EUROPEAN ECONOMY

EUROPEAN COMMISSION

DIRECTORATE-GENERAL FOR ECONOMIC
AND FINANCIAL AFFAIRS

ENLARGEMENT PAPERS

ISSN 1608-9022
http://europa.eu.int/comm/economy_finance
N° 24 - August 2005

2004 Pre-accession economic programmes of acceding and candidate countries: overview and assessment

by
Directorate General for Economic
and Financial Affairs

KC-AA-05-024-EN-C

ISBN 92-894-5976-X

ECFIN.D.I/REP/52400 – EN

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INTRODUCTION AND SUMMARY

This Enlargement Paper brings together into a single document the Directorate General for Economic and Financial Affairs evaluations of the fourth[1] Pre-Accession Economic Programmes (PEPs) of the acceding countries, Bulgaria and Romania, and candidate countries, Croatia and Turkey.

One of the economic priorities of the 1999 and 2000 Accession Partnerships was the establishment of an annual fiscal surveillance for the candidate countries. This gave birth to the so-called Pre-Accession Fiscal Surveillance Procedure, which aims at preparing countries for the participation in the multilateral surveillance and economic policy co-ordination procedures currently in place in the EU as part of the Economic and Monetary Union. The Pre-Accession Economic Programmes (PEPs) are part of this procedure.

The PEPs have two objectives. First, to outline the medium-term policy framework, including public finance objectives and structural reform priorities needed for EU accession. Second, they offer an opportunity to develop the institutional and analytical capacity necessary to participate in EMU with a derogation from the adoption of the euro upon accession, particularly in the areas of multilateral surveillance and co-ordination of economic policies. The development of the institutional capacity to co-ordinate between the various ministries, government agencies and the central bank is a particularly important aspect ensuring the success of the Pre-Accession Fiscal Surveillance Procedure.

The PEPs were to be submitted between mid October and 1 December 2004, which all countries complied with. In addition, as towards the end of the year Romania got a new government with a different agenda as regards economic policy, the country submitted a revised PEP by mid February.

Pre-accession Economic Programmes 2004: key figures

- Real GDP growth (% change)

	2003	2004	2005	2006	2007
Bulgaria	4.3	5.0	5.3	5.3	5.5
Romania	5.2	8.3	6.0	6.1	6.3
Croatia	4.3	3.9	4.4	4.5	4.6
Turkey	5.8	9.6	4.8	5.1	5.1

- General government balance (% of GDP)

	2003	2004	2005	2006	2007
Bulgaria	-0.1	0.1	-0.5	0.0	-1.3*
Romania	-2.0	-1.3	-0.7	-0.9	-1.9
Croatia	-6.3	-4.5	-3.7	-3.2	-2.9
Turkey	-10.1	-6.3	-4.4	-2.1	-0.5

- Government gross debt (% of GDP)

	2003	2004	2005	2006	2007
Bulgaria	48.4	40.8	37.4	34.2	32.5
Romania	21.0	18.4	17.5	19.0	19.8
Croatia	51.6	53.8	52.5	52.5	52.0
Turkey	80.2	78.4	75.3	72.2	68.3

* according to the Bulgarian authorities, this figure was based on wrong accounting for EC funds in 2007 (pre-financing of CAP). The correct figure would be, instead of a deficit of 1.3%, a surplus of 0.8%.

[1] In the case of Croatia it was the first Pre-Accession Economic Programme, as the country was recognized as candidate country, and thereby included in the Pre-accession Fiscal Surveillances Procedure, in June 2004.

They have been made public by the countries and can be found on the web under following addresses:

Bulgaria	http://aeaf.minfin.government.bg/cms/docs/en/operative/pi_progr/PIP_2004_en.zip
Croatia	http://www.mfin.hr/download.php?id=508
Romania	http://www.cnp.ro/en_PEP.html
Turkey	http://www.dpt.gov.tr/files/Pep30112004i.pdf

Overall, the submissions show that

- all PEPs are based on a fairly consistent macroeconomic and fiscal framework. In the light of the recent very positive economic development in all countries, the PEPs are overall only mildly optimistic.
- The fiscal frameworks foresee a continued budget close-to balance for Bulgaria or a further decline of general government deficits in the other countries.
- The structural reform agendas, as presented in the PEPs, are vast and partly ambitious. Often, however, the PEPs only describe ongoing activities, and the links to the macroeconomic and fiscal frameworks within the PEPs are often less clear. The four PEPs provide overall for consistent and party ambitious policy frameworks for economic stabilization, fiscal policy and structural reform. Their methodology and presentation has improved vis-à-vis previous years (not for Croatia, which submitted its first PEP).

On 12 July 2005, the Ministerial Meeting between the ECOFIN and their counterparts from acceding and candidate countries adopted (a) for the two acceding countries “joint opinions” on their respective PEPs and (b) for the two candidate countries within the meeting’s “joint conclusions” conclusions on their PEPs. Excerpts from the documents mentioned under (a) and (b) are contained in this document (Paragraphs 2 of the respective countries’ sections).

PRE-ACCESSION ECONOMIC PROGRAMME OF BULGARIA

1. INTRODUCTION

The Bulgarian authorities have submitted the 2004 Pre-Accession Economic Programme (PEP) covering the period 2004 to 2007 to the European Commission on 1 December 2004. It is Bulgaria's fourth PEP after the ECOFIN Council of 26/27 November 2000 had expressed its wish for a regular in-depth dialogue with accession countries. The programme largely complies with the requirements of the consolidated outline in terms of content, form and data. For the first time, data on output gap, cyclically adjusted budget balance and long-term sustainability of public finance have been included, however still lacking fully developed methodologies. The PEP is broadly consistent with other economic policy documents such as the Memorandum to the new 25-months precautionary stand-by arrangement with the International Monetary Fund (IMF) of July 2004. The programme mostly follows the conclusions of the Joint Ministerial Meeting of 4 November 2003 on the Bulgarian 2003 PEP, but does less so with respect to measures aiming to increase the flexibility of labour markets.

The programme is oriented towards providing the conditions for sustaining the process of catching-up with EU countries. It envisages a continuation of sound fiscal policies and the process of structural reforms in the pre-accession period. For the first time 2007 as the expected first year of EU membership is included in the programme, which gives rise to particular economic policy challenges regarding the absorption of the increasing inflow of EU funds and the declared objective of compliance with all convergence criteria to achieve an adoption of the euro by 2009/2010.

2. JOINT OPINION

"On 12 July 2005 the ECOFIN Ministers of the present Member States and the Acceding Countries examined the 2004 Pre-Accession Economic Programme of Bulgaria on the basis of an assessment prepared by the Commission Services with a contribution from the ECB and adopted this joint opinion. ….

Ministers commend the Bulgarian authorities for sustaining the process of catching-up by maintaining the budget close to balance and continuing the process of structural reforms. They consider the Bulgarian Pre-accession Programme 2004 a useful medium-term framework for economic policy in Bulgaria on its way to EU accession. They welcome that macroeconomic performance in 2004 turned out better than expected and consider the macroeconomic scenario plausible although further improvements in its methodological basis could be made.

Ministers welcome the public finance scenario of a budget close to balance which is adequate in view of the possible risks for the external balance in a currency board arrangement and in view of potential inflationary pressures. Ministers consider that, while built-in buffers and conservative revenue forecasts increase fiscal flexibility and limit fiscal risks, they are also an impediment to the envisaged reduction of the tax burden and the expenditure-to-GDP ratio. They recommend to use future PEPs as a platform to commit the government to a more explicit strategy for the use of the Fiscal Reserve Account in order to *avoid its future depletion for an ad hoc-financing of additional public expenditure with potentially negative effects on macroeconomic stability. Ministers welcome the reforms in the social security system and in particular the pension system which have improved the long-term sustainability of public finances in Bulgaria. They note that reforms in public administration, also to prepare for EU accession, may require new staff, but should not go along with net increases in employment in public administration but rather be accompanied by reductions elsewhere. Ministers consider that the programme's description of the structural reform agenda is often more backward-looking than forward-looking and therefore not always providing a full picture of forthcoming reforms. They welcome the good progress in privatisation, the reduction of state aid and the restructuring and liberalisation of network industries, which should continue. Ministers emphasise the need to further strengthen the business environment in the economy, in particular by addressing remaining weaknesses in governance and administrative capacity. Ministers encourage the authorities to make further efforts for reforms in education and healthcare and for increasing the flexibility of the labour market.*

Finally, Ministers note Bulgaria's progress in developing the institutional and analytical capacity required to participate in EMU. However, they recommend Bulgaria to intensify its efforts to ensure that fully compatible ESA 95 data will progressively become a main reference for fiscal analysis before the time of Bulgaria's accession to the EU."

3. MACROECONOMIC DEVELOPMENTS

3.1. Recent macroeconomic developments

The programme starts with a clear and concise picture of economic developments in 2003 and - as far as data were available at the time of submission - in 2004. Following real GDP growth of 4.3% in 2003, the Bulgarian economy continued its expansion at a rate of 5.6% in 2004. Growth is based on strong domestic demand fuelled by increases in net income, employment and bank credit. While this resulted in high import growth, exports were also growing stronger since the summer 2004, and the external balance of goods and services even had a positive contribution to growth in the third quarter. On the supply side, the good harvest, a strong increase in industrial production and a good tourism season were contributing to high output growth. Following a period of low inflation in the first months of 2003, rates accelerated from mid-2003 to mid-2004 due to higher food prices, as a consequence of a drought-related bad harvest in 2003, as well as increases in excise tax rates, administrative prices and import prices. These effects eased in the second half of 2004 so that consumer price inflation year-on-year was 6.1% on average and 4.0% at the end of the year. Unemployment decreased to 12.0% in 2004 since jobs were created in the private sector and in government schemes for long-term unemployed. The current account deficit, which had deteriorated to 9.3% of GDP in 2003, turned out better at 7.4% of GDP in 2004 with improvements in all its balances except for the trade deficit which deteriorated further. Net inflows of foreign direct investment covered the current account deficit both in 2003 and 2004.[2]

[2] BNB balance of payments figures report a net FDI inflow of 7.6% of GDP in 2004. This figure takes into account a financial transaction of a value of 3.3% of GDP due to the change in foreign ownership of Mobiltel, the market leader in GSM mobile telephony in Bulgaria, through a Bulgarian intermediary which

3.2. Macroeconomic scenario

As in previous programmes, the 2004 PEP reflects the economic policy priorities of the Bulgarian government of further reducing the gap of living standards to the EU Member States which is expected to be supported by EU membership in 2007 and the increase in EU funds. The required high growth rates are seen to be supported by continued economic stability as well as a sustainable development and the accumulation of high-quality human capital.

Table 1: **Comparison of key macroeconomic and budgetary projections**

		2003	2004	2005	2006	2007
Real GDP growth	COM	4.3	5.7	6.0	4.5	n. a.
(% change)	**PEP**	**4.3**	**5.0**	**5.3**	**5.3**	***5.5***
Consumer price	COM	2.3	6.2	4.0	4.0	n. a.
inflation (%)	**PEP**	**2.4**	**6.3**	**3.7**	**3.6**	***4.0***
General government	COM	0.6	1.4	-0.5	0.0	n. a.
balance (% of GDP) (*)	**PEP**	**-0.1**	**0.1**	**-0.5**	**0.0**	***-1.3***
Primary balance	COM	2.7	3.2	1.4	1.8	n. a.
(% of GDP) (*)	**PEP**	**2.0**	**2.1**	**1.7**	**2.3**	***0.9***
Government gross	COM	46.3	38.5	32.5	29.8	n. a.
debt (% of GDP) (*)	**PEP**	**48.4**	**40.8**	**37.4**	**34.2**	***32.5***

Note: PEP data in bold, COM in regular font

The macroeconomic framework appears overall consistent and sufficiently comprehensive. The underlying scenario of real GDP growth rates gradually increasing to 5½% in 2007 does not appear unrealistic and remains ¼ percentage point below the rates projected in the 2003 PEP. However, latest available data suggest that the situation in 2004 was better than expected in the 2004 PEP. The demand-side contributions to growth in 2005 to 2007 show some unexplained volatility (cf. Appendix 1, Table 1). The objective of keeping the budget close to balance seems overall compatible with the macroeconomic scenario of a sustained and high growth path. Nevertheless, it is surprising that the increase in the minimum wage by 25% at the beginning of 2005 and the fiscal expansion from a balanced budget in 2006 to a deficit of -1.3% of GDP in 2007 do not seem to have more visible macroeconomic effects.

The projections for the medium-term macroeconomic framework were made with the same model as used in previous PEPs and builds on the assumptions of the IMF and the European Commission on the development of the global and the European economy respectively. An alternative macroeconomic scenario is presented which assumes oil prices to be around USD 40 in 2004 and 2005 and about USD 35 in 2006 and 2007 which is about 5 USD per barrel higher than assumed in the PEP's main scenario and still about 5 USD below the price assumed by the Commission in the 2005 spring forecast for 2005 and 2006.[3] The estimated negative effect is only marginal in 2004 and mostly absorbed in 2005, when real growth would be 0.55 percentage points lower, while there would be no effects in 2006 and 2007.

was reported as a capital outflow in 2004 and will most likely be reported as a capital inflow in 2005 once the acquisition by the new foreign owner is accomplished.

[3] Hence there is a difference in the oil prices assumptions of about 10 USD per barrel between the PEP's main scenario and the Commission's spring 2005 forecast.

Real sector

The projected real GDP growth rates of the PEP's macroeconomic scenario are lower than those of the Commission's spring 2005 forecasts for Bulgaria in 2005 and higher in 2006. The Commission assumed that in 2005 consumption would be further stimulated by a slight loosening of fiscal and wage policies in view of national elections by mid-2005 and that in 2006 some downward adjustment would be necessary to rebalance the economy and bring it closer to its medium-term potential growth rate. National accounts data show that real GDP growth in 2004 was 5.6% year-on-year.

In the PEP projections, real GDP growth of 5% and higher is driven by high domestic demand resulting from increases in real wages, employment and bank credits. Gross fixed capital formation increases at double-digit rates which lifts its ratio to GDP from 21.7% in 2003 to 22.8% in 2007. Negative contributions come from the external balance of goods and services as well as, from 2005 on, changes in inventories. On the supply side, all three broad sectors are growing. Employment growth between 1% and 2% brings the unemployment rate down to 10% in 2007. This results in labour productivity growth varying around 4% which is close to what is assumed as real wage growth and would keep real unit labour costs roughly stable.

The PEP only briefly refers to the cyclical developments of the economy as presented in Table 8 of Appendix 1. The output gap values are explained to be based on expert assessments made at the Agency for Economic Analysis and Forecasting (AEAF) with the fundamental assumption being that an unemployment rate of 10% corresponds to full employment. In line with the programme's unemployment projection, the output gap diminishes gradually until potential output is reached in 2007. While the AEAF's rather basic methodology may give rise to some caution as to the reliability of the estimates, it does not deviate much from the commonly estimated potential growth rate of about 5 % for Bulgaria. The PEP states that the work for model-based estimates of the output gap is ongoing in the AEAF.

External sector

In 2004, the current account deficit turned out at 7.4% of GDP. Assuming the continuation of strong imports, the trade deficit is projected to keep on deteriorating in absolute terms but to stabilise in relative terms at about 13½% of GDP in 2006/2007. Assuming the absence of major changes in other items, the current account deficit takes a similar development until 2006 whereas in 2007 it is projected to drop to 7% of GDP (from 8% in 2006) because of the expected increase in EU transfers. Compared to the 2003 PEP, the projections for the current account deficit have more than doubled in nominal terms.

External financing is expected to come to a large extent from net foreign direct investment (FDI) inflows peaking at 9.3% of GDP in 2004 and declining to 5.4% of GDP in 2007. Given that the privatisation process is likely to come to its end in 2005, it remains to be seen whether greenfield FDI of that order of magnitude is a realistic assumption. Positive net portfolio investment inflows are reflected in the projected increase in foreign debt in absolute terms. However, foreign debt decreases only slightly in relative terms to 66% to GDP in 2007, with public foreign debt accounting for less than half of it. The gap would be financed by falling foreign reserves in 2007.

3.3. Monetary and exchange rate policy

Since 1997 Bulgaria is maintaining a currency board arrangement under which the Bulgarian currency (BGN, lev) is fixed at a rate of 1 EUR equals 1.95583 BGN by the Law of the Bulgarian National Bank (BNB). In September 2004 the BNB and in November 2004 the BNB jointly with the Government issued documents which outline the strategy towards the adoption of the euro. The declared objective is to apply for ERM II immediately after accession and to adopt the euro (including cash) in the second half of 2009 or on 1 January 2010, both at the present exchange rate of the currency board.

In 2004, as in previous years, monetary aggregates have been growing at rates above 20% to remonetise the economy and are well covered by foreign exchange reserves. Bank credits to the non-financial sector kept on growing close to 50% year-on-year and achieved a ratio of 35% of GDP at the end of 2004. About 42% of all credits are in foreign currency, mostly euro, and 33% are credits to households. This strong increase in financial intermediation became possible through the repatriation of domestic banks' assets from abroad and foreign capital inflows induced by the positive interest rate differential. However, the PEP does not discuss the potential risks related to these developments with a view to banks' capabilities of credit management and the resulting high imports. Precisely for these reasons, the BNB has introduced several measures throughout 2004 and again in early 2005 to reduce banks' liquidity and to tighten supervision.

Table 2: **Comparison of macroeconomic developments and forecasts**

	2003		**2004**		**2005**		**2006**		**2007**	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	4.3	4.3	5.7	5.0	6.0	5.3	4.5	5.3	n. a.	5.5
Contributions:										
- Final domestic demand	8.8	8.2	6.7	7.5	9.9	6.7	6.5	6.8	n. a.	7.1
- Change in inventories	0.8	0.7	0.4	0.2	0.1	-0.6	0.0	-0.2	n. a.	-0.2
- External balance of goods and services	-7.1	-4.6	-1.4	-2.7	-4.0	-0.8	-2.0	-1.4	n. a.	-1.4
Employment (% change)	3.5	2.9	3.1	1.5	2.0	2.0	1.0	1.5	n. a.	1.5
Unemployment rate (%)	13.6	13.7	12.0	12.4	10.8	11.6	10.0	10.7	n. a.	10.0
GDP deflator (% change)	2.1	2.1	5.5	5.1	4.6	3.5	4.4	3.7	n. a.	4.0
CPI inflation (%)	2.3	2.4	6.2	6.3	4.0	3.7	4.0	3.6	n. a.	4.0
Current account balance (% of GDP)	-9.3	-8.5	-7.4	-8.8	-8.5	-8.3	-7.0	-8.0	n. a.	-7.0

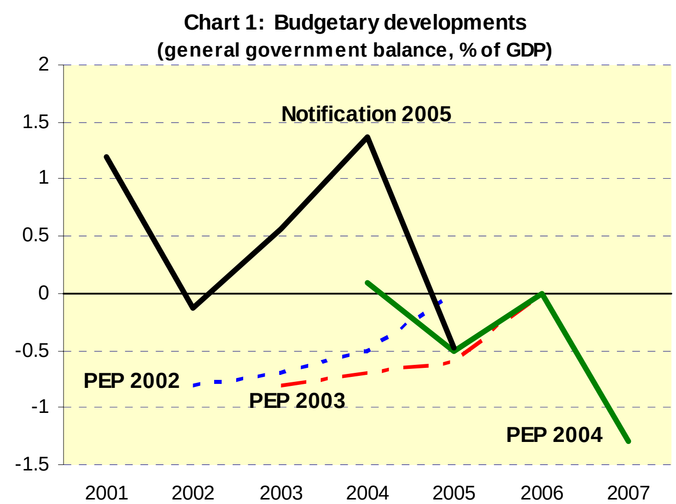
Sources: Pre-Accession Economic Programme (PEP); Commission services Spring 2005 forecasts (COM)

Inflation is projected to remain below 4% in the years to come. If domestic demand continued to be strong in 2005 and growth to run above potential, this could be difficult to achieve, particularly under a fixed exchange rate peg regime, because of the induced pressure from prices of non-traded goods (Balassa-Samuelson effect). In 2006, even if growth were to moderate, this could still be challenging since contributions to consumer price inflation are calculated to be 2 percentage points from changes in administered prices and 1.1 percentage points from higher excise tax rates.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Programme overview

The public finance framework is presented in a consistent way and is generally well explained. Explicit fiscal objectives are to keep the budget close to balance while gradually reducing the tax burden and streamlining expenditure on the basis of budgetary and structural reforms. However, this strategy is not maintained in 2007 when, due to EU accession, an increase in the deficit and the expenditure-to-GDP ratio is envisaged. Public debt is projected to decrease further, with an improved structure to reduce risks. Given that the macroeconomic scenario assumes actual growth to remain close to potential growth, the cyclically adjusted balance is mostly identical to the actual balance. Fiscal risks, which are mentioned to be related to reform progress in the social security system, health protection and fiscal decentralisation, are reduced by fiscal buffers and reserves in the order of 4% of GDP. Budget data are consolidated but not yet fully on an accrual basis as required by ESA 95 methodology.



Budgetary targets for 2005 and 2006 are -0.5% and 0.0% of GDP and broadly following those of the 2003 PEP and the Commission's spring 2005 forecast (see Chart 1). For 2007, a deficit of 1.3% of GDP and a nearly 3 percentage point increase in the expenditure-to-GDP ratio is deemed necessary because of EU accession. General government debt is targeted to decline to 32.5% of GDP in 2007, more favourably than expected in the 2003 PEP.

A recurrent pattern in 2003 and 2004 was the considerable revenue overrun. On the one hand, this conservative approach to revenue budgeting facilitates achieving the planned fiscal targets and supports credibility. On the other hand, it gives the government room for discretionary spending at the end of the year which impedes the objective of bringing down the tax burden and the expenditure-to-GDP ratio. As a result, the revenue-to-GDP ratio expected for 2004 in the 2004 PEP is 40.4% of GDP which compares to 37.5% foreseen in the 2003 PEP.

The decrease by 2.2 percentage points of the revenue-to-GDP ratio between 2004 and 2005 is mostly brought about by a reduction of direct taxes and non-tax revenues while indirect taxes and external aid remain broadly stable relative to GDP (see Table 3). Thus, the implementation of the schedule for gradually bringing excise tax rates upwards to levels as required by the *acquis* is not expected to have a visible effect on revenues relative to GDP. In the context of the 2005 budget, reductions in income tax rates were decided, but no further cuts in rates are foreseen until the end of the PEP period. In 2007, the increase in revenue of 1.8 percentage points of GDP is mostly related to external aid, i.e. EU funds. The foreseen reduction of expenditure relative to GDP by 2.1 percentage points between 2004 and 2006 is to a large extent resulting from decreases in wages and scholarships, maintenance and subsidies. The subsequent increase in 2007 by 3.1 percentage points arises from increases in expenditure on defence, subsidies, investment and others. For the period 2005 to 2007, expenditure is expected to correspond to ceilings set in last year's medium-term framework for 2004 to 2006. The PEP mentions defence, education and healthcare as spending priorities where reforms are unfinished. Interest payments remain broadly stable relative to GDP since the reduction in debt is assumed to be compensated by an increase in interest rates.

Table 3: **Composition of the budgetary adjustment** (% of GDP)

	2003	**2004**	**2005**	**2006**	**2007**	**Change: 2004-07**
Revenues	40.9	40.4	38.2	38.2	40.0	-0.4
of which:						
- Taxes and social security contributions	32.3	32.3	30.8	31.1	31.2	-1.1
- Other (residual)	8.6	8.1	7.4	7.1	8.8	0.7
Expenditure	41.0	40.3	38.6	38.2	41.3	1.0
of which:						
- Primary expenditure	38.9	38.1	36.5	35.9	39.1	1.0
of which:						
Gross fixed capital formation	2.8	3.5	3.7	3.7	4.6	1.1
Consumption	10.3	9.9	9.6	9.4	9.5	-0.4
Transfers & subsidies	18.3	17.3	16.2	16.1	16.5	-0.8
Other (residual)	7.5	7.4	7.0	6.7	8.5	1.1
- Interest payments	2.1	2.1	2.1	2.3	2.3	0.2
Budget balance	-0.1	0.1	-0.5	0.0	-1.3	-1.4
- Cyclically adjusted	0.7	0.2	-0.1	0.2	-1.3	-1.5
Primary balance	2.0	2.1	1.7	2.3	0.9	-1.2
Gross debt level	48.4	40.8	37.4	34.2	32.5	-8.3

Sources: Pre-Accession Economic Programme (PEP), ECFIN calculations

The PEP considers fiscal risks to be manageable. First, arrears accumulated by local governments and the health system amounted to 0.3% of GDP at the end of the first half of 2004. Second, deficits in the social security system are covered by the central budget and should not have an immediate effect on the consolidated budget. Third, sensitivity to variations in the assumed inflation, interest and exchange rates is regarded as fairly small. These risks are reduced by on-going structural reforms and by the envisaged buffers in the central budget execution in the order of 4% of GDP. One of these buffers is the rule to spend only about 90% of the operational expenditure in the first three quarters of the year and to release the remaining part only if fiscal and economic performance developed as expected. Furthermore, there is a contingency and structural expenditures reserve of 0.6 to 0.8% of GDP which increases to 1.4% of GDP in 2007.

In view of the considerable built-in flexibility of the budget, a significant deterioration of the deficit is unlikely to happen as long as the underlying macroeconomic framework materialises. Keeping the budget close to balance is adequate in order to avoid a further deterioration of the high current account deficit. However, the higher expenditure and deficit in 2007 involves the risk of being rather expansionary.

4.2. Targets and adjustment

The budget year 2004 was characterised by higher revenues than projected, mostly because of strong economic activity and buoyant imports. At the middle of the year, the government agreed with the IMF to revise the initial target of a deficit of 0.7% of GDP to a balanced budget and, in case revenue overruns were even higher, not to spend more than 1% of GDP in addition to what was foreseen in the budget. In November 2004, the accumulated budget surplus (in cash terms) peaked at about 3.9% of GDP. The government decided some additional spending on pensions, health system, municipalities and a newly created public infrastructure projects company so that the cash surplus at the end of the year was 1.7% of GDP. Based on ESA 95 methodology the consolidated surplus was slightly lower at 1.3% of GDP.

The final decision for the adoption of the 2005 budget was taken by the Parliament on 17 December 2004 and confirmed the PEP's deficit target of 0.5% of GDP. Following negotiations in the Parliament to ensure a majority vote, modifications were made to the government's draft budget, among others to foresee more expenditure on education and research, which increased revenue and expenditure by about 0.3% of GDP. The highest growth rates for expenditure are on social policy, healthcare and education. Along with the budget a number of changes in taxation were decided including a reduction of the corporate tax rate from 19.5% to 15% and of the personal income tax rates from a corridor of 12%-29% to 10%-24%, shorter depreciation periods as well as a shortening of the delay for VAT reimbursements for exporters from 45 to 30 days. The expected impact of these measures on revenues is already taken into account and quantified in the PEP. Public sector wages are envisaged to increase by 5% on average at mid-2005. Political risks to the 2005 budget arise from the national elections in June 2005 which will not only make it difficult for the current government to reject demands for further expenditure but could also make the budget subject to revisions by a new government.

Following and agreement with the IMF, the Bulgarian government has in May 2005 revised its fiscal target for 2005 to a surplus of 1% of GDP, which will be financed through higher than originally expected revenues and cuts expenditures including on the public infrastructure projects company. Compared to 2004 this still implies a slight fiscal easing, albeit to a much lower extent than originally foreseen.

The balanced budget in 2006 is similar in structure to the 2005 budget whereas the deficit of 1.3% of GDP in 2007, if it were to result from EU accession, goes along with a substantial increase in the expenditure-to-GDP ratio. Avoiding the possibly adverse effects on inflation and current account deficit should be possible if more efforts were made to restructure the budget in 2007 to adapt it to the budgetary effects of accession (see Box).

4.3. Debt developments

The debt-to-GDP ratio of general government is projected to decline from 48.4% in 2003 to 32.5% in 2007. For the years 2004 to 2006 this is between 5 and 6 percentage points lower than the levels expected in the 2003 PEP. Following a buy-back of foreign debt in January 2005 (see below), general government debt has already dropped to about 36% of GDP. According to the 2005 Fiscal Notification, general government debt is expected to decline to 33.4% by the end of 2005. The main contributions to the change in debt ratio come from the primary balance and nominal GDP growth as well as, in 2004, exchange rate changes and privatisation receipts.

Budgetary effects of Bulgaria's EU accession in 2007

The PEP's budget framework for 2007 is characterised by EU accession with assumed negative net budgetary effects of 2% of GDP and a deficit of 1.3% of GDP in 2007, following a balanced budget in 2006. Comparing the years 2006 and 2007, the ratio of total expenditure to GDP increases from 38.2% to 41.3% of GDP, capital expenditure from 3.7% to 4.6%, subsidies from 1.2% to 1.9%, and "other" expenditure from 6.7% to 8.5%, whereas other items remain broadly constant.

At first sight, this is difficult to reconcile with DG ECFIN's estimates, presented in the table below, on the budgetary effects of Bulgaria's accession in 2007.[4] Starting point are the commitment appropriations and payment appropriations in current prices from 2007 to 2009 as agreed in the accession negotiations. Payments are much lower than commitments to take account of possible absorption problems. However, payments from pre-accession assistance will continue and have been added here.[5]

Bulgaria: Budgetary effects of EU accession in 2007 (in % of PEP-projected GDP)

	Commit-ments	Payments
Ccontribution to EU budget	1.1	1.1
EU transfers	4.7	4.3
of which:		
- pre-accession aid	*0.0*	*2.0*
- Structural Funds	*1.5*	*0.7*
Net transfers	3.7	3.3
National co-financing	0.9	1.0

Source: DG ECFIN

A main conclusion from these calculations is that net transfers from the EU budget to Bulgaria in 2007 will be sizeable and positive. Even if all potential "fiscal burdens" from accession (such as co-financing needs and Structural Funds additionality requirements) are taken into account, the net budgetary effect should still be positive in 2007.

