ECCU5
Bulgaria – Croatia – Romania

A COMPILATION OF STAFF KNOWLEDGE OF SELECTED EUROPEAN UNION INTEGRATION ISSUES

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ECCU5

STAFF WORKING PAPER

A STUDY OF SELECTED EUROPEAN UNION INTEGRATION ISSUES

MACROECONOMIC POLICY DESIGN FOR GROWTH, COMPETITIVENESS, EMPLOYMENT

Bulgaria, Croatia and Romania
Economic Report

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This report is primarily intended as a compilation of staff knowledge for better learning within the Bank and to support policy dialogue between the Bank and senior government officials. It does not reflect the views of the World Bank as an institution and is not, at this stage, being circulated beyond the aforementioned groups.

The report was prepared by a team consisting of Zoran Anusic, Czaba Feher, Richard Florescu, Irina Kichigina, and Catalin Pauna with input from Sanja Madzarevic-Sujster and Stella Ilieva. Input was also sought from the World Bank Country Economists on the experience of the eight recently acceding EU counties. Overall direction of the report was provided by Ron Hood and Marcin Sasin.

FOREWORD

This report is primarily intended as a compilation of staff knowledge for better learning within the Bank and to support policy dialogue between the Bank and senior government officials. The focus on Bulgaria, Croatia and Romania reflects the fact that these countries fall within one administrative unit within the Bank. While each of these three is unique from a historical and development perspective, they all share many of the same challenges as well as a common desire to join the European Union. Accordingly, comparisons have been drawn between the experiences of the most recent European Union entrants and Bulgaria, Croatia and Romania. The report is not, however, intended to assess the accession prospects for these three, nor does it imply anything about the prospects of other countries which were not covered, but which may also wish to join the EU at some point in the future.

The report has four parts:

1) an overview of recent economic and political events;
2) a discussion of reform challenges; and
3) analysis of three selected topics: judicial reform, pension reform, and
4) the lessons for these countries from the experience of eight countries that recently joined the EU. The material for the latter special topic was drawn from a recent World Bank Report that has been released publicly[1].

Bulgaria, Croatia and Romania must overcome a larger development gap vis-a-vis existing EU members than was faced by new entrants in previous EU enlargements. It is this substantial growth and development challenge that is the focus of the report. The analysis sustains the following broad recommendations:

1. Tackle vigorously the problems of governance and corruption which are key obstacles to development.

2. Focus on upgrading administrative and implementation capacities especially for effectively absorbing future EU grants.

3. Maintain a prudent fiscal framework while better aligning expenditure policies for efficiency, growth and development in key areas
    - Pensions
    - Health
    - Education
    - Infrastructure

[1] The World Bank's EU8 Quarterly Economic Report.

4. Decisively conclude the agenda of structural reform measures that has been pursued now for several years
    - Privatization
    - Bankruptcy processes
    - Reduction of arrears/subsidies/debt forgiveness
    - Labor market reform

5. Pursue the reform agenda aggressively before accession, but recognize that EU accession does not in itself guarantee rapid growth and income convergence.

We hope that this will be useful in the ongoing policy dialogue.

Anand K. Seth,

The World Bank Country Director for Croatia, Bulgaria and Romania

A. Macroeconomic Overview

Bulgaria – Romania – Croatia

- **Year 2004 was a year of sound economic performance and progress in all countries.**
- **Growth accelerated thanks to strong investment and rising consumption in Bulgaria and Romania, where external imbalances should be watched closely and fiscal policy must stand ready to react.**
- **By contrast, Croatia lags Bulgaria and Romania in economic growth and fiscal consolidation, and opening of its EU accession negotiations has been delayed.**

Political Environment

2004 was a year of progress for Bulgaria, Croatia, and Romania (hereafter BCR). Bulgaria and Romania signed the EU accession treaty in April 2005, and are expected to join the EU in January 2007. Croatia successfully completed negotiations on the Stabilization and Association Agreement, and was given the EU candidate country status in June 2004. However, the start of EU accession negotiations with Croatia has since been postponed, owing to unresolved issues with the Hague International Tribunal.

2004-2005 saw elections in all three countries. Bulgaria and Romania had parliamentary elections, presidential elections were held in Croatia and Romania, and local elections in Croatia. These elections resulted in some changes in domestic political scenes, but there were no major changes to the main political course towards the EU accession.

Economic Growth and the Labor Market

Economic growth in 2004 was robust in all three countries: 5.6 percent in Bulgaria; 3.8 percent in Croatia; and 8.3 percent in Romania, or a weighted average of 6.6 percent in the region as a whole. Growth accelerated in Bulgaria and Romania compared to previous years. The improvement in the performance of the Romanian economy was predominantly driven by domestic demand, led by growing consumption. In Bulgaria consumption and investment continued to record high growth rates, but it was the improving net export position that accounted most for the acceleration of the GDP growth in 2004. On the contrary, Croatian economic growth slowed down in 2004 and early 2005, mainly as a result of a deceleration of investment. Net exports contributed more to the growth than before in Croatia.

The BCR growth experience mirrored developments in the eight new EU member states (hereafter EU8)[2]. These states that joined the EU in 2004 recorded an exceptional growth that year and have continued growing in 2005. The main drivers of growth in these states were also investment and private consumption, although with a somewhat greater role played by net exports.

On the supply side, agriculture was a strong performer in Romania (thanks to the harvest recovery), making a record contribution to the aggregate growth. Industry expanded at moderate rates in Croatia and

[2] The EU8 are eight Central European and Baltic countries that became a new member states in 2004, i.e. Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia. The EU15 are old member states.

Romania, but surged by over 5 percent in Bulgaria as a result of increased foreign direct investment and increasing international prices for the main exports goods. Construction and services also enjoyed a sound expansion in the region, except in Croatia where construction decelerated significantly due to a halt in investment.

Economic expansion translated into better labor market outcomes and increased incomes in BCR. Across the region unemployment rates gradually declined, and currently stand at about 12 percent, 14 percent, and 7 percent for Bulgaria, Croatia, and Romania respectively. These developments compare favorably with EU8, where growth has spurred little job creation so far.

Fiscal Position

BCR have made good progress in fiscal adjustment in the past few years. All countries have improved their consolidated budget balances, and Bulgaria recorded a surplus in 2004. However, Romania's and Croatia's medium-term budgetary outlook is less certain, because of some fiscal relaxation in Romania and persistent structural problems in Croatia.

Increased scrutiny of budget balances is crucial not only in BCR but also in the EU8. Gradual reduction of deficits (from alarmingly high levels in Poland, Hungary and Slovakia) has been recently encouraged by the EU as part of the countries' convergence programs. Increasing tax revenues and tax system overhauls have facilitated the consolidation.

Monetary Developments

Inflation developments have been relatively favorable across the region, with some upswing related to increased oil prices (all countries), administered prices, and strong domestic demand sustained in part by credit expansion (Romania, Bulgaria). These factors are projected to gradually wane in 2005 and inflation should return to previous low levels (Bulgaria, Croatia) or continue to fall (Romania). In Romania, the disinflation process could be somewhat complicated by the recent liberalization of the capital account and related continued monetary easing. However, the appreciation of the currency should help.

An unprecedented credit expansion in Bulgaria and Romania has fuelled steady growth of real wages and rising domestic consumption. Both countries have implemented measures aimed at restraining the growth with partial success. However, since the level of financial intermediation is low in these countries, credit expansion has not jeopardized the soundness of the banking systems. Moreover, heightened banking supervision and strong economic growth helped to maintain the quality of bank portfolios, but caution is required if the credit expansion does not decelerate in the medium term. To restrain credit growth, Croatia had to resort temporarily to direct quantitative ceilings, although this led to disintermediation and to direct borrowing from abroad, showing the limited impact of the monetary tightening measures and further need to consolidate the fiscal balance.

External Position

Over the past year increased external demand (growth accelerated among all major trade partners) together with positive effects of past investment in industry have resulted in improved trade to GDP ratios in BCR. At the same time, however, rapid expansion of investment (Bulgaria, Romania) and consumption (Romania) triggered substantial import needs, which has led to a deterioration of trade deficits in Bulgaria and Romania. Good performance of services and remittances has helped improve the current account in Bulgaria somewhat, but proved insufficient in Romania where the current account deteriorated.

While current account deficits in BCR are high by international standards, record-high FDI inflows, which covered 70-100 percent of the deficits across the region in 2004, have alleviated the problem. FDI inflows are projected to remain high prior to the EU accession, and should continue to mitigate the external imbalances in Bulgaria and Romania.

Interestingly, developments in BCR parallel those of EU8 in the 1990s. In the second half of 1990s most EU8 countries experienced a disturbing expansion of current account deficits. This was related to fast modernization of the economies' capital stock, as well as the high import content of exports. As in BCR, deficits were largely covered by high FDI inflows. While most EU8 countries have seen their external deficits narrow in recent years as growth has slowed, and EU transfers, productivity, and exports increased, high external deficits are still a concern in Hungary and the Baltics.

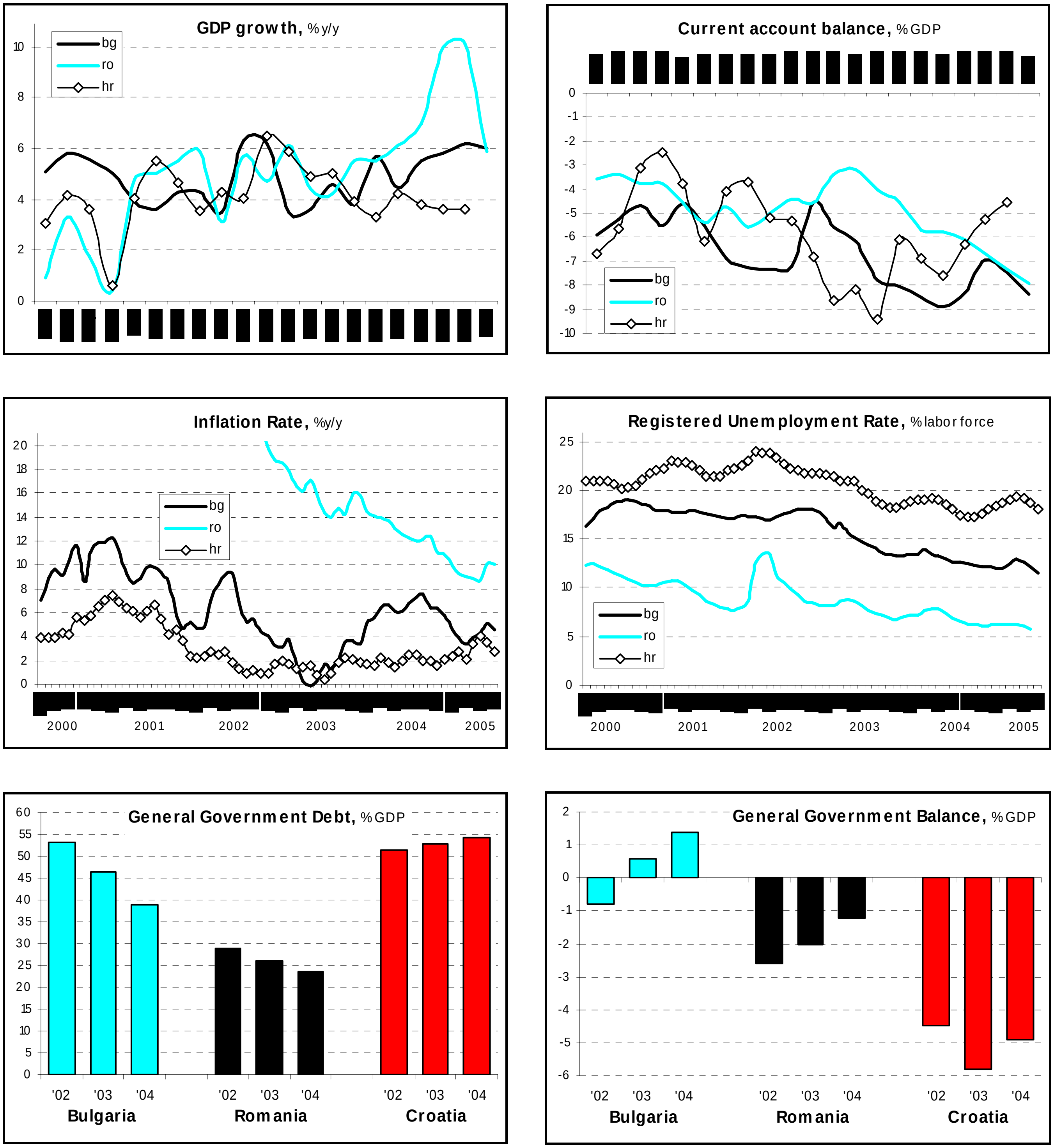
Outlook 2005-2006

The outlook for 2005-2006 is positive, particularly for Bulgaria and Romania, though much depends on the progress in the EU accession process. Bulgaria and Romania need to improve observance of the commitments made during EU accession negotiations to strengthen judicial systems, control corruption, withdraw state aid, and reform public administration. Croatia would benefit from closer cooperation with the Hague International Tribunal, and anchoring of its policies to the EU accession to promote economic and social performance.

In the short term GDP growth is likely to slow, especially if private consumption cools down. Investment is likely to continue to grow solidly. The economic growth predicted for 2005-2006 should help generate jobs in the private sector. However, in the medium term, labor market developments will depend on the speed and comprehensiveness of restructuring of the public sector. It is important that BCR avoid the trap of the 'jobless growth', characteristic of the EU8, by taking steps to ensure that labor supply and demand conditions are conducive to job creation, particularly at the lower end of the wage scale.

Bulgaria and Romania deserve credit for the prudent fiscal policies they have established and these will need to be continued in the light of high current account deficits and credit growth (both countries), as well as the appreciation pressures and the need for further disinflation (Romania). In Croatia, fiscal problems are deeply rooted and require structural changes, particularly significant fiscal consolidation and public sector downsizing to control external debt levels. The EU accession process is expected to discipline public finances and support investment in the medium term, thus facilitating reforms, which are necessary to sustainably anchor the current economic growth.

