A Primer on Budgetary Questions on the New EU Members States.

by
Lúcio Vinhas de Souza [1]
Dóra Borbély

Kiel Institute for World Economics (IfW)

Abstract: This paper analyses budgetary questions of central and eastern European countries in the run up to EU and EMU membership. It starts with a presentation of some theoretical considerations, followed by a description of the current budgetary situation in the future member states, and by the estimation of structural budget deficits for them. The first section concludes with an initial estimation of the fiscal costs of Accession. The following sections present country studies of two nations: Poland, the largest future member state, and Portugal, a "convergence" country and a member of the EU and of the Euroarea. Both countries show similar recent experiences of worsening fiscal positions, and due to similar reasons. Portugal also presents a useful warning of inconsistent efforts towards fiscal consolidation masked by the one-off gains from entry into the Euroarea, and the relaxing of the constraints enabled by the elimination of the exchange rate risk. It also highlights the advantages and limits of the SGP framework.

JEL Codes: E6, E21, E62, H2, H6.

Keywords: Public Debt, Debt Stock, Structural Budget Deficits, HP filter, Fiscal Policy, European Union, Accession, SGP.

Version prepared for the Money, Macro and Finance Research Group 35th. Annual Conference, September 10 -12 2003, Cambridge University, United Kingdom.

[1]This paper is based in a work prepared by the Authors for the for the DGECFIN, European Commission, in March 2003. All usual disclaimers apply. Corresponding author: Kiel Institute for World Economics (IfW), Düsternbrooker Weg n° 120, 24105 Kiel, Germany, tel. +(49) (431) 8814-205, fax +(49) (431) 8814-500, email desouza@ifw.uni-kiel.de, website http://www.tinbergen.nl/~phare/Partners/Souza.html.

I.Introduction.

From May 1 2004, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia -from now on denoted as Acceding Countries (ACs)- shall become full-fledged members of European Union[2]. One single country, Poland, is responsible for roughly 50.3% of the total GDP (of around 360 Billion Euros) of this group of new entrants and for roughly 43% of a joint population of close to 90 Million human beings. When they become member states in May 2004, some temporary derogations in terms of the "four freedoms" that underpin the Common Market are expected to remain (namely, the one concerning the free movement of labour).

In a number of ways –but not in GDP terms- this will be the biggest wave of expansion of the Union since its birth in 1957, surpassing the North Sea Accession of 1973 (the Kingdom of Denmark, the Republic of Ireland and the United Kingdom), the Mediterranean Accession of 1982 (the Greek Republic), the Iberian Accession of 1986 (The Kingdom of Spain and the Portuguese Republic) and the Nordic-Central European Accession of 1995 (the Republic of Austria, the Republic of Finland and the Kingdom of Sweden).

Upon Accession, the new member states will participate in the EU's fiscal multilateral surveillance mechanism[3]. Furthermore, upon entry into the Euroarea –a stated policy objective of virtually all the Accession Countries- the more stringent Maastricht Criteria[4] and the provisions of the SGP (Stability and Growth Pact)[5] will apply.

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[2]Bulgaria and Romania have 2007 as an indicate Accession date. Turkey, who is also applying for membership, has no set date for the beginning of negotiations. Croatia formally applied for membership in March 2003.

[3]Effectively, the European Commission has used its annual assessments of the Accession Countries for a similar purpose. From 2001, with the PEP (Pre-Accession Economic Programmes), the exercise took a more formal character.

[4]Some benchmarks, aiming to ensure monetary and fiscal stability in the joint currency area, where defined in the framework of the Maastricht Treaty. Two are monetary, one is linked to exchange rate stability, and the final one is fiscal. They are:

i) *The Inflation Convergence Criterion*-an inflation rate which should not exceeds by more than 1.5 % the average inflation rate of the three best-performing countries;

ii) *The Interest Rate Convergence Criterion*-the average long-term nominal interest rate should not be more than 2% above the average interest rate of 3 countries with the lowest inflation rate;

iii) *The ERM Criterion*-currencies of future EMU members should be have been in the ERM (Exchange Rate Mechanism) without devaluation or revaluation for at least two years;

iv) *The Excessive Debt Criterion*, which is composed of a budget deficit component, declaring that a country's budget deficit should not exceed 3% of its GDP, and of a stock of debt component, stating that the stock of outstanding government debt should not exceed 60% of that country's GDP (on otherwise be in a descending sustainable trajectory towards these benchmarks).

Additionally, an "operational" element was also set, concerning the legal and institutional features of the national Central Bank (CB), namely, its independence from government interference, a mandate towards price stability, the prohibition of monetary financing of deficits, and the availability of a set of market-based instruments that enable the CB to conduct monetary policy actions.

[5]The SGP aims to assure the continuous compliance with the fiscal criteria of the Maastricht Treaty, and to assure medium-term budgetary positions in surplus close to balance for the Euroarea member states. To try to impose a more binding constraint on the fiscal behaviour of the member countries of

The SGP is actually part of a worldwide trend to fiscal policy rules, which started as early as 1985 in the United States, with the so-called "Gramm-Rudman Act" (OECD, 2002). They may have both national and sub-national components –like the balanced budget provisions existing in 48 of the 50 federated US states– even in unitary states (as one may see in the sections on Poland and Portugal on this work). They may be also understood as the complement to the monetary policy rules increasingly used in monetary integrated areas –like the Euroarea itself- to assure the consistency and effectiveness of the policy mix (see ECB, 2003).

Part of the economic rationale behind the SGP lies on enabling "automatic stabilizers" to work properly during and economic cycle (see Gali and Perotti, 2003).Another justification behind fiscal policy rules rests on expected positive growth effects: since the early 1990s, and the seminal work by Giavazzi and Paganno (see Giavazzi and Paganno, 1990), the notion of "non-Keynesian", growth enhancing effects is an important underpinning of the analysis of fiscal policies in the EU. One could explain these "non-Keynesian" outcomes by a situation where a credible contractionary stance by the monetary and/or fiscal authority is perceived by forward-looking agents as indicating an increase in the sustainability of the policy framework, a lessening of a crowding-out, leading to greater private investment and, therefore positive growth effects. As this chain of events is contrary to what one would expect in the traditional Keynesian framework, hence its name.

This is a very elegant and theoretically appealing argument, as it would indicate the existence of a strong "expectational" channel for economic policy[6]. Nevertheless, some recent evidence (see Giavazzi, Jappelli and Pagano, 2000, Afonso 2001, Lambertini and Tavares, 2002) seems to questions the existence of such effects and/or condition the probability of a successful budgetary consolidation to factors like the duration, intensity and direction of the budgetary action, and the existence of the exchange rate instrument. Even the initial results from Giavazzi and Paganno have been questioned, being attributed to, in effect a "data artefact" (see Kamps, 2001).

Beyond that, even recent works that assume the existence of such expectational effects have tried to provide a critical analysis of the effectiveness of the SGP (either proposing deeper reforms, as in Blanchard and Giavazzi, 2003 –who roughly suggest the formal implementation of a "golden rule" for public investment in the SGP, others roughly backing it as it stands, as in Butti, Eijffinger and Franco, 2003, mainly due to "political economy" reasons in the negotiation of an optimal supranational fiscal policy rule which preclude a "first best").

EMU, a system of punitive pecuniary fines was introduced by it, through which –after a lengthy joint political decision process, with ultimate decision placed on a unanimous vote by the Council- individual EU member countries that incur in non-cyclical adjusted deficits that are deemed to be "excessive" –namely, over the 3% benchmark- would transfer up to 0.5% of their GDP to the Union. The SGP also aims to create a mid-run framework for fiscal policies, through the national multi-year "Programmes for Stability and Growth".

[6]On the *actual* empirical and economic relevance of the so-called "Lucas critique", a recent work by Rudebusch (see Rudebusch, 2002) estimates that reduced form specifications -both backward or forward-looking- are rather *insensitive* to policy shifts, or, in other terms, that the coefficients would be structurally stable within the used estimation sample. These results actually echoes very similar ones obtained much earlier, by Taylor (1989).

Parallel and above the compliance with those sets of fiscal frameworks and their eventual effectiveness, Accession will imply direct and indirect fiscal costs for the new member states. The direct ones arise from the sheer payment of contributions to the EU budget, to costs of the implementation of EU regulations and standards (in sectors like environment, safety, transport, etc.[7]). As a counterpart of such costs, the new member states will be able to access the usual set of Structural and Cohesion Funds, plus a partial access to the European Agricultural Guidance and Guarantee Fund (EAGGF)[8]. Even before entry, they were able to benefit from transfers from pre-Accession mechanisms, like the PHARE and SAPARD programmes (see Annex).

The indirect effects will arise from the tax effects from the expected increase in growth, the decline in interest rates and risk premiums, the reduction in tax revenues from sources like import duties and excises, and the -continued- implementation of a tax regime that is compatible to the one in current EU members.

