EUROPEAN ECONOMY

EUROPEAN COMMISSION

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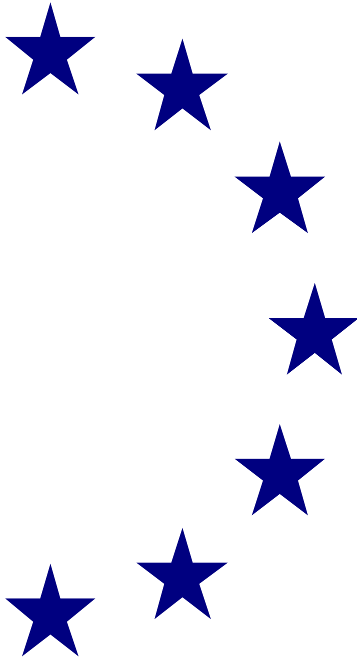

ISSN 1608-9022
http://europa.eu.int/comm/economy_finance
N° 27 - May 2006

2005 Pre-accession Economic Programmes of acceding and candidate countries

by
Directorate General for Economic
and Financial Affairs

KC-AA-06-027-EN-C

ISBN 92-79-01383-1

ECFIN.D.I/2006/REP/52943– EN

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INTRODUCTION

In this Enlargement Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessments of the 2005 Pre-accession Economic Programmes of acceding counties (Bulgaria, Romania) and candidate countries (Croatia, 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. They have been made public by the countries and can be found on the web under following addresses:

Bulgaria	http://www.aeaf.minfin.bg/cms/docs/en/operative/pi_progr/PEP2005EN.pdf
Romania	http://www.cnp.ro/site/pep+-+editia+2005.html?child=11&language=English
Croatia	http://www.mfin.hr/str/120/
Turkey	http://ekutup.dpt.gov.tr/ab/kep/pep2005.pdf

As the former Yugoslav Republic of Macedonia became candidate country only in December 2005, it will submit its first PEP only towards the end of 2006.

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. Growth rates in Bulgaria are foreseen at close to or above 6%, at 5% in Turkey and between 3.5% and 4% in Croatia.
- The fiscal frameworks foresee a continued narrowing of deficits in Croatia and Turkey, whereas in Bulgaria and Romania a slight loosening is foreseen, caused by, as the PEPs argue the effects of EU accession.

- 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.

On 5 May 2006, 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. The texts of these documents are contained in Annex 1.

Pre-accession Economic Programmes 2005: key figures

- Real GDP growth (% change)

	2004	2005	2006	2007	2008
Bulgaria	5.6	5.7	5.7	5.9	5.9
Romania	8.3	5.7	6.0	6.3	6.5
Croatia	3.8	3.9	4.0	4.1	4.3
Turkey	8.9	5.0	5.0	5.0	5.0

- General government balance (% of GDP)

	2004	2005	2006	2007	2008
Bulgaria	2.2	1.8	0.0	-0.2	-0.7
Romania	-1.5	-0.4	-0.7	-1.0	-1.5
Croatia	-3.9	-3.1	-2.4	-2.2	-1.9
Turkey	-5.2	-1.3	0.2	-0.9	0.0

- Government gross debt (% of GDP)

	2004	2005	2006	2007	2008
Bulgaria	38.9	31.3	26.3	23.9	22.7
Romania	18.1	17.1	15.1	14.6	14.6
Croatia	44.8	45.1	42.7	42.1	41.5
Turkey	74.8	70.0	65.6	61.4	56.7

PRE-ACCESSION ECONOMIC PROGRAMME OF BULGARIA (2005 -2008)

- OVERVIEW AND ASSESSMENT -

1. INTRODUCTION

The Bulgarian authorities submitted the 2005 Pre-Accession Economic Programme (PEP) on 9 December 2005. The programme covers the period 2005 to 2008 and is the fifth PEP since the ECOFIN Council of 26/27 November 2000 expressed its wish for a regular dialogue with candidate and accession countries. The programme is broadly consistent with other key strategic policy papers, such as the National Development Plan 2007-2013 which was adopted by the Council of Ministers on 27 December 2005, the Ministry of Finance's budget projection for the period 2006-2008 from May 2005, or the latest Memorandum to the stand-by arrangement with the International Monetary Fund (IMF).

The programme largely complies with the requirements of the consolidated outline in terms of content, form and data. It provides a concise update of the latest economic developments and an overall consistent and comprehensive macroeconomic framework. Both fiscal and structural reform policies are explained in detail. The programme reflects the conclusions of the Joint Ministerial Meeting of 12 July 2005, although information on additional measures to improve the business environment and labour market flexibility remains limited. Calculations of the output gap, the cyclically adjusted budget balance and the sustainability of public finances have been updated but no information on further methodological improvements is provided. Data are mostly in line with ESA 95, even though not all government expenditures are fully recorded yet on an accrual basis.

Similar to previous programmes, fulfilling the commitments for accession and achieving a tangible improvement in living standards of the population are the overarching objectives. The PEP envisages the continuation of prudent fiscal policies with a budget close to or even above balance for most years. A fiscal expansion in 2007 and 2008 is, however, considered unavoidable because of additional accession-related expenditures. In line with this fiscal stance and continuing strong economic growth, the government debt ratio is expected to decline further from 31.3% of GDP to 22.7% of GDP over the programme period. The currency board arrangement is intended to be maintained at the current exchange rate until the eventual adoption of the euro. The declared intention of the Bulgarian National Bank (BNB) and the government is to apply for ERM II membership immediately after accession and to introduce the euro as quickly as possible thereafter. Structural reforms primarily aim at strengthening Bulgaria's attractiveness for foreign investment, increasing competitiveness, raising the quality of human capital and fostering innovation, thus largely supporting the achievement of the programme's overall objectives and the macroeconomic scenario.

2. MACROECONOMIC DEVELOPMENTS

2.1. Recent macroeconomic developments

The programme gives a clear and concise overview of economic developments in 2004 and the first half of 2005, for which data were available at the time of drafting. Real GDP growth was 5.7% in 2004 and accelerated further in the first half of 2005 to 6.2%. It was mainly driven by strong domestic demand which in turn was fuelled by credit growth, higher employment and rising incomes. In the second half of 2004 higher exports gave an additional boost to GDP growth. The further acceleration in the first half of 2005 was mainly the result of particularly strong gross fixed capital formation and higher government expenditures in the run-up to the elections in June 2005. Heavy floods during the summer 2005 led to a significant drop in agricultural production and also a marked slow-down in the growth of services and industry, implying also a substantial decline in the growth of exports. Thus real GDP growth decelerated significantly in the third quarter of 2005 and reached 5.5% for the whole year. Price increases were relatively high in the first half of 2004 due to higher food prices and increases in administered prices and excise duties. In the second half of 2004 inflation started to slow down, reaching 4% until the end of the year, and remained relatively stable at this rate for most of 2005. On the back of rising prices for oil, food, and certain services, inflation accelerated again in the last four months of 2005. For the whole year, average inflation thus decreased from 6.1% in 2004 to 5.0% in 2005, while end-of-year inflation increased from 4.0% to 6.5%. Employment growth slowed down from above 3% in 2004 to 2.0% in 2005, reflecting mainly a scaling-down of government employment programmes and lower public sector employment. The unemployment rate continued to fall from 12.0% in 2004 to 10.1% in 2005. Following changes in the methodology for estimating wage income abroad and the recording of imports at FOB prices, the figures for the current account deficit and the trade deficit in 2004 and 2005 have been revised considerably in March 2006. According to the new methodology, the current account deficit increased from 5.8% of GDP in 2004 to 11.8% in 2005, while the trade deficit rose from 15.1% of GDP in 2004 to 20.4% in 2005.

Table 1: **Comparison of macroeconomic developments and forecasts**

	2004		**2005**		**2006**		**2007**		**2008**	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	5.6	**5.6**	6.0	**5.7**	5.5	**5.7**	5.5	**5.9**	n. a.	**5.9**
Contributions:										
- Final domestic demand	6.8	**6.7**	9.4	**9.6**	7.6	**6.9**	7.4	**7.2**	n. a.	**7.2**
- Change in inventories	0.8	**0.9**	0.2	**0.4**	-0.2	**-0.2**	0.1	**-0.1**	n. a.	**0.1**
- External balance of goods and services	-1.9	**-1.9**	-3.6	**-4.4**	-1.9	**-1.1**	-2.0	**-1.2**	n. a.	**-1.4**
Employment (% change)	3.1	**3.3**	1.8	**1.8**	1.0	**1.1**	0.7	**1.1**	n. a.	**1.2**
Unemployment rate (%)	11.9	**12.0**	10.7	**10.8**	9.9	**10.4**	9.4	**10.2**	n. a.	**10.0**
GDP deflator (% change)	4.2	**4.2**	3.3	**3.6**	5.4	**5.7**	4.7	**2.7**	n. a.	**2.5**
CPI inflation (%)	6.1	**6.2**	4.5	**4.9**	5.5	**6.7**	3.5	**3.1**	n. a.	**2.8**
Current account balance (% of GDP)	-8.5	**-8.5**	-12.2	**-13.6**	-12.0	**-12.1**	-10.8	**-10.1**	n. a.	**-8.5**

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

2.2. Macroeconomic scenario

The programme's macroeconomic framework appears overall consistent and sufficiently comprehensive. Economic growth is expected to increase steadily from 5.6% in 2004 to 5.9% in 2007 and 2008 which is in line with the stated objective of realising a tangible improvement of living standards of the population. This implies an upward revision of real GDP growth rates by around 0.4 percentage points per year compared to the 2004 programme, but is not unrealistic in the light of recent experience, a steadily increasing investment ratio and further progress in economic and company restructuring. Without the negative supply-side shock of the floods, the 2005 outcome would probably have been even higher. The macroeconomic scenario also envisages a steady reduction in the external deficit, robust employment growth of above 1% per year and a sustained reduction of inflation rates after a temporary hike in 2006 resulting from increases in excise duties. The projected fiscal stance of a government budget close to or above balance is largely consistent with this scenario, although the fiscal expansion foreseen in 2007 and 2008 might jeopardise the target of reducing the inflation rate and the external deficit.

The projections for the medium-term macroeconomic framework were made with the same model as in previous PEPs and take into account the assumptions of the IMF and the European Commission on the development of the global and the European economy. A sensitivity analysis is carried out, considering inter alia a 10% increase in the euro price of crude oil, an acceleration of world economic growth by 1%, higher growth of individual demand components, and an appreciation of the US dollar vis-à-vis the Bulgarian lev. While rising oil prices would have a significant impact especially on inflation, higher world economic growth could give a strong boost to Bulgarian export growth. On the whole, the induced changes to the macroeconomic scenario would, however, remain relatively limited.

Real sector

Compared to the Commission's autumn forecast, the projected real GDP growth rates in the PEP are lower for 2005 and higher for 2006 and 2007 (see Table 1). The weaker performance in 2005 can mainly be attributed to flood related disruptions and higher oil prices which affected output in all sectors and also exports. For the following years, the PEP assumes a more moderate expansion of domestic demand but also a less negative contribution from net exports than the Commission's forecast. Real GDP growth would continue to be driven by strong gross fixed capital formation expanding at double digit rates throughout the programme period and by consumption growth, which is, however, expected to return to more moderate levels than in 2005. Real growth of exports of goods and services is projected to accelerate again from actual 7.2% in 2005 to double digit rates as from 2006. This is not unrealistic in view of some one-off factors contributing to the drop in export growth in 2005. At the same time, a significant moderation of import growth from over 14% in 2005 to below 11% in 2006 would reduce the negative contribution from net exports already in 2006. This will, however, depend crucially on whether domestic consumption growth will indeed slow down in 2006 to the extent foreseen in the programme. On the supply side, all sectors are expected to contribute positively to growth. The strongest contribution would continue to come from the service sector, while industry and in particular construction would replace services as the fastest growing sectors. Employment growth is expected to remain at above 1% each year during the programme period, mainly thanks to a 2.1 percentage point increase in the participation rate within just two years to 65% in 2008. In view of more moderate increases in recent years and growing difficulties to bring currently inactive groups back into the labour market, this assumption may be somewhat

optimistic and would suppose increased efforts to tap into the labour reserve. Labour productivity is expected to continue growing at rates of around 4½% and would remain fully in line with expected real wage increases.

Only aggregate information on the cyclical development of the economy and potential output growth is provided. The information on output gap and growth potential from the 2004 PEP is updated, but no further methodological improvements have been made. Potential growth is expected to be between 5 and 5½% in 2005 and 2006 which is more or less in line with common estimates. With growth rates above potential between 2004 and 2006, the output gap is expected to turn positive in 2005 and to remain positive until 2007. A strong acceleration of potential growth to above 6% in 2007 is assumed to lead to a negative output gap again in 2008. While strong capital formation and productivity increases due to company restructuring and upgrades of human capital should indeed have a positive impact on potential growth, other factors mentioned in the programme to explain the increase in 2007 are less convincing. Many of the accession-related effects of better access to a larger internal market and the removal of trade barriers are likely to have been realised already during the pre-accession period. On the other hand, the positive effects from Structural Fund transfers depend crucially on the administrative and economic absorption capacity and will probably become evident only with a certain time lag.

External sector

The current account deficit has been revised considerably upwards compared to the 2004 programme for all years. According to the programme it was expected to reach 13.6% of GDP in 2005 and to decrease steadily by 5.1 percentage points until 2008. The actual outcome in 2005 before methodological changes was even higher at 14.8% of GDP, while following the data revision in March 2006 it was lower at 11.8%. This increase was largely the result of a higher than expected trade deficit, which on the back of higher oil prices and strong imports of investment goods widened to 20.4% of GDP (after methodological changes) instead of the 18.4% foreseen in the programme. The programme expects a re-acceleration of merchandise export growth as from 2006 which together with a slow-down in import growth and a slight improvement in the terms of trade would lead to a steady decline of the trade deficit by around 1.5 percentage points until 2008 starting already in 2006. While this pattern is generally consistent with the assumptions in the Commission's autumn forecast, the latter expects a more gradual closing of the gap between import and export growth rates and therefore also a more gradual reduction in the trade deficit. Apart from the higher trade deficit, a lower surplus in the services balance also contributed to the widening current account deficit in 2005. Higher expenditures for transport services - linked to surging import growth - and a moderation of growth in the tourist industry have implied a reduction of the surplus to 2.5% of GDP in 2005, which is even lower than the 2.8% expected in the programme. Following the mentioned revisions due to methodological changes, the reduction was less pronounced and the revised surplus in the services balance reached 3.1% of GDP in 2005. The PEP expects this decline to be a temporary phenomenon with a return to previous and even rising levels of surpluses in the service balance from 2006. This will, however, depend crucially on whether the former high rates of growth in the tourist sector can indeed be re-established and might be a somewhat optimistic scenario. In line with high inflows of FDI over the past years, the deficit in the income balance is expected to increase slightly as a share of GDP in the future, whereas increasing current transfers, especially after enlargement, would contribute to a considerable reduction in the current account deficit.

In order to address the high current account deficit and following an agreement with the IMF in January 2006 (which was thus not foreseen in the assessed programme), a further tightening of fiscal policy is envisaged in 2006 (see Section 3.1). This will also be accompanied by measures to restrict bank lending even further and to target more specifically household and mortgage lending. The revised fiscal target in particular represents a much more appropriate response to the rising external deficit than the balanced budget originally foreseen in the programme and in the 2006 budget law. The fiscal targets for 2007 and 2008 currently envisaged in the programme would, however, represent a massive fiscal expansion and would thus risk aggravating the existing external imbalances.

Net FDI inflows are expected to stabilise at above EUR 2 billion per year even with the privatisation process coming to an end and would thus continue to finance almost completely the current account deficit. This is not fully in line with the experience in 2005, when Greenfield FDI have indeed remained relatively strong but could still not prevent a fall in net FDI inflows by more than 17% due to a decline in privatisation related FDI.

2.3. Monetary and exchange rate policy

Since 1997 Bulgaria maintains a currency board arrangement under which the Bulgarian lev (BGN) is fixed to the euro at a rate of 1 EUR equals 1.95583. 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 2009 or the beginning of 2010 at the present exchange rate.

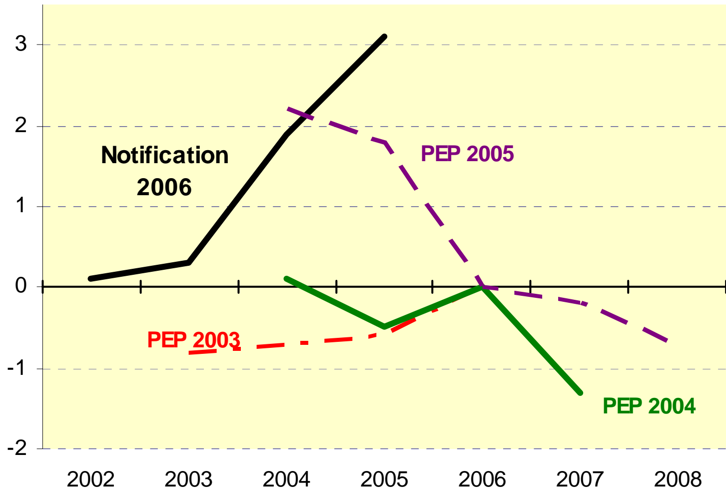
Monetary aggregates continued to grow at rates above 20% in 2005 and remain well covered by foreign exchange reserves. Since 2004, the BNB has introduced a set of measures to curb credit growth in order to ensure financial sector stability and contain potential risks for the credit portfolio of banks. As of 1 April 2005, additional minimum reserve requirements have been introduced for banks whose loan portfolio increases by more than 5% in a quarter, 12.5% in a six-month period, 17.5% in a nine-month period or 23% in a twelve-month period. Following these measures, credit growth to the private sector decreased from close to 50% in 2004 to 34.0% until the end of the year. The reduction in the growth rate has been most pronounced for lending to the corporate sector, whereas household credit and especially mortgage credits continued to grow relatively strongly at rates of 58.4% and 97.4% until the end of 2005. While these measures have thus been relatively effective in slowing credit growth, there is also evidence that in particular enterprises have found alternative sources of financing, especially through leasing firms or through private foreign borrowing. The effect on containing the current account deficit has therefore been more limited. Since the submission of the programme and in view of the rising current account deficit, the BNB has further tightened its measures on credit growth as from 1 January 2006. It now targets an average growth rate of below 20% for bank credits to the non-financial sector in 2006 and introduced extra prudential requirements on household and mortgage loans.

Inflation is projected in the programme to accelerate to 6.7% in 2006. This is mainly the result of an increase of excise duties on cigarettes and alcohol to EU minimum levels on 1 January 2006 and thus a year earlier than originally planned. This will contribute 2.5 percentage points to inflation in 2006, but will help reducing inflation in 2007 due to a base year effect. For 2008 a further deceleration of inflation to below 3% is expected, but is not fully explained in the

programme. Against the background of high domestic demand and a considerable fiscal easing foreseen for 2007 and 2008, it remains to be seen whether this can indeed be achieved. Potential inflationary pressures under the fixed exchange rate regime from price increases on non-traded goods where productivity increases tend to be smaller than for traded goods (Balassa-Samuelson effect) are mentioned in the programme. However, increasing bottlenecks in the labour market might also entail upward pressures on wages and prices, in particular if the envisaged strong increase in participation rates fails to materialise, and might thus jeopardise the envisaged reduction of inflation.

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

The public finance framework gives a concise, consistent and sufficiently comprehensive overview of budgetary priorities and developments expected over the programme period. The aim is to maintain a balanced or close-to-balance budget while at the same time reducing the tax and social security burden on taxpayers, increasing the efficiency of public spending and streamlining the size of the public sector by containing public expenditures to around 40% of GDP. Key measures on the revenue and expenditure side are well explained and accompanied by quantitative estimates of their impact. As in previous years, the fiscal outcome in 2005 turned out far better than projected in the 2004 PEP due to substantial revenue overruns. The practice of underestimating budget revenues during the budget preparation facilitates the ex-post achievement of the fiscal target. But it reduces fiscal transparency and prevents further progress in reducing the tax and social security burden. It also encourages discretionary spending especially towards the end of the year, which until recently did not require parliamentary approval as long as the overall budget target was not breached. This has been changed slightly with a new law entering into force in 2006, which limits extra expenditures without parliamentary approval to 1.5% of planned government revenues. Since additional expenditures can be covered from revenue overruns, the practice of underestimating revenues also reduces the potential for further streamlining public expenditures. Compared to the 2005 fiscal notification, the budget surplus for 2004 has been revised upward by 0.9 percentage points to 2.2% of GDP. This results from a reclassification of the Public Investment Projects company. This company was established at the end of 2004 with a view to finance public infrastructure projects in the following year. In the 2005 fiscal notification, the establishment of the company was treated as a capital transfer in 2004 thus



reducing the fiscal surplus in 2004. In the meantime, it has been decided to integrate the company into the consolidated fiscal programme. In the programme, the expenditures made by the company are now accounted for mainly in 2005 and therefore reduce the fiscal surplus reported in 2005 while increasing the 2004 surplus by an equivalent amount. A number of fiscal risks are identified in the programme and their potential impact is discussed. This concerns in particular possible extra expenditures for flood repairs and exchange rate and interest rate risks. Potential risks linked for example to structural reforms or large infrastructure projects are, however, not addressed. Data are largely compatible with ESA 95, but government expenditures are not yet fully reported on an accrual basis.

3.1. Targets and adjustment

Following an agreement with the IMF in May 2005, the government revised its 2005 fiscal target from a 0.5% of GDP deficit to a surplus of at least 1% of GDP. In addition, 69% of any tax revenue overruns (excluding personal income tax) were to be saved and not to be used to increase expenditures. As in previous years, the budget execution in 2005 was characterised by substantially higher revenues than originally foreseen in the budget. This was mainly due to the underestimation of budget revenues, strong economic growth, boosting mainly revenue from VAT and customs duties, and also improved revenue administration and compliance. As a result, and despite reductions in the corporate and personal income taxes, the actual revenue-to-GDP ratio increased from 42.1% in 2004 to 43.3% in 2005, which is 5.1 percentage points higher than originally projected in the 2004 PEP. In line with these higher revenues, expenditures were also higher than planned. Especially due to extra expenditures in the run-up to the elections in June, unanticipated spending on flood relief and partial coverage of hospital arrears, the expenditure-to-GDP ratio increased to 40.1% in 2005 thus overshooting the initial target in the 2004 PEP by 1.5 percentage points.

The programme projections for 2006 are largely in line with the Budget Law which was adopted by Parliament on 20 December 2005. The programme envisages a fully balanced budget with both the revenue- and expenditure-to-GDP ratios reverting to below 40%. On the revenue side, pension contributions have been cut by 6 percentage points in January 2006. This measure is going to reduce revenues by around 1.5% of GDP. Regarding personal income tax, the lowest tax bracket of 10% for incomes below EUR 77 per month is abolished. At the same time, the threshold for non-taxable income has been raised from EUR77 per month to EUR 92 per month. The estimated impact on the budget will be around 0.4% of GDP. The introduction of some elements of family taxation and some changes to corporate taxes will cut revenues by a further estimated 0.2% of GDP. On the other hand, excise taxes on cigarettes and alcohol will be aligned with EU minimum levels in 2006 instead of 2007, leading to an expected significant increase in revenue of 0.75% of GDP. Revenue compliance is expected to be further improved with the National Revenue Agency becoming fully operational in 2006 and being exclusively responsible for the collection of taxes and social security contributions. On the expenditure side, pensions have been increased by 5% in January in line with the indexation system in place. Public sector wages are to rise by 6% on 1 July 2005. In addition, teachers have received a wage increase of 4% already as from January 2006. In the budget law for 2006, around 1% of GDP is foreseen to cover expenditures for flood repairs. The budget law envisages a certain flexibility in the budget execution, making 7% of central government expenditures and transfers to municipalities conditional on a reduction of the current account deficit to 12% of GDP and thus allowing a shift to a budget surplus in case of a continued widening of the

current account balance. As indicated in the programme, revenue forecasts for the 2006 budget law have again been relatively conservative, and the shift to a budget surplus during the year is therefore a likely scenario. Following the above-mentioned agreement with the IMF to address the widening current account deficit, the Bulgarian government has in the meantime revised its fiscal target to a 3% of GDP surplus (cash basis, up from 2.3% of GDP in 2005) with an additional adjustor of saving at least 50% of any revenue over-performance.

No major changes in revenue or expenditure policies are foreseen in 2007 and 2008. Subsidies would remain relatively constant as a share of GDP with the largest part going to agriculture and the railway sector. On the other hand interest expenditures would gradually decline due to the rapidly declining public debt. In line with an increased absorption of EU funds and the implementation of major infrastructure projects in the transport and environment sector, capital expenditures as a share of GDP would, however, increase steadily over the programme period. The programme thus envisages a substantial fiscal relaxation with the budget balance turning negative in both 2007 and 2008. This is largely due to additional expenditure needs linked to accession which are deemed to be unavoidable. While the projected extra accession-related expenditures are lower than in the 2004 PEP, they still amount to 1% of GDP in 2007 and 1.5% of GDP in 2008. This is mainly due to national co-financing requirements under the Structural and Cohesion Funds and to national contributions to the EU budget. If this scenario were to materialise it would entail significant risks for macroeconomic stability. Even according to the programmes own assumptions, fiscal policy would be pro-cyclical in 2007. This would clearly put in question the aim of reducing the current account deficit and further bringing down inflation rates. At this stage, the programme foresees, however, that no substitution of national expenditures by EU transfers would occur at all and that all co-financing expenditures would come on top of existing expenditures. This could probably be avoided, if further efforts were undertaken to restructure the expenditure side of the budget, if national spending priorities were better aligned with spending priorities under the EU's Structural Funds, and if for example in agriculture national subsidies were to be at least partly replaced by CAP payments. Moreover, to the extent that extra accession-related expenditure needs can indeed not be fully compensated by appropriate budget restructuring, intensified efforts to cut spending in other areas will be crucial to avoid negative consequences for the external balance and for price stability.

The PEP does not see any major risks for the sustainability of public finance. The floods over the summer months are identified as a possible fiscal risk with the direct damage estimated at around EUR 430 million (2.0% of GDP). In the meantime, additional expenditures for flood relief have, however, been accounted for in the 2005 and 2006 budgets. There should therefore not be any major further risks associated with the floods. Simulations in the programme show that thanks to the steady reduction of government debt and the active debt management, the sensitivity to exchange rate or interest rate changes has been significantly reduced compared to last year's programme. On the other hand, a number of potential risks linked to structural reforms or large investment projects are not fully addressed in the programme. In the health sector there has been a recurrent pattern of expenditure overruns especially in hospitals. In 2005, hospitals accumulated around EUR 100 million in debt, which were partly covered by additional transfers from the National Health Insurance Fund and the central budget. While the programme envisages a number of measures to reform the health sector and to tighten financial discipline (see also Section 5.2), it remains to be seen whether these changes can produce results in the immediate future. The still precarious financial situation of the national railway carrier could also lead to further unexpected expenditure needs. Important and large investment

projects are planned over the programme period, including especially in the energy sector with an expected volume of more than EUR 6 billion until 2007. It is expected that a considerable part of these projects will be financed from private sources without state guarantees, but so far only around a third of these investments have been financially secured. Major investments will also be necessary in the environment sector in order to meet EU requirements. The programme refers to the use of EU funds for the financing of these projects, but no estimates of the full costs likely to be involved in this area are provided. While the analysis of potential fiscal risks is therefore not fully comprehensive, remaining risks should not pose major difficulties for the sustainability of public finance. Given the sound fiscal policies pursued for a number of years and the significant and continued reduction in government debt, these risks should on all accounts be manageable. They could, however, add extra pressure on the fiscal stance and thus aggravate the risks for reducing the current account deficit and bringing down inflation.

Table 2: **Composition of the budgetary adjustment** (% of GDP)

	2004	**2005**	**2006**	**2007**	**2008**	**Change: 2005-08**
Revenues	42.1	42.5	39.2	40.1	39.9	-2.6
of which:						
- Taxes and social security contributions	34.0	34.3	32.4	32.2	31.7	-2.6
- Other (residual)	8.1	8.2	6.9	7.9	8.2	0.0
Expenditure	40.0	40.7	39.2	40.4	40.6	-0.1
of which:						
- Primary expenditure	38.2	39.1	37.7	38.9	39.4	0.3
of which:						
Gross fixed capital formation	4.0	5.1	4.7	5.3	6.0	0.9
Consumption	10.2	10.7	10.6	10.6	10.4	-0.3
Transfers & subsidies	17.2	17.4	16.6	16.1	15.9	-1.5
Other (residual)	6.9	5.9	5.8	6.9	7.0	1.1
- Interest payments	1.8	1.6	1.5	1.5	1.2	-0.4
Budget balance	2.2	1.8	0.0	-0.2	-0.7	-2.5
- Cyclically adjusted	2.2	1.7	-0.2	-0.3	-0.7	-2.4
Primary balance	4.0	3.4	1.5	1.2	0.5	-2.9
Gross debt level	38.9	31.3	26.3	23.9	22.7	-8.6

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

While the fiscal framework is characterised by a substantial fiscal easing towards the end of the programme period, there appears to be no significant risk that the 3% reference value might be breached or that the fiscal stance might deviate considerably from a balanced or close-to-balance budget. According to the programme's own assumptions, the fiscal stance will, however, be pro-cyclical in 2007, if no extra efforts on the expenditure side are undertaken, and could therefore jeopardise the planned reductions in the external deficit and in the inflation rate.