Arguing in the PEP for the need of a higher deficit in 2007 due to accession can therefore only hold in a static accounting approach in two ways. First, when the final beneficiary is non-government, transfers from the EU budget are accounted outside the general government sector while they might sometimes require co-financing from the government. Second, when the general government sector is the final beneficiary, they are accounted as fully additional expenditure, i.e. appearing on both the revenue and the expenditure side of the budget without substituting previously existing national programmes. In that way, the EU transfers have almost no effect on the balance, while the contribution to the EU budget and national co-financing of EU programmes have a negative effect.

Notwithstanding this reasoning, which is broadly in line with Eurostat rules, the budget could be adequately restructured so that previously existing national expenditure is substituted by EU funds or used to co-finance EU programmes which are not subject to a strict "additionality" requirement. Then a positive budgetary effect in net terms should prevail and the expenditure-to-GDP ratio would not necessarily increase.

[4] A similar methodology was used for the ten new Member States by Hallet, M. (2004), 'Fiscal effects of accession in the new Member States', *Economic Papers*, No 203 (European Commission, Directorate-General for Economic and Financial Affairs), Brussels, and by Hallet, M./ F. Keereman (2005): Budgetary transfers between the EU and the new Member States: manna from Brussels or a fiscal drag? *ECFIN Country Focus* Vol. 2, Issue 2 of 03.02.2005.

[5] Pre-accession payments were assumed to amount to a quarter of the commitments foreseen in the roadmap for 2006 plus the payment appropriations included in the 2005 draft EU budget.

The government pursues an active debt management strategy to reduce the related risks. The share of domestic debt in total government debt increased by 1.9 percentage points to 13.6% and the external financing is envisaged to be negative until 2007 in order to further increase the domestic share also with a view to developing the non-banking capital market in Bulgaria. New foreign debt is only envisaged to refinance existing debt. An equal balance in currency structure USD/EUR and in floating/fixed interest rates has almost been achieved. The government guaranteed debt amounts to 6% of total government debt. The average maturity has been prolonged with the issuance of several 5 to 15 years government bonds over the last years.

A specific feature of Bulgarian public finance is the fiscal reserve account (FRA) which is mostly held at the Central Bank and implies that government debt is much lower in net terms. Historically, it has been created in 1997 to function as a safety net for the currency board arrangement by which, in case of emergency, foreign debt obligations could be serviced for about one year. However, due to privatisation proceeds and the budget surpluses in the last years, it has reached 12.5% of projected GDP at the end of 2004. There are no clear legal guidelines for the use of the FRA except for a floor of BGN 2.5 million (about 6% of GDP) stipulated in the 2005 budget law. The 2004 PEP only mentions that the FRA “allows for the future financing to contribute to the attainment of the strategic objective of the debt management process rather than to provide resources for debt servicing” (p.64). This strategy was applied in July 2004 when the government used the FRA to finance a buy-back of all Brady discount (“DISC”) bonds of a nominal value of USD 680 million. In January 2005, the government bought back all interest arrears Brady bonds (“IAB”) of a nominal value of USD 937.5 million financed by the FRA.[6] This operation reduces gross public debt (and the FRA) by more than 3 percentage points compared to what is indicated in the PEP. This has improved the long-term sustainability of public finance without further stimulating domestic demand. However, the PEP could be a good platform to commit the government to a more explicit strategy for the use of the FRA in order to avoid its future depletion for an ad hoc-financing of additional public expenditure with potentially negative effects on macroeconomic stability.

5. STRUCTURAL REFORMS

5.1. Programme overview

The PEP gives a good overview of reform progress in the past, but is incomplete on the planned reform agenda until 2007. The government considers structural reforms as an essential complement to its fiscal policy for achieving the objectives of sustained growth and stability while reducing the degree of intervention in the economy. In line with the previous PEP and to a large extent the conclusions on the economic criteria of the Commission’s 2004 Regular Report on Bulgaria, the finalisation of privatisation, reforms in the health and education systems as well as further liberalisation and restructuring of the network industries are considered to be the most important items on the reform agenda.

Privatisation made significant progress in 2004 with the sale of the telecommunication company and the electricity distribution companies to foreign investors. Many minority state-owned shares and smaller companies were privatised through the stock exchange. The largest

[6] The only Bulgarian Brady bonds remaining are the Front Loaded Interest Reduction Bonds (FLIRBs) of a nominal value of USD 648 million with a due date of 2012.

enterprises left for privatisation are in the energy and transport sectors as well as the tobacco company. Several measures were introduced to restructure the railway company which tends to make losses and to require subsidies. Liberalisation in the electricity sector made progress by implementing third party access for some large enterprises. Some reform measures were introduced in the health and education sectors but are still insufficient to substantially improve their efficiency.

Table 4: **Net direct budgetary impact of key reform commitments (in EUR million)**

Description of the Policy	2004	2005	2006	2007
Changes in the corporate income tax		-97		
Changes in the personal income tax		-60		
Introduction of elements of family income taxation			-63	
Increase of excise tax rates		26		
Introduction of the vignette system for the use of the road infrastructure		50		
Completion of the privatisation process (reduction of dividends)			-43	-5
Reduction of active measures on the labour market			7	5
EU pre-accession funds (including national co-financing)		-4	9	1
Increased social pension and minimum pension		-87		
Total impact on the budget (in EUR million)		-172	-90	1
Total impact on the budget (in % of GDP)		-0.9	-0.4	0.0

Source: 2004 Pre-accession Economic Programme (PEP)

Although the matrix of political commitments on the budgetary effects of key reforms in each year is duly completed in the PEP, the main text refers only rarely to these estimates. From Table 4 the reform agenda might appear very front-loaded, but one has to take into account that measures will always be better known for year n+1 than for subsequent years. To some degree this might also reflect the fact that the heaviest reforms, many of them related to economic transition, are approaching their end. The reduction of income tax rates and the introduction of family income taxation will bring some losses in revenues. The completion of restructuring and privatisation of state-owned enterprises is expected to continue triggering important FDI inflows and to allow a further reduction of the already low level of state aid, but will also imply a phasing out of privatisation receipts and dividend payments. A general system of road charging on motorways is being introduced in 2005 after its introduction for trucks in 2004. In telecommunication, following the privatisation of the ex-monopoly in 2004, the liberalisation of the fixed-line sector continues as well as the award of a third GSM license and of 3 UMTS licenses in 2005 will bring more competition. In the energy sector the main measures are the further liberalisation in line with the *acquis communautaire* and the closing down of units 3 and 4 of the Kozlodui nuclear power plant at the end of 2006. On the labour market the main focus is on active policies for long-term unemployed. An increase in pensions is expected to imply additional expenditure in 2005.

The reform strategy is broadly in line with key objectives of the Lisbon agenda by improving the efficiency of product and capital markets. The progress in structural reforms has been important in bringing state aid relative to GDP down closer to the EU average (see table in the annex of this assessment). Of particular importance is the achieved and envisaged progress on the liberalisation of the network industries. Further reforms in the health and education systems will be important not only to make public spending more efficient but also to enhance social cohesion and the transition to the knowledge-based society. The sound macroeconomic environment continues to improve the situation on the labour market. However, counter to the conclusions of the Ministerial Meeting on the 2003 PEP and those of the 2004 Regular Report, the 2004 PEP almost completely lacks measures aiming to increase the flexibility of the labour market.

5.2. Product and capital markets

The process of privatisation, which was the most important contribution to enterprise restructuring and the reduction of government intervention in the economy, is approaching its end. At the end of November 2004 there were 95 majority state-owned enterprises left for sale, after 2.878 had been sold. Privatised assets amounted to 86.95 % of the state owned assets estimated in 1993 and due to privatization in the medium term. Following the renewed failure to privatise the main part of the tobacco monopoly Bulgartabac, about 20 companies from the tobacco, energy and transport sectors are the largest ones remaining for privatisation. Among the smaller ones still to be privatised are companies offering specific services or products such as road maintenance and repair, defence industry enterprises, special commercial and service enterprises. In the first nine months of 2004, the private sector accounted for 77% of gross value added.

Competition policy, which is mostly under the responsibility of the Commission for the Protection of Competition, was further strengthened by a number of measures. New implementing rules on state aid were adopted in May 2004. A national plan for the restructuring of the steel industry was decided which limits permitted state aid to the steel sector until 2007. A new law on public procurement and implementing rules were adopted in October 2004 which, among others, foresee the creation of a public register and an agency to enhance transparency.

The main objectives of the energy strategy are security, competitiveness and environment protection. A full participation in the regional energy market of South-Eastern Europe and in the common energy market of the EU after accession is envisaged. Measures for increasing energy efficiency and saving will be implemented. The restructuring of the energy sector has progressed further and the regulatory framework is mostly in place. Laws on energy, energy efficiency and secondary legislation were adopted in 2004. The last step of energy price increases in order to achieve cost recovery was made in summer 2004. The unbundling of gas and electricity transmission will be implemented according to the *acquis* calendar. Public and private investment in energy projects amounts to € 2.3 billion until 2007. However, no mention is made in the PEP of the expected effects of the foreseen closure of units 3 and 4 of the Kozlodui nuclear power plant before the end of 2006 and of the financing of a new nuclear power plant in Belene.

In the transport sector, preparations are being made for granting concessions for the airports in Burgas and Varna as well as for sea and river ports. The restructuring of the railway company progressed by institutionally separating track, passenger and freight services and by reducing staff and railroads. Subsidies to the railway company are granted in the framework of an agreement for the provision of public services. A first license to a private freight railway operator was attributed in 2004. A road vignette system was introduced for trucks in 2004 and for light automobiles in 2005.

In the telecommunication sector, the privatisation of the ex-monopoly Bulgarian Telecommunication Company (BTC) triggered its restructuring. There is increasing competition in fixed-phone services through interconnection agreements with BTC and other cable investors. A third provider of GSM mobile phone services, for which BTC received a license in 2004, will enter the market in 2005. A change in ownership of the currently leading mobile phone provider is expected in 2005. The procedure for granting three UMTS licenses started at the end of 2004 and should be completed in early 2005 so that services are expected to start in 2007. The information society is promoted by a national research network, training measures, e-government measures and ICT centres across the country.

The banking sector shows a very dynamic development on the basis of its small size and fragmented structure. Total assets were 55.7% of GDP by mid-2004 and increased by 16% year-on-year while the stock of credits to non-financial corporations and households keeps on growing by a rate of close to 50% year-on-year. The Central Bank (BNB) prepares the payments system for its nearing integration into euro area system. It introduced banking supervision measures to restrain the high credit growth and to align with EU banking legislation.

The non-banking financial sector is a much less important for financial intermediation than the banking sector. The stock exchange index SOFIX reached new record highs in 2004 and increased by 40% between the beginning and the end of the year. Stock exchange turnover was dominated by trade in compensatory notes and privatisation-related shares. At the beginning of 2005, the government brought its nearly 35% share of BTC to the stock exchange against compensatory notes. The PEP forecasts market capitalisation and turnover of the stock exchange to develop in line with GDP and to remain at about 9% and 2% of GDP respectively. Insurance premiums have increased to 2.2% of GDP and pension funds to 1.7% of GDP. The transposition of EU insurance directives into national legislation will be completed by the end of 2005.

5.3. Labour market

The medium-term objectives of the employment strategy 2004-2010 are to increase employment and to reduce unemployment, and the longer-term objective is to enhance economic activity and human resource development. An active labour market policy is being implemented to prevent long-term unemployment for disadvantaged groups and social exclusion. The National Action Plan focussed on vocational training and life-long learning. Contrary to recommendations, recent changes in the Labour Code regulating for example the stability of employment contracts in the case of a change in enterprise ownership and equalising the rights and obligations of part-time/temporary employees to those of full-time/permanent employees failed to increase labour market flexibility. The authorities intend to conduct a study on labour market flexibility whose results will be reflected in the 2005 Action Plan on Employment. The impact of the increase of the minimum wage by 25% from BGN 120 to BGN 150 at the beginning of 2005 is not analysed in the PEP, for example with a view to direct employment effects or indirect effects through a spillover into excessive wage demands in other sectors beyond productivity growth.

In education, the need for a more substantial reform is only partly met by some measures. A new mandatory pre-school year and a 13th grade in vocational secondary schools were introduced in 2003/2004. Educational requirements and national examinations in vocational training have to comply with newly defined curricula. Delegated budgets will be introduced in all schools until 2009. A strategy for the development of higher education until 2010 has been adopted to improve financing and accounting in higher education in 2006 and 2007. Quota of students according to the needs of the labour market will be applied in 2007. A credit point system is effective in higher schools since 2004.

5.4. Other reform areas

The strategy for administrative reform 2003-2006 is focussed on preparations for EU accession. It includes an increase in public sector staff, recruitment based on competitions, merit-based career development and a wider use of one-stop-shops. Five out of 20 e-government services recommended by the EU have been implemented. Furthermore, it is foreseen to develop the administrative capacity of the six planning regions to manage Structural Funds. Efforts on judicial reform and the fight against corruption are continuing. In the context of fiscal decentralisation, transfers from central to local government will be made for responsibilities in education, healthcare, culture, social welfare, defence and security, and administration. At the same time, the enhanced local autonomy on services will go along with the obligation to finance them by own revenues.

In order to facilitate transactions on the land market, a consolidated cadastre database started to operate at regional level. A more pro-active government intervention for land consolidation is planned. A main element of the 2005-2014 environmental strategy is the integration of environmental concerns into other sector policies.

Further clarification on the part of the proposal that concentrated on agricultural land reform with a view to addressing the issue of land fragmentation would have been useful. The report focused on preparations for SAPARD but it lacked information on problem areas in agriculture and rural areas which needed to be addressed in the measures proposed. Furthermore, quantitative information on the overall spending for agriculture and rural development could have been provided.

Since the submission of the PEP, the Commission and Bulgaria have signed a 'Joint Inclusion Memorandum' which sets out the main challenges and policy priorities in the fields of social protection and social inclusion including the commitment to concrete follow-up actions as regards for example labour market policy, education, or measures for vulnerable and disadvantaged groups.

6. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

6.1. The quality of public finances

On the revenue side, the recent overruns indicate that reforms in the customs service and the tax administration are effective. In 2006, the National Revenue Agency (NRA), which has so far only two regional pilot offices, should become fully operational and will be authorised to collect all revenues of central government, local governments, social security institute and health insurance fund. This is expected to enhance the efficiency of revenue collection.

On the expenditure side, the programming budgeting methodology, which is currently applied only in some Ministries, will be introduced in all primary-level budget spending units in 2007 and the budget execution will then be fully on an accrual basis. Capital expenditure is estimated to have increased from 2.8% of GDP in 2003 to 3.5% of GDP in 2004 and projected to remain around that level until in 2006. In 2007, also due to the inflow of EU funds, a share of 4.6% of GDP is targeted. In the area of human capital, rather high growth rates are expected for expenditure on education and research, although from a low base, so that its share relative to GDP remains low by international comparison (see table in the annex of this assessment).

The reduction in public sector employment, largely due to the process of privatisation, tends to go along with substantial increases in employment in public administration. While reforms in the public administration, also to prepare for EU accession, may require new staff, they should not necessarily go along with net increases in employment in public administration but rather be accompanied by reductions elsewhere. According to Table 2 on labour market developments in Appendix 1 (p.118), public sector employment has decreased by 3.5% in 2003 and 2004 respectively and will continue decreasing by 3% each year from 2005 to 2007. In line with this projection, Table 8 on expenditure of the consolidated state budget (p.59) shows a gradual decline of wages and scholarships from 5.2% in 2003 to 3.9% in 2007. However, Appendix 9 on administrative reform (p.156) mentions that "in 2003, statistics showed an increase of the scope of the civil service by 10.3% on a year-to-year basis" and that on "1 April 2004, 8353 new positions at the central and regional administration were designated for civil servants". Data from the Bulgarian National Statistical Institute indicate that in December 2003 there were 2.8% more employees in the public sector and 13.4% more employees in public administration than one year earlier; the corresponding figures for December 2004 are -5.4% and 7.4%.

6.2. The sustainability of public finances

Bulgaria has already implemented and plans further measures to improve the long-term sustainability of public finances. Provided their full implementation and given the achievement of the programme's reform agenda and fiscal consolidation, Bulgaria is relatively well placed to meet the costs of a rapidly ageing population. Nevertheless, developments in relation to the reform of the pension and health-care systems need to be monitored carefully.

Table 9 of Appendix 1 (p.126) gives a projection of the long-term sustainability of public finances, however without giving further methodological explanations in the main text. Total general government expenditure and revenues are projected to decline to 36% of GDP in 2020 and to remain at this value until 2050. This is achieved by bringing pension payments down from 7.7% of GDP in 2005 to below 5% of GDP and stabilising healthcare and interest payments at 5% and 2% of GDP respectively. Pension contributions would be stabilised at about 4½% of GDP. Main assumptions are a gradual decrease of growth rates of real GDP and labour productivity and an increase in participation rates of those 15 and older from 51.5% in 2005 to 57.2% in 2050 going along with a stabilisation of the unemployment rate at 5% from 2030 onwards.

A main objective of social security reform is an improvement in the financial stability of the system. Efforts for higher collection rates with a view to the sizeable shadow economy have been made through a reinforcement of the obligation to register employment contracts and through assumed minimum incomes by sector to calculate social security contributions. A gradual shift of the employer/employee shares is made from 70%/30% in 2005, to 65%/35% in 2006 and 60%/40% in 2007.

For the three-pillar pension system the aim is to stabilise the first (compulsory) pillar and to further develop the second (supplementary) and third (voluntary) pillars. The supplementary pension funds (universal, occupational, voluntary) are forecast to double their assets between 2004 and 2007 from € 376 million to € 746 million which is, relative to the PEP-projected GDP, from 1.9% to 3.0%. The successive increase of eligibility requirements on age and length of service to become eligible for pensions is continuing.

Contributions to the National Health Insurance Fund (NHIF) will increase from 6% in 2005 to 8% in 2006 to make a gradual shift of healthcare financing from central government to the contribution-financed health insurance fund between 2004 and 2007 while keeping health expenditure stable at 4.3% of GDP. Table 8 on expenditures of the consolidated state budget (p. 59) indicates NIHF expenditure of 2.2% of GDP in 2003 and 2004, of 2.0% of GDP in 2005 and of 2.8% of GDP in 2006 and 2007. The new law on healthcare became effective at the beginning of 2005 which aims to reduce abuses of the system. A core part of healthcare reform is a more standardised cost calculation for medical services in a move towards activity-based payments and improved transparency and accounting. Hospitals are still a main problem of financing since most of them are not yet privatised and accumulating debt.

* * *

Annex table 1: **Structural indicators**

	BULGARIA					EU 25				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
General economic background										
Real GDP [1]	5.4	4.1	4.9	4.5	5.6	3.7	1.8	1.1	1.0	2.3
Labour productivity [2]	9.2	7.8	3.3	1.0	2.4	2.1	0.8	0.8	0.8	1.8
Real unit labour cost [3]	-5.4	0.8	-0.8	5.5	-0.7	0.4	0.4	-0.4	-0.5	-0.9
Real effective exchange rate [4]	96.5	103.7	105.8	109.0	113.3	98.7	100.5	103.0	106.1	108.8
Inflation rate [5]	10.3	7.4	5.8	2.3	6.1	2.4	2.5	2.1	1.9	2.1
Unemployment rate [6]	16.9	19.8	17.8	13.7	12.0	8.6	8.4	8.7	8.9	9.0
Employment										
Employment rate [7]	50.4	49.7	50.6	52.5	54.2	62.5	62.9	62.9	63.0	63.3
Employment rate - females [8]	46.3	46.8	47.5	49.0	50.6	53.7	54.3	54.7	55.1	55.8
Employment rate of older workers [9]	20.8	24.0	27.0	30.0	32.5	36.6	37.4	38.8	40.2	40.5
Long-term unemployment [10]	9.4	11.9	11.7	8.9	7.1	3.9	3.8	3.9	4.0	4.1
Product market reforms										
Relative price levels [11]	37.9	39.6	41.6	42.1	:	100	100	100	100	100
Total trade-to-GDP ratio [12]	42.9	43.5	41.8	43.9	48.1	:	9.7	9.2	9.0	9.4
Total FDI inflows [13]	8.0	5.9	5.8	10.3	8.4	16.0	7.6	8.3	6.1	3.9
Market share electricity [14]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aids [15]	0.7	0.5	0.2	0.5	:	0.3	0.3	0.3	:	:
Business investment [16]	12.1	14.7	15.3	16.5	17.8	18.4	17.9	17.2	16.8	17.0
Knowledge-based economy										
Tertiary graduates [17]	38.1	41.4	44.1	n.a.	n.a.	43.2	47.0	49.0	52.2	n.a.
Spending on human resources [18]	4.41	3.53	3.57	n.a.	n.a.	4.9	5.1	5.2	n.a.	n.a.
Educational attainment [19]	74.9	78.2	77.5	75.6	76.0	76.4	76.2	76.5	76.6	76.7
R&D expenditure [20]	0.52	0.47	0.49	0.50	n.a.	1.88	1.92	1.93	1.95	n.a.
Internet access [21]	n.a.	n.a.	n.a.	n.a.	10.0	n.a.	n.a.	n.a.	n.a.	42.0

1. Growth rate of real GDP in %. 2. Growth rate of real GDP per person employed in %. 3. Ratio of compensation per employee to nominal GDP per person employed, total economy, annual percentage change. 4. Vs IC36 (1999 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs). 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population aged 15-64.

11. Of private final consumption (EU25=100). 12. average value of imports and exports of goods and services in % o GDP; the value for EU 15 is the total for the Small Member States. 13. In % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Percentage of households who have Internet access at home.

f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value, q: estimated from quarterly values.

Source: Commission services.

PRE-ACCESSION ECONOMIC PROGRAMME OF ROMANIA

1. INTRODUCTION

Romania submitted its 2004 Pre-Accession Economic (PEP) on 30 November 2004, covering the period 2004-07. A new Government took office in December 2004 and against the background of its adoption of a major tax reform, Romania submitted a new 2004 PEP on 18 February 2005. The programme was elaborated by the National Commission for Economic Forecasting in view of key policy documents in relation to Romania's EU accession and in co-operation with ministries and other public institutions. Social partners and NGO's were consulted, and the programme was approved by the Government, who considers it a forerunner of Romania's future convergence programme.

The programme broadly complies with the requirements of the consolidated outline for the 2004 PEP in terms of content, form and data. The PEP provides evidence of progress in the analytic capacity of the authorities, albeit the lack of cyclically adjusted budget balances, the scarce analysis of the long-term sustainability of public finances and limited quantified estimates of the impact of key fiscal and structural measures point to room for further improvement. The programme provides a factually correct summary of recent macroeconomic performance with due emphasis on unexpected developments and sets out a sufficiently comprehensive and broadly consistent macroeconomic framework. The programme presents its medium-term fiscal and other policy objectives and provides a detailed account of ongoing structural reforms in product, capital and labour markets in the light of EU-integration. The PEP is, however, yet to give a fully adequate and lucid illustration of the interplay between structural reform and fiscal and wage policies, in particular as the actual instruments are not concisely described and no clear timetable set. The programme follows the requested format and provides largely complete tables, which are in all but a few cases correctly compiled. The increased use of ESA 95 data compared to last year's submission is evidence to the gradual alignment to the requirements of EU accession, although further efforts are warranted to ensure that fully compatible ESA 95 data become a main reference for fiscal analysis before the time of Romania's accession.

The programme's strategy is centred on continued macroeconomic stabilisation and further structural reforms. The main fiscal policy instruments would consist in a significant relaxation of income, profit and social security taxation combined with strengthened tax collection, broader tax base and an efficiency enhancing expenditure policy. The general government budget deficit would stay under control and quasi-fiscal subsidies further reduced. Monetary policy would aim at sustainable disinflation via the implementation of an inflation targeting regime, progressive reduction of the interest rate level and increased flexibility of the exchange rate, while wage policy would support disinflation and competitiveness. The structural reform agenda consists of the continuation of a broad array of initiatives in order to enable Romania to cope with the competitive pressure and market forces within the EU.

2. JOINT OPINION

On 12 July 2005 the ECOFIN Ministers of the present Member States and the Acceding Countries examined the 2004 Pre-Accession Economic Programme of Romania on the basis of an assessment prepared by the Commission Services with a contribution from the ECB and adopted this joint opinion.

Ministers commend Romania for progress made in reforming its economy and in reducing macroeconomic imbalances. They highlight the rapid fall in inflation, which is supported by an appropriate monetary policy, and the positive role that fiscal policy has played in achieving lasting economic stability. They emphasise that the current strong recovery creates favourable conditions for accelerating structural reforms and addressing Romania's fiscal challenges. They call for caution in the policy mix in order to ensure that high domestic demand and strong real appreciation will not jeopardise the sustainability of the external balance. Maintaining a focus on enhanced price stability and further disinflation is of the utmost importance in the coming years.

Ministers note that Romania's fiscal policy strategy, as outlined in the PEP, is pro-cyclical and surrounded by a series of important downside risks. They note that the considerable cuts in income and corporate profit tax are only partly financed. They welcome that revenue raising measures were adopted in April 2005 and that the revised 2005 budget brings important changes to the fiscal policy framework presented in the PEP, which would limit the pro-cyclical impact of initial reforms and support the continued embedding of Romania's economic policy in an IMF programme framework, which however also requires further revenue increasing measures and a prudent public sector wage policy for the 2006 budget. In view of Romania's experience, they acknowledge the merits of strengthening the supply side conditions of the economy in the medium term, notably by reducing non-wage labour costs. At the same time, they express concern about the risk of a larger than projected adverse impact of the fiscal reform on revenues and encourage the Romanian authorities to implement additional measures to permanently strengthen the revenue base. They advise a cautious approach to estimating the positive effects from rate cuts on the tax base and a further use of quantified estimates for fiscal policy analysis. They also underline the scope for further improvements in revenue collection. Given the needs for public investment aimed at strengthening the economy's growth potential and preparing for EU accession, they support the envisaged restraint of current expenditures and subsidies and consider that a clear medium-term expenditure framework could contribute to redirecting public expenditure towards human capital, infrastructure and administrative capacity, and they note that absorption capacity of EU transfers should be strengthened.

In light of the ageing of the population, the structural imbalance of the public pension system and the expected increase in health expenditure, Ministers urge Romania to increasingly focus on the long-term sustainability of its public finances and develop a comprehensive strategy for reforming the pension system with the twofold purpose of improving its financial sustainability and providing an adequate pension level. Ministers note that the Romanian authorities have accelerated the reform preparation process and moved forward the initial date for the implementation of the second pension pillar.

Ministers call for strong efforts to further reduce quasi-fiscal subsidies stemming from the financing requirement of state-owned enterprises, implicit subsidies provided via the energy sector and the accumulation of tax arrears. Ministers note the additional measures taken by the Government, as envisaged in the PEP, to reduce the tax arrears. A vigorous *implementation of sector reforms, in particular for energy, mining, transport and agriculture, remains crucial for strengthening Romania's competitiveness and preparing Romania's accession to the EU. They also urge Romania to vigorously pursue reforms in the labour and product markets, which are crucial for enhancing the growth potential. They welcome the amendment of the Labour Code and emphasise the need to constantly increase the employment and participation rate, among other by improving flexibility in the labour market and limit entry into disability and early retirement schemes. Ministers welcome the measures in favour of the development of the private sector but stress the need for additional action to improve the investment climate, in particular by addressing remaining weaknesses in governance and administrative capacity.*

Finally, Ministers note Romania's progress since last year in developing the institutional and analytical capacity required to participate in EMU. However, they recommend Romania to intensify its efforts to ensure that fully compatible ESA 95 data will progressively become a main reference for fiscal analysis before the time of Romania's accession to the EU.

3. MACROECONOMIC DEVELOPMENTS

3.1. Recent macroeconomic developments

The programme presents a factually correct overview of economic developments in 2003 and the first three quarters of 2004, albeit both years' higher than expected public expenditure growth appears to be only partially explained. Concerning 2004, the document makes use of all relevant national account, external trade and current account data available at the time of revising the 2004, but could have benefited from a full update with regard to the budget execution. Compared to last year, the presented data gives more emphasis to monetary variables, current and capital account developments, which is welcomed.

In 2003, Romania's four-year economic recovery continued, as real GDP grew by 5.2%. However, growth was increasingly unbalanced and mainly driven by domestic demand. Household consumption rose strongly by 7.2% driven by surging consumer credit and high wage growth. With a real growth of 4.6%, government consumption also expanded considerably. Gross fixed capital formation increased rapidly at 9.1%, pointing to the ongoing replacement of Romania's capital stock. The strong domestic demand led to a sustained import growth of 16.4%, while export growth decelerated, reaching 11.4% for the year. Consequently, net exports turned strongly negative, and the current account deficit widened to 6.0% of GDP. For 2004, preliminary figures show that GDP grew by 8.3%. Growth was driven by a further strengthening of household consumption, growing by 10.8%, and by strong gross fixed capital formation, growing by 10.1%. Public consumption recorded an annual growth rate of 4.6%. Although exports accelerated in 2004 to a growth rate of 14.1%, they continued to be outpaced by rapid import growth of 17.8% due to higher demand for both consumer and investment goods. As a result, net exports contributed negatively to real growth by 2.8% of GDP. The trade deficit widened further to 9.0% of GDP and the current account deficit increased to 7.5% of GDP.