This work will begin by presenting a brief analysis of the budgetary trajectory of Acceding countries, and an initial description of the fiscal costs of Accession. This will be followed by a deeper analysis of the fiscal developments in two countries, the largest Acceding one, Poland, and a current member state which has undergone recent budgetary problems while being part of the Euroarea, the Portuguese Republic.

I.1. The Current Deficit and Debt Positions.

The fiscal positions of the future member states are described in a synthetic fashion in the Table 1 below. Beyond any data comparability questions, we must remember that the individual countries face different levels of remaining transition-related expenses[9].

Table 1: Budget Deficits, 1997-2002 (in percentage of GDP)

	1997	1998	1999	2000	2001	2002*
Czech Republic	-2.7	***-4.5***	***-3.2***	***-3.3***	***-5.5***	***-6.4***
Estonia	2.0	-0.4	***-4.0***	-0.4	0.2	-0.2
Hungary	***-6.8***	***-8.0***	***-5.3***	***-3***	***-4.1***	***-5.7***
Latvia		-0.7	***-5.3***	-2.7	-1.6	-1.8
Lithuania	-1.1	***-3.1***	***-5.6***	-2.7	-1.9	-1.9
Poland	***-4.3***	-2.3	-1.5	-1.8	***-3.9***	***-4.1***
Slovakia	***-5.5***	***-4.7***	***-6.4***	***-12.8***	***-5.6***	***-4.6***
Slovenia		-2.3	-2.2	***-3.2***	-2.5	-1.8

Source: Kopits and Székely, 2003 and EC, 2002. *Projections.

[7]Of course, in principle, such expenses, as the ones related to investment in human and physical infrastructure, would eventually have to be incurred by the countries in question.

[8]The main component of the CAP transfers. The level of funds was capped at 25% of the level received by the farmers of current EU member states, raising to their level within a 10 year horizont. As a last minute deal during the final negotiations, the governments of the new member states will be allowed to top up this flows to their national frames using national funds.

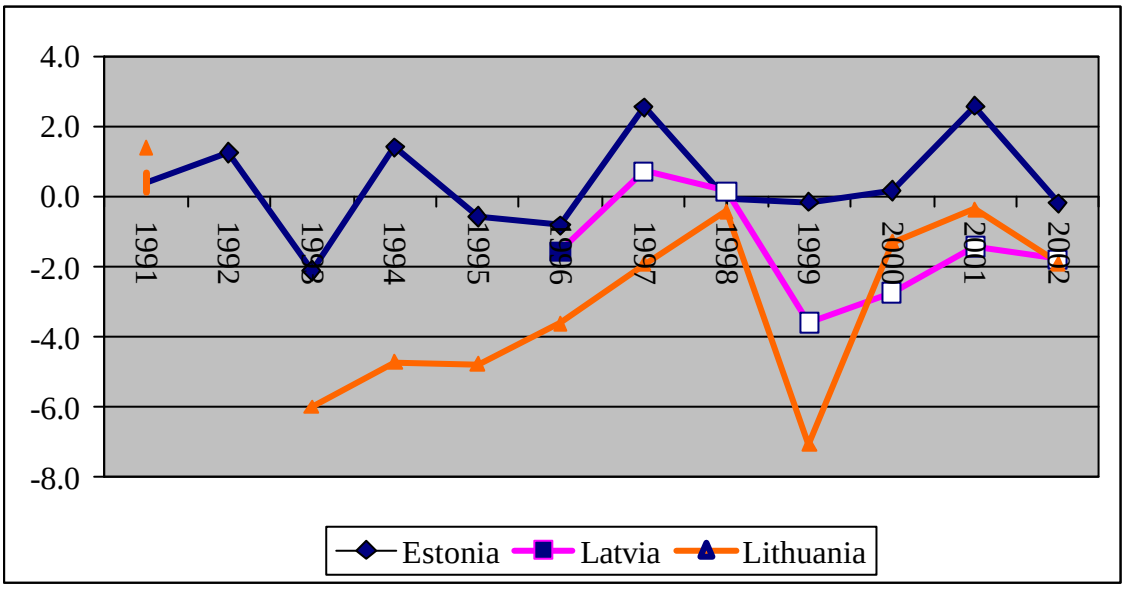
[9]Gleich, 2003, relates budget institutions to observed fiscal outcomes in Central and Eastern European Countries. We do not control for that here.

As we may see, two somewhat clear sets seemingly can be defined among the future member states, a Baltic and a Central European ones[10].

We observe that the budgetary situation in 2000-2002 has remained stable and close to balance in Estonia (which has a constitutional provision for balanced budgets), improved in Lithuania and in Latvia (while remaining well within SGP limits), while worsening in most of the others. The SGP limits were breached -or were close to being breached (figures in bold and italic)- in the Czech Republic, Hungary Poland and Slovakia. The Czech Republic, Hungary and Slovakia seem to have continuously very high deficits. The Figures 1 and 2 below present this graphically for each of those two groups of countries.

The Baltic countries' budgetary positions seem to follow a close to balance pattern. The worsening observed in 1998-1999 can be attributed to counter-cyclical response to the external shocks of the 1998 Russian Crisis and the following Oil Price Shock, and was duly corrected afterwards.

Figure 1: Baltic Deficits, 1991-2001 (in percentage of GDP)

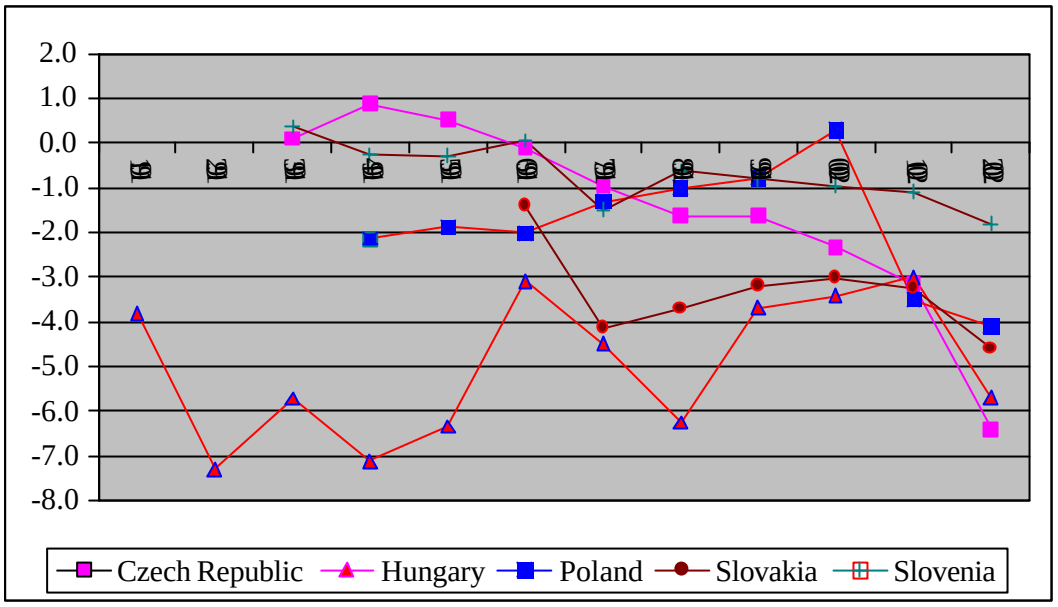


Source: EC, 2002.

On the other hand, the Central European set (see Figure 2), seems to show a worsening pattern of fiscal deficits, which started around 1999-2000, for most of the countries (for the Czech Republic, the worsening of the fiscal position is continuous throughout the sample). This worsening does not seem to be related only neither to external shocks (the 1998 Russian Crisis, the recent oil price shock, and the prolonged downturn in the EU, and, specially, in Germany) or to domestic downturns and the operation of automatic stabilizers.

[10]The usual questions related to the comparability of budgetary figures among countries also apply here. The last year of the series refers to projections presented by the countries in their Pre-Accession Economic Programmes (PEPs), which are assumedly as mostly ESA 95 compatible. The earlier years of the series, for comparability reasons, follows the GFS (Government Financial Statistics) methodology used by the IMF.

Figure 2: Central European Deficits (in percentage of GDP)



Source: EC, 2002.