3.2. Debt developments

The PEP projects the debt-to-GDP ratio of general government to decline from 38.9% in 2004 to 22.7% in 2008. For the years 2005 to 2007 this is between 7.5 and 8.5 percentage points lower than the levels expected in the 2004 PEP. The reduction of government debt in 2005 was partly linked to the early re-payment of the last remaining Brady bonds in two tranches in January and July. Further debt repayments to the IMF and the World Bank have been made in December 2005 and January 2006. The change in the debt ratio is mainly the result of the primary surplus and strong nominal GDP growth. The government pursues an active debt management strategy to reduce any remaining debt-related risks. The share of domestic debt in total government debt thus increased by 3.7 percentage points to 17.2% at the end of 2004. An almost equal share of fixed and flexible rate debt has been achieved with the share of flexible interest rate debt falling by 5 percentage points to 51.7%. Similarly, the share of lev and euro denominated debt has increased by 9 percentage points to 52.6% of total government debt. The average maturity of outstanding debt has increased to 6½ 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 was 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 EUR 2.3 billion at the end of 2005, representing 10.8% of GDP. There are no clear legal guidelines for the use of the FRA except for a floor of BGN 2.5 billion (about 6% of GDP) stipulated in the 2006 budget law. The 2005 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). As already mentioned in last year's assessment of the 2004 programme, 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.

4. STRUCTURAL REFORMS

The PEP contains a fairly comprehensive overview of structural reform measures and tends to be more forward-looking in the presentation of priorities and initiatives than in previous years. Increasing competitiveness, achieving stable economic growth, promoting innovation, raising human capital, encouraging investment and increasing incomes are the main objectives of the structural reform agenda. The most relevant structural reform areas are covered but are not fully integrated into a general reform strategy. This is most obvious in relation to measures for improving the business environment. Individual measures are discussed under separate headings but no systematic, cross-cutting strategy is presented. Within the different areas, the strategies and envisaged measures are generally well explained. Only few structural reform measures have, however, been included in the policy matrix and few quantitative estimates of effects are being provided. Structural reforms are largely in line with key objectives of the Lisbon Agenda and there is a strong focus on raising competitiveness, creating jobs and fostering the transition to a knowledge-based economy. They support the fulfilment of the second Copenhagen economic criterion and are generally well aligned with the main conclusions of the 2005 Comprehensive Monitoring Report. In promoting competitiveness and

balanced economic growth, the structural reform measures support the overall policy mix and should help to achieve the macroeconomic objectives.

4.1. Product and capital markets

As highlighted in the programme, the privatisation of state-owned enterprises is well advanced and even completed in many sectors. A limited number of companies, mostly in the energy or construction sector, remain to be sold. The programme does, however, not present a clear timetable on when this privatisation process is expected to be completed. Also due to national elections, progress on privatisation was actually more limited in 2005 than originally planned. A number of privatisation projects, including for example the sale of Bulgartabac or three thermal power plants, either failed or was significantly delayed. Bringing the privatisation process to a successful conclusion will require intensified efforts and a high degree of political will, especially in view of the increasingly complex and politically sensitive nature of many remaining privatisation projects. Conditions for ensuring effective market competition have been steadily improved by largely aligning competition and state aid policy with the EU acquis. The programme foresees some further steps to finalise legislative alignment and to further strengthen administrative capacity especially of the courts.

The PEP contains a number of individual measures which could improve certain aspects of the business environment. But no comprehensive or systematic strategy is presented. Some key measures, such as the reform of business registration, which aims to take business registration out of the courts and turn it into a purely administrative procedure, are not mentioned at all in the programme. Plans for reforming state administration aim at improving the quality of services, enhancing the provision of training and developing e-government services. If implemented properly, these measures could help to improve the efficiency of the administrative environment for businesses. The introduction of one-stop shops and the review of regulatory regimes with a view to their alleviation or abolishment are to continue. The review of regulatory regimes has been going on since 2002 and out of 192 regimes identified for abolition or alleviation, 62 have by now been abolished and 99 have been simplified. This process is thus coming to an end, and new initiatives may have to be considered in order to further reduce the regulatory burden on businesses. Regarding the judicial system, a draft Administrative Procedure Code has recently been adopted by Parliament while a revised Civil Procedure Code is expected to be submitted to Parliament during the year. The programme also refers to recently adopted legislation on private bailiffs and on mediation as an out-of-court settlement procedure. These measures could help to speed up contract enforcement and avoid lengthy court procedures, but would need to be fully implemented and sufficiently promoted. Some measures for improving the efficiency of court procedures are mentioned in an Annex, but the state of implementation remains unclear. No concrete plans for further improvements of bankruptcy legislation and procedures are included in the programme.

A “Law on Small and Medium-Sized Enterprises” was adopted in 2004 and an Executive Agency for SMEs was established under the Ministry of Economy and Energy. Annual programmes for encouraging the development of SMEs are approved by the Council of Ministers. The programme does, however, not provide any details on concrete measures envisaged over the programme period. A “Strategy for Investment Encouragement” for 2005-2010 was adopted by the Council of Ministers in June 2005 and aims to promote both domestic and foreign investment through improving the administrative and legislative framework,

developing infrastructure, enhancing the quality of the workforce, implementing regional policies for investment encouragement, supporting investments in innovations and investment marketing. This strategy largely relies on already existing initiatives in different areas and no concrete measures or timetable for implementation have been presented. Despite some noticeable progress in recent years, surveys still show that the business environment in Bulgaria continues to be hampered by overly complex and costly procedures for market entry and exit as well as contract enforcement, and by inefficiencies in the functioning of the judicial and administrative systems. Trust in the legal system in particular appears to be low and legal procedures are considered ineffective and lengthy. Further progress in facilitating the environment for doing business in Bulgaria will therefore be critical for improving the functioning of product markets and thus for strengthening the growth potential and adaptive capacity of the economy. This will also play a key role in achieving a sustained reduction of external imbalances and in strengthening the ability of Bulgarian firms to withstand competitive pressures.

In the energy sector, the programme envisages that the liberalisation and restructuring process will continue further in the run-up to accession in line with the requirements of the internal energy market. The unbundling of the National Electricity Company is expected to be completed until 2007 and preparations for the restructuring of Bulgargas have started. Important investment projects for the modernisation and expansion of existing production capacities and infrastructure are planned over the programme period, involving an overall investment volume of around EUR 6 billion. In line with the "National Long-term Programme for Energy Efficiency and Renewable Energy Sources (2005-2015)", a number of measures are being envisaged. An "Energy Efficiency Fund" has for example become operational since September 2005 providing financial assistance for energy saving measures. In view of the very high energy intensity of the Bulgarian economy and growing concerns over the security of energy supplies, it seems, however, that these efforts could be further intensified. On transport, the programme highlights the progress achieved in liberalising in particular the railway sector and envisages some further alignment with EU requirements, for example in aviation. After the separation of the railway company into a service provider and an infrastructure company, subsidies to the service provider have been put on a more transparent and predictable basis through the conclusion of a multi-annual public service contract. However, the service provider continues to make losses and there are additional fiscal risks linked to rising energy prices and an ambitious investment and modernisation programme. Further cost-cutting measures are envisaged in the programme for the infrastructure company but not for the service provider, where, however, a separation between the provision of freight and passenger transport services is planned. Regarding ports and airports, the strategy for modernisation relies largely on granting concessions to private operators. Regarding telecommunications, the programme records the progress made in completing the privatisation process in the sector, in liberalising the provision of services and in putting in place the legal and regulatory framework to ensure competition.

Table 3 summarises the net budgetary impact of some of the reform measures envisaged. The measures are almost completely concentrated in 2006 reflecting the aim to leave revenue and expenditure policies largely unchanged over the programme period. On the other hand, the potential future budgetary impact of a number of ongoing reforms in health or education as well as envisaged investment projects in energy or environment have not been included in this overview.

Table 3: **Net direct budgetary impact of key reform commitments (in EUR million)**

Description of the Policy	2005	2006	2007	2008
Reduction of pension contributions		-350		
Changes in the personal income tax		-90		
Increase of excise tax rates		180		
Increase in pension ceiling		-4.5		
Indexation of pensions		-103		
Action plan of Health Strategy for disadvantaged groups	-0.2	-0.53	-0.14	
Total impact on the budget (in EUR million)		-368	-0.14	0
Total impact on the budget (in % of GDP)		-1.9	0.0	0.0

Source: 2005 Pre-accession Economic Programme (PEP)

The banking sector continues to show a very dynamic development. Total assets were 70.5% of GDP by mid-2005 increasing from 65.6% in 2004 and 50.1% in 2003. Following the introduction of additional measures to curb credit growth in April 2005, the growth of credits to non-financial corporations and households slowed down to 34% until the end of 2005. The BNB prepares the payments system for its integration into the euro area system. Further improvements to the banking and supervision legislation are planned to ensure full compliance with the EU acquis. The non-banking financial sector is still relatively less important but non-bank financial intermediation is deepening steadily. The stock exchange index SOFIX reached new record highs in 2005 and increased by 32% during the year. Total market capitalisation has more than doubled in the first half of 2005 compared to the previous year mainly because of the sale of the remaining 35% government stake in the Bulgarian Telecommunication Company over the stock exchange. Insurance premiums have further increased from 2.2% of GDP in 2004 to 2.9% in the first half of 2005. Over the same period, pension funds increased their assets from 2.1% to 2.4% of GDP.

4.2. Labour market

The employment policy priorities of the programme are largely aligned with the European Employment Strategy and the 'Joint Assessment Paper' which was signed by the Commission and the Bulgarian government in 2002. The main objectives of the employment strategy are to raise the quality of human capital and to improve the employability of the labour force. The programme provides detailed information on efforts to improve life-long learning, modernise vocational education and training, including continuing vocational training, improve the efficiency of the public employment service and promote regional mobility. However, the programme reports to a large extent on past achievements and provides only limited information on concrete policy plans over the programme period. Hardly any concrete measures are being discussed on how to raise labour market flexibility, in particular as regards overly restrictive provisions on working time or the use of fixed-term contracts in the Labour Code. The programme only mentions a number of surveys and studies that have been carried out to identify possible areas for increasing labour market flexibility. It also refers to the ongoing work of a tripartite working group formed at the Ministry of Labour and Social Policy which is supposed to elaborate a 'Pact for Economic and Social Development' including proposals for greater labour market flexibility. But no deadline for the submission of this report

is mentioned and there are no plans for concrete measures in this area, including for example on the integration of seniority bonuses into the regular pay scale. The cut in pension contributions in 2006 will reduce non-wage labour costs and therefore improve incentives for job creation and moving jobs out of the informal sector. Despite this change, the social security burden on enterprises will, however, remain relatively high. The programme does not discuss at all the experience with active labour market programmes or prospects for their future development. Moreover, while significant increases in the participation rate are envisaged in the macroeconomic scenario, the programme does not outline any initiatives which would specifically aim at increasing participation or employment rates in particular of groups currently not active on the labour market. The PEP thus provides only an incomplete overview of labour market policies during the programme period with a focus mainly on measures to improve education and training as well as life-long learning. Intensified efforts to improve investments in human capital, to strengthen life-long learning and to raise participation rates will be particularly important for overcoming bottlenecks and mismatches in the labour market, and thus to avoid upward pressures on wages and prices. At the same time, increasing labour market flexibility will be crucial for improving the functioning of the labour market and strengthening the adaptability of the Bulgarian economy within the context of a fixed exchange rate system.

4.3. Other reform areas

In education, only a limited number of reform measures are presented, focusing mainly on the gradual introduction of new curricula, improving computer training and provision of ICT equipment in schools, and reforming vocational education and training. There is no wider discussion of plans to improve the quality of education, of better aligning education and training with labour market needs or adapting the educational sector to a rapidly shrinking and ageing population.

In the administrative reform area, a Ministry for State Administration and Administrative Reform was established in August 2005. The main objectives in this area are to speed up reforms and to improve the services provided by the administration especially in view of accession. The main priorities mentioned in the programme are to develop and optimise state administration structures, to strengthen human resource development in the public administration, to develop further e-government initiatives, to improve the quality of the services to business and citizens and to improve co-ordination with municipalities. A list of short-term as well as long-term measures, including legislative changes, is envisaged for 2006 and beyond. A revised Law on Administration was adopted in March 2006 separating more clearly the administrative and the political level of the state administration and strengthening provisions to prevent corruption. A comprehensive review of administrative structures with a view to their optimisation is also to be carried out. Finally, within the context of Structural Fund preparations, a new operative programme for ‘Administrative Capacity’ is being formulated. Overall, the PEP sets out a fairly comprehensive set of measures for public administration reform which if implemented properly could substantially improve the functioning of the administrative system.

Productivity in agriculture continues to be hampered by fragmented land ownership and the small size of the majority of farms. A land consolidation strategy together with draft legislation on land consolidation is being prepared, but there are no concrete deadlines for its adoption or

implementation. National financial support for the agricultural sector has increased from EUR 11 million in 2001 to more than EUR 80 million in 2004, comprising both subsidies and investment credits. Under the SAPARD programme, close to EUR 200 million were spent since 2000r on modernising farms, improving breeding conditions and investing in new machinery. The main challenges in the sector remain the need to increase productivity, to align with EU standards and to improve living standards in rural areas.

In the environmental sector, reforms are mainly driven by the need to fully meet EU standards and requirements. This will require both public and private investments especially in the areas of waste water management and pollution control and reduction. A new National Environment Strategy for the years 2005-2014 together with an Action Plan for 2005-2009 focuses on the provision of good quality water, preserving a high quality environment in inhabited areas, preserving biological diversity, incorporating ecological policies in other sectoral or regional policies, ensuring efficient environmental management and accomplishing global commitments.

5. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

5.1. The quality of public finances

On the revenue side, the National Revenue Agency (NRA) has become operational in January 2006 and will be solely responsible for the collection of taxes and social security contributions. This is supposed to improve tax compliance, reduce costs of tax collection and improve services to taxpayers, including through facilitating the access to services via the Internet. On the expenditure side, multi-annual and programme budgeting, which are currently applied only in some ministries, are supposed to be gradually rolled out to other ministries. There is no reference to a specific timetable in this respect, whereas the 2004 PEP had envisaged the full introduction in all primary-level budget spending units by 2007. A new law on the 'Structure of the State Budget' is expected to improve budget execution through stricter enforcement of budget discipline. As regards the structure of expenditures, the absorption and co-financing of EU Structural and Cohesion Funds is expected to increase capital expenditures from 4.0% of GDP in 2004 to 6.0% of GDP in 2008. Expenditures on research and development are expected to increase steadily until 2010 but will remain at a comparatively low level of 0.73% of GDP (including both public and private expenditures).

Especially in view of the projected accession-related extra expenditure needs and the related risks for the fiscal stance in 2007 and 2008 further efforts would be important to enhance the efficiency of public spending, optimise the size of the public sector and improve the quality of services provided. As already highlighted in the assessment of the 2004 PEP, the size of the public administration has continuously increased since 2001 despite an overall reduction in public sector employment. Between 2003 and 2004, the number of employees in public administration increased by more than 6%, and in 2005 it increased again by close to 9%. Reforms in the public administration, also to prepare for EU accession, may require new staff. But if accompanied by appropriate restructuring, this does not necessarily require a net increase in employment. The transparency and efficiency of budget planning and execution could also be improved further. As mentioned above, the current practice of under-estimating budget revenues and at the same time under-budgeting certain expenditures such as end-of-year wage

bonuses, reduces the transparency of budget execution, limits the room for lowering the tax burden, and encourages discretionary spending in particular towards the end of the year.

5.2. The sustainability of public finances

A projection on the long-term sustainability of public finances is provided in Table 9 of Appendix 1. However, there is no separate section in the main text discussing the scenario or explaining the underlying assumptions and methodology. Total general government expenditure and revenues are projected to decline to 36% of GDP in 2020 and to remain at this level. Pension expenditures as a share of GDP have been revised considerably upwards compared to the 2004 PEP. Especially in the later years, the difference amounts to around 2 percentage points. In line with this, pension contributions have also been revised upwards to a similar degree. Neither of these changes is sufficiently explained in the programme and it is surprising that these changes do not affect the long-term revenue- and expenditure-to-GDP ratios. Further key assumptions in the scenario are a gradual decrease of growth rates of real GDP and labour productivity and an increase in the participation rate of the working age population from 62.3% in 2005 to 71.7% in 2050.

A comprehensive pension reform has been adopted in 2000 with the aim of improving the financial sustainability of the system. The pension age is gradually being increased until 2009 to 63 for men and 60 for women. The eligibility criteria for pensions depending on both the age and the years of service are also being increased. Measures have been taken to tighten the rules on early retirement schemes, to improve the correspondence between contributions and benefits received and to link pension increases to inflation and increases in the social security income. The reduction of pension contributions to the first pillar pension fund by 6 percentage points in 2006 will reduce pension revenues by approximately 1.5% of GDP and lead to a greater reliance of the pension system on transfers from the state budget. Contributions to the additional, compulsory funded pension insurance for persons born after 1959 will be gradually increased from 3% in 2005 to 7% in 2007 with an equivalent reduction in the contribution to the first pillar pension fund. Possible changes to the indexation formula for pension increases are currently being discussed and could lead to a higher financial burden on the pension system. At the same time, the 2006 Budget Law envisages the establishment of a 'Silver Fund', which would be financed partly from privatisation revenues and would serve as a special reserve fund for the pension system.

Reforms in the health sector aim at improving financial stability and economic efficiency with a particular emphasis on hospitals. Overall health expenditures are expected to remain relatively stable at around 4.3% of GDP over the programme period and to increase to 5% of GDP in the long run. Expenditures for hospitals are projected to increase from 1.7% of GDP to almost 3% of GDP in 2008. The main reform measure foreseen in the programme envisages the concentration of hospital financing in the hands of the National Health Insurance Fund with a progressively closer linkage between payments and services provided. Tighter controls over hospital expenditures and changes to the management structures are supposed to introduce greater financial discipline. A draft law under discussion envisages the possibility of introducing co-payments by patients to achieve full cost coverage of their treatment. A more comprehensive strategy for the restructuring of the hospital sector is to be prepared by the Ministry of Health. It is envisaged that this might include the privatisation of certain hospitals and polyclinics as from 2007. The envisaged measures should help to improve financial

discipline in the hospital sector while at the same time improving the quality of services. However, a comprehensive strategy on how to deal with existing overcapacities and how to better align the supply of health services with the needs of a shrinking and ageing population still remains to be developed.

Bulgaria has thus 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.

* * *

Annex table 1: **Structural indicators**

	BULGARIA					EU 25				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
General economic background										
Real GDP [1]	4.1	4.9	4.5	5.7	5.5	1.9	1.2	1.2	2.4	1.6
Labour productivity [2]	8.9	3.5	1.6	2.2	n.a.	0.8	0.8	0.6	1.6	n.a.
Real unit labour cost [3]	0.8	-3.4	0.4	1.6	1.9	0.3	-0.4	-0.2	-1.1	n.a.
Real effective exchange rate [4]	107.5	107.7	110.7	117.2	123.4	91.4	96.8	108.9	115.6	113.0
Inflation rate [5]	7.4	5.8	2.3	6.1	5.0	2.5	2.1	1.9	2.1	2.2
Unemployment rate [6]	19.5	18.1	13.7	12.0	9.9	8.4	8.8	9.0	9.1	8.7
Employment										
Employment rate [7]	49.7	50.6	52.5	54.2	n.a.	62.8	62.8	62.9	63.3	n.a.
Employment rate - females [8]	46.8	47.5	49.0	50.6	n.a.	54.3	54.7	55.0	55.7	n.a.
Employment rate of older workers [9]	24.0	27.0	30.0	32.5	n.a.	37.5	38.7	40.2	41.0	n.a.
Long-term unemployment [10]	12.1	12.0	8.9	7.2	n.a.	3.8	3.9	4.1	4.1	n.a.
Product market reforms										
Relative price levels [11]	39.5	41.6	42.6	43.0	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	59.2	56.3	58.1	63.4	68.6	37.5	37.6	38.1	39.8	40.9
Total FDI in reporting economy [13]	9.5	9.8	10.5	14.0	8.4	40.8	40.8	44.9	n.a.	n.a.
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]	0.5	0.2	0.5	n.a.	n.a.	0.3	0.3	n.a.	n.a.	n.a.
Business investment [16]	14.7	15.3	16.5	17.8	n.a.	17.8	17.2	16.9	17.1	n.a.
Knowledge-based economy										
Tertiary graduates [17]	4.9	5.5	5.1	n.a.	n.a.	47.0	49.0	52.2	n.a.	n.a.
Spending on human resources [18]	3.5	3.6	n.a.	n.a.	n.a.	5.1	5.2	n.a.	n.a.	n.a.
Educational attainment [19]	78.2	77.5	75.6	76.0	76.8	76.1	76.5	76.5	76.6	77.3
R&D expenditure [20]	0.5	0.5	0.5	0.5	n.a.	1.9	1.9	1.9	1.9	n.a.
Internet access [21]	n.a.	n.a.	n.a.	10.0	n.a.	n.a.	n.a.	n.a.	43.0	48.0

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 IC34 (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 (2005 -2008)

- OVERVIEW AND ASSESSMENT -

1. INTRODUCTION

Romania submitted its 2005 Pre-Accession Economic (PEP) on 1 December 2005, covering the period 2005-08. 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 2005 PEP in terms of content, form and data. The PEP provides evidence of progress in the analytic capacity of the authorities, notably the computation of cyclically adjusted budget balances, the improved analysis of the long-term sustainability of public finances and quantified estimates of the broad public sector deficit, including the effects of arrears, off-budget guarantees and financing of state-owned enterprises. The programme provides a factually correct summary of recent macroeconomic developments, although more emphasis could have been put 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. As the envisaged structural policy actions are not always concisely described and as a clear timetable is often not set, the PEP is yet to give a full illustration of the interplay between structural reform and fiscal and wage policies. The programme follows the requested format and provides largely complete tables, which are in all but one case correctly compiled. The increased use of ESA 95 data is evidence to the gradual alignment towards EU standards, which is also supported by the ongoing changes to the national budgetary accounting. At the same time, further efforts are warranted to ensure fully compatible, timely and sufficiently detailed ESA 95 data before the time of Romania's accession.

The programme's strategic goal is restated as ensuring a sustainable real convergence of the Romanian economy and continuing to improve the business environment in order to enable Romania to cope with the competitive pressures and market forces within the European Union. Reduction of inflation and regional disparity are also mentioned as priorities. Compared to the 2004 PEP, the programme sets fewer and clearer objectives, but does not in all cases clearly assign the key instruments envisaged, both in relation to the structural reform agenda and to the macroeconomic objectives. Fiscal policy will remain geared towards stimulating economic growth, but in respect of the need to ensure macroeconomic stability, and towards providing the resources necessary to finance accession related expenditure. The general government budget deficit would stay under control and quasi-fiscal subsidies be further reduced. Monetary policy will aim at sustainable disinflation within an inflation targeting regime that discretionarily blends interest rate policy, exchange rate policy, prudential and administrative measures in order to reach the announced target. 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. MACROECONOMIC DEVELOPMENTS

2.1. Recent macroeconomic developments

The programme presents a concise and factually correct overview of economic developments in 2004 and the first two quarters of 2005. A more explicit view on the macroeconomic consequences of the considerable tax cuts undertaken in January 2005, notably the extent to which they may explain why domestic demand and inflationary pressures did not moderate as expected, would have been welcomed. Moreover, some further discussion of the impact of rapid exchange rate appreciation, high nominal wage growth, energy price hikes and disastrous floods could have been envisaged. The document makes use of all relevant national account, external trade and current account data available at the time of submitting the PEP, but could have benefited from an update with regard to the atypical budget execution in 2005. Compared to last year, the presentation gives more emphasis to inflation dynamics and to the financing of the growing current account deficit, which is welcomed.

Table 1: **Comparison of macroeconomic developments and forecasts**

	2004		**2005**		**2006**		**2007**		**2008**	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	8.3	**8.3**	5.2	**5.7**	5.3	**6.0**	5.0	**6.3**	n. a.	**6.5**
Contributions:										
- Final domestic demand	11.0	**11.0**	8.9	**10.5**	8.4	**7.9**	7.6	**7.6**	n. a.	**7.9**
- Change in inventories	0.1	**0.1**	0.0	**0.0**	0.0	**0.1**	0.0	**0.1**	n. a.	**-0.1**
- External balance of goods and services	-2.8	**-2.8**	-4.9	**-4.8**	-3.5	**-2.0**	-2.4	**-1.4**	n. a.	**-1.3**
Employment (% change)	0.4	**0.2**	1.6	**0.1**	0.5	**0.3**	0.0	**0.2**	n. a.	**0.1**
Unemployment rate (%)	7.1	**8.0**	6.5	**7.9**	6.1	**7.8**	5.9	**7.6**	n. a.	**7.4**
GDP deflator (% change)	15.9	**15.9**	12.5	**11.5**	8.5	**8.2**	6.9	**6.2**	n. a.	**4.7**
CPI inflation (%)	11.9	**11.9**	9.1	**9.0**	7.4	**7.0**	6.0	**5.0**	n. a.	**3.6**
Current account balance (% of GDP)	-7.6	**-8.7**	-8.1	**-8.1**	-9.9	**-7.0**	-10.4	**-5.9**	n. a.	**-5.1**

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

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

In 2004 GDP grew by 8.4% on the back of a broad based increase in supply and a vast harvest. Growth was sustained by a further strengthening of household and NPISH consumption, growing by 14.2%, on the back of high real wage gains, and by strong gross fixed capital formation, which grew by 10.8%. With a real growth of 4.2%, government consumption also expanded considerably. The strong domestic demand led to a sustained import growth of 22.1%, which outpaced export growth of 13.9%. Net exports contributed negatively by 4.5% of GDP to real growth. In 2005, GDP grew by 4.1%, well below expectations. The slump was caused by a decline in agricultural value added of close to 14% due to floods and the vast 2004 harvest as well as a growth in industrial value added of only 2.5%, which is of some concern

for the medium-term outlook. Reduction in stocks following floods had a negative impact on GDP growth of 1.1%. Household consumption continued to grow strongly by 9.7% against the background of purchases of new goods increasing by over 20%, while the rural population's own consumption fell. Gross fixed capital formation accelerated over the course of 2005 to a 13% growth for the year. Due to a significant decline in export growth to 7.6% and continued strong import growth of above 17%, net exports had a negative contribution to real GDP growth of 5.0%. The trade deficit widened further to around 9.9% of GDP. Following a methodological revision the 2004 current account deficit was adjusted up from 7.5% of GDP to 8.4% of GDP. The 2005 current account deficit increased further to 8.7% of GDP.

2.2. Macroeconomic scenario

The programme's strategic goal is restated as ensuring a sustainable real convergence of the Romanian economy and continuing to improve the business environment in order to enable Romania to cope with the competitive pressures and market forces within the European Union. Reduction of inflation and regional disparity are also mentioned as priorities. Macroeconomic stabilisation is no longer an explicit objective, which in view of the unbalanced composition of growth, slowing disinflation and widening external balance over the course of 2005 is not reassuring. Fiscal policy will remain geared towards stimulating economic growth, but in respect of the need to ensure macroeconomic stability, and towards providing the resources necessary to finance accession related expenditure. Monetary policy will aim at sustainable disinflation within an inflation targeting regime, which blends interest rate policy, exchange rate policy, prudential and administrative measures in order to reach the announced target. A prudent wage policy in the public sector, including state-owned enterprises, is set as a condition for achieving the programme's fiscal targets, but the public sector wage policy appears to be fully determined by the envisaged 60% nominal wage increase over the programme period and not by budgetary considerations. A looser than intended public sector wage policy, which would spill over to the private sector wage formation, therefore remains a main risk for the programme.

One macroeconomic framework is presented, which is sufficiently comprehensive and gives a broadly consistent overview of demand and supply side developments. Based on an improved production function methodology, the framework gives a clear presentation of the sources of potential GDP growth. While adding to the analytical dimension of the programme, the potential growth path appears optimistic in its projection of potential employment and investment ratio, and seems moreover to benefit from a very high and unexplained contribution from total factor productivity. For this reason, potential GDP grows at an average 6.6% over the programme period, which is 1-1.5 percentage point above other estimates of Romania's potential GDP growth. An average 6.3% real GDP growth over the programme period can therefore go hand in hand with diminishing output gap, accelerated disinflation and rapidly declining external imbalances. In view of recent year's widening output gap and the many signs in the economy of excess demand, the lacking substantiation of how demand and supply side changes would bring about such remarkable growth rate and at the same time improve stability is a main weakness in the framework. The programme to some extent recognises this by pointing to an insufficient supply side response to final demand as a main risk, which would engender slower growth, inflationary pressures and a further deterioration of the external balance.

Relative to last year's PEP, the major revision relates to the composition of growth in 2005, which is more driven by household and government consumption than expected, while gross fixed capital formation and in particular exports grew considerably slower than expected. This occurrence, which can not be explained by the disastrous floods alone but must be seen also in the light of tax cuts, strong appreciation and robust credit growth, seems not to have altered the programme's conviction that private consumption growth will moderate significantly in coming years in spite of major determinants of household consumption remaining in favour of continued strong consumption growth (falling unemployment, rising employment, considerable wage increases, declining inflation, continued appreciation and solid credit growth). Moreover, in spite of the private sector savings ratio dropping in 2005 well below expected, it is still expected to surge over the programme period for which no clear explanation is provided.