Chart: Bulgaria, Croatia, Romania: Recent Economic Developments



Sources: Eurostat 2005, national statistical offices, World Bank STRMG and ECA-HFID databases

Bulgaria

- **2004 was favorable for Bulgaria. The economy continued rapid expansion, with high investment and accelerating exports supporting strong GDP growth.**
- **In the medium run growth prospects are good, as they are underpinned by fiscal discipline and the forthcoming EU accession.**
- **Bulgaria has concluded the negotiations for entry to the EU and hopes to join in 2007. However, a safety clause in the Accession Treaty allows for the postponement of entry by one year if EU commitments are not implemented on time.**

Political Environment

In April 2005, Bulgaria signed the accession treaty (ratified by the Bulgarian Parliament in May) envisaging country's accession to the EU on January 1, 2007. The EU has reconfirmed its accession commitment made to Bulgaria, provided that the country fulfills the membership criteria in several areas, most importantly in judicial reform and corruption control. The commitment has a provision for a one year postponement which hinges on reform progress.

General elections were held on June 25, giving victory to the socialists with the ruling national movement of Simeon II (NMS2) in second place. A new nationalist party made a surprise showing, coming in fourth behind the Turkish minority party (MRF) which also did well. With seven parties entering parliament and none coming close to a majority (the socialists did worse than expected with less than one-third of the vote), negotiations for a coalition government have been difficult. Prospects for a stable government look uncertain and early elections are a possibility. While all parties fully support Bulgaria's EU accession in 2007, the current political uncertainty may affect the pace of reform which in turn may have implications for timely completion of remaining EU commitments.

Substantial progress was achieved in the privatization of the energy sector with seven electricity distribution companies sold to strategic foreign investors, and seven district heating companies sold on the domestic market. While some of the small tobacco processing companies were privatized in 2005, the privatization of the tobacco monopoly to strategic investors failed for the second time.

Economic Growth and the Labor Market

Thanks to high domestic demand and increasing exports, economic growth rose in 2004 reaching 5.6 percent y/y. Industrial output grew by an impressive 21.5 percent y/y as of December 2004, while the tourism industry enjoyed an exceptionally good year. Evidence in 2005 suggests that positive trends will continue, albeit at somewhat slower pace. The National Statistical Institute reported 6 percent y/y GDP growth in the first quarter of 2005, but economic growth is expected to decelerate in the subsequent quarters of 2005 due to the accumulation of inventories in 2004.

Economic growth has translated into more jobs. Employment grew by 3 percent in 2004 according to the labor force survey (LFS), and unemployment fell to 12 percent, which constitutes an improvement from to 17.8 percent in 2002 and 13.7 percent in 2003. In the first quarter 2005 unemployment declined further to 11.3 percent, and real wage growth accelerated from 3.9 percent in 2004 to 5.5 percent y/y in the first quarter of 2005. The government has agreed on a 25 percent increase in the minimum wage.

Fiscal Position

In 2004 the general government budget recorded a surplus of about 1.7 percent of GDP, as a result of fiscal discipline and booming tax revenues related to high economic growth, and restrained public expenditure aimed at alleviating external imbalances. This created the space to cut the corporate income tax rate from 19.5 percent to 15 percent. The outlook for 2005 is also positive, with government recently announcing a target of 1 percent of GDP surplus (against a deficit of 0.5 percent planned previously). First quarter budget performance is satisfactory and suggests that the new surplus target is achievable.

Better budget outcomes, rising privatization revenues and higher nominal GDP, caused public debt to fall from 43.6 percent of GDP in 2003 to 38.5 percent of GDP in 2004. After a Brady bond buy-back in the first quarter, public debt fell even further in the first quarter and is expected to shrink to about 32 percent of GDP in 2005.

Monetary Developments

The money supply has continued to grow at a high rate (29 percent y/y in Jan-Apr) largely due to surging credit to households (78 percent increase y/y) and firms (55 percent increase y/y). The credit surge is partly attributable to the low base, but also reflects rising income, consumption needs of households and positive expectations about the future. To contain credit growth the central bank introduced lending restraints on commercial banks. It will take some time for them to have effect, however, since banks use creative accounting to circumvent the limit.

After falling to almost 3 percent y/y in the beginning of 2005, CPI inflation has been on the rise, reaching 5.3 percent y/y in April, mostly due to increased fuel prices, transport and health services. Producer prices are also growing fast, owing to expensive raw materials (7.7 percent y/y in April, up almost 3 percentage points from January). However, with credit growth restrictions and the envisaged fiscal restraint, inflation is expected to return close to the 3.5 percent target.

External Position

The current account remains in deficit. It narrowed slightly in 2004 to 8.6 percent of GDP, compared to 9.3 percent in 2003. However, the trade gap continued to widen: 14 percent of GDP in 2004 compared to 12.5 percent deficit in 2003. In view of the relatively moderate consumption growth, Bulgaria’s high economic potential and high FDI inflows (8.4 percent of GDP in 2004), this is managable, as long as FDI covers most of the deficit and as long as fiscal discipline prevents external imbalances from further widening.

Bulgaria

	2002	2003	2004	2004 Q3	2004 Q4	2005 Q1	2005 Jan	2005 Feb	2005 Mar	2005 Apr
Fiscal and monetary policy indicators										
Fiscal balance to GDP (%)	-0.6	0.0	1.7							
Public debt to GDP (%)	56.0	47.8	40.9							
M3 (eop, yoy % change)	12.7	21.7	23.5	18.2	23.5	35.0	22.6	23.4	35.0	26.5
Domestic credit (eop, yoy % change)	21.4	30.4	29.8	33.2	29.8	58.3	30.9	34.0	58.3	41.3
Money market interest rate, eop	1.23	1.11	1.99	1.99	1.99	1.97	1.93	1.92	1.97	2.09
Exchange rate (BGN/USD, eop)	1.8850	1.5486	1.4359	1.5761	1.4359	1.5087	1.5004	1.4753	1.5087	1.5095
Real effective exchange rate (Jun'97=100)	129.8	147.5	156.3	146.6	156.3	156.8	155.6	155.9	156.8	156.3
Financial market indicators										
Stock market index	183.1	454.3	625.3	586.5	625.3	840.0	714.9	907.6	840.0	783.2
Demand Deposits, (eop, BGN millions)	3361.3	4155.8	5670.0	4896.9	5670.0	6843.4	5603.0	5787.3	6843.4	5899.9
Foreign currency deposits to total deposits (eop, %)	49.3	48.2	43.7	47.6	43.7	45.7	44.7	45.1	45.7	44.6
Output, demand and inflation										
GDP (yoy, %)	4.9	4.5	5.6	5.8	6.2	6.0				
Industrial production index (eop, yoy, %)	4.0	23.5	21.5	17.4	21.5	14.2	11.2	7.9	14.2	13.9
Consumer prices (eop, yoy, %)	3.8	5.6	4.0	6.3	4.0	4.3	3.3	3.9	4.3	5.1
Balance of payments										
Trade balance ($ US millions)	-1594.4	-2518.7	-3352.9	-561.8	-1204.5	-854.4	-260.5	-273.3	-320.5	-361.4
Exports, fob ($ US millions)	5692.1	7540.5	9858.6	2675.1	2749.1	2724.7	838.4	841.1	1045.2	966.0
Exports, fob (yoy %)	11.3	32.5	30.7	35.8	39.1	26.8	32.7	14.2	33.9	34.8
Imports, fob ($ US millions)	-7286.6	-10059.2	-13211.5	-3236.8	-3953.6	-3579.0	-1098.8	-1114.5	-1365.7	-1327.5
Imports, fob (yoy %)	8.9	38.1	31.3	30.5	34.6	28.6	33.0	21.1	31.8	27.9
Current account balance ($ US millions)	-826.7	-1855.9	-1805.7	491.4	-1117.2	-923.8	-373.7	-241.2	-308.9	-360.1
Current account balance to GDP (%)	-5.6	-9.3	-7.5							
Reserves and debt indicators										
Reserves excluding gold ($ US millions)	4406.8	6291.0	8776.0							
Reserves cover of merchandise imports (months)	5.6	5.7	6.1							
Reserves to M3 (%)	64.6	62.7	64.9							
Short term debt to total debt	16.5	21.3	27.0							
External debt to exports (%)	126.1	112.5	107.8							
External debt service to exports (%)	16.4	14.1	22.2							
IBRD debt outstanding and disbursed ($ US millior	958	1266								
Other										
Fitch Sovereign Long Term Foreign Debt Rating	BB	BB+	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-
Moody's Sovereign Long Term Foreign Debt Ratin	B1	Ba2	Ba1	Ba1	Ba1	Ba1	Ba1	Ba1	Ba1	Ba1
S&P Sovereign Long Term Foreign Debt Rating	BB	BB+	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-
JCRA Sovereign Long Term Foreign Debt Rating	BB+	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-

Sources: IMF, World Bank, National Sources.

Croatia

- **Economic performance in 2004 was less than expected. As investments decelerated sharply, growth slowed to 3.8 percent despite increased net exports. Relatively weak economic performance is projected to continue in 2005, already confirmed by growth data in Q1 (at 1.8 percent).**
- **Persistent fiscal slippages complicate economic management and increase external vulnerability.**
- **Croatia was granted EU candidate country status in June 2004, but the opening of EU accession negotiations was postponed because of an unmet political condition.**

Political Environment

Croatia completed in February 2004 negotiations on the Stabilization and Association Agreement, which envisages promotion of political and economic stability and development through policy dialogue and strengthened cooperation, and creation of a free trade zone by 2007. The country was granted the EU candidate country status in June 2004, but the opening of the EU accession negotiations was postponed due to unresolved issues with the Hague Tribunal.

Recent local elections provided a signal for the ruling coalition that special attention is needed to maintain support for the government.

Economic Growth and the Labor Market

The economy slowed down to 3.8 percent y/y in 2004 (from 4.3 percent y/y in 2003) and 1.8 percent in the first quarter of 2005. Investment has been driving GDP growth for several years, mainly due to a huge public component. The recent slowdown in public investment combined with other factors, including relatively tight monetary policy, have brought total fixed capital formation almost to a halt, which has significantly affected GDP growth. Private consumption grew at a moderate 4 percent y/y. Among the sectors, services grew most dynamically, at 5 percent y/y.

Available evidence points to continuation of these somewhat disappointing economic dynamics into 2005. Industrial output grew 3.2 percent y/y in January-May, retail trade by 2.3 percent in the same period, while construction activity fell by 6.6 percent y/y in January-April.

There appears to be some gradual improvement in the labor market, with employment growing by 2.9 percent (according to LFS), but the unemployment rate (ILO methodology) declined only slightly to 13.8 percent. Real wage growth hovers around 3-4 percent.

Fiscal Position

Fiscal consolidation in 2004 was less than expected. The 2004 fiscal deficit declined to 4.9 percent from 6.3 percent in 2003, but overshot the target of 4.5 percent. Persistent fiscal problems with an unreformed health system, high and growing social spending, and continued state support to loss-making state owned enterprises contributed to this situation. The first quarter of 2005 saw further slippages in the central budget, jeopardizing the 3.7 percent of GDP deficit target. The overspending on pensions, health and wage bill combined with a poor revenue performance triggered by economic slowdown, increased the projected deficit for 2005 to above 4.2% of GDP.

Monetary Developments

Although consumer price inflation picked up to 3.0 percent in June 2005, this is mostly the result of one-off changes (food and tobacco) and no sustained inflationary pressures are expected to emerge, so the headline inflation figures are projected to return to about 2-2.5 percent.

Monetary policy over-compensates for a loose fiscal stance. The central bank maintains a stable and relatively conservative discount rate of 4.5 percent, unchanged since 2002. To curb the continuing external debt growth, the CNB Council at end-May decided to introduce additional restrictive measures to reduce external borrowing and withdraw excess liquidity from the banking system. The marginal reserve requirement rate was raised from 30 pct to 40 pct in order to make external borrowing less lucrative to banks. Additionally, the foreign exchange reserve requirement calculation base (allocated in domestic currency) was increased from 42 pct to 50 pct, in order to subdue inflation pressures caused by excessive kuna liquidity.

External Position

The current account deficit narrowed to 4.6 percent of GDP in 2004, from 6.9 percent in 2003. Exports accelerated strongly by 18 percent y/y, while import growth slowed to 6.4 percent y/y, reflecting weaker demand for capital goods. Tourism recorded a slightly lower surplus (18.1 percent of GDP in 2004 compared to 19.9 percent in 2003).

External trade in goods deteriorated in early 2005. Exports of textiles and transport equipment fell, while imports rose by 7.7 percent mostly owing to an increased energy component. However, moderating economic growth is projected to depress imports more than exports and improve the current account somewhat in 2005-2006.

Because of slower privatization, net foreign investment dropped significantly from an exceptional 6.6 percent in 2003 to 2.2 percent of GDP in 2004 and covered only half of the current account deficit (compared to 97 percent in 2003).