Using a Hodrick-Prescott (HP) method, and after Coricelli and Ercolani (see Coricelli and Ercolani, 2002)[11], we attempted to estimate the structural, or cyclically-adjusted budget (CAB) deficits for the countries in our sample (the use of theoretically more correct production function method, was deliberately avoided due to data limitations). Following Coricelli and Ercolani, ibidem, CAB is defined as the difference between the cyclical components of revenues (CR) and expenditures (CE), as given respectively by: (I have changed the indices of the elasticities.)

$$CR = \left(\frac{iT}{Y}\right)^{*} e_{iT,Y}{}^{*} gap_t + \left(\frac{cT}{Y}\right)^{*} e_{cT,Y}{}^{*} gap_t + \left(\frac{indT}{Y}\right)^{*} e_{indi,Y}{}^{*} gap_t + \left(\frac{sscT}{Y}\right)^{*} e_{sscT,Y}{}^{*} gap_t$$

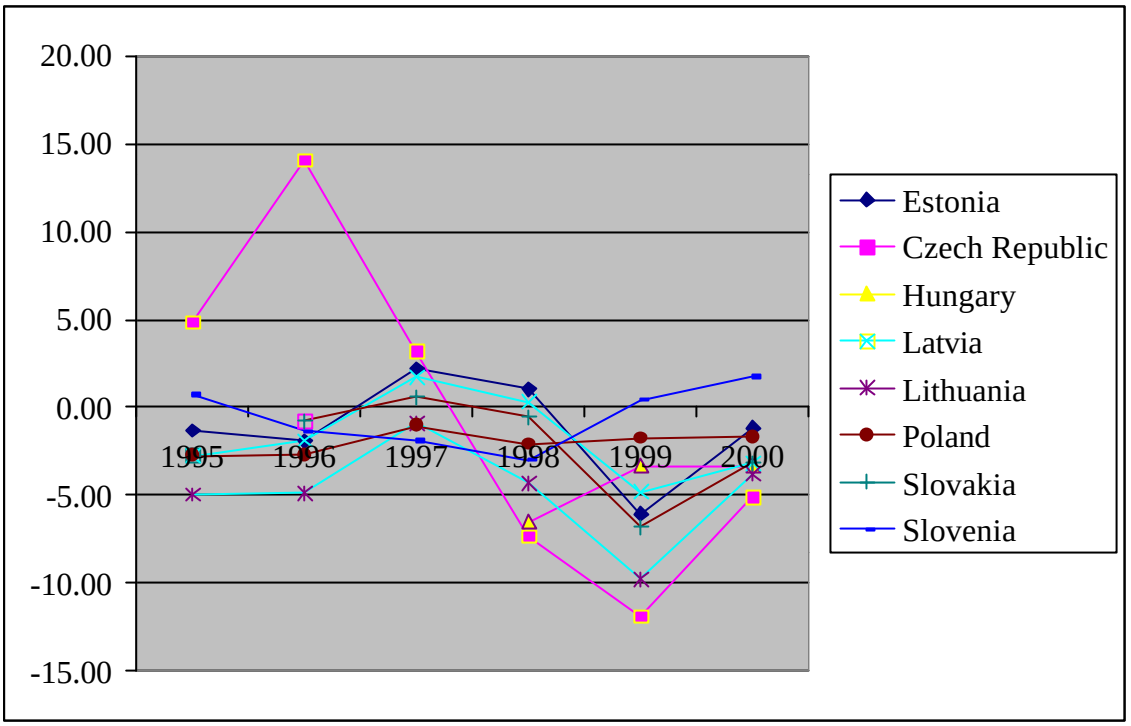
$$CE = e_{ui,ur}{}^{*} e_{ur,Y}{}^{*} gap_t$$

where ***iT*** stands for individual taxes, ***cT*** for corporate taxes, ***indT*** for indirect taxes, ***sscT*** for social security contributions, ***Y*** for GDP and ***å*** are the elasticities, with the elasticities for CE indicating, respectively, the elasticity of unemployment benefits towards the rate of unemployment and the elasticity of unemployment to output.

The results are presented in Figure 3 below, which only partially bears out the insights from the two previous figures.

[11]There were serious data problems, even with such a simple specification, especially with the estimation of the unemployment benefits' elasticities. In general, our estimated elasticities were quite small, with the social security contributions closer to "normal" values (the usual values for the current member states lies in the 0.6-1.2 interval). For the unemployment benefits elasticities, for lack of data for Latvia, Lithuania and Slovenia, they were just assumed as one.

Figure 3: Structural Deficits Estimations (in percentage of GDP)

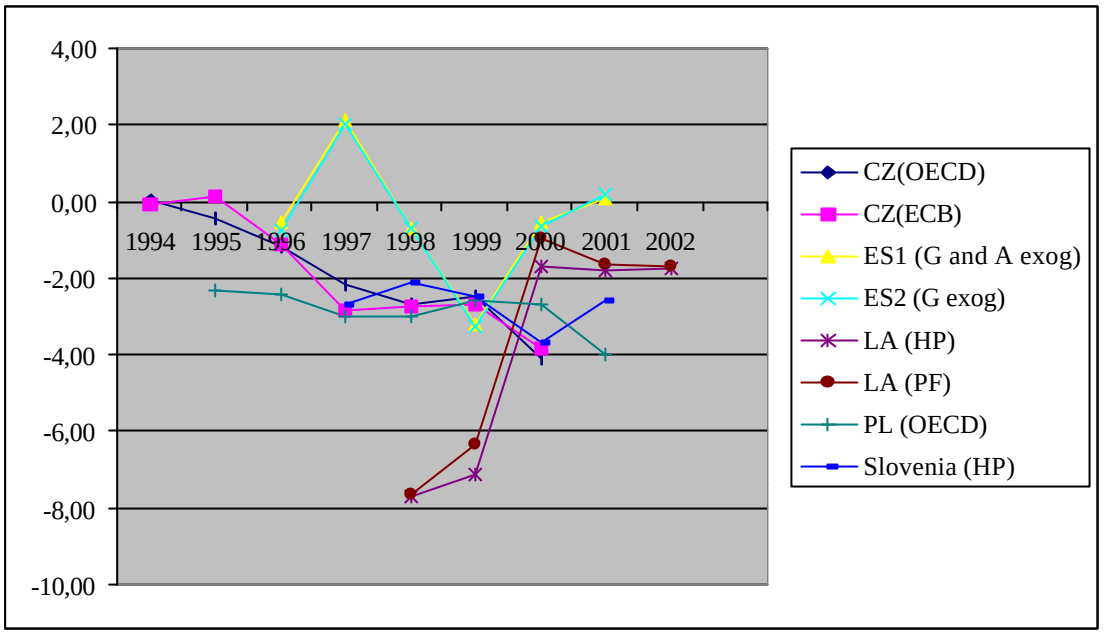


Source: IMF IFS, estimations by the authors.

Due to the data problems encountered, and to the counter-intuitive behaviour of some of the estimated CAB series in our sample, we show in Figure 4 other estimations available for some of the Acceding Countries[12]. We do not show the Coricelli and Ercolani ones, as they refer to only one year, 2000, and to only three countries in the current Enlargement wave. They behave in a much more intuitive way, and also support our previous conclusions: the Central European set shows almost monotonically worsening CABs, were the series for Estonia show a cyclical pattern, with the most recent tendency being towards balance.

[12]The estimations for the Czech Republic (CZ) were kindly provided by the CNB (Czech National Bank), and will be published soon in a CNB Working Paper: they were also estimated using the production function method, in the OECD and ECB variants (see Bezdìk, Dybczak, and Krejdl, 2003). The estimations for Estonia (ES) were kindly provided by the Bank of Estonia: they use a production function method, and the two variants presented vary as to exclusion of agriculture and the government sector from the estimation of the output gap (ES1) and only agriculture (ES2). The figures for Lithuania (LA) were taken from Klyviene, 2003 (see Klyviene, 2003), and were produced both with the HP and production function methods. The figures for Poland (PL) were estimated by the OECD, using a production function method and elasticities taken from "similar economies" (see OECD, 2002). Finally, the estimations for Slovenia were done by the IMAD (see IMAD, 2002) and used the HP method.

Figure 4: Other Structural Deficits Estimations (in percentage of GDP)



Sources: Bank of Estonia, Bezdìk *at al* 2003, IMAD 2002, Klyviene 2003, OECD 2002.

Looking now at the stock of public debt, we may see that all of the Acceding countries are within a SGP 60% limit, and most of them are actually much below it (see Table 2 below).

Table 2: Stock of Government Debt, 1997-2002 (in percentage of GDP)

	1997	1998	1999	2000	2001	2002
Czech Republic	13	13.7	14.5	17	23.7	25.6
Estonia	6.9	6	6.5	5.1	4.8	4.4
Hungary	64.2	61.9	61	55.4	53.1	52.9
Latvia		10.6	13.7	13.9	16	16.8
Lithuania	15.7	17.1	23	24	23.1	23.6
Poland	46.9	41.6	42.7	38.7	39.3	43.3
Slovakia	28.8	28.9	40.2	45.2	44.1	39.3
Slovenia		25.1	26.4	27.6	27.5	27.9

Source: Kopits and Székely, 2003 and EC, 2002. *Projections.