The external outlook underpinning the macroeconomic framework seems appropriate. Based on a stronger momentum of the EU economic recovery, robust world economic activity and high commodity prices, it is in line with the Commission Autumn 2005 forecast. Following the sharp nominal appreciation of the currency since the second half of 2004 and the expectation of continued capital inflows, the programme expects a moderate nominal appreciation of around 1% annually over the programme period.

Real sector

For the period 2006-2008, 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 moderate over the programme period compared to recent years, notably due to a gradual easing of household consumption growth, while annual investment growth will expand by close to 12% on average on the back of a strong increase in both private and public sector investments. EU transfers, which in the macroeconomic scenario are expected to reach 4% of GDP after accession, will progressively fund an increasing share of investments. Real government expenditure is seen to grow by an average 3.1% annually, which is well below the rate recorded in 2004 and 2005. In line with the PEP's overall objective of ensuring a sustainable external position, the substantial negative contribution to GDP growth from the net exports currently observed declines over the programme period against the background of more tempered import growth.

The supply side is still expected to display a fast adaptation to changes in final demand in spite of some evidence of the contrary having occurred in 2005. 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 confidence, is plausible. High activity is also expected in the services sector, which is forecasted to grow by 6.7% on average, while real agricultural production growth will hover around 3% annually. Industrial production growth of above 5% will continue to underpin economic growth, and the programme suggests that the considerable slowdown in industrial value added over 2005 is of a temporary nature. This is questionable since the energy price shock and the loss of domestic and international competitiveness following high wage growth and rapid exchange rate appreciation has caused a broad slow down in both manufacturing, mining and energy production, with all but a few manufacturing productions (furniture, transport means and petroleum production) having recorded declining growth rates in 2005. The effects of this triple shock to industrial production in 2005 may moreover not vanish very quickly and may indeed

speed up the structural adjustment process in the enterprise sector, which could take a medium-term toll on industrial production.

The PEP foresees higher participation and employment rates and gradually falling unemployment. Working-age employment is broadly stable and seen as determined, on the one hand, by growing employment in the SME sector and in relation to FDI inflows, and, on the other hand, by the effect from lay-offs caused by the restructuring in the enterprise sector and lower public employment. Due mainly to a higher employment rate, the ILO unemployment rate is expected to fall moderately over the programme period. 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 labour market developments seem to break with the very steady decline in participation and employment rates over the past decade. The programme does not provide explicit arguments for this trend reversal, which could, however, be understood as a continuance of the relatively good labour market performance observed in 2005, which the programme relates to the impact of the tax reform on downsizing the informal economy. There are indeed indications that the tax reform strengthened the incentive to bring into the open unreported salaries for people having a formal work contract, thereby causing a shift from informal to formal remuneration. With high payroll taxes now envisaged to be cut, some positive effect of the flat-rate income tax on official employment could persist over the programme period, but whether this can fully off-set the likely decline in industrial and public sector employment remains questionable.

The macroeconomic outlook is more optimistic than the Commission Autumn 2005 forecast, which took into account a stronger effect on the external balance of the expected real appreciation of the currency, considerable wage growth and expected deterioration in terms of trade. The Commission forecast does not incorporate a noticeable slowdown of public consumption growth as in the case of the PEP and foresees a more moderate growth in gross fixed capital formation. Bearing in mind the advantages of a cautious macroeconomic scenario, the PEP’s discussion of an alternative scenario consisting of weaker domestic supply, laxer wage and fiscal policy and a larger negative contribution from external trade to GDP is very relevant.

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 6.6% potential GDP growth during 2005-08, explained in particular by a strong increase in the capital stock and a very large positive contribution from total factor productivity growth (TFP), which explains around three quarters of potential growth. The computation of potential GDP growth is very sensitive to the specification of TFP, and Romania’s estimate that TFP growth contributes by about 5 percentage points to potential GDP growth is well above the highest estimates of about 3 percentage points in the case of the 10 recently acceded Member States. Furthermore, contrary to what has been observed hitherto, labour will no longer subtract from but add to potential growth. Given the steady decline in the working age participation rate since the mid-1990’s, the programme’s assumption of increasing participation rate and a further decline in NAWRU yield a fairly optimistic profile of potential employment over the programme period. The labour force may well fall and not increase as projected in the PEP, not least since 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. If holding the participation rate and NAWRU constant at the 2004 level, a positive output gap of approximately twice the size foreseen in the PEP would persist over the programme period. At the same time, the programme may have wished to relate its estimates of potential employment to the envisaged reform of agriculture, notably how to deal with the 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 and low earnings, which function as a retreat for many unemployed, elderly and poor people.

External sector

In line with the expectation of high private consumption and investment activity, the programme foresees a lasting trade deficit of about 10% of GDP over the programme period. The stabilisation of the widening trade deficit encountered over recent years contrasts with the Commission Autumn 2005 forecast, which expected a continued widening to above 12% of GDP in 2007. This discrepancy is explained by differences in the forecasts' terms of trade and the PEP's more pronounced slowdown in import growth. In the PEP, an increase in current transfers (remittances and EU transfers) of about 1% in GDP over the programme period would alleviate the impact of the trade deficit on the current account deficit, which is expected to retreat strongly to 5.1% of GDP in 2008. The programme, however, leaves out a concise estimate of the current transfers expected from the EU. With a view to the past shortfall between projected and actual EU transfers, it should be recalled that such transfers to a large degree depend on advancing the institutional and programmatic framework necessary to absorb the increase in available EU funding. Based on the presentation of expected budgetary flows between Romania and the EU in the PEP's fiscal chapter, the increase in EU transfers would origin from the payments from structural and cohesion funds, which would amount to 0.6% of GDP in 2008. However, the majority of these transfers would be recorded as capital transfers. As agricultural transfers would not be expected to significantly exceed Romania's contribution to the EU budget in 2007-08, it is therefore difficult to explain the strong growth in current transfers by EU transfers. Furthermore, the foreseen improvement in the incomes balance by 1% of GDP and the improvement in the services balance, which moves from a deficit of 0.5% of GDP in 2005 to a surplus of 0.2% of GDP in 2008, also seem out of line with the PEP's expectation of increasing foreign investment, which could be expected to lead to increasing repatriation and re-investment of profits, and continued trade integration, which could be expected to worsen the current deficit in transport and other services.

Overall, current account developments could well turn out much less comforting than scheduled in the programme. This concern is confirmed by the PEP's savings-investment balance perspective, which yet again presents a highly optimistic increase in private sector savings over the programme period. In spite of the private sector savings ratio in 2005 having turned out nearly 5 percentage point lower than expected in last year's PEP, the programme still expects a 7 percentage point increase in the savings ratio over the programme period. While last year's PEP argued that the tax cuts would lead to increasing private sector savings, the current programme sees the competitive pressure from Romania's entry into the Internal Market as the main reason why the corporate sector will save more. Even if that effect could occur, it seems contradictory to the PEP's statement that the acceleration of structural reforms will lead to a fast adaptation of Romanian production to international market demand, and the programme fails to provide a convincing argumentation for the expected remarkable change in the savings/consumption pattern of the private sector.

Given the PEP's current account projections, the expectation of a significant increase in EU capital transfers from 2007 and the exchange rate appreciation, the foreign-debt-to-GDP ratio is projected to fall by 6 percentage points of GDP and would reach 25% of GDP in 2007. 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, however, plausible, even if the programme builds on a cautious assumption that FDI inflows will gradually decline from 5.3% of GDP in 2005 to 3.3% of GDP in 2008. In the light of improved credit ratings, Romania's EU accession perspective and the already distinctly lower risk premium on sovereign debt, this should cause no difficulty. Large international reserves could also, in case of needs, facilitate the financing of the current account deficit.

The programme re-iterates Romania's commitments in the context of EU accession as regards liberalisation of the capital account, which will be completed by 1 September 2006 at the latest by liberalising the operations in money market instruments. The operations in current and deposit accounts by residents with foreign financial institutions was liberalised in 2005, and in January 2006 foreigners gained access to the state bond auctions, which in 2006 are expected, however, to remain quite small in size due to limited need for new debt issuing. The programme mentions Romania's decision in the beginning of 2004 to delay the liberalisation of non-residents' access to domestic deposit accounts denominated in the domestic currency in order not to spur further credit growth and add to the potential volatility of the balance of payments. In April 2005, this liberalisation was successfully undertaken, and confirmed a welcome 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-discrimination and proportionality. While safeguards may play a positive role in preventing certain short-term inflows, prudence in fiscal and wage policy would also facilitate the further capital account liberalisation by reducing the need for a tightening of the currently accommodating interest rate policy in order to meet the ambitious inflation targets set for 2006 and 2007.

2.3. Monetary and exchange rate policy

The PEP carefully describes the implementation of direct inflation targeting since August 2005, but is somewhat vague in offering insights into how the authorities will overcome the monetary policy dilemmas experienced and does not contain a clear forward-looking view on how various monetary policy instruments will be used over the programme period. Against the background of first adjusting upwards and subsequently missing its 2005 inflation target, the central bank will focus on sustainable disinflation, while progressively paying less attention to economic growth, exchange rate and external balance objectives. The PEP is, however, much less explicit than recent central bank policy statements in recognising that achievement of the ambitious disinflation path also depends crucially on fiscal and wage policies, which must bear an increasing responsibility for domestic demand management and the external balance.

Inflation expectations will be anchored primarily by the announcement of the inflation target and the continued appreciation of the currency, which will be supplemented by the interest rate and sterilisation policy as well as the use of prudential and administrative measures, which should ensure that credit growth remains within non-inflationary boundaries and that financial stability is preserved. While this all-encompassing set of instruments illustrates that the central bank is willing to pursue its inflation target with all means available, the programme also implicitly suggests that monetary policy has in reality run out of effective traditional instruments to curb inflationary pressures and that the current unorthodox inflation targeting will therefore continue over the programme period. In this respect, more clarity about the conditions under which the central bank's interest rate policy will again become an effective tool and the extent to which the central bank would allow a sharper nominal appreciation than foreseen in the programme would have been welcomed. Enhanced transparency in this respect would alleviate the concern that may seek but fail to simultaneously pursue inflation and exchange rate objectives. That could cause a risk to the medium-term credibility of the regime change from a managed float regime to full-fledged inflation targeting in which the interest rate policy will ultimately become the predominant monetary policy tool.

Going hand in hand with the switch to inflation targeting, the central bank has pursued a more flexible exchange rate policy by limiting and making forex market interventions more unpredictable and abandoning the pre-announced forecast for the annual real exchange rate appreciation. This policy of a "soft managed float" along with increasing capital inflows implied a nominal appreciation of around 7% against the euro over the course of 2005. The programme anticipates an annual nominal appreciation of the exchange rate vis-à-vis the euro in the vicinity of 1% over the programme period which combined with a slower decline in inflation would translate into a more pronounced real appreciation than foreseen in the 2004 PEP. The programme aims at continuing a managed float for the time being in order to prevent a misalignment with fundamentals in the form of an unsustainable real appreciation. This policy seems to imply that the central bank may continue to intervene on the forex market in an irregular and unpredictably way in order to stem volatile capital inflows by disrupting appreciation expectations. As the absence of forex market interventions since Autumn 2005 also seems to indicate it is, however, questionable whether such discouragement policy can be successfully pursued over several more years in view of a strong underlying trend in inflows, further liberalisation of the capital account in the run-up to EU accession and the significant losses of the central bank due to the cost of sterilisation. A free float of the currency is planned only for when the interest rate differential to international markets has been sufficiently reduced and a lower than 4% annual inflation rate achieved. This would according to the programme happen in 2008. Interestingly, the freeing of the exchange rate at this time is not associated with a steeper appreciation of the currency but the contrary, even if capital inflows will remain high.

The programme unambiguously explains that monetary policy has faced a dilemma in using interest rate policy to restrain aggregate demand and stem the overly rapid credit growth without giving a further impetus to the resurgence in capital inflows. For this reason, the setting of key interest rates and the degree of sterilising excess liquidity has over the course of 2005 oscillated between tightening and easing, but have generally been accommodating in relation to aggregate demand and credit growth. Although explicable, the frequent change in the direction of the central bank's interest rate policy has by market participants not been perceived as neither fully transparent nor entirely consistent. As the effectiveness of the interest rate policy has also been hampered by credit growth being predominantly foreign currency lending and by a low responsiveness of the commercial banking system to minor policy rate changes, the

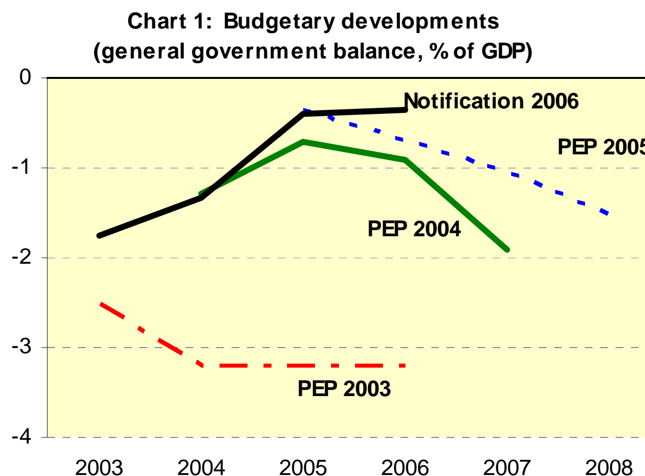
central bank has progressively resorted to stricter minimum reserve requirements, prudential measures (stricter lending norms and increased provisioning requirements) and administrative measures (limit on foreign currency lending to three times the equity of a bank) in order to put a brake on credit growth. Although successful in slowing the expansion of foreign currency credits, the measures have not been able to prevent an overall reacceleration of private sector credit growth. As other measures than administrative ones by now appear to be largely exhausted, a further resort to quantitative restrictions may regrettably be deemed necessary unless interest rate policy is tightened, which the programme does not favour, or a sharper nominal appreciation is allowed for.

The inflation path outlined in the programme is adjusted upwards as compared to the 2004 PEP by about 1%-point in 2005 and 2006, implying that average annual inflation would be brought down at a slower pace from 9.0% in 2005 to 3.6% in 2008. The programme's 2006 end-year inflation projection of 5.5% differs from the official target of 5%, but in the absence of any strong appreciation during 2006 and with a view to the significant inflationary risk from fiscal and wage policy as well as from international energy prices and administered prices, even this level may be difficult to achieve. The hypotheses underpinning the inflation forecast are helpful for identifying factors directly or indirectly determining inflation, even if the programme surprisingly refrains from mentioning wage developments, credit growth and import price dynamics in this context. Contrary to the 2004 PEP, the programme omits a presentation of the determinants of *future* inflation dynamics, and gives only a valuable and detailed account of developments in 2005. This shortfall is regrettable, not least since some estimate of the future food, non-food and services price inflation on the basis of the central bank's improved forecasting framework would have clarified to what extent low food price increases and considerable increases in administered prices are expected to continue to significantly affect headline inflation. It is given, however, that administered prices will continue to have an impact on price level and expectations, while the programme is silent with respect to the probably weaker disinflationary effect from import prices and the inflationary pressure stemming from credit growth. The programme mentions that an increase in the relative price of non-tradables due to the spill-over on wages from higher productivity growth in the open sector (Balassa-Samuelson effect) will result in inflationary pressure. In this context, some account of the future interplay between the outlined wage policy and inflation would have been natural. The programme correctly stipulates that a prudent policy-mix will play a key role in keeping aggregate demand in check, but it does not consider wage slippage a possible risk to the macroeconomic scenario and falls short of convincing that wage developments would not again cause considerable inflationary pressures.

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

The programme's fiscal framework aims at making budgetary resources available for efficiency enhancing expenditures, which would contribute to attain the programme's overall objective of sustaining the real convergence process. Budgetary resources would be provided by an improved capacity to absorb increasing EU transfers and a revenue policy centred on broader tax base, strengthened tax collection, improved symmetry in the taxation of various sources of income and a gradual cut in social security tax rates. Overall, the programme displays awareness of the possible benefits to be reaped from improving the tax system and the structure

of expenditure. The programme puts relatively more emphasis on revenue developments, where key measures are generally well explained, albeit an increased use of quantified estimates for the most important revenue raising measures could be envisaged. Compared to last year's submission, the programme projects a more realistic path for total revenues following the significant cuts in income and profit tax in 2005.



The programme is less convincing in explaining how considerable budgetary financing needs in many areas would go hand in hand with a consolidation of public finances under the constraints of a 1.5% of GDP decline in the revenue ratio and a stable expenditure ratio. An upcoming medium-term fiscal strategy is expected to substantiate the expenditure side of the programme by presenting medium-term priorities within an integrated budgetary framework. Success in the execution of the 2006 budget will be crucial to ensure that the programmed widening of the cyclically adjusted deficit over the programme period, which constitutes a pro-cyclical policy stance, can be contained to the planned level. While the programme's analysis of the cyclically adjusted budget balance is an important analytical step forward, it relies on an optimistic projection of potential GDP growth. The computation therefore tends to underestimate the output gap and the cyclically-adjusted deficit recorded in 2005. As Romania's 6.6% estimate for potential GDP growth over the programme period is 1-1.5 percentage point above other estimates of potential output, the output gap is likely to widen further instead of narrowing if the programme's macroeconomic projection materialises. This casts some doubt over the medium-term fiscal prospects. The programme rightly identifies and openly deals with a number of important downside fiscal risks, some of which could have been analysed in more depth. 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 progress, the detailed account of expected EU transfers is still described on a cash basis and it remains unclear whether the budgetary accounting of EU transfers is fully aligned with the decision of Eurostat from February 2005 on the treatment of such transfers. Moreover, ESA 95 is not yet the main reference for Romania's fiscal analysis and a need remains to provide fully compatible and detailed ESA 95 data before accession.

3.1. Targets and adjustment

In 2005, the fiscal outcome was influenced by four main developments: the budgetary effect from reducing the profit tax rate from 25% to 16% and introducing a 16% flat rate income tax, very high growth in revenue from indirect taxes, significant undershooting in public spending and a jump of 2% of GDP in non-tax revenues and grants. Each of these factors are of importance in explaining the 2005 fiscal outcome, which with a deficit of 0.8% of GDP in

national budgetary accounting terms was lower than foreseen in the original 2005 budget. First, the cuts in the income and profit tax rate had a negative impact on direct tax revenues of about 1% of GDP in 2005, including the revenue raising effect of broader profit tax base and higher tax rates for micro-enterprises and other earnings (dividends, interest and capital gains). The concern about a decline in Romania's already low revenue-to-GDP ratio was therefore confirmed. The negative impact on income and profit tax collection from introducing the flat tax rate and cutting the profit tax rate was in 2005 not as large as the reduction in the average tax rates. If taking into account the cyclical position of the economy, the revenue loss was, however, either larger (income tax) or fully in line with (profit tax) the reduction in the tax rate. The revenue loss was mitigated by a higher than expected growth in official employment, which reflects the formalisation of some jobs. Broadening of the tax base, stepped-up efforts of the tax administration to improve collection and the switch of micro-enterprises to pay the standard profit tax helped to limit the negative impact of the rate cut on collection.

Second, revenue collection from cyclically sensitive indirect taxes turned out well above expected due in particular to much higher than budgeted revenues from VAT on the back of rapid consumption growth, rising imports and higher than foreseen inflation. Continued strong household consumption, which was supported by the tax reform, therefore temporarily gave extraordinary revenue gains, but the revenue raising measures carried out via the amendment to the Fiscal Code in June 2005 and administrative improvements that strengthened enforcement also proved to be of value. Third, slower than planned implementation of public investment programmes had a sizeable impact on the budgetary outcome with total capital spending falling

Table 2: **Composition of the budgetary adjustment** (% of GDP)

	2004	**2005**	**2006**	**2007**	**2008**	**Change: 2005-08**
Revenues	32.1	33.4	32.9	32.2	31.9	-1.5
of which:						
- Taxes and social security contributions	28.4	27.7	28.4	28.3	28.0	0.3
- Other (residual)	3.7	5.7	4.5	3.9	3.9	-1.8
Expenditure	33.5	33.7	33.6	33.2	33.5	-0.2
of which:						
- Primary expenditure	32.2	32.6	32.5	32.2	32.4	-0.2
of which:						
Gross fixed capital	3.9	4.2	4.7	4.8	5.1	0.9
Consumption	6.0	5.9	5.8	6.6	6.6	0.7
Transfers & subsidies	20.6	19.7	19.0	17.6	16.5	-3.2
Other (residual)	1.7	2.8	3.0	3.2	4.2	1.4
- Interest payments	1.4	1.2	1.1	1.0	1.0	-0.2
Budget balance	-1.5	-0.4	-0.7	-1.0	-1.6	-1.2
- Cyclically adjusted						
Primary balance	-0.1	0.8	0.4	0.0	-0.6	-1.4
Gross debt level	18.1	17.1	15.1	14.6	14.6	-2.5

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

from 2004 by 0.7% of GDP according to the PEP. Compared to budgeted, capital spending declined by 1.7% of GDP, and in spite of a significant slippage in public sector wage policy, rapid growth in pension payments and the repair costs following a series of disastrous floods, total public spending therefore turned out below budgeted. The lower spending was not entirely voluntary as shown by total expenditure being revised up in all three revised budgets over the course of 2005, last time in November. Some investment projects did not advance as planned due to difficulties in their implementation. Finally, the programme shows that non-tax revenue and grants each increased by 1% of GDP from 2004 to 2005, which the programme does not explain. Presumably, the increase in grants relates to EU payments under PHARE and ISPA following the low releases of such funds in 2004, but the preliminary national budget data for 2005 seem not to confirm this strong increase. Similarly, the strong increase in non-tax revenue can only be partly explained by the extension of the road toll.

The total impact of these factors implied a growing general government surplus over the course of 2005, and even with extraordinarily high spending in the month of December, the recorded budget deficit still turned out below the original budget's target and the revised deficit target of 1% of GDP in national budgetary accounting terms, which was confirmed in a budgetary rectification in November. At the aggregate level, fiscal policy did therefore not turn out pro-cyclical in 2005 as witnessed by a declining structural deficit. This ex-post outcome does, however, not give sufficient guidance to the appropriateness of the fiscal policy stance. The tax reform and public sector wage policy both had a significant pro-cyclical impact on domestic demand and gave a boost to real disposable incomes in the household and enterprise sector at a time of buoyant consumption and investment growth. Fiscal policy therefore bears part of the responsibility for an unbalanced pattern of growth, widening external imbalances and slower disinflation. Moreover, the initially underfinanced tax reform, the inability to effectively restrain public sector wage growth and three increases in the expenditure budget over the course of 2005 in spite of a backlog in executing spending underscore that Romania did not consolidate its public finances to the full extent possible. The government's efforts towards the end of 2005 to reach its deficit target by increasing spending implied that the general government balance worsened by 1.9% of GDP in the month of December 2005 alone. This coincided with the central bank's announcement that it would most likely miss its 2005 inflation target and that the 2006 target was set increasingly under pressure, and illustrates the very limited demand management considerations in the conduct of fiscal policy. In terms of the broad public sector deficit, Romania showed clear progress in 2005 as efforts were intensified 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 and it is a step forward that the programme contains a specific estimate for the envisaged reduction in the quasi-fiscal subsidies, which gives a clear benchmark for the actions targeting the quasi-fiscal subsidies to state-owned enterprises.

For 2006, the programme's deficit target of 0.7% of GDP broadly confirms the adopted budget's deficit target. In the programme, a slight retreat in the revenue ratio would occur due to non-tax revenues declining by 1% of GDP, while fiscal revenues climbs by ½% of GDP on the back of broader income and profit tax base. Approximation to acquis in the field of excises, customs and VAT will secure revenue gains, which can fully finance the first of a series of cuts in social security contributions over the programme period. Contrary to the 2004 PEP, where revenue from social security contributions was expected to increase by 1% of GDP when

gradually cutting contribution rates by up to 10%-point, this year's submission foresees a realistic decline in social security revenue of 0.9% of GDP over 2006-08 as a consequence of reducing contribution rates by 2% yearly and redirecting part of the contributions from the public pension system to the privately managed occupational pension pillar from 2008. Other revenue estimates are generally plausible and based on well-explained legal and administrative measures. The programme seems to rely, however, on some important amendments to the Fiscal Code, but it is unclear whether these measures will take effect in 2006 or only late in the year, which could negatively affect revenue collection. Moreover, there is a clear risk that real growth will not reach the fairly optimistic 6.0%, which may also have repercussions for revenue collection. The programme would also have benefited from a more extensive quantified analysis of the budgetary effect of various measures, including the expected gains from improving tax administration.

In terms of expenditure policy for 2006, the programme aims at supporting the real convergence process and prepare for EU accession. Main investment priorities within infrastructure, education, environment and agriculture are outlined as well as initiatives to strengthen the education system, increase R&D, improve the functioning of the judiciary and review the health system. While these expenditure landmarks are very appropriate, the provision of a functional allocation of public spending on the basis of COGOF standards would have been useful. As a main shortcoming, the programme is not lucid in substantiating means by which a major restraint of current expenditures and wages will allow the many expenditure priorities to be hosted within a stable expenditure ratio. The programme appears for 2006 to build on questionable assumptions with regard to public sector wage growth and current expenditure for goods and services. Like the 2006 budget, the programme apparently assumes a zero nominal wage growth for public sector employees with the exception of personnel being paid the minimum wage, which in 2006 will increase by 6.5%. Together with a restrictive policy in filling existing vacancies, this will help reducing the public sector wage bill by 0.4% of GDP. Although a cautious public sector wage setting policy is indeed needed in order to re-establish a prudent fiscal policy, declining real wages seem unrealistic. Moreover, neither the adopted budget nor the programme seems to incorporate the decision to increase most public sector wages by 5% as of 1 February and by another 6% by 1 September. The cost is around 0.3% of GDP and seems not to be budgeted. In the programme, the budgetary allocation for goods and services declines in 2006 by 0.9% of GDP to a level well below what has been attained in recent years. The programme does not specify any measures behind this change, which is hard to associate with, for example, the increasing costs in the health sector and the need for further flood repairs in 2006. On these grounds, the Commission services' Autumn 2005 forecast expected a higher general government deficit of 1.4% of GDP in 2006. The ability to restructure expenditures, maintain a restrictive wage policy and use all non-programmed revenue gains to consolidate public finances will therefore be a litmus test for the credibility of the programme's expenditure policy in general and for the 2006 budget execution in particular. Romania should stand ready to implement additional measures to permanently strengthen revenues and thereby move in the direction of raising the revenue-to-GDP ratio as publicly announced by the government.

For the years 2007-08, the programme envisages a continued restraint of wage expenditure and subsidies, while increasing revenue from indirect taxes and from profit and income tax will partly off-set the declining social security contributions and lower non-tax revenues. The revenue ratio retreats by 1% of GDP, which translates into the primary balance worsening by 1% of GDP from 2006-08. The programme deals in some detail with expected payments vis-à-

vis the EU budget. Contrary to the last submission, where EU grants were expected to reach 2.1% in 2007, the 2005 PEP revises downwards the expected EU grants to slightly above 1% of GDP in 2007-08, due primarily to a lower absorption of structural funds. In view of Romania's track record in absorbing available EU funds, this estimate seems plausible although it casts some doubt over Romania's ability to fully benefit from the appropriations agreed in the financial perspectives 2007-13, which would require a strengthened capacity for absorbing EU transfers. Still, the 2005 PEP confirms the positive net transfers from the EU following accession, even though the contribution to the EU budget is revised significantly upwards since the last submission. In the programme, all EU transfers seem to be fully included on both the revenue and expenditure side of central government. According to the Eurostat decision of February 2005, 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. The programme also highlights that stricter enforcement of tax obligations, initiatives to improve voluntary compliance and better tax administration will gradually help to diminish evasion. The good experience with measures taken to strengthen tax collection shows indeed the upside potential for increasing revenues in the medium term, but the programme falls short of presenting such estimates.

The fiscal framework identifies five risks, which are either related to the policy-mix (the external deficit) or may impact on the fiscal outcome (lower GDP growth, off-budget guarantees, sustainability of the pension system and capacity to absorb EU funds). In view of the conduct of fiscal policy in 2005, the PEP explicitly favours a welcome prudent approach in the management of fiscal policy in order to ensure external sustainability. However, the programme downplays the external constraint and does not contain any clear commitment to adjust fiscal policy, should the current account deficit widen further in 2006. Interestingly, the programme states that fiscal policy will have a main responsibility for external sustainability if the monetary and exchange rate policy will set the reduction of inflation as a priority. Since August 2005, the National Bank of Romania has operated an inflation targeting regime and has under its statute as primary objective to ensure and maintain price stability. The analysis of the sensitivity of the revenue ratio to GDP growth shows resilience, which is not surprising given the elasticity of various revenue sources. A more complete analysis, covering also the sensitivity of expenditures, would have been more revealing, notably since the macroeconomic framework is optimistic in its growth projection. The PEP's analysis of contingent liabilities in the form of state guarantees issued for companies' foreign loans confirms that the efforts since 2003 to reform the energy sector, more restrictive provisions in the Public Debt law for issuing state guarantees and tightened financial discipline vis-à-vis state-owned enterprises are bearing fruit. The PEP's calculation of failure ratio is, however, incorrect and it would have been appropriate to mention that although the stock of state guarantees for companies is declining, the issuance of new state guarantees for companies has been increasing over recent years. The risk of not being able to absorb available EU resources is pertinent, and the opportunity cost of unspent funds could have been explored in more depth. In addition to the risks highlighted in the programme, the full amount to be paid from central government as financial compensations for the non-restitution of property confiscated during the communist period is uncertain. The recent establishment of a Property Fund may have significant budgetary implications. Under this construction, the state would transfer shareholding positions in state-owned and partly privatised enterprises to the Property Fund and citizens' claims for compensation (recovery titles) would be converted into shares in the Fund. Under ESA 95 accounting rules, this financial transaction could be expected to be counterbalanced by a capital transfer from general

government, which would have a negative impact on net lending. With the total amount of recovery titles estimated to amount to around 5% of expected 2006 GDP (4.5 billion euro), the budgetary impact is potentially large. Another issue with potentially significant budgetary impact relates to environmental liabilities, for example the cost of clean-up in the mining sector.