Table 1: **Comparison of key macroeconomic and budgetary projections**

		2003	2004	2005	2006	2007
Real GDP growth	COM	5.2	8.3	5.5	5.1	n. a.
(% change)	**PEP**	**5.2**	**8.3**	**6.0**	**6.1**	**6.3**
Consumer price	COM	15.3	11.9	8.2	6.5	n. a.
inflation (%)	**PEP**	**15.3**	**11.9**	**8.1**	**6.0**	**4.4**
General government	COM	-2.0	-1.4	-2.4	-2.6	n. a.
balance (% of GDP)	**PEP**	**-2.0**	**-1.3**	**-0.7**	**-0.9**	**-1.9**
Primary balance	COM	n. a.	n. a.	n. a.	n. a.	n. a.
(% of GDP)	**PEP**	**-0.3**	**0.1**	**0.7**	**0.3**	**-0.8**
Government gross	COM	21.3	18.5	19.1	19.6	n. a.
debt (% of GDP)	**PEP**	**21.0**	**18.4**	**17.5**	**19.0**	**19.8**

3.2. Macroeconomic scenario

The programme's strategic goal is restated as being the continued restructuring of the economy in order to enable Romania to cope with the competitive pressures and market forces within the European Union. A broad array of priority objectives related to both continued macroeconomic stabilisation and deepened structural reforms is listed. Among these, the improved functioning of markets, the transition towards a knowledge-based economy and the promotion of environmentally and socially sustainable economic growth are new priorities. Moreover, the 2004 programme sets inflation reduction and an incomes policy sustaining disinflation as priority targets. This is an improvement compared to the 2003 PEP, where these objectives were treated as hypotheses underpinning the macroeconomic scenario. Due, probably, to the extended list of priorities, the programme is not succinct in presenting the key instruments envisaged, in particular in relation to the structural reform agenda. Concerning macroeconomic stabilisation, main fiscal policy instruments would be a significant relaxation of income, profit and social security taxation combined with strengthened tax collection, broader tax base and an efficiency enhancing expenditure policy. The general government budget deficit would stay under control and quasi-fiscal subsidies be further reduced. Monetary policy will aim at sustainable disinflation via the implementation of an inflation targeting regime, progressive reduction of the interest rate level and increased flexibility of the exchange rate. A restrictive wage policy remains the third stabilisation instrument emphasised, but although the programme stresses the need for a prudent wage policy to compensate for the pro-cyclical fiscal policy, some of the concrete steps foreseen seem to suggest a somewhat looser incomes policy than in last year's submission.

One macroeconomic framework is presented, which is sufficiently comprehensive and gives a useful and broadly consistent overview of demand and supply side developments over the programme period. Based on an improved production function methodology, the framework focuses more on the sources of potential GDP growth than in previous submissions. While clearly adding to the analytical dimension of the programme, the potential growth path seems at the same time to have determined the forecasted GDP growth, thereby implicitly *assuming* that domestic demand and inflation pressures will moderate over the period. Hence, the coherence between the macroeconomic scenario presented and the policy-mix outlined is only partial, in particular in relation to the effect of fiscal relaxation on domestic demand as well as the considerable real wage growth foreseen, which due to the positive effect of income tax cuts on net wages and on the back of a rapid increase in the minimum wage would show an annual average growth of more than 8% during 2004-07. The programme to some extent recognises this by making clear that an accelerated implementation of the structural reform agenda is an essential prerequisite for the consistency of the framework. In the light of this, a more explicit and quantified analysis of structural measures to reduce the broad public sector deficit, including stricter enforcement of tax claims, reduction of losses in state-owned enterprises and energy price adjustments, would have added to the framework.

Relative to last year's PEP, three major revisions have occurred. First, growth is over the entire programme period more unbalanced as domestic demand is revised significantly upwards, in particular due to higher household consumption, while net exports display a stronger negative contribution to GDP. Secondly, the private sector savings-investment balance is expected to be significantly more negative while the public sector savings-investment balance is expected to be significantly less negative over the programme period. This revision is in line with developments over the last two years and seems indeed plausible, although the underlying factors for the downward revision of the private sector's savings ratio, such as high credit growth and pent-up consumer demand in large segments of the population, are not well explained. Thirdly, both imports and exports are expected to grow at nearly twice the rate foreseen in the 2003 PEP. Stronger import growth is explained mainly by the upwards adjustment of domestic demand compared to last year's submission, while stronger exports are explained by higher external demand, the positive effects on exports from increasing FDI, export promotion measures and the lower profit tax. While it is realistic that foreign trade will grow at double-digit rates, the programme correctly underscores that the projected real appreciation accentuates the need for continued productivity gains to maintain competitiveness.

The external outlook underpinning the macroeconomic framework seems appropriate, albeit no table on the programme's external assumptions is provided. Based on a stronger momentum of the EU economic recovery, accelerating world economic activity and rising commodity prices, it is in line with the Commission Autumn 2004 forecast. Although the decision of the central bank to pursue a more flexible exchange rate policy by abandoning the pre-announced target for the real exchange rate's appreciation and limiting forex market interventions may make the nominal exchange rate largely unpredictable, some further mentioning of the expected nominal and/or real exchange rate path against the euro would have been appropriate. In spite of a significant nominal appreciation of the currency since Autumn 2004 and the expectation of continued strong capital inflows, the programme expects the average nominal exchange rate in 2005 to remain at the end-2004 level

Real sector

For the period 2005-2007, the programme forecasts continued strong GDP growth of above 6% annually, which is driven both by domestic demand and by a considerable reduction in the negative contribution from net exports. Domestic demand is expected to gradually moderate over the programme period, but remains strong on the back of a solid 6.3% average real growth of household consumption and buoyant investment growth, which is expected to expand by close to 13% annually. Real government expenditure is seen to grow by an average 2.3% annually, which is half the rate recorded in 2003 and 2004. In line with the PEP's overall objective of ensuring a positive contribution of the external sector to economic growth, the substantial negative contribution to GDP growth from the external balance observed in 2003-04 declines gradually over the programme period against the background of sustained export growth and more tempered import growth.

On the supply side, the macroeconomic outlook foresees particularly high growth in the construction sector, averaging 11% over the programme period, which, in view of expected gains in households' disposable income and enterprises' net profits, improved access to mortgage credits and growing consumer and business confidence, is plausible. High activity is also expected in the services sector, which is forecasted to grow by 6.5% on average, while real agricultural production growth will hover below 3% annually. Overall, industrial production will continue to underpin economic growth, although the programme plausibly predicts that the structural adjustment process in certain sectors, such as mining and energy production, may take a short-term toll on industrial production, which would therefore be marginally below GDP growth.

The PEP foresees higher participation and employment rates and gradually falling unemployment. Working-age employment growth is positive and seen as determined by private sector employment growth, and by the effect from lay-offs caused by the restructuring of state-owned enterprises and lower public employment. Mainly due to a higher employment rate, the ILO unemployment rate is expected to fall moderately. Labour productivity is seen to grow broadly in line with GDP. Although labour market trends should be interpreted with caution as data are affected by revisions, changing methodology and the existence of a large informal sector, the expected development in participation and employment rates seems out of line with past developments. The programme explains this discrepancy by the positive demand and supply effects from lower income and corporate taxation.

The macroeconomic outlook is largely in line with the Commission Spring 2005 forecast, which seem, however, to take into account a stronger effect on the external balance of the expected real appreciation of the '*leu*' following the change in exchange rate policy, while it does not incorporate a noticeable slow down of public consumption growth as in the case of the PEP. Bearing in mind the advantages of a cautious fiscal strategy in relation to the macroeconomic scenario, the discussion of an alternative scenario consisting of even stronger domestic demand and a larger negative contribution from external trade to GDP could have had its merits, not least in highlighting the role of a prudent fiscal policy in improving the domestic savings-investment balance.

Compared to last year's PEP, the programme's projections of sources of growth are based on an improved production function methodology, which has been elaborated in line with the work of the Economic Policy Committee. This analytical approach yields optimistic projections of an average 7.4% potential GDP growth during 2004-07, explained by an increasing capital stock and higher total factor productivity. Contrary to what has been observed hitherto, labour will no longer subtract from potential growth. Given the steady decline in participation rate since the mid-1990's, the programme's assumption of an increasing participation rate and stable potential employment over the programme period appears, however, questionable. The labour force may well fall more rapidly than projected in the PEP, not least as the programme also stresses the need for further privatisation and restructuring in the enterprise sector, which has until now been associated with many people leaving the labour force when becoming redundant. Projecting potential employment on the basis of a declining participation rate in line with actual developments since 1995 would yield a negative contribution from labour to potential GDP growth in the order of ½-1% of GDP. Under this assumption, the absence in the PEP of a positive output gap over the programme period would no longer hold as actual GDP would exceed potential GDP from 2005.

External sector

In line with the expectation of high private consumption and investment activity, the programme foresees a lasting trade deficit over the period, gradually declining however from 9.2% of GDP in 2004 to 8.5% in 2007. Such narrowing of the trade deficit contrasts with the Commission Spring 2005 forecast, which expected a continued widening to above 10% of GDP until 2006. This discrepancy is only partly explained by the forecasts' different exchange rate assumptions and trade volumes. Presumably, more positive terms-of-trade developments is therefore an important factor in explaining the PEP's smaller trade deficit.

Increasing current transfers, both in the form of remittances and EU pre-accession assistance, would alleviate the impact on the current account deficit, which is expected to gradually decline to 6.3% in 2007. The significant shortfall of more than 0.6% of GDP between projected and actual current transfers from the EU in 2004 underlines, however, that such transfers may fluctuate from year to year and to large degree depend on advancing the institutional and programmatic framework necessary to absorb the increase in available EU funding. For the year 2007, an unexplained jump in remittances of close to 0.4% of GDP seems to neutralise the negative effect on net EU transfers caused by Romania's contribution to the EU budget. Overall, current account developments could well turn out less comforting than scheduled in the programme, not least given the risk of higher domestic demand pressure and slower export growth. From a savings-investment balances perspective, the PEP contains useful and consistent private and public sector balances. The private sector savings-investment balance is expected to be significantly more negative than in last year's submission, albeit the deficit declines over the period. This revision is in line with developments over the last two years, but a more elaborated account of why the private sector savings ratio in 2004 turned out nearly 7% of GDP lower than expected in last year's PEP would have been valuable, in particular since the ratio is still expected to improve considerably over the period, thereby helping to contain the current account deficit. To alleviate the concerns over a further decline in private sector savings, the programme argues that structural reforms will increase the propensity to save in the corporate sector and that the gains in households' disposable income caused by lower income taxes will primarily be saved. While the planned improvement of the financial balance in the state-owned enterprise sector is commendable, the programme fails to provide a fully convincing argumentation for how this will occur, in particular towards the end of the programme period when also the general government deficit is set to increase. Moreover, the programme's hypothesis that pent-up consumer demand has been largely met and that the increased indebtedness of some households may put a brake on consumption at the aggregate level seems relatively optimistic.

Given the PEP's current account projections, the assumption that FDI inflows will remain above 4% of GDP throughout the period, the expectation of a significant increase in EU capital transfers in 2007 and the exchange rate appreciation, the foreign-debt-to-GDP ratio is projected to fall by almost 10 percentage points of GDP and would reach 20.9% of GDP in 2007. Nevertheless, given the uncertainty surrounding the size of the current account deficit and the effective absorption capacity of EU funds, a larger resort to international financial markets seems plausible. In the light of Romania's progress in macroeconomic stabilisation, improved credit ratings, EU accession perspective and the already distinctly lower risk premium on Romanian sovereign debt, this should cause no difficulty. Large international reserves could also, in case of needs, facilitate financing of the current account deficit.

The programme re-iterates Romania's commitments in the context of EU accession as regards the gradual liberalisation of the capital account. At the same time, the programme mentions the potential impact on the conduct of monetary policy from possibly strong capital inflows caused by the still relatively high domestic interest rate level. These inflows are expected to necessitate continued sterilisation operations by the central bank in order to limit the effect on liquidity. Against the background of rapid credit growth, a widening current account deficit and the emergence of inflationary pressure, Romania decided in the beginning of 2004 to delay the liberalisation of non-residents' access to domestic deposit accounts denominated in *'leu'* in order not to spur further credit growth and add to the potential volatility of the balance of payments. The programme explains this decision, and highlights that the postponement is a temporary measure applicable until April 2005. Indeed, Romania liberalised on 11 April 2005 the access of non-residents to deposit accounts denominated in "leu". The liberalisation is a welcome step, which has been carefully prepared by Romania and confirms the return to the agreed timetable for dismantling remaining capital movement restrictions. Although the opening of deposit accounts to foreigners did not in the first instance trigger an unmanageably large surge in inflows, partly due to the preceding lowering of the policy interest rate, the potential volatility of the balance of payments has increased. Against this background, the regulatory framework was amended in order to allow for the introduction of safeguard measures, which can be resorted to in case of excess short-term capital flows leading to balance of payments disequilibria or severe disturbances of monetary and exchange rate policies that might entail considerable swings in domestic liquidity. If activated, the safeguard measures would be limited in time and be applied in respect of the principles of non-discriminatory and proportionality. While safeguards may play a positive role in preventing certain short-term inflows, interest rate cuts are largely a function of further disinflation. Prudence in fiscal and wage policy is therefore warranted also to facilitate further capital account liberalisation.

3.3. Monetary and exchange rate policy

The PEP carefully describes the monetary policy regime, which will over the programme period undergo a gradual and carefully sequenced changeover from a managed float regime, in which the exchange rate is used as the main anti-inflationary instrument, to an inflation targeting regime, in which interest rate changes will ultimately become the predominant monetary policy tool. The central bank will continue to aim at sustainable disinflation, while progressively paying less attention to economic growth, exchange rate and external balance objectives. Inflation expectations will be anchored via the announcement of an inflation target, by a further real appreciation of the *'leu'* and through the use of policy interest rate changes which should ensure that credit growth remains within non-inflationary boundaries. Going hand in hand with the switch to inflation targeting, the central bank has opted for a more flexible exchange rate policy by limiting forex market interventions and abandoning the pre-announced target for the annual real exchange rate appreciation. This policy change has since its official announcement on 2 November 2004 caused a nominal appreciation of around 12% against the euro. The programme anticipates a broadly unchanged nominal exchange rate vis-à-vis the euro over the programme period, which would translate into a significantly more pronounced real appreciation than foreseen in the 2003 PEP. The euro is from 2005 the only reference currency for exchange rate policy as the euro-dollar currency basket previously used for assessing the real appreciation of the *'leu'* is abandoned.

The monetary policy conducted until now has contributed to both gradual disinflation and a real exchange rate development compatible with a sustainable current account position. Notwithstanding this record, the envisaged implementation of an inflation targeting regime appears well-founded and appropriate. Inflation targeting offers in the Romanian context the advantages of a clear focus on further disinflation, increased accountability of the monetary authorities and a high degree of flexibility in the choice of monetary policy tools, which take account of the determinants of inflation and the evolving monetary policy transmission mechanism. Provided that the technical and institutional framework is fully completed, the programme's objective to switch to inflation targeting seems attainable, although the programme is scarce in presenting an exact timetable and does not specify how the inflation target will be defined. The more pronounced real appreciation associated with freeing the exchange rate also implies, that inflation targeting is an attractive option to permanently bring the inflation rate down towards EU-levels, thereby avoiding the risk of sticky inflation. The programme is, however, rather timid in discussing how a steeper real appreciation would impact on external trade and the process of real convergence, although the risk of insufficient productivity gains is highlighted as a danger to the macroeconomic scenario. In the same vein, the programme is not explicit in recognising, that the changeover to inflation targeting will imply that fiscal and wage policies must bear an increasing responsibility for domestic demand management and the external balance.

The inflation path outlined in the programme is broadly similar to the 2003 PEP, implying that average annual inflation would be brought down to 4.4% in 2007 compared to 11.9% in 2004. The hypotheses underpinning the inflation forecast are made more explicit than in last year's PEP, which is helpful for the identification of factors directly or indirectly determining inflation. Interestingly, a reduced budgetary deficit is mentioned among these, although the programme expects the general government deficit to increase by 1.2% of GDP in the period 2005-07.

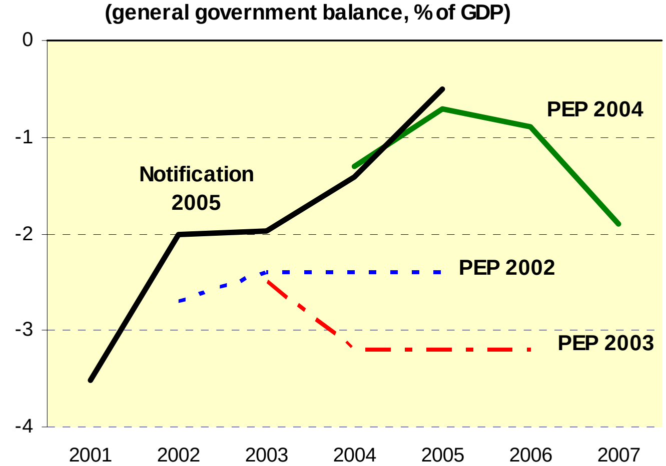
Key determinants of inflation dynamics are well explained. Relative prices will continue to be affected by the upwards adjustment of administered prices, in particular for natural gas, electrical power, district heating and railway tariffs. The inflationary impact of these adjustments would be highest in the first part of the period 2005-07, and could contribute by more than half to the rise in CPI. As the adjustments fade out in the second half of the period and in tandem with an expected impact from increased competition and higher efficiency of utilities suppliers, the impact from administered prices will be substantially reduced. A significant disinflationary impact from real appreciation of the currency is expected to persist over the programme period, yet of diminishing importance. Further restructuring of loss-making state-owned enterprises is expected to strengthen financial discipline and thereby limit the inflation stemming from the accumulation of arrears and from a wage policy out of line with productivity gains. This emphasis on structural policies as a main driver of disinflation is welcomed. Given this recognition, and in view of wage policy continuing to strongly stimulate price increases, a more exhaustive account of the future interplay between wage policy and inflation would, however, have been of interest. This is the case both in relation to the state-owned sector, where the programme suggests some relaxation of the monitoring of wage developments, and in relation to the minimum wage and public sector remuneration, where a real wage growth equal to real GDP growth is envisaged. While the programme correctly stipulates, that a prudent policy-mix will play a key role in keeping aggregate demand in check, it falls short of convincing that wage slippage would not cause inflationary pressure over the programme period.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Programme overview

The programme's fiscal framework is centred on a significant relaxation of income, profit and social security taxation combined with strengthened tax collection, a broader tax base and an efficiency enhancing expenditure policy. Moreover, the improved capacity to absorb increasing EU transfers is central to fiscal developments. While this framework is consistent with the objective of sustaining the real convergence process and higher long-term potential output, it is not entirely convincing with respect to the projected effects on budgetary and external balances and with respect to the effectiveness of measures to curb quasi-fiscal subsidies. In the same vein, the coherence with the macro-economic framework is not fully ensured, in particular as regards the hypothesis that sizeable tax cuts will go hand in hand with markedly reduced domestic demand pressure and a strong improvement in the private sector savings-investment balance, thereby helping to contain the current account deficit. Hence, a certain dissonance is noted between the likely effects of the fiscal policy measures and the stated role of fiscal policy in a policy-mix challenged with dampening domestic demand, safeguarding the external balance and sustaining the reduction of inflation. Given the magnitude of the fiscal reform, a more extensive analysis of its short- and medium-term budgetary effects, including heavier reliance on quantified estimates, would have made the fiscal framework more trustworthy. The omission of estimates for the cyclically adjusted balance is a step back compared to last year's submission and underpins the concern that the timing of the tax reform has not fully taken into account the cyclical position of the economy. At the same time, however, the programme is very frank in recognising that the fiscal strategy is risky, that fiscal policy is pro-cyclical and that the scenario presented is conditioned on the full accomplishment of the programme's structural policies. Furthermore, the programme rightly identifies and openly deals with a range of important downside fiscal risks, some of which could have been taken into account in the main scenario. The description of the fiscal framework benefits from the increased use of data compiled according to ESA 95, in particular for the breakdown of revenue and expenditure. While this is a noteworthy step forward, various measures to broaden the tax base and the detailed account of expected EU transfers are still described on a cash basis. This illustrates that ESA 95 is not yet the main reference for fiscal analysis. Moreover, budgetary accounting of EU transfers should be fully aligned with the recent Eurostat decision on the treatment of such transfers.

Chart 1: Budgetary developments (general government balance, % of GDP)



At the aggregate level, the fiscal plans resemble last year's PEP in the projection of an increasing general government deficit over the programme period and a moderate expansion of the still low debt-to-GDP ratio. The general government deficit is projected to narrow to 0.7% of GDP in 2005 due to a restrictive expenditure policy, which more than compensates for the revenue shortfall caused by the tax reform, followed by a widening of the deficit to 1.9% in 2007. Due to lower interest rate payments, higher GDP growth and improved revenue collection, the deficit would, however, be significantly smaller than projected in the 2003 PEP. Both revenue and expenditure ratios would decline slowly until 2006, but then jump by respectively 2% and 3% of GDP in 2007 for which the programme holds increased EU transfers, Romania's contribution to the EU budget and co-financing of EU funded projects responsible. Somewhat surprisingly, the large cuts in profit and income tax as well as the envisaged reduction in social security contribution rates are seen to yield a less steep decline in the revenue-to-GDP ratio than expected in the 2003 PEP, even though a more timid fiscal relaxation was envisaged at the time.

Romania has over recent years adopted an increasingly responsible fiscal stance, characterised by lower general government deficits than budgeted, a slowly increasing revenue ratio and a declining expenditure ratio. A broader tax base and improved revenue collection have played a significant role in this good performance which is, however, also explained by stronger than expected growth and additional savings on interest payments. In previous PEP submissions, the achieved degree of fiscal consolidation was not projected, which pointed to the use of a relatively cautious macroeconomic scenario and a prudent approach to incorporating gains from improved tax compliance and collection. The programme's projection of some further revenue gains from improved tax administration is therefore realistic, but given that last year's submission excluded such gains in the main scenario, a quantification of the expected gains would have been useful.

Likewise, a specific estimate for the envisaged reduction in the quasi-fiscal subsidies, like in the 2003 PEP, would have given a clear sign of the expected results from actions targeting the financing requirement of state-owned enterprises and the implicit subsidies provided via the energy sector. Over recent years, Romania's expenditure policy has remained pro-cyclical and although the projection of an increasing primary deficit did not materialise, the substantial reduction in interest payments and unexpectedly high revenue growth was not fully used to consolidate public finances. Against this background, the programme's projection of a major restraint of current expenditures and subsidies will be a litmus test for the ability to not letting non-programmed revenue gains translate into extra expenditure.

With the exception of 2005, where the fiscal reform would cause a decline in profit and income taxes of 1.5% of GDP, direct taxes are projected to increase on the back of higher revenues from social security and income tax. Contrary to the 2003 PEP, where the envisaged 5%-point reduction in social security contribution rates was expected to cause a decline in social security contributions of 0.8% of GDP over the programme period, this year's submission foresees social security contributions to increase by 0.9% of GDP in spite of gradually cutting contribution rates by up to 10%-point from 2006. Indirect taxes are projected to rise considerably on the back of higher excise collection caused by the progressive alignment with *acquis*. Non-fiscal revenues would decline, but this loss is more than outweighed by increasing EU transfers, which are expected to amount to 3.1% in 2007. Over the programme period, considerable reductions in current expenditures for personal and material, declining interest rate payments, reduced social transfers and a sizeable reduction in subsidies would yield savings of around 5% of GDP. This room is used for significantly higher public investment and for transfers to other sectors with the aim of co-financing EU funded projects, in particular in the year of accession.

The fiscal framework identifies seven highly relevant risks, which are either rooted in the fiscal strategy or may impact on the fiscal outcome. Although the PEP commits to adjust fiscal policy if needed, the fiscal scenario could with some advantage have taken into account a number of the risks. The tax reform may spur consumption and investment at a time of buoyant domestic demand, double-digit real wage growth, solid credit growth and strongly appreciating currency. Corrective fiscal measures could therefore be needed to avoid an unsustainable widening of the current account deficit. A more pronounced appreciation of the currency, which would have a negative net impact on the budget due to a decline in revenue from excise duties[7], could add to the need for fiscal adjustment. Also, an immediate negative impact on the revenue-to-GDP ratio from a rapid reduction in social security contribution rates is indeed likely, and although further reduction of non-wage labour costs would strengthen the supply side conditions of the economy it is for this reason welcomed that the programme makes rate cuts contingent on a satisfactory revenue development. Furthermore, the risk of not being able to absorb available EU resources is pertinent. Finally, substantial quasi-fiscal subsidies have remained a serious impediment for a responsive and transparent fiscal policy, and the PEP rightly underscores that a lenient attitude to financial discipline in the enterprise sector would entail serious risks. In addition to the risks highlighted is the programme, the full amount to be paid from central government as financial compensations for the non-restitution of property under Law 10/2001 is uncertain. The government has not yet decided how to schedule the compensation, which could amount to more than 0.5% of GDP annually on average over the next decade. The current budget incorporates only cash compensations foreseen.

Table 2: **Comparison of macroeconomic developments and forecasts**

	2003		**2004**		**2005**		**2006**		**2007**	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	5.2	5.2	8.3	8.3	5.5	6.0	5.1	6.1	n. a.	6.3
Contributions:										
- Final domestic demand	7.8	7.9	11.0	11.9	8.9	8.9	7.1	7.8	n. a.	7.6
- Change in inventories	0.1	0.1	0.1	0.6	-0.1	-0.1	0.0	0.0	n. a.	0.0
- External balance of goods and services	-2.7	-2.7	-2.8	-3.6	-3.3	-2.9	-1.9	-1.7	n. a.	-1.3
Employment (% change)	-0.1	0.0	-0.1	0.1	-0.1	0.3	-0.1	0.2	n. a.	0.1
Unemployment rate (%)	6.8	7.0	7.1	7.5	7.0	7.3	7.1	7.2	n. a.	7.1
GDP deflator (% change)	19.5	19.5	15.8	13.6	11.8	9.5	8.7	7.3	n. a.	5.7
CPI inflation (%)	15.3	15.3	11.9	11.9	8.2	8.1	6.5	6.0	n. a.	4.4
Current account balance (% of GDP)	-6.0	-6.0	-7.5	-7.6	-8.3	-7.1	-8.7	-6.7	n. a.	-6.3

PEP: ILO unemployment rate. COM: Eurostat, harmonised unemployment rate

Sources: Pre-Accession Economic Programme (PEP); Commission services Spring 2005 forecasts (COM)

Against the background of the risks identified, in particular that the tax cuts may have a larger adverse impact on the revenue-to-GDP ratio than projected, the budgetary outcome could turn out less comforting than expected. As recent year's markedly good revenue performance can be partly attributed to favourable cyclical conditions, slowing growth could imply a rapid deterioration in the general government balance and an insufficient margin to the 3% reference value. Care should therefore be taken to ensure that the pro-cyclical fiscal policy does not over a prolonged period engender a widening of the primary deficit, which could cause prejudice to the long-term sustainability of public finances. Given the many needs for public investment

[7] In Romania, the imposition of harmonised excise duties (such as alcohol, tobacco and energy products) is expressed in EUR. As a first round effect, appreciation of the currency therefore causes declining budget revenues in "lei" terms. The PEP includes a sensitivity analysis pointing to a 16% nominal appreciation of the currency during 2005-07 causing a decline in budget revenues equivalent to 0.3% of GDP.

aimed at strengthening the economy's growth potential and prepare for EU accession and in view of the already considerable limitation of current expenditures foreseen in the programme, the room for any further strong fiscal adjustment on the expenditure side is limited. As the programme rightly points out, additional measures to increase direct and indirect taxes, including a further broadening of the tax base, could be envisaged to pre-empt the occurrence of an increasingly unbalanced budget**.**

4.2. Targets and adjustment

In 2004, the relatively prudent fiscal stance both contributed to and benefited from a favourable macroeconomic environment, which in pair with a further decline in interest payments and progress in tax compliance and collection implied a better than expected revenue performance. Mainly for this reason, the planned general government deficit of 3.0% of GDP reported by Romania in March 2004 was significantly undershot and amounted instead, according to Romania's latest fiscal notification, to 1.4% of GDP. The primary deficit, planned to be 1.4% of GDP, was contained to 0.2% of GDP. In cash terms (GFS methodology), tax revenues turned out 8.8% higher than originally budgeted and revenues from corporate profit tax, customs and excise duties fared particularly well. Legal and administrative improvements, such as the new Fiscal Code and the establishment of the National Agency for Fiscal Administration, paid off. Higher non-fiscal revenues also compensated for a considerable shortfall in EU transfers. In view of the need to dampen domestic demand and contain the current account deficit, two budgetary rectifications in July and August revised the 2004 general government deficit target (ESA 95) down to 2.2% and subsequently to 1.7% of GDP, while still allowing for some extra pre-election spending, notably generous increases of pension benefits and public sector wages. In cash terms (GFS methodology), total expenditures overran the original budget by 2.5%, with wage expenditures and material expenditures significantly higher than budgeted. Interest payments were 0.3% of GDP (ESA 95) lower than originally budgeted, while public sector gross fixed capital formation amounted to 3.4% of GDP (ESA 95), well above the 3.0% of GDP planned. Substantial quasi-fiscal subsidies continued to weigh on the broad public sector balance, but Romania intensified in 2004 its efforts to limit the accumulation of tax arrears, improve the weak financial performance of state-owned enterprises and gradually scale down the implicit subsidies to enterprises and households via the provision of energy below costs and non-collection of bills. These achievements were important for improving medium-term fiscal prospects, albeit further progress is warranted.