A series of remarks have to be made here: beyond the common question of hidden liabilities (social and insurance schemes), the dynamics of the debt stock are, again, quite different between subgroups. While the unweighted average of the stock of debt lies below 30% in 2002 for the whole group, they are below 15% in the Baltic set[13] (or slightly above 16%, GDP weighted), and close to 38% in the Central

[13]Concerning the Baltic countries, one must remember also that those countries started their new lives as independent countries with a virtually null stock of debt, given that the political agreement that led to the Russian Federation inheriting all former "Soviet" assets also implied that it assumed all the liabilities, including public debt stocks. Also, the "division" of debt stocks between Slovenia and the rest of Yugoslavia implied non-economic reasons for their initial debt position. See Hallerberg, Vinhas de Souza and Clark, 2002.

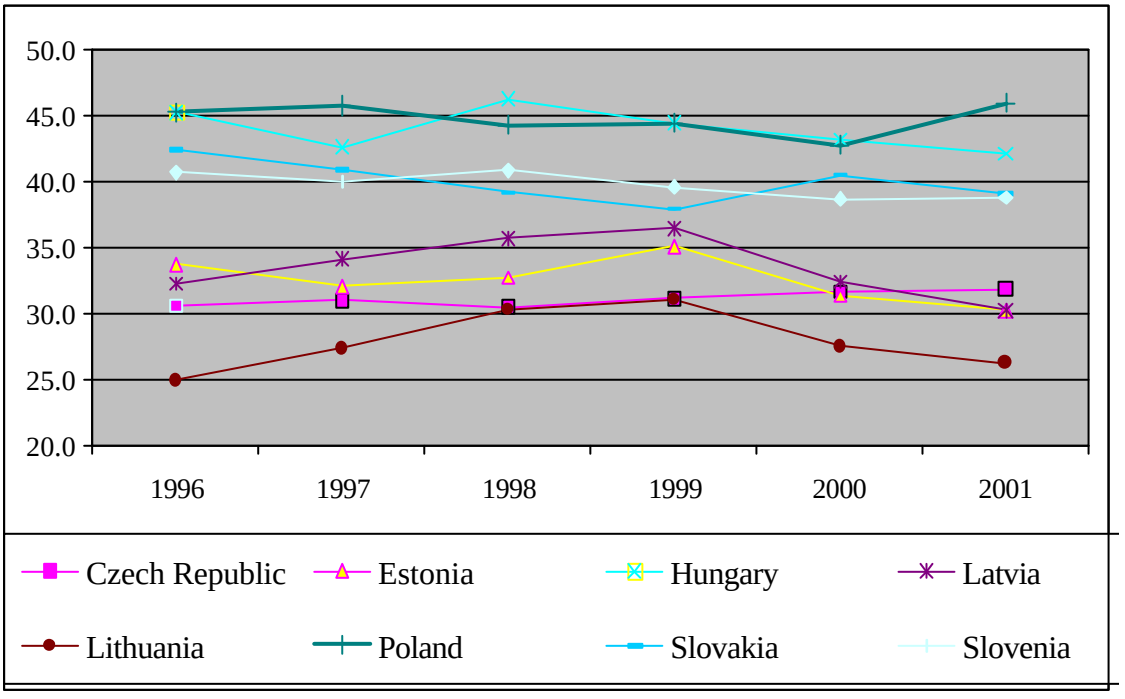
European one (weighted, this last figure jumps to above 40%, a growth trend initiated in 2000).

I.2. The Size of Government.

The future member states cannot be, a priory, classified as "big government" countries (see Figure 5). For most of them, if anything, the share of government in the economy, measured by the share of government expenditures to GDP has fallen from the early 1990s, to an un-weighted average of close to 36% in 2001 (IMF/IFS data). Part of this reflects, of course, the removal of direct state presence in the economy of those formally centrally planned economies. By 2001, the unweighted share of GDP generated by the private sector had reached 73%, according to EBRD data (see EBRD 2002), from a rather marginal share in the early 1990s.

On the other hand, we may observe certain causes for concern in specific countries (Hungary, with one of the highest –and stable- share of government expenditure in GDP in the sample, Poland, whose worsening situation is not fully reflected in Figure 5, the Czech Republic, whose share is continuously creeping upwards). All those are Central European countries. The Baltic set, on the other hand, shows a small –and falling- share of government expenditures in GDP (the average was below 29% in 2001, while for the other countries it stood close to 40%).

Figure 5: Share of Government Expenditure in GDP



Source: IMF IFS, estimations by the authors.

This conclusion is supported by more formal econometric studies (see IMF, 2002 and European Commission, 2002(c)), that estimate that the size of the government expenditures for most of the Acceding Central European countries is above the one for countries with similar GDPs per capita, and below for the Baltic countries. The degree of distortion seems to be particularly large for Poland, with a 5 to 10% excess of predicted expenditures on GDP.

I.3. Fiscal Costs of Accession.

On the direct fiscal costs of Accession, some very preliminary estimations have been done by the IMF (see Kopits and Szekely, 2003, and Backé, 2002[14]) for a selected set of Acceding countries. They are presented in Table 3 below.

Assuming a conservative inflow of EU funds (which have been capped at 3% of the a acceding country's GDP, but we may envisage problems in the absorption of this total: for an overview of the funds earmarked for the new member states, see Annex, which indicate an availability of funds equivalent to roughly 3% of the countries' GDP), the direct fiscal effect would be between –1.75% to –0.5, essentially due to infrastructure, tax and institutional reform and harmonization (which, we stress again, would have to be eventually incurred anyway in some point in the future).

The indirect effects from the long run growth enhancing effects from reform and membership, which would have positive GDP and a tax base effects. The most substantial short run indirect effect would be the convergence of the interest rate to the Euroarea benchmark, which can be worth a few percentage GDP points for most of the Central European economies, with their larger stocks of public debt and high real interest rates (the CBA –Currency Board Arrangements- Baltic economies, by and large, have already observed this convergence to Euroarea interest rates, so they will only marginally benefit from this effects: see Vinhas de Souza 2002). This reduction in interest rates should also have positive long run effects on growth, due to dynamic effects in private investment (for a case study, see Box I, below).

Table 3. Summary Fiscal Effects of EU Accession in Selected Countries (in percentage of GDP)

	Czech Rep.	Estonia	Hungary	Poland	Slovakia	Slovenia	Backé
Direct Effects	**-1.75**	**-1.25**	**-0.75**	**-0.50**	**-1.50**	**-1.00**	
-Contribution to the EU budget	-1.25	-1.25	-1.25	-1.25	-1.25	-1.25	-1.0 to –1.2
-Structural Funds Transfers	1.5	1.5	1.5	1.5	1.5	1	-0.9 to +1.3
-Cohesion Funds Transfers	0.5	0.5	0.5	0.5	0.5	0.5	
-Reform of Public Administration	-1.5	-1.5	-1	-1.5	-1.5	-1	0/?
-Phase out of Production Subsides	1	0.25	1.5	2	1	1	+0.2 to 2.0
-Realignment of Customs Duties	-0.5	0.25	-0.5	-0.5	-0.5	-0.5	+0.2 to –0.5
-Tax Harmonization	0	0.5	0	0.25	0.25	0.25	+0.5
-Infrastructure Expenditures	-1.5	-1.5	-1.5	-1.5	-1.5	-1	?
Indirect Effects							
-Positive Growth Effects	(+)	(+)	(+)	(+)	(+)	(+)	+
-Structural Reform	(+)	(+)	(+)	(+)	(+)	(+)	+
-Tax Revenue Windfall	(+)	(+)	(+)	(+)	(+)	(+)	-/+
-Decline in Interest Rates	0.2	0.4	2.5	2.0	1.5	1.4	+/0

Sources: Kopits and Szekely, 2003, and Backé, 2002, modified by the authors.

[14]Backé follows the methodology of Kopits and Szekely, and reaches roughly the same conclusions as them, but do not presents country specific results, only aggregates.

Taking all this into consideration, EU membership shall not present an undue fiscal burden, however negative direct effects, for the future members states (as it was not, in all the previous Enlargement waves). From a EU point of view, most of the economies also seem to respect at least one of the fiscal surveillance criteria, with the Baltic countries comfortably fulfilling all of them. Specific problems may arise only in individual Central European ones. Given that one of those nations also happens to be the largest Acceding country, Poland, we will dedicate the next section of this work to it.

Box I: EU Membership and Growth: The Case of Portugal

There are several different "convergence" experiences for poorer EU member states, from a fast path that lead the country in question to surpass the EU average (Ireland), to effective non-convergence (Greece), to intermediate degrees of GDP *per capita* convergence (Spain, Portugal). We will here briefly present the Portuguese experience.