Against the background of the risks identified, in particular that slowing growth could bring an end to recent year's markedly good revenue performance and that the realism of programmed expenditures relies heavily on the ability to restructure expenditures and maintain a restrictive wage policy, the budgetary outcome could turn out less comforting than expected. Nevertheless, if Romania succeeds in executing the 2006 budget as adopted and thereby reaches a 2006 deficit at the programmed level, there are reasonably good chances of avoiding the occurrence of an excessively unbalanced budget in the aftermath of EU accession, even if GDP growth would be below projected. A full use of non-programmed revenue gains to consolidate public finances and implementation additional revenue measures, which would ensure a reversal of the declining revenue ratio, would support the sustainability of Romania's public finances. The programme's somewhat ambiguous view on the need for fiscal consolidation is demonstrated by the cyclically adjusted primary balance worsening by more than 0.9% of GDP over the programme period, which brings the cyclically adjusted budget deficit to 1.7% of GDP in 2008. The risk that fiscal policy could engender a widening of the primary deficit was emphasised in the assessment of the 2004 PEP, and the aim for a pro-cyclical fiscal stance remains a concern. Moreover, under a less optimistic estimate of potential growth at the level of 5-5.5%, the positive output gap would not decline but continue to grow. It should at the same time be noted that the projection of an increasing primary deficit in Romania's previous PEP submissions' did not materialise and that some fiscal consolidation was instead achieved. While the programme in general seeks to reconcile the stated objective of fiscal prudence with the priority of using fiscal policy to sustain growth, there is little recognition of the role that fiscal consolidation and avoidance of a pro-cyclical policy stance can play in creating the conditions for macroeconomic stability and sustained high growth over a prolonged period of time.

3.2. Debt developments

The programme points to a favourable evolution of general government debt over the programme period as the debt-to-GDP ratio is expected to progressively decline to below 15%. Since the calculation of the contributions to the change in gross debt is erroneous (the programme expects a primary surplus in 2005 and the exchange rate has appreciated considerably), a significantly lower debt level than shown in the programme should have occurred already in 2005. Over the programme period, 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 1.4% of GDP from 2005 to 2008, the declining trend in Romania's low general government debt-to-GDP ratio is projected to come to an end in 2007. The programme does not expect any positive impact from privatisation receipts on debt developments, and the large privatisations concluded in 2004 and 2005 have apparently not had any material impact on reducing public debt. This is surprising, and it is not clear if this is due to the receipts having been placed in deposits and currency holdings, while the government considers their use for other purposes than debt redemption, namely pension reform and infrastructure investments Although the programme contains a useful sensitivity

analysis of the impact of appreciation on debt service, the programme refrains from estimating the effect of currency movements on the debt ratio, also for 2005 where the domestic currency appreciated considerably against the currencies in which the foreign debt is denominated. Given that close to three quarters of total public debt is contracted in foreign currencies, the programme's projection of an average nominal appreciation of 3% over the programme period would help to further reduce the debt ratio below the programme's projection.

A new Law on Public Debt was adopted in 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 has sought to develop the primary and secondary markets and consolidate the use of debt instruments with longer maturities by issuing series with maturities from 7 to 15 years. Although this has contributed to developing the financing capacity of domestic securities markets and their improved functioning by extending the interest rate curve, the government bond market remains weakly developed and is characterised by an irregular and small amount of issues as well as limited number of transactions on the secondary market. No bond issue has been established as a benchmark so far. Therefore, and reiterated by the fact that Romania's public debt stock still consists of roughly half government securities and half loans, the objective of further developing the domestic securities market is important and would help improve the risk management of public debt. The gradual extension of the average maturity of domestic debt, notably by establishing pricing benchmarks over a three-year maturity horizon, would also assist in the conduct of monetary policy. Moreover, the opening of a government securities market for non-residents in 2006 would be facilitated by a further deepening of markets. The programme is not revealing on the extent to which foreign financing will be resorted to over the programme period, but states that general government financing needs will be covered primarily from domestic sources in order to help absorbing the liquidity surplus in the banking system. A more elaborated discussion of for example the "pros and cons" of local governments' use of Eurobond-issues and the need for financing made available by IFI's would have been of interest.

4. STRUCTURAL REFORMS

The 2005 PEP presents a comprehensive agenda of structural reforms meant to improve the functioning of product, capital and labour markets and boost the competitiveness and the supply-side response of the Romanian economy in order to support the fulfilment of the second Copenhagen economic criterion and accelerate economic growth. The timetable for implementing various reforms is not always clear and the emphasis on continuing already initiated reforms does not facilitate the distinction between new and existing measures. In general, the policy response to structural challenges is appropriate, but in some cases the programme falls short of addressing identified shortcomings, such as the weak business environment or the inefficient district heating sector. In some cases, there is a notable discrepancy between the serious reform delay observed and the proposed corrective measures, as for the infrastructure development or the pension system reform. In the same vein, the link between the structural part of the programme and its fiscal strategy is sometimes weak, reducing the coherence and consistency of the document. It is difficult to disentangle the net budgetary effect of different reforms as it is also not clear what would be the entire fiscal effect of a reform over the medium term. The programme's convergence in the direction of key

objectives of the Lisbon agenda, including the transition to a knowledge-based economy is much more manifest in the 2005 PEP.

4.1. Product and capital markets

The programme covers various reforms in the areas of privatisation and restructuring in the enterprise sector and public utilities, competition and state aid, opening of markets, development of SMEs and financial sector that would improve the functioning of product and capital markets. The 2005 PEP does not provide detailed information about improving the business environment, despite the obvious need to upgrade the functioning of the judiciary, create an environment that fosters entrepreneurship, ensure unhindered market exit of unviable companies and strengthen governance in both the private and public sectors. The programme does not deal with how to ensure that multiple new regulations do not permanently impair the stability of the legal framework, which would negatively affect the business environment. The envisaged revision of the Fiscal Code, for example, should be based on a sustainable medium-term fiscal framework.

The process of privatisation or liquidation of remaining majority state-owned companies from the portfolio of the Authority for the recovery of state assets (AVAS) is supposed to be completed in 2006. However, the Romanian authorities have announced recently that the deadline will be postponed to 2007. Some limited progress was recorded in 2005, but several privatisation targets were missed due to the low level of attractiveness of remaining companies and the uncertainty surrounding the accumulated historical debts. Only scarce information is provided about the slowly advancing liquidation of non-viable companies from their portfolio. The programme's targets for restructuring and privatising companies owned by various line ministries could have been clearer, notably since the results achieved in 2005 were uneven across different sectors. Important privatisations of electricity and gas distributors were finalised while limited progress was achieved in the areas of nuclear and thermal energy generation, defence and agriculture. The programme to restructure and close non-viable mines will be further pursued in a broadly satisfactory way. In the transport sector, no clear timetable is being provided for restructuring and privatising various railway activities and the national air carrier TAROM, which has been making losses for several years. The opening of markets and gradual privatisation of major operators in network industries such as telecom and postal services will continue, but the planned listing of Romtelecom shares has not yet taken place. More concrete commitments than in the past are set for the defence and tourism sectors, but the targets seem overambitious due to the little progress observed hitherto. The programme deals separately with two other privatisation methods – privatisation through restitution and through the sale of minority stock on the stock exchange. Although the two methods will increase private ownership, they cannot be expected to yield the same positive effects in terms of restructuring and improving the operations of the companies, as in the case of privatisations with a strategic investor.

Improving the functioning of markets is envisaged through an active competition policy, tight state aid, enhanced use of electronic tenders for public procurement and further opening of the electricity and gas markets. The programme contains clear objectives to consolidate the relatively good progress achieved in the area of competition and state aid in 2005. The opening of the electricity and natural gas markets is on schedule and there is a precise commitment to fully open them during 2007. In the "Public Finance" section, the programme deals with the

important issue of quasi-fiscal subsidies stemming first and foremost from the tolerance of tax arrears. Tax arrears and losses incurred by state-owned enterprises remain large, despite the reductions achieved in 2004 and 2005. Moreover, given the significant level of direct subsidies received by certain companies, in particular in the mining and transport sectors, which have nonetheless failed to sufficiently restructure their operations, a clearer commitment to reducing subsidies would have been welcomed. The SME strategy remains comprehensive and benefits from increased focus on facilitating access to financing by raising the capitalisation of the guarantee fund for SME loans and promoting the SME supporting programmes.

The Romanian authorities will continue reforms that promote the development of the financial sector and enhance its stability. The banking sector leads in terms of achieved progress and the programme sets out clear short- and medium-term objectives related to further alignment with the *acquis*, supervision of banks on a consolidated basis, implementation of early warning systems, quantifying capital requirements under the Basel II Agreement and improving accounting standards. Sound aggregate profitability and solvency ratios together with stress-tests performed by the Central Bank show that the Romanian banking system is well capitalized and the systemic risk is relatively low. The successful sale of the largest commercial bank, BCR to Erste Bank will raise the weight held by private banks in the banking system's total assets to 94%. The programme also refers to the fairly advanced stage reached in the privatisation process of the state-owned savings bank, CEC. Recently, the Romanian authorities decided to continue the privatisation process after having delayed it in order to ponder upon a possible reconsideration of the privatisation strategy as the preliminary non-binding offers had been regarded as inadequate. While trying to obtain the best possible deal is a legitimate objective, reversing the sale of CEC to a strategic investor would not further the improvement of the banking sector and would leave unresolved the question of the blanket state guarantee from which it benefits. The development of the capital market will benefit from a further alignment to European standards and principles although the programme is less forward looking. It is surprising that the programme does not mention the recent merger between the BSE and the RASDAQ markets as an important step forward for consolidating and deepening the capital market. The priorities of the programme in the insurance sector are mainly oriented towards improving the legislative and institutional framework and the strengthening of market supervision.

4.2. Labour market

The programme covers different reforms aiming at increasing employment and further reducing the unemployment rate. However, it does not seem to develop a strategic approach to employment and labour market reform in line with the European Employment Strategy, which is of some concern in light of the nearing accession. The continuous decline in the participation and employment since the beginning of the transition was due to structural problems associated with the transition itself, mainly the mismatch between the labour force's skills endowment and market requirements and the sluggish pace of creating new jobs in a slow-reforming economy. In 2004 both ratios went up and the programme expects the positive trend to continue over the programme period driven by active policy measures, enhanced flexibility of the labour market determined by the recent liberalisation of some restrictive provisions in the Labour Code and a continuation of the tax reform by cutting high payroll taxes.

The active policy measures described by the 2005 PEP are a continuation of measures previously launched, generally based on state subsidies targeted at creating and preserving employment and increasing education and vocational training. Although the new measures have a larger scope and benefit from increased financial support, their positive marginal impact is not likely to be substantially different from previous years. The amendment of the Labour Code in July 2005 represents a step forward towards improving labour market flexibility related to fixed-term contracts, individual and collective dismissals and allocation of working hours. Other labour market rigidities such as the centralised wage bargaining system and the benchmark role of the minimum wage continue to inhibit wages from reflecting productivity differences across regions and skill profiles. It is surprising that the programme does not attempt to assess the effects on employment of the introduction of the single income tax rate in January 2005. As foreseen in the 2004 PEP, the tax reform succeeded in increasing the level of official employment, less by strengthening the supply-side conditions in the labour market and more by shifting employment into the formal economy, but the overall effect was limited by the still high payroll taxes. The 2005 PEP envisages a reduction of payroll taxes by 2% every year, during the period 2006-2008, that will reinforce the positive impact of the tax reform, but it is difficult to assess whether this relatively modest cut can determine by itself the increase in employment assumed by the programme.

4.3. Other reform areas

There seems to be a fairly large discrepancy between the need to achieve rapid progress in developing an adequate infrastructure that would support the fast-growing economic activity and the modest targets and incomprehensive measures provided by the programme. Despite the limited progress recorded especially in the road sector in 2005, the budget allocations indicated in the programme for the 2006 projects are reduced to around half from last year's programme. The most recent government position reveals a major reconsideration of priorities and resource allocation in this sector, but it is questionable whether infrastructure projects may be substantially accelerated without an improved capacity of project implementation and adequate earmarking of financial resources. The programme contains a comprehensive set of initiatives to transform subsistence into commercial farming, improve the functioning of land and agricultural markets and build the institutional capacity for implementing the CAP and absorb the community funds. Nevertheless, there is little reassurance that the provision of further subsidies through the fairly costly "Farmer" programme, which aims not only at supporting the agricultural sector, but also at diversifying the rural economy, will improve significantly the absorption of SAPARD funds. The already slow introduction of the multi-pillar pension system is being further delayed by the need to amend the legislative framework adopted in 2004. The programme contains a strong commitment to the setting-up of the third-pillar privately managed pension funds in 2006 and the introduction of a second-pillar in 2007, but in view of the need to ensure an adequate supervisory framework for operation of the funds and given the pending parliamentary approval, a delayed implementation seems likely. Also, for the first time the budgetary impact of the reform is quantified, but the relevance of the figures is still unclear due to the uncertainties surrounding the implementation schedule. In the field of education, the programme does not differ much from the previous PEP including the earmarked budget resources that amount to about 4% of GDP. However, additional funds up to 1% of GDP could be made available in the education sector conditional on the presentation of suitable projects. The 2005 PEP presents a much more comprehensive strategy to develop a knowledge based economy in line with the Lisbon agenda. The strategy is based on the implementation of new

programmes in the areas of scientific research, innovation and transition to an information society which are underpinned by a notable increase of budgetary appropriations, nonetheless from a fairly low level. Given Romania's ambition to fully align consumer and production prices for heating in 2007, it would have been useful to assess the progress achieved in the reform of the district heating sector.

Table 4: **Net budgetary impact of key reforms**

Description of policy	2005	2006	2007	2008
1. Road infrastructure	554	545	740	885
2. Pension system reform	109	555	279	0
3. Agriculture sector reform	8	224	227	242
4. Mining sector reform	47	46	50	42
5. School rehabilitation programme	55	95	32	36
Total budgetary impact (mill. EUR)	773	1465	1328	1205
Total budgetary impact (% of GDP)	1.0	1.6	1.3	1.0

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

5. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

5.1. 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 more transparent Fiscal Code and Fiscal Procedures Code, aimed at ensuring greater stability of tax legislation and administration, as well as the improved functioning of the National Agency for Fiscal Administration, which is responsible for the unified collection, audit and enforcement of tax and social security contributions. These measures have led to some results in improving revenue collection, although a large upside potential is recognised to still exist, and the PEP's emphasis on both strengthened enforcement and improved voluntary compliance, supported by lighter and more automated procedures for submitting tax statements, is welcomed. 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, allocating expenditure and financing investments via loans, but without much strengthening of the control mechanisms for local public finances.

The planning and execution of expenditures have, however, shown less progress. Line ministries' expenditure estimates, notably for investment programmes, seem not to be particularly reliable, while the Ministry of Finance appears to not be sufficiently well positioned to cross-check the trustworthiness of planned expenditure and exert influence over line ministries' budget execution over the course of the budget year. This is one reason for the

recourse to frequent budgetary rectifications (June, July and November in 2005), which have at the same time been used to distribute unbudgeted revenue gains to priority areas or to cover expenditure overruns. It is welcomed, that the programme, contrary to previous submissions, explicitly recognises the need to improve prioritisation, programming and transparency in the expenditure policy, and explains that an increased use of expenditure programmes and a new expenditure classification, compatible with ESA 95, have been applied for drafting the 2006 budget. This is a step forward, but does not yet provide a clear medium-term expenditure framework, which can support the redirection of public expenditure towards human capital, infrastructure and administrative capacity. The budget execution in 2005, which exhibited a strong surge in wage expenditure and transfers at the expense of capital spending, did not live up to the aim of making the allocation of public expenditure more conducive to the real convergence process. The accumulation of a budgetary surplus of 1% of GDP over the first eleven months of 2005 followed by spending of close to 2% of GDP in the month of December also exemplifies the executive shortcomings, which do moreover not facilitate the co-ordination of fiscal and monetary policy. An overarching expenditure 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. 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, this would facilitate a lasting budgetary consolidation and limit pro-cyclical budget interventions.

The programme seems to devote more attention in the expenditure policy to improving the quality of physical and human capital over the programme period, although the lack of estimates for the allocation of public expenditure on main sectors makes it difficult to assess whether the composition of expenditures will in reality live up to the increasing awareness of the role that public finances can play in enhancing potential output. A substantial increase in public investment is foreseen, but compared to last year's PEP the envisaged increase has been scaled down considerably. Social transfers other than in kind and social benefits are expected to decline considerably as a share of GDP over the programme period, and given the many needs for social improvement and the observed difficulty in recent years to limit the growth of transfers and subsidies, 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 increasing wages for teachers, which were hiked both in 2005 and 2006, or to investments in for example the school rehabilitation programme. The programme is also silent about the fact that the government has offered up to 1% of GDP in additional unbudgeted spending for investment in education in 2006 provided that suitable projects are presented. The programme also aims at strengthening public R&D expenditure, and restates last year's objective of achieving 1% of GDP in R&D expenditure in 2007. In the light of total R&D expenditure amounting to around 0.4% of GDP in 2004, half of which was financed by government, further efforts to strengthen the knowledge base of the economy clearly seem warranted. The programme contains a highly commendable analysis of the amount of quasi-fiscal subsidies provided by government to a group of large state-owned enterprises via acceptance of non-payment of tax obligations, default on the debt service of state guaranteed loans and the companies' financing requirement due to losses. The thirty state-owned enterprises covered in the analysis represent part of a hard core of perennial non-paying

enterprises and the considerable reduction of the quasi-fiscal subsidies since 2003 confirm the progress made by strict monitoring under Romania's IMF programme, targeted restructuring initiatives and more consequent tax enforcement. These achievements are important for improving medium-term fiscal prospects and the progress made is a good example of how structural reforms can underpin fiscal sustainability. Moreover, the programme's specific estimate for the further reduction in the quasi-fiscal subsidies over the programme period is an important commitment for further improving financial discipline, which will require firm action vis-à-vis the enterprise sector as a whole.

The fiscal policy set out in the programme aims at providing strong incentives to work and invest, but does with the exception of the envisaged pension system reform not provide the private sector with incentives to save more. The low corporate tax creates an additional incentive for investment, thereby increasing potential output, stimulating technology transfer and enhancing international competitiveness. Notwithstanding these merits, and as the experience in 2005 showed, it is questionable whether the tax cut will increase the corporate sector's propensity to save. Due to pent-up consumer demand and the improved eligibility for bank credits caused by the tax reform's increase in real disposable income, household savings appear to have declined further in 2005. It is noteworthy, that the revenue shortfall from cutting income and profit tax was one of the reasons why public investment declined in 2005 since, faced with the demand for spending cuts, some line ministries chose to postpone investment projects. Although efforts were made to spare expenditure aimed at preparing for EU accession, the worsened composition of expenditure in 2005 represented an important opportunity cost of the tax reform. Hence, a more gradual approach to lowering the profit tax could have been envisaged, not least since the investment ratio has grown rapidly over recent years, reaching 23.3% of GDP in 2004. Moreover, FDI has picked up considerably over recent years, and foreign investors seem not to have been discouraged by the profit tax level, but rather by shortcomings in the business environment, such as the functioning of the judiciary, regulatory stability, transparency and predictability of the tax administration and some remaining restrictive provisions in the Labour Code.

5.2. The sustainability of public finances

The programme deals with the sustainability of public finances mainly by presenting a long-term projection of the financial state of the public pension systems revenues and expenditures against the background of expected demographic developments and the envisaged changes to the pension system. Financing of the public pension system, which amounted to around 6% of GDP in 2005, has been broadly stable since the 1990's, and the public pension fund records annually a deficit of about 0.5% 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. Over recent years, the so-called "re-correlation" of pensions has also added to the expenditure pressure in the public pension system. 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 2002-05 annual budgetary costs of on average more than 0.3% of GDP. The process will continue in 2006, causing additional expenditure of 0.4% of GDP. Moreover, due to an increasing number of self-employed, lower public employment and the growing informal economy, the number of contributors to the public pension system nearly

halved during the 1990's. Surging contribution rates also had an adverse impact on compliance and currently less than half of the active population contributes to the public pension system. Romania therefore faces already today a very unfavourable economic dependency ratio of 110.5 percent in 2003 (82.9 percent if excluding retired farmers).

The long-term estimate of pension expenditures as a share of GDP shows a descending trend until 2015, which seems to be related to high GDP growth, demographic stability, removing from the public pension system of the state budget the financing of farmers' pensions as of 2005 and a lower growth in the beneficiaries of early retirement and disability pension. Even with constantly falling revenues of the pension system as a share of GDP, the system's financing gap therefore closes until 2015 after which the deficit widens considerably to around 2% of GDP due mainly to longevity with the old-age dependency ratio increasing from 35% in 2000 to 51% by 2050. It should be noted that these calculations are based on the assumption of GDP growth remaining above 5% until 2030, a significant increase in both male and female participation rate and higher fertility rate. The analysis of the financial state of the public pension fund seems to incorporate the effect of the envisaged cuts in social security contribution rates on the funding of the public pension fund, but the diversion of contributions from the first pillar system to the second pillar, once established, seems to be left out.

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 establishment of a privately managed second pillar pension system based on compulsory participation for younger employees is envisaged for 2007, which seems however to be unrealistic given the still pending parliamentary approval and the additional need to fully establish a functioning supervisory authority. Both the second and third pillar will benefit from tax incentives. Finally, the statutory retirement age is being gradually lifted for both men and women. As regards the need for further reform, the programme does not present any measures, which could be taken to prevent an increasingly underfinanced first pillar. In view of 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 put the first pillar back on a sound footing. Moreover, the programme seems to assume 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 further reform 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 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. Over recent years, the health fund has experienced a substantial increase in expenses and has had large difficulties in meeting its payment obligations towards for example medical suppliers. The programme is not clear in addressing other elements of the three-pronged strategy, in particular measures to raise the employment rate. This casts some doubt over the real long-term growth scenario, which hinges on attaining high employment rates. 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. 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 further refinement of the projections in order to base the analysis 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				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
General economic background										
Real GDP [1]	5.7	5.1	5.2	8.4	4.1	1.9	1.2	1.2	2.4	1.6
Labour productivity [2]	4.5	13.4	8.0	7.9	n.a.	0.8	0.8	0.6	1.6	n.a.
Real unit labour cost [3]	-1.1	-5.6	-2.6	4.5	2.9	0.3	-0.4	-0.2	-1.1	n.a.
Real effective exchange rate [4]	140.9	138.3	137.1	140.3	n.a.	91.4	96.8	108.9	115.6	113.0
Inflation rate [5]	34.5	22.5	15.3	11.9	9.0	2.5	2.1	1.9	2.1	2.2
Unemployment rate [6]	6.6	7.5	6.8	7.6	7.7	8.4	8.8	9.0	9.1	8.7
Employment										
Employment rate [7]	62.4	57.6	57.6	57.7	n.a.	62.8	62.8	62.9	63.3	n.a.
Employment rate - females [8]	57.1	51.8	51.5	52.1	n.a.	54.3	54.7	55.0	55.7	n.a.
Employment rate of older workers [9]	48.2	37.3	38.1	36.9	n.a.	37.5	38.7	40.2	41.0	n.a.
Long-term unemployment [10]	3.2	4.0	4.2	4.5	n.a.	3.8	3.9	4.1	4.1	n.a.
Product market reforms										
Relative price levels [11]	41.8	41.2	41.5	43.2	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	55.4	60.4	64.4	70.1	74.6	37.5	37.6	38.1	39.8	40.9
Total FDI in reporting economy [13]	n.a.	n.a.	18.4	24.7	n.a.	40.8	40.8	44.9	n.a.	n.a.
Market share electricity [14]	n.a.	n.a.	n.a.	31.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aids [15]	3.9	1.0	n.a.	n.a.	n.a.	0.3	0.3	n.a.	n.a.	n.a.
Business investment [16]	20.7	21.3	22.2	22.3	n.a.	17.8	17.2	16.9	17.1	n.a.
Knowledge-based economy										
Tertiary graduates [17]	3.2	4.0	5.0	n.a.	n.a.	47.0	49.0	52.2	n.a.	n.a.
Spending on human resources [18]	3.3	3.5	n.a.	n.a.	n.a.	5.1	5.2	n.a.	n.a.	n.a.
Educational attainment [19]	77.3	75.3	73.8	74.8	75.2	76.1	76.5	76.5	76.6	77.3
R&D expenditure [20]	0.4	0.4	0.4	0.4	n.a.	1.9	1.9	1.9	1.9	n.a.
Internet access [21]	n.a.	n.a.	n.a.	6.0	n.a.	n.a.	n.a.	n.a.	43.0	48.0

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 IC24 (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 (2005 -2008)

- OVERVIEW AND ASSESSMENT -

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."

In December 2005, Croatia submitted its second Pre-Accession Economic Programme (the "2005 PEP") to the Commission, which covers the period 2006-2008. It presents a generally coherent macroeconomic framework, including medium-term fiscal targets and projections for key macroeconomic variables. The document partly complies with the content, form and data requested. It contains significant technical improvements as compared to the previous submission, taking account of recommendations of last year's conclusions of the Joint Ministerial Meeting. It is largely consistent with earlier policy documents, such as the government's "Fiscal Policy Guidelines" adopted in July 2005 and budget for 2005 enacted in November 2005.

The programme's key targets are keeping the public debt ratio below the Maastricht reference value of 60% of GDP and stabilising external debt at the projected end-2005 level of around 83% of GDP over the medium term. Continued fiscal consolidation remains the key policy instrument for macroeconomic adjustment. Monetary policy continues to be geared towards low inflation and exchange rate stability. The continuation of privatisation and enterprise restructuring remains an important priority to foster a more vivid private sector development, although privatisation objectives appear generally less ambitious compared to the previous submission.

Real GDP growth projections over the programme period have been significantly revised downwards compared to the 2004 PEP, by half a percentage point per year to around 4%. This scenario appears more realistic and broadly in line with the stability-oriented macroeconomic policy mix. It largely concurs with the European Commission's recent autumn forecast. The 2005 PEP projects that real GDP growth would be largely driven by domestic demand while net external demand is projected to have a very small positive effect despite the assumption of a favourable external environment and relatively strong export performance.

The 2005 PEP projects a gradual narrowing of the current account deficit from an expected 5.8% of GDP in 2005 to 3.8% of GDP in 2008, based on strong growth of merchandise exports

of around 10-11% on average over the reference period. Deficit projections seem generally optimistic, as export growth may turn out to be weaker than projected. Moreover, the projected reduction of the private sector savings-investment gap may not be fully plausible for a small catching-up economy with relatively easy access to foreign savings. The programme's scenario of relatively strong growth underpinned by progress with enterprise restructuring, privatisation and investment could imply higher than projected private sector savings-investment gaps. While the programme assumes that a significant part of the current account deficit over the 2005 PEP period will be financed by net FDI inflows, it does not present detailed projections for financial and capital account developments. Some information is provided on future plans with respect to the liberalisation of capital movements as required under the EU acquis.

The 2005 PEP does not foresee significant changes to the monetary and exchange rate policy framework, which has been successful for many years in keeping inflation low and the exchange rate stable. Widespread asset substitution limits the scope for larger exchange rate flexibility and a more active monetary policy stance. However, the programme would have benefited from a more in-depth discussion on the effectiveness of policy instruments under these constraints and on the particular role of market based versus non-market instruments. The PEP projects a gradual reduction of inflation from 3.3% in 2005 to 2.6% in 2008 and a constant nominal exchange rate vis-à-vis the euro over the programme period. Actual inflation may turn out to be higher than projected as increasing domestic demand pressures could result from continued strong private sector credit growth and significant one-off transfers to pensioners. Moreover, the country is likely to be exposed to real appreciation pressures during the catching up phase, which would push inflation up in the context of exchange rate stabilisation.

The fiscal strategy of the 2005 PEP envisages a gradual reduction of the consolidated general government deficit from an expected 3.1% of GDP in 2005 to 1.9% of GDP in 2008. As interest payments remain at about 2.2% of GDP per year, the primary balance will gradually improve from a deficit of 0.9% of GDP in 2005 to a small surplus of 0.3% of GDP in 2008. Fiscal consolidation will be based on a noticeable reduction of the public spending ratio by around one percent of GDP per year (from 49.3% of GDP in 2005 to 46.1% of GDP in 2008). In particular, spending on wages, subsidies, social transfers and public investments as a share of GDP is programmed to be reduced. The revenue to GDP ratio is planned to decline by 2 percentage points over 2005 to 2008, in line with the stated objective to reduce the relatively high tax burden on the economy. The public debt ratio is projected to fall from an expected 45.1% of GDP in 2005 to 41.5% of GDP in 2008, mainly driven by a reduction of primary balances and particularly strong privatisation receipts in 2006.