Croatia

	2002	2003	2004	2004		2005	2005			
				Q3	Q4	Q1	Jan	Feb	Mar	Apr
Fiscal and Monetary Policy Indicators										
Fiscal Balance to GDP (%)***	-4.5	-5.8	-4.5	-0.7	-0.4	-2.8	-0.8	-0.8	-1.2	…
Public Debt to GDP (%)	51.5	52.8	54.2	54.3	54.2	52.4	51.3	51.5	52.4	…
M4 (eop, yoy % change)	9.5	11.0	8.6	7.6	8.6	-1.4	-0.7	-0.8	-1.4	-1.5
Domestic credit (eop, yoy % change)	30.0	14.6	14.0	8.0	14.0	0.6	-0.2	0.6	0.6	1.9
Money market interest rate, eop	1.9	7.0	6.0	7.5	6.0	5.6	4.2	4.9	5.6	5.1
Interest rate on kuna credits not indexed to f/c, eop	11.2	11.8	11.7	12.1	11.7	12.1	12.0	12.0	12.1	11.8
Exchange rate (HRK/EUR) eop	7.44	7.65	7.67	7.55	7.67	7.44	7.55	7.51	7.44	7.36
Real effective exchange rate index (CPI deflated, 1995=100)	96.2	94.6	90.9	92.8	90.9	89.1	91.0	90.2	89.1	…
Financial Market Indicators										
Stock market index	1,172.6	1,185.1	1,565.8	1338.2	1,565.8	1,843.1	1,923.5	2,085.5	1,843.1	1,788.5
International bond traded spread (bps), eop	134.6	115.8	45.4	68.9	45.4	58.5	41.4	42.9	58.5	65.5
Demand Deposits (HRK million), eop	21,166	23,315	23,591.3	23,534	23,591	23,485	24,061	23,456	23,485	23,390
Foreign curr deposits to total deposits (eop, %)	67.8	64.6	64.0	63.3	64.0	63.5	63.3	63.5	63.5	62.8
Output, Demand and Inflation										
GDP (yoy % change)	5.2	4.3	3.8	3.6	3.6	…	…	…	…	…
Industrial production index (yoy % change)	5.4	4.1	3.7	3.0	4.0	0.3	6.3	-1.6	-2.9	6.3
Consumer Prices (yoy % change)	1.7	1.8	2.1	1.9	2.3	3.0	2.0	3.3	3.9	3.5
Balance of Payments										
Trade balance ($US millions)	-5,648.3	-7,908.0	-8,346.3	-1,987.9	-2,211.6	-2,102.2	-547.2	-575.5	-979.5	-861.1
Exports FOB ($US millions)**	5,003.9	6,308.0	8,208.2	2,114.7	2,286.4	1,958.0	576.8	681.9	699.3	823.1
Exports FOB (yoy % change)	5.1	26.1	30.1	40.9	28.9	5.6	11.3	12.3	1.2	25.5
Imports FOB ($US millions)**	10,652.2	14,216.0	16,554.5	4,102.6	4,498.1	4,060.2	1,123.9	1,257.4	1,678.9	1,684.1
Imports FOB (yoy % change)	20.2	33.5	16.4	13.3	12.8	11.4	11.7	6.4	14.9	27.2
Current account balance ($US millions)	-1,915.7	-2,071.9	-1,666	2,431.8	-1,454	…	…	…	…	…
Current account balance to GDP (%)	-8.4	-7.2	-4.9	7.1	-4.2	…	…	…	…	…
Reserves and Debt Indicators										
Reserves excluding gold ($US millions)	5,886	8,191	8,759	7,949.3	8,759	8,680	8,559	8,665	8,680	8,781
Reserves cover of merchandise imports (months)	6.6	6.9	6.3	5.8	5.8	…	…	…	…	…
Reserves to M4 (%)	36.2	38.9	35.3	35.1	35.3	36.1	35.6	35.6	36.1	…
Reserves to Amt+Short term debt (usd)	2.2	1.8	1.7	3.1	3.6	…	…	…	…	…
Short term debt to total debt (%)	3.3	7.6	5.9	5.0	5.9	13.7	12.2	11.6	13.7	…
External debt to exports (%)	148.1	165.7	173.1	…	…	…	…	…	…	…
External debt service to exports (%)	24.5	21.4	21.3	18.4	19.5	…	…	…	…	…
Amortization (US$ millions)	2,194	2,778	3,324	1,244.1	585	…	…	…	…	…
International Bond Issues ($US millions)	847	984	1,098	0	0	0	0	0	0	0
IBRD debt outstanding ($US millions)	588	777	856	797.2	856.0	835.7	842	855	836	840
Other										
Fitch Sovereign Long Term Foreign Debt Rating	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-
Moody's Sovereign Long Term Foreign Debt Rating	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3
S&P Sovereign Long Term Foreign Debt Rating	BBB-	BBB-	BBB	BBB-	BBB	BBB	BBB	BBB	BBB	BBB

* estimate

** monthly data from trade statistics; quarterly data from BOP

Sources: IMF, World Bank, National Sources.

Romania

- **Romania's economic performance in 2004 was remarkable. Spurred by exports, investment and domestic consumption, economic growth expanded by more than 8 percent y/y, while inflation was brought down to single digits.**
- **The country concluded the acquis negotiations with the EU and hopes to join in 2007. However, a safety clause in the Accession Treaty allows for the postponement of entry by one year if EU commitments are not implemented on time.**
- **Concerns about the overheating of the economy persist. The current account deficit is widening, due to the fast expansion of consumer credit, fuelling inflationary expectations.**
- **Prospects for 2005 are positive. The challenge is to maintain macro stability in an environment of eased monetary policy, a widening current account deficit, high nominal interest rates, and currency appreciation pressures.**

Political Environment

2004 was a good year for Romania. The country closed the acquis negotiations with the EU, paving the way for accession in 2007. At the same time, Romania entered 2005 with a new president, Mr. Basescu, and a new coalition government led by Prime Minister Popescu-Tariceanu.

In April 2005, Romania signed the Accession Treaty, bringing the country's EU accession aspirations in January 2007 one step closer to fulfillment. The EU has reconfirmed its accession commitment made to Romania, provided that the country remains on track vis-à-vis the reform calendar agreed with the Union. The functioning of the judiciary, the quality of the public administration, the effectiveness of public expenditure management and enforcement of the competition legislation, including for state aid, remain Romania's principal reform challenges.

Recent Economic Performance

Economic growth reached 8.3 percent y/y in 2004, up from 5.2 percent in 2003, driven in part by exceptional agricultural production, 22 percent up y/y. Despite the impressive export performance, imports grew even faster and the net export contribution to growth was negative. Investment exhibited a 10 percent y/y expansion. Private consumption also grew by 10 percent y/y, up from 7 percent in 2003. Although growth remains relatively broad-based, there is cause for concern about overheating of the economy, particularly in view of rising external imbalances. Growth brought a moderate decline in registered unemployment to 6.5 percent, while total employment grew slightly, by 0.7 percent. Real wages continued to increase rapidly, at close to 10 percent y/y, fuelling inflationary pressures.

Fiscal Position

Due to strong revenue growth and expenditure restraint (at least prior to the run-up to the November elections) the budget deficit was lower than expected at 1.1 percent of GDP in 2004, down from 2.3

percent in 2003. Revenue collection, at 29.6 percent of GDP, remained comparatively low, and the composition of expenditure remained rigid.

On January 1, 2005 the government reduced corporate and personal income tax rates to a flat rate of 16 percent. While there are concerns that the sharp reduction in taxes will negatively affect revenues and eventually require compensatory fiscal tightening elsewhere, preliminary consolidated budget results for the first five months of 2005 are somewhat comforting, with revenue collection up in real terms. This has led to a budget surplus of 0.4 percent of GDP during January-May 2004. As part of the Stand-by discussions with the IMF, the government aims for a 0.75 percent of GDP deficit in 2005.

Monetary Developments

Disinflation continued in 2004, as the annual CPI fell from 14.1 percent at end-2003 to 9.3 percent at end-2004, thanks largely to a deceleration of food prices. Currently, CPI inflation is about 9.5 percent y/y. The main sources of inflationary pressures remain the increases in administered prices (electricity, gas), rising international commodity prices, fast growth of wages (23 percent y/y nominally in 2005q1) and the related household consumption expansion (12.5 percent up y/y), fuelled also by eased access to credit. The substantial nominal appreciation of the ROL against the Euro has contributed to disinflation. The recent floods, which affected large areas of the country during April-June, are expected to lead to increases in food prices. This has prompted the central bank to review upwards the 2005 end-year inflation target, to 8 percent, from 7 percent expected at the beginning of the year.

In line with falling inflation and in order to prepare for a new step towards capital account liberalization (access of non-residents to ROL term-deposits with domestic banks which took place in April 2005), the central bank continued to lower its key policy interest rates. In 2005 rates have already been cut by 450 basis points, bringing the real interest rates down to a record-low of 2.5 percent in real terms in May 2005. Broad money grew at a rate of 30 percent y/y in real terms. This is down from about 50 percent in the previous year, thanks partly to limiting measures. Surging foreign currency credit (up 39 percent y/y in real terms) is feeding household borrowing. To contain the risk of an eventual swing in the short term capital inflows, a series of temporary safeguard clauses have been introduced.

External Position

The current account deficit widened to 7.6 percent of GDP in 2004 from 6 percent in 2003, driven by the deteriorating trade balance (-9 percent of GDP). Although both exports and imports expanded robustly, import growth (at 23 percent y/y currently) outpaced exports (18 percent y/y). At least one-fifth of the import growth was due to the purchase of investment-related machinery and equipment. The ROL appreciated vis-à-vis the Euro by 9.5 percent y/y in January-May 2005, forcing the central bank to intervene in the foreign exchange market to contain further appreciation, which would have jeopardized exports, still dominated by labor-intensive, low margin commodities. The current account deficit of 2004 was, however, almost fully covered by record-high FDI inflows, mainly in the form of receipts coming from the privatization of state-owned enterprises and workers remittances. Nevertheless, concerns remain regarding the widening of the current account deficit, especially in view of a protracted ROL appreciation. Foreign reserves have continued to increase to a level of 5-6 months of imports as a result of the interventions of the central bank.

Romania

	2002	2003	2004	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1	2005 Jan.	2005 Feb.	2005 Mar.	2005 Apr.	2005 May	2005 Jun.
Fiscal anf Monetary Policy Indicators														
Fiscal balance to GDP(%)	-2.6	-2.3	-1.1	-0.13	-0.59	-0.25	-1.14	0.13	-	-	0.13	0.37	0.36	-
Public Debt to GDP(%)	28.9	26.9	22.8											
M2 (yoy % change)	38.2	23.3	39.9	30.3	30.4	36.9	39.9	41.1	39.6	42.2	41.1	43.9	46.7	46.5
Domestic Credit (yoy % change)	39.8	50.4	21.2	50.7	40.5	46.4	21.2	20.2	17.1	19.7	20.2	23.1	24.4	19.9
Interest rate (period average)	26.8	17.8	17.5	20.5	18.2	17.2	16.0	9.3		8.3	6.8	6.9	7.1	
Exchange rate (LCU/$US)	33,055	33,200	32,637	32,430	33,750	33,543	30,823	28,297	29,076	28,244	27,570	28,041	28,508	29,695
Real effective exchange rate index (1990=100)	112.1	116.1	125.6	120.5	122.2	126.0	133.7	144.8	145.2	145.4	147.6	149.5	149.4	
Financial Market Indicators														
Stock Market Index	1,659.1	2,171.9	4,364.7	2,972.2	3,076.1	3,221.8	4,364.7	5,181.1	5,645.1	6,225.9	5,181.1	4,794.4	4,712.9	4,852.9
International bond traded spread (bps)	288.0	172.0	58.0	165.0	132.0	102.0	58.0	59.0		49.0	59.0	62.0	56.0	
EMBI Global Index Spread (bps)														
Deposit stock (LCU billion)	328,134	402,763	569,971	423,687	437,700	490,707	569,971	601,711	558,828	575,553	601,711	603,462	632,764	646,188
Foreign curr deposits to total deposits (%)	44.7	42.5	41.2	44.4	41.3	40.4	41.2	38.3	41.5	39.3	38.3	37.6	39.0	39.3
Output, Demand, and Inflation														
GDP (yoy% change)	5.1	5.2	8.3	6.1	6.6	8.1	8.3	5.9		…				
Industrial production index (yoy% change)	4.3	3.1	5.3	5.8	4.4	4.5	5.3	4.0	8.6	3.6	4.0	8.4	-4.7	
Consumer Prices (yoy % change)	22.5	15.3	11.9	13.6	12.3	11.9	10	8.8	8.9	8.9	8.7	10	10	9.7
Balance of payments														
Trade balance ($US millions)	-3980.7	-6385.1	-9123.2	-1384.9	-2196.2	-2114.4	-3582.8	-2054.9	-502.0	-671.1	-882.7	-978.5	-1146.7	-1193.2
Export fob ($US millions)	13876.0	17618.0	23515.4	5377.1	5681.6	5691.5	6521.6	6682.8	1987.4	2146.2	2551.1	2326.4	2248.6	2265.6
Export fob (yoy % change)	21.9	27.0	33.5	32.7	35.0	24.3	36.5	24.3	24.3	10.3	19.2	20.8	12.9	13.6
Import CIF ($US millions)	17856.7	24003.1	32638.6	6762.0	7877.7	7805.9	10104.4	8737.7	2489.4	2817.3	3433.8	3304.8	3395.3	3458.7
Import CIF (yoy % change)	14.8	34.4	36.0	38.7	32.3	30.5	40.5	29.2	20.9	19.3	24.1	28.1	19.2	25.1
Current Account Balance ($US millions)	-1525.0	-3461.5	-5539.0	-605.5	-1948.5	-2786.7	-5771.7	-1178.5	-178.6	-439.2	-504.8	-636.8	-1623.3	
Current Account Balance (yoy % to GDP)	-3.3	-6.0	-7.6	-0.8	-2.1	-1.4	-3.1	-1.2						
Reserve and Dedt Indicators														
Reserves excluding gold ($US millions)	6,125.7	8,040.0	14,802.9	8,223.4	9,399.1	11,915.8	14,802.9	16,271.3	14,650.3	15,918.5	16,271.3	16,722.1	16,374.1	16,594.3
Reserves cover of merchandise imports (months	3.9	3.8	5.2	3.5	3.8	4.5	5.0	5.4	5.6	5.7	5.3	5.3	5.1	…
Reserve to M2(%)	54.9	56.9	66.7	57.1	62.1	70.0	68.2	68.1	67.0	67.1	68.1	67.6	66.6	66.8
Reserve to Amt+Short term debt (%)	147.4	183.6	334.3	187.8	214.7	272.2	334.3							
Short term debt to total debt (%)	3.0	6.4	10.5	..	..	..	10.5	16.0	11.3	10.9	16.0	17.0	18.7	
External debt to export (%)	102.0	101.5	95.6	84.5	88.3	94.0	95.6	93.4	83.9	91.6	93.4			
External debt services to export (%)	19.1	20.8	21.9	..	..	..	21.9	..	..	..	..	..	..	..
Amortization ($US millions)	2,596.0	2,791.0	3,013.0	727.32	411.75	777.48	1096.45	717.32	89.7	343.14	284.48	338.75	346.88	..
International Equity Issues ($US millions)	0	0	0	0	0	0	0	0	0	0	0	0	0	0
International Bond Issues ($US millions)	1,062.0	814.0	0	0	0	0	0	0	0	0	0	0	0	0
Foreign bank loan commitments ($US millions)	1,340.0	953.0	1,016.0	200.0	306.0	182.0	328.0	653.0		120.0	400.0			
IBRD debt outstanding ($US millions)	2,173.0	2,296.0	2,522.0											
Others														
ICRG political risk (0high risk - 100low risk)	71.0	71.0	69.5	71.5	73.0	71.5	69.5	71.0		71.5	71.0	71.0	71.0	
Fith Sovereign Long Time Debt rating	BB-	BB	BBB-	BB	BB	BB	BBB-	BBB-		BBB-	BBB-	BBB-	BBB-	
Moody's Sovereign Long Time Debt rating	B1	Ba3	Ba3	Ba3	Ba3	Ba3	Ba3	Ba3		Ba3	Ba3	Ba3	Ba3	
S&P Sovereign Long Time Debt rating	B+	BB	BB+	BB	BB	BB+	BB+	BB+		BB+	BB+	BB+	BB+	

Notes for annual and quarterly numbers:
Unless otherwisw stated, figures are end-of-the-periodexcept for REER Exchange Rate, Interest rate and Consumer price, witch take average of the month numbers.
Trade, Current Account and Capital Flow numbers are cumulative totals.
Month or year value
For Year:12 month average
For Quarter: 3 month average
For Month: Month Value
For Year:12 month average
For Quarter: 3 month average
For Month: Month Value
For Year:12 month sum
For Quarter: 3 month sum
For Month:
For Year: y-o-y change in 12 month average
For Quarter: y-o-y change in 3 month average
For Month: y-o-y change in month value

Sources: IMF, World Bank, National Bank of Romania.

