very disappointing. The cumulative general government budget deficit for the first four months totaled 400.4 billion forints, up from 316.1 billion forints for the same period of 2002. As a result, the deficit reached 48.1% of the full-year target. In April alone, the budget deficit exceeded the market consensus, reaching 118.2 billion forints, compared with 74.3 billion forints a year earlier. While budget expenditures are usually frontloaded in the first quarter of the year, this year's pattern is rather worrisome, as the increase in the deficit has clearly been due to increased spending, rather than lower revenues. In May, growth in the deficit slowed considerably, with the cumulative total reaching 408.7 billion forints, but then exploded by 192.4 billion forints in June. This brought the cumulative deficit to a stunning 601.1 billion forints, or 72% of the annual target after just six months of the year. More importantly, the preliminary figures do not include the deficits in budgets of local governments that are added to the final annual budget figure in December. The general government budget was also in deficit because of a larger deficit in the social security fund that offset the surplus in the state budget. The government recently revised its budget deficit target for the year to 4.8% of GDP, but even this figure looks quite unrealistic in light of the performance to date.