Fiscal objectives appear encouraging and appropriate against the background of relatively high spending ratios and significant state intervention in the economy. The programme contains scattered information on the fiscal strategy and would have benefited from a more systematic and comprehensive description of fiscal and other economic policy measures and their respective fiscal impacts. The objective to reduce subsidies is not underpinned by the presentation of a detailed subsidy reduction strategy. Moreover, it remains partly unclear, which measures will be taken to reduce social spending. The lack of precision is a shortcoming and raises the question whether the programme is sufficiently backed by concrete policies. Therefore, and taking experience with sometimes weak policy implementation over the recent past into account, fiscal outcomes may turn out to be less comforting. The programme path of fiscal consolidation will require considerable efforts in accelerating the design and implementation of reforms to achieve the projected reduction in spending ratios.

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

		2004	2005	2006	2007	2008
Real GDP growth	COM	3.8	3.6	4.0	4.4	n. a.
(% change)	**PEP 2005**	**3.8**	**3.9**	**4.0**	**4.1**	**4.3**
Consumer price	COM	2.1	3.0	3.1	3.2	n. a.
inflation (%)	**PEP 2005**	**2.1**	**3.3**	**3.2**	**2.8**	**2.6**
General government	COM	-4.9	-4.5	-3.7	-3.4	n. a.
GDP)*)	**PEP 2005**	**-3.9**	**-3.1**	**-2.4**	**-2.2**	**-1.9**
Primary balance *)	COM	-2.7	-2.3	-1.5	-1.2	n. a.
(% of GDP)	**PEP 2005**	**-1.7**	**-0.9**	**-0.1**	**0.0**	**0.3**
Government gross	COM	44.8	45.2	44.4	43.1	n. a.
debt (% of GDP)	**PEP 2005**	**44.8**	**45.1**	**42.7**	**42.1**	**41.5**

**) data are on cash basis, deficit figures are not comparable due to a change in methodology in the 2005 PEP*

The PEP 2005 covers structural reforms related to the enterprise and financial sector, labour market, agricultural sector, health care, social welfare reform, education and judiciary. Laying the base for the development of a more dynamic private sector and fostering an acceleration of sustainable growth over the medium term, are the key structural reform objectives of the programme. To this end, the programme aims to strengthen competition policy and state aid control, to accelerate privatisation and enterprise restructuring (railways, shipbuilding, steel) and to foster SME development. The overall orientation is appropriate and strongly commended, as the Croatian economy still suffers from inefficiencies and weaknesses that constrain productivity and growth. The presentation of the structural reform agenda sometimes lacks a precise description of policy measures to be undertaken and reforms are not always related to structural weaknesses and deficiencies identified. Moreover, the programme does not systematically establish links between the structural part of the programme and its fiscal strategy, which partly undermines the coherence and consistency of the document. As a technical improvement over the previous submission, the programme provides estimates on the budgetary impact of structural reforms which however seem to largely capture administrative costs, rather than estimating the full fiscal dimension of structural reforms envisaged.

The 2005 PEP reports on a number of measures that should improve the quality of public finances over the medium term. Ongoing and planned reforms should contribute to improving public expenditure management, such as the full implementation of a single Treasury Account and the establishment of internal audit systems in all line ministries and extra-budgetary funds as well as the planned adoption of a new public procurement law. It is the declared objective of the 2005 PEP to reduce the tax burden of the economy, however, apart from minor changes to the VAT, the document does not report on specific tax policy measures. Structural reforms focus on measures to raise the efficiency of tax administration. The fiscal strategy does not contain explicit medium term targets for spending on education, infrastructure development or research and development. The programme does not explicitly report on the sustainability of public finances. On pension reform, the re-introduction of the pension indexation formula based on the average of price inflation and gross nominal wages rate (the so-called Swiss formula) in July 2005 is presented as an essential policy measure to restore the fiscal and social sustainability of the pension system. Further pension reform measures are not envisaged over

the PEP horizon. Ensuring the sustainability of the pension system would require from the authorities to withstand continuous pressures from strong constituencies to increase pension benefits. While a comprehensive health care reform is part of the structural reform agenda, the document remains rather vague on the nature and timing of reform measures. It appears that in order to ensure the long-term sustainability of the health care system, the authorities would need to tackle this policy area with more determination.

It can thus be concluded:

- Croatia's second Pre-Accession Economic Programme for 2006-2008 is a comprehensive economic policy document, outlining a fundamentally sound and coherent medium-term macroeconomic framework. The document contains some technical improvements compared to previous year's submission and partly complies with content, form and data requested. The programme should help strengthening guidance for economic policy making.

- The Croatian economy has recently shown stronger and accelerating growth with low inflation and exchange rate stability. Fiscal consolidation has continued, but external imbalances remain, in particular in the form a relatively high external debt-to-GDP ratio. The programme's growth scenario seems plausible while its medium-term projections for inflation, fiscal and external balances seem rather optimistic.

- The programme's policy mix of continued fiscal consolidation and stability-oriented monetary policies appears appropriate to tackle macroeconomic imbalances under the specific circumstances of widespread asset substitution. The programme would clearly have benefited from a more systematic and comprehensive presentation of specific fiscal and other economic policy measures and their expected budgetary effects.

- The structural reform agenda seems generally ambitious and its emphasis on fostering private sector dynamics is appropriate and strongly commended. The programme would have benefited from a more systematic description of policy measures and their relevance for the implementation of the fiscal strategy. The programme requires a strong commitment and efforts on the part of the Croatian authorities to accelerate reforms in a large number of areas and to remove obstacles that have led to weak policy implementation in the past.

1. Introduction

On 8 December 2005, the Croatian Minister of Finance, Mr Ivan Suker, submitted on behalf of the Croatian government the second Pre-Accession Economic Programme (the "2005 PEP") of Croatia to the Commission, following government adoption on 29 November and subsequent consultation of social partners. The programme covers the period 2006-2008 and presents a rather coherent macroeconomic framework, including medium-term fiscal targets and projections for key macroeconomic variables. It is broadly consistent with earlier policy documents, such as the government's "Fiscal Policy Guidelines" adopted in July 2005 as well as the draft budget for 2005 with its medium-term budgetary projections, approved in November 2005. The document partly complies with the content, form and data requested. The text and some of the attached tables would have benefited from further editing. The programme contains some improvements as compared to the previous submission. In particular, it provides for a public debt sensitivity test as well as a more comprehensive analysis of fiscal risks based

on a set of different macroeconomic assumptions. It also provides some information on the fiscal impact of structural reforms and an overview of the state of implementation of structural reforms outlined in the previous submission. Fiscal balances are reported in GFS 2001 as compared to GFS 1986 in the previous submission, which is an important step towards the eventual introduction of ESA 95. However, additional information would have been useful to allow a comparison with fiscal balances reported in previous years' PEP. The programme's key targets are to keep the public debt ratio below 60% of GDP and to stabilise external debt at the projected end-2005 level of around 83% of GDP over the medium term. This is to be achieved through continued fiscal consolidation, namely a gradual reduction of the general government deficit (GFS 2001) to 1.9% of GDP by 2008. The programme aims to lay the foundation for more robust growth through a deepening of structural reforms and private sector development. As last year's submission, the programme puts emphasis on privatisation and the restructuring of the shipbuilding, railway, and steel sector. The specific contribution of structural reform measures to the reform of goods, capital and labour markets is not always carefully analysed and the programme would have benefited from establishing a systematic link between structural reforms envisaged and the objectives to be achieved.

2. MACROECONOMIC DEVELOPMENTS

2.1. Recent macroeconomic developments

As regards the presentation, the relevant descriptive part of the 2005 PEP would have benefited from a more comprehensive overview of macroeconomic developments since the previous submission, also based upon the data provided in the Annex. Instead, reporting focuses to a large extent on second quarter 2005 outcomes. Annual data for key economic variables in 2004 (estimates) and 2005 projections are in most cases not provided in the text. Recent developments are not always presented in relation to the 2004 PEP projections. In some cases, it should have been possible to provide more recent data (e.g. on external debt) and more details (e.g. on employment trends). Some important data are not provided at all (e.g. on labour productivity and unit labour cost developments). In some cases the factual description of trends would have benefited from more accuracy, as sometimes it remains unclear whether mentioned growth rates refer to year-on-year or period average changes. The part on monetary policy does not seem to provide a comprehensive description of policy decisions taken and their motivation. Information on recent fiscal developments would have preferably been dealt with under Section 3 of the programme.

The 2005 PEP and its attached tables cautiously project a slight acceleration of real GDP growth from 3.8% in 2004 to 3.9% in 2005, while actual GDP growth reached 4.3%. Growth in 2005 was mainly driven by domestic demand, in particular by an acceleration of investment growth (from 4.4% to 4.8%) and a significant increase in public consumption growth (from -0.3% to 0.8%), while private consumption growth decelerated, resulting from a continued relatively tight stance of monetary policy. Exports of goods and services in 2005 grew by 4.6% in real terms, while imports increased by 3.5%. Net external demand contributed with a meagre 0.1 percentage points to real growth, compared to 0.4 percentage points in 2004. The contribution of gross fixed capital formation increased from 1.2 to 1.4 percentage points, while the contribution of private consumption declined from 2.3 to 2.1 percentage points. Recently published official labour market data for 2005 suggest stagnation in employment, while the

programme assumes a 1.6% increase. The PEP projects a further reduction of the unemployment rate (ILO) to 13.3% in 2005 while it stood at 13.1% in the first half of 2005, after 13.8% in 2004. As predicted by the document, average inflation in 2005 reached 3.3%, up from 2.1% in 2004. During 2005, the exchange rate of the Kuna vis-à-vis the euro appreciated by 1.4% in nominal terms. Preliminary data suggest the real effective exchange rate (deflated with consumer prices) to have appreciated by 4%. The programme rightly projects the current account deficit to increase in 2005, fuelled by a relatively strong growth of foreign borrowing. According to recently published balance-of-payments data, the current account deficit reached 6.3% of GDP against the PEP projection of 5.8%, up from 5.2% in 2004. The PEP notes that the external debt to GDP ratio continued to grow during 2005, but at a slower pace compared to the previous year. The programme projects the end-2005 ratio at 83% of GDP, lower than the actual ratio of 84.7% of GDP.

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

	2004		**2005**		**2006**		**2007**		**2008**	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	3.8	**3.8**	3.6	**3.9**	4.0	**4.0**	4.4	**4.1**	n. a.	**4.3**
Contributions:										
- Final domestic demand	3.5	**3.5**	3.4	**3.2**	3.5	**3.8**	3.9	**4.0**	n. a.	**4.0**
- Change in inventories	-0.2	**-0.2**	-0.2	**0.7**	-0.1	**0.0**	0.0	**0.0**	n. a.	**0.0**
- External balance of goods and services	0.5	**0.5**	0.4	**0.1**	0.5	**0.2**	0.4	**0.0**	n. a.	**0.2**
Employment (% change)	1.6	**1.2**	0.9	**1.6**	1.0	**1.4**	1.2	**1.2**	n. a.	**1.2**
Unemployment rate (%)	13.8	**13.8**	13.3	**13.3**	12.9	**12.8**	12.1	**12.4**	n. a.	**12.0**
GDP deflator (% change)	3.3	**3.3**	2.5	**3.5**	2.9	**3.3**	3.3	**3.1**	n. a.	**3.1**
CPI inflation (%)	2.1	**2.1**	3.0	**3.3**	3.1	**3.2**	3.2	**2.8**	n. a.	**2.6**
Current account balance (% of GDP)	-5.3	**-5.2**	-6.2	**-5.8**	-5.8	**-5.3**	-5.2	**-4.5**	n. a.	**-3.8**

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

2.2. Macroeconomic scenario

The 2005 PEP presents a medium-term macroeconomic scenario with projections for key economic variables, covering real sector, fiscal, external and labour market developments. Alternative scenarios to the macroeconomic programme are not provided, but the PEP contains a debt sensitivity test and a fiscal risk analysis as mentioned before. The scenario is presented in an overall coherent and consistent way. The explicit objectives of the programme are to keep public debt below 60% of GDP and to stabilise external debt at the expected end-2005 level of around 83% of GDP, which does not appear overly ambitious. Fiscal policy remains the key instrument, to be supported by the continuation of structural reforms to foster economic growth. As in the 2004 PEP, monetary policy remains primarily geared at maintaining price and exchange rate stability. The policy mix appears reasonable for a small open economy with a high level of asset substitution which implies a limited scope for monetary and exchange rate policy discretion. Divergences from the previous submission, in particular lower growth rates and higher public and external debt levels are explained by less favourable than expected external environment, including the oil price hike as well as statistical revisions in balance of payments and external debt reporting.

Real sector

The 2005 PEP is based on a scenario of relatively robust real GDP growth, averaging a little above 4% over the programme period, following an expected 3.9% increase in 2005. As compared to the previous submission, real GDP growth projections have been significantly revised downwards, by around half a percentage point per year, due to lower growth of domestic demand. Growth of private consumption is projected to accelerate in 2006 and 2007 to around 4% from 3.5% expected in 2005. Investment growth accelerates over the entire period from 4.9% in 2006 to 5.6% in 2008, after 3.4% expected in 2005, as a result of stronger private investment boosted by an improved business environment. Exports of goods and services are projected to increase stronger than imports, but net exports will only marginally contribute to growth over the PEP period. Growth projections seem overall plausible and broadly in line with the stability-oriented macroeconomic policy mix of the programme. They largely concur with the European Commission's recent autumn forecast, which projects the same growth rate for 2006, but a slightly higher growth for 2007, based on stronger investment and export growth. Uncertainties remain with respect to domestic demand growth. Namely, a key driving factor for private consumption in 2006 and 2007 seems to be transfers in the context of expected repayments of debt to pensioners, the timing and precise impact of which remained uncertain. Moreover, strong credit growth and an increase in consumers and investors confidence following the start of EU accession negotiations could result in stronger private consumption and investment. As regards the composition of growth, the 2005 PEP projects GDP growth to be largely driven by domestic demand, while net external demand has a very small positive effect. According to the Commission's forecast net external demand adds around half a percentage point to GDP in 2006 and 2007, in line with the assumption of a favourable external environment, a strong tourism performance, and a continuation of structural reforms that will lead to stronger merchandise exports. On the supply side, 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. Projections of labour market developments are largely in line with the recent Commission's forecast. The 2005 PEP assumes an average employment growth of around 1.3% over the reference period, which facilitates a gradual reduction of the unemployment rate to 12% by 2008. Unfortunately, the document does not explicitly assess factors determining labour market and productivity developments and their effect on growth over the medium term.

External sector

The 2005 PEP projects a gradual and significant narrowing of the current account deficit from an expected 5.8% of GDP in 2005 to 3.8% of GDP in 2008. It outlines a scenario of continued strong growth of merchandise exports of around 10-11% on average over the reference period, as enterprise restructuring continues, productivity increases and the Croatian economy becomes more competitive. Since merchandise imports are projected to grow at a lower 7% on average, the trade deficit is expected to shrink from 24% in 2005 to 21.4% in 2008. The programme also emphasises that the reduction of the current account deficit reflects favourable developments of services. However, data provided in annexed table 3 suggest a gradually declining surplus of the services balance as a % of GDP, from 17.4% in 2005 to 16% in 2008. In fact, services export growth is projected to stagnate at around 5% which may contradict with the notion elsewhere in the programme of a rising importance of tourism for growth and external adjustment over the medium term. Nonetheless, surpluses in the services balance will continue to counterbalance a significant part of the merchandise trade deficit over the reference period.

Net factor income from abroad is projected to decline as a percentage of GDP, which is also the result of lower payments of net interest on external debt. The surplus in the balance of net current transfers is projected to slightly decrease as a % of GDP, while EU transfers which account for about 60% of total net transfers, remain stable at around 2.4% of GDP. Other important factors determining net transfers, such as workers' remittances, are not elaborated in the document. Current account trend projections outlined in the 2005 PEP seem generally plausible, although deficit figures appear slightly optimistic. In particular, the projected significant reduction of private sector balances does not seem to be entirely plausible in the programme context. Relatively strong growth underpinned by progress with enterprise restructuring, privatisation and investment is likely to go hand in hand with a continuation of net foreign borrowing by the financial sector to finance domestic credit expansion to the private sector, implying a continuation of private sector's savings-investment gaps.

The PEP 2005 does not provide detailed projections on developments of the financial and capital account. It assumes that a significant part of the current account deficit over the programme period will be financed by net FDI inflows. Provided data suggest coverage of 91% in 2006 and 85% in 2007 and full coverage in 2008. The programme assumes that the EU accession perspective would increasingly strengthen foreign investor's confidence. The planned privatisation in 2006 of large companies, such as parts of the oil refinery and of the telecom company would also boost FDI inflows. The document mentions that retained earnings will continue to strengthen FDI inflows over the programme period without quantifying this effect. It should also be noted that reinvested earning have a neutral effect on the balance of payments and are not a source to finance current account deficits. The projected net inflow of FDI accounts for 5.4% of GDP in 2006, 4.5% in 2006 and 3.9% in 2008. This profile seems ambitious and will certainly require an acceleration of enterprise restructuring and privatisation. 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 8.5% on average in 2006-2008.

2.3. Monetary and exchange rate policy

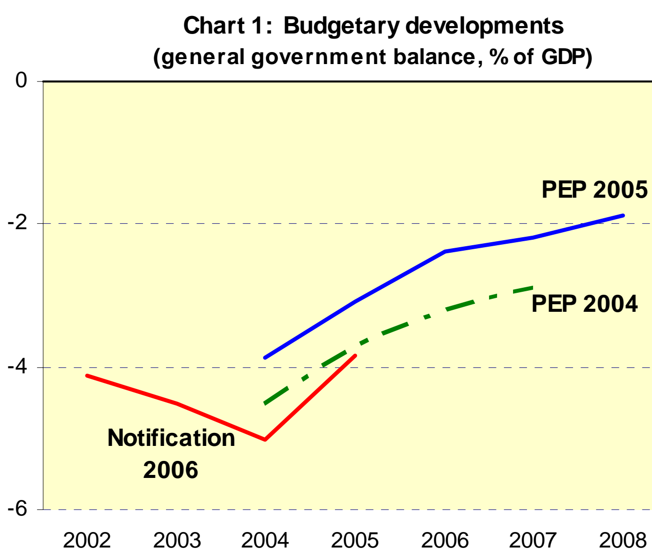
The 2005 PEP contains a short description of the current monetary and exchange rate policy framework, which is officially labelled as a managed float, but has de facto more similarities with a currency board. The primary policy objective is price stability and the exchange rate has traditionally been used as a stabilisation anchor. The main instruments of monetary policy have been interventions in the foreign exchange market to smooth exchange rate fluctuations. In order to sterilise the liquidity effects of interventions and to discourage foreign borrowing by commercial banks, the central bank has used non-market based instruments, such as liquidity and marginal reserve requirements. The introduction of open market operations in April 2005 is presented as an additional instrument to improve liquidity management and allow more reliance on interest rates in the conduct of monetary policy. The PEP concludes that the current framework of a managed float is the most appropriate regime to ensure price and exchange rate stability and is also line with the requirements of later participation in ERM II. This appears reasonable, as widespread euroisation of the financial system limits the scope for monetary policy discretion. Larger exchange rate flexibility would imply significant credit risks due to un-hedged non-financial sector balances. However, the programme would have benefited from a more in-depth discussion on the effectiveness of policy instruments under these constraints as well as on the particular role of market based versus non-market instruments. In particular, the

programme could have specified in more detail the economic conditions under which the reliance on non-market instruments could be reduced.

Following a significant increase of annual average inflation to 3.3% expected in 2005, the PEP projects a gradual reduction of inflation to 3.2% in 2006 and a further decline to 2.8% in 2007 and 2.6% in 2008. In line with the set policy objectives of the programme, it assumes that the exchange rate of the Kuna vis-à-vis the euro will remain constant at around HRK 7.45 over the programme period, thus supporting a lowering of annual inflation. The programme states that weak demand pressures, moderate wage growth and labour productivity increases are conducive to lowering inflation over the medium term. Actual inflation may turn out to be higher than projected. First, the programme itself mentions that second round effects of recent energy prices increases as well as adjustments of VAT rates and excises could eventually push prices upwards. Second, it should be added that domestic demand pressures may be stronger than projected, resulting from continued strong private sector credit growth and significant one-off transfers to pensioners. Third, the country may continue to be exposed to real appreciation pressures, resulting from Balassa-Samuelson effects and continued and possibly stronger net capital inflows. As the stabilisation of the nominal exchange rate is an explicit policy objective under the programme, real appreciation would be reflected in higher domestic inflation.

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

The 2005 PEP presents a rather coherent and consistent medium-term public finance framework with fiscal projections for the main categories on the revenue and expenditure side of the consolidated general government budget. As in the previous year's submission, fiscal policy is described as an integral part of an economic reform strategy which aims to improve the investment climate through comprehensive structural reforms. Continued and ambitious fiscal consolidation is presented as the key instrument to stabilise a high and recently rising external debt to GDP ratio and to keep public debt below 60%. The programme contains some information on fiscal policy measures envisaged during the programme period, but would have benefited from a more comprehensive and systematic description fiscal measures, including an assessment of quantitative budgetary effects. A comparison with the fiscal framework of the previous submission is difficult due to the change in the accounting methodology (i.e. from GFS 1986 to GFS 2001), and the document does not provide data to allow such a comparison. The programme provides estimates on the output gap and cyclically adjusted balances over the reference period. It also contains a comprehensive



analysis of fiscal risks, including risk sensitivity analysis, which is clearly an improvement over the previous submission.

The fiscal programme envisages a significant gradual reduction of the consolidated general government deficit from an expected 3.1% of GDP in 2005 to 1.9% of GDP in 2008. As interest payments remain at about 2.2% of GDP, the primary balance will gradually improve from a deficit of 0.9% of GDP in 2005 to a small surplus of 0.3% of GDP in 2008, accordingly. Fiscal consolidation will exclusively be based on a noticeable reduction of the public spending ratio (including net acquisition of non-financial assets) by around one percent of GDP per year (from 49.3% of GDP in 2005 to 46.1% of GDP in 2008). In particular, spending for wages, subsidies, social transfers and investments as a share of GDP is programmed to be reduced. At the same time, the revenue to GDP ratio is planned to decline by 2 percentage points over 2005 to 2008, in line with the stated objective to reduce the relatively high tax burden. The public debt ratio is projected to fall from an expected 45.1% of GDP in 2005 to 41.5% of GDP in 2008, mainly driven by a reduction of primary balances and particularly strong privatisation receipts in 2006.

3.1. Targets and adjustment

For 2005, the last year 2004 PEP projected a deficit of the consolidated general government budget (GFS 1986) of 3.7% of GDP, in line with the budget 2005 adopted in November 2004. However, in the course of the first half of 2005 it became evident that budget targets were unattainable, due to lower than projected growth and revenues and weak policy implementation. Early 2005 saw an overrun in spending and general delays in the implementation of important structural reform measures. In July 2005 the Parliament adopted a supplemental budget with more realistic revenue and spending projections. In order to contain the deficit within the revised target of 4.2% of GDP (GFS 1986), the new budget included additional measures to reduce spending on goods and services, subsidies and investments in 2005. Moreover, the government started implementing a number of key structural reforms which were expected to yield savings later in 2005 and beyond and to support continued fiscal consolidation over the medium term. These measures included, among others, cuts in housing and employment subsidies, the introduction of administrative fees in health care, and the change in the pension indexation formula. The 2005 PEP provides for some factual information on the developments of broad budget categories during the first half of 2005 without relating those to the targets set in the 2004 PEP. The programme also lacks a discussion of important fiscal policy measures adopted during the second half of 2005. The document does not provide any, even preliminary, indications as to what extent revised budget targets for 2005 are expected to be implemented. Preliminary data from the Ministry of Finance suggest that the general government deficit in 2005 was around 4.1% of GDP, slightly below the revised annual target.

For the year 2006, the programme envisages a further reduction of the general government deficit. On the basis of GFS 2001, which is applied for fiscal projections of the 2005 PEP, the deficit is set to fall by 0.7 percentage points to 2.4% of GDP. This target is consistent with the consolidated budget adopted in November 2005. The programme projects consolidated general government spending, including net acquisition of non-financial assets, to be reduced by one percentage point. The deficit reduction is largely driven by a reduction in spending on wages (by 0.4 percentage points), subsidies (by 0.2 percentage points), and social benefits (0.6

percentage points). Projections on the public sector wage bill assume a real wage freeze, which may appear somewhat optimistic against the background of continuously strong pressures for pay rises. The projected decline of spending on subsidies in terms of GDP is not underpinned by a comprehensive presentation of the subsidy reduction strategy and its main components to be implemented in 2006. The document only contains some sketchy information on the lowering of subsidies to the railway system (by 12.8% year on year), resulting from ongoing restructuring. On the other hand, agricultural subsidies (by 5.4% year on year) are projected to grow. The planned reduction of social benefit spending appears to be partly the result of a health care reform package, which is expected to yield annual savings in the amount of 0.3% of GDP over the programme period. Some measures such as the introduction of administrative fees for heath care services have already been implemented in 2005. However, the adoption of a more comprehensive health care reform, initially envisaged for end-2005, has so far been delayed and may therefore be difficult to realise the expected cost savings in 2006. Moreover, it remains unclear which additional measures will be taken to reduce social spending as programmed in the fiscal strategy, in particular as a comprehensive reform of social benefit spending has not yet been enacted so far. It appears that considerable efforts to accelerate the design and implementation of reforms in the mentioned areas are required to fully implement the fiscal consolidation as programmed. It should also be noted that spending on goods and services is projected to increase by 21% in 2006 as a result of the inflow of EU pre-accession funds. No further details on underlying assumptions with respect to project implementation and absorption capacity are however provided. Consolidated general government revenues are set to decline by 0.2 percentage points. The only mentioned tax policy measure taking effect in 2006 is related to VAT on tourism services, the net effect of which is however not quantified.

In 2007 and 2008, the general government deficit is projected to further decline to 2.2% and 1.9% of GDP, respectively. A major part of adjustment over these two years is planned to be realised through a reduction of primary spending, in particular of government consumption (by one percentage points) and spending on social benefits and subsidies (by 1.4 percentage points) while public investment as a share of GDP is programmed to stay at around the same level (at 3.8%). Interest payments are projected to remain at 2.2% of GDP. As only limited information is provided on specific expenditure measures to support fiscal adjustment over the latter part of the PEP period, an assessment about the quality of fiscal adjustment is rather difficult. New tax policy measures are not envisaged for 2007 and 2008. The revenue to GDP ratio is projected to further decline by one percentage points and 0.7 percentage points in 2007 and 2008, respectively. The reduction comes both from indirect and direct taxes, which is somewhat striking. Even under the assumption of unchanged tax rates, the projected strength of domestic demand as well as the need to adjust excises could well imply a stronger growth of indirect taxes.

The 2005 PEP includes a sensitivity analysis with three different scenarios and identifies relevant risks that are either rooted in lower growth or weaker fiscal and structural policy implementation. In the first scenario, real growth rates are reduced by 50% over the PEP period, caused by either a less favourable external environment or structural reform delays, leading to significantly higher fiscal deficits in each year over the reference period, by 4.4 percentage points on average. The second scenario assumes a 50% lower revenue growth in 2006- 2008, while real GDP growth rates are left unchanged, which would lead to rising deviations from baseline fiscal deficits, by 1.7 percentage points in 2006 to 3.9 percentage points in 2008. Finally, the third scenario assumes a one-off increase in spending on social transfers or subsidies in 2006 (of HRK 1 billion), leading to higher fiscal deficits by around 0.5

percentage points on average over the reference period. The risk analysis is appreciated as a technical improvement compared to the previous submission. In highlighting the fiscal effects of a range of possible risks, it should prepare the ground for the design of possible counterbalancing and contingency measures in the case risks actually occur. The 2005 PEP vaguely mentions some possible counter-measures in the event of risk occurrence, but it remains unclear how precisely the fiscal strategy would respond to potential overspending, a risk that has materialised quite frequently in the past few years.

In conclusion, the programme demonstrates the authorities' commitment to continued and significant fiscal consolidation over the medium term, to be brought about by expenditure cuts. This strategy appears appropriate against the background of relatively high spending ratios and significant state intervention in the economy. The lack of preciseness on fiscal measures to be adopted is a major shortcoming of the otherwise sound fiscal scenario and may raise the question whether the programme is sufficiently backed by policies. At the same time, potential risks of over-spending may result from weaker that planned policy implementation, as recent experience has shown. Therefore, the process of fiscal consolidation may eventually turn out to be less ambitious than projected.