For 2005, the programme's budget deficit target of 0.7% of GDP is considerably lower than the 2005 budget, which was approved before the adoption of the fiscal reform. It is therefore no good yardstick for this year's likely budgetary outcome, although it is of interest that the original budget on the back of a much more timid relaxation of income and profit taxes projected a significantly larger general government deficit in 2005 than the programme. The PEP is not entirely lucid in explaining the differences to the approved budget and would have benefited from a more extensive analysis of the budgetary effect of various measures, including a heavier reliance on quantified estimates. For example, the programme restricts itself to mentioning that the cuts in income and profit tax will engender a revenue short-fall of 30.000 billion *'lei'* (1.1% of projected 2005 GDP). No breakdown between income and profit tax reductions is provided, and it is not clear whether the estimate refers to the difference to the 2004 budget outcome or to the approved 2005 budget. Presumably, the latter is the case since the estimate would then be in better correspondence with the projection of a reduction in revenue from profit and income taxes of 1.5% of GDP from 2004 to 2005. The programme specifies a number of measures on the revenue side, which in 2005 would yield compensatory

Budgetary effects of Romania's EU accession in 2007

The PEP's fiscal framework is characterised by a significant jump in the general government deficit to 1.9% of GDP in 2007 following a deficit of 0.9% of GDP in 2006. Comparing the years 2006 and 2007, the ratio of total expenditure to GDP increases from 34.2% to 37.2% of GDP, of which capital expenditure grows from 4.2% to 5.3% of GDP and transfers from 13.2% to 15.3% of GDP. The PEP explains that this increase is caused by Romania's contribution to the EU budget and the financing of projects receiving EU grants. EU grants are expected to increase from 1.2% of GDP in 2006 to 3.1% of GDP in 2007.

The PEP also presents a cash-based view of budgetary flows, showing that EU grants are expected to increase from 1.4% of GDP in 2006 to 2.2% of GDP in 2007, while Romania's contribution to the EU budget is set to amount to 0.9% of GDP in 2007. For this reason, net transfers remain broadly stable. Co-financing would grow from 0.4% GDP in 2006 to 0.9% of GDP in 2007.

Most of the PEP's estimates of transfers from pre- and post-accession instruments and the estimate of Romania's contribution to the EU budget are in line with DG ECFIN's estimates in the table below. The starting point is the commitment and payment appropriations in current prices agreed in the accession negotiations.[8] Payments are much lower than commitments to take account of possible absorption problems. However, payments from pre-accession assistance will continue[9] and the PEP projects lower payments from pre-accession instruments in 2007 than DG ECFIN, which partly explains the difference in the estimate of total transfers. Moreover, the PEP seems to have disregarded transfers associated with internal policies and temporary budgetary compensations, which in 2007 would amount to nearly 0.5% of GDP.

A main conclusion from these calculations is that net transfers from the EU budget to Romania in 2007 will be sizeable and positive.

Romania: Budgetary effects of EU accession in 2007 (in % of PEP-projected GDP)

	Commit-ments	Payments
Ccontribution to EU budget	0.9	0.9
EU transfers	3.3	3.0
of which:		
- pre-accession aid	*0.0*	*1.3*
- Structural Funds	*1.1*	*0.5*
Net transfers	2.4	2.1
National co-financing	0.7	0.7

Source: DG ECFIN

Even if all potential "fiscal burdens" from accession (such as co-financing needs and Structural Funds "additionality" requirements) are taken into account, the net budgetary effect should still be positive in 2007.

Arguing in the PEP that accession causes a higher deficit in 2007 therefore only holds in a static accounting approach in two ways: 1.) when the final beneficiary is non-government, transfers from the EU budget are accounted outside the general government sector while they might sometimes require co-financing from the government. 2.) when the general government sector is the final beneficiary, they are accounted as fully additional expenditure, i.e. appearing on both the revenue and the expenditure side of the budget without substituting previously existing national programmes. In that way, EU transfers have almost no effect on the balance, while the contribution to the EU budget and national co-financing of EU programmes have a negative effect.

Notwithstanding this reasoning, which is broadly in line with Eurostat rules, the budget could be adequately restructured so that previously existing national expenditure is substituted by EU funds or used to co-finance EU programmes which are not subject to a strict "additionality" requirement. Then a positive budgetary effect in net terms should prevail and the expenditure-to-GDP ratio would not necessarily increase.

[8] A similar methodology was used for the ten new Member States by Hallet, M. (2004), 'Fiscal effects of accession in the new Member States', *Economic Papers*, No 203 (European Commission, Directorate-General for Economic and Financial Affairs), Brussels, and by Hallet, M./ F. Keereman (2005): Budgetary transfers between the EU and the new Member States: manna from Brussels or a fiscal drag? *ECFIN Country Focus* Vol. 2, Issue 2 of 03.02.2005

[9] Pre-accession payments were assumed to amount to a quarter of the commitments foreseen in the roadmap for 2006 plus the payment appropriations included in the 2005 draft EU budget.

revenue of 0.8% of GDP. These are notably postponing planned cuts in social security contributions, moving forward the rise in excise duties and increasing a number of tax rates. Some of the measures were not yet adopted at the time of submitting the PEP. Also, the programme highlights that the tax base will be broadened by eliminating certain exceptions and deductions allowed for profit and incomes tax, but the measures are not specified. Likewise, there is no quantification of the expected gains from improving tax administration and curbing tax arrears.

Notwithstanding these efforts, the revenue-to-GDP ratio, excluding EU grants, is seen to decline by 1.6% of GDP from 2004 to 2005. The main reason for the projected fall in the general government deficit is therefore to be found in the envisaged restraint of the expenditure side and an improved capacity to absorb EU transfers. Considerable reductions in current expenditures for material and personal, reduced social transfers and some reduction in subsidies would cause a fall of 1.4% of GDP in the expenditure-to-GDP ratio. The majority of these measures are not specified and were only approved in a budgetary rectification in June. For this reason, the programme's fiscal projection for 2005 is different from the Commission services' Spring 2005 forecast. The programme expects the budget revenue from grants, in particular EU grants, to evolve very favourably, doubling to 1.6% of GDP in 2005. In view of the significant pick-up in EU capital transfers to Romania in 2004, this estimate may hold. However, given that disbursements related to technical assistance (current transfers) in 2003 amounted to less than half the amount projected in last year's PEP and in 2004 dropped to one fourth of the amount expected, some further reasoning for this sudden improvement in absorption would have been welcomed.

For the years 2006-07, the programme envisages a continued restraint of non-EU related spending, while direct taxes are projected to increase by 1.2% of GDP on the back of higher revenues from social security contributions and from income tax; the latter apparently due to increased official employment and taxation of incomes from capital gains and interests. According to the programme, the gradual cut by up to 10% in the social security contribution rate, of which 8% reduction for employers and 2% reduction for employees, will stimulate companies' voluntary compliance and lead to an immediate positive effect of 0.8% of GDP on collection. The programme also highlights that stricter enforcement will diminish evasion of social security taxes and contribute to the positive Laffer curve effect projected. The good experience with measures taken to strengthen tax collection shows that improved administration would indeed increase revenues, but the programme is not convincing in arguing that these gains would be immediately able to more than compensate for the considerable reduction in the contribution rate, not least since no forceful steps to improve enforcement are emphasised. In the 2003 PEP, the envisaged 5%-point reduction in contribution rates was expected to cause a decline in social security contributions of 0.8% of GDP over the programme period, while this year's submission foresees social security contributions to increase by 0.9% of GDP until 2007 in spite of gradually cutting contribution rates by up to 10%-point. The programme deals in some detail with expected payments vis-à-vis the EU budget. Receipts from the EU are expected to increase to 3.1% of GDP in 2007, while co-financing and the contribution to the EU budget would both amount to 0.9% of GDP in 2007. Intriguingly, the programme holds costs related to EU accession responsible for the widening of the general government deficit to 1.9% of GDP in 2007 (see also box). In the programme, all EU transfers seem to be fully included on both the revenue and expenditure side of central government. According to a recent Eurostat decision, in cases where the government advances payments to the final beneficiary, the government must be considered as acting "on behalf" of the EU, and neither the transfer from government to the beneficiary, nor the transfer from the EU to government has to be recorded in the government accounts.

4.3. Debt developments

The programme points to a relatively favourable evolution of general government debt over the programme period as the debt-to-GDP ratio is expected to remain broadly stable below 20%. Strong nominal GDP growth and falling interest payments will continue to support a further decline of the debt-to-GDP ratio, which is however limited by the debt-increasing effect of the envisaged deterioration in the primary balance. With the primary deficit gradually widening by 1.5% of GDP from 2005 to 2007, the declining trend in Romania's still moderate general government debt-to-GDP ratio is projected to come to an end in 2005.

The programme does not expect any positive impact from privatisation receipts on debt developments, and the significant privatisations concluded in 2004 have not had any impact on reducing public debt, although privatisation receipts of around 1.5% of GDP have been placed in deposits and currency holdings. In the light of the still unfinished privatisation agenda, further scope therefore exists for using privatisation receipts to bring down public debt. The programme refrains from estimating the effect of currency movements on the debt ratio. Given that more than two thirds of total public debt is contracted in foreign currencies, the programme's expectation of an average nominal appreciation of 5% (respectively 14% in the alternative scenario) over the programme period would help to reduce the debt ratio below the programme's projection. Moreover, as the useful sensitivity analysis of the programme shows, a stronger than expected appreciation would cause a minor positive impact by reducing interest payments. Against this background, the programme's projection of other factors increasing the debt-to-GDP ratio by around 4%-points in both 2006 and 2007 is difficult to validate and may be due to a wrong compilation of annex table 5.

A new Law on Public Debt was adopted in June 2004, which resulted in a significant alignment with *acquis*. The law came into force on 1 January 2005 and within this framework, the Ministry of Public Finance will seek to continue an active debt management strategy with the objective of consolidating the use of debt instruments with maturities longer than 3 years, diversifying the debt portfolio by issuing state securities in foreign currencies and with variable interest, and increasingly develop the financing capacity of domestic markets. These objectives are welcomed and their attainment would together with a restricted issuance of state guarantees for the contracting of foreign loans by public institutions' help improve the risk management of public debt. Significantly limiting the use of off-budget guarantees, such as the guarantees issued under the Risk Fund for External Loan Guarantees, is equally important. The gradual extension of the average maturity of debt, notably by establishing pricing benchmarks over a three-year maturity horizon for domestic paper, would also assist in the deepening of secondary markets and the conduct of monetary policy.

5. STRUCTURAL REFORMS

5.1. Programme overview

The structural reform framework provided in the programme is very comprehensive, although the emphasis on continuing already initiated reforms does not facilitate the distinction between new and existing measures. Given the exhaustiveness of the annex table on reform measures undertaken, the main text would not have suffered from a more succinct presentation of past achievements. This would also have allowed the various arrays of the reform programme to stand out as a coherent entirety. The programme contains a clear commitment to continue the structural reform programme in order to enable Romania to cope with the competitive pressure and market forces within the EU. Notwithstanding this strength, the presentation of factors underpinning the choice of concrete reforms and the related instruments could in some cases have been clearer. Also, a clearer timetable with more tangible targets to be met would have improved the PEP as a benchmark for tracking whether progress is sufficient to fully prepare the economy for accession. The policy matrix presented is largely complete and provides quantitative estimates of the impact of most of the important measures, although the description of measures does not in all cases associate well with the main text and the content of the budgetary cost estimates are therefore at times cloudy.

The programme's reform agenda consists of the continuation of a broad array of initiatives taken to improve the functioning of the market economy and strengthen the competitiveness of the economy by market opening, allowing fiercer competition and higher productivity. In the enterprise sector, the main measures would be continued privatisation and restructuring of state-owned enterprises, opening of regulated network industries, stricter enforcement of competition and state aid policy, improvement of the administrative and legal environment and promotion of SME's. In the financial sector, further alignment of the legislative and regulatory environment in combination with the completion of bank privatisation would sustain recent years' significant reform progress. For the labour market, the programme's fiscal policy is intended to help overcoming a declining employment rate, a shrinking labour force and a large informal economy, but no other major reform measure is clearly set out which could significantly alter developments or promote a more flexible labour market. Additional reform areas include, inter alia, the agricultural sector, improved infrastructure, increased resources for education and some initial steps to reform the pension system. The overall reform strategy is largely unchanged from last year's submission, albeit putting more emphasis on the promotion of a knowledge-based society.

The many reform initiatives follow the strategy embedded in the National Development Plan of Romania, which sets EU accession as a fundamental aim. In many respects, the reforms therefore stem from Romania's overall commitment to align its legal framework with the acquis and the endeavour to fully meet the Copenhagen economic criteria. Notwithstanding the objective of EU accession, which has helped to progressively broaden the consensus about economic reform and ensured increased consistency of reform efforts, the broader objective of the programme is to pursue an economic reform path, which has succeeded in gradually modernising Romania's economic structure, increasing real incomes and improving living standards.

The programme bears witness to the considerable budgetary financing needed to support the re-allocation of economic resources and mitigate the social impact of rapid economic change. Most key reforms are costly and will have a sizeable negative net budgetary effect over the programme period (see table 5). There is a tangible risk that implementation delays could imply a back-loading of key reforms, which could eventually entail a gap between policy goals and results. That may impact negatively on Romania's economic preparedness for EU membership. Economic transition also demands an enduring commitment from the authorities to continuously bring forward structural reforms, even under the fear of political and social costs. For some sensitive sectors where reform has traditionally been slow, such as energy, mining, transport and agriculture, the programme does not stand out as being more ambitious than in the past and the envisaged measures are at times vague. Moreover, like in previous years, there is no quantified discussion of the impact of key measures to limit quasi-fiscal subsidies in spite of the recognition that the programme's success hinges on results in this field.

The reform objectives set out in the PEP do converge in the direction of key objectives of the Lisbon agenda, but further efforts in reforming the functioning of product and labour markets would be needed to progressively close the gap to the average position of current Member States. Moreover, Romania is making progress towards the knowledge-based economy from a very low level. Adapting the education system to the needs of the labour market constitutes a major challenge and much remains to be done to strengthen R&D and innovation. While the reform strategy laid out is in general supportive for Romania's fulfilment of the second Copenhagen economic criteria by the time of accession, relatively few new measures or policy shifts are envisaged. A vigorous implementation remains crucial in order to be prepared for membership by 2007. In terms of supporting the macroeconomic policy-mix, the PEP aims at reducing quasi-fiscal subsidies, but the measures intended to reduce losses in state-owned enterprises, raise energy prices and curb non-payment are generally not new and have in the past been applied with only some success.

Table 3: **Net budgetary impact of key reforms**

Description of policy	**2004**	**2005**	**2006**	**2007**
1. Privatisation of state-owned companies	+ 891.7	+ 326.8	+ 9.1	+ 6.0
2. Mining sector reform	- 40.2	- 49.4	- 48.1	- 39.7
3. Pension system reform	n. a.	- 524.9	- 1048.4	- 339.5
4. Road infrastructure	n. a.	- 752.4	- 1000.9	- 1176.7
5. School rehabilitation programme	- 14.5	- 76.9	- 68.1	-35.2
Total budgetary impact (mill. EUR)	n. a.	- 1076.8	- 2156.4	- 1585.1
Total budgetary impact (% of GDP)	n. a.	1.5	2.7	1.8

Sources: Pre-Accession Economic Programme (PEP), ECFIN calculations

5.2. Product and capital markets

The programme contains four strategic objectives directly related to sustaining the reform process in product and capital markets. First, the process of privatisation and restructuring in the enterprise sector would be completed. Relatively clear intermediate targets are set for the privatisation or liquidation of remaining majority state-owned companies from the portfolio of the authority for the recovery of state assets (AVAS). The PEP is also more precise than in past years with regard to privatising **companies owned by various ministries, and although no precise timetable is presented, the budgetary estimate reveals the intention to finalise important further privatisations in the energy sector in 2005, some of which were not concluded as planned in 2004. Also in other network industries, such as telecom and postal services, the programme envisages to follow-up on the achieved opening of national markets by gradually privatising major operators. On the contrary, no concrete commitments are set for the defence and tourism sectors other than the general intention to continue the privatisation process. In the transport sector, the programme foresees a further privatisation of some subsidiaries of state-owned companies in the field of road, rail and maritime transport as well as the sale of a share in Bucharest International Airport. The programme does in no way deal with the use of public-private partnerships in facilitating the upgrading and expansion of the road network, although Romania consider such partnerships important for a cost-efficient implementation of its** ambitious motorway programme, which Romania previously envisaged to implement over the period

2004-12 and which would amount to close to 10% of 2004 GDP. Nor is it discussed to what extent PPP schemes are expected to qualify for being treated outside general government.

Second, an improved functioning of markets is envisaged by means of an active competition policy, tight state aid policy, transparent rules for public procurement and minimising administrative barriers for businesses. This renewed commitment is commendable and welcome, notably in view of the previous weak enforcement record.. The programme recognises the existence of moral hazard among both state-owned and private enterprises caused by the lenient attitude to tax arrears and the widespread use of debt-rescheduling schemes at often generous and unclear terms. This has led to mounting tax arrears, and the programme gives a noteworthy political commitment to stop the granting of exemptions and increase the penalty interest rate to a level comparable to bank financing. The PEP does not explain how the rules for public procurement will become more transparent, and in the light of previous *ad hoc* government decisions a strong commitment to rule out any future derogation from existing legislation would have been appropriate. The list of actions aimed at improving the business environment addresses most deficiencies earlier pointed to, such as the need to further cut red tape, make tax administration more transparent, reform the functioning of the judiciary, improve bankruptcy legislation as well as its application and fight corruption, but the lack of any clear timetable or intermediate targets will make it difficult to use the PEP to track whether progress is sufficient to fully prepare the economy for accession.

Third, a more modern structure of the economy would be pursued by the restructuring of ailing heavy industries and support to the development of the services sector and SME's. Implementing the mining restructuring plan appears central in this respect with the aim to strike a balance between, on the one hand, downsizing and gradual elimination of subsidies and, on the other hand, socio-economic and environmental rehabilitation. G**iven the considerable direct subsidies to certain companies, which have nonetheless continued to accumulate arrears, a clearer commitment to reducing subsidies would have been welcomed.** Continued reorganisation of the railway sector is also envisaged, but contrary to the mining sector no comprehensive strategy is yet in place, and **the restructuring measures envisaged in the PEP fall short of convincing that companies will not** continue to make losses and accumulate tax arrears in spite of sizeable direct subsidies. As part of the strategy for reforming public utilities in the energy sector, a reform of the district heating sector has been formulated. Its successful implementation will be a major challenge, not least since the plan requires substantial investments in metering and networks and since the envisaged abolition of producer subsidies from 2007 would imply considerable price increases for households. As the PEP does not mention previously announced estimates for metering investment costs (reaching from 360 million to 1.1 billion euro) and does not deal with the removal of producer subsidies, some doubt is cast over whether the district heating strategy is still valid. It should be noted, that the programme expects the budgetary cost of granting heating aid to double over the programme period.

In comparison, the SME strategy is comprehensive, setting out an array of more than 30 policy initiatives, among which improved access to finance, promotion of credit guarantee schemes and export development activities are most prominent in terms of public financing. Some further discussion of the expected effects of these measures would have been valuable, not least since the lack of credible financial records of companies and deficiencies in the markets underpinning the value of loan collateral remain important obstacles not addressed in the programme. Also, the programme is mute on the reasoning for a scheme under which SME's can have refunded as grants the corporate tax paid on re-invested profits. This measure, apart from the distortions it may entail in favour of incumbent enterprises and against external financing, may be at odds with the maximum cap on state aid intensity.

Fourth, regulatory and legislative reforms would facilitate the further development of the financial sector and enhance its stability. The programme sets out clear short- and medium-term priorities for regulation and supervision of banks, capital markets and insurance companies, most of which are related to the further alignment with acquis. A number of important steps foreseen for the banking sector, such as the gradual increase of the deposit guarantee, the supervision of banks on a consolidated basis and improved accounting standards, would cater for increased stability and confidence in the sector. The PEP also shortly mentions the intention to privatise the state-owned savings bank, CEC, in 2005-06 and to proceed with the sale of a majority stake in the biggest commercial bank, BCR, to a strategic investor. This would be welcomed, since the finalisation of these privatisations would sharpen the competitive edge on both credits, where BCR has a strong position, and on savings, where CEC still benefits from a blanket deposit guarantee. In the capital market, a further alignment to European standards and principles would contribute to deepen the markets and increasingly attract funds from both households and institutional investors. For the insurance sector, the PEP foresees a smooth growth pattern on the back of legal and institutional improvements, but no particular reform is foreseen and the text falls short of addressing the role the sector could play in deepening financial markets, inter alia by providing life insurance products to supplement public pensions or by establishing and managing private pension funds.

5.3. Labour market

The programme reiterates a number of new measures envisaged to be implemented over the coming years, but aims in general at pursuing the active labour market policies already launched. A broad array of these measures are described, including in particular public subsidies aimed at creating and preserving employment, increased education and vocational training aimed at preventing shortage of skilled labour and institutional improvements to the public employment service that could facilitate the matching of supply and demand in the labour market. Moreover, it is envisaged to continue from 2006 the reduction of the still high pay-roll taxes. These measures all seem relevant, and may have had over recent years some impact on reducing long-term and youth unemployment although these improvements may also be of a cyclical nature.

Some of the measures envisaged, such as the modulation of the unemployment benefit according to contribution rate and period, are apparently not yet designed in the detail, and it is difficult to identify potent labour market measures in the programme, which would be able to reverse the steady drop since the mid-1990’s in both female and male employment rates. Tax measures, in particular the reduction in income and social security tax, is the main approach by which the programme hopes to bring back into (formal) activity the large share of the working age population that remains outside the labour market. The tax reform implies an important reduction from 40% to 16% in the highest marginal income tax rate. This step would in general strengthen supply side conditions in the labour market and may in particular give an incentive for bringing into the open unreported salaries, which would generate additional tax revenue over the medium-term. At the same time, the positive effect on labour supply and employment should not be overestimated since part of the observed effect could be mostly statistical due to the shift from informal to formal remuneration for people having a formal work contract. Moreover, a number of obstacles will continue to discourage people working fully in the informal sector from re-entering the formal labour market. High payroll taxes still discourage employment and official reporting of salaries, and a stronger positive effect of the flat-rate income tax could therefore be expected to occur only when payroll-taxes are further reduced. In the same vein, further progress in placing the pension system on a sound footing could add to the effect of the flat-rate tax by making formal employment more attractive, in particular for the low income groups for which the marginal tax rate was not reduced by the reform. Finally, the significant cut in profit tax from 25% to 16% would be expected to have a positive effect on labour demand, but the programme does not contain any estimate in this respect, and it is debatable to what extent a lower profit tax could instead speed up the structural change towards less labour-intensive production.

Deep-rooted structural problems associated with the transition process itself, such as the mismatch between the labour force's skills endowment and the requirements of a market environment, seem to explain the continuous decline of the participation rate, which came down to 62.2% in 2003. Although the net replacement rate of various out-of-work allowances is generally low, and therefore the benefit system generally creates few disincentives to labour market participation, the extensive use of early retirement and disability schemes may have played an important role in lowering the participation rate. In particular, this is the case for the advantageous access to early retirement for some professions, the rapid increase in withdrawals from the labour market on disability schemes and the use of prolonged severance payments intended to cushion the effects of redundancies in the state-owned enterprises. In the light of a participation rate for the 55-64 year old that remain below 40%, the programme naturally adheres to the objective of preventing early exit from the labour market, but is particularly weak in addressing specific measures to limit entry into such schemes and falls short of considering stricter eligibility criteria.

The programme sees improved labour market mechanisms and higher flexibility of the labour force as a strategic objective. Labour market flexibility is indeed instrumental to improve the reallocation of resources, strengthen the economy's resilience to adverse shocks, maintain Romania's comparative advantage in labour-intensive production and create new jobs. The programme, however, confines itself to shortly mentioning that the Labour Code will be amended in co-operation with the social partners in order to ensure the code's uniform application. Although the programme does not explain what amendments the government considers inescapable, it states that the revision will address some restrictive provisions, which are considered major impediments to the investment climate, such as the conditions for fixed-term contracts and the requirements for collective dismissals, which are more restrictive than EU obligations imply. It is unclear whether the revision will also deal with the procedures for individual dismissals that are cumbersome and allow for protracted judicial recourse, the difficulties for the employer to redistribute working hours and the limited ability to dismiss personnel, which may serve as a barrier to hiring new employees. The programme would also have gained from discussing the merits of the fairly centralised wage bargaining system and the benchmark role of the statutory minimum wage, which could prevent wages from reflecting productivity differences across regions and skill profiles. In spite of a restrictive wage policy in the state-owned and public sector, only a moderate change in the relative wage structure between sectors has occurred. Moreover, there is some indication of a relatively small responsiveness of wages to unemployment developments in local labour markets, implying that wages do not seem to fully play their role in mitigating regional disparities.

5.4. Other reform areas

The PEP emphasises that agricultural reform is a priority with the objective of increasing competitiveness, ensuring high-quality production, speeding up land reform and preparing for the Common Agricultural Policy. Apart from the issue of land reform, where the programme aims to complete the privatisation process and the restitution of land entitlements, the instruments envisaged seem to be mostly producer subsidies, market regulation and financial support for rural development. Until accession, the budgetary cost of agricultural subsidies amounts to close to 450 million euro annually (approximately 0.7% of GDP), which would decline to around 160 million euro as of 2007 when EU agricultural transfers take effect. While these instruments may well be successful over time in increasing productivity on some agricultural holdings, it is much less clear how the policies will deal with the problem of the agricultural sector being a retreat for many unemployed, elderly and poor people who supplement low incomes with subsistence agriculture. The PEP does not clearly distinguish between policies aimed at necessary economic restructuring of the sector and policies aimed at social and rural development objectives. That leaves some concern that a dual rural economy may arise over time, characterised by a competitive fringe of larger effective farms and numerous old-fashioned farms with low productivity, low earnings and an insufficient investment level.

In the field of education, the PEP gives increased weight to reforming the education system by improved access to quality education in terms of education material, staff qualifications and adequate schooling premises. This is welcomed as public spending on education has been low, which has caused an increasing quality gap between rural and urban areas and led to a high rate of non-enrolment and drop outs in rural areas. In the field of social inclusion, the PEP sets out a number of important objectives centred on improved social protection of for families and elderly people as and improvement to the administrative and institutional framework for social assistance. Since the submission of the PEP, the Commission and Bulgaria have signed a Joint Inclusion Memorandum which in the detail sets out the main challenges and policy priorities in the fields of social protection and social inclusion including the commitment to concrete follow-up actions.

6. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

6.1. The quality of public finances

The programme aims to further build on a number of institutional and legal measures taken over recent years to strengthen the budgetary framework and tax administration. These include the new Fiscal Code and Fiscal Procedures Code, which ensure greater transparency and stability of tax legislation and administration, as well as the establishment of the National Agency for Fiscal Administration, which is responsible for the unified collection, audit and enforcement of social security contributions. Also, a new Public Finance Law was adopted, which modernises the budgetary framework for central government, inter alia by elaborating indicative multi-annual budgets, setting expenditure ceilings for all budgetary agents and making use of budgetary reserve funds. This was complemented by initiating a process of fiscal decentralisation, which increases the fiscal autonomy of local authorities in terms of raising revenues. While these measures are likely to continue to contribute to an improvement in revenue collection, the programme puts little emphasis on a clear medium-term expenditure framework needed for redirecting public expenditure towards human capital, infrastructure and administrative capacity. Such a framework could link the budget execution more concretely to a comprehensive strategy of re-allocating public spending, inter alia by increasing the role of the multi-annual budgetary framework. This would facilitate the decision-making process, improve time consistency and contribute to sufficient flexibility on the expenditure side of the budget, thereby avoiding the pitfall of rapidly increasing primary deficits when the favourable cyclical conditions come to an end. The framework could also comprise strengthened mechanisms for effective control over line ministries' budget execution during the budget year and the progressive use of performance based budgeting. In combination with stricter overall expenditure control, inter alia by resisting the temptation to use the frequent budgetary rectifications to increase expenditure in line with unexpectedly high revenues, this would facilitate a lasting budgetary consolidation and limit pro-cyclical budget interventions. Being an overarching policy document, the PEP itself could become an important element in the formulation of such an expenditure framework.

The programme also envisages to make the allocation of public expenditure more conducive to the real convergence process and to improve the quality of physical infrastructure and institutions. Compared to last year's submission, additional information in relation to the functional distribution of public spending is provided according to ESA 95 standards, but some estimate for the allocation of public expenditure on main sectors would have been useful. Although the information is not sufficiently detailed to fully assess the extent to which the composition of public expenditure and revenue supports the programme's strategic priorities, the programme reflects an increasing awareness of the role that public finances can play in enhancing potential output. A substantial increase in public investment is the main factor explaining the increase of public expenditure over the programme period. According to the programme, investment will be driven by the financing of environment, rural development and infrastructure projects, part of which is the implementation of a very costly motorway programme.

Subsidies, social transfers other than in kind and social benefits are expected to decline considerably as a share of GDP over the programme period, although adequate resources for social protection measures remain a priority. Given the many needs for social improvement and the observed difficulty in recent years to limit the growth of transfers and subsidies to the rate initially planned, a more precise description of measures planned would have been welcomed. Funding for education is set to increase, but the programme does not explain the extent to which this is due to the wage hikes agreed in 2004. The programme aims at increasing public R&D expenditure to 1% of GDP in 2007, which in the light of current R&D expenditure just above 0.4% of GDP in 2004, around half of which was financed by businesses or from abroad, would constitute a major effort to strengthen the knowledge base of the economy.