During the second half of the 1990s public investment was at a level above the EU averages (from 2.8% of GDP in 1985 to 4.1% in 2001), mainly due to EU funds. Since joining the Union in 1986, Portugal has received, on average, 3% of GDP in transfers per year –or over 7% of total Portuguese public expenditures- including both structural and cohesion funding. They have played some part in the modernisation and restructuring of the Portuguese economy, and seem to have aided convergence to EU average productivity levels, especially via infrastructure development: as an example, the density of motorways doubled between 1994 and 2000 and a significant proportion of railway lines were electrified (see OECD, 2003). Nevertheless, one must note that the results of several studies (see Pita Barros and Garoupa, 1997, Vinhas de Souza, 1998 and Lebre de Freitas, 2003) show that Portugal's convergence to the EU average was actually faster *before* its entry into the EU –during what is sometimes called the "EFTA" membership period- than afterwards (by as much as a 3 times faster growth of GDP *per capita* during the 1961-1973 sub-sample: see Lebre de Freitas, 2003, ibid.) and without any signs of structural breaks in 1986, the year of Portuguese EU accession. This has lead to, among other things, questioning about the effectiveness of the use of such a substantial share of public investment (see Bronchi, 2003 and Ferreira Leite, 2003).

Additionally, formal model estimations show that Portugal's participation in the Union increased the level of GDP *per capita* on a 10-year horizon by *only 1%*, as compared to the counter factual scenario (See Ministério das Finanças, 1998). Those results are based on estimations done with an Endogenous Growth Model -EGM (see Gaspar and Pereira, 1995). Such reduced gains are due to the assumption, on the alternative scenario used in that study, that Portugal would keep the *same type of sustainable macro policies, regardless of the participation or not on the EU*. Therefore, the main channel of transmission in that model that can be *exclusively* attributed to EU membership – given that is patently obvious that any country can pursue sustainable macro policies without being a member of the EU or, as a matter of fact, any other multi or supra-national body, and derive gains from those- was the increase in official transfers, i.e., EU funds (as commercial integration was already largely a reality, its effects were marginal in the outcome, and the completion of financial integration generated only temporary gains –besides the fact that commercial and financial liberalization are worldwide, not regional specific, trends- the model indicates that *only net EU public transfers affected Portuguese GDP growth substantially and permanently*).

Another more recent study (see Pereira, 1999) estimates gains from Euroarea membership resulting mostly from the reduction of the risk premium- ranging from a GDP increase, as compared to a baseline *status quo*, from 2.9% to 13.6% (full gains from participation compared with the non-participation scenario, which leads to an increase in the risk premium), with a "central scenario" of a 10% increase (or a 0.4% gain in the annual growth rate). The model assumes that the reduction of long-run interest rates is driven both by the sustainable fulfillment of the Maastricht and SGP criteria, leading to a reduction in the level of public debt, and by credibility gains associated with Euroarea participation. The reduction in interest rates increases private investment, and allows public investment to concentrate in infrastructure and human capital accumulation, basic determinants of long-run growth.

We again point out that most of those effects are related to the maintenance of sustainable macro policies, not to EMU or EU accession *per se*. It is, therefore difficult to identify growth effects that are ***exclusively*** related to EU or EMU membership, beyond the pure effects of net fiscal transfers.

Nevertheless, after almost a generation of EU membership, Portugal has not yet converged to the EU average welfare and productivity levels, and, after the third Community Support Framework (CSF III), which will provide the equivalent of an annual 2.7 per cent of GDP between 2000 and 2006 (which is expected to represent around 20 % of total investment), mainly on information and communication technology (ICT) projects, there is no guarantee that EU funds will be available for Portugal at these levels after 2006, implying potentially greater budgetary pressures thereafter, if infrastructure spending is to continue at rates that will help a faster convergence to EU levels.

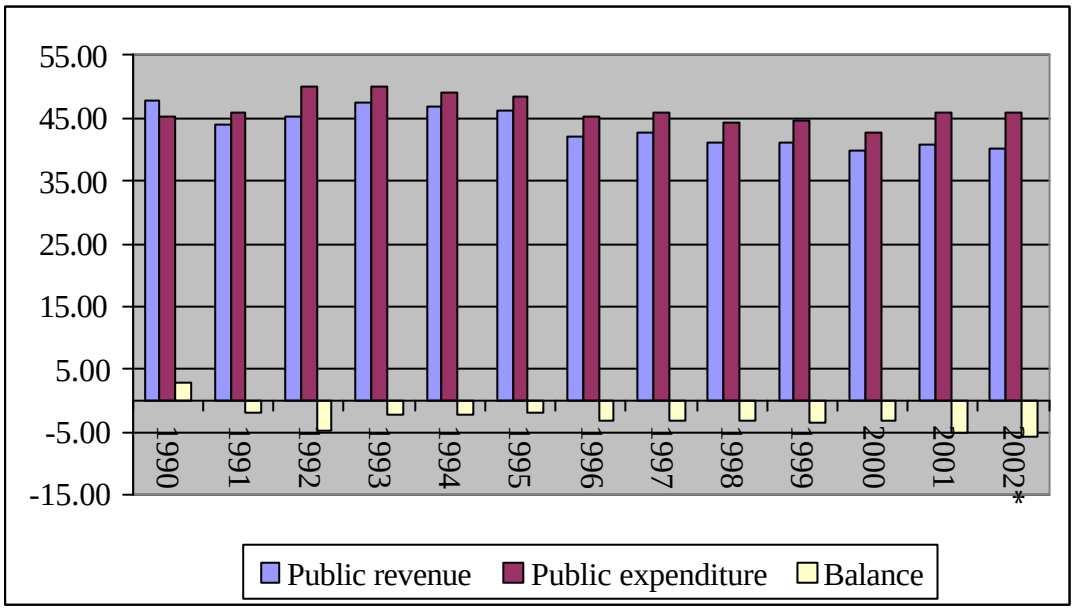
II. The Largest Accession Country: Poland.

The case of Poland is particularly relevant, as it represents, as indicated above, over 50% of the GDP of the 2004 enlargement wave (using 2001 data), and is a country with potential budgetary problems.

II.1. Fiscal Performance and Procedures, 1990-2000

During the early years of "transition", Poland saw a comprehensive fiscal reform, which comprised both the revenue and expenditure sides. Direct subsidies were dramatically cut or eliminated, while the tax system inherited from the command economy period was substantially overhauled (see Kemme and Rapacki, 2000 and 2003). Figure 6 and 7 below summarizes fiscal developments since the early 1990s.

Figure 6: Overall Fiscal Trends (in percentage of GDP)

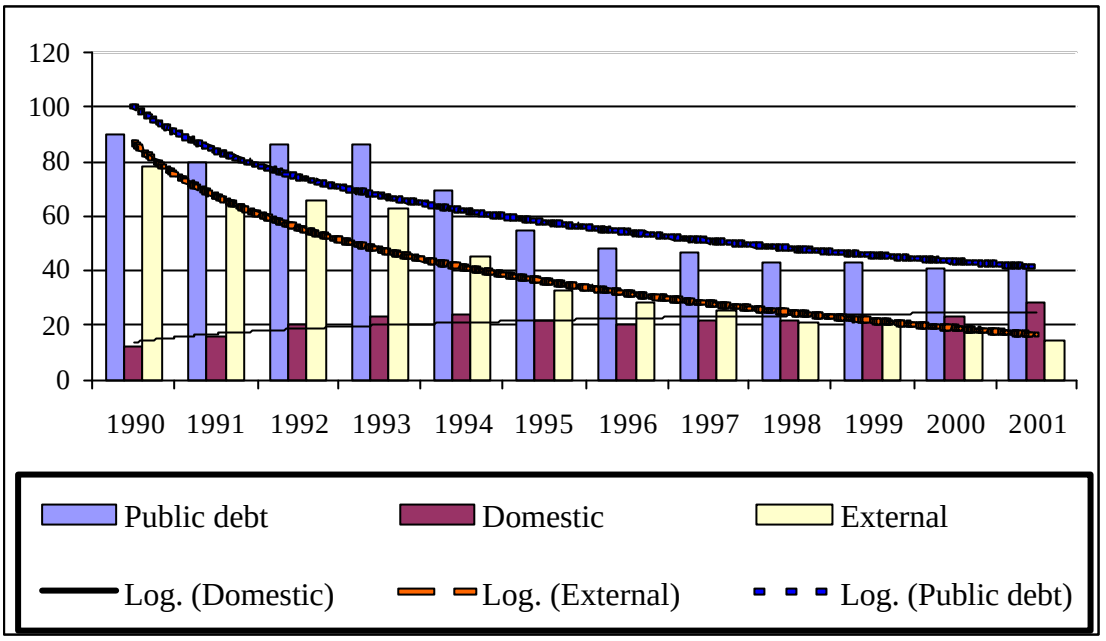


Source: OECD

The Maastricht fiscal criteria were met during most of the 1990s (with the exception of 1992), as the budget deficit was either below the ceiling of 3% of GDP or only slightly above (Figure 6).