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

	2004	**2005**	**2006**	**2007**	**2008**	**Change: 2005-08**
Revenues	46.6	46.1	45.9	44.9	44.2	-2.0
of which:						
- Taxes and social security contributions	41.4	41.4	40.9	40.5	40.1	-1.3
- Other (residual)	5.2	4.7	5.1	4.4	4.1	-0.7
Expenditure	50.5	49.3	48.3	47.1	46.1	-3.2
of which:						
- Primary expenditure	48.3	47.1	46.0	44.9	43.9	-3.2
of which:						
Gross fixed capital formation	4.7	4.4	3.9	3.8	3.8	-0.6
Consumption	17.2	16.8	17.0	16.5	16.0	-0.8
Transfers & subsidies	22.6	21.8	21.0	20.3	19.6	-2.2
Other (residual)	3.9	4.0	4.1	4.2	4.5	0.5
- Interest payments	2.2	2.2	2.3	2.2	2.2	0.0
Budget balance	-3.9	-3.1	-2.4	-2.2	-1.9	1.2
- Cyclically adjusted	-3.9	-3.1	-2.4	-2.3	-2.2	0.9
Primary balance	-1.7	-0.9	-0.1	0.0	0.3	1.2
Gross debt level	44.8	45.1	42.7	42.1	41.5	-3.5

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

3.2. Debt developments

The respective chapter in the 2005 PEP starts with a brief description of the institutional framework for public debt management and provides as short overview of recent public debt developments. According to recently revised data for 2002 - 2004, public debt has grown from

49.1% of GDP to 50.7% during that period, while general government debt, defined as public debt minus outstanding guarantees, has risen stronger from 40.5% of GDP to 44.8%. A key feature is a large share of foreign debt (around 55%) and of foreign currency denominated debt. One of the main objectives mentioned in the PEP, also stipulated in the budget law, is to keep public debt below 60% of GDP over the medium term, which in itself does not appear particularly ambitious. However, the PEP 2005 projects a gradual reduction of the general government debt from 45.1% of GDP in 2005 to 41.4% of GDP in 2008. Over this period, nominal GDP growth in itself will reduce the debt ratio by around 3 percentage points per year. This effect is partially offset by interest payments which are projected to increase the ratio by 2.3 percentage points on average per year. It should be noted that projections on interest payments in table 4 and 5 differ slightly from those in table 5 on debt dynamics. The impact of the exchange rate over the reference period is negligible, which is in line with the programme's assumption of a stable exchange rate. The lowering of the debt ratio is primarily driven by a significant reduction of the primary balance in 2006 and its further improvement in 2007 and 2008. Not surprisingly, the debt sensitivity analysis in the PEP confirms that the public debt ratio is particularly sensitive to changes in primary balances. Privatisation receipts are also expected to impact favourably on the debt ratio with a particularly strong effect in 2006 (2.1 percentage points). However, the projected impact of privatisation may turn out to be overly optimistic, as a significant share of government stakes to be privatised seem to be earmarked for other purposes, namely for the redemption of the so-called "old pensioners debt", and would thus not be available as a source for budget financing. Therefore, actual debt developments could turn out to be less favourable than projected. Moreover, as underpinned by the debt sensitivity analysis, weaker policy implementation, be it in the fiscal policy or the structural reform area, will negatively impact on public debt developments.

The 2005 PEP also aims at reducing the foreign currency exposure through a further shift to domestic borrowing, thereby fostering the development of domestic capital markets. Replacing foreign with domestic borrowing is also seen as a strategy to help stabilising the high external debt ratio of the country. However, depending on market and liquidity conditions, more intense domestic government borrowing may lead to a crowding out of the private sector, which could turn to foreign markets, thus partly undermining the intended external debt stabilisation. Stronger domestic financing could under current circumstances also increase rollover and refinancing risks due to the generally shorter maturities of domestic debt markets, and could lead to higher borrowing costs. Therefore, the scope for shifting debt to domestic markets might at this stage be rather constrained. In order to lower interest rate risks, the debt strategy foresees an increase of the share of fixed interest debt to 70-75% over the medium term. While this may lead to more predictable debt service obligations, it may not necessarily imply a less costly solution.

4. STRUCTURAL REFORMS

The 2005 PEP covers structural reforms related to the enterprise and financial sector, labour market, agricultural sector, health care, social welfare reform and education. The presentation is largely descriptive, providing information on past and ongoing reforms with strong emphasis on legislative harmonisation with the respective parts of the EU *acquis*. In a nutshell, laying the base for the development of a more dynamic private sector and fostering an acceleration of sustainable growth over the medium term, appear to be the key structural reform objectives of

the programme. This orientation is appropriate and should be strongly commended. The Croatian economy is still suffering from inefficiencies and weaknesses, including significant state intervention in the economy, that constrain productivity and growth. A more dynamic supply response therefore necessitates a bold and ambitious structural reform agenda. The 2005 PEP appears to address these needs to some extent. Policy measures include a strengthening of competition and state aid rules as well as an acceleration of enterprise restructuring and privatisation. This should underpin the government's objective to reduce enterprise subsidies gradually over the reference period. Other measures include legislative action, institutional strengthening, the implementation of sector-related and partly EU-financed projects, as well as the design of policy strategies and programmes. Sometimes, policy measures are not well defined and not always related to structural weaknesses and deficiencies identified. Moreover, the programme does not systematically establish a link between the structural part of the programme and its fiscal strategy. It is therefore difficult to see to what extent and in which particular areas the structural reform agenda could underpin the implementation of the fiscal strategy. This weakness partly undermines the coherence and consistency of the document. As a technical improvement over the previous submission, the programme provides a table with estimates the budgetary impact of structural reforms, a summary of which is presented below in table 4. However, it appears that estimates do not fully capture fiscal effects of the reform measures on the spending and revenues side, notably of privatisation, subsidy reduction, and health reform. In fact, the provided list of fiscal effects seems - with a few exceptions - to confine itself to purely administrative costs of reforms, rather than estimating the full fiscal dimension of structural reforms envisaged, including cost savings that would result from a rationalisation of spending or revenue increases.

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

Description of the Policy	**2005**	**2006**	**2007**	**2008**
Strengthening competition and state aid policy	-1.3	-1.7	-2.4	-2.1
Enterprise restructuring	-412.3	-408.6	-431.1	-527.5
Financial sector - Incentives for housing savings	-46.3	-35.2	-37.5	-48.1
Labour market reforms	0.0	-25.0	-34.3	-36.2
Agriculture sector reform	-254.7	-269.0	-287.3	-283.4
Health reforms	12.7	49.0	49.0	49.0
Other reforms (public administration, judiciary, education etc)	-2.1	-65.5	-69.0	-69.4
Total impact on the budget (in EUR million)	-704.0	-756.1	-812.6	-917.7
Total impact on the budget (in % of GDP)	-2.3%	-2.4%	-2.4%	-2.5%

Source: 2005 Pre-accession Economic Programme (PEP)

4.1. Product and capital markets

The 2005 PEP touches upon the following main reform areas related to the functioning of product markets: strengthening of competition policy and state aid control, acceleration of privatisation and enterprise restructuring (railways, shipbuilding, steel), and SME development. The programme attaches a high importance to the continuation and acceleration of company privatisation or liquidation. However, privatisation objectives appear generally less ambitious as compared to previous years' PEP, which foresaw the finalisation of the privatisation process by end-2005 (with some exceptions). The document outlines some of the reasons for recent delays in the implementation of the privatisation agenda, mostly related to

unresolved property issues and the financial situation of companies. It remains rather unclear in which way the mentioned new models of privatisation could provide a new impetus to the process of divesting state property. The programme announces the privatisation of 45 majority-owned state enterprises in the first half of 2006 and of three large enterprises (oil, telecom, and insurance companies) during 2006. With respect to the sale of minority shares, the document remains rather vague. The finalisation of privatisation process by 2007 is mentioned as a possibility rather than a policy commitment. On the fiscal impact, namely the potential receipts from privatisation, the structural part of the programme is rather cautious, estimating the sale of the remaining government portfolio to generate some HRK 0.75-1 billion. This estimate contrasts significantly with the underlying projection in the fiscal part of the programme, namely the section on debt dynamics, which assumes privatisation receipts in the order of HRK 6.5 billion over the PEP period. The further liberalisation of rail transport and the restructuring of the large railway company remain a policy priority. While the paper outlines recent progress in that respect, it does not provide a precise timetable for the implementation of railway restructuring over the PEP period, such as for the separation and privatisation of non-core businesses. The restructuring of the Croatian shipbuilding industry, currently accounting for 12-15% of the country's exports, but heavily relying on government subsidies, is another key priority within the PEP, but the timing of further action to that end remains unclear. Moreover, the outlined privatisation model for the first shipyard to be possibly sold in 2006 – 2008 (Uljanik) suggests retaining a government blocking minority and reserving a significant amount of shares for employees. Under these conditions it might be more difficult to find strategic investors, undermining the prospects for privatisation and restructuring of the sector. The programme suggests that the envisaged restructuring and eventual privatisation of two steel plants implies significant fiscal costs due to debt write-offs and the provision of new state guarantees; quantitative estimates are however not being provided. The programme presents a large number of support schemes to foster the development of the SME sector which appear to partly overlap and may suggest a duplication of initiatives. This may suggest the need for some streamlining to ensure efficient, effective and well targeted support. Contrary to last year's submission, the programme does not provide detailed information on the reform of network industries.

The Croatian financial sector is dominated by commercial banks, accounting for 81.6% of assets by end-2004, which are to a large extent foreign-owned and generally very liquid, well capitalised, and highly profitable. Banking supervision lies within the responsibility of the Croatian National Bank and appears to be broadly in line with relevant EU legislation. The credit risk associated with the high level of euroisation as well as a generally weak legal framework for the enforcement of creditor rights remain potential vulnerabilities to the banking system. Measures in the 2005 PEP focus on legislative alignment which aims to strengthen risk analysis as well as early warning systems of banks and to gradually ensure compliance with the new capital requirements framework based on Basel II. A number of measures are foreseen to strengthen the supervision of the non-banking sector. The implementation of the new capital requirements framework and the consolidation the new Croatian Financial Supervisory Authority in the non-bank sector represent significant medium-term challenges which require a period of institutional stability. Finally, a further liberalisation of capital movements is precisely scheduled for 2006, allowing non-residents to invest in short-term government paper and relaxing restrictions for residents' investment in foreign securities. A further liberalisation of capital movements is precisely scheduled for 2006, allowing non-residents to invest in short-term government paper and relaxing restrictions for residents' investment in foreign securities.

4.2. Labour market

The programme rightly states that despite recent improvements in the performance of the labour market, serious problems persist, as evidenced by low employment and participation rates, a high youth unemployment rate and a significant share of job seekers being long-term unemployed. The programme's envisaged policy response concentrates on a number of measures, to be initiated in the context of the National Action Plan for Employment 2005 – 2008. These focus largely on strengthening vocational training, education and life-long learning and help alleviating mismatches between skills endowment and requirements of the labour market. Among the various measures proposed, the programme seeks to provide disincentives for non-registered employment through the introduction of fines. The envisaged establishment of entrepreneurial zones and local development agencies as well as the further facilitation of business registration may over the medium term impact favourably on labour demand and employment creation. The programme does apparently not foresee any further policy reforms that are potentially conducive to increasing the flexibility of labour markets, such as measures related to the tax/benefit, employment protection or wage bargaining system. In view of the current on-going Joint Assessment of the employment policy priorities for Croatia (JAP), it should be noted that a more in-depth analysis of employment policy as well as labour market structural reform will be carried out under this joint framework.

4.3. Other reform areas

The reform of the social welfare system is one of the key priorities of the structural reform agenda. The stated reform objective is to improve the efficiency of social benefit spending through a better targeting of the most neediest parts of the population and in particular of families. Planned measures include the upgrading of social welfare infrastructure and facilities and the establishment of social welfare centres and social welfare homes. However, while the overall of objective of rationalising social spending is commended, the programme would have benefited from more detailed information on the future design of social policy and its fiscal implications over the medium term. Issues related to social policy reforms will be intensively be discussed in the Joint Inclusion Memorandum (JIM). The 2005 PEP includes various measures in the area of agriculture that aim to improve the functioning of agricultural land markets, such as the acceleration of land privatisation and the resolution of outstanding ownership problems. The two large remaining state-owned agricultural and food-producing companies are planned to be privatised at the beginning of 2006. More detailed information would have been useful on the development of state aid to agriculture over the programme period, including information about shares for market support and rural development, main measures (direct payments, production support etc). Apparently, measures have been taken to prepare for the implementation of SAPARD from 2006. The continuation of education reform on the basis of an Educational System Development Plan (2005-2010) should generally be supportive of the development of a knowledge-based economy. The emphasis on judicial reform is appropriate and the successful implementation of envisaged measures would certainly be conducive to improving the overall business environment and prospects for investment and growth.

5. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

5.1. The quality of public finance

The 2005 PEP reports on a number of measures that should improve the quality of public finances over the medium term. In order to improve public expenditure management, the programme foresees the full implementation of a single Treasury Account for all line ministries as well as the inclusion of extra-budgetary funds, such as the funds for the Croatian Motorways and the Croatian Road. Moreover, internal audit units have already been established in a number of line ministries and are planned to be set up in all other ministries and extra-budgetary funds. Legislation has been adopted according to which line ministries are obliged to prepare fiscal impact assessments for all new proposals for legislation and policies. According to the programme, these assessments are planned to cover the social and environmental impact as well as the impact on state aid and competitiveness. It is the declared objective of the 2005 PEP to reduce the relatively high tax burden of the economy, however, apart from minor changes to the VAT, the document does not report on specific tax policy measures envisaged over the programme period. Thus, the projected reduction of the tax burden would apparently result from nominal growth of GDP rather than from tax rate changes. Structural reforms focus on measures to raise the efficiency of tax administration, following up on earlier measures, such as the establishment of large tax-payers offices and a Financial Police. The planned adoption of the new public procurement in late 2006 as well as the planned strengthening of procurement agency should help strengthening expenditure control considerably. The fiscal strategy of the programme does not explicitly mention details about re-orientation of spending that would increase the quality of public finances over the reference period. No explicit medium targets are set for spending on education, infrastructure development or research and development.

5.2. The sustainability of public finances

The 2005 PEP does not contain a distinct chapter dealing with the sustainability of public finances and does not comment on the long-term projections for the period 2005 - 2050 provided in annexed table 9. According to these, total expenditures (excluding net acquisition of non-financial assets) are projected to gradually decline from 44.9 in 2005 to 32.8% of GDP in 2050, while total revenues are set to go down from 46.1 to 36.4% of GDP during the same period. Spending on old age pensions is expected to be more than halved from 10.7% to 4.9% of GDP. This is a considerable change compared to the previous PEP submission, which projected old age pensions to increase (from 10.8% in 2005 to 12.4% in 2050). Pension contributions would gradually decline from 7.1% of GDP in 2005 to 5.6% of GDP in 2050, while the previous PEP assumed an increase from 7.4% to 8.5% in the same period. Health care spending is projected to be reduced from 8.5% to 6.3% of GDP by 2050. The main assumptions are a constant long-term real GDP growth of 4%, and a constant growth of labour productivity of 5%. The long-term projections do not include any assumption on participation rate developments, but growth and productivity figures apparently imply a continuously declining active labour force over the projection period. Finally, the unemployment rate (ILO definition) is projected to be reduced from 13.3% to 7% by 2050.

The 2005 PEP does not explicitly report on pension reforms envisaged over the PEP horizon or beyond. According to the document, the re-introduction of the pension indexation formula based on the average of price inflation and gross nominal wages rate (the so-called Swiss

formula) in July 2005 was an essential policy measure to restore the fiscal and social sustainability of the pension system. The change in pension indexation appears to be main reason for a significant reduction of projected spending on old age pensions over the long term. Ensuring the sustainability of the pension system will certainly require from the authorities to withhold occasional claims from strong pensioners constituencies for higher pensions.

The programme states that the development of a Health Care Development Strategy (2006-2011) was still in process. It should guide the re-organisation and rationalisation of primary and secondary health care. With respect to the fiscal dimension, the 2005 PEP's stated objective is to reduce the share of health spending in GDP and settle outstanding arrears of the health care system. An important measure to improve the financial situation of health care was the introduction in October 2005 of administrative fees to be paid for health care prescriptions. The document estimates the fiscal impact to be around 0.15% of GDP per year. Moreover, the PEP reports that an inter-ministerial working group on heath care reform was established in 2005 to agree on specific reform proposals. However, the adoption of a more comprehensive health care reform package that has already been on the agenda for some time has so far been delayed and the document remains rather vague on the nature and timing of envisaged health care reforms. It appears that in order to ensure the long-term sustainability of the health care system, the authorities would need to tackle this policy area with more determination.

* * *

Annex table 1: **Structural indicators**

	CROATIA					EU 25				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
General economic background										
Real GDP [1]	4.4	5.6	5.3	3.8	4.3	1.9	1.2	1.2	2.4	1.6
Labour productivity [2]	10.5	1.1	5.3	2.2	n.a.	0.8	0.8	0.6	1.6	n.a.
Real unit labour cost [3]	-9.5	2.3	-2.6	0.8	n.a.	0.3	-0.4	-0.2	-1.1	n.a.
Real effective exchange rate [4]	104.5	105.0	103.4			91.4	96.8	108.9	115.6	113.0
Inflation rate [5]	3.7	1.7	1.8	2.1	3.3	2.5	2.1	1.9	2.1	2.2
Unemployment rate [6]	15.8	14.8	14.3	13.8	n.a.	8.4	8.8	9.0	9.1	8.7
Employment										
Employment rate [7]	51.8	53.4	53.4	54.7	n.a.	62.8	62.8	62.9	63.3	n.a.
Employment rate - females [8]	44.9	46.7	46.7	47.8	n.a.	54.3	54.7	55.0	55.7	n.a.
Employment rate of older workers [9]	37.5	24.8	28.4	30.1	n.a.	37.5	38.7	40.2	41.0	n.a.
Long term unemployment [10]	n.a.	8.9	8.4	7.3	n.a.	3.8	3.9	4.1	4.1	n.a.
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]	42.7	40.6	43.0	43.3	43.9	37.5	37.6	38.1	39.8	40.9
Net FDI [13]	5.9	2.7	6.7	2.6	n.a.	40.8	40.8	44.9	n.a.	n.a.
Market share electricity [14]	n.a.	n.a.	82.0	n.a.	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	n.a.	n.a.	n.a.
Business investment [16]	22.3	24.8	27.5	27.6	n.a.	17.8	17.2	16.9	17.1	n.a.
Knowledge based economy										
Tertiary graduates [17]	n.a.	n.a.	3.0	n.a.	n.a.	47.0	49.0	52.2	n.a.	n.a.
Spending on human resources [18]	n.a.	4.3	n.a.	n.a.	n.a.	5.1	5.2	n.a.	n.a.	n.a.
Educational attainment [19]	n.a.	90.3	90.7	92.5	93.9	76.1	76.5	76.5	76.6	77.3
R&D expenditure [20]	n.a.	1.1	1.1	n.a.	n.a.	1.9	1.9	1.9	1.9	n.a.
Internet access [21]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	43.0	48.0

1. Growth rate of real GDP in %. 2. Growth rate of real GDP per person employed in %, according to LFS 15-64. 3. Ratio of compensation per employee to nominal GDP per person employed, total economy, annual percentage change. 4. Vs IC24 (1995 = 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 (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 % 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, Croatia's Central Bureau of Statistics.

PRE-ACCESSION ECONOMIC PROGRAMME OF TURKEY (2005 -2008)

- OVERVIEW AND ASSESSMENT -

SUMMARY AND CONCLUSIONS

The Turkish authorities submitted the 2005 Pre-Accession Economic Programme (PEP) covering the 2005-2008 period to the European Commission on 1 December 2005. It is Turkey's fifth PEP after the ECOFIN Council of 26/27 November 2000 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 consistent with other economic policy documents such as the Memorandum related to the Stand-By Arrangement with the International Monetary Fund (IMF) of May 2005 and the World Bank's Country Economic Memorandum published in March 2006. The medium-term budget framework (2006-2008) 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 line ministries. The structure and content of the Pre-Accession Economic Programme gives proof of a high and improving degree of familiarity with the technical tools and analytical requirements of this exercise, in particular on the ESA95-methodology and on the implications of structural measures. The new programme takes into account most of the points raised in the assessment of the 2004 PEP.

The PEP 2005 identifies, besides the need for increasing welfare, the successful completion of the negotiations process, and rapid real income convergence towards EU-25 levels as a key objective. Differences from last year's PEP are for example attempts to quantify some of the fiscal implications of reforms and a more optimistic scenario underpinning the programme, which largely reflects a better than anticipated macroeconomic performance and faster fiscal consolidation registered in 2005.

The programme estimates that the Turkish economy will grow at rates around potential, which will be close to 5% in 2006-2008. Gross fixed capital formation would be mainly driven by the private sector and increase by an average 7.9% in the reporting period. Exports are projected to increase by 9.6% annually, compared with 8.8% for imports. Private consumption would grow by an average 4.4% annually. These projections are more or less in line with the Commission's forecasts. However, the Commission is slightly more optimistic on private consumption growth and believes that exports' growth will be more moderate than the PEP assumes.

Turkey's current account deficit has risen significantly in 2005 to 6.4 of GDP from just over 5% in 2004. The PEP projects that the current account deficit will decline gradually to 5.3% of GDP by 2008. The maturity of capital inflows would lengthen gradually. FDI would increase from about 0.5% in GDP in 2004 to and average 2% in 2005-2008. Net portfolio investments are expected to decline from about 4% of GDP (about €9 billion) to less than 2% of GDP by 2008. Turkey has liberalised its capital account already in the 1980s. The success of this scenario strongly depends on a significant improvement in the investment climate, declining real interest rates and continued market and consumer confidence. Continued access to external

sources of finance appears to be of crucial importance for achieving the described financing pattern, since currently a significant part of these flows continue to be potentially volatile short-term capital. Therefore external deficits need to be monitored closely. A further deterioration of the trade balance may pose a potential challenge to stability in 2006-2008.

The policy mix strongly emphasises disinflation and fiscal sustainability. Monetary and income policies are expected to support the disinflation process. The floating exchange rate regime will be maintained. From January 2006 onwards, a formal inflation targeting has been introduced. In addition, a band of two percentage points at each side of the objective has been installed. 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 available financial instruments. Due to increased energy oil prices, in combination with some rigidities in services' prices, inflationary pressures appear to have stopped easing. The PEP inflation forecast for 2005-2008 seems therefore slightly optimistic. Wage restraint in the private and public sector might contribute to a further easing of inflationary pressures.

The section on fiscal issues gives a good summary on how the Turkish authorities intend to rebalance public finances and to maintain fiscal sustainability. The achievement of the fiscal objectives relies to a large extent on maintaining a significant primary surplus and on benefiting from declining interest rates. As in previous years, a strong fiscal performance is the cornerstone of the economic programme. There has been a strong improvement in the public sector primary balance, which averages 8.5% of GDP in 2004-2006 from a deficit of 2.4% in 1999. The programme foresees some fiscal loosening in 2007-2008, which is reflected in a fall of the primary surplus to 6% of GDP. Resolute fiscal consolidation enabled a reduction of gross public debt to GDP ratio, from 108% in 2001 to 74.8% in 2004. The PEP projects a further fall to 56.7% by 2008. Compared with the fiscal notification, public finance ratios appear much better, which is in large part due to higher growth and lower interest rates than anticipated in Spring 2005, when the fiscal notification was finalized. Nevertheless, risks continue to exist, due to the still high level of debt and its maturity and currency composition, in particular in view of Parliamentary and Presidential elections foreseen in 2007.

The structural reform programme described in the PEP builds strongly on reforms initiated or laid out in the 2004 PEP and reviews recent achievements and main future directions. The overall aim of the agenda is to continue the transformation of the Turkish economy and the public administration to support the strengthening of market forces and increase overall efficiency. Privatisation is a key part of the agenda and the programme notes the significant achievements made in this area and the work still in progress, although no benchmarks are given concerning the speed or fiscal implications of remaining targeted privatisations. The programme also foresees continued work on improving the investment climate. The PEP acknowledges substantial deficiencies concerning the labour market and the need to make labour market legislation more flexible, but contains limited details on how the structural issued identified should be addressed. The broad public administration reform agenda presented in the 2004 PEP has continued to be brought forward, although encountering some delays in the legislative area. Also in the area of health and social security reforms delays have been encountered but a continuation of the reform process is broadly outlined, although fiscal impacts of reforms are not clearly described.

The structural reforms agenda will, if fully implemented, be broadly supportive of the enhancement of Turkey's capacity to cope with competitive pressure and market forces within the Union. In particular, labour market policies to address deficiencies will be needed and further improvements in the monitoring of state aid. In addition, in the areas of education and enhancement of the investment climate further strong focus is needed while future plans in the programme are less clear. Concerning support for the transformation to a knowledge-based economy, as laid out in the key objectives of the Lisbon agenda, the PEP is lacking clear policies and descriptions concerning R&D and innovation, while the planned reforms in social security and health systems, if implemented in a responsible manner, fits well within the Lisbon agenda.

The sustainability of the fiscal adjustment can only be ensured by improving the quality of adjustment. Some key structural fiscal reforms that yield efficiency gains in public expenditures are underway, notably through the Public Financial Management and Control Law (PFMCL). However, in order to make appropriate room in the budget for growth-enhancing public expenditures and lower taxes, the authorities should envisage comprehensive tax reforms, with the aim of broadening the tax base while reducing distortions and inequities associated with the existing system. The reform of the social security system is of paramount importance to further improve Turkey's fiscal situation. The package which has been initiated by the government in winter 2005 aims at separating pensions, health and social assistance functions and unifying the social security institutions in view of increased efficiency and transparency. In the field of pensions, the reform introduces parametric changes including the retirement age, replacement rate, valorisation rate and pension indexation. With the help of the reform, the pension system deficit currently at about 4% of GDP is expected to decline by 1% below the baseline projection of no reform by 2020.

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

		2004	**2005**	**2006**	**2007**	**2008**
Real GDP growth	COM	8.9	5.0	5.2	5.1	n. a.
(% change)	**PEP**	**8.9**	**5.0**	**5.0**	**5.0**	***5.0***
Consumer price	COM	8.6	8.1	7.4	6.3	n. a.
inflation (%)	**PEP**	**8.6**	**7.7**	**5.8**	**4.4**	***4.0***
General government	COM	-5.7	-1.2	-1.1	-1.0	n. a.
balance (% of GDP) (*)	**PEP**	**-5.2**	**-1.3**	**0.2**	**-0.9**	***0.0***
Primary balance	COM	7.5	7.3	6.7	6.0	n. a.
(% of GDP) (*)	**PEP**	**8.2**	**8.4**	**8.9**	**6.1**	***-6.0***
Government gross	COM	80.8	71.3	66.6	62.8	n. a.
debt (% of GDP) (*)	**PEP**	**74.8**	**70.0**	**65.6**	**61.4**	***56.7***

(*) COM data for public finances use fiscal notification 2006

It can thus be concluded that

- The PEP 2005, which covers the period from 2005 to 2008, aims to sustain the process of successful EU-accession and real income convergence, in particular 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, broadly consistent with other strategic documents, such as the IMF programme.

- Macroeconomic performance in 2005 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 anticipated. This trend of rising external imbalances needs to be closely monitored. The PEP 2005 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 targets, albeit somewhat optimistic not the least in view of the 2007 elections. A tighter fiscal stance, in particular in 2007-2008, when primary surpluses are projected to fall by 2 percentage points would further alleviate the potential risks to the external balance. Risks continue to exist, albeit to a lesser extent, as the current level of debt is still high, and its maturity relatively short. Vulnerability to interest rate and foreign currency shocks is not negligible despite the increasing share of fixed rate debt in the total. Improving the quality of fiscal adjustment is an important challenge for ensuring debt sustainability and making room for growth-enhancing expenditures and lower taxes.
- 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 privatisation, public administration reform and improvements of the investment climate. However, the reform agenda is vast, and several measures outlined in the 2004 PEP have been delayed. The presented budgetary impact of reforms is not very comprehensive in its scope. Further reform efforts are particularly important concerning the monitoring of state aids, improvements of the business climate and in the area of the functioning of the labour market.

1. INTRODUCTION

The Turkish authorities submitted the 2005 Pre-Accession Economic Programme (PEP) covering the period 2005 to 2008 to the European Commission on 1 December 2005. It is Turkey's fifth PEP since the ECOFIN Council of 26/27 November 2000. 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.

The programme is largely compliant with the requirements in terms of content, form and data. It provides evidence of progress made in institutional and analytical capacity and it does address some specific issues raised in last year's assessment, namely the publication of Turkey's public finances key indicators using the ESA95 methodology and the introduction of the Harmonized Index of Consumer Prices (HICP). The underpinning macroeconomic framework appears broadly coherent and consistent. As in previous years, a medium-term fiscal framework is presented. The PEP is also to some extent consistent with other policy

documents, although the World Bank's Country Economic Memorandum is providing much more detail on economic policy priorities, namely in the area structural reforms.

Increasing welfare of the society continues to be the main objective of the economic policy during the period of 2005-2008. To this end, strengthening macroeconomic stability and rapid income convergence are seen as key elements in the proposed scenarios. 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 2005 period, which are appropriate and well-defined, 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 2004.

2. MACROECONOMIC DEVELOPMENTS

2.1. Recent macroeconomic developments

The report presents a succinct and clear overview of economic developments in 2004 and 2005. Concerning 2005, the document covers all relevant data available by late November. Compared to last year, the presented data is slightly more detailed.