The fiscal policy as set out in the programme aims at providing strong incentives to work and invest, but is rather vague in providing the private sector with incentives to save more. Lower corporate tax creates an additional incentive for investment, thereby increasing potential output, stimulating technology transfer and enhancing international competitiveness. Notwithstanding these merits, it is questionable that the tax cut should be fully self-financed and increase enterprises' propensity to save. It is noteworthy, that the cut in profit tax was partly financed by postponing previously agreed reductions in the social security contribution rate, and the programme seems not to hold up the advantages of lower profit tax against the consequences of raising other revenues and cutting expenditure. Cutting expenditure aimed at preparing for EU accession could jeopardise Romania's preparedness for membership and could eventually hamper the smooth integration into the internal market. Hence, a more gradual approach to lowering the profit tax could have been envisaged, not least since the investment ratio has already grown rapidly over recent years, reaching 23.3% of GDP in 2004 according to the programme. Moreover, FDI has picked up considerably since 2003, and foreign investors seem not to be primarily concerned by the profit tax level, but rather by other shortcomings in the business environment, such as the functioning of the judiciary, regulatory stability, transparency and predictability of the tax administration, restrictive provisions in the Labour Code and some remaining discriminatory government interference.

6.2. The sustainability of public finances

The programme deals with the long-term sustainability of public finances mainly by discussing the risk of a financially unsustainable public pension system against the background of four main factors: contribution rate, collection rate, real GDP growth and demographic developments. Financing of the public pension system, which would amount to 7-8% of GDP in 2005, has increased gradually since the late 1990's, and the public pension fund has consistently recorded a deficit of up to 1% of GDP. The programme explains that this development is caused by the number of beneficiaries growing from 3.4 million in 1990 to 6.1 million in 2004, but does not give emphasis to the extensive use of early retirement and disability schemes throughout the 1990's, which are important factors in explaining this development. Moreover, due to an increasing number of self-employed and people working in agriculture and in the informal economy, the number of contributors has nearly halved during the 1990's and currently less than half of the active population contributes to the public pension system. Thus, with 0.7 employees per pensioner in 2002 compared to 3.4 employees per pensioner in 1990, Romania faces already today a very unfavourable economic dependency ratio. The programme contains no long-term estimate of pension expenditures as a share of GDP, but briefly discusses the underlying assumptions for the period 2000-50, which are based on the assumptions of GDP growth remaining above 5% until 2030, constantly low unemployment rates and a significant increase in both male and female participation rate until 2030. Demographically, increased life expectancy is expected to be mitigated by a higher fertility rate, although the old-age dependency ratio is still expected to increase from around 35% in 2000 to 51% by 2050.

The programme underlines that reform steps were taken to improve the financial balance of the system. These steps include setting up third-pillar private pension funds, for which participation will be optional, and the introduction as from 2008 of a privately managed second pillar pension system based on compulsory participation for younger employees. Furthermore, the public pension fund will from 2005 be alleviated by moving the financing of farmers' pensions and some shorter-term benefits to the state budget. Finally, the statutory retirement age is being gradually lifted for both men and women. Regrettably, the programme does not comprise any analysis of the financial state of the public pension fund. Previous estimates submitted showed that if aiming at a positive real growth in public pensions in order to gradually restore the replacement ratio at the level of 1990 and if continuing the so-called "re-correlation" of pensions, the deficit in the pension fund would reach 1.2% of GDP in 2007. Re-correlation consists in increasing benefits for many pensioners in order to even out disparities between various cohorts, caused by high inflation and different indexation, and incurred in 2002-04 budgetary costs of around 1.3% of the average annual GDP. The intended intensification of the re-correlation, which alone in 2006 would amount to close to 0.7% of GDP, would tend to further increase the deficit in the pension fund over the coming years. Moreover, the envisaged cuts in social security contribution rates could have an immediate negative impact on the funding of the public pension fund. Also, it is not clear to which extent the diversion after 2006 of contributions from the first pillar system to the second pillar is taken into account in the programme. At the same time, however, the programme aims at preserving the real level of public pensions once the re-correlation is finalised. This is a more moderate approach to lifting public pensions than in the past, both in terms of replacement ratio and in terms of the real level of pensions, which grew by close to 11% in 2004.

As regards the need for further reform, the programme states that supplementary measures may be taken in the light of demographic developments. In view of the ageing of the population and the structural imbalance of the public pension system, which already today requires significant transfers from the state budget to the social security budget to cover the shortfall of financing, this appears to be a modest ambition. Given the existent shortfall of contributors to the pension system and the relatively certain estimates of a sharp increase in the old-age dependency ratio, a more pro-active and comprehensive strategy would be required to prevent an increasingly underfinanced first pillar and a persistently low replacement rate, which would cause increasing disparity in living standard between the working and the retired population. Both financial and social reasons therefore accentuate the need to develop and implement a comprehensive strategy for reforming the pension system with the twofold purpose of improving its financial sustainability and providing an adequate pension level.

While pension reform is indeed a central issue, challenges in the health system and measures envisaged to ensure its longer-term financial balance are barely considered. The current low standards and coverage of medical care in combination with the impact of ageing and growing real incomes make it likely that a significant expenditure pressure may occur in this field. In line with the sustainability projections carried out by the EPC, other age-related expenditure, in particular for education and unemployment benefits, would also have to be factored in. Other elements of the three-pronged strategy, in particular measures to raise the employment rate, are not well addressed. This casts some doubt over the real growth scenario, which hinges on attaining high employment rates. Also, given the considerable emigration of Romanians since the 1990's, some discussion of how expected migration flows could impact on the size of the working age population would have been useful. As the projections are highly sensitive to demographic developments, the programme could have been clearer in presenting the demographic scenario, and in particular the means by which higher fertility rates and higher participation rates for women can be attained simultaneously. Altogether, the PEP does not provide sufficient information to comprehensively assess the long-term sustainability of public finances. A broader coverage of issues and the elaboration of projections based on a methodology and assumptions comparable to recent analyses of the EPC would be instrumental to better ascertain the impact of ageing on public finances and should be an important element in Romania's preparation for the participation in the EU economic policy co-ordination.

* * *

Annex table 1: **Structural indicators**

	ROMANIA					EU 25				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
General economic background										
Real GDP [1]	2.1	5.7	5.0	4.9	8.3	3.7	1.8	1.1	1.0	2.3
Labour productivity [2]	0.6	7.0	7.2	6.1	8.1	2.1	0.8	0.8	0.8	1.8
Real unit labour cost [3]	21.7	-1.1	n.a.	-0.8	-2.5	0.4	0.4	-0.4	-0.5	-0.9
Real effective exchange rate [4]	137.5	140.5	132.2	131.7	137.8	98.7	100.5	103.0	106.1	108.8
Inflation rate [5]	45.7	34.5	22.5	15.3	11.9	2.4	2.5	2.1	1.9	2.1
Unemployment rate [6]	6.8	6.6	7.5	6.8	7.1	8.6	8.4	8.7	8.9	9.0
Employment										
Employment rate [7]	63.0	62.4	57.6	57.6	57.7	62.5	62.9	62.9	63.0	63.3
Employment rate - females [8]	57.5	57.1	51.8	51.5	52.1	53.7	54.3	54.7	55.1	55.8
Employment rate of older workers [9]	49.5	48.2	37.3	38.1	36.9	36.6	37.4	38.8	40.2	40.5
Long-term unemployment [10]	3.5	3.2	4.0	4.2	4.2	3.9	3.8	3.9	4.0	4.1
Product market reforms										
Relative price levels [11]	41.9	41.9	41.2	40.5p	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	42.9	43.5	41.8	43.9	48.1	:	9.7	9.2	9.0	9.4
Total FDI inflows [13]	2.9	2.9	2.5	3.1	7.1	16.0	7.6	8.3	6.1	3.9
Market share electricity [14]	100.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aids [15]	1.7	3.9	1.0	n.a.	n.a.	0.3	0.3	0.3	:	:
Business investment [16]	17.0	18.3	18.2	19.1	19.1f	18.4	17.9	17.2	16.8	17.0
Knowledge-based economy										
Tertiary graduates [17]	18.0	20.2	26.7	39.3	n.a.	43.2	47.0	49.0	52.2	n.a.
Spending on human resources [18]	2.89	3.28	3.53	n.a.	n.a.	4.9	5.1	5.2	n.a.	n.a.
Educational attainment [19]	75.8	77.3	75.3	73.8	74.8	76.4	76.2	76.5	76.6	76.7
R&D expenditure [20]	0.37	0.39	0.38	0.40	n.a.	1.88	1.92	1.93	1.95	n.a.
Internet access [21]	n.a.	n.a.	n.a.	n.a.	6.0	n.a.	n.a.	n.a.	n.a.	42.0

1. Growth rate of real GDP in %. 2. Growth rate of real GDP per person employed in %. 3. Ratio of compensation per employee to nominal GDP per person employed, total economy, annual percentage change. 4. Vs IC36 (1999 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs). 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population aged 15-64.

11. Of private final consumption (EU25=100). 12. average value of imports and exports of goods and services in % o GDP; the value for EU 15 is the total for the Small Member States. 13. In % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Percentage of households who have Internet access at home.

f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value, q: estimated from quarterly values.

Source: Commission services.

PRE-ACCESSION ECONOMIC PROGRAMME OF CROATIA

1. Summary and conclusions

The ECOFIN Council of 26/27 November 2004 considered: "...that a regular in-depth dialogue with accession countries on a large spectrum of macro-economic policy and financial stability issues will assist the accession process. It could be used both as a means to identify risks and vulnerabilities in these countries and as a way to help them define their strategy for economic integration into the EU. Such a dialogue would further enhance the cooperation and the exchange of information between existing and future Member States ahead of their accession. (...) The Commission is invited to report each year to the Council (Ecofin) on its assessment of the fiscal notification and the Pre-accession Economic Programmes, which are to be presented by the accession countries from 2001 onwards, as well as on the conclusions of the high level meeting."

Following the recognition of Croatia as a candidate country by the Council on 18 June 2004, Commission services invited the Croatian authorities to present a first Pre-Accession Economic Programme (the "2004 PEP"). On 1st December 2004, the Croatian Minister of Finance, Mr Ivan Suker, submitted on behalf of the Croatian government the first PEP of Croatia to the Commission, following its adoption by the government on 30 November. The authorities have subsequently sent revised sets of tables as the previous version contained a number of obvious errors and inconsistencies. The programme, which covers the period 2005-2007, presents a rather coherent macroeconomic framework, including medium-term fiscal targets and projections for key macroeconomic variables. While data are presented according to the GFS methodology, the introduction of ESA 95 standards is envisaged, yet not precisely scheduled. A significant part of the programme reports on structural reform measures already undertaken, in particular highlighting changes of the legislative framework. The assessment of envisaged structural reform measures would have benefited from a clearer definition of policy objectives and more information on instruments and cost estimates. Given the pioneer character of the document, it only partly complies with the content, form and data requested in the consolidated outline. The document is consistent with the government's "Fiscal Policy Guidelines" adopted in July 2004 and the draft budget for 2005 and its medium-term budgetary projections, adopted in November 2004.

The main objective of the programme is to reduce macroeconomic risks stemming from external imbalances, i.e. a significant current account deficit and a high and rising external debt, through a policy of considerable fiscal adjustment over the programme period. Monetary policy will continue to be geared at preserving price and exchange rate stability. The programme envisages an acceleration of privatisation and restructuring, in particular in the agriculture, shipbuilding and tourism sector and the development of a vibrant SME sector.

The 2004 PEP projects a robust and slightly accelerating real growth, averaging 4.5% over the programme period, based on continuously strong domestic demand. Such growth rates appear rather optimistic. Against the background of a projected significant slowdown of public investment, such a growth scenario would require a rapid and strong acceleration of private investment growth. The latter may however to some extent continue to be undermined by persisting structural weaknesses of the economy. Also, the projected acceleration of public consumption growth may contradict with the fiscal consolidation foreseen. The European

Commission's recent spring 2005 forecast projects a somewhat slower growth acceleration in 2005 and 2006, based on a more modest increase of domestic demand growth in the context of continued stabilisation policies. With respect to the sources of growth, the 2004 PEP assumes a rather static contribution of demand components over the programme period. The broadly neutral effect of net foreign demand appears to be in contradiction with the otherwise favourable external assumptions of the programme. The European Commission's Spring forecast predicts the sources of Croatian GDP growth to gradually change over 2004 - 2006, reflecting a shift from domestic to net foreign demand, as a result of an improving performance of exports of goods and services.

The 2004 PEP projects a gradual and significant narrowing of the current account deficit from 7.2% of GDP in 2003 to 3.8% of GDP in 2007, mainly driven by a reduction of the public sector savings-investment gap. The projected deficit reduction is seen as result of continued fiscal adjustment and a favourable external environment. However, it should be noted that under a scenario of robust growth and accelerated enterprise restructuring, privatisation and investment, the private sector savings and investment gap could well increase, absorbing net foreign savings, which may suggest larger current account deficits than those projected. The document does not address these kind of considerations. Unfortunately, the 2004 PEP does not provide detailed information on the financial and capital accounts. It only states that a major share of current account deficits in 2005 and 2006 is projected to be financed by net FDI inflows. In 2007, the deficit would be fully financed by net FDI.

The 2004 PEP foresees no major changes with respect to the monetary and exchange rate policy framework. Indeed, the high degree of currency substitution and the ensuing credit risks constrain exchange rate flexibility and the scope for an independent monetary policy. The PEP assumes a constant nominal exchange rate against the euro over the entire programme period. Annual average inflation is projected to increase to 2.6% in 2005, mainly as a result of a lagged effect of the oil price hike in 2004, and to decline to 2.3% and 2.2% in 2006 and 2007, respectively. The projected inflation trend seems somewhat optimistic, as a scenario of accelerating growth, productivity increases, and net capital inflows could lead to real appreciation pressures, implying higher inflation rates over the programme period, in particular under the assumption of a constant nominal exchange rate. Further administrative price adjustments may also continue to fuel inflation to some extent. The Commission's recent forecast projected average CPI inflation in 2005 and 2006 to increase to 2.7 and 2.8%, respectively, somewhat above the projected rates in the 2004 PEP. The 2004 PEP would have benefited from a brief presentation of possible policy responses to real appreciation pressures that may occur over the medium term, also in view of the preparation for ERM II participation.

The 2004 PEP projects a significant gradual reduction of the general government balance from an expected 4.5% of GDP in 2004 to below 3% in 2007. Croatia's first fiscal notification submitted in March 2005 reports a higher deficit of 5.2% of GDP for 2004, though part of the deviation from the 2004 target is due to the use of GFS 2001 in the fiscal notification, while the PEP targets are defined on the basis of GFS 1986. The equivalent deficit for 2004 is 4.9% of GDP, significantly higher than planned, which implies the need for a stronger fiscal adjustment in 2005 and beyond if the PEP's fiscal targets are to be met. Fiscal adjustment is projected to take place primarily through a reduction of the share of public spending from 52.1% of GDP in 2004 to 49.7% of GDP in 2007, or by 2.4 percentage points, while total revenues will decline slightly from 47.6% to 46.8% of GDP during the same period. The fiscal strategy foresees a reduction of the share of spending on wages, pensions, and social security, as well as a significant reduction of subsidies to the non-agriculture enterprise sector. Gross public debt is projected to be reduced to 52% of GDP in 2007, or by 1.8 percentage points as compared to

2004. The marked and continuous reduction of primary balances and revenues from privatisation, that are expected to be particularly significant in 2005 appear to explain a major part of continuous debt adjustment over the PEP period. The impact of interest payments on debt growth is projected to increase over the programme period, also in line with the planned shift from external to domestic financing which may entail somewhat higher borrowing costs.. Debt figures in the 2004 PEP and those reported in the first fiscal notification are not comparable, as the latter do not include contingent liabilities of the general government.

While the overall fiscal adjustment envisaged seems appropriate and encouraging, it is difficult to detect whether the programme is sufficiently backed by permanent structural policy measures on both the revenue and expenditure side. The document contains only little information on specific fiscal or other economic policy measures and quantitative assessments of budgetary effects are generally not provided. While acknowledging the pioneer character of the 2004 PEP, the document would have certainly benefited from a larger degree of precision in this respect. A number of potential fiscal risks are not elaborated in the programme, such as reliance on one-off revenues measures and potential over-spending of other levels of governments and government agencies which seem still difficult to control, e.g. the Health Fund and the Railway system.

The 2004 PEP covers structural reforms related to the enterprise and financial sector, labour market, agricultural sector and public administration. Moreover, it reports on a broad range of other horizontal or sector reforms, including judicial reform, environmental protection, education, transport and public procurement. The main policy objectives are the swift completion of privatisation of socially-owned enterprises, the promotion of SME development, a continuation of pension and social security reforms and the reform of public administration. Key measures are legislative alignment with EU law, institutional strengthening, and state financial support, in particular financial aid schemes for SMEs and for the restructuring of loss making enterprises in agriculture, tourism and shipbuilding.

The presentation of the future structural reform agenda sometimes lacks a precise description of policy priorities, objectives and key measures to be undertaken. Reforms are not always related to specific structural deficiencies and cost estimates are generally not provided. Future programmes would certainly benefit from more detailed information in this respect. Privatisation and restructuring plans seem very ambitious and certainly require a renewed and strong reform commitment from the Croatian authorities as well as a swift removal of those obstacles that have seriously delayed the privatisation process in the past. With respect to the financial sector, the 2004 PEP does not provide plans as to the privatisation of the largest insurance company that was repeatedly announced in the past but has not yet materialised. On social security reforms, the PEP outlines a number of policy objectives, such as enhancing the efficiency and transparency of the system, but remains rather vague on the nature of policy measures planned to be undertaken.

The 2004 PEP reports on a number of measures that are principally appropriate to enhance the quality of public finance. A key objective of the programme is a more efficient public administration. Public finance reforms are targeted at enhancing fiscal transparency and spending control. A reorientation of public spending towards education, research and development is foreseen, but a quantitative budgetary assessment is not provided. A reform of public procurement is planned to be implemented in 2005. Continued investments in and maintenance of road infrastructure to improve inter-regional connections are also foreseen under the programme. The 2004 PEP does not explicitly deal with the sustainability of public finance; it however reports on parametric reforms to be undertaken during the programme period with a view to financially strengthening the first pillar of the pension system, including the re-adjustment of the pension formula in 2005. It is also intended to promote the second and third pillar, which could favourably impact on domestic savings, investment and growth. Overall, pension reforms envisaged could help curtailing the budgetary implications of an ageing population.

Table 1: **Comparison of key macroeconomic and budgetary projections**

		2003	2004	2005	2006	2007
Real GDP growth	COM	4.3	3.7	4.0	4.3	n. a.
(% change)	**PEP**	**4.3**	**3.9**	**4.4**	**4.5**	***4.6***
Consumer price	COM	1.8	2.1	2.7	2.8	n. a.
inflation (%)	**PEP**	**1.8**	**2.2**	**2.5**	**2.3**	***2.2***
General government	COM	-6.3	-5.0	-4.4	-3.9	n. a.
balance (% of GDP)	**PEP**	**-6.3**	**-4.5**	**-3.7**	**-3.2**	***-2.9***
Primary balance (*)	COM	n. a.	n. a.	n. a.	n. a.	n. a.
(% of GDP)	**PEP**	**-3.0**	**-1.9**	**-1.3**	**-0.7**	***-0.3***
Government gross	COM	51.6	53.8	53.2	52.5	n. a.
debt (% of GDP)	**PEP**	**51.6**	**53.8**	**52.5**	**52.5**	***52.0***

**) data are on cash basis*

It can thus be concluded:

- Croatia's first Pre-Accession Economic Programme for 2005-2007 is a comprehensive economic policy document, outlining a fundamentally sound medium-term macroeconomic framework, appropriate to address the current external imbalances. Given its pioneer character, the document only partly complies with the content, form and data requested. It is consistent with other policy documents which it complements and it should help strengthening guidance for economic policy making.

- Over the past two years, the Croatian economy has benefited from relatively strong, but decelerating growth with low inflation and exchange rate stability. Significant fiscal and current account deficits have contributed to a high and rising external debt and need to be urgently addressed. The programme's medium-term macroeconomic projections for growth, inflation and fiscal balances seem partly optimistic.

- The programme's policy mix of continued fiscal adjustment and stability-oriented monetary policies addresses the current imbalances of the Croatian economy in an appropriate way. However, the programme would have benefited from more detailed information on specific fiscal policy measures, their expected budgetary effects as well as the potential fiscal risks involved to fully assess the quality and sustainability of fiscal adjustment.

- The structural reform agenda seems generally ambitious and will certainly require a strong reform commitment from the Croatian authorities as well as a swift removal of those obstacles that have seriously delayed reforms in the past. The presentation of envisaged structural reforms would have benefited from a clearer definition of objectives and specific measures, including estimates on the respective budgetary effects involved.

2. JOINT MINISTERIAL CONCLUSIONS

"On 12 July 2005, the Economic and Finance Ministers of the EU and the acceding and candidate countries, along with representatives of the Commission and the European Central Bank and representatives of the Central Banks of the acceding and candidate countries, met for their seventh economic policy dialogue meeting.

...

Ministers welcomed the 2004 Pre-accession Economic Programmes of the two candidate countries. Ministers endorsed the following conclusions as regards the assessment of these programmes:

Croatia

1. *Given its pioneer character, Croatia's first PEP only partly complies with the content, form and data requested, but it should help strengthening guidance for economic policy making.*
2. *Over the past two years, the Croatian economy has benefited from relatively strong, but decelerating growth with low inflation and exchange rate stability. Significant fiscal and current account deficits have contributed to a high and rising external debt and need to continue to be urgently addressed. The programme's medium-term projections 2004-2007 for growth, inflation and fiscal balances seem partly optimistic, although coherent.*
3. *While the overall envisaged fiscal adjustment seems appropriate and encouraging, the programme would have benefited from more detailed information on specific fiscal policy measures, their expected budgetary effects as well as the potential fiscal risks involved to fully assess the quality and sustainability of fiscal adjustment.*
4. *The structural reform agenda seems ambitious, with reforms planned in a broad range of areas. It will certainly require a strong commitment from the Croatian authorities as well as a swift removal of institutional weaknesses that have seriously delayed reforms in the past. The structural reform agenda sometimes lacked a precise description of policy priorities, objectives and key measures to be undertaken, without cost estimates being provided. Future programmes would benefit from more detailed information in this respect.*

In view of the above assessment, Ministers were of the opinion that Croatia needs to continue to address as appropriate the present macroeconomic imbalances – mainly government deficit, current account deficit and external debt. Croatia also needs to tackle the remaining deep-rooted structural problems that may impair its capacity to stay on a path of strong growth. In this respect, EPC is invited to complement its 2004 work on the structural challenges in the candidate countries by an analysis on Croatia. Croatia should especially continue to advance privatisation and enterprise restructuring.

…"

3. INTRODUCTION

On 1 December 2004, the Croatian Minister of Finance, Mr Ivan Suker, submitted on behalf of the Croatian government the first Pre-Accession Economic Programme (the "2004 PEP") of Croatia to the Commission, following government adoption on 30 November. The programme, which covers the period 2005-2007, presents a rather coherent macroeconomic framework, including medium-term fiscal targets and projections for key macroeconomic variables.

While data are presented according to GFS methodology, the introduction of ESA 95 standards is envisaged, yet not precisely scheduled. A significant part of the programme reports on structural reform measures already undertaken, in particular highlighting changes of the legislative framework. The section on structural reforms does not appear to be a self-contained analysis. It is generally difficult to read and sometimes lacks an analytical assessment of how these measures contribute to the reform of goods and capital markets in the light of EU-integration. The programme would have also benefited from a clearer definition of policy objectives and more information on instruments and cost estimates. Given the pioneer character of the document, it only partly complies with the content, form and data requested in the consolidated outline. The document is consistent with the government's "Fiscal Policy Guidelines" adopted in July 2004 and the draft budget for 2005 and its medium-term budgetary projections, adopted in November 2005. The section on structural reforms is broadly in line with the respective parts of the 2005 National Programme for the Integration of the Republic of Croatia into the European Union.

The main objective of the programme is to reduce macroeconomic risks stemming from external imbalances, i.e. a high current account deficit and a rising external debt, through a policy of significant fiscal adjustment over the programme period. The general government deficit is programmed to be reduced to below 3% of GDP by 2007 and the public debt to be stabilised at around 52% of GDP. Inflation is projected to remain low, supported by exchange rate stability and moderate wage policies. A reduction of interest rates is expected to encourage private investment and consumption over the programme period. The external debt to GDP ratio is projected to remain stable at slightly above 80% in 2004-2006 (after 74.6% at end-2003), before it would fall to 79% in 2007. The programme envisages an acceleration of privatisation and restructuring, including in the agriculture, shipbuilding and tourism sector.

4. MACROECONOMIC DEVELOPMENTS

4.1. Recent macroeconomic developments

The PEP presents a fairly comprehensive overview of recent economic developments in 2003 and the first eight months of 2004 for most economic indicators. In some cases, it should have been possible to provide more recent data (e.g. on inflation) and more details (e.g. on merchandise trade developments). Some important data are not provided at all (e.g. on wage developments) and in some cases the factual description would have benefited from more accuracy. The descriptive part contains also projections for 2004 which are not always consistent with projections of the macroeconomic programme presented later (e.g. on the current account deficit).

According to the PEP, real GDP growth declined from 5.2% in 2002 to 4.3% in 2003 and 4% in the first half of 2004, as a result of a deceleration of private consumption growth. This trend continued through end-2004, resulting in a lower annual GDP growth of 3.8% for the year as a whole. Total employment grew by 2.6% in 2003 and unemployment rates based on labour force survey data continued to decline from 14.7% in 2003 to 13.8% in the first half of 2004. Inflation remained low at 2% year-on-year in August 2004, as a result of moderate wage growth and only modest adjustments of administered prices. In the second half of 2004, inflation accelerated to 2.7%, mainly as a result of higher energy prices. The Kuna exchange rate remained stable in nominal terms and continued to appreciate in real effective terms in 2003 and in 2004 by 2.5% and 3.2%, respectively. Monetary policy continued to be rather tight, curbing domestic credit growth to the non-banking sector which slowed down from 30% in 2002 to 14.6% in 2003 and 13% in 2004. The current account recorded a significant deficit of 7.2% of GDP in 2003, reflecting a huge trade deficit and a negative income balance. A strong export performance in 2004 supported a significant reduction of the current account deficit to below 5% in 2004. The PEP emphasises that the external debt continued to grow, reaching 77.3% of GDP in July 2004, as compared to 74.6% at end-2003. The external debt-to-GDP ratio climbed further to 82% of GDP by end-2004. The general government deficit in 2003 stood at 6.3% of GDP, breaching the initial target of 4.5%, due to higher-than-planned spending commitments. Based on first half year data, the PEP projects the 2004 deficit to be reduced to 4.5% as initially targeted, while it actually reached 4.9% of GDP.

Table 2: **Comparison of macroeconomic developments and forecasts**

	2003		**2004**		**2005**		**2006**		**2007**	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	4.3	4.3	3.7	3.9	4.0	4.4	4.3	4.5	n. a.	4.6
Contributions:										
- Final domestic demand	6.5	6.5	3.9	3.9	3.8	4.4	3.9	4.6	n. a.	4.8
- Change in inventories	-0.7	-0.7	-0.2	0.0	-0.2	0.0	-0.1	0.0	n. a.	0.0
- External balance of goods and services	-1.5	-1.5	0.0	0.0	0.3	0.0	0.5	-0.1	n. a.	-0.2
Employment (% change)	0.1	0.3	0.5	-0.7	1.0	1.6	1.2	1.5	n. a.	1.5
Unemployment rate (%)	14.5	14.7	13.9	14.9	13.3	14.2	12.5	13.3	n. a.	12.1
GDP deflator (% change)	3.2	3.3	2.9	2.2	3.4	2.6	3.4	2.3	n. a.	2.2
CPI inflation (%)	1.8	1.8	2.1	2.2	2.7	2.5	2.8	2.3	n. a.	2.2
Current account balance (% of GDP)	-7.0	-7.2	-5.3	-5.6	-4.7	-5.1	-4.5	-4.4	n. a.	-3.8

Sources: Pre-Accession Economic Programme (PEP); Commission services Autumn 2004 forecasts (COM)

4.2. Macroeconomic scenario

The PEP outlines a medium-term macroeconomic scenario with projections for key variables, covering real sector, fiscal and external developments. Alternative scenarios are not presented. Projections are based on a financial programming and accounting methodology. The scenario is presented in an overall coherent and consistent way. The main objective is the reduction of macroeconomic risks stemming from current external imbalances in the form of significant current account deficits and a high and increasing external debt. The key policy instrument to achieve these objectives is fiscal consolidation, namely a reduction of the fiscal balance to below 3% of GDP by 2007, through a rationalisation of current spending and lower public investments. Monetary and exchange rate policies remain primarily geared at price stability and the exchange rate is programmed to remain stable vis-à-vis the euro. The policy mix appears appropriate under the specific Croatian circumstances, i.e. a high level of currency substitution which limits the scope for a fully autonomous monetary and exchange rate policy. The macroeconomic scenario would have benefited from elaborating on possible strategies and policies to address the potential conflict between low inflation and a stable exchange rate in an open catching-up economy with liberalised capital markets and access to finance. The projections are based on the assumptions of an economic recovery in the EU/euro area, Croatia's main trading partner, which is broadly in line with the Commission's external assumptions in the spring economic forecast. Moreover, world trade in goods and services is assumed to grow.