The public debt/GDP ratio was sharply reduced in the first half of the 1990s, and since 1995 it has been below the 60% level (Figure 7). The main reason for this was the decision of Poland's official and private creditors (the Paris and London Clubs, respectively) in 1992-93 to effectively forgive up to 40% of the external debt inherited from the command economy period. This debt relief appeared in the official statistics as both a substantial decrease in the volume and share of foreign debt relative to GDP. Therefore, since the mid-1990s the ratio of foreign debt to GDP has been steadily falling, while the share of domestic debt has increased.

Figure 7: Composition and Trend of the Debt Stock



Source: OECD.

As indicated previously, Poland is a 'big-government' country, when compared with countries with a similar GDP level, even after correcting for factors like openness (see Section I.2). Also, the level of public expenditure as a proportion of GDP in Poland was above the mean for OECD countries (44.1% in 1999 and 42.7% in 2000 vs. 37.9% in 2000) and slightly below the EU average (46.4% in 2000: see OECD, several years). Within the OECD and the EU, only the Euroarea members exhibited a substantially higher relative level of public expenditure (48.6% in 1999, and 50.7% of GDP for the 1990-99 period).

With regard to the composition of public expenditures, the 1990s witnessed a clear shift of public expenditure towards redistributive objectives[15]. While in 1991 transfer payments represented 20.5% of central government expenditures, in 1995 this proportion increased to 26.1% and to 32.2% by 2000. Simultaneously, the share of transfer payments from the central budget in GDP went from 6.1% in 1991 to 7.7% in 1995. In the second half of the 1990s some 20% of GDP, or 45% to 50% of total public spending, was for transfer payments. The clear majority of transfers went towards social security and welfare programs. In 1999 the social safety net accounted for 44.3% of consolidated public expenditures, a level comparable with western countries and above that prevailing in Central European economies. The counterpart of it was an inadequate level of public investment.

Beyond rising unemployment benefits (in 2002, close to 20% of the work force was *officially* unemployed), the major underlying cause of the high share of social security expenditure is the pension system. In Poland, pensions as a percentage of GDP amounted to nearly 14% in 2000, the highest level of all of the Central European

[15]OECD, several years, World Bank, 2003, Kemme and Rapacki, (2000), and Rapacki, (2002).

countries, and above the average for both OECD and the EU[16]. The explanation for this are the lax eligibility rules for disability and family pensions (effectively, this was a deliberate policy decision, taken to smooth the post-transition structural adjustment process by subsiding labour force withdrawal: see OECD, 2002). The share of non-discretionary expenditures in total state budget expenditures has steadily grown, from 57.7% in 1999 to 63.2% in 2001 (see OECD, 2002).

Since 1999 the general government deficit has exceeded the Maastricht ceiling. The main cause were the extra-budgetary funds – their expenditure in 1999-2000 increased much faster than revenue, and the resulting deficit rose to 3.1% of GDP (Figure 6). The single most important source of these developments was the FUS. Its initial surplus turned into a deficit, amounting to 0.8% of Poland's GDP. The deterioration in the fiscal position of the government led to two unfavourable macroeconomic effects.

The more expansionary fiscal policy has also required adjustments in monetary policy, which contributed to the decline in growth and revenues. From 1999 till mid 2001, monetary policy has undergone a sharp tightening, to control for the inflationary expectations and counteract the expansionary fiscal policy: real interest rates were increased to double-digit levels. This was very effective in disinflating the Polish economy (CPI growth was only 3.6% in 2001, down from 8.5% in 2000), but it also led to a crowding-out of private investment and a reduction in growth (since 2001, they have fallen by more than 1.400 basis points).

Concerning budgetary procedures, it is necessary to point out here that Poland has a particularly complicated one. To start with, in spite of being a unitary state, Poland has several sub-national groupings (16 *voivodships* –provinces- 315 *poviats* - counties- and 2489 *gminas* –municipalities), all with some kind of fiscal/budgetary authority. From an expenditure perspective, the general government encompasses the "State Budget" –roughly, the central government- all sub-national units mentioned previously, and over *3000* extra-budgetary funds, at all administrative levels.

The practical result is that the "State Budget" represents *only* 40% of general government expenditures, the extra-budgetary funds other 40%[17], while the remaining falls under the sub-national units. Its' evaluation is further complicated by the large number of concepts used to measure the budgetary balance in Poland: the balance of the "State Budget", the GFS methodology, the ESA95 and the "Economic Deficit". Concerning this last concept, Polish fiscal authorities have applied it since 1998, to account for the discrepancy between Poland and the EU in terms of transfers to pension funds: while in the EU employee's contributions to private pension funds via extra budgetary funds are treated as part of fiscal revenues, in Poland they are not. Figure 7 shows the size and composition of the "Economic Deficit" in 1998-2003. Although this measure – compared to the general government balance on a cash basis - is a more precise measure of the fiscal position of the Polish government, it is not

[16]According to the most recent OECD statistics, based on more stringent criteria, the average GDP share of pensions in OECD countries was 7.4% in 2000; the same ratio for Poland was 10.8%, and 7.8% and 6.0% for the Czech Republic and Hungary, respectively (Dang, Antolin and Auxley, 2001).

[17]Fortunately, the three largest extra-budgetary funds, the FUS (social insurance fund), the KRUS (farmers' social insurance fund) and Labour Fund (responsible, among other things, for the unemployment benefits), are two-thirds of this total. Other 15% are on the 16 *voivodships* health funds.

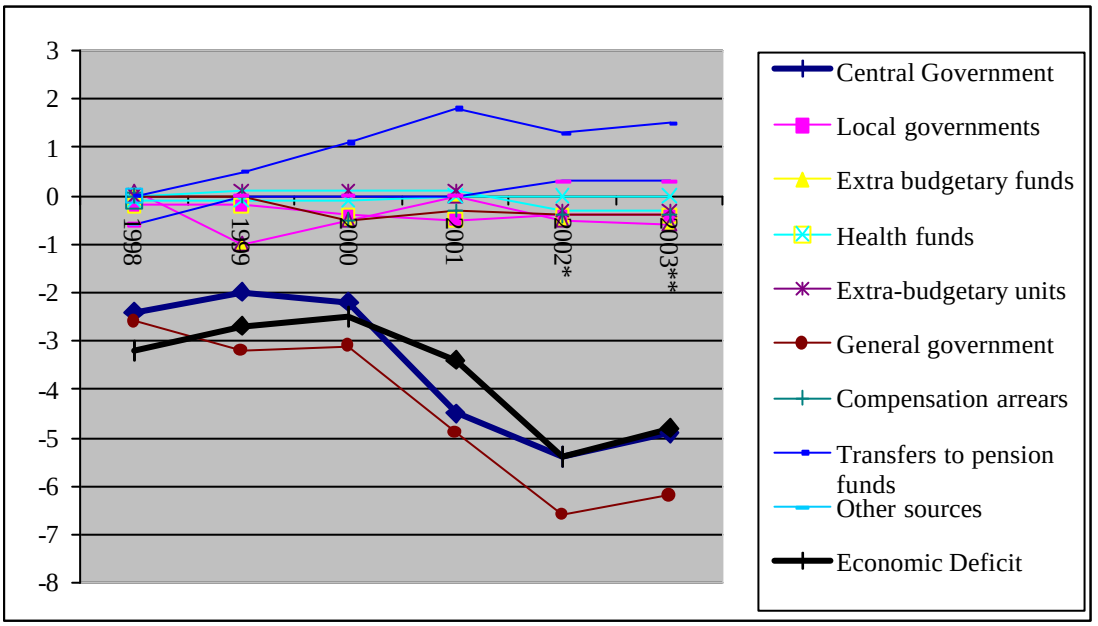
fully compatible with the ESA95 accrual basis method, which is the most adequate one to assess the sustainability of the fiscal instance.

Additionally, the formal budgetary proposal procedure through Parliament only includes the "State Budget", and the Ministry of Finance only supervises expenditure and revenues on it. Also, there is no effective Medium Term Expenditure Framework (MTEF) applied to budgetary process and, furthermore, there is virtually no Parliamentary supervision of the extra-budgetary funds.

II.2. Trends in 2001-2002.

2001 saw a dramatic worsening of the fiscal position of the Polish government. As indicated in Figure 8, the "Economic Deficit" more than doubled (to 4.8% of GDP, up from 2.1% in 2000: see OECD, 2002).

Figure 8: Composition of Deficit



Source: OECD, several years, and Rapacki 2002.

The factors responsible for this are the effects of external shocks and the domestic slowdown (GDP growth in 2001 was 1%, while the 2000 was of 4.%), the cumulative effects of past fiscal policies (the growth in compulsory expenditures was a full 93% of the total expenditure growth in 2001: see Worldbank, 2003), and also the political budgetary cycle originating from the 2001 elections.