The Turkish economy continued to grow at high rates after the sharp recession of 2001. Real GDP grew by respectively 8.9% and 7.4% in 2004 and 2005. The recovery in 2002-2003 was mainly driven by exports and restocking domestic demand remained weak. From 2004 onwards, 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. In spite of high energy prices and significant price increases in the services sector, inflationary pressures have continued to decline, albeit at a decelerating pace, in 2004-2005. 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 significant additional job creation. Rural unemployment rates remained significantly lower than in urban areas, largely due to the widespread practise of unpaid family workers in agricultural areas. The recovery in the real sector has had only very modest effects on employment. In the fourth quarter of 2005, jobless rates stood at 10.6% with participation rates steady – albeit very low compared to the incumbent EU-Member States - at 48%.

The current account deficit widened significantly from 0.8% of GDP in 2002 to 5.2% of GDP in 2004 and 6.4% in 2005, reflecting very strong imports due to the acceleration of economic activity and the high import content of exports and re-stocking. In 2005, the external balance continued to deteriorate in the context of increasing energy prices in one of the most oil-dependent economies in the world. 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 2005.

A strict monetary policy has been an important element in the disinflation process. During 2004-2005, 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 significantly 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 significantly increase its foreign exchange reserves.

Public finances improved due to strict adherence to strong fiscal restraint in a context of declining interest rates, while current non-interest expenditures increased. The 2005 general government deficit decreased dramatically from 5.7% of GDP in 2004 to 1.2% of GDP in 2005. The improvement reflects to a large extent a drop in interest rate payments from 11.6% of GDP in 2004 to 9.8% in 2005. Non-interest expenditures increased from 33.5% to 34.9% of GDP, while tax revenues went up from 31.2% of GDP in 2004 to 32.7% in 2005. The large improvements on the expenditure side combined with progress – even though less spectacular - on the revenue side led to a slightly higher primary surplus of 8.4% in 2005.

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

	2004		**2005**		**2006**		**2007**		**2008**	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	8.9	**8.9**	5.0	**5.0**	5.2	**5.0**	5.1	**5.0**	n. a.	**5.0**
Contributions:										
- Final domestic demand	12.3	**12.6**	6.6	**6.5**	6.3	**5.2**	6.0	**4.7**	n. a.	**4.9**
- Change in inventories	0.9	**1.2**	-0.4	**-0.5**	-0.3	**0.0**	-0.3	**0.4**	n. a.	**0.2**
- External balance of goods and services	-4.2	**-4.9**	-1.2	**-1.0**	-0.7	**-0.2**	-0.6	**-0.1**	n. a.	**-0.1**
Employment (% change)	2.6	**3.0**	2.0	**2.0**	2.1	**2.5**	2.0	**2.5**	n. a.	**2.5**
Unemployment rate (%)	10.3	**10.3**	10.0	**9.8**	9.8	**9.8**	9.8	**9.7**	n. a.	**9.6**
GDP deflator (% change)	9.9	**9.9**	7.6	**7.7**	6.8	**6.0**	6.4	**4.5**	n. a.	**3.5**
CPI inflation (%)	8.6	**8.6**	8.1	**7.7**	7.4	**5.8**	6.3	**4.4**	n. a.	**4.0**
Current account balance (% of GDP)	-6.2	**-5.2**	-6.0	**-5.9**	-6.2	**-5.8**	-5.8	**-5.5**	n. a.	**-5.3**

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

2.2. Macroeconomic scenario

As in previous years, the quantitative framework for the period 2005-2008 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 further elaborated on, but still deserves more attention in particular in a medium-term perspective. The programme's external assumptions are largely in line with international forecasts, including the EU Commission's Autumn 2005 forecast. Compared to these forecasts, the Turkish programme is somewhat more optimistic with respect to the pace of further disinflation and the widening of the external deficits. The assumption on the EUR/USD exchange rate is based on the one in the Commission's Autumn 2005 forecast.

Real sector

The real sector scenario used in the programme is close to markets consensus and broadly in line with the Commission Autumn 2004 forecast. Both sources assume that the Turkish economy will grow at rates - close to potential - of around 5% per annum through the programme period, driven by continuous rapid productivity growth. However, while the Commission believes that growth will mainly come from private consumption and domestic investment, with a negative contribution from the external balance, the PEP assumes that net exports will increase substantially compared to previous years. Job creation is expected to be modest in both scenarios. The disinflation process is set to continue, but the Commission projects that the pace will slowdown rapidly. The already mentioned different views on exports make that the PEP assumes that the current account deficit falls from a peak in 2005, while the Commission believes that the gap will rather stabilize around 6% of GDP.

Based on 2 of the 3 different methods used to calculate potential output, the programme considers that the economy has reached potential output in 2004-2005 and will remain close to potential in 2006-2008. Interestingly enough, no major 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 2004 PEP, the current programme has largely maintained the GDP growth profile for 2005-2008. Concerning the sources of growth, the 2004 programme shows a stronger reliance on investment and public consumption, while the expectations concerning private consumption and imports are more cautious. This growth pattern is largely plausible, given a diminishing negative impact of the strict fiscal policy on public consumption and disposable income and the elections foreseen in 2007. 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 2005 would have deserved a more detailed explanation.

Regarding the contribution of the various production factors to economic growth, Turkey's output appears to have been mainly driven by capital, contributing 73.2% to total growth during 1990 – 2000 and by 66.93% in 2001-2004. The share of labour has been 23.5% in 1990-2000, and fell dramatically to a contribution of 4.3% in 2001-2004 following the 2001 financial crisis. The increase in total factor productivity has been respectively 3.3% and 28.9% in 1990-2000 and 2001-2004. During the remaining programme period, this distribution is expected to become more even, with the share of capital accumulation in growth generation reaching 41.6% on average during 2005-2008, the share of employment 29.8% on average and that of total factor productivity 28.6%. The increase in the investment ratio from 21.3% of GDP in 2002 to 28.5% 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 slightly more optimistic than the Commission 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 since the 2001 financial crisis. For the programme period, a decrease in the current account deficit is expected. The underpinning scenario is somewhat optimistic on the growth of merchandise exports and - albeit to a lesser extent- on 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 6.48% of GDP in 2005 to 5.3% in 2008. The programme does not anticipate any difficulties in financing the current account deficit, despite a very constrained capital account outlook with considerable repayment obligations towards the IMF, amounting to about EUR 8 billion during 2005-2008.

In addition to the baseline scenario, the programme presents four alternative scenarios on energy imports, analysing the effect of a shift in oil demand combined with energy price volatility. The results of this analysis show that price changes significantly affect the current account, and that this impact is aggravated by the high growth. This points to high vulnerabilities of the Turkish current account. Besides, the programme includes a scenario whereby the TRY real exchange rate appreciates by 5 percentage points relative to the baseline scenario in 2006. Under these assumptions the current account balance would deteriorate by ¾ percentage points for 2006-2008.

2.3. 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. The central bank is using short-term interest rates as its main policy tool. As from January 2006, an explicit inflation targeting policy has been will be implemented. By this shift, the anchor of base money and net domestic assets will be replaced by sheer inflation. In a preparatory phase, administrative and statistical capacities have been increased. The publication of quarterly inflation reports and decisions of the Monetary Policy Committee, which will decide by voting on changes in key interest rates, is expected to substantially enhance transparency.

Due to improved fiscal discipline and structural reforms in the financial sector, the effectiveness of monetary transmission mechanisms has already significantly increased. Besides enhancing the overall transparency and predictability, a more credible management of expectations and more confidence are seen as key factors aiming at further improving monetary transmission. In the PEP2005, the Central Bank explicitly announced a closer monitoring of consumer loans. This new development is clearly inspired by recent increases in private sector lending, due to a falling fiscal dominance, in a context of a widening current account deficit.

The exchange rate policy remains characterised by a free float. The interventions made so far aimed at smoothening excessive exchange rate volatility and to build reserves. Based on reversed currency substitution and a strong balance-of-payments situation, the programme implies a real appreciation of the exchange rate during 2005-2008. This should continue to support the disinflation process. Turkey has successfully introduced its new currency, the new Turkish Lira (TRY), on 1 January 2005. In tandem, it aligned the CPI with standard EU-practices (Harmonized Index of Consumer Prices), thereby using 2003 as a base year. Available indicators point at very little additional pressures stemming from the introduction of a new currency, mainly concentrated in the services' sector.

Inflation continued to come down from around 8.6% in 2004, to 8% at the end of 2005, in spite of high energy prices. The most important factors that have contributed to this reduction 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 is another factor which contributed to the decline. The envisaged permanent reduction in chronic inflation aims at converging towards EU averages by the time of accession.

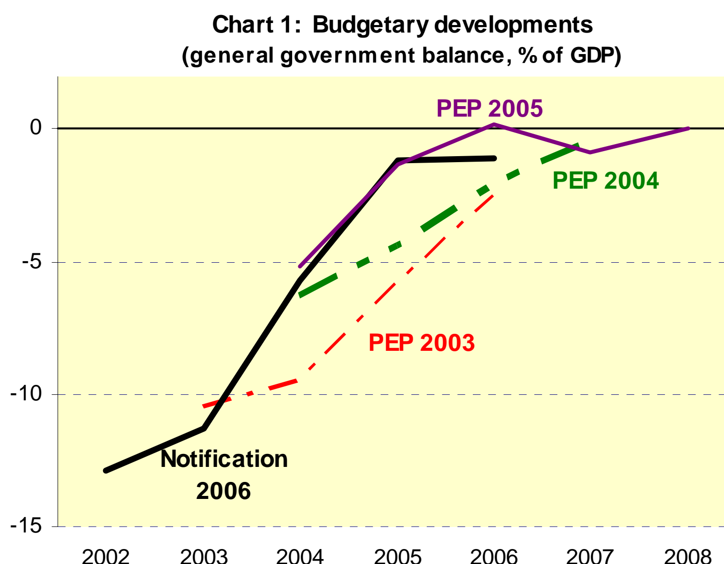
3. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

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 not only to disinflation but also to debt sustainability. As in previous years, the document does not describe in great detail how to achieve those targets and therefore lacks some coherence. The presentation of the public finances would have gained significantly from a more in-depth discussion of the various measures, in particular the social security reform, and their impact on the presented objectives. Main revenue-related measures are an improvement of efficiency in tax collection and a broadening of the tax base, which should be neutralised by the reductions in private and corporate income taxes. On the expenditure side, the emphasis is on reducing the social security deficits. Unfortunately, like in previous years, no quantitative estimates of the budgetary effects of the individually described measures are given. Budgetary objectives appear broadly realistic, in particular since real interest rates are falling faster than anticipated in a context of high growth. The 2005 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. However, it appears that the importance of structural issues has started coming down after 2002 due to 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. Given the strong volatility in the last decade it remains very difficult to assess the present cyclical position of the Turkish economy. The programme would benefit from some clarifications on the methodology used in the individual sections. Indeed, it is not always clearly stated when and why non-ESA 95 compatible data are used.

3.1. Targets and adjustment

According to the PEP 2005, the public sector borrowing requirement (general government deficit) amounted to 1.3% of GDP in 2005, which compared very favourably with the 2004 projection of 4.4% of GDP in the 2004 PEP. Stronger than anticipated economic growth led to higher revenues, real interest rates fell faster than expected, and higher privatisation receipts explain the large difference. In 2006, a general government budget surplus of 0.2% of GDP is targeted. This appears optimistic compared with the 2005-2007 medium-term fiscal framework, which underpins the new IMF Stand-By Agreement, and which is based on deficits averaging 1% of GDP.

The key objective of the medium-term fiscal framework is to achieve primary surpluses of above 8% in 2004-2006 and around 6% of GDP in 2007-2008. The share of general government revenues in GDP is expected to decline over the programme period from 43.3% in 2005 to 41.9% in 2008, reflecting changes to the health system, the phasing out of a number of temporary revenue measures and the effect of the reduction in income taxes. 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. In contrast with previous years, a straightforward reduction in the tax burden from 24.9% to 23.5% is foreseen. A significant fall in general government expenditure is programmed in relative terms, from 44.7% of GDP in 2005 to 41.9% in 2008. The main driving forces for this foreseen decline are 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 4 percentage points of GDP, from 9.8% of GDP in 2004 to 6% in 2008.



The projected fall in interest rates is plausible, but remains highly dependent on exogenous factors, such as overall sentiment vis-à-vis emerging markets and global interest rates. However, the sensitivity analysis made in the programme suggests that the overall picture is rather realistic, in particular regarding 2006.

Up to 2005, fiscal consolidation was largely based on revenue-increasing measures, in particular from higher indirect taxes. Indirect tax revenues increased from 11.7% of GDP in 1999 to 16.9 percent of GDP in 2005. In contrast to primary revenues, non-interest expenditures reflect no major changes during the period, with expenditures for personnel, goods and services and current transfers largely unaffected by fiscal consolidation. Primary expenditures hovered at around 35% of GDP, reflecting no major expenditure rationalisation. In a context of EU-accession and implicitly income convergence, Turkey would need to achieve efficiency gains in public expenditures in order to make appropriate room in the budget for growth public expenditures and lower taxes, for example on public investment in education or infrastructure.

In the remaining years of the programme (2007-2008), projections are very much in line with 2006 numbers. Given that elections are scheduled in 2007, however, risks of fiscal slippages are more significant. Privatisation receipts fall back from 1.7% of GDP in 2006 to 0.7% in 2007-2008, which must reflect largely the recent sale of Turk Telekom. According to the programme's calculations of the cyclically adjusted budget, fiscal policy will remain neutral.

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

	2004	2005	2006	2007	2008	Change: 2005-08
Revenues	41.7	43.3	44.1	42.7	41.9	-1.4
of which:						
- Taxes and social security contributions	31.4	32.7	33.0	33.7	33.0	0.3
- Other (residual)	10.4	10.7	11.1	9.0	8.9	-1.8
Expenditure	46.9	44.7	43.9	43.6	41.9	-2.8
of which:						
- Primary expenditure	33.5	34.9	35.2	36.6	35.9	1.0
of which:						
Gross fixed capital	3.1	3.8	3.7	3.7	3.7	-0.1
Consumption	18.2	18.0	17.8	18.6	18.1	0.1
Transfers & subsidies	8.7	9.4	9.3	9.1	9.0	-0.4
Other (residual)	3.4	3.8	4.2	5.3	5.1	1.3
- Interest payments	13.4	9.8	8.7	7.0	6.0	-3.8
Budget balance	-5.2	-1.3	0.2	-0.9	0.0	1.3
- Cyclically adjusted	-7.8	-3.4	-2.6	-2.6	-1.5	1.9
Primary balance	8.2	8.4	8.9	6.1	6.0	-2.4
Gross debt level	74.8	70.0	65.6	61.4	56.7	-13.3

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

The reform of the social security system is of paramount importance to further improve Turkey's fiscal situation. The social security deficit increased from 1.9% of GDP in 2000 to 4.8% of GDP in 2005. Given the favourable demographic profile of Turkey, the currently high deficits pose a bigger challenge in the long run considering that the number of elderly will start to increase as the demographic shift starts to kick in. The proportion of Turkey's population aged 65 and above to the labour force will increase by 10% between 2000 and 2020, according to OECD projections. The projected deficit of the system is expected to reach 6.7% of GDP in the long term, under a no-reform scenario. The section on public finances would have benefited from greater detail on the reform of the health and pensions systems.

Given that profitable state-owned enterprises (SOE), like Turk Telekom and Tupras, have now been privatised, the contribution of SOEs to the public sector revenues surplus will decrease. In 2004, SOEs transferred YTL 1.4 billion or 0.3% of GDP to the budget. The PEP is unclear on how these revenue losses for the consolidated budget will be mitigated.

Although education is not under-funded as a percentage of GDP, efficiency and effectiveness is low. Turkey will need to build on the success of its 1997 education reform by better concentrating the sector's significant financial, human, and material resources on ensuring the enrolment, attendance and completion of basic education for all students, upgrading the quality of learning, increasing secondary school enrolment and completion rates, and improving students' transition from schooling to employment if it wants to be successful in its income convergence towards EU-levels and in its eventual integration in EU-labour markets.

3.2. Debt developments

The gross debt level is expected to fall continuously and rapidly, from 74.8% of GDP in 2004 to 56.7% in 2008. The public debt ratio is expected to fall due to declining interest rates and primary surpluses of over 8% of GDP throughout in 2005-2006 and 6% thereafter. Consequently, interest payments are programmed to fall gradually from 13.4% in 2004 to 6% in 2008. 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. The Treasury will apply an active risk management strategy to improve the management of contingent liabilities. 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 published on a quarterly basis and the responsible minister presents an annual special report to parliament and to the budget commission.

Various sensitivity analyses were presented. One examined the sensitivity of public finances with respect to lower 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 2005 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 3 percentage points above the baseline scenario, whereby the gross debt level would fall to 62.3% in 2008. While this analysis concludes in a plausible manner that the sensitivity of the debt stock has fallen, the analysis would benefit from the inclusion of more critical scenarios (for example growth rates and real interest rates respectively 2 percentage points and 5 percentage points above the baseline scenarios). Although such scenarios are not very likely to materialise, they cannot be ruled out yet and remain a source of risk.

4. STRUCTURAL REFORMS

The structural reforms presented build strongly on the rather ambitious reform programme initiated and outlined in last year's PEP. The general aim of the measures is to continue the transformation of the Turkish economy and public administration and attempt to support the strengthening of market forces and increased efficiency. The scope of the programme is rather comprehensive, but the strategic aims are sometimes less clear or have been changing, and bringing forward the reform agenda has in some areas been slower and more complicated than envisaged, for example concerning public administration and social security reforms. In several areas the policy matrix lacks a forward looking perspective and rather focuses on achievements and work in progress. Overall, there are limited descriptions in the PEP of measures beyond the current year and time tables for the further implementation of reforms continues to be somewhat vague, although admittedly some details are likely to be found in underlying strategies and plans mentioned. Despite these weaknesses, the structural reforms agenda should, if fully implemented, be broadly supportive of the enhancement of Turkey's capacity to cope with competitive pressure and market forces within the Union. However, particular attention should be given to plans to address labour market rigidities, which is mentioned but not clearly spelled out in the programme, and improvements in the monitoring of state aid, which

continues to lag behind. In the areas of education further strong focus is also needed while future plans to achieve this are less clear.

As for the quantification of costs of outlined reforms the programme contain information on the cost of a number of projects to be implemented under the programme, although not always comprehensively over time, and with limited estimates of fiscal impacts from implemented reforms in terms of savings or increased expenditures. Concerning support for the transformation to a knowledge-based economy, as laid out in the key objectives of the Lisbon agenda, the PEP is lacking clear policies and descriptions concerning R&D and innovation, an important area to support strong economic growth. For another core item of the Lisbon agenda, attracting more people to the labour market, efforts are described but should be further strengthened in view of the substantial challenges in the area. .

4.1. Product and capital markets

Privatisation has for decades been an important part of the Turkish reform agenda but progress has previously been slow. The PEP outlines substantial achievements made in this field in 2005, with several high profile privatisation cases and a number of smaller privatisation deals completed or near completion. In particular, the sale of a 55% stake of Turk Telekom was finalised and the sales of TUPRAS (oil refinery) and Erdemir (steel concern) are in the process of being completed. The PEP presents a more comprehensive overview than in previous years of achievements in terms of completed privatisation transactions in 2005 and companies which are in the process of being privatised. The scope and aims regarding privatisation remains similar to the previous programme, although the process has been expanded to include games of chance companies and real estate holdings. However, the description of future expected developments or goals remain limited. In addition, although the speed of the process has picked up, certain legal and administrative difficulties remain for the companies still in the process. Concerning the revenues of privatisation, sales prices are included in the PEP but the inclusion of actual revenue streams in 2005 and future projections would also have been useful not totally clear to me what you mean there. Concerning the energy sector, the privatisation of TEDAS (the Turkish Electricity Distribution Inc) has encountered delays compared to the timetable outlined in the 2004 PEP and no expected date for the completion of the process is laid out in the PEP.

In the area of competition law and policies, the legal prerequisites for the setup of a unit within the State Planning Office to supervise and monitor state aid, envisaged in the 2004 PEP, have proceeded but the operations are not yet established. The lack of regulations and monitoring concerning state aid continues to affect transparency and the overall competitive environment negatively. As regards improvements of the investment environment, which is an important area in the context of the traditionally low inflows of investment, work is reported to continue under the reform programme adopted in 2001 and its technical committees. Progress is gradually being made but continuous efforts are needed. Policies have fluctuated on how investment promotion should be organised and the responsibility of policies is currently with the Treasury but this will be further evaluated over the programme period. The organisational uncertainty has contributed to measures being implemented on an ad-hoc basis. In addition to a firm structure, the capacity and strategic vision in the area of investment promotion should also be improved.

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

Description of the Policy	2005	2006	2007	2008
1. Labour market	-735.0	-846.6	-716.7	-727.0
2. Agriculture	*-1545.2*	*-1414.0*	*-308.3*	*-285.6*
3. Regional Development	*-2.6*	*-113.8*	*-98.9*	*-88.1*
4. Health and social security	*-2.6*	*-17.9*	*-79.2*	*-84.9*
5. Info and Com. Technologies	*-0.7*	*-0.5*	-	-
6. Transportation	-	*-2.0*	-	-
7. Energy	-	*-0.1*	*0.0*	-
Total impact on the budget	*-2286.2*	*-2394.8*	*-1203.1*	*-1185.5*
Total impact on the budget (in % of GDP)	*-0.8*	*-0.8*	*-0.4*	*n/a*

Source: 2005 Pre-accession Economic Programme (PEP), ECFIN calculations

As regards the banking sector, the PEP mentions the adopted strategy for the privatisation of the state-owned banks and the roadmap concerning the adaptation to Basel II rules. It outlines regulatory changes already introduced or in progress. The new banking law which was adopted in November 2005 is an important step taken since the last PEP to improve the regulatory framework. However, the PEP does not mention future measures to ensure effective implementation of the law, which would be important to further strengthen supervision. In addition, general further strengthening of the regulatory framework in the context of further adaptation to EU and Basel II principles is still needed, which is only partly outlined in the adopted plans, as well as firm action to implement the adopted strategies on the privatisation of state banks. Concerning the draft law on Micro Financing Organizations, the PEP foresees that the law will contribute to the deepening of financial markets. However, the draft is not in line with the EU *acquis* and is to some extent in contradiction with the Microfinance Consensus Guidelines[1]. The reform programme envisaged for Capital Markets is clearly spelled out for the period until 2008 and has a strong focus on EU *acquis* compliance and improved operations. The described draft insurance law as well as the outlined development of the supporting legislation will be important to support the strengthening of the insurance sector, but the process of enacting the law has so far been slow and should be pressed forward.

4.2. Labour market

The PEP broadly describes the main problems in the labour market. It rightly singles out the low employment rates (in particular among women), the miss-matches and quality deficiencies regarding education and the inflexibility of the labour market as some of the main issues. These substantial deficiencies in the market will be very important to tackle and are broadly addressed in the programme, although it is rather weak on the forward looking strategy to achieve improvements. The PEP outlines some active labour market policies to be implemented to support change, but there is no assessment of funds available for 2006-2008. ISKUR (The General directorate for Turkish Employment Agency) plays an important role in the implementation of such policies and its work is broadly described in the PEP. However, its institutional capacity and efficiency should continue to be strengthened to further increase the

[1] A document adopted by 29 donor agencies including the European Commission in September 2002, which provides guiding principles on regulation and supervision of microfinance

impact of the agency on the labour market, which is not addressed in the PEP. Work towards creating a National Employment Strategy proceeded during 2005 but went more slowly than was previously outlined. After the finalising of a joint assessment together with the Commission, the process is outlined to be followed by the creation of a National Action Plan. This document should be an important tool to support needed reforms and polices conducive to EU integration although the details of the strategy are not yet clear.

As regards labour market regulations, the PEP acknowledges the need to make the labour market legislation more flexible, but it does not outline any efforts or plans to bring about such changes. This is a very important area to be addressed, in particular in light of the growing work force, high non-wage labour costs and in order to enhance job creation and to improve the incentives to hire workers. Firm efforts to improve flexibility will be crucial to enhance the functioning of the labour market. There are also several problems to be addressed related to the labour market and the educational sector, such as the low overall educational level of the work force, high unemployment for the better educated and low demand for the vocationally trained labour. Educational levels have been improved over the last years but continued efforts are needed to address the current miss-matches and this is broadly recognised in the PEP. While the main critical areas, such as improvements in primary education and vocational education are planned to being addressed by specific projects, nothing specific is mentioned for higher education.

4.3. Other reform areas

The broad public administration reform agenda, which was outlined in the 2004 PEP, has continued to be brought forward. The overall aim is to create a smaller, more efficient and transparent administration and the planned changes are important in the overall reform context. However, in some areas legal changes are taking considerable time to be seen through. Concerning the reform of civil services, the draft law which had been prepared at the time of the 2004 PEP has not yet been adopted and parts of the law dealing with the Fundamental Principles and Restructuring of Public Administration was deemed unconstitutional by the national assembly and is in need of re-discussion. However, good progress was achieved concerning local administration reform, where several laws were adopted with the aim to clarify decision structures and responsibilities between the central and local level and to improve the flexibility in the functioning of local government. Further work to strengthen the financial structure of local administration is envisaged. Work to strengthen overall public financial management and control is also ongoing, with further EU alignment envisaged and multi-year budgeting and medium term fiscal planning being introduced.

Other areas on which the programme focuses are agriculture and rural development. The programme acknowledges the importance of work and progress in these two areas going hand in hand. To move forward on agricultural reform, a strategy document has been prepared as well as the legal framework to support the strategy and also a project to prepare for the implementation of the CAP. These measures should enhance reform efforts concerning agriculture, although the strategy is not fully in line with principles for the common agriculture policy within the EU. The main challenges of the policies outlined will be to support structural changes in agriculture and promoting the sustainable development of rural areas through the development of rural infrastructure and the diversification of rural economies while ensuring

coherence of policies in the two areas when preparing for EU accession and aligning to the EU acquis for these two policies.

The ambitious reforms in the areas of health and social security laid out in the 2004 PEP have continued to be brought forward. However, progress on the legal front has been slower than expected, partly due to the complexity and scope of the reforms, and the reform package has not yet been enacted. The fiscal impacts of these reforms are not addressed in the programme, possibly since the effects are beyond the scope of the programme. In the area of health reforms the proposed legislation will need to be complemented with certain regulatory changes so as to keep control over costs, an element which is not addressed in the programme.

Concerning infrastructure reforms, the liberalisation of the telecommunication sector is envisaged to proceed, for example by the adoption of a new electronic communications law streamlining legislation, which would be a welcome development, and by further strengthening of the Telecommunication Authority. Work on restructuring of the railway sector continues and the new legal framework for the railway sector is envisaged to be prepared during 2006. In the energy sector, an area where reforms have been clearly needed, extensive reform and restructuring efforts are ongoing and numerous legislative changes as well as liberalisation and privatisation plans are outlined in the PEP. However, implementation of enacted legislation has previously been difficult and is likely to continue to be a challenge.

5. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

5.1. The quality of public finances

The Turkish government has often turned to *ad hoc* measures to achieve its fiscal 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. Turkey has accomplished a remarkable effort of fiscal consolidation but ensuring a high-quality fiscal adjustment will be a key challenge on the way to the EU. Indeed, fiscal imbalances might emerge over the medium term, either as a result of past policy commitments, for example in education and access to universal health insurance, or owing to a still pending reform agenda. In addition, infrastructure investment may need to increase in less developed regions, given the persistence of regional disparities in Turkey.

As public expenditures are already relatively high there is little room for Turkey to further increase expenditure in order to meet pressing convergence challenges. Expenditure should also be contained in order to make room for lower taxes in the long run while preserving a sound fiscal framework. Policy would thus need to focus on trade-offs in expenditure allocations, possibly by reducing spending in functional areas (such as general public services and defence, public order and safety) where it appears to be oversized in comparison with other similar countries. At the same time, reforms should be implemented with the aim of improving the efficiency of expenditure programs in areas where expenditure pressures are being felt, such as health care, education, social protection. Horizontal reforms, focused on the modernization of civil service pay and employment system and the rationalization of the investment program, would also help contain pressures on the wage bill as well as investment spending and thus contribute to better control public expenditure across functional areas. 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.

5.2. The sustainability of public finances

The programme does not contain a section on the sustainability of public finances. It would greatly benefit from some medium-term analysis, which should be predominantly based on demographic and macroeconomic scenarios. Turkey's situation differs dramatically from the incumbent EU-Member States. With its very young population (the average age is just 26.5), falling birth rates, and significant in- and outward migration, some more in-depth analysis appears a crucial section in a the context of a PEP, in particular since the Turkish authorities are moving to new health and pension systems, whereby key indicators, like for example retirement age, dependency ratio and overall labour market participation might significantly change.

Indeed, even provided full implementation of the reform proposals, and given the achievement of the programme's reform agenda and fiscal consolidation, Turkey is not so well placed to meet the costs of an ageing population. The introduction of a new and responsible social security system, and more generally, the future costs of the pension and health-care systems should therefore be monitored very carefully.