Real sector

The PEP is based on a scenario of relatively robust real growth, averaging around 4.5% over the programme period, following a further decline of the growth rate in 2004 to 3.8%. Growth projections are somewhat more optimistic as compared to the recent Spring 2005 forecast presented by the European Commission, which projects real GDP to grow by 4.0% and 4.3% in 2005 and 2006, respectively. The PEP assumes a significant acceleration of private consumption growth from 3.8% in 2004 to 4.6% in 2005, to be followed by a 4.3% increase in both 2006 and 2007. However, the assumption of continued fiscal consolidation, tight monetary policy, and moderate wage adjustments may suggest a more moderate growth profile. This led the Commission to forecast a 4.1% growth of private consumption in 2005 and 2006. The PEP contains contradictory information on the projected real growth of public consumption. While the text part on page 12 assumes an average annual real growth of 3.6%, table 1 in the ANNEX indicates a different growth profile of public consumption with lower, but still positive and accelerating growth rates in 2005-2007. However, both scenarios do not appear to be consistent with the projected strong fiscal adjustment, even under the assumption of a lower government consumption deflator. The projected growth profile of gross fixed capital formation with substantially lower growth rates during the PEP period as compared to 2003 appears plausible and reflects the gradual termination of public investment projects to be followed by a stronger private investment toward the latter part of the PEP period.

In the 2004 PEP scenario, real growth over the period 2004 to 2007 remains to be exclusively driven by domestic demand. Private consumption and gross fixed capital formation are projected to contribute 2.6 and 1.5 percentage points, respectively, to real growth on an annual average. The effect on real growth of net foreign demand remains broadly neutral over the programme period, which is somewhat surprising against the background of overall favourable external assumptions of the programme, e.g. further trade integration and good export performance. Based on similar external assumptions, the recent Commission's forecast projects a gradual change of the sources of Croatian GDP growth over the forecast period 2004 to 2006, reflecting a shift from domestic to net foreign demand. The contribution of domestic demand falls from 6.5% in 2003 to a still strong 3.9% in 2004 - and 2006. Net exports are projected by the Commission to contribute positively to growth in 2005 and 2006 with 0.3% and 0.5%, respectively. Such a scenario is also plausible under the policy mix and the external assumptions presented in the PEP. Actual developments in 2004 also point to a changing growth composition, as net external demand for the first time since 2000 posted a positive contribution to GDP growth. On the supply side, the document's projections of a relatively strong growth of both industry and services over the PEP period appear plausible and in line with the underlying assumptions of the programme. The document does not provide information as to what extent the growth scenario is based on projections on Croatia's potential growth. It neither elaborates on expected changes in factors of production (e.g. labour market developments) and productivity. Moreover, a more detailed assessment on which factors would lead to an "improved labour productivity" (pages 12, 18) would have added to the quality of the 2004 PEP.

External sector

The PEP projects a gradual and significant narrowing of the current account deficit from 7.2% of GDP in 2003 to 3.8% of GDP in 2007. It outlines a scenario of strong and accelerating growth of merchandise exports while merchandise imports are projected to grow more slowly. Export recovery is seen as a result of further integration with the EU economy, together with stronger FDI, ongoing enterprise restructuring and improved labour productivity raising price competitiveness. As a result, the merchandise trade deficit is projected to be reduced from 27.4% in 2003 to 23.2% in 2007, i.e. by 4.2% of GDP. The 2004 PEP does not contain a competitiveness assessment on the basis of projected real effective exchange rate trends. The programme assumes a continuously good performance of tourism and related air traffic services, but does not provide any quantification on the latter. As a result, a huge surplus of the services balance, although slightly declining as a % of GDP, continues to counterbalance a significant part of the merchandise trade deficit over the reference period. Information provided on the projected development of net factor income from abroad (incl. interest income) is rather cryptic. Table 3 suggests that net interest payments to the rest of the world will slightly increase in 2005, but markedly decline in 2006 and 2007 both in euro terms and as a percent of GDP. While the document does not explicitly provide an explanation for this trend, lower interest payments to non-residents may seem plausible against the planned shift from foreign to domestic borrowing. Other net factor income from abroad are projected to remain broadly constant as a share of GDP. The surplus in the balance of net current transfers is projected to slightly increase, on the back of an expected growth of workers' remittances. As a percentage of GDP, the surplus in current transfers will decline from 4.4% in 2004 to 3.9% in 2007. The significant reduction of the current account deficit to below 5% that took place in 2004 is a welcome development and supportive of the strong current account adjustment in 2005-2007, as programmed in the PEP. However, it should be noted that the lower deficit in 2004 was partly a result of an improved export performance, but also due to some one-off transaction in the income balance, resulting from the transfer of patent rights of a Croatian company to an affiliate abroad. Overall, the projected reduction of the current account deficit in 2005 – 2007 seems rather optimistic. From a savings-investment perspective, the deficit reduction may be interpreted as a reflection of gradually lowering fiscal imbalances, as envisaged in the programme. If fiscal policies turn out to be more expansionary than envisaged, current account deficits may actually be higher. Moreover, the underlying assumptions of the 2004 PEP of robust growth, as well as accelerated enterprise restructuring, privatisation and investment could well imply higher private sector savings and investment gaps than those indicated in table 3, absorbing higher net foreign savings. The latter would also suggest higher current account deficits than those projected in the PEP.

The PEP does not provide detailed quantitative information on developments of the financial and capital account. A significant share, i.e. above 90%, of the current account deficits in 2005 and 2006 are projected to be financed by net FDI inflows. In 2007, the deficit is fully financed by net FDI. The PEP assumes that foreign investor's confidence will be strengthened through the negotiations on EU membership, the implementation of the current IMF programme and continuous reform efforts in the country, notably in the area of privatisation and public administration reform. The projected net inflow of FDI accounts for 4.6% of GDP in 2005, 4.1% in 2006 and 3.9% in 2007. This profile does not seem overly optimistic in the context of envisaged macroeconomic and structural policies and the expected acceleration of privatisation and investment in the Croatian economy. The programme does not elaborate on the development of foreign currency reserves over the reference period; table 3 however suggests a steady annual increase in foreign reserves by around 6%. No information is provided on the state of play and future plan with respect to the liberalisation of capital movements as required under the EU acquis.

4.3. Monetary and exchange rate policy

The PEP contains a comprehensive description of the monetary and exchange rate policy framework that has practically been in place during the past ten years which is labelled as a "managed float". The primary policy objective is price stability. The exchange rate has traditionally been used as a stabilisation anchor, following periods of high and hyperinflation in the early 1990ies. The scope for larger exchange rate flexibility is constrained against the background of a highly euro-ised financial system with a significant share of banking deposits denominated in foreign exchange. In order to lower exchange rate risks, commercial bank's lending is either denominated in or indexed to the euro. However, as borrowers are usually not in a position to hedge foreign exchange liabilities, the Croatian financial sector is faced with significant credit risks. Against this background, exchange rate stability becomes an important intermediate policy objective in the context of monetary policy. De facto, the Croatian monetary and exchange rate regime is more similar to a fixed exchange rate system than to a floating. The scope for an independent monetary policy is rather constrained. The main instruments of monetary policy are interventions in the foreign exchange market to alleviate excessive fluctuations, changes in obligatory reserve requirements to steer banking liquidity and to sterilise liquidity effects of interventions, and the obligation for commercial banks to keep a minimum of foreign exchange liquid assets as a general safeguard against exchange rate and credit risks.

The 2004 PEP briefly concludes that no major policy changes are planned as the current instruments of monetary policy have proven efficient in ensuring price stability in the specific Croatian context. Annual average inflation is projected to increase to 2.6% in 2005, mainly as a result of a lagged effect of the oil price hike in 2004, and to decline to 2.3% and 2.2% in 2006 and 2007, respectively. The PEP assumes that the exchange rate of the Kuna vis-à-vis the euro will remain constant at around HRK 7.52 over the programme period.

The programme emphasises that the current system is also compatible with the main elements of ERM II and that therefore no major adjustments would in due time be necessary to satisfy the conditions for ERM II entry. Moreover, the PEP claims that the eventual introduction of the euro would substantially reduce credit and exchange rate risks currently embedded in the Croatian financial system and therefore argues "in favour of a speedier EMU accession". Croatia's EMU accession strategy still needs to be prepared.

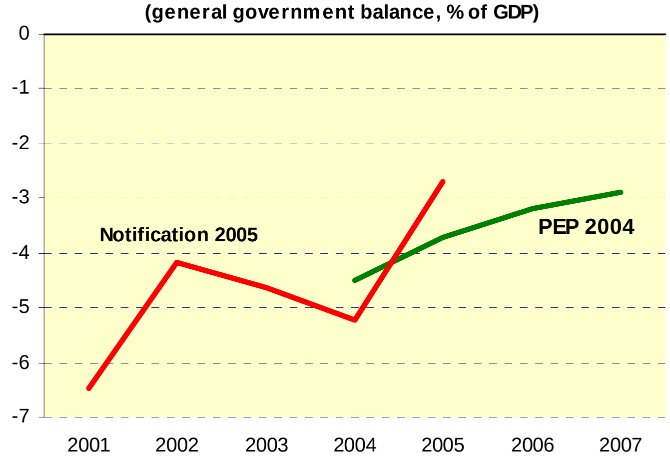
The programme's policy conclusions appear reasonable, as the scope for larger exchange rate flexibility and a fully autonomous monetary policy is indeed very constrained in a highly euroised financial system with a large share of open positions and limited hedging possibilities. However, the PEP would have benefited from a brief discussion of pros and cons of alternative policy options. Moreover, the PEP does not discuss potential policy conflicts that could arise under the current framework. More specifically, the Croatian economy, which is projected to grow stronger and to realise higher productivity gains as compared to the EU economy, may be confronted with some real appreciation pressures, arising from Balassa -Samuelson effects and continuous capital inflows. These effects might be weaker than experienced in other transition countries at similar level of development, as prices of non-tradable goods seemed to have already converged to some extent to EU levels. Nevertheless, the authorities will be confronted with policy choices as the real appreciation could be brought about by either higher domestic inflation or an appreciation of the nominal exchange rate or a combination of both. As the programme assumes a constant nominal exchange rate vis-à-vis the euro over the programme period, real appreciation would be reflected in higher domestic inflation. Against this background, the projected inflation trend in the 2004 PEP may seem rather optimistic. A scenario of accelerating growth, productivity gains, continued net capital inflows etc could imply higher inflation rates in the years 2006 and 2007 than those projected in the programme. Moreover, administrative price adjustment may also continue to fuel inflation to some extent during the programme period. Also based upon these considerations, the Commission's recent Spring forecast projects average CPI inflation in 2005 and 2006 to increase to 2.7 and 2.8%, respectively.

5. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

5.1. Programme overview

The 2004 PEP presents a medium-term fiscal framework in line with the "Fiscal Policy Guidelines", a policy document adopted by the Croatian government in July 2004. The fiscal framework contains projections of broad fiscal aggregates for each level of government and outlines elements of the fiscal strategy over the programme period. The main policy objective is to reduce macroeconomic risks stemming from a high and increasing public and external debt through a significant reduction of the general government deficit. Fiscal adjustment is presented as part of an overall economic strategy aimed at improving the investment climate and reducing the role of the state in the economy.

Chart 1: Budgetary developments
(general government balance, % of GDP)



Ongoing public finance reforms are aimed at enhancing fiscal transparency and budget control, improving the efficiency of public administration, and fostering fiscal decentralisation. Policy measures include the reduction of subsidies to the enterprise sector and of enterprise arrears. The share of spending on wages, pensions and social security will be reduced while more public funds will be made available for education and science. The PEP also envisages a comprehensive tax reform to support investment and growth and to ensure a more equitable distribution of income. The 2004 PEP does not systematically describe all underlying tax reform and expenditure reduction measures that are planned to be undertaken during the programme period. It only provides limited quantitative information on the budgetary effects of some fiscal measures over the programme period. It is therefore difficult to detect whether the programme is backed to a sufficient extent by policy measures to achieve the planned fiscal adjustment. While acknowledging the pioneer character of the 2004 PEP, the document would have certainly benefited from more details and precisions in this respect. The programme does not elaborate on the cyclical position of the economy and the respective budgetary impact. The discussion of fiscal risks is useful, but does not specify possible quantitative effects and policy responses associated with these risks. No sensitivity analysis based on different assumptions for key macroeconomic variables is provided. Budget data are mostly presented on a GFS 1986. The introduction of ESA 95 methodology is explicitly mentioned as a policy objective, although the programme does not specify a timeframe for implementation.

The PEP projects a significant gradual reduction of the general government balance from an expected 4.5% of GDP in 2004 to 2.9% of GDP in 2007, or by 1.6 percentage points. Gross public debt is projected to be stabilised at around 52% of GDP during the programme period, following an increase to 53.8% in 2004 compared to 51.6% in 2003.

Table 3: **Composition of the budgetary adjustment** (% of GDP)*

	2003	**2004**	**2005**	**2006**	**2007**	**Change: 2004-07**
Revenues	46.4	47.6	47.2	46.8	46.8	-0.8
of which:						
- Taxes and social security contributions	42.1	42.5	42.8	42.9	42.9	0.3
- Other (residual)	4.2	5.1	4.4	4.0	4.0	-1.1
Expenditure	52.7	52.1	50.9	50.0	49.7	-2.4
of which:						
- Primary expenditure	50.6	49.9	48.5	47.5	47.1	-2.8
of which:						
Gross fixed capital	6.7	6.8	5.7	5.7	5.8	-1.0
Consumption	19.7	18.8	18.6	18.2	18.0	-0.8
Transfers & subsidies	22.3	23.2	23.0	22.6	22.4	-0.8
Other (residual)	1.9	1.2	1.2	1.1	0.9	-0.3
- Interest payments	2.1	2.1	2.1	2.1	2.1	0.0
Budget balance	-6.3	-4.5	-3.7	-3.2	-2.9	1.6
- Cyclically adjusted	-6.3	-4.4	-3.7	-3.4	-3.3	1.1
Primary balance	-3.0	-1.9	-1.3	-0.7	-0.3	1.5
Gross debt level	51.6	53.8	52.5	52.5	52.0	-1.7

Sources: Pre-Accession Economic Programme (PEP), ECFIN calculations
** data are provided on a cash basis*

The projected fiscal adjustment in 2005 – 2007 is certainly ambitious, particularly against the background of the recent track record in 2003 and 2004. Major fiscal slippages occurred in 2003, although under the responsibility of the previous government. The fiscal deficit reached 6.3% instead of 4.5% of GDP as agreed under the IMF programme, mainly due to higher-than-planned current spending, an accumulation of budgetary arrears and an expansion of quasi-fiscal activities. In 2004, the new government aimed to reduce the deficit to 4.5%, however, officially released budget data for 2004 suggest that the fiscal target has not been met and point to a consolidated general government deficit of around 4.9%, mainly as a result of lower-than-expected revenues from VAT and excises. This implies that an even stronger fiscal adjustment in 2005 and beyond is needed if the PEP's fiscal strategy is to be fully implemented.

A key feature the PEP's fiscal programme is a significant reduction of the expenditure-to-GDP ratio from 52.1% in 2004 to 49.7% in 2007, or by 2.4 percentage points. A major part of this reduction is programmed for 2005, when the share of spending will be reduced by 1.3 percentage points, to be followed by a further decline of 0.8 and 0.3 percentage points in 2006 and 2007, respectively. Total revenues are set to decline slightly from an expected 47.6% in 2004 to 46.8% of GDP in 2007, or by 0.8 percentage points, a large part of which is front-loaded in 2005. Such a fiscal scenario will certainly require a strong and sustained commitment to fiscal discipline, including difficult policy decisions on permanent structural measures to reduce the share of public spending. Moreover, following recent delays in implementing reforms, concrete fiscal measures need to be implemented rapidly.

The PEP presents a number of potential fiscal risks, which may result from changes in the external environment. Lower growth in the EU than assumed under the programme is indeed very likely to impact on GDP performance in Croatia. Higher interest rates would increase the costs of debt service, impacting directly on the budget. The programme also mentions risks that could arise from to domestic policy decisions, i.e. fiscal risks stemming from higher pensions or state guarantees. Other risks, that seem also obvious in the present context, are not mentioned, such as a worse than expected revenue performance. The 2004 budget relied to some extent on revenues from one-off transactions that are by nature not sustainable. Moreover, shortfalls in current revenues from VAT and excise towards the end of 2004 point to potential risks, especially if measures to combat tax evasion do not lead to the desired effects. Also, there appears to be quite some potential for over-spending by government agencies that seem still difficult to control, e.g. the health and railway sectors. There is also a risk that the government might give in mounting pressures to increase public sector wages and subsidies.

Against this background, the actual budget outcome over the PEP period may turn out to be less comforting that envisaged in the programme.

5.2. Targets and adjustment

In line with the adopted budget framework for 2004, the 2004 PEP assumes that a significant fiscal adjustment would already take place in 2004, leading to a reduction of the general government deficit to 4.5% from 6.3% a year before. This adjustment would take place largely on the revenue side. Consolidated general government revenues in 2004 are programmed to increase by 1.2 percentage points (from 46.4% to 47.6% of GDP). Although the PEP does not explicitly mention all the factors of revenue growth, part of the expected increase in the share of revenues to GDP may be due to one-off measures, including expected revenues from dividend payments and from the sale of a concession for a third GSM operator. Consolidated general government expenditures are set to decline by 0.6 percentage points (from 52.7 to 52.1% of GDP). The PEP reports that the consolidated general government deficit reached 7.4 billion HRK in the first semester of 2004, equivalent to 3.6% of projected full-year GDP. The programme claims that important adjustments in the second half of 2004 on both the revenue and expenditure side will help reducing the deficit to 4.5% of GDP. In that context, an addendum to the 2004 PEP reports on the adoption of a revised central government budget in mid-July, which was aimed at bringing on budget the transactions of the Croatian Railways. In order to compensate for this additional spending and to secure the deficit target of 4.5% of GDP, one-off measures (intended sale of government shares in Croatian telecommunication) and larger revenues from VAT, social contributions and income taxes were foreseen in the revised central budget. As already pointed out, available budget data for 2004 show that the consolidated general government deficit reached 4.9%% instead of the targeted 4.5%. While it seems that current spending has been broadly contained as planned, it appears that both one-off revenues and revenues from indirect taxes have underperformed to a considerable extent.

For the year 2005 and in line with the budget adopted in November 2004, the PEP foresees a further reduction of the general government deficit to 3.7% of GDP, equivalent to an adjustment of 0.8 percentage points compared to the planned 2004 deficit. However, the required adjustment in 2005 turns in fact out to be significantly higher, amounting to around 1.2 percentage points on the basis of the actual budget outcome in 2004. The PEP projects consolidated general government spending to be reduced by 1.3 percentage points while consolidated revenues will decline by 0.5 percentage points. Data provided in table 4 of the ANNEX suggest that fiscal adjustment in 2005 differs from the one planned in 2004. It will be driven by a significant reduction in government spending, in particular by a decline in gross fixed capital formation as a share of GDP. Also, the share of public consumption and of spending on social transfers is projected to be slightly reduced, while the share of interest payments and subsidies will somewhat increase. The PEP does not report on specific fiscal measures on the revenue or spending side that are planned to be undertaken to implement the 2005 budget, which makes it difficult to assess the quality of fiscal adjustment in 2005. Also, the underperformance of revenues in 2004 and recent delays in adopting already agreed measures to contain public spending in 2005 (e.g. in the pension and health care area) may put in question the achievement of the fiscal deficit target in 2005.

In 2006 and 2007, the general government deficit is projected to be further reduced to 3.3% and 2.9% of GDP, respectively. A major part of adjustment is planned to be realised through a reduction of primary expenditure, in particular of government consumption and spending on transfer and subsidies while public investment as a share of GDP is projected to stay at around the same level. The share of interest payments are projected to increase from 2.4% of GDP to 2.6% in both years. Concrete fiscal measures that would support fiscal adjustment over the latter part of the PEP period are not reported.

5.3. Debt developments

The PEP contains a brief overview of recent debt developments. The public debt ratio has increased considerably over the last five years from 42.3% of GDP in 1999 to 51.6% of GDP in 2003 and a substantial share of outstanding public debt is external (i.e. around 60% in 2003), i.e. either denominated in or indexed to foreign currencies. The descriptive part of the PEP would have benefited from a more precise definition of public debt (e.g. it is not clear whether it includes government arrears) and a short assessment of the main reasons for the relatively high public and external debt level. More specifically, the PEP could have briefly mentioned the issue of takeover of debt from former Yugoslavia and increasing external borrowing from international capital markets following the granting of an investment grade credit rating in 1997. Moreover, the PEP lacks information on the average maturity and the amortisation schedule of the current stock of public debt and on the medium-term refinancing needs.

The main medium-term objective is to reduce the share of external debt in public debt. Hence, official domestic borrowing is envisaged to gradually replace external borrowing, also with a view to stabilising and eventually reducing the overall stock of external debt in relation to GDP (to below 80% by 2007). This objective is planned to be achieved through a number of policy measures, such as the reduction of general government deficit, the continuation of privatisation and strict limitation on the issuance of government guarantees. Following an expected increase of the public debt-to-GDP ratio to 53.8%, it is projected to be reduced to 52% in 2007. The 2004 PEP does not contain a detailed assessment of factor contributing to the change in gross public debt. However, the annexed table 5 provides some indications, although it does not follow the usual sign convention and is not complete. From there, it seems that the marked reduction of primary balance deficits and revenues from privatisation, which are expected to be particularly significant in 2005 (i.e. 1.9% of GDP) explain a major part of continuous debt adjustment over the PEP period. The effect of interest payments on debt growth increases gradually, also in line with the planned shift from external to domestic financing which may entail somewhat higher borrowing costs. At the same time, the intended increase in the share of fixed interest debt to 70-75% - from 68% in 2003 - should partly compensate this effect. Nor the PEP neither annexed table 5 provide information on exchange rate effects on the growth of public debt. The current currency composition of public debt suggests however that exchange rate changes e.g. between the euro and the USD/JPY could significantly impact on the growth of the debt stock in national currency terms. This holds true even under the assumption that the share of euro-denominated debt will be increased.

As mentioned above, a greater reliance on domestic borrowing is projected to be part of the envisaged external debt reduction strategy. It is also seen as an important requirement to foster the development of domestic financial markets, which is claimed to be important to ensure additional financing options for the government (and the economy). However, the possible advantages of such a strategy would need to be compared with the potential drawbacks, which are not elaborated in the PEP. Although a shift to domestic financing might reduce exchange rate risks, it could under current circumstances increase rollover and refinancing risks due to the generally shorter maturities of domestic debt markets. Therefore, the scope for shifting debt to domestic markets might at this stage be constrained until the kuna yield curve will be extended over the medium term.

The PEP gives a brief presentation of the legal and institutional arrangements for debt management, which apparently has considerably improved through the adoption of the Budget Act in 2003. The latter gave the key responsibility of debt management to the Ministry of Finance, introduced reporting obligations on debt and guarantees and clearly defined debt management activities. The PEP refers to a recent joint IMF/World Bank study which assesses shortcomings and risks with respect to public debt management and outlines recommendations for the reorganisation of debt management with a view to enhancing transparency, efficiency and risk assessment and control. The PEP mentions some activities planned for 2005 with a view to fully addressing the identified shortcomings. These measures however seem to fall short of the scope of reforms needed to improve debt management capacity. Notably, two of the three mentioned measures are explicitly related to ongoing external assistance, namely projects that are expected to be financed under the CARDS programme (i.e. purchase of a new debt management system, technical assistance). While CARDS assistance can certainly support some of the important reforms in this area, it can not replace the authorities' commitment and action to implement the wide-ranging reforms urgently needed in this important policy area.

6. STRUCTURAL REFORMS

6.1. Programme overview

In line with the consolidated outline, the 2004 PEP covers structural reforms related to the enterprise and financial sector, labour market, agricultural sector and public administration. Moreover, it reports on a broad range of other horizontal or sector reforms, including judicial reform, environmental protection, education, transport and public procurement. The presentation is for a great part descriptive and backward looking, providing information on past reforms with an emphasis on legislation. The main policy objectives are the swift completion of privatisation of socially-owned enterprises, the promotion of SME development, a continuation of pension and social security reforms and the reform of public administration. Key measures are legislative alignment with EU law, institutional strengthening, and state financial support. The latter contains financial aid schemes for SMEs and for the restructuring of loss making enterprises, in particular in agriculture, tourism and shipbuilding. The presentation sometimes lacks precise definitions of policy objectives and respective instruments. Not all of the measures listed in the structural reform matrix are described in the text. Key reforms are not always related to specific structural deficiencies and cost estimates are generally not provided. Most of the measures are expected to be implemented during the 2004 PEP period; some others are being extended beyond the current PEP time frame.

In spite of progress with structural reforms that has been made over the past few years in some important policy areas, the Croatian economy is still suffering from significant inefficiencies and weaknesses that constrain productivity and growth. Also, some earlier announced reforms have been delayed during 2004, in particular in the field of privatisation and enterprise restructuring. Moreover, some policy changes seem to have at least partly reversed previous reforms, such as in the area of pensions. Public administration reform and the reform of the judiciary have progressed more slowly than previously expected. Against this background, the 2004 PEP structural reform agenda looks ambitious and will require continued reform commitment and enhanced policy implementation over the programme period.

Key policy measures in the area of privatisation and real sector restructuring are front-loaded in 2005 and may appear very ambitious. Also, some specific measures e.g. in the area of state aid and pension adjustment are scheduled for 2005. Other policies, such as SME development, social security reforms and legislative alignment are planned to occur more gradually. Sector specific policies also tend to be of a continuous nature. As the programme does not provide any detailed information on the sequencing of specific reforms, it is difficult to assess implementation risks.

6.2. Product and capital markets

The PEP outlines the following main reform areas related to the functioning of product markets: the finalisation of privatisation of socially-owned enterprises, the strengthening of competition policy and state aid control, the restructuring of public utilities and SME development. Since the start of privatisation in the early 1990's, some 2,000 companies have already been sold, mainly on the basis of stock exchange auctions or public tenders. As of September 2004, the Privatisation Fund still held minority or majority shares in 1,073 companies. Enterprises in the tourism, agriculture and shipbuilding sector account for a significant share of the Fund's assets in gross nominal value terms. Privatisation of state ownership in these sectors has generally been delayed, as many companies are loss making and highly indebted (shipbuilding, agriculture) or suffer from a lack of maintenance and unresolved real estate issues (tourism). The cancellation of share sales and strong resistance from trade unions have also delayed privatisation. The declared policy objective is to accelerate privatisation and finalise it by end-2005 (for shipbuilding later). This is expected to be achieved through the re-organisation of the Privatisation Fund, a more effective communication policy, new privatisation methods (e.g. public private partnership), and financial restructuring of companies to make them more attractive for potential investors. The PEP remains quite vague on the precise policy measures. It does not quantify the potential budgetary costs of state financial support. Overall, given recent implementation delays, major financial problems of a large number of enterprises and fiscal constraints, the completion of privatisation by end-2005 seems rather ambitious and would certainly require a stronger commitment on the part of the government, including the willingness to eventually liquidate enterprises. On competition policy, some progress has been made, namely with respect to the establishment of the legal framework for anti-trust and state aid policy, although it has not yet been sufficiently aligned with the EU acquis. Further legislative harmonisation is therefore a key priority. The problem of a still weak administrative capacity and enforcement record are planned to be addressed through an increase in staff and financial resources of the competition agency. The PEP rightly puts emphasis on strengthening state aid policy through the establishment of a fully-fledged state aid registry, enhanced cooperation with sector regulators and measures raising public awareness about state aid rules. With respect to reforms in the area of public utilities, the 2004 PEP very much focuses on recent and outstanding legislation. In the energy sector, a number of new laws are in preparation aimed at bringing regulatory frameworks and policies gradually in line with the EU acquis. The schedule for next phases of the privatisation of the oil company INA remains open. In the transport sector, an important objective is the restructuring of Croatian railways and opening of railway services to competition. In the telecommunication area, the license for a third GSM operator has been awarded with a view to enhancing competition. Also the market entry of new operators on the fixed line market is being prepared. The PEP envisages liberalising the telecommunication market by 2007 through the adoption of EU compatible legislation. SME policies are guided by the “Programme of Incentives for SME’s (2004-2008)” which was adopted by the government in May 2004. The programme foresees a large number of support schemes, such as subsidies, state guarantees and co-financing arrangements. The PEP does not provide estimates on their respective effects on growth or on budgetary costs.

The Croatian financial sector is dominated by banks, accounting for 83% of assets. The privatisation of the Croatian banking sector was largely completed by end-2000, followed by further sector consolidation which reduced the number of banks from 53 at end-1999 to 40 in 2004. Almost 97% of banking assets are privatised and 91% are foreign owned. Banks are generally very liquid, well capitalised, and highly profitable. Banking supervision lies within the responsibility of the Croatian National Bank and is in line with relevant EU legislation. The credit risk associated with the high level of euro-isation as well as a generally weak legal framework for the enforcement of creditor rights are potential vulnerabilities to the banking system. The PEP does not report on new reform measures related to the banking sector. With respect to the non-banking financial sector, major policy initiatives concern further alignment of legislation, the promotion of investment funds, and the introduction of an efficient and unified supervision. The 2004 PEP does not give any indication as to the privatisation of the largest insurance company that was repeatedly announced in the past but has not yet materialised.