If no countervailing action had been undertaken the budget deficit could have risen to 11% of GDP in 2002 (Kemme and Rapacki, 2003). The new governing coalition, in office since October 2001, pledged to keep the deficit within the 5%-5.5% band. To achieve that it had to resort to measures including spending cuts and higher or new taxes (for instance, the new tax on deposit interest earnings and capital gains).

Despite these corrections, Poland's public finances deteriorated further in 2002. The general government deficit is expected to have risen to 6.6% of GDP, whereas the

economic deficit is to reach 5.3%. The share of public debt in GDP rose in 2001, for the first time since 1992, to 42%, and is estimated to have surpassed 48% in 2002. If government guarantees and warranties for business borrowing are included, public debt would have exceed the ceiling of 50% of GDP by early 2003 (see World Bank, 2003: these figures are not the same as presented on Tables 1 and 2, as those use ESA95 accounting procedures). By law this would call for initiating special precautionary procedures in the design and implementation of the central budget and would further constrain fiscal policy[18].

Additionally, in 2002 there was also a sharp decrease in the volume of privatisation proceeds – down by nearly 70 per cent from the 2001 level. For most of the 1990s receipts from divestment of state-owned firms and assets provided a considerable part of financing of the budget deficit. Shrinking privatisation revenues will result in greater public sector borrowing requirements (PSBR), increased government borrowing and rising costs of public debt servicing.

The future direction and consistency of, not only budgetary, but structural policies in Poland, is still rather unclear, mainly due to internal problems with the coalition that took power in October 2001.

[18]The "Act on Public Finance", a section of the Polish Constitution, sets some domestic public debt rules for Poland. The stock of debt cannot exceed 60% of GDP. When the stock reaches intermediate levels of 50% and 55% of GDP, corrective measures have to be taken by the central and local governments to bring it back below the 50% level (albeit with a "scape clause" for special situations). Sub-national units also have a limit of 60% stock of debt to their revenues. The so-called "Belka Programme" of 2001 also tried to introduce a fiscal rule for the *growth in central government expenditur*e, the "CPI+1%", but it was fomally abondoned in 2003, as it turned out to be inconstitutional (the Polish Constitution formally states a budgetary *level* targeting).

III. A EU/EMU Benchmark: The Case of Portugal.

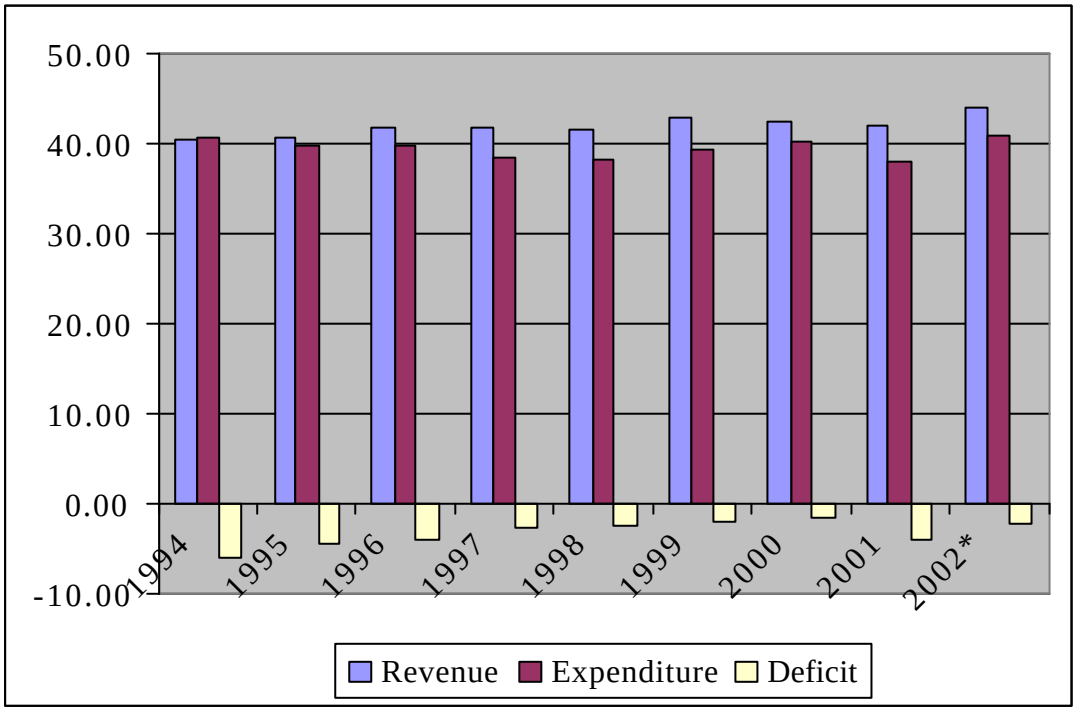
Using the reference of a case of a Southern European economy in a process of catching up with the EU average, namely, of Portugal, can be a useful example for the new members states.

The less developed members of the European Union are traditionally used as a benchmark for the CEEC, as they would seem to share several features: those are mostly small, open economies, with below EU average incomes, deficient infrastructure (in terms of both physical and human capital), larger than average primary sectors, with a -recent- history of restricted international integration and authoritarian regimes[19].

Beyond that, as a member of the Euroarea, Portugal also may provide an example of the effectiveness of fiscal policies and of the SGP under EMU.

III.1. Recent Developments

Figure 9: Fiscal Developments in Portugal (in percentage of GDP)



Source: OECD, several years.

Compared with Poland, Portugal's budgetary procedures are rather straightforward and centralized: it's a unitary republic (with the exception of the island chains of Madeira and Azores, which are "Autonomous Regions", with certain degree of political autonomy), with the municipalities largely dependent of block

[19]This sort of "benchmarking" has several provisos, for instance, Spain –like, for instance, Poland- has features of a large, closed economy. More fundamentally, all earlier EU members were already market economies, with substantial degree of international integration.

grant transfers from the Central Government (as are the "Autonomous Regions") and rather centralized budgetary procedures.

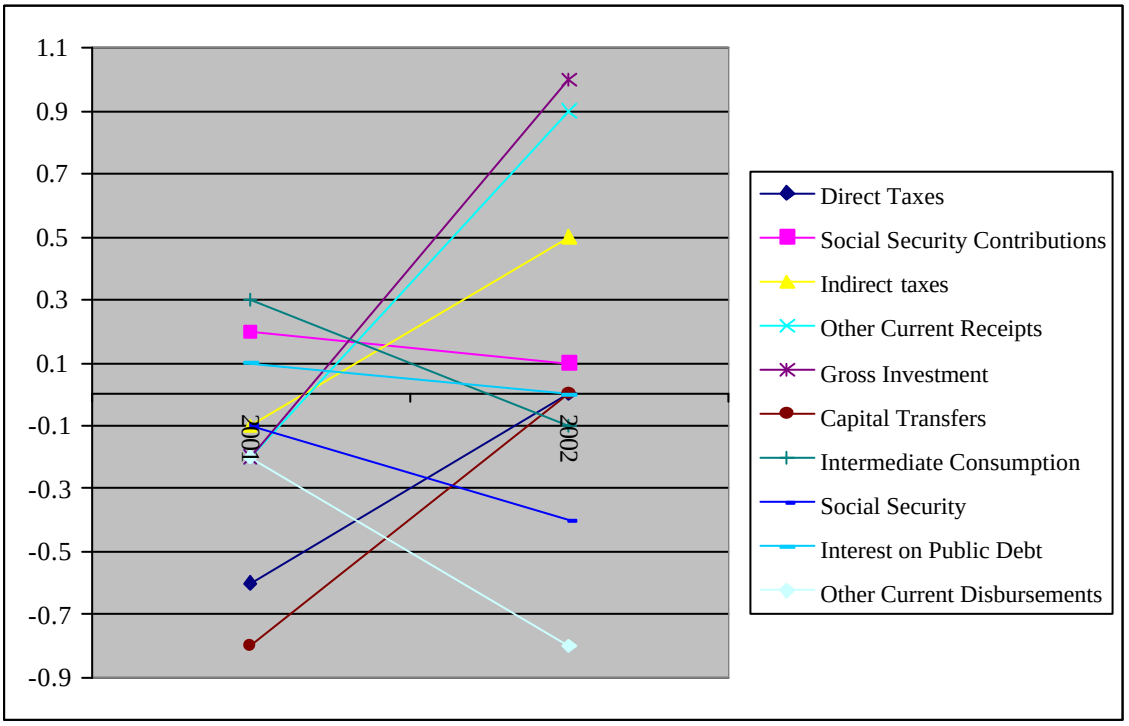
Portugal's share of government expenditure to GDP in 2001 was 42%, slightly below the EU average, but above the one observed in economies with similar income levels. The distinguishing characteristic of its budgetary performance in the late 1990s was the expansion in primary current expenditures, to the note of 3% of GDP (see Figure 9) . This was essentially driven by (see Bronchi, 2003 and OECD, 2002):

-An expansion of the government's wage bill, which by 2001 had reached close to half of all primary current spending, due both to the expansion of public employment (it grew at almost twice the overall rate of employment growth between 1995 and 2001) and of public sector salaries (which, during the same interval, increased by 20% in real terms, as opposed to 14% in the private sector[20]);

-An expansion of social services and welfare related expenditures (for instance, the 1999 introduction of a "minimum guaranteed income").