* * *

Annex table 1: **Structural indicators**

	TURKEY					EU 25				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
General economic background										
Real GDP [1]	-7.5	7.9	5.8	8.9	7.4	1.9	1.2	1.2	2.4	1.6
Labour productivity [2]	-8.5	8.1	6.6	6.7	2.2	0.8	0.8	0.6	1.6	n.a.
Real unit labour cost [3]	n.a.	n.a.	n.a.	n.a.	n.a.	0.3	-0.4	-0.2	-1.1	n.a.
Real effective exchange rate [4]	78.1	74.0	76.3	77.3	88.2	91.4	96.8	108.9	115.6	113.0
Inflation rate [5]	56.8	47.0	25.3	10.1	8.1	2.5	2.1	1.9	2.1	2.2
Unemployment rate [6]	8.3	10.3	10.5	10.3	10.3	8.4	8.8	9.0	9.1	8.7
Employment										
Employment rate [7]	47.8	46.9	45.8	46.1	n.a.	62.8	62.8	62.9	63.3	n.a.
Employment rate - females [8]	26.3	27.0	25.7	24.3	n.a.	54.3	54.7	55.0	55.7	n.a.
Employment rate of older workers [9]	35.8	35.7	33.5	33.2	n.a.	37.5	38.7	40.2	41.0	n.a.
Long-term unemployment [10]	1.8	3.1	2.5	4.0	n.a.	3.8	3.9	4.1	4.1	n.a.
Product market reforms										
Relative price levels [11]	48.0	51.9	55.6	57.8	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	31.9	33.6	38.5	41.9	43.1	37.5	37.6	38.1	39.8	40.9
Total FDI in reporting economy [13]	13.8	9.3	12.5	9.9	n.a.	40.8	40.8	44.9	n.a.	n.a.
Market share electricity [14]	70.0	59.0	45.0	n.a.	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	n.a.	n.a.	n.a.
Business investment [16]	17.2	16.5	15.5	18.0	n.a.	17.8	17.2	16.9	17.1	n.a.
Knowledge-based economy										
Tertiary graduates [17]	2.8	3.1	3.4	n.a.	n.a.	47.0	49.0	52.2	n.a.	n.a.
Spending on human resources [18]	3.7	3.6	n.a.	n.a.	n.a.	5.1	5.2	n.a.	n.a.	n.a.
Educational attainment [19]	40.5	42.8	44.9	41.8	43.9	76.1	76.5	76.5	76.6	77.3
R&D expenditure [20]	0.7	0.7	n.a.	n.a.	n.a.	1.9	1.9	1.9	1.9	n.a.
Internet access [21]	n.a.	n.a.	n.a.	7.0	n.a.	n.a.	n.a.	n.a.	43.0	48.0

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 IC34 (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 25 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: JOINT MINISTERIAL OPINIONS AND CONCLUSIONS

1. Joint Opinion on the 2005 Pre-Accession Economic Programme of Bulgaria

"On 5 May 2006 the ECOFIN MINISTERS OF THE PRESENT MEMBER STATES AND THE ACCEDING AND CANDIDATE COUNTRIES examined the 2005 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.

Bulgaria's fifth Pre-Accession Economic Programme provides a medium-term policy framework, covering the period 2005-2008. It includes public finance objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The programme was adopted by the Bulgarian Council of Ministers.

Description

The 2005 PEP updates last year's programme and aims at fulfilling the commitments for accession and achieving a tangible improvement in living standards. It envisages the continuation of prudent fiscal policies and of structural reforms. The macroeconomic scenario expects real GDP growth to increase from 5.6% in 2004 to 5.9% in 2007 and 2008. This implies an upward revision of growth rates by around 0.4 percentage points compared to the 2004 PEP, which is not unrealistic in the light of recent strong investment growth and productivity gains resulting from economic restructuring. Following the substantial widening in 2005, projections for the current account deficit have been revised considerably upward. It is, however, expected to decline again steadily by more than 5 percentage points until 2008, mainly because of higher EU transfers and a steady recovery of the trade and services balances. Net FDI inflows would remain relatively stable and finance almost completely the current account deficit in most years. The PEP envisages robust employment growth of above 1% per year and a sustained reduction of inflation to below 3% by 2008. Additional measures to curb bank credit growth entered into force in April 2005 and have been effective in bringing down growth rates to close to 30%. It is the declared objective of the Bulgarian National Bank (BNB) and the Government to apply for ERM II participation immediately after accession and to adopt the euro in the second half of 2009 or early 2010, both at the current exchange rate of the currency board.

The public finance framework aims at maintaining a balanced or close-to-balance budget while reducing the tax burden, increasing the efficiency of public spending and streamlining the size of the public sector. After a 3.1% of GDP surplus in 2005, the programme foresees a balanced budget in 2006. Following an agreement with the IMF, this target has in the meantime been revised to a 3% of GDP surplus (cash basis, up from 2.3% in 2005). For 2007 and 2008, the PEP projects government deficits of 0.2 and 0.7% of GDP because of extra accession-related expenditures. General government debt would decrease further from 31.3% of GDP in 2005 to 22.7% in 2008. With actual output close to or slightly above potential, the cyclically-adjusted balance does not deviate significantly from the actual balance.

The PEP sets out an extensive list of structural reform measures aiming to improve the functioning of product and factor markets, strengthening competitiveness and encouraging investment. Privatisation of state-owned enterprises is well advanced and the liberalisation and

restructuring of network industries has made further progress. The programme includes a number of measures in the areas of administrative and judicial reform which would improve certain aspects of the business environment. Labour market reforms mainly focus on improving education and training as well as life-long learning. Plans for health reform concentrate on strengthening financial discipline in the hospital sector. Some measures to improve the quality and long-term sustainability of public finances are envisaged in the programme.

Assessment

The PEP largely complies with the main methodological requirements. Data on output gap, cyclically adjusted budget and long-term sustainability of public finances have been presented but calculations of potential growth are not yet based on a production function approach and the methodology for assessing the long-term sustainability of public finances is insufficiently explained. The macroeconomic framework appears overall realistic, consistent and comprehensive. However, the reduction of the current account deficit might turn out to be more gradual, especially if the moderation in private consumption and investment growth and thus the decrease in the trade deficit should be less pronounced than expected. The recovery of the surplus in the services balance that relies on a substantial re-acceleration of growth in the tourist industry may be difficult to attain. The projected stabilisation of net FDI inflows at levels above EUR 2 billion per year, although not fully consistent with the experience in 2005, could be possible considering the experience of the new Member States where the FDI inflow in the accession year increased substantially. It remains to be seen whether the projected increase in participation rates necessary to maintain an employment growth of above 1% can be achieved. Against the background of strong domestic demand and a considerable fiscal easing in 2007 and 2008, the expected reduction of inflation to below 3% in 2008 could also prove too optimistic.

The continuation of a prudent fiscal policy with a budget close to balance is generally consistent with the macroeconomic scenario. However, the substantial fiscal easing foreseen for 2007 and 2008 would imply a pro-cyclical fiscal stance in 2007 and would, if implemented jeopardise the aim of reducing the current account deficit and further bringing down inflation rates. This easing could probably be avoided by aligning national spending priorities better with those under EU Structural Fund programmes, by substituting certain national expenditures, for example on agriculture, with EU payments, and by intensified efforts to streamline government spending. The pattern of revenue over-performance highlighted in last year's assessment continued in 2005. The practice of under-estimating budget revenues helps to achieve or outperform fiscal targets, but reduces considerably the transparency of budget execution, impedes a further reduction of the tax burden and encourages discretionary spending. Fiscal risks appear manageable, although risks related to certain structural reforms and major investment projects have not been fully considered in the PEP and could entail further upside pressures on government expenditures.

The structural reform agenda is largely in line with key objectives of the Lisbon Agenda and supports the fulfilment of the second Copenhagen economic criterion. The PEP highlights the progress made in improving the functioning of product and financial markets through privatisation, liberalisation of network industries and improvements in the regulatory framework in line with EU requirements. It contains a set of individual measures which – if properly implemented – would improve the business environment in Bulgaria. However, these measures are not embedded in a comprehensive and systematic strategy. The PEP does not present any concrete proposals for increasing labour market flexibility and gives only very

limited indication on the future direction of active labour market and wage policies. Further efforts on education and health reform would be particularly important to improve the quality of services, increase the efficiency of public spending and adapt these sectors better to the needs of a rapidly ageing and shrinking population.

Opinion

Given the above assessment, Ministers commend the Bulgarian authorities for sustaining the catching-up process and achieving a fairly high degree of macroeconomic stability by maintaining prudent fiscal policies and continuing structural reforms. They consider the 2005 Pre-accession Economic Programme a useful medium-term framework for Bulgaria's economic policy in preparation for EU accession. Ministers are concerned by the widening of the current account deficit in 2005. They welcome, however, that measures have been taken to contain the external deficit by tightening fiscal policy and constraining credit growth.

Ministers welcome the public finance scenario of a balanced or close-to-balance budget which is largely adequate in view of possible risks for the external balance in a currency board arrangement. Given the high current account deficit, an additional fiscal tightening would, however, appear appropriate and Ministers therefore welcome the revision of the fiscal target for 2006. They urge the Bulgarian authorities to intensify efforts to avoid a fiscal expansion in 2007 and 2008 which could otherwise threaten the aim of reducing the external deficit and bringing down inflation. Ministers consider that while the practice of very conservative revenue projections helps to achieve fiscal targets thanks to revenue overruns, it limits the scope for reducing the tax burden. Ministers note that moderate real wage increases in line with productivity gains have helped to secure competitiveness within the context of the currency board arrangement and underline that the continuation of this trend in the future will be critical. Ministers welcome the advanced state of privatisation and the further progress reached on the restructuring and liberalisation of network industries. They encourage the Bulgarian authorities to maintain the structural reform momentum and to successfully complete the privatisation process. Ministers note the measures foreseen to improve the business environment, but emphasise that further progress in this area will be crucial to strengthen the adaptive capacity of the Bulgarian economy. They encourage the Bulgarian authorities to fully implement the reform of business registration. They call for further strong efforts to improve the functioning of the judiciary and of the administrative system which is of particular importance for the business climate. The improvement of the regulatory environment for businesses should continue with renewed ambition. Ministers welcome the improvement in the labour market situation and the measures taken to reduce non-wage labour costs and to promote education and training as well as life-long learning. Further progress in education reform and intensified efforts to raise employment rates will be important to tackle mismatches in the labour market and to strengthen the growth potential. Ministers regret that no concrete measures to increase labour market flexibility are envisaged in the programme. Action should in particular be taken to allow for more flexible labour market arrangements Ministers encourage the Bulgarian authorities to intensify their efforts in reforming the education and health systems, in particular in view of a rapidly ageing and shrinking population, and welcome the steps taken to ensure the long-term sustainability of public finances.

Finally, Ministers note Bulgaria's progress in developing the institutional and analytical capacity required to participate in EMU. They underscore Bulgaria's obligation to ensure the provision of fully compatible, detailed and timely ESA 95 data before accession."

2. Joint Opinion on the 2005 Pre-Accession Economic Programme of Romania

"On 5 May 2006 the ECOFIN MINISTERS OF THE PRESENT MEMBER STATES AND THE ACCEDING AND CANDIDATE COUNTRIES examined the 2005 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.

Romania's fifth Pre-Accession Economic Programme provides a medium-term policy framework, covering the period 2005-2008. It includes public finance objectives and structural reform priorities needed for EU accession and prepares further the institutional and analytical capacity necessary to participate in EMU. The programme was adopted by the Government of Romania.

Description

The 2005 PEP, submitted on 1 December 2005, sets out an overall economic policy strategy oriented towards sustainable real convergence of the Romanian economy towards the EU and improvements to the business environment in order to enable Romania to cope with the competitive pressures and market forces within the European Union. The programme sets relatively few and clear objectives, among which the reduction of inflation and regional disparity. The macroeconomic framework projects continued strong GDP growth of above 6% annually, driven by domestic demand and a considerable reduction in the negative contribution from net exports. Domestic demand is expected to moderate over the programme period, notably due to a gradual easing of growth of household consumption, while annual investment growth would be strong. The current account deficit is expected to narrow from 9.0% of GDP in 2005 to 5.1% in 2008 due to an increase in remittances and EU transfers and a significant improvement in the incomes and services balance. Driven by growing employment in the SME sector and solid FDI inflows, the programme projects higher employment rate and falling unemployment. Monetary policy will aim at sustainable disinflation within an inflation targeting regime that blends interest rate policy, exchange rate policy, prudential and administrative measures. A prudent wage policy in the public sector, including state-owned enterprises, and a further reduction of the quasi-fiscal subsidies are set as conditions for achieving the programme's targets.

Fiscal policy will remain geared towards stimulating economic growth seeking to ensure macroeconomic stability and providing the resources necessary to finance accession-related expenditure and to sustain real convergence. Budgetary resources would be raised by an improved capacity to absorb increasing EU transfers and a revenue policy centred on a broader tax base, strengthened tax collection and improved symmetry in the taxation of various sources of income, which would finance a gradual cut in social security tax rates. The general government deficit is projected to widen from 0.4% of GDP in 2005 to 1.6% in 2008 against the background of a 1.5% of GDP decline in the revenue ratio and a broadly stable expenditure ratio. General government gross debt in ESA 95 terms would decrease from 17.1% of GDP in 2005 to 14.6% in 2008. Quasi-fiscal subsidies in the form of the financing of state-owned enterprises, the accumulation of tax arrears and the non-payment of state guaranteed loans would be further reduced.

The programme includes a comprehensive agenda of structural reforms to improve the functioning of product, capital and labour markets and boost the competitiveness and supply-

side response of the Romanian economy. Numerous objectives and initiatives derive from the strategy embedded in the National Development Plan of Romania, which sets EU accession as a fundamental aim. Therefore, they reflect Romania's commitment to fully align its legal framework with the acquis, fulfil the Copenhagen second economic criterion and progressively move towards a knowledge-based economy in line with the Lisbon agenda. In general, the policy response to structural challenges is appropriate, but the link to the macroeconomic and fiscal scenario is weak at times, reducing the coherence of the overall programme.

Assessment

The programme provides a factually correct summary of recent macroeconomic developments and sets out a comprehensive and broadly consistent macroeconomic framework. A more explicit view on the macroeconomic consequences of the considerable tax cuts undertaken in January 2005, notably the extent to which they may explain the continued domestic demand and inflationary pressures, would have been welcomed. Based on an improved production function methodology, the framework clearly presents the sources of potential GDP growth, but the potential growth rate seems optimistic and benefits in particular from a comparatively very high contribution from total factor productivity. This impairs the realism of an average 6.3% real GDP growth going hand in hand with diminishing output gap, accelerated disinflation and rapidly declining external imbalances. The programme projects a significant moderation of private consumption growth even while foreseeing considerably gains in disposable incomes, rising employment, declining inflation, continued appreciation and solid credit growth. Furthermore, the surge in the private sector savings ratio, which would reverse the unexpected drop in 2005, is largely unexplained. Hence, it seems likely that excess demand would persist in the economy. It is also likely that the shock in 2005 to industrial production from energy price hikes, rapid exchange rate appreciation, floods and considerable wage growth may help to speed up the structural adjustment process in the enterprise sector, which could imply a temporary lowering of industrial production growth. Bearing in mind the advantages of a cautious macroeconomic scenario, the PEP's discussion of an alternative scenario consisting of weaker domestic supply and a larger negative contribution from external trade to GDP growth combined with laxer wage and fiscal policy is very relevant.

The fiscal framework benefits from a well-explained and realistic projection of revenues, but is less convincing with regard to considerable budgetary financing needs in many areas being hosted within a stable expenditure ratio and a 1.5% of GDP decline in the revenue ratio. This drop in the revenue ratio is projected against the background of the significant cuts in income and profit tax in 2005, which, including the effect from revenue raising measures, had a net negative impact on direct tax revenue of about 1% of GDP. The loss of revenue was less than the reduction in the average tax rates would have suggested. However, if taking into account the cyclical position of the economy, it was for income tax larger and for profit tax fully in line with the rate reductions. It was mitigated by a higher growth in official employment, which reflects the formalisation of some jobs, and by strong growth in revenue from indirect taxes, notably VAT, due to both the cyclical position of the economy and improvements in tax collection. This led to a stable revenue ratio in 2005. Romania succeeded in accommodating large flood repairs without a rising general government deficit, but wages, subsidies and transfers grew more than budgeted. The programme displays awareness of the benefits from redirecting expenditures towards physical and human capital in order to sustain real convergence, but the ability to implement a much more restrictive wage policy, carry out a major restraint of current expenditures and effectively restructure expenditures will be a litmus

test for the credibility of Romania's expenditure policy. Moreover, a strengthened capacity for absorbing EU transfers is required if Romania is to fully benefit from the appropriations under the financial perspectives 2007-13. The programme seeks to reconcile the objective of fiscal prudence with the priority of using fiscal policy to sustain growth, but there is little recognition of the role that fiscal consolidation and avoidance of a pro-cyclical policy stance can play in creating sound conditions for sustained high growth. Success in the execution of the 2006 budget will be crucial to ensure that the widening of the cyclically adjusted deficit over the programme period can be contained to the planned level. Furthermore, with a less optimistic potential growth rate than used in the programme, the cyclically-adjusted deficit would get close to 3% of GDP in 2008 if the programme's projection of aggregate demand materialises. This raises doubts over Romania's medium-term fiscal prospects. In addition to the fiscal risks highlighted in the programme, the full amount to be covered by general government via the Property Fund as financial compensations for the non-restitution of property is uncertain and potentially significant in the context of post-accession fiscal surveillance. Challenged also by a financially fragile public pension system and likely expenditure pressure from the health system, non-programmed revenue gains and additional revenue measures should be fully used to support the sustainability of Romania's public finances. In this context, the Council welcomes the recently approved reform package in the health area.

The programme contains a clear commitment to continue structural reforms in the light of EU integration and bears witness to important privatisations accomplished in energy and banking, good progress in the area of state aid policy, opening of the electricity and natural gas markets, and a reduction of quasi-fiscal subsidies. The structural reform agenda appears broadly supportive of Romania's objective to attain sufficient competitiveness within the Union. Yet, for certain sectors where reform has been slower, such as transport and agriculture and some areas of energy, the envisaged measures could have been bolder and placed within a clearer time table. To sustain the reform process, improvements in the institutional framework necessary for absorbing EU funding seem warranted. A clearer commitment to liquidate non-viable companies and reduce subsidies in order to support the re-allocation of economic resources and prepare for EU accession would have been welcomed.

Opinion

Given the above assessment, Ministers commend the Romanian authorities for sustaining the catching-up process and express their recognition of Romania's progress in reforming its economy and the renewed commitment to ensure macroeconomic stability. They highlight the contribution of monetary policy to the continued decline in core inflation and support a clear focus on further disinflation in coming years, which is of the utmost importance. They note the overall consolidation of public finances over recent years, including the reduction in the broad public sector deficit, which has played a positive role in safeguarding sustainable economic growth. They emphasise that the strong underlying growth creates favourable conditions for accelerating structural reforms and addressing Romania's fiscal challenges. They call for caution in the policy mix in order to not to jeopardise the sustainability of the external balance and further disinflation.

Ministers consider the 2005 Pre-accession Economic Programme a useful medium-term framework for Romania's economic policy in preparation for EU accession. They welcome the programme's increased awareness of the need for a prudent fiscal policy and the clear objective of enhancing Romania's growth potential by redirecting expenditures towards physical and

human capital, and encourage Romania to develop a clear medium-term expenditure strategy. They note that the programme's fiscal policy strategy is pro-cyclical and surrounded by certain downside risks, notably with regard to public sector wage policy. They advise caution about the effects of the cuts in income and corporate profit tax rates on the revenue to GDP ratio, which could make it more difficult to provide fiscal space for expenditures in relation to EU accession and would cause a deterioration of the fiscal position if the favourable cyclical conditions come to an end. In view of the need to strengthen revenues, Ministers commend the Romanian authorities on their efforts to broaden the tax base and improve revenue collection and encourage them, moreover, to give more consideration to the option of raising some carefully targeted tax rates, notably to contribute to ensuring balanced growth and improving the structure of the tax system. They emphasise that the credibility of Romania's expenditure policy depends on a more cautious public sector wage policy, the ability to restrain current expenditures and an improved capacity to absorb EU transfers.

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 implement a comprehensive strategy for reforming the pension system. In view of Romania's experience, they acknowledge the merits of strengthening the supply side conditions of the economy, notably by reducing non-wage labour costs and revisiting the use of early retirement and disability schemes.

Ministers commend Romania for its 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. The acceleration of reforms, in particular some areas of energy as well as transport and agriculture, and the liquidation of non-viable enterprises, remain crucial for strengthening Romania's competitiveness and preparing EU accession. Ministers also urge Romania to vigorously pursue reforms in the labour and product markets, and to enhance the supply-side response of the economy by accelerating the development of an adequate road infrastructure. They welcome the amendment of the Labour Code and emphasise the need to further address the rigidities in the labour market and to consider how to further reduce the relatively high payroll taxes. Ministers stress the need for further improving the business environment, in particular by addressing remaining weaknesses in the functioning of the judiciary, governance and administrative capacity as well as rigorously implementing control of money laundering in the non-banking financial sector. They also salute Romania's increased focus on the objectives of the Lisbon agenda and encourage the authorities to pursue with more determination policies corresponding to their current priorities in areas such as human capital and infrastructure development, transition to an information society and absorption of knowledge by enterprises.

Finally, Ministers note Romania's progress since last year in developing the institutional and analytical capacity required to participate in EMU. They underscore Romania's obligation to ensure that the process of providing fully compatible, detailed and timely ESA 95 data is accomplished before Romania's accession to the EU."

3. Joint Conclusions of the Ministerial Dialogue between the Economic and Finance Ministers of the EU and the Acceding and Candidate Countries

"On 5 May 2006, the Economics and Finance Ministers of the EU and the acceding and candidate countries, along with representatives of the Commission and the European Central Bank and of the central banks of the acceding and candidate countries, met for their eighth economic policy dialogue meeting, including in relation to their preparation for the integration into the EU fiscal surveillance and economic policy co-ordination as of accession.

Romania and Bulgaria (acceding countries)

Ministers endorsed the attached Joint Opinions on the 2005 Pre-accession Economic programmes (PEP) of Bulgaria and Romania. They emphasised that both countries had now entered a crucial phase of their final preparations for accession, in particular with respect to the implementation of the aquis. Ministers repeated the importance of respecting the commitments made by the acceding countries, including the deadlines fixed in the negotiations. Against the background of the Commissions monitoring reports, Ministers urged Bulgaria and Romania to solve all outstanding issues prior to accession.

Croatia and Turkey (candidate countries)

Ministers welcomed the 2005 Pre-accession Economic Programmes of the two candidate countries. Ministers endorsed the following conclusions as regards the assessment of these programmes:

Croatia

1. Croatia's second Pre-Accession Economic Programme for 2006-2008 is a comprehensive economic policy document, outlining a fundamentally sound and coherent medium-term macroeconomic framework. The document contains some technical improvements compared to previous year's submission and partly complies with content, form and data requested. The programme should help strengthening guidance for economic policy making.

2. The Croatian economy has recently shown stronger and accelerating growth with low inflation and exchange rate stability. Fiscal consolidation has continued, but external imbalances remain, in particular in the form a relatively high external debt-to-GDP ratio. The programme's growth scenario seems plausible while its medium-term projections for inflation, fiscal and external balances seem rather optimistic.

3. The programme's policy mix of continued fiscal consolidation and stability-oriented monetary policies appears appropriate to tackle macroeconomic imbalances under the specific circumstances of widespread asset substitution. The programme would clearly have benefited from a more systematic and comprehensive presentation of specific fiscal and other economic policy measures and their expected budgetary effects.

4. The structural reform agenda seems generally ambitious and its emphasis on fostering private sector dynamics is appropriate and strongly commended. In this context, Ministers welcomed the EPC report on structural policy challenges in Croatia. There was broad agreement on the main conclusions of the report. Croatia has made important progress with the implementation of its structural reform agenda, but there remains scope to

accelerate the pace of reforms in a number of key areas: completing privatisation and restructuring; continuing fiscal consolidation and reforms to welfare systems; improving the flexibility of the labour market; and improving the business environment and the regulatory framework for network industries. In this respect, the programme would have benefited from a more systematic description of policy measures and their relevance for the implementation of the fiscal strategy. The programme requires a strong commitment and efforts on the part of the Croatian authorities to accelerate reforms in the areas mentioned above and to remove obstacles that have led to weak policy implementation in the past.

Ministers acknowledged that significant progress had been achieved in transforming the Croatian economy and encouraged Croatia to continue the process of reform with determination. In view of the above assessment, Ministers invited Croatia to remain vigilant with respect to the budget risks which may jeopardise sustained fiscal consolidation and to the high external debt. Moreover, Croatia should continue to tackle the structural problems of the economy, also by reducing the share of the public sector.

Turkey

1. The PEP 2005, which covers the period from 2005 to 2008, aims to sustain the process of successful EU-accession and real income convergence, in particular 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, broadly consistent with strategic documents of the IMF and the World Bank.

2. Macroeconomic performance in 2005 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 anticipated. This trend of rising external imbalances needs to be closely monitored. The PEP 2005 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.

3. The public finance scenario of a gradual reduction in the budget deficit is adequate in its targets. Further fiscal consolidation would be conducive to alleviate the potential risks to the external balance. Risks continue to exist, albeit to a lesser extent, as the current and decreasing level of debt is still high, and its maturity although lengthened since 2002 remains short. Vulnerability to interest rate and foreign currency shocks is not negligible despite the increasing share of fixed rate debt in the total. Improving the quality of fiscal adjustment is an important challenge for ensuring debt sustainability and making room for growth-enhancing expenditures and lower taxes.

4. 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 privatisation, public administration reform and improvements of the investment climate. However, the reform agenda is vast, and several measures outlined in the 2004 PEP have been delayed. The presented budgetary impact of reforms is not very comprehensive in its scope. Further reform efforts are particularly important concerning the monitoring of state aids, improvements of the business climate and in the area of the functioning of the labour market.

Minister welcomed the improving macroeconomic performance of the Turkish economy in 2005 and encouraged Turkey to continue transforming the economy with determination, and in line with the IMF supported programme. In view of the above assessment, Ministers were of the opinion that Turkey should monitor closely the evolution of the current account deficit. While the reform agenda has proceeded in many areas, such as the recently approved social security reform, Turkey should tackle other structural reforms.

Statistics

Bulgaria Romania (acceding countries)

Ministers welcomed the Progress Report of 26 April 2006 on the implementation of the Action Plan on Economic, Monetary and Financial Statistics in the acceding and candidate countries and the ongoing efforts in its implementation. Despite the progress achieved further work will be needed to ensure compliance with the Action Plan.

Bulgaria and Romania should continue their efforts to reach full compliance at the time of accession, particularly in the areas of government debt and deficit (both acceding countries should improve compliance with ESA 95 accounting rules), annual national accounts, the Harmonised Index of Consumer Prices (notably by Bulgaria) and long-term government bond statistics. Furthermore, the availability and timeliness of certain infra-annual statistics (notably quarterly employment and quarterly public finance statistics), the implementation of monetary financial institutions (MFI) interest rate statistics, and the preparation of quarterly financial accounts. It is also important that both acceding countries devote sufficient resources to the compilation of all other statistics needed for the Convergence Reports and deliver all data in line with the regulations. Moreover, it is noted that the enhancement of the role of the National Statistical Institutes as well as smooth co-operation with the other relevant authorities at a national level, will be important. The acceding countries are invited to urgently step up their efforts in these respects, and the EFC should continue to monitor progress closely on the basis of regular progress reports.

Croatia, the Former Yugoslav Republic of Macedonia and Turkey (candidate countries)

Ministers welcomed progress made by Croatia and Turkey regarding the transmission of economic statistics. They stressed however that further significant improvement is needed to comply with the requirements of the Action Plan on Economic, Monetary and Financial Statistics for the acceding and candidate countries. Efforts need to be stepped up in particular in the areas of national accounts and infra-annual statistics. The main priority for the Former Yugoslav Republic of Macedonia should be to build up the capacity for a regular production and transmission of data in line with the requirements of the Action Plan. All candidate countries must provide for a regular transmission of nationally available data.

Overall conclusions

Ministers concluded that it was crucial for Bulgaria and Romania to complete the preparations for accession by fully implementing the acquis and by resolving all outstanding issues prior to accession. Croatia and Turkey should continue the reform process by pursuing macroeconomic stabilisation and fiscal consolidation. In the framework of their reform agenda, both countries should focus on sustained structural reforms of the economy.

Countries face a series of common macroeconomic, financial stability and structural changes. Concerning macroeconomic and financial stability, while varying between countries, common features appear to be:

- strong expansion of domestic demand;
- after few years of disinflation or low inflation, as of 2005 inflation has picked up in some countries and disinflation has slowed in others;
- rapid credit growth;
- important role of foreign currencies in the banking sector;
- large or widening current account deficit.

On the structural side, challenges refer to accomplishing privatisation and advancing enterprise restructuring, improving the business environment to stimulate investment and enhance competitiveness, strengthening administrative capacity and legal certainty (including contract enforcement), combating corruption and money laundering in some countries and reforming labour markets and intensifying efforts to integrate the informal economy into the formal sector.

Ministers recalled the Action Plan on Economic, Monetary and Financial statistics for the acceding and candidate countries adopted in May 2003, which should continue to be a top priority for the statistical authorities in all these countries. Statistical offices should have the necessary resources to be able to meet the requirements of the action plan. Progress has been made, but further significant improvement is needed. Notably Bulgaria and Romania should urgently step up their efforts in order to reach full compliance at the time of accession.

Ministers underlined their commitment towards continuing, with the support of the Economic and Financial Committee, the Economic Policy Committee and the Commission, the surveillance of progress with economic, budgetary and structural policies in acceding and candidate countries. Ministers will meet again in the course of 2007 to continue their dialogue. Also, the dialogue at the level of the Economic and Financial Committee and their counterparts will continue in 2007."