6.3. Labour market

The 2004 PEP gives a fairly comprehensive overview of the situation on the Croatian labour market. Participation rates are relatively low, unemployment of youth is particularly high, and long-term employment accounts for more than one half of total employment. Recent labour market reforms have introduced incentives for active job seeking and substantially reduced the level of employment protection that has been assessed as one of the most stringent in Europe. These measures are expected to continue to improve the functioning of labour markets, as evidenced by recent increases in employment despite a slight deceleration of growth. Employment subsidies are mentioned as the main financial instrument to enhance employment creation, but the document does not provide details, e.g. on the design and fiscal costs. Unfortunately, the programme lacks a precise description of future measures listed in the structural reform matrix which includes, among others, the setting up of redundancy programmes for companies under restructuring, the implementation of an active employment policy and the institutional strengthening of the Croatian Employment Bureau. During 2003 and 2004, the Croatian authorities have prepared a National Action Plan for Employment, which has not yet been adopted. On social security reforms, the PEP outlines a number of policy objectives, such as enhancing the efficiency and transparency of the social system, but remains rather vague on the nature of policy measures planned to be undertaken. It also remains unclear what is precisely meant by the envisaged de-centralisation and partial privatisation of social welfare activities.

6.4. Other reform areas

Public administration reform is a key priority under the 2004 PEP. A comprehensive strategy of public administration reform has not yet been developed and adopted by the government. The 2004 PEP contains an ambitious agenda of policy measures aimed at improving transparency and efficiency of state administration, including the implementation of a new Civil Service Act. The programme could have elaborated more on specific reform measures envisaged to strengthen institutional capacity relevant for the acquis in the economic and financial domain. In the area of agricultural reform, the 2004 PEP envisages the development of agricultural land markets, the improvement of the cadastre system, the privatisation of agricultural companies and the establishment of institutions required for future participation in the Common Agricultural Policy. Detailed information could have been provided on the development of state support for this sector over the programme period and on the proposed agricultural policy instruments. The programme also foresees continuing work on a Regional Development Strategy that does not yet exist in Croatia. Urgent judiciary reforms that have been delayed for long are another key priority and should help enforcing creditor’s rights and improving the overall business environment. The planned restructuring of the Croatian railways entails the opening of railway infrastructure to domestic and foreign providers of transport services, the division into core and non-core business and the privatisation of the latter. These measures should contribute to enhancing competition and improving the quality and efficiency of passenger and cargo transport services. The 2004 PEP also covers areas such as environmental protection, education and research, tourism, and public procurement.

7. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

7.1. The quality of public finances

The 2004 PEP reports on a number of measures that are principally appropriate to improve the quality of public finance. Public finance reforms are aimed at enhancing fiscal transparency and budget management. This includes the “bringing on budget” of previously off-budgeted items as well as improved budget reporting according to international standards with a view to introducing ESA95 at a later stage. The scope of the Treasury system established in 2000 is planned to be broadened to cover all extra-budgetary funds’ and government’s agencies’ operations. This should result in a strengthening of expenditure control over the medium term. A more efficient public administration is an explicit policy goal of the programme, based on principles such as merit-oriented pay, increased staff competence and a politically impartial civil service. As already mentioned above, a reorientation of public expenditure from current spending on wages, transfers and subsidies towards spending on education, research and development is foreseen. The document does however not provide a quantitative assessment of this planned shift in government spending. The envisaged reform of public procurement is planned to be implemented in 2005 and should also contribute to improving the quality of public finance. The 2004 PEP also foresees continued investments in and maintenance of road infrastructure to improve inter-regional connections. The document leaves open if and to what extent investment costs are planned to be covered by private sources of finance.

7.2. The sustainability of public finances

Croatia has already embarked on pension reforms, which have complemented the pay-as-you-go system through a funded system, consisting of a second (mandatory) and a third (voluntary) pillar. The 2004 PEP envisages parametric reforms with a view to financially strengthening the first pillar. The most important measures in that respect is the planned re-adjustment of the pension formula in 2005 (from wage indexation to a Swiss formula), an increase of the retirement age and the inclusion of previously non-insured groups of employees. Overall, past and planned pension reforms should help curtailing the budgetary implications of an ageing population and should favourably impact on domestic savings, investment and growth, provided that planned reforms are comprehensively and timely implemented.

Table 9 of the Annex provides a projection of the long-term sustainability of public finances over the period 2005-2050; however the text does not explicitly deal with the sustainability of public finance and does not further comment on the table. Total general government expenditure and revenues are projected to gradually decline to around 37-38% of GDP by 2050. Old age pension payments in GDP are projected to increase from 10.8% in 2005 to 12.4% by 2050, while interest and health care payments will slightly be reduced to 1.6% and 7.4% of GDP, respectively. Pension contributions would gradually increase from 7.4% to 8.5% of GDP during the respective period. The main assumptions are a constant long-term potential GDP growth of 4% and a constant growth of labour productivity of 5%. Projections for participation rates are not provided. The unemployment rate, according to the Labour Force Survey, is set to decline substantially from 13.8% in 2005 to 7.0% in 2050.

An important objective under the 2004 PEP is the adoption of a Health Care Development strategy covering the period until 2015, which should guide the completion of privatisation of primary heath care and the rationalisation of secondary health care institutions. In order to enhance the fiscal situation of the health fund, the 2004 PEP foresees a reduction of costs through co-payments for medicine and changes with respect to the fund's coverage of medical treatments. However, quantitative estimates of potential cost savings are not provided.

* * *

Annex table 1: **Structural indicators**

	CROATIA					EU 25				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
General economic background										
Real GDP [1]	2.9	4.4	5.2	4.3	3.8	3.7	1.8	1.1	1.0	2.3
Labour productivity [2]	-1.9	10.4	0.7	4.2	2.2	2.1	0.8	0.8	0.8	1.8
Real unit labour cost [3]	n.a.	n.a.	n.a.	0.3	1.1	0.4	0.4	-0.4	-0.5	-0.9
Real effective exchange rate [4]	103.7	100.0	98.2	95.7	92.6	99.4	101.4	103.5	106.4	108.6
Inflation rate [5]	4.6	3.7	1.7	1.8	2.1	2.4	2.5	2.1	1.9	2.1
Unemployment rate [6]	16.5	16.3	15.2	14.7	14.2	8.6	8.4	8.7	8.9	9.0
Employment										
Employment rate [7]	63.0	62.4	57.6	57.6	57.7	62.5	62.9	62.9	63.0	63.3
Employment rate - females [8]	45.5	44.9	47.4	46.7	47.8	53.7	54.3	54.7	55.1	55.8
Employment rate of older workers [9]	24.2	23.7	26.8	29.0	30.4	36.6	37.4	38.8	40.2	40.5
Long-term unemployment [10]	n.a.	n.a.	n.a.	8.4	6.9	3.9	3.8	3.9	4.0	4.1
Product market reforms										
Relative price levels [11]	n.a.	n.a.	n.a.	n.a.	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	49.6	51.4	49.8	51.7	51.4	:	9.7	9.2	9.0	9.4
Total FDI inflows [13]	5.7	5.9	2.7	6.9	2.6	16.0	7.6	8.3	6.1	3.9
Market share electricity [14]	n.a.	n.a.	n.a.	82.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aids [15]	n.a.	n.a.	n.a.	n.a.	n.a.	0.3	0.3	0.3	:	:
Business investment [16]	21.8	22.3	24.6	27.5	n.a.	18.4	17.9	17.2	16.8	17.0
Knowledge-based economy										
Tertiary graduates [17]	n.a.	n.a.	n.a.	13.1	n.a.	43.2	47.0	49.0	52.2	n.a.
Spending on human resources [18]	4.50	4.20	4.32	4.20	n.a.	4.9	5.1	5.2	n.a.	n.a.
Educational attainment [19]	n.a.	n.a.	90.3	90.7	92.5	76.4	76.2	76.5	76.6	76.7
R&D expenditure [20]	1.23	1.07	1.12	1.14	n.a.	1.88	1.92	1.93	1.95	n.a.
Internet access [21]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	42.0

1. Growth rate of real GDP in %. 2. Growth rate of real GDP per person employed in %. 3. Ratio of compensation per employee to nominal GDP per person employed, total economy, annual percentage change. 4. Vs IC36 (1999 = 100), current year's values are based on consumer's price index deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs).
6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU25) or 50-64 (Croatia) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population aged 15-64.
11. Of private final consumption (EU25=100). 12. average value of imports and exports of goods and services in % of GDP; the value for EU 15 is the total for the Small Member States. 13. In % of GDP. 14. Market share of the largest generator (% of total net generation).
15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Percentage of households who have Internet access at home.

f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value, q: estimated from quarterly values.

Source: Commission services, Croatia's Central Bureau of Statistics.

PRE-ACCESSION ECONOMIC PROGRAMME OF TURKEY

1. SUMMARY AND CONCLUSIONS

On 1 December 2004, the Turkish authorities submitted the 2004 Pre-Accession Economic Programme (PEP) to the European Commission. It covers the 2004-2007 period, and it is Turkey's fourth PEP after the ECOFIN Council of 26/27 November 2000 had expressed its wish for a regular in-depth dialogue with accession countries. The programme largely complies with the requirements of the consolidated outline in terms of content, form and data. However, the PEP does not provide a consistent time series of public finance indicators for the 2003-2007 period, whereby ESA95 standards are used. In view of the objective of the programme, information in the tables should also be provided in EUR and not in only in USD-terms.

The PEP is broadly consistent with other economic policy documents such as the Memorandum related to the new Stand-By Arrangement with the International Monetary Fund (IMF) of May 2005. The medium-term budget 2005-2007 is largely in line with what is indicated in the PEP. The PEP has been formally approved by the "High Planning Board", which consists of the Prime Minister and representatives of key ministries. The structure and content of the Pre-Accession Economic Programme gives proof of a high degree of familiarity with the technical tools and analytical requirements of this exercise.

The new programme takes into account many of the points raised in the assessment of the 2003 PEP and illustrates improving technical and analytical capacities of the Turkish administration. The format and information provided in the programme are to a large extent in line with the requirements. Compared to last year, the current programme is more optimistic with respect to the economic framework and fiscal targets.

As last year, the programme's key objectives during the period 2004-2007 are to strengthen macroeconomic stability and to increase the welfare of the society. Key priorities are to ensure a sustainable growth environment, to reduce inflation and to bring down government deficit and debt ratios to EU levels. Lowering regional differences is also considered to be important in the programme period. These measures are implemented with the perspective of fulfilling the Copenhagen criteria for EU membership. The macroeconomic framework appears both realistic and consistent. The policy mix strongly emphasises disinflation and fiscal sustainability. Monetary and income policies are supposed to support the disinflation process. The floating exchange rate regime will be maintained. The success of this economic scenario strongly depends on a significant improvement in the investment climate, declining real interest rates and continued market and consumer confidence. Access to external sources of finance appears to be of crucial importance for achieving the described growth pattern. The underlying growth scenario of 5% per annum is very similar to the Commission's growth forecasts. The Turkish economy has been booming in 2004, driven mainly by private consumption and domestic investment. The country's fiscal performance has been impressive, with the primary surplus overshooting its target by about 1 % of GDP. Since mid-2004 economic growth has slowed down to more sustainable levels, close to potential output. In particular domestic demand has been softening. Due to this, and in combination with the strong lira, inflationary pressures appear to have further eased. The PEP inflation forecast for 2005-2007 is more optimistic than the Commission forecast, albeit not unrealistic, and conditional upon further wage restraint in the private and public sector.

The widening of the trade deficit needs to be monitored closely. The Commission believes that the deterioration of the trade balance poses a potential challenge to stability in 2005-2007. In spite of the strong tourism revenues, the 2004 current account deficit amounted to USD 15.6 billion (5.1% of GDP), and over one billion more than in the 2004 PEP. Over half of the deficit was financed by portfolio investment inflows. The same PEP 2004 foresees an increase of about 90% in FDI in 2005. Capital movements in Turkey have been fully liberalized.

A strict monetary policy has been an important element in the disinflation process, using base money as a key monetary anchor. During 2002-2003, the Central Bank further improved its perception as an independent institution with the primary objective of achieving and maintaining price stability. The increased confidence of market participants supported the strengthening of the Turkish currency and allowed to gradually reduce benchmark interest rates.

From January 2006 onwards, a formal inflation targeting will be introduced. In its initial stages, the existing framework of base money targets, accompanied by indicative targets on net domestic assets will be retained. These targets will remain under close review. In early 2006, an inflation consultation clause will be introduced. Consequently, the monetary policy committee will assume full responsibility for setting interest rates. Working within the free floating exchange rate regime, the central bank plans to strengthen its net international reserves, and to continue its daily foreign exchange purchase auctions. Furthermore, efforts have been undertaken to reduce the costs of banking intermediation and to diversify the financial instruments available.

In the aftermath of the recovery following the 2001 financial crisis, public finances have improved mainly due to declining interest rates, while current non-interest expenditures remained broadly stable. The general government deficit decreased dramatically from 29.8% of GDP in 2001 to respectively 12.6% and 8.8% in 2002 and 2003 (in ESA 95 terms). The improvement reflects to a large extent a drop in interest rate payments from 18.7% of GDP in 2001 to 14.3% in 2003. Non-interest expenditures remained stable at slightly above 22% of GDP, while tax revenues went up slightly from 21.5% of GDP in 2002 to 23.4% in 2003. The large improvements on the expenditure side combined with the small progress on the revenue side led to a significantly higher primary surplus of 5.1% of GDP (GFS method)[10] in 2003, up from 3.7% in 2002.

The programme presents the government’s structural reform agenda, which mainly focuses on the need to improve the functioning of product and capital markets in order to increase the efficiency and competitiveness of the Turkish economy. Important areas include reforms concerning the labour market, continued restructuring and strengthening of the financial sector, privatisation of state-owned enterprises and policies to improve the investment climate. The programme also outlines measures to increase efficiency and decentralisation of public administration through a broad reform agenda.

The outlined rather ambitious reform agenda has a clear focus on alignment with EU regulations as well as on reforms to improve the functioning of the Turkish economy and seems well in line with goals under the Lisbon agenda. Initiated or near-term reform efforts are outlined in the programme while the degree of future policy commitment and in particular the

[10] The table on general government revenues and expenditures seems to be aggregated according to the GFS standard. A presentation in ESA 95 might have indicated much higher primary surpluses.

timing of envisaged reforms are rather vague, especially beyond 2005. The budgetary impacts of reforms are only presented for some areas and the numbers are not always presented in detail.

The section on fiscal issues gives a good summary on how the Turkish authorities intend to rebalance public finances and to maintain fiscal sustainability. However, a more detailed presentation of expenditure and revenue categories, whereby they use the ESA95 definition, would have been helpful. The achievement of the fiscal objectives relies to a large extent on maintaining a significant primary surplus and on benefiting from declining interest rates.

It can thus be concluded that:

- The Pre-accession Programme 2004 covering the period 2004 to 2007 aims to sustain the process of catching-up by reducing budgetary deficits and general government debt and continuing the process of structural reforms. The programme largely complies with the requirements of the consolidated outline in terms of content, form and data. It is a useful medium-term framework for economic policy in Turkey on its way to EU accession and is broadly consistent with other strategic documents, such as the IMF programme.
- Macroeconomic performance in 2004 turned out better than expected with buoyant growth, declining inflation and a lower than expected budget deficit. However, the current account deficit is substantially higher than in 2003. This trend of rising external imbalances needs to be closely monitored. The PEP 2004 forecasts a significant shift in the composition of the capital account, whereby FDI would start to replace portfolio investment as the main financing item as from 2005. The overall macroeconomic scenario until 2007 is plausible although further improvements in its methodological basis could be made.
- The public finance scenario of a gradual reduction in the budget deficit is adequate in its target, albeit somewhat optimistic. However, a tighter fiscal stance would further alleviate the potential risks to the external balance.
- The structural and institutional reform agenda presented in the programme is overall adequate. Implementation of the reform agenda has been proceeding in areas such as banking sector reform, public administration reform and improvements of the investment climate. However, the remaining reform agenda is vast, and several measures outlined in the 2003 PEP have been delayed. The presented budgetary impact of reforms is not comprehensive in its scope. Further reform efforts are particularly important in the area of privatisation and in the area of the functioning of the labour market.

2. JOINT MINISTERIAL CONCLUSIONS

"On 12 July 2005, the Economic and Finance Ministers of the EU and the acceding and candidate countries, along with representatives of the Commission and the European Central Bank and representatives of the Central Banks of the acceding and candidate countries, met for their seventh economic policy dialogue meeting.

...

Ministers welcomed the 2004 Pre-accession Economic Programmes of the two candidate countries. Ministers endorsed the following conclusions as regards the assessment of these programmes:

...

Turkey

1. *The improvement of this year's programme was welcomed as it incorporates many of the suggestions made in the assessment of the 2003 PEP. It illustrates improving technical and analytical capacities of the Turkish administration. The format and information provided in the programme are to a large extent in line with the requirements.*
2. *The macroeconomic performance in 2004, with buoyant growth, declining inflation and a lower than expected budget deficit, is welcome. However, the current account deficit was substantially higher than in 2003. The external imbalances need to be closely monitored. The overall macroeconomic scenario until 2007 is plausible although further improvements in its methodological basis could be made.*
3. *The public finance scenario of a gradual reduction in the budget deficit is adequate in its target, even somewhat ambitious. However, a tighter fiscal stance would further alleviate the potential risks to the external balance. Moreover, the main fiscal risks, although reduced considerably compared to the last PEP, remain related to the relatively high level of debt and its sensitivity to interest rate and exchange rate fluctuations.*
4. *Progress has been made on structural reforms, in areas such as banking sector reform, public administration reform and improvements of the investment climate. However, the remaining reform agenda is vast, and several measures outlined in the 2003 PEP have been delayed. Further reform efforts are particularly important in the areas of fiscal sustainability (in particular the attainment of the primary surplus target agreed with the IMF is essential for underpinning macroeconomic stabilisation), privatisation, the business environment, and the functioning of the labour market.*

In view of the above assessment, Ministers were of the opinion that Turkey needs to continue improving its macroeconomic situation – mainly inflation, government deficit, debt level and current account deficits. Maintaining a focus on enhanced price stability and further disinflation is of the utmost importance in the coming years. Turkey also needs to focus on sustainability of public finances, advance privatisation and reform the labour market and the agricultural sector.

3. INTRODUCTION

The Turkish authorities submitted the 2004 Pre-Accession Economic Programme (PEP) covering the period 2004 to 2007 to the European Commission on 1 December 2004. It is Turkey's fourth PEP since the ECOFIN Council of 26/27 November 2000 which expressed its wish for a regular in-depth dialogue with accession countries. The programme largely complies with the requirements of the consolidated outline in terms of content, form and data. The PEP is broadly consistent with other economic policy documents such as the Memorandum related to the new stand-by arrangement with the International Monetary Fund (IMF) of May 2005. The budget 2005-2007 is largely in line with the PEP assumptions.

Like in previous years, the Pre-accession Economic Programme has been prepared under the leadership of the State Planning Organisation, including contributions from and consultations with all relevant institutions, in particular the Treasury, the Ministry of Finance, the Ministry of Agriculture, the Central Bank, the Privatisation Agency, the Banking Regulation and Supervision Agency, etc. The document has been formally approved by the "High Planning Board", which consists of the Prime Minister and representatives of key ministries.

Increasing welfare of the society will continue to be the main objective of the economic policy during the period of 2004-2007. To this end, along with strengthening macroeconomic stability, further improvement of the current social policy implementations will be possible.

The main perspective in determining economic policy in the process of EU accession, is the further improvement of the economic structure in the context of Copenhagen economic criteria, with an ultimate aim of achieving convergence towards the Maastricht criteria. The basic priorities of Turkey's macroeconomic policies during PEP 2004 period, are to reduce inflation permanently, to bring the ratio of the public deficits and public debt stock to GDP closer to the EU averages and to establish a sustainable growth environment in the economy, as it was the case under the PEP 2003.

4. MACROECONOMIC DEVELOPMENTS

4.1. Recent macroeconomic developments

The report presents a clear and concise picture of economic developments in 2002 and 2003. With respect to 2004, the document covers all relevant data available by late November. Compared to last year, the presented data is slightly more detailed.

The Turkish economy experienced a rapid recovery after the sharp recession of 2001. Real GDP grew by respectively 5.8% and 8.9% in 2003 and 2004. The recovery in 2002-2003 was mainly driven by exports and restocking, while domestic demand remained weak. In 2004, private consumption and private gross fixed capital investment growth accelerated dramatically. The broadening of the recovery was supported by production indicators, in particular industrial output and capacity utilisation.

Inflationary pressures have declined gradually since 2002. Important factors for this development were increased confidence, in large part due to strict and consistent monetary and fiscal policies, and a strong exchange rate. Furthermore, moderate public sector wage agreements helped to strengthen credibility of the government's disinflation programme. Observed high growth rates did not immediately lead to additional job creation. Unemployment even increased from 10.3% in 2002 to 10.5% in 2003, while employment declined by 1.0% in the year to 2003. Rural unemployment rates remained significantly lower than in urban areas, largely due to the widespread practise of unpaid family workers in agricultural areas. Since mid-2004, however, statistics started to suggest that the recovery in the real sector has begun to show its effects on employment. In the second quarter, jobless rates fell to 9.3% with participation rates steady –albeit very low compared to the incumbent EU-Member States- at 49.2%

Table 1: **Comparison of key macroeconomic and budgetary projections**

		2003	2004	2005	2006	2007
Real GDP growth	COM	5.8	7.7	5.0	5.1	n. a.
(% change)	**PEP**	**5.8**	**9.6**	**4.8**	**5.1**	***5.1***
Consumer price	COM	25.3	10.6	8.7	6.4	n. a.
inflation (%)	**PEP**	**25.3**	**10.7**	**9.6**	**6.1**	***4.5***
General government	COM	-9.7	-3.9	-3.9	-3.0	n. a.
balance (% of GDP) (*)	**PEP**	**-10.1**	**-6.3**	**-4.4**	**-2.1**	***-0.5***
Primary balance	COM	n. a.	n. a.	n. a.	n. a.	n. a.
(% of GDP) (*)	**PEP**	**-6.7**	**-7.8**	**-7.5**	**-7.2**	***-7.0***
Government gross	COM	87.2	80.8	75.9	71.9	n. a.
debt (% of GDP) (*)	**PEP**	**80.2**	**78.4**	**75.3**	**72.2**	***68.3***

(*) PEP data for public finances use GFS definition; COM forecast is done in ESA 95.

The current account deficit widened significantly from 0.8% of GDP in 2002 to 3.3% of GDP in 2003 and 5.1% of GDP in 2004, reflecting very strong imports due to the acceleration of economic activity – in part due to pent-up demand- and the high import content of exports and restocking. In 2004, the external balance continued to deteriorate. Despite a strengthening of the exchange rate, Turkish exports managed to increase their share in global markets and to raise their share of higher value added commodities in total exports. Tourism revenues reached a record high in 2004.

A strict monetary policy has been an important element in the disinflation process, using base money as a key monetary anchor. During 2002-2003, the Central Bank could further improve its reputation as an independent institution with the primary objective of achieving and maintaining price stability. The increased confidence of market participants supported the strengthening of the Turkish currency and allowed to gradually reduce benchmark interest rates. Furthermore, efforts have been undertaken to reduce the costs of banking intermediation and to diversify the financial instruments available. The Central Bank maintained the free floating exchange rate regime and limited its interventions to the smoothening of sharp fluctuations. In addition, it used the strength of the Turkish currency to increase its foreign exchange reserves.

Public finances improved mainly due to declining interest rates, while current non-interest expenditures remained broadly stable. The ESA 95 general government deficit decreased dramatically from 29.8% of GDP in 2001 to respectively 12.6% and 8.8% in 2002 and 2003. The improvement reflects to a large extent a drop in interest rate payments from 18.7% of GDP in 2001 to 14.3% in 2003. Non-interest expenditures remained stable at slightly above 22% of GDP, while tax revenues went up significantly from 21.5% of GDP in 2002 to 23.4% in 2003. The large improvements on the expenditure side combined with progress –even though less spectacular-on the revenue side led to a significantly higher primary surplus of 5.1% of GDP (GFS method)[11] in 2003, up from 3.7% in 2002.

[11] The table on general government revenues and expenditures seems to be aggregated according to the GFS standard. A presentation in ESA 95 might have indicated much higher primary surpluses.

4.2. Macroeconomic scenario

Like in previous years, the Turkish authorities have presented a comprehensive economic framework for the period 2004-2007. The main policy priorities are to ensure a sustainable growth environment, reducing inflationary pressures and bringing public sector deficit and debt ratios to EU averages. Key instruments in this respect are the strengthening of the market economy and the improvement of competitiveness by reducing state influence and the establishment of independent regulatory agencies. The key objective of monetary policy is to support price stability. Base money is the central aggregate to influence monetary developments in the economy. The PEP 2004 explains in quite detail how implicit inflation targeting will be, in the near future, replaced by explicit inflation targeting for achieving and maintaining price stability. In contrast with last year in the PEP 2003, an in-depth presentation on the implementation strategy has been included without, however, any precision on the date of introduction. With respect to exchange rate policy, the programme envisages the continuation of the current free floating exchange rate regime. Income policy will use inflation

Table 2: **Comparison of macroeconomic developments and forecasts**

	2003		**2004**		**2005**		**2006**		**2007**	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	5.8	**5.8**	7.7	**9.6**	5.0	**4.8**	5.1	**5.1**	n. a.	**5.1**
Contributions:										
- Final domestic demand	5.9	**5.9**	13.6	**9.7**	7.7	**3.9**	7.0	**4.5**	n. a.	**4.4**
- Change in inventories	3.0	**3.0**	0.0	**1.3**	-1.0	**-2.4**	-1.0	**-0.9**	n. a.	**-0.2**
- External balance of goods and services	-3.1	**-3.1**	-6.0	**-1.4**	-1.7	**3.3**	-0.9	**1.5**	n. a.	**0.9**
Employment (% change)	-1.0	**-1.0**	2.0	**2.4**	2.0	**2.5**	2.0	**2.5**	n. a.	**2.5**
Unemployment rate (%)	10.5	**10.5**	10.3	**10.0**	10.0	**9.8**	9.6	**9.6**	n. a.	**9.3**
GDP deflator (% change)	26.8	**22.5**	10.0	**8.2**	8.9	**7.9**	6.0	**6.4**	n. a.	**4.5**
CPI inflation (%)	25.3	**25.3**	10.6	**10.7**	8.7	**9.6**	6.4	**6.1**	n. a.	**4.5**
Current account balance (% of GDP)	-2.9	**-2.2**	-5.3	**-3.4**	-4.0	**-2.3**	-4.0	**-2.0**	n. a.	**-1.8**

Sources: Pre-Accession Economic Programme (PEP); Commission services Autumn 2004 forecasts (COM)

targets as guideline for public sector wage settlements. In an attempt to improve the personal income distribution, pensions of low-income groups have been raised. In order to strengthen the private sector wage bargaining process, the current social dialogue in the framework of the Economic and Social Council will continue.

As in previous years, the quantitative framework for the period 2004-2007 is well presented and contains detailed information on key variables. The link between the macroeconomic framework and the impact of structural reforms described in sections 3 and 4 has been elaborated on, but still deserves more attention. The programme's external assumptions are in line with international forecasts, including the EU Commission's Spring 2004 forecast. Compared to these forecasts, the Turkish programme is somewhat more optimistic with respect to world import prices. The assumption on the EUR/USD exchange rate is based on the one in the Commission's Autumn 2004 forecast.

Real sector

The real sector scenario used in the programme is broadly in line with the Commission Spring 2005 forecast. Both sources assume that the Turkish economy will grow at rates - close to potential -of around 5% per annum through the programme period, mainly driven by private consumption and domestic investment, and with a negative contribution from the external balance. Job creation is expected to be modest. The disinflation process is set to continue. The current account deficit falls from a peak in 2004, mainly due to strengthening exports of goods and services.

The economic background of the 2004 PEP is characterised by slightly stronger output growth , and a more dramatic slowdown –which has already started in the third quarter of 2004 to 4.8% in 2005 and 5.1% during the remaining programme period.

Based on 2 of the 3 different methods used to calculate potential output, the programme expects that the economy will has reached potential output in 2004 and will remain close to potential in 2005-2007. Interestingly enough, no rising inflationary pressures are expected from this growth pattern. The main reasons for the favourable growth performance are the effects of structural reforms. Compared to the 2003 PEP, the current programme has largely maintained the GDP growth profile for 2004-2007. For 2004, it is more optimistic, based on a better then expected output performance realised. Concerning the sources of growth, the 2004 programme shows a stronger reliance on investment and private consumption, while the expectations concerning private and public consumption and imports are more cautious. This growth pattern is largely plausible, given the negative impact of the strict fiscal policy on public consumption and disposable income. Furthermore, the programme appears to be reasonable in assuming a positive effect of decreasing interest rates, declining economic volatility and the diminishing crowding out of private investment through public sector borrowing on private investment. However, the high growth rates of imports observed in 2004 would have deserved a more detailed explanation. Although pent-up demand was certainly an important factor behind the sudden increase in imports of durable goods, the high import content of investment and exports could be elaborated upon. Furthermore, a reference to the likely implications of this growth profile on government revenues would have been appreciated.

Regarding the contribution of the various production factors to economic growth, Turkey's output appears to have been mainly driven by capital, contributing 73% to total growth during 1990 – 2000 and even by 87.3% in 2001-2003. The share of labour has been 23.5% in 1990-2000, and swapped to a negative contribution of 23% in 2001-2003 following the 2001 financial crisis. The increase in total factor productivity has been respectively 3.3% and 35.6% in 1990-2000 and 2001-2003. During the remaining programme period, this distribution is expected to become more even, with the share of capital accumulation in growth generation reaching a share of 31.1% on average during 2004-2007, the share of employment 25.2% on average and that of total factor productivity 43.7%. The increase in the investment ratio from 21.3% of GDP in 2002 to 25% in 2007 will be increasingly financed by domestic savings, reflecting increased confidence in economic stability.