B. Structural Reform Challenges

Bulgaria – Romania – Croatia

Introduction

This section presents a snapshot of structural reform progress in Bulgaria, Croatia and Romania. The reforms, achievements and challenges are presented in a comparative perspective, in relation to EU8 and EU15 countries. The key areas covered include convergence, labor market, business environment and quality of governance, privatization, sustainability and quality of public finances, education, knowledge society and innovation, infrastructure, agriculture, social cohesion and social policy. A summary is then provided in two annexes, one showing challenges and recommendations in the form of country-specific policy matrices and a second one showing a structural reform "scoreboard".

The EU Lisbon process increasingly applies to BCR. The key points of the Lisbon strategy are growth, jobs, competitiveness, innovation, social inclusion and sustainable development. In these areas BCR under-perform relative to the EU15, but they appear to have made progress similar to the less advanced EU8 countries and challenges are very similar. There are, nevertheless, some areas, where BCR (and EU8) fare better than most EU15.

BCR have still an unfinished agenda of transition-related reforms and next generation challenges are just around the corner. There are some national variations, but the overall progress towards the completion of this aspect of transition in BCR is still insufficient. Despite recent impressive acceleration, BCR reforms continue to lag the EU8 countries. In fact, BCR are not yet at the stage EU8 countries were two years before their accession.

There are four main messages:

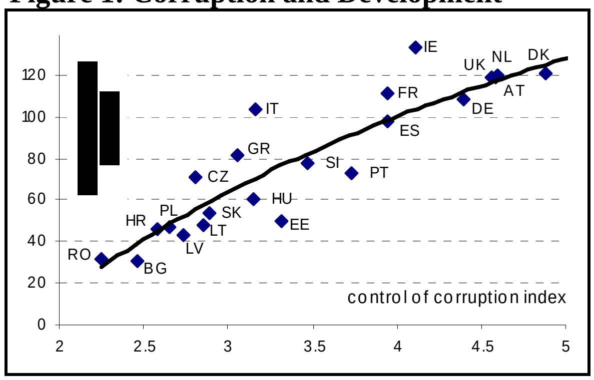
- **Weak governance and corruption are key obstacles to development in BCR and must be tackled vigorously and decisively.** What really differentiates BCR from EU8 and EU15 is the quality of governance, rule of law and the extent of corruption. Not surprisingly, BCR usually do better in areas where governance is less of an issue and worse where it is. This is of concern since there is overwhelming evidence that governance is critical in determining whether countries ascend the development ladder (see Figure 1).

- **BCR need to focus on upgrading administrative and implementation capacities.** In BCR, adoption of *acquis communautaire* and several legislative measures related to other reforms has been fast and relatively smooth. The challenge now is with implementation, that in some cases has lagged. Effectiveness requires more than just good legislation. Additional resources will fail to yield better outcomes unless public administration is upgraded so it can improve the allocation and effectiveness of expenditures.

- **The transition reform agenda needs to be completed before accession.** EU membership brings a set of new challenges. Reform fatigue or a sense of complacency can, however, emerge once the accession goal is achieved. EU8 countries that managed to push reforms in the run-up to the EU, benefit from that now, while those that did not are gradually falling behind in rankings.

- **EU accession does not in itself guarantee growth and convergence.** Greece and Ireland both experienced 15 years of divergence following EU accession. Policy formulation and implementation is ultimately the responsibility of the country. The EU membership provides only an opportunity to leverage reforms, including grant resources.

Figure 1: Corruption and Development

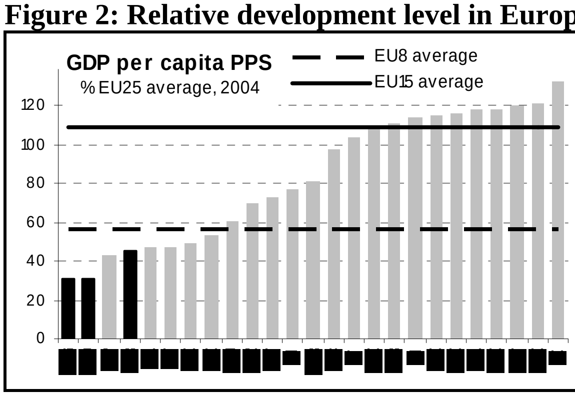


Source: Eurostat 2005, World Bank Governance Indicators 2005.

The Challenge of Convergence and the Lisbon Agenda

The development gap between BCR and the EU appears particularly large in comparison with previous EU enlargements. In view of their ambitions to join the EU, all three countries face a challenge of catching up with the rest of the EU. By 2005, Bulgaria and Romania are forecast to reach about 32 percent and Croatia 46 percent of the EU25 average GDP per capital level (at PPS), compared to the average of 58 percent for EU8 (or 53 percent of EU25 level two years prior to their accession, see Figure 2).

Figure 2: Relative development level in Europe



Source: Eurostat, 2005.

Convergence requires a sustained effort. The last few years saw markedly improved macroeconomic performance after uneven and sluggish economic growth over the 1990s. Although it brought BCR's income closer to the EU average this was not sufficient to visibly reduce the development gap with the

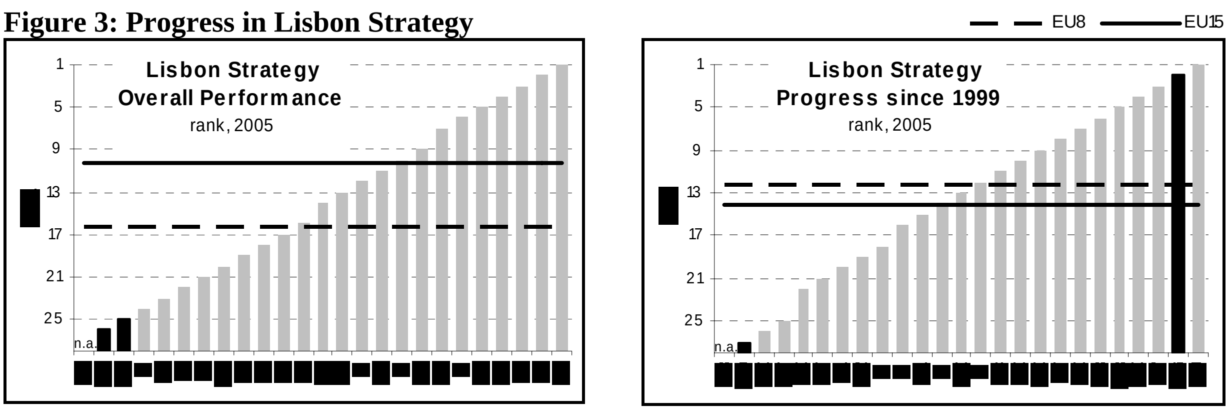
EU8 peers, most of whom now are now moving quickly in the process of convergence. In fact, the gap between BCR and EU8 in terms of average GDP per capita levels widened slightly between 2000 and 2005, though BCR were catching up with some of the EU8 including Poland, Slovenia and the Czech Republic.

Macroeconomic stability is a necessary condition for the convergence process, but structural reforms are crucially important to sustain it over the medium term. Over past years BCR, particularly Bulgaria and Romania, have been successful in containing fiscal imbalances and bringing down inflation. Sustained convergence over longer also depend on the structural characteristics of the economy matter. The last few years saw an impressive acceleration of the reform effort in all three candidate countries.

Progress on the Lisbon agenda in the EU has been slow and very uneven. The Council meeting in Lisbon in the year 2000 set a goal for the EU to become a competitive and dynamic knowledge-based economy, capable of sustainable economic growth with more and better jobs and greater social cohesion. In order to anchor the policies, the EU has set for itself a range of specific targets in key areas of reforms, including labor market, business environment, and environment. These targets are to be achieved by 2010. The best performers on the Lisbon scoreboard are the Nordic countries, EU8 countries are spread in the middle of the range while BCR close the ranking (see Figure 3).

Many of the EU8 countries (Baltics and Hungary) lead the progress rankings. Interestingly, Bulgaria has made the second greatest progress since 1999. On the other hand, Romania seems to have advanced very little. In 2004 and 2005 the Commission conducted a mid-term review of the Strategy which concluded that progress was clearly inadequate. The Commission intends to strengthen ownership of the Lisbon Agenda through putting more explicit responsibilities on countries. Tasks and accountabilities are to be clearly assigned between the EU and national level. According to the proposal, governments will be expected to prepare and discus with their parliaments a single National Action Program for Lisbon. The 2010 deadline has not been lifted.

Figure 3: Progress in Lisbon Strategy



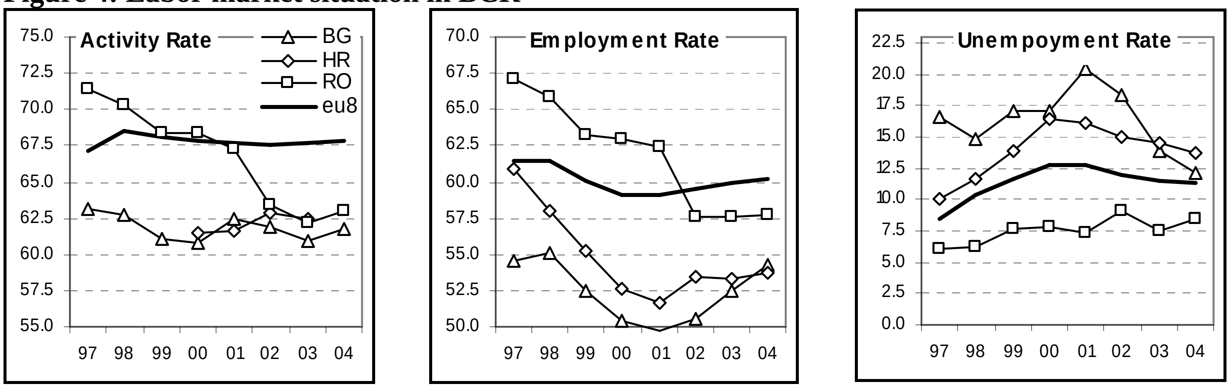
Source: Center for European Reform (2005), ranking based on a situation and progress on 14 "Lisbon indicators."

Labor Market

Both activity and employment rates in Bulgaria, Croatia and Romania remain below average EU8 and EU15 levels. In addition, unemployment rates are higher (except Romania) than in EU8 and EU15. Interestingly, Bulgaria managed to increase its employment rate by 4 percentage points and to significantly reduce unemployment over 2002-2004 (albeit that the recovery started from very low levels, see Figure 4).

Recent experience of the EU8 and the EU15 in terms of growth and jobs is different. In the EU15 there was job creation with limited growth, while the EU8 experienced jobless growth, on average. This is because the increased use of flexible contract arrangements in the EU15 (among other things) allowed more people to participate in the labor market at a given level of economic activity, while in the EU8 low initial productivity levels and labor hoarding allowed for significant expansion of output without creating additional employment. The rule of thumb seems to be that it takes at least 5 percent annual growth to start generating jobs in net terms in the EU8.

Figure 4: Labor market situation in BCR



Source: Eurostat, 2005; national statistics.

The EU recognizes that labor market reforms are a priority. This is because employment is the only viable way to ensure social inclusion and economic sustainability. Current employment rates in Europe are generally too low, so the EU has set itself an ambitious goal of increasing it to 70 percent by 2010.

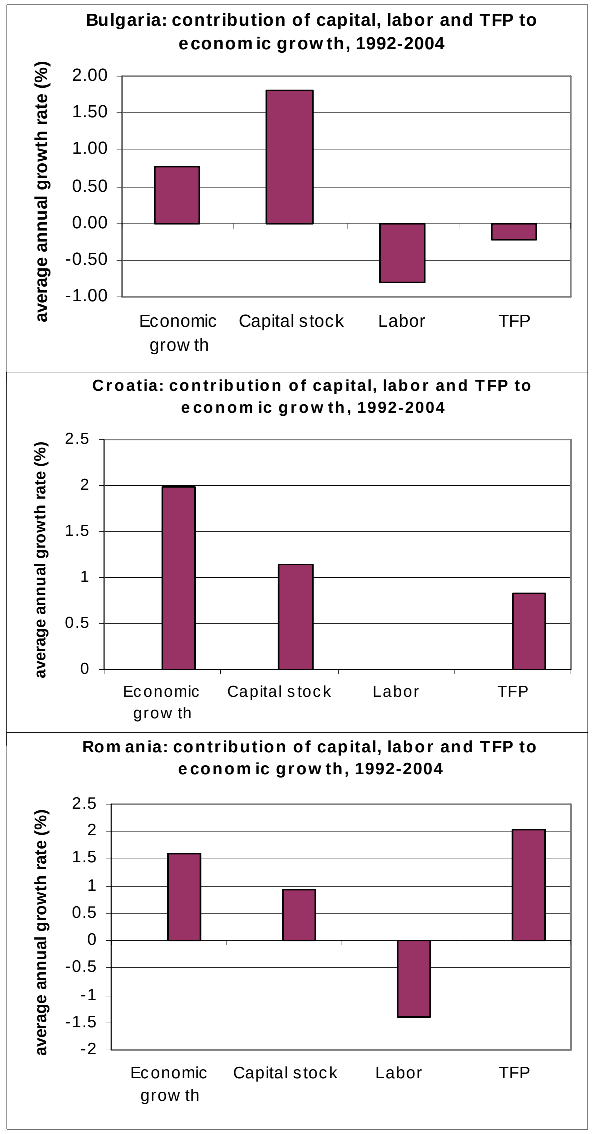
BCR share the challenge of boosting employment with most other EU countries. In fact BCR are doing as well or better than Poland, Hungary and Slovakia. However, these latter three are the worst performers in the EU8 and their situation is far from satisfactory. The underlying causes are similar in all six countries, namely (i) past and ongoing economic restructuring; (ii) disincentives to labor market participation (iii) a high tax wedge; (iv) administrative and legal barriers to job creation including rigidities in the labor market; (v) skill mismatches.