This increase in primary discretionary spending essentially "eat away" the gains from higher revenue –arising from a 5-year long economic expansion that ended in 2001- and smaller interest expenditures, accruing from the convergence of interest rates to the Euroarea benchmark (see Figure 10).

Figure 10: Composition of Deficit



Source: OECD, several years.

[20]Portugal and Centeno (2001), estimate a wage premium for *public sector employees* in Portugal –not corrected for human capital differences- of amazing 64% for women and 37.6% for men, the highest in the EU.

This substantial reversal in the previous gains in terms of fiscal consolidation was also strongly pro-cyclical, as the country was experiencing an economic boom from 1995 to 2000, with average growth rates of almost 4% and effective full employment (partially due to expansion of public sector employment). Of course, contrary to Poland, no counteracting monetary policy was possible, as Portugal was an Exchange Rate Mechanism (ERM) member aiming for early Euroarea entry, which happened in 1999: more than that, given the relatively high inflation in Portugal, monetary policy was effectively accommodating. (Note: Until 2002 Portugal's monetary policy still had the chance to counteract via interest rate changes, didn't it? EMR did merely not allow exchange rate policy.)

Notably after 1997, efforts towards fiscal consolidation essentially stopped in Portugal. After that year, general government deficit was unchanged for two years, had a slight improvement in 2000, but was faced with a substantial worsening in 2001, due to reduced revenues and increased expenditures –including the ones by local authorities, with a budgetary political business cycle component- and methodological changes on its estimation:

-Reduced tax revenue: substantial growth reduction (to 1.6% in 2001 and 0.5% in 2002) affected the projected budgetary revenues, plus an increase in tax non-compliance;
-Increased expenditures: due to the action of the "automatic stabilizers" given the slowdown, to increases in discretionary expenditures, and to the 2001 and 2002 elections;
-Methodological Changes: Implementation of the ESA 95, plus the incorporation into the budget of the capital transfers to state enterprises.

Each of these components was responsible for roughly one third of a worsening of the deficit of 3% of GDP, to the initial 2001 Budget forecast of 1% (see OECD, 2002).

Successive revisions of the 2001 budget deficit for 2001 culminated in a recommendation by the European Commission of January 2002 "with a view to giving early warning to Portugal in order to prevent the occurrence of an excessive deficit". A later ECOFIN meeting decided against making the recommendation, because of the outgoing Portuguese government[21]. A second Commission recommendation was issued in October 2002, with the same Council reaction. Nevertheless, the Council requested the newly elected Portuguese government to present a corrective programme, which was done in the "2003-6 Programme for Stability and Growth" presented in December 2003, which roughly envisaged a 0.5% of GDP yearly deficit reduction.

The new government, after a special commission lead by the President of the Portuguese Central Bank investigated the status of the Portuguese public finances, reached the conclusion that the deficit of the previous year had reached 4.1% of GDP,

[21]The then ruling alliance lost the local elections of December 2001. This lead to the resignation of the then Prime Minister (not legally required, but given the clear loss of confidence expressed by the Portuguese population, politically necessary). The (same) caretaker prime minister called for early legislative election in March 2002, on which the left of the centre alliance was defeated by a coalition of right of the centre parties.

almost two percentage points above the later 2001 budget forecasts. The new government introduced a series of measures of reduction of expenses and revenue increases, coupled with more long-term budgetary reforms (with effects akready in 2002, as Figure 10 shows).

These contractionary –and pro-cyclical- policies by the new Government in 2002 were necessary to correct for the budgetary imbalances (or, in other terms, the previous pro-cyclical fiscal policies). The May 2002 Supplementary Budget imposed the following set of measures (a process actually initiated by the previous government, with the 2001 "Framework Law"):

-Raising of VAT by 2%;
-Postponement of promised tax reductions;
-Public sector hiring freezes and creation of "redundant" public employees in "common pools" for regional and agency relocation;
-Consolidation and elimination of public agencies;
-Annual capping of 2% expenditure growth of autonomous funds and services
-Restrictions on debt accumulation by local authorities.

As a result of the swift approval of the proposed reforms, the March 2003 communication of "Excessive Deficit Procedure" sent to the Commission indicated that the objectives projected for 2002 had actually been surpassed (2.6% deficit instead of 2.8%, 58% of debt stock, instead of 59.3%: they implied a truly substantial adjustment of the Portuguese public sector of over 1.5% of GDP in single year), even against a background of continuous weak external demand (essential for a small open economy like the Portuguese), both in the Euroarea and in extra-EU markets, and continuous global uncertainty.

III.2. Comparison of the Two Experiences.

The Polish and Portuguese experience share some similar features: an expansion of discretionary public spending in similar items (public sector wages, social security programmes), cyclical downturn, inconsistent policy mixes and a component of budgetary Political Business Cycle (PBC)[22].

There are, of course, differences: budgetary and fiscal procedures in Poland seem to need a much moretough structural reform than their Portuguese counterparts. On the Portuguese side, EU and Euroarea membership allowed the pursuing of unsustainable policies in a way that would have been possible before. Without EU and Euroarea membership, the outcome would have been an external sustainability crisis, like the ones that led, for instance, to the two IMF adjustment programmes of 1978/1979 and specially 1983/1985, when the economy was in recession for two full years (see Vinhas de Souza, 1996). Or, in other terms, inside the EU/EMU, adjustment was still necessary, but it was not as costly as it might have been otherwise.

[22]Hallerberg, Vinhas de Souza and Clark, 2002, ibid., find that Eastern European nations show a rather similar tendency to *opportunistic* budgetary PBCs as their Western counterparts (monetary ones were prevented in the EU due the ERM and later the ECB frameworks).

The Portuguese experience also seems to shows the potential benefits of a rules-based budgetary policy, and of the multilateral surveillance framework provided by the EU's SGP. The existence of the multilateral mechanism and its constraints both warned the incoming government and prompted it to take the necessary corrective measures. Also, its reliance on multi-annual assessment programmes for fiscal policies induces a mid-term perspective on the policy formulation process.

IV. Conclusions.

The main conclusion of this work is that no undue fiscal problems seem to arise from the *Accession* of the future members states to the EU, neither from their current fiscal trends nor with relation to the costs of Accession. Some concerns, however, do exist for individual countries, especially in Central Europe, including the major Acceding Country, Poland.

Poland seems to be in need of a tough structural reform of its budgetary and fiscal procedures. As Accession approaches, the continuing lack of a firm political leadership and of a clear mandate to reforms will grow ever more urgent.

Important budgetary questions must be faced by all Acceding Countries, but they are mostly related to the necessary modernization and reform process of those economies, and to long-term problems, like the financing of the social security, and not to Accession *per se*. These actually only echoes the experiences of all the previous Enlargement waves, were no substantial fiscal questions arose linked to EU membership *per se*.

Portugal can be seen as an example of the potential benefits, and also of the limitations, of EU/EMU membership: being in a EU member state is positive for growth, but it is no replacement for consistent and sustainable domestic policies. Also, its recent budgetary problems, far from a case of the potential negative effects from the current EU multilateral budgetary surveillance, the SGP, show its potential usefulness, as an external mechanism of mutual surveillance, with its clear reference benchmarks and its long-run framework for the assessment of fiscal policies.

Nevertheless, the responsibility for the swift and so far successful reaction to correct the 2001- early 2002 fiscal imbalances must be awarded to the Portuguese electorate, which, given the opportunity, quickly replaced its government by one whose internal preferences were more conducive to sustainable fiscal behaviour, and with a clear mandate for structural, even painful, reforms.

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Annex: Funds for the New Members States, 2004-06 (Mil. of Euros, 2004 prices)

Expenditure Requirements of Enlargement (2004 prices)	2004	2005	2006
1: Agriculture	2.094	4.137	4.579
-CAP	361	2.243	2.564
-Rural development	1.733	1.893	2.015
2: Structural Actions (After Capping)	6.710	7.633	9.692
-Structural Fund	3.812	5.250	6.567
-Cohesion Fund	2.898	2.383	3.125
3: Internal Policies And Supp. Transitory Expenditure	1.613	1.581	1.519
-Existing internal policies	937	975	1.014
-Nuclear safety	138	138	138
-Institution building	221	133	66
-Schengen	317	334	300
5: Administration	557	618	678
Total	***10.975***	***13.969***	***16.467***