As a result of strong capacity increasing investment, the programme is rather optimistic concerning employment generation, expecting an average employment increase of about 2½% each year. However, an increase in the labour force will limit the decline in unemployment.

External sector

Turkey's current account balance has significantly deteriorated in the aftermath of the 2001 financial crisis. For the programme period, a decrease in the current account deficit is expected. The main reasons for this scenario are optimistic assumptions on the growth of merchandise exports and tourism revenues. The expected volume of workers remittances is forecasted to stabilize around USD 1 billion. As a result, the current account deficit is expected to decline from around 5% of GDP in 2004 to 3% in 2007. The programme is not very clear about the expected structure of the financing of the current account gap. However, the programme expects no difficulties in financing the current account deficit, despite considerable repayment obligations towards the IMF, amounting to about EUR 8 billion during 2005-2007.

In addition to the baseline scenario, the programme presents two alternative scenarios, analysing the effect of lower than expected external demand and of missing the inflation targets. In the trade shock scenario, exports in 2005 are expected to be 1% of GDP (about EUR 2.5 billion or less than 5% of total export values) below the base line scenario. As a result of the high import content of exports, the impact on GDP growth and the current account is significant in the first year (GDP growth would fall by just under 2%), but very limited in the remainder of the programme period. As last year, the programme also contains a brief discussion of possible factors negatively affecting the disinflation path, such as the deviation from fiscal discipline, unexpected developments in the exchange rate and oil prices etc. However, no further quantification has been included in the PEP 2004.

4.3. Monetary and exchange rate policy

The key objective of monetary policy is to ensure price stability, or –in other words- to support the disinflation process. At present, the central bank is using base money and short-term interest rates as main policy tools. Clearly specified floors and ceilings for monetary aggregates, such as net domestic assets and net international reserves, are key orientation marks in this respect. The central bank is ready, both technically and institutionally, to switch to an explicit inflation targeting and will do so as soon as an agreement is reached with all parties involved on the process of monetary policy decisions, more specifically on sharing information with the public. As requested in last year’s PEP assessment, a more detailed roadmap on this shift was included this year.

The exchange rate policy is characterised by a free float. The only interventions made aim at smoothening excessive exchange rate volatility. Based on reversed currency substitution and a strong balance-of-payments situation, the programme implies a real appreciation of the exchange rate during 2004-2006. This should support the disinflation process. Turkey has successfully introduced its new currency, the new Turkish Lira, on 1 January 2005 (see Box 1). In tandem, they have aligned their CPI with actual consumer spending, thereby using 2003 as a base year. First indicators point at no –or very little- additional pressures stemming from the latter operations.

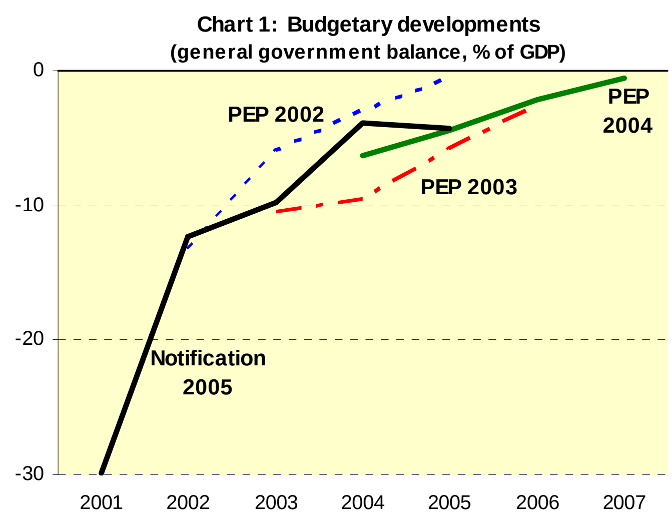
Inflation came down substantially from around 30% in 2002, to 18.4% at the end of 2003 and single digits from September 2004 onwards. The most important factors that contributed to this fall achieved in inflation are the increased confidence in the economy as a result of the strict monetary and fiscal policies that were implemented and therefore the steady decline in inflationary expectations. The incomes policy implemented under the programme was another important factor which contributed to the decline in inflation.

The envisaged permanent reduction in chronic inflation aims at converging towards EU averages by the time of accession. The Central Bank has been implementing an implicit inflation targeting regime, in order to achieve its targets. It intends to shift to formal (explicit) inflation targeting policy in January 2006.

5. Budgetary targets and the medium-term path of the public finances

5.1. Programme overview

The overall objective of Turkey's fiscal policy is to contribute to the establishment of a sustainable growth environment and at the same time to support the disinflation process. Achieving substantial primary surpluses appears to be the main fiscal tool in this respect, contributing to disinflation and debt sustainability. As last year, the document does not describe in great detail how to achieve those targets. The presentation of the public finances would have gained significantly by discussing the various measures and their impact on the presented objectives. Main revenue-related measures are an improving of efficiencies in tax collection and a broadening of the tax base. On the expenditure side, the emphasis is on reducing public sector employment and to raise the efficiency of the current expenditure system. Unfortunately, like last year, no quantitative estimates of the budgetary effects of the described measures are given.



The programme foresees an increase in the general government fixed capital formation, from 3.4% of GDP in 2004 to 3.9% in 2005-2007. No further information is given on how those additional expenditures are supposed to be used. Furthermore, more details on plans to improve the quality of public investment would have been useful.

Compared to the 2003 PEP, the 2004 document expects a higher primary surplus and a faster decline of general government net borrowing. The main reason is a more optimistic assumption on the decline in interest payments and the expectation of a declining share of revenues. As a result of a lower government lending and higher growth recorded in 2004, the debt ratio declines faster than in the 2003 programme. Like last year, the detailed tables on public sector finances are not in line with ESA 95 standards.

The programme appears realistic, in particular since real interest rates are falling faster than anticipated in a context of high growth.

Table 3: **Composition of the budgetary adjustment** (% of GDP)

	2003	**2004**	**2005**	**2006**	**2007**	**Change: 2004-07**
Revenues	42.7	43.4	44.5	44.1	43.7	0.3
of which:						
- Taxes and social security contributions	33.0	33.8	35.1	35.1	35.2	1.4
- Other (residual)	9.7	9.6	9.4	9.0	8.5	-1.1
Expenditure	52.8	49.7	48.9	46.2	44.2	-5.5
of which:						
- Primary expenditure	36.0	35.6	37.0	36.9	36.7	1.1
of which:						
Gross fixed capital	3.7	3.4	3.9	3.9	3.9	0.5
Consumption	17.9	17.7	17.5	17.4	17.3	-0.4
Transfers & subsidies	12.5	12.6	12.8	12.7	12.5	-0.1
Other (residual)	1.9	1.9	2.8	2.9	3.0	1.1
- Interest payments	16.8	14.1	11.9	9.3	7.5	-6.6
Budget balance	-10.1	-6.3	-4.4	-2.1	-0.5	5.8
- Cyclically adjusted	-10.6	-8.9	-6.3	-3.9	-2.1	6.8
Primary balance	6.7	7.8	7.5	7.2	7.0	-0.8
Gross debt level	80.2	78.4	75.3	72.2	68.3	-10.1

Sources: Pre-Accession Economic Programme (PEP), ECFIN calculations

The 2004 programme comprises for the second time cyclically adjusted budgetary balances. The results point at a relatively high share of the structural component in the Turkish fiscal performance, which, however, has started coming down after 2002 due lower interest rates in combination with high primary budget surpluses. The calculations also indicate that the growth of the Turkish economy during most of the programme period is very close to potential. However, given the strong volatility in the last decade, it is very difficult to assess the present cyclical position of the Turkish economy.

5.2. Targets and adjustment

According to the PEP 2004, the general government deficit amounted to 6.3% of GDP in 2004, which compared very favourably with the 2004 projection of 9.5% of GDP (in the 2003 PEP). Stronger than anticipated economic growth –which also led to more receipts- and a faster fall in real interest rates largely explain the difference.

In 2005, a general government budget deficit of 4.4% of GDP is targeted. This is broadly in line with the 2005-2007 medium term fiscal framework, which underpins the new IMF-Stand By Agreement.

The key objective of the medium-term fiscal framework is achieving substantial primary surpluses during the whole programme period of 7.8% in 2004 and decreasing gradually to 7% of GDP in 2007.

The share of general government revenues in GDP is expected to decline during the programme period, reflecting the phasing out of a number of temporary revenue measures and the effect of additional fiscal measures promoting investment. To some extent, these revenue-reducing measures will be compensated by the intended widening of the tax base and the improved efficiency of tax collection. Overall, general government receipts are expected to range between 43.5 and 44.5 percentage points of GDP during 2004-2007. In contrast with previous years, no straightforward reduction in the tax burden is foreseen.

A significant fall in general government expenditure is programmed in relative terms, from just under 50% of GDP in 2004 to 44% in 2007. The main driving forces for this foreseen decline are reductions in public sector employment and the effects of efficiency increasing measures. The largest contribution to the decline in total general government expenditures, however, is stemming from a decline in interest payments, decreasing by nearly 7 percentage points of GDP, from 14.1% of GDP in 2004 to 7.5% in 2007.

5.3. Debt developments

The programme sets out the institutional arrangements for the management of public debt and describes the Law on Public Finance and Debt Management from April 2002, which regulates debt management and introduces borrowing limits. The debt ratio is expected to fall due to declining interest rates and primary surpluses of over 7% of GDP throughout the 2004-2007 period. Consequently, interest payments are programmed to fall gradually from 16.8% in 2003 to 7.5% in 2007. Furthermore, the sustainability of the public debt will be improved by measures to lengthen the debt maturities, to diversify financial market instruments and to provide for liquidity reserves. For improving the management of contingent liabilities, the treasury will apply an active risk management strategy. In order to strengthen the transparency of debt management, a single borrowing authority has been determined and stricter rules of debt management have been introduced. Risk accounting has been established. In view of improving transparency, public debt management reports are now published on a quarterly basis and the responsible minister presents an annual special report to parliament and to the budget commission. In line with the programme, the gross debt level is expected to fall continuously and rapidly, from 80.2% of GDP in 2003 to 68.3% in 2007.

Various sensitivity analyses were presented. One examined the sensitivity of public finances with respect to growth and higher interest rates. The growth shock scenario itself is split into two sub-scenarios, one assuming a reduction in public expenditures, while the other assumes public expenditures to remain constant in nominal terms. A separate sensitivity analysis focuses on the debt stock dynamics. According to the PEP 2004 calculations, the debt situation appears to be sustainable. The most critical scenario is the one assuming growth to be one percentage point lower and real interest rates to be 5 percentage points above the baseline scenario, whereby the gross debt level would remain broadly constant at just under 80% throughout the programme period.

6. STRUCTURAL REFORMS

6.1. Programme overview

The 2004 programme presents a rather ambitious structural reform agenda outlining present and planned policy measures in a wide range of areas. The areas covered are similar to the 2003 PEP and the programme gives a fairly good overview of implemented measures and activities under progress. However, in many cases the programme provides limited information on clear strategies and actions beyond 2005 as well as limited information about envisaged time frames for reforms. The programme mainly focuses on reforms aiming at improving the functioning of markets, in particular reforms in the areas of labour markets, product and capital markets, privatisations and improvements in the investment climate. This is in line with the conclusions in the Commission's 2004 Regular Report on Turkey where deficiencies were noted in the functioning of the Turkish market economy. Some areas of reforms are also linked to the issue of fiscal sustainability (such as reforms of the health care and social security systems) and the harmonisation with EU regulations and practices.

The financial link and budgetary impact of the presented measures are in most areas vague, which can partly be explained by the fact that future strategies and time schedules are vague as well. In some cases, such as for labour markets, agricultural policies and social security, attempts are made to estimate budgetary effects of policies over the programming period (see table 4). Apart from agricultural support (where direct support to farmers is included and which equals about 0.65% of GDP for 2004) the presented budgetary impacts are very small. It is however unclear if this reflects the true fiscal impact of reforms since many areas have been left out or may not be fully accounted for. The policy matrix presented in the programme gives a fairly good overview of what has been achieved in terms of structural reforms and which measures have been initiated, but gives less guidance on planned measures.

Table 4: **Net budgetary impact of key reforms (EUR million if not other stated)**

Description of policy	**2004**	**2005**	**2006**	**2007**
1. Labour market	-553.4	-663.5	-703.2	-650.0
2. Agriculture[12]	-1590.5	-1517.5	-227.1	-263.3
3. Regional development	-1.4	-13.5	-123.8	-137.6
4. Health care and social security	-6.0	-74.0	-223.7	-260.8
Total budgetary impact)	-2146	-2268	-1054	-1312
Total budgetary impact (% of GDP)	0.87	0.83	0.3	-

Sources: Pre-Accession Economic Programme (PEP), ECFIN calculations

The fulfilment of the agenda outlined in the 2003 PEP has for most areas been fairly good but delays or changed plans have been recorded in others. Privatisation is one key area where targets outlined in the 2003 PEP were not met, although some progress was noted in the course of 2004. In the areas of competition policies and improvements of the investment climate, the

[12] For 2004 and 2005 all investments and direct transfers to be made under the Agricultural Reform implementation Project is included.

creation of some envisaged institutions were cancelled or delayed. However, in these fields progress was noted on a number of other issues such as attempts to reduce bureaucracy and increase the protection of property rights. Reforms and restructuring of the banking sector proceeded although state owned banks continue to be a source of distortions in the sector. The large reform agenda linked to public administration also moved forward although implementation has so far in most areas been limited.

Improving market conditions and the preparatory work already achieved has improved prospects for successful implementation of some previously difficult reforms such as privatisation. However, the programme is vague on expectations in terms of time frames. Strong political support (and in some cases strong market confidence) will be crucial for successful implementation. The large scope of the reform agenda may also put a strain on public administration and delay the process. In some areas a clearer prioritising of reform efforts could be beneficial.

6.2. Product and capital markets

The aim of reforms concerning product and capital markets is to strengthen the market economy and entrepreneurship, and the economy's overall efficiency and competitiveness. Improving the functioning of product markets is mainly addressed through privatisations, competition policy and improvements of the investment climate. Privatisation has been on the Turkish reform agenda for the last two decades but progress has overall been rather limited. Efforts have increased over the last years, but negative market conditions and the at times insufficient political determination have hampered the process. Privatisation receipts were far below projections in 2002 as well as in 2003 although privatisation did pick up during 2004.

The framework for privatisations outlined in the 2004 PEP is similar to the presentation in the previous programme, with the same sectors targeted for privatisation. However, the programme does not clearly show what has been achieved during the year in terms of privatisations, while one can note that several planned privatisations failed or were cancelled during 2004. The 2004 PEP outlines relaunches of the privatisation processes for a number of high profile companies such as Turk Telekom, Turkish Airlines and PETKIM (Petrochemical Corporation). The initial steps towards the privatisation of the Turkish Electricity Distribution Company (TEDAS) have also been taken with the tender planned to be launched in 2005 and the privatisation completed by 2006. The programme gives a historic overview of privatisation receipts and revenues, which shows that the net positive inflow from privatisations has been very limited. No attempts are made to estimate future privatisation receipts. The scope of the privatisation scheme seems appropriate, however in the light of previous delays the question which remains is the speed of the process. Improving market conditions and lessons learned from previous failed tenders should facilitate sales in the envisaged areas. However, success also requires strong political will and continued improved investor confidence.

In the area of competition law and policy, the programme describes important improvements to the legal framework but gives very limited insight into future planned measures. The establishment of a body coordinating and controlling state aid practices, which was envisaged in the 2003 PEP to be in place already at the end of 2003, has been delayed and no time table for its creation is presented in the 2004 programme.

The programme also emphasises reforms aiming at improving the overall investment climate, in particular in the light of the traditionally low inflows of FDI. Despite a now liberal legislative framework, businesses are hampered by, for example, complex bureaucracy and an inadequate protection of property rights. The PEP describes the main framework for reforms (accepted in December 2001) under which technical committees in a large number of fields have been set up and it outlines several measures which have been initiated or implemented to address relevant shortcomings. These include improvements in the capacity of the Turkish Patent Institute, the approval of an SME strategy and attempts to simplify the bureaucratic procedures concerning sectoral licencing. These measures seem to focus on some of the most urgent areas of reform although the details of implemented measures are difficult to assess. However, reforms are needed in a wide range of areas and a description of future strategy and plans is not provided. The Investment Advisory Council, which has recently been established to advise Turkey on necessary reform measures and which consists of high level executives from different countries, should be an important additional instrument to help Turkey adopt the right priorities concerning future reform efforts in this field. In the 2003 programme, an Investment Promotion Agency was envisaged to be soon established, but plans have changed and such an institution is not included in the 2004 PEP.

As regards the financial markets and in particular the banking sector, substantial restructuring has taken place and reform efforts continued in 2004, largely in line with the measures outlined in the 2003 PEP. A limit in the deposit guarantee system was introduced, the Savings Deposit Insurance Fund (SDIF) and the Banking Regulation and Supervision Agency (BRSA) were separated and some measures to reduce banking intermediation costs were implemented, although further cost reducing measures are envisaged in the 2004 programme. Banks balance sheets have continued to strengthen, although this is also a consequence of improved market conditions. However, progress on the privatisation of state-owned banks has been very limited and privatisations foreseen in the 2003 PEP failed to materialise. The state-owned banks are a source of distortion in the banking sector and a change of ownership structure is important for the future growth and development of banking activities. The 2004 programme does not outline any timetable for the privatisation agenda. Given previous delays and the problems attached to privatising the state-owned banks, it is likely to remain a difficult area for reforms. To further strengthen the regulatory framework, the 2004 programme foresees the adoption of a number of legal measures which should help bringing banking legislation closer to international standards. However, the programme focuses on measures during 2005 and does not provide a more medium-term agenda for banking sector reforms. Concerning the area of capital markets, planned measures until 2007 are more clearly outlined and a strong focus on compliance with EU regulations can be noted. Also for the insurance market the programme aims for alignment with EU regulations.

6.3. Labour market

The programme identifies certain weaknesses of the Turkish labour market, such as a low participation and employment rate (particularly among women), a high level of informal employment and low labour productivity. In addition, increasing competition in the agricultural sector is creating an outflow of workforce from rural to urban areas, potentially increasing overall unemployment. These weaknesses have been accentuated over the last years and labour market imbalances have increased. The measures proposed to address these issues are mainly in the areas of education, active employment policies and support for rural development and SMEs. Although these areas are highly relevant, measures targeting directly the problems of the high level of informal employment and the relatively inflexible labour market are not explicitly mentioned and could have been appropriately included in the programme.

In the field of education, the programme foresees budgetary expenditure on basic education rising by 30% between 2004 and 2006. Since educational levels are still comparatively low, this seems well motivated. However, an outline of measures and planned budgetary impacts, if any, for other levels of education, such as secondary and higher education (as was done in the 2003 PEP) would have been useful as these should also be areas of priority for improvements. In terms of active employment policies, only a few measures are outlined in the programme, such as social support projects to dampen the effects of privatisations and an active labour programme which is partly EU funded. Anticipated spending on these types of projects only constitutes 1% of total commitments in the area of labour market (including education). However, the programme also foresees continued preparation of a National Employment Strategy, which for example will include strategies on how to enhance employability and how to facilitate access to the labour market for disadvantaged groups. Since the submission of the PEP, the Commission and Turkey has also started drafting a 'Joint Inclusion Memorandum' which sets out the main challenges and policy priorities in the fields of social protection and social inclusion including the commitment to concrete follow-up actions.

6.4. Other reform areas

The programme outlines a broad administrative reform agenda, including the restructuring of public administration, review and reorganisation of the functioning of government and reform of local administrations among other areas. Special focus is also given to improved financial management concerning SEEs and efforts to increase fiscal transparency through improvements in accounting and reporting standards. The programme gives a fairly comprehensive overview of the problems facing the public administration. The changes will mainly aim at creating a smaller and more efficient administration and to increase transparency. The Turkish public sector is not large by international standards, but the structures are partly ill suited for the changing conditions of the Turkish economy and society. Plans to modernize it are therefore important in the overall reform context. Since the 2003 PEP, a law on the principles of the restructuring of public administration which aims at decentralisation and at simplifying decision making has been passed by parliament. Several other laws are in the stage of adoption or are planned to be adopted. However, implementation, in particular at the local level and concerning decentralisation, will be key to the success of reforms. Any expected budgetary impacts of the performed of planned reforms has not been outlined.

Other areas on which the programme focuses are the health care and social security systems. The two systems demonstrate various structural problems and are under funded. Reforms carried out in 1999 did not produce the expected positive results. The 2004 programme outlines a new round of reform efforts, which includes a draft of the reform of the social security system and planned reforms of the general health insurance aiming at increasing efficiency and the coverage of the population. Reforms concerning social aid and services are also foreseen. Given the present trend of growing expenditure on health care and social protection, reforms to make the systems financially sustainable and more efficient is important. However, since the reforms are not described in detail, their impact and appropriateness is difficult to assess. The presented budget effects of reforms do not include any estimates of costs for social security reforms, even though this might be explained by potential costs occurring after the programming period.

Several issues are also planned to be addressed in the areas of agricultural and rural reforms, for example reforms on the implementation of the direct income support to farmers and reforms in the fields of phytosanitary and plant production. Although many measures and actions are foreseen in order to meet EU commitments (e.g. food safety, organic farming, preparation of rural development plan, FADN, animal identification system), the proposal does not give adequate information on how Turkey intends to deal with the difficult situation posed in rural areas (with regards for instance to unemployment, unpaid employment, illiteracy, low levels of human capital, poor opportunities for non-agricultural employment, and low levels of health and quality of life).

Other areas covered in the programme include regional development, information and communication technologies and reforms in the areas of transportation and energy.

7. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

7.1. The quality of public finances

In the past, the Turkish government has often turned to ad hoc measures to achieve its targets. The programme states that, in order to reduce the need for such practices in the future, efforts to widen the tax base, better capture the unregistered economy, and decrease the number of tax exemptions will be intensified.

Efficiency considerations are considered to be the main priority in public expenditure policies. Conversely, the Turkish authorities have embarked in an ambitious reform of the revenue administration. To this end, a new law has been prepared, and is expected to be enacted soon. This regulation intends to increase the efficiency of tax collection, by means of enhancing automation, training staff and improving all underpinning facilities. In addition, tax laws and regulations will be amended in order to re-assess tax exemptions with the objective of simplification and rationalization of the tax system.

Very little information is made available in the PEP 2004 on the fiscal effects of the structural reform agenda. The programme would definitely benefit from more explicit links to the individual measures, for example the social security reform. In addition, all additional steps towards strengthening the quality and transparency of the public finances would positively affect expectations, thereby supporting the downward trend in inflation.

7.2. The sustainability of public finances

Like in the last PEP, the main fiscal risks are seen to be those related to the debt stock's high sensitivity to interest rate and exchange rate fluctuations and a lower than expected primary surplus, resulting from higher than expected public spending for wages and transfers to the social security institutions.

Long-term sustainability issues, such as the financial implications related to the demographic structure or to pension issue, are not discussed. Accordingly, no quantitative information on those issues has been provided. Contingent liabilities and lower than expected privatisation revenues appear to be additional risks to the sustainability of public finances. In this context, a presentation of potential contingency plans in order to compensate for those risks would have been interesting.

Annex table 1: **Structural indicators**

	TURKEY					EU 25				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
General economic background										
Real GDP [1]	7.3	-7.5	7.9	5.8	9.0	3.7	1.8	1.1	1.0	2.3
Labour productivity [2]	15.0	-7.2	8.3	1.4	6.9	2.1	0.8	0.8	0.8	1.8
Real unit labour cost [3]	n.a.	0.0	-12.1	5.7	1.7	0.4	0.4	-0.4	-0.5	-0.9
Real effective exchange rate [4]	95.9	78.6	74.1	76.4	82.3	98.7	100.5	103.0	106.1	108.8
Inflation rate [5]	54.9	54.4	45.0	21.6	8.6	2.4	2.5	2.1	1.9	2.1
Unemployment rate [6]	6.5	8.4	10.4	10.5	10.3	8.6	8.4	8.7	8.9	9.0
Employment										
Employment rate [7]	48.8	47.8	46.9	45.8	43.7	62.5	62.9	62.9	63.0	63.3
Employment rate - females [8]	25.8	26.3	27.0	25.7	22.9	53.7	54.3	54.7	55.1	55.8
Employment rate of older workers [9]	36.3	35.8	35.7	33.5	n.a.	36.6	37.4	38.8	40.2	40.5
Long-term unemployment [10]	1.3	1.7	2.9	2.4	n.a.	3.9	3.8	3.9	4.0	4.1
Product market reforms										
Relative price levels [11]	60.6	48.0	51.9	55.0	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	27.5	32.5	30.0	29.0	31.6	:	9.7	9.2	9.0	9.4
Total FDI inflows [13]	0.1	2.0	0.5	0.5	0.6	16.0	7.6	8.3	6.1	3.9
Market share electricity [14]	75.0	70.0	59.0	45.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aids [15]	n.a.	n.a.	n.a.	n.a.	n.a.	0.3	0.3	0.3	:	:
Business investment [16]	n.a.	18.1	16.6	n.a.	n.a.	18.4	17.9	17.2	16.8	17.0
Knowledge-based economy										
Tertiary graduates [17]	2.6	2.8	3.1	n.a.	n.a.	43.2	47.0	49.0	52.2	n.a.
Spending on human resources [18]	3.49	3.65	3.56	n.a.	n.a.	4.9	5.1	5.2	n.a.	n.a.
Educational attainment [19]	n.a.	n.a.	n.a.	n.a.	n.a.	76.4	76.2	76.5	76.6	76.7
R&D expenditure [20]	0.64	0.72	0.66	n.a.	n.a.	1.88	1.92	1.93	1.95	n.a.
Internet access [21]	n.a.	n.a.	n.a.	n.a.	7.0	n.a.	n.a.	n.a.	n.a.	42.0

1. Growth rate of real GDP in %. 2. Growth rate of real GDP per person employed in %. 3. Ratio of compensation per employee to nominal GDP per person employed, total economy, annual percentage change. 4. Vs IC36 (1999 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs). 6. Unemployed persons as a share of the total active population. 7. For Turkey, employed persons 15 years of age and over in % of total population of the same age group, for EU refers to population aged 15-64. 8. For Turkey, employed women aged 15 years of age and over in % of total female population of the same age grouping, for EU refers to employed women aged 15-64.
9. Employed persons aged 55-64 in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population aged 15-64.
11. Of private final consumption (EU25=100). 12. average value of imports and exports of goods and services in % o GDP; the value for EU 15 is the total for the Small Member States. 13. In % of GDP. 14. Market share of the largest generator (% of total net generation).
15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Percentage of households who have Internet access at home.

f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value, q: estimated from quarterly values.

Source: Commission services.

Annex table 1: **Structural indicators**

	BULGARIA					EU 25				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
General economic background										
Real GDP [1]	5.4	4.1	4.9	4.5	5.6	3.7	1.8	1.1	1.0	2.3
Labour productivity [2]	9.2	7.8	3.3	1.0	2.4	2.1	0.8	0.8	0.8	1.8
Real unit labour cost [3]	-5.4	0.8	-0.8	5.5	-0.7	0.4	0.4	-0.4	-0.5	-0.9
Real effective exchange rate [4]	96.5	103.7	105.8	109.0	113.3	98.7	100.5	103.0	106.1	108.8
Inflation rate [5]	10.3	7.4	5.8	2.3	6.1	2.4	2.5	2.1	1.9	2.1
Unemployment rate [6]	16.9	19.8	17.8	13.7	12.0	8.6	8.4	8.7	8.9	9.0
Employment										
Employment rate [7]	50.4	49.7	50.6	52.5	54.2	62.5	62.9	62.9	63.0	63.3
Employment rate - females [8]	46.3	46.8	47.5	49.0	50.6	53.7	54.3	54.7	55.1	55.8
Employment rate of older workers [9]	20.8	24.0	27.0	30.0	32.5	36.6	37.4	38.8	40.2	40.5
Long-term unemployment [10]	9.4	11.9	11.7	8.9	7.1	3.9	3.8	3.9	4.0	4.1
Product market reforms										
Relative price levels [11]	37.9	39.6	41.6	42.1	:	100	100	100	100	100
Total trade-to-GDP ratio [12]	42.9	43.5	41.8	43.9	48.1	:	9.7	9.2	9.0	9.4
Total FDI inflows [13]	8.0	5.9	5.8	10.3	8.4	16.0	7.6	8.3	6.1	3.9
Market share electricity [14]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aids [15]	0.7	0.5	0.2	0.5	:	0.3	0.3	0.3	:	:
Business investment [16]	12.1	14.7	15.3	16.5	17.8	18.4	17.9	17.2	16.8	17.0
Knowledge-based economy										
Tertiary graduates [17]	38.1	41.4	44.1	n.a.	n.a.	43.2	47.0	49.0	52.2	n.a.
Spending on human resources [18]	4.41	3.53	3.57	n.a.	n.a.	4.9	5.1	5.2	n.a.	n.a.
Educational attainment [19]	74.9	78.2	77.5	75.6	76.0	76.4	76.2	76.5	76.6	76.7
R&D expenditure [20]	0.52	0.47	0.49	0.50	n.a.	1.88	1.92	1.93	1.95	n.a.
Internet access [21]	n.a.	n.a.	n.a.	n.a.	10.0	n.a.	n.a.	n.a.	n.a.	42.0

nominal GDP per person employed, total economy, annual percentage change. 4. Vs IC36 (1999 = 100), current year's values are based on
11. Of private final consumption (EU25=100). 12. average value of imports and exports of goods and services in % o GDP; the value for
f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value, q: estimated from quarterly values

Source: Commission services.