In BCR very low starting productivity levels allowed for substantial productivity gains through labor shedding and substitution of labor by capital. Unfortunately the productivity gap vis-à-vis the EU15 still remains significant, which suggests that employment gains could be slow to materialize. There are nevertheless policies that are more conducive to job creation than others.

Labor market incentives and policies encouraged people to withdraw into economic inactivity in a perhaps misguided attempt to alleviate unemployment tensions, which were mounting during the restructuring process. This happened through a combination of increased social benefits and early retirement schemes which reduced the net cost of withdrawal from the labor force and dampened effective labor supply. Interestingly, some of the EU15 countries, who applied similar policies in the 1970s and 1980s, are now struggling to bring people back to the labor market.

Box 1: Total Factor Productivity in Bulgaria Croatia and Romania

Simple growth accounting decomposes real GDP growth into the contributions of capital and labor and the growth rate of the total factor productivity (TFP). The TFP, also known as the Solow residual, is generally interpreted in the literature as a measure of structural change in an economic system, which can not be attributed to or explained by the dynamics of the measurable input factors. Calculations of this nature (detailed in Annex 1) highlight the important role that the renewal of the productive capital stock has played, in general, as a driver of economic growth in BCR. During the period 1992-2004, in all three countries, the capital stock increased faster than the economy overall. The analysis points towards the central role of investment to economic turnaround. The contribution of labor is in general negative, even after controlling for the quality of the labor force, especially in the early part of the period. This is explained by the massive drop in participation as a result of the output collapse at the beginning of transition. All three countries, like virtually all former socialist economies, started the transition with high employment rates, to compensate for the productivity gap with the West.



A high and non-discriminating tax wedge, has suppressed labor demand in BCR. Research shows that there is a negative relationship between the size of the tax wedge and employment, i.e. the higher the taxes levied on labor costs, the lower the employment performance, particularly at the lower end of the income distribution. In BCR, as well as in EU8, total labor costs for low-skill workers are simply too high in relation to productivity, so low-skill workers are first to be laid off during economic restructuring and become unemployed or shift to the informal sector.

Currently, the labor tax on low wage earners is particularly high in Romania (49.5 percent in 2005) and Croatia (47.1 percent in 2003), compared to averages of 40.8 percent and 37.2 percent in the EU8 and the EU15. The situation in Bulgaria is somewhat better (35.2 percent in 2003) after the government has arranged for an almost 5 percentage point decline in the tax wedge over past couple of years.

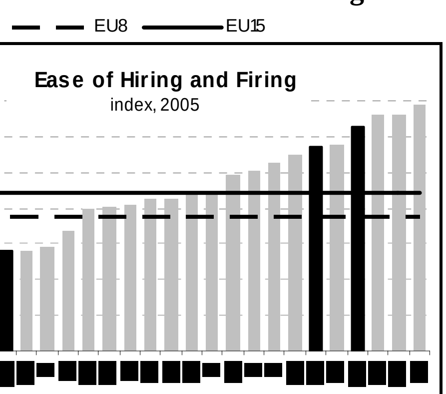
It is, however, the combined effect of the tax and benefit systems that matters for economic activity decisions. Workers consider the net income gain (or loss) when deciding to return to employment and giving up benefits. The EU15 countries are working to design a “work pays better than welfare”-type of reforms. Among the EU8 only Slovakia, with some preliminary success, attempted a comprehensive overhaul of the tax-benefit system with and explicit aim of improving labor market activity. Other EU8 countries have for some time been cutting labor taxes gradually and across the board, in preparation for the expected EU-accession-related investment inflows. Some of them, however, contemplate measures aiming at easing the tax burden, particularly for low wage earners.

Labor Codes have excessive regulation of hiring, firing and hours worked. This is problematic in Croatia and particularly in Romania where labor regulations have been some of the strictest among the EU25 (see Figure 5). Romania has introduced some new measures recently and is contemplating further liberalization of its code to provide a more pro-employment policy environment. It is strongly recommended that these reforms be introduced before accession, as many of EU8 countries did, in order to benefit more from increased EU-accession related investment. In Bulgaria the adjustment constraints imposed by the currency board system mean that labor market flexibility is even more crucial than in other countries. However, its labor market outcomes in terms of participation rates, net employment creation and unemployment lag those of other countries in the region.

The need to deregulate employment relations is particularly pressing in BCR because of the large informal sectors. The size of the informal economy, between 35 and 40 percent of the official GDP in BCR, is at the high end of the same estimates for the EU8, let alone the EU15. Strict labor regulations, among other things, do not provide incentives that would induce activities to shift to the formal sector.

Deregulation is needed that would allow flexible labor contract arrangements (temporary and part-time work) [3]. EU8 countries are now moving towards promotion of a greater use of such contracts. Their potential is significant: about 30 percent of the total employment growth in the EU15 over the period 1995-2001 was attributable to increases in fixed-term contracts. Similarly, the increase in part-time jobs, mostly taken by women, represents more than 40 percent of all jobs created in the same period.

Figure 5: Strictness of labor market regulation in Europe



Source: World Bank, *Doing Business*, 2005.

New jobs being created require skills that are different from what is offered by available workers. These skill mismatches point to inadequacies of the educational system in BCR (and also in the EU8) that still produce graduates with skills that have little value in the modern labor market. This problem is

[3] European Commission (2003)

particularly pronounced in Bulgaria. Another issue is an apparent lack of life-long learning and retraining possibilities. Less than 3 percent of workers in BCR are upgrading their skills through participation in on-the-job learning, compared to 10 percent in the EU15 and 7.5 percent in the EU8. BCR share these skills and education problems with several of the EU8 although some such as Poland and the Czech Republic are making serious efforts to overhaul their curricula.

In summary, actions are needed on both labor supply and demand. An investment environment conductive to business creation coupled with flexible labor markets and tax and benefit schemes creating incentives to work are indispensable elements of any strategy aiming at increased job creation.

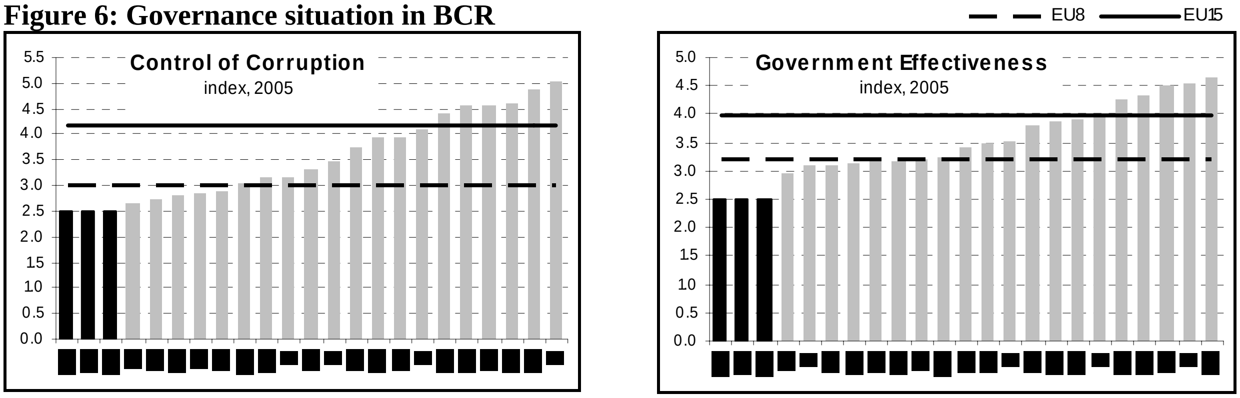
Business Environment and Quality of Governance

Governance problems in BCR are broadly similar in nature to those faced by EU8 countries, but are more deeply entrenched. These include the need to eliminate corruption, to build an ethos of integrity and performance in the system, to improve coordination and coherence of the operations between governing bodies, to assure proper allocation of tasks and resources to various levels of the government, and to improve cross-governmental management functions relating to human resources, budgeting, and legislative planning.

Problems in the control of corruption are particularly pronounced among BCR. Although they are comparable to what is seen worldwide on average (in Bulgaria and Croatia) or somewhat worse (Romania), these problems become strikingly clear when EU standards are applied (see Figure 6). This is confirmed by various surveys, including those of the World Bank and Transparency International, where BCR score the worse than the EU25. Potential explanations include country specific problems related to the political and economic legacy of the 1990s decade, the lower level of development, and the late start of the EU integration process.

Corruption is one of the major institutional problems also for several EU8 countries such as Poland, Latvia, Czech Republic, and Slovakia, and in the EU15's Italy and Greece. There has been very little change in the relative ranking of BCR versus EU8 and EU15 in corruption surveys, and the gap remains significant.

Figure 6: Governance situation in BCR



Source: World Bank Governance Indicators 2005.

With respect to the ease of doing business the picture is mixed. Some evidence suggests that BCR were able to install a relatively business-friendly regime. The Doing Business surveys by the World

Bank indicate that setting up a new business is less costly and takes less time in BCR on average than in the EU8.

Further evidence identifies weak points and suggests areas for improvement. Registering property is very burdensome and non-wage labor costs are generally high. Surveys indicate deficiencies in protection of investors and enforcement of contracts, although in the latter case BCR fare on average better than EU8. Furthermore, in BCR the instability and uncertainty related to the regulatory regime and economic policies in general are considered a major obstacle to business activities. Registry and permit services in BCR are also perceived as more corrupt than in the EU8 (except Poland) and EU15.

Overall, it appears that while BCR have been successful in introducing several legal arrangement facilitating market entry and market regulation, their effective implementation lags behind. This is not be surprising given the weak capacity of public administration. An even simpler administrative regime might be needed in BCR to make up for deficiencies in governance quality.

Competition policy regulations and practice, although much improved, lag the EU8. This is partly due to the fact that the appropriate legal framework for competition protection agencies has been introduced or significantly amended only recently. In Bulgaria, modifications to the laws were introduced in 2002, and in Croatia and Romania in 2003. Also, the capacity of competition agencies would need significant boost, given the large increase in responsibilities after major privatizations (particularly in the network industries) and adoption of the complex provisions of the EU *acquis*. Moreover, unlike BCR, some EU8 countries and many EU15 countries have consumer groups that are effective in preventing competition abuses. Public campaigns could be a useful and cost-effective tool for raising awareness of consumer rights and other competition-related issues also in BCR. Improvements in the effectiveness of competition policy to level the playing field for domestic businesses and enforce market rules are particularly important for the future ability of BCR businesses to be successful in the competitive EU market.

Finally, although market exit legislation is judged to be good implementation is lagging. According to EBRD, BCR have the best insolvency laws among transition economies, surpassing those of the EU8. However, the efficiency ranking of insolvency regimes is quite different, and BCR (Bulgaria in particular) is classified the least efficient among transition countries. This problem is closely connected to the inefficiencies in the judiciary. Bankruptcy cases (particularly in Romania) are stalled in the courts for excessive periods because of cumbersome procedures and lack of appropriately trained judicial staff.

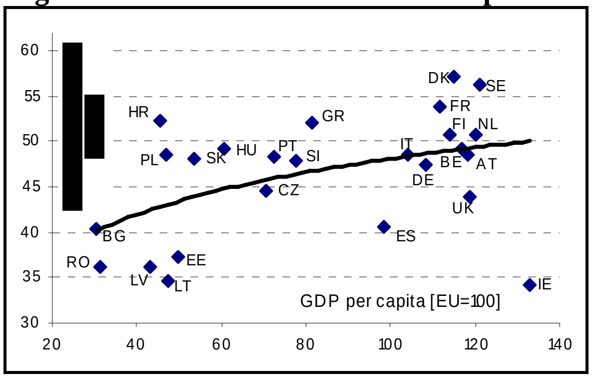
Privatization

Completion of privatization remains an important task for BCR governments, particularly so in Croatia and Romania. The expected gains are: improved efficiency, a level playing field for all businesses, reduction of the burden of (explicit and hidden) subsidies and quasi-fiscal deficits, and the reduction of corruption. Privatization challenges persist as well in some of the EU8 countries. Large scale privatization in Poland and Slovenia is less advanced than in BCR. Among BCR, Bulgaria is most advanced in privatization, and the process should be largely completed in the near future. Romania and Croatia made a push in privatization recently, although Croatia still has a relatively large agenda. These processes are reflected in the comparison of private sector's share in the respective economies, which is estimated at 75 percent of GDP in Bulgaria, 70 percent in Romania, but only 60 percent in Croatia.

Sustainability and Quality of Public Finances

In Bulgaria and Romania, both general government spending and revenues as a share of GDP are below EU8 and EU15 averages, while Croatia has an extensive overnment sector. In 2004, general government expenditures (estimate) amounted to 36 percent of GDP in Romania, 40 percent in Bulgaria and 50 percent in Croatia (see Figure 7). Recent years witnessed prudent fiscal policies with a general government budget in surplus in Bulgaria (a necessity given the monetary regime), gradual reduction of deficits in Romania and persistently high deficits in Croatia. The continuation of fiscal prudence in Romania and Bulgaria and a decisive reduction of the size of the government and its deficits in Croatia are essential to bringing about income convergence.

Figure 7: Government size and development



Source: Eurostat, 2005.

On the revenue side, broadening of the tax base remains an important policy objective in all three countries, and there has been some progress in this area. In Romania, collection, audit and enforcement of social security contributions have been unified, a large taxpayer unit has been set up, and improvement in tax collection by some 1.5-1.9 percent of GDP are expected by 2006. In Bulgaria, a National Revenue Agency responsible for collection of taxes and social security contributions is expected to become operational in 2006. Romania recently introduced a major tax reform replacing progressive PIT and relatively high CIT rate by flat PIT and CIT at low levels (16 percent). Experience of some of EU8 countries (Slovakia, Estonia) suggest that this will support private sector development, reduce the unofficial sector and may even help increase total tax revenues over the short term. However, rate cuts need to be complimented by measures to increase the simplicity and integrity of the system.

BCR face an array of difficult challenges on the expenditure side of public finances. Croatia needs substantial consolidation of expenditures over the coming years. In particular the government needs to: reduce the public sector wage bill from the current level of around 11 percent of GDP; cut back subsidies (about 3 percent of GDP); decisively rationalize social benefit programs, including pensions (close to 29 percent of GDP); and consolidate public investment. Romania also needs to cut large quasi-fiscal deficits and state subsidies. It also lacks a comprehensive pension reform. In Bulgaria and Romania public investment expenditures might need to selective increases. In all countries a health care reform ensuring cost-containment is necessary.

Health sectors in BCR face serious challenges that threaten the future of public finances and the quality of health services over time. Recent reforms in the Croatian health care system, although improving health outcomes, came at a high cost. The Romanian system is not financially sustainable: there are chronic problems of government and hospital arrears to pharmaceutical companies and utilities suppliers. In Bulgaria, excess capacity of health care institutions is coupled with low quality services. In all countries measures are required to contain public health expenditures.

The problems faced by BCR in the health sector are shared with EU8. However the EU8 started reforms a couple of years ago and fiscal discipline and good budgetary practices paid off in those countries which took them seriously. The problems common to BCR and EU8, have the following roots: a tradition of over-hospitalization, the use of expensive inpatient care as opposed to cheaper outpatient care, state ownership and centralized administration, weak financial management, wage pressures by health personnel, an increasingly complex market for health services, and surging expenditures on drugs. In such an environment increasing total health expenditures (while revenues were not keeping pace) resulted in the accumulation of large debts in most EU8 countries. The challenge is, thus, to achieve efficiency, contain costs and introduce meaningful competition among service providers. Interestingly, three out of eight EU8 countries, namely Estonia, Slovenia and Latvia managed to prevent debt accumulation in their health sectors, while being subject to the same pressures and problems. The main difference seems to be that these countries prioritized and enforced fiscal discipline and good budgetary practices.

The budgeting processes have been improving in BCR over the last few years, in particular in Bulgaria and Romania, but there is still some distance to go. This is an area where many of EU8 countries lag as well, and best practice examples need to be sought in the EU15 and elsewhere. Bulgaria has made most progress of the three. It has been testing program budgeting, with direct links between programs, budget allocations, objectives and performance targets in some ministries and it plans to introduce such systems for the whole budget in the next few years. Croatia has already introduced program budgeting into its Medium-Term Expenditure Framework 2004-2007, and is currently trying to improve the linkages with the performance targets. Romania has also introduced some elements of program budgeting and a Medium Term Expenditure Framework, but the budget process is not effectively driven by strategic policy decisions. Line agency budget submissions are not prioritized and routinely exceed the treasury circular ceilings resulting in inefficient, ad hoc cuts, unfunded mandates and frequent budget rectifications. Progress in Romania and Bulgaria has been better with respect to accounting, audit and control processes, largely as a result of EU accession requirements. Bulgaria, in particular has instituted good internal audit processes. Croatia has made little progress in the internal audit processes, although the pace of change is quickening, with the support of EU technical assistance.

Significant progress has been made in all three countries in eliminating off-budget accounts. However, Romania still has substantial implicit subsidies and arrears. Further challenges exist with respect to fiscal decentralization where clearer expenditure and revenue assignments are needed.

BCR should take advantage of the possibilities created by information technology to simplify the functioning of the government and relations with citizens and business. For instance on-line taxation services can greatly reduce the time business spend on tax declarations, cut the cost of running the system and simplify the control of tax compliance. BCR currently lag EU countries in terms of e-governance (the EU15 top the league, just behind the US), and more effort is needed in this sphere.[4]

Education, Knowledge Society and Innovation

Creation of a knowledge-based economy is an overarching priority of the EU. BCR seriously lag in implementing this agenda.

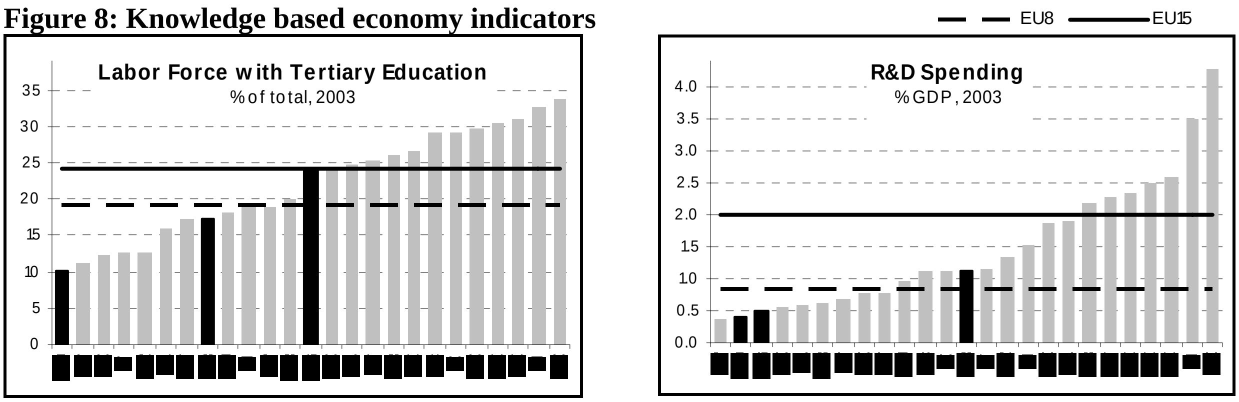
The picture of educational attainment in BCR is mixed. Bulgaria, with 24 percent of the labor force having tertiary education, is on a par with the EU15 and above the EU8 average of 19 percent. Croatia (17 percent in 2001) is only slightly behind most EU countries, while in Romania the share was only 10 percent, below all EU economies (see Figure 8). However, a somewhat different picture emerges from analysis of education in mathematics, science and technology - areas that are important from the perspective of knowledge-based economies, and where there are skill shortages throughout Europe. Here,

[4] EIU, 2005 and UNPAN, 2004

the number of graduates (in the population aged 20-29) is the highest in Romania – above the average of EU8 – while Bulgaria, and particularly Croatia, had lower numbers of young science and technology graduates.

Educational outcomes leave much to be desired. The quality of education can be proxied by TIMSS test results. Among BCR, Bulgaria and Romania participate in the TIMSS project. Scores of Romanian eighth-grade students have been consistently among the lowest compared to the eight EU countries participating in three waves of TIMSS. In contrast, Bulgarian eight-grade students fared very well ten years ago, but since then there has been a serious deterioration in education outcomes, and Bulgaria gradually fell to very low levels.

Figure 8: Knowledge based economy indicators



Source: Eurostat 2005.

Life long learning systems are severely underdeveloped in BCR. These systems are crucial to ensure a sufficiently adaptable workforce for the economy to internalize technological progress and adapt to fast changing demands of globalization. In BCR adult participation rates in education and learning lag those of the EU8 and the EU15. In 2003, only between 1.3 percent (in Romania) and 2.1 percent (in Croatia) of people aged 25-64 participated in training or education. These figures are significantly lower than those of any EU country, where the average participation rate was 10 percent and 6.9 percent in the EU15 and the EU8 respectively. Experience of the EU8 suggests that a significant improvement in this area is possible over a relatively short time, as long as there is enough commitment of policymakers. For example, average participation rate in the EU8 increased from 6 percent in 2002 to 7.7 percent in 2004. Slovak's ruling coalition decided to make the knowledge-based economy its election theme.

BCR have for some time experienced declining educational enrollment at lower levels, and increasing enrollment (and enrollment rates) in tertiary education, creating problems with respect to financing and quality. These trends have been visible for the last decade or so in BCR and were due to demographic processes (declining school age cohorts) and a general drive towards higher education. Such trends are also evident in several EU countries (particularly the EU8 countries) and they create new challenges.

While there are a few country-specific issues, the basic reform needs are similar:

- Reallocate and consolidate resources at the primary and secondary education levels in order to rationalize the school network, optimize teacher-to-student ratios and improve the quality of education while at the same time preventing the emergence of access barriers (e.g. in rural areas where some schools need to be closed).

- Prevent the deterioration of the quality of university level education and couple this with strengthening of, and more innovation in, financing of tertiary education.
- Resist the temptation to increase the number of students in fields where educational services are cheap to provide but do not equip students with skills needed for success in the changing labor market (technical education needs reform in many countries).
- Improve access to education and training among adults.

Research and development (R&D) expenditures are very low in BCR and the EU8. In 2002, R&D expenditure amounted to 0.7 percent of GDP in BCR, compared to 2 percent of GDP in EU15.[5] As a result, during 2000-2002, the number of patent applications sent to the European Patent Office (EPO) or to United States Patent and Trademark Office (USPTO) per capita was a small fraction of the same ratio for EU8 countries, and was completely negligible when compared to EU15. Also, the share of high-technology exports remains low in Bulgaria and Romania, though it is higher in Croatia. While increases of the public R&D expenditures appear necessary in BCR and in EU8, it is also important that these resources be used efficiently, and this requires effective evaluation and monitoring. Even more important is creating an environment that stimulates private R&D investment and promotes linkages between research centers and businesses for the commercial use of innovations.

Infrastructure

The improvement of infrastructure quality, including transport, energy, telecommunications, environment and municipal services is a crucial ingredient of a successful development strategy. The current state of infrastructure reflects the heritage of the past, while future development of this sector will be defined by the effectiveness of the regulatory regime in place.

Bulgaria and Romania have underinvested in physical infrastructure. Croatia started an intensive infrastructure investment program (especially roads and highways) but this has contributed to a major deterioration of its fiscal position and a buildup of debt. All three countries need substantial investments to raise productivity, sustain growth and to meet specific obligations under the Acquis - particularly in transportation and environment. BCR face the challenge of financing these investments.

EU structural funds are expected to make an important contribution to infrastructure finance. However, BCR need to prepare a pipeline of projects in a manner satisfactory to the EU so that these grant resources can be tapped. The EU resources will be available in amounts of up to 4 percent of GDP annually starting in 2007. But they must be used in set time frame. Use of preaccession funds has been slow due to difficulties with the preparation and implementation of projects. While the use of preaccession funds is more closely monitored and controlled than the post accession funds, past experience suggests there is a significant risk that some portion of these grant resources will not be fully utilized. Moreover, counterpart funds of approximately 25 percent must be provided through the national budget in order to access the post accession EU grants. There is therefore competition with other needs such as health and pensions. This creates even greater urgency to make fiscal necessary fiscal consolidations.

BCR face considerable challenges in the environmental sector. The costs of meeting the provisions of the acquis are staggering. Areas which are most problematic such as water and solid and liquid waste treatment and disposal fall largely within the domain of local government. This is precisely where planning and implementation capacities are weakest. The challenges of decentralization and shifting, and in some instances unclear, revenue and expenditure assignment systems, complicate matters further.

[5] In turn, the R&D expenditures in EU15 are on average clearly below levels in the US and Japan.

Some of the most costly environmental problems are concentrated in poorer communities do not have the resources to deal with them. They do not have the local tax bases to pay for needed investments in water and waste water, nor even to come up with the counterpart funds necessary for getting the EU structural fund grants. They cannot (and should not) borrow from banks because of their low tax bases and limited debt service capacities, and sale of municipal bonds practical for only a very few of the larger urban communities. This problem is therefore intimately bound up with the challenge of reforming inter governmental fiscal transfer systems and developing sub-national planning and implementation capacities.

BCR lag behind the EU in telecommunication infrastructure. In 2003, the number of mobile phones per 1000 inhabitants ranged between 324 in Romania to 584 in Croatia, compared to an EU8 average of 709 and an EU15 average of 869. There is also a gap in the number of internet users per 100 households: in 2004 it ranged between 6 in Romania to 16 in Croatia compared to the EU8 average of 24 and EU15 average of 45. These data suggests that BCR are roughly 2 years behind EU8 in terms of modern telecommunications, and given the speed and non-linear nature of evolution of the ICT sector, BCR could catch up with the EU and eventually with the EU15 relatively quickly. Moreover, fixed line monopolies (for local calls) have now been ended in all three countries which should result in infrastructure improvements and a fall in prices. At present these processes appear to be advancing particularly fast in Romania.

The progress in network industries (e.g. telecommunication, but also electricity) depends heavily on proper regulation of the market and ensuring a meaningful competition. Existing evidence suggests that following recent reforms, regulatory quality in BCR is on a par with EU8 standards. Also, the progress in infrastructure privatization is similar and in some areas BCR (Bulgaria and Romania in particular) are regional leaders in terms of the share of the market served by private entities (e.g. the whole electricity distribution sector in Bulgaria is privately owned). This suggests that BCR can be expected to gradually overcome the problem of poor infrastructure quality and catch up with EU8 and eventually with some of the EU15 countries.

Agriculture and Rural Development

The agricultural sector in BCR is much larger than in any EU country. By 2003, it accounted for above 8 percent of the total value added in Croatia and almost 12 percent in Bulgaria and Romania, i.e. 2-3 times the EU8 average. More importantly, the sector provides employment to a much larger share of all employed. Romania stands out particularly. The recession of late 1990s combined with large scale land restitution resulted in significant migration to rural areas. New migrants turned to subsistence agriculture to escape unemployment and poverty. As a result, by 2003 agriculture accounted for almost 40 percent of total employment. The land reform (implemented between 1991 and 2000) also contributed to a significant fragmentation of plots (average of 2.3 hectare) and resulting low productivity. Bulgaria faces somewhat similar problems with highly fragmented land holdings which hinder emergence of competitive, market oriented production. In both countries the agriculture sector is a reservoir of a substantial hidden unemployment. The situation in Croatia (which largely avoided collectivization of land under communism) is more favorable in this respect and the agriculture employment share (around 15 percent) is on the par with some of the EU countries (Greece, Portugal, Latvia, Lithuania and Poland). Still, average farm size remains very small.

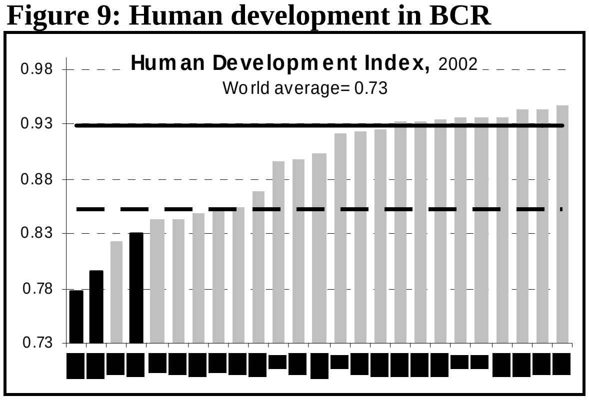
The major challenges in BCR are promotion of land consolidation, support to the emergence of market oriented farms and pursuit of policies favorable to creation of off-farm employment in rural areas. Consolidation requires a creation of an efficient land market. Only then can agricultural investment increase, allowing for higher yields and better protection against weather conditions (irrigation systems, defenses against floods, etc.). Also, agriculture should be integrated into broader rural development strategies promoting off-farm employment opportunities. Strengthening of food processing industry and related services, and ensuring competition in this market is a precondition for a transition to higher value added production from rural areas. Effective use of EU funds for such purposes is very important. EU accession will put BCR to a test in terms of countries' ability to implement phytosanitary and veterinary standards. On the positive side, natural conditions in all three countries suggest prospective comparative advantage in agricultural production. Full opening of the EU market will create opportunities. The experience of EU8 countries points to a strong export potential of the food processing sector, once the necessary restructuring is done. However, it is clear that, particularly for Romania, a major exodus from the agricultural sector into other more productive lines of employment is necessary to raise average incomes.

Social Cohesion and Social Policy

Despite a gradual decline of overall poverty rates along economic growth, the problem of poverty is still acute and increasingly difficult to tackle. This is because poverty became more concentrated in some groups of the population that are less responsive to social policies and are often endangered by social exclusion. These include the Roma minority, the long-term unemployed and economically inactive households with excessive reliance on social benefits of various kinds. Reforms should go towards laying out incentives for social integration (e.g. through employment) rather than deepening dependence on social assistance. This requires carefully designed active labor market policies supporting unemployed, older workers, the inactive and low wage earners and generally better targeted social assistance. These policies should be put together in a coherent framework with proper activity incentives in place and safeguards against misuse of benefit schemes.

While the most recent ranking of countries according to the Human Development Index (HDI) classifies BCR at the very bottom or below the EU range, improvements are more likely to be achieved through strengthening the effectiveness of social, health and education policies than by increasing resources. Croatia is 48th in the world HDI ranking, Bulgaria – 56th and Romania – 69th (see Figure 9). For example, in Romania and Bulgaria, life expectancy at birth (70 and 72 years) is among the lowest among EU and candidate countries. In Croatia (75 years) the situation is somewhat better, though still below all EU15 countries. While improvements in quality of education and health are needed in all three countries, given the financial constraints these are unlikely to be achieved by increasing financial resources. Efforts should instead be concentrated on improving allocation and more effective use of available resources. This is not an easy task and requires institutional capacity to implement difficult reforms, while the reform design would be most likely country-specific.

Figure 9: Human development in BCR



Source: UNDP, 2004.

Appendix 1: Policy Matrices

BULGARIA, Policy Matrix		
Problems / challenges	**Areas affected**	**Recommendations / Comments**
Labor market: - low employment rate (despite recent improvements), - high unemployment among youth;	fiscal sustainability social inclusion	- Further improvement of investment climate needed on the labor demand side - Educational system needs an overhaul for a better match between skill supply and demand - Some more flexibility in labor market (building on recent improvements) could help increase employment among youngest and older cohorts - Minimum wage should be kept in check, as this is not an effective tool for labor market policies - Effectiveness of active labor market policies will need to be measured and improved. ALMP should be targeted towards bringing the long-term unemployed to work and making sure that work pays better than welfare.
Business environment and public administration - still relatively unfavorable despite recent improvements - difficult *de facto* market entry / exit - corruption continues to be a problem - ineffectiveness of the judiciary system	investments, including FDI labor market	- Public administration reform, in particular towards more effective implementation of existing regulations - Effective anti-corruption actions are needed - Local government structures require strengthening with a view to building their capacity and improving inter-governmental coordination - Judicial reform: - Court procedures need to be faster - completion of judicial and administrative reforms should be prioritized - Shifting business registration from courts to central agency; ensure effectiveness and client-orientation of this agency - Intensive efforts are needed to reduce corruption, improve organization of courts, reduce delays, enhance the general quality of justice, in particular with respect to commercial law; - Creating appropriate condition for mediation could reduce the burden on courts
Public finances - fiscal sustainability over long run needs preserving and strengthening	macroeconomic stability	- Rationalization of the expenditure side of the budget is a key medium term challenge - More transparency in fiscal planning, including better data provision; uniform treatment of public infrastructure project company (PIP). Improved allocation of expenditures. Capital expenditures to be planned under hard budget constraint and carefully monitored

BULGARIA, Policy Matrix		
Problems / challenges	**Areas affected**	**Recommendations / Comments**
		- A gradual shift to program budgeting, with direct links between programs, budgeted allocations, objectives and performance targets would be a major achievement
<u>Educational system</u> - Needs deep reforms	labor market international competitiveness social inclusion	- Improve expenditure management, geared to the declining school age population; enhance quality control; incentives needed towards rationalizing the school network - Financial resources need to be moved from staff compensation (excessive number of teachers) to quality improvements (upgrading curricula, equipment, training of teachers, etc.); incentives need to be provided for teachers to improve their skills - Equity in access to education needs to be assured, in particular for ethnic minorities and disadvantaged children;
<u>Social protection</u> - Complexity and multiplicity of social protection and benefit programs - with the significant reduction of poverty rates, the nature of poverty has changed – the problem are pockets of deep poverty among certain groups - in health services: capacity surplus coupled with low quality of equipment and services	quality of life labor market fiscal sustainability	- Consolidation of the social protection and benefits; improving targeting, better control of efficiency. Making sure work pays better than welfare. - Further efforts necessary to prevent misuse and fraud in disability and other benefits (sick leave, etc.). Effectiveness of social assistance has been on the rise with better targeting. - Fighting deep poverty often associated with social exclusions and disadvantaged position of vulnerable groups will become a major challenge - Hospital restructuring needs to proceed. Redirection of funds from enhancing capacity to improving quality; expanding output-based payment for inpatient care services; ensuring a meaningful competition among service providers

Sources: EC 2004; IMF cr05169; WB PAL3 PAD 2005; EBRD 2004; IMF cr05169; WB PEIR 2002

CROATIA, Policy Matrix		
Problems / challenges	**Areas affected**	**Recommendations / Comments**
Labor market: - low employment - high unemployment - rigidity of labor market	fiscal sustainability social inclusion	- Improvement of the overall investment climate is needed (including faster restructuring of SOEs) - Labor markets need deregulation towards more flexibility - Improvements in the quality of education (particularly tertiary level) important to ensure supply of highly qualified workforce
Business environment and public administration: - weak administrative capacity and excessive size of public administration - corruption - low capacity / quality of the judiciary system	governance effectiveness international competitiveness labor market fiscal sustainability	- Public administration (and wage bill) needs significant downsizing - Effectiveness and quality of public administration through: organizational restructuring, staffing by merit, enhancing of transparency, fighting corruption - Both internal and external audit need strengthening (particularly in tax and customs administration) - Implementation of the anti-corruption strategy requires a push; public awareness campaigns could play a role - Simplification of construction related permit processes in order to attract new investment, including FDI
Privatization and restructuring Excessive role of the state in the economy - private sector accounts for only ca. 60 percent of GDP - unfinished privatization agenda (despite some recent improvement) Problems with financial discipline in public enterprises - arrears - relatively high subsidies (despite the plan for their gradual reduction)	business environment fiscal sustainability governance effectiveness labor market	- Privatization or liquidation of the remaining state-owned utilities and small enterprises in the tourism sector needs acceleration - Privatization of liquidation of agrokombinats and shipbuilding should be speeded up. - Promotion of private sector participation in infrastructure sectors (also at municipal levels) along with strengthening the capacity of regulatory bodies - Reduction of subsidies (ca. 3.4 percent of GDP in 2004) - Rapid reduction of quasi-fiscal activities of public enterprises - Clear division of oversight responsibilities on the governments' holdings in enterprises. At present the responsibilities of Croatian Privatization Fund, MoF, and other ministries are not clearly defined; clear rules for dividend payments need to be put in place, creating adequate incentives for the Croatian

CROATIA, Policy Matrix		
Problems / challenges	**Areas affected**	**Recommendations / Comments**
		Privatization Fund.
Public finance unsustainable fiscal position - large fiscal deficits, - rapid buildup of debt - unfavorable structure of expenditures - budget revenues - fiscal transparency	macroeconomic stability investment climate	- Fiscal consolidation needed urgently; sustainable cuts needed on the expenditure side; debt management needs strengthening - Public sector wages, subsidies and social spending need downscaling, education and R&D could be gradually increased; investment expenditures should be closely monitored to assure that current high investment levels are justified by their effectiveness - Fiscal transparency needs to be improved (e.g. use of guarantees, government assumption of debt of public enterprises, recording of quasi-fiscal activities) - The process of assigning resources to activities needs to better respond to actual needs and avoid the frequent ad hoc reallocations - Comprehensive tax reform will be needed, aiming, inter alia, at better tax collection, simplification of the system and broadening of the tax base

Sources: WB CEM 2003; WB PAL 2005; EBRD 2004, 2005; PEP 2004; IMF cr04365; WB briefing for new government 2004.

ROMANIA, Policy Matrix		
Problems / challenges	**Areas affected**	**Recommendations / Comments**
Labor market - low employment - 'hidden' unemployment in SOE sector and agriculture related to: - difficult business environment - relatively high tax wedge for wage earners; - overall rigidity of employment;	fiscal sustainability social inclusion enterprise restructuring competitiveness	- Improve business climate on the labor demand side to reduce transaction costs for enterprises and increase competitiveness - Need for further reform of labor regulations in order to reduce rigidities in the labor market (accompanied by simpler, equitable and transparent labor protection regulations) - Reduce burden of social contributions on wages (paying also attention to pension and health revenues). This is possible by widening the tax base and bringing the informal economy into the open.
Business environment and public administration – high corruption; – low quality of governance in public administration; – unstable and unevenly enforced legal framework – difficult market entry/exit – distortions to fair competition – Institutional capacity (of the judiciary, market regulatory bodies, tax and other administration) for policy execution identified as major impediment to investment	labor market, governance investment climate	- Judicial reform needs special attention in order to boost capacity and reduce corruption - Barriers to market entry/exit need to be significantly reduced – *de facto* rather than *de jure*. Recent improvements were noted (e.g. silent approval procedure) - Public administration's capacity needs upgrading to fully utilize EU pre- and post-accession funds (in the past too much money was chasing too little absorption capacity in Romania)
Privatization and restructuring Financial discipline in the enterprise sector: – persistent financial indiscipline; – inefficient bankruptcy procedures;	investment climate fiscal sustainability labor market	- Complete privatization and sectoral reforms in utilities, particularly energy, mining and transport (railways); this in particular involves bringing the tariffs to adequate levels - Continue downsizing the public sector and imposing hard budget constraints, eliminating arrears and non-payments to utilities – district heating, but also gas and electricity (particularly by SOEs) - Promote competition (and improve regulation) in network industries - Improve bankruptcy procedures and make them

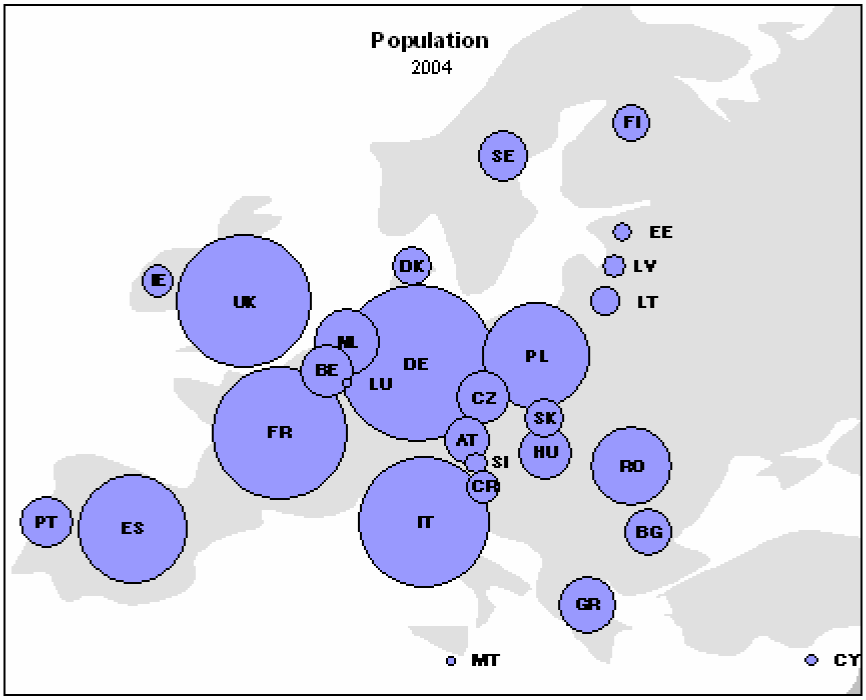
ROMANIA, Policy Matrix		
Problems / challenges	**Areas affected**	**Recommendations / Comments**
		operational - Strengthen financial and commercial discipline in SOEs, particularly in public utilities
Fiscal sustainability: - fiscal position has been gradually improving over the last few years helped by strong economic activity and reforms - new tax system introduced in 2005 is simpler and should help in broadening the tax base - fiscal prudence needs to continue	macroeconomic stability improved public resource allocation international competitiveness	- Control public wage growth and improve collection rates in order to reduce payment arrears (to the budget and other enterprises) and quasi-fiscal deficits - Broaden the tax base, and improve the efficiency of tax collection - Depending on tax revenues collection under the new system, there may be scope for reducing social security contributions - Subsidies need to be phased out decisively - Investment expenditure, while clearly needed given the state of the infrastructure, should not threaten fiscal sustainability – close scrutiny of projects is needed - Social expenditures are expected to be on the rise in the medium to long term. This calls for long term planning.
Agricultural sector: - sector serves as a safety net for relatively large strata of the population, who rely on subsistence agriculture; - productivity is very low; and poverty high among rural population - average size of plots is very low, resulting in scarcity of farming equipment and low productivity	labor market international competitiveness fiscal sustainability social inclusion	- Create conditions for land consolidation (efficient land market) is important to increase investment and thus productivity and competitiveness of the sector - Develop non-farm employment alternatives in rural areas; create favorable conditions for development of services sector (including services related to agricultural production and distribution); improve rural infrastructure, access to credit. - Improve access of rural population to education, and health services.
Social system: - pensions - health system - other social protection - social inclusion, reduction of poverty	fiscal sustainability quality of life, social inclusion labor market	- Current PAYG pension system could be strengthened by broadening tax base, limiting early retirement, and avoiding granting special pension privileges to particular groups. - Reforms to the health system should address financial viability; i.e. ensure proper budget management, effective competition and cost-containment - Relations between National Health Insurance House, Ministry of Health, health service

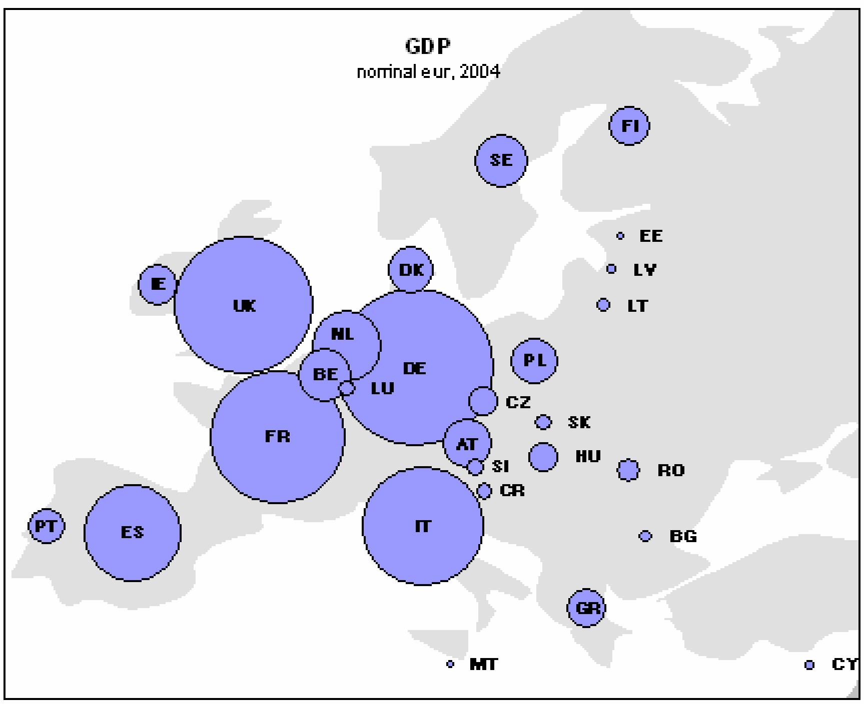
ROMANIA, Policy Matrix		
Problems / challenges	**Areas affected**	**Recommendations / Comments**
		providers and pharmaceutical companies need to be more transparently defined and monitored; Informal health-related payments should be tackled; - In education challenges include (i) improvements of education for disadvantaged groups, particularly Roma and (ii) promoting life long learning.

Sources: WB Doing Business 2005; EC 2004; WB CAS completion report 2005; EBRD 2005; IMF cr04221; WB PAL update 2005.

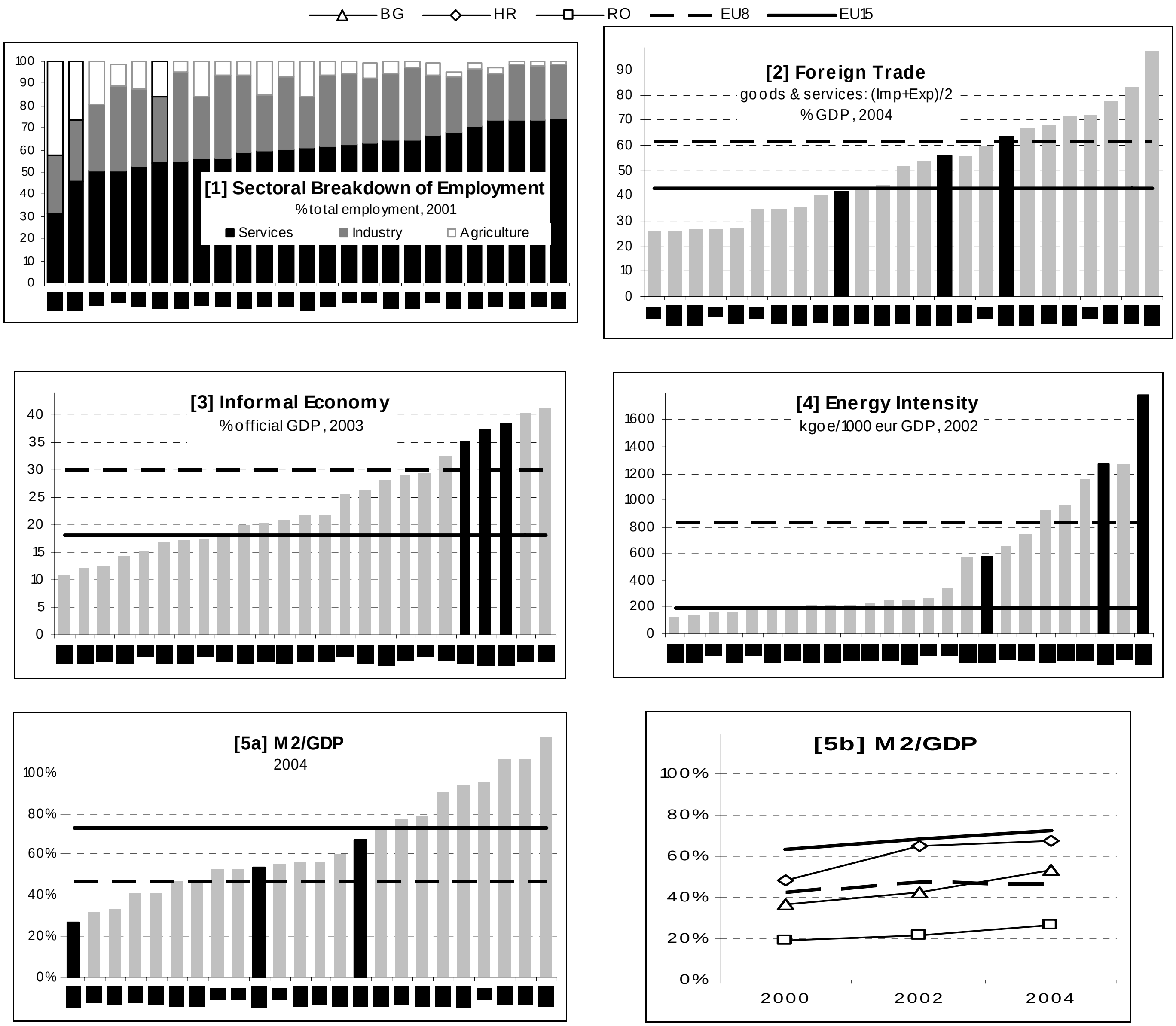
Appendix 2: A Reform Structural Scoreboard

EU28 at a glance



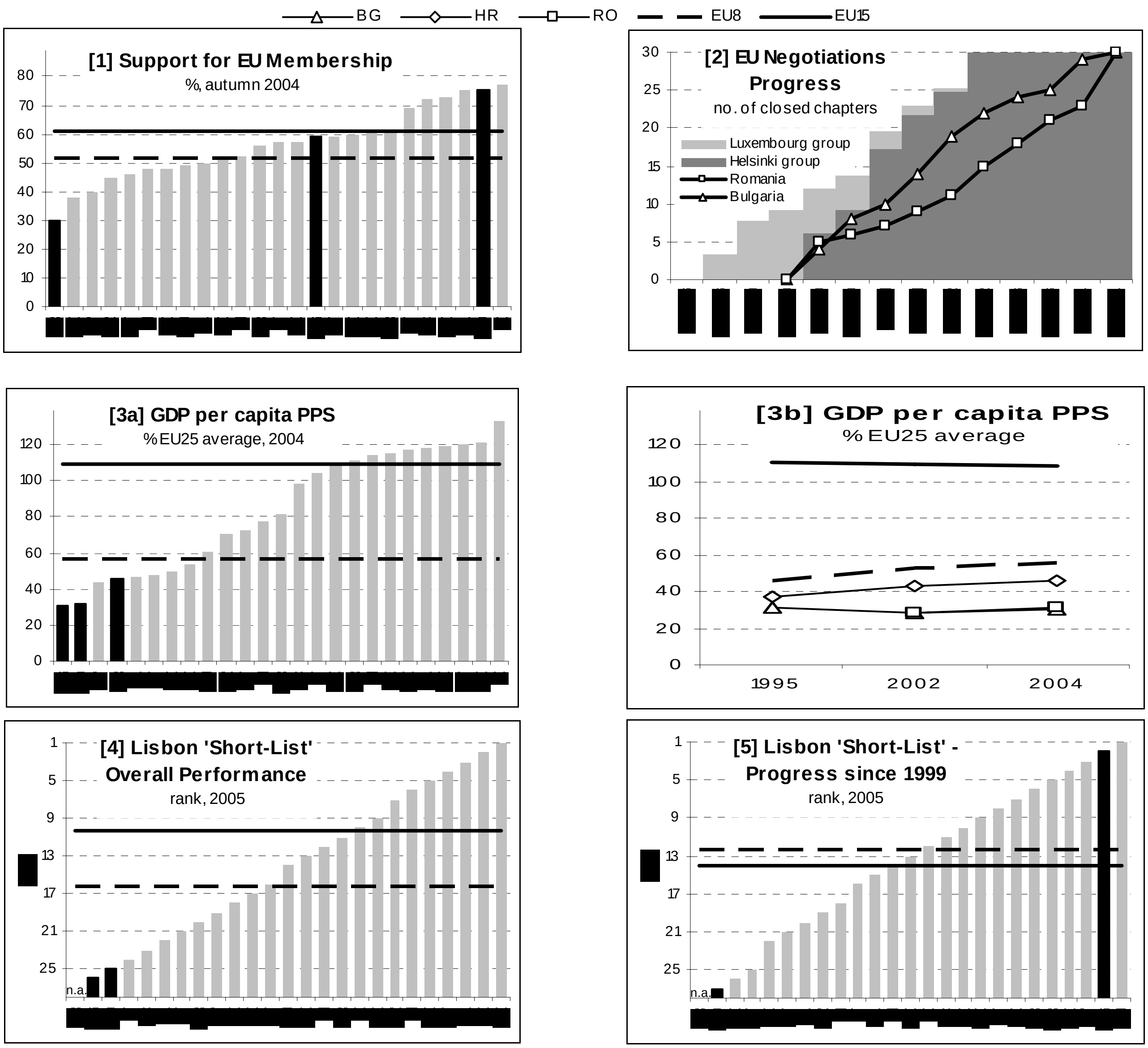


Structure of the economy

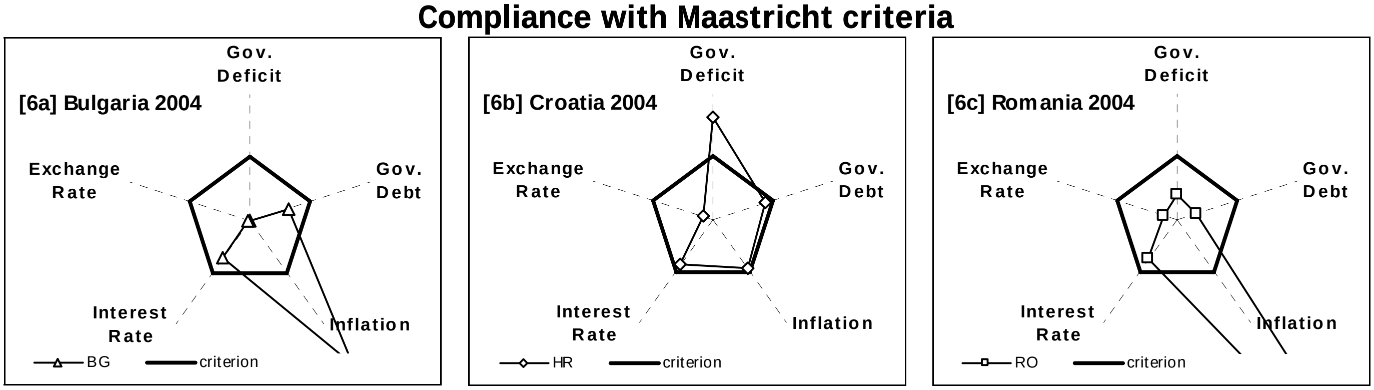


Sources: [1] WDI 2004; [2,4] Eurostat 2005; [3] Schneider 2004, [5] Eurostat 2005, national sources, World Bank, ECB 2005; *Notes*: [2] FR, HU, IE, RO, SI: 2003; [4] HR: est.; [5] LT, LV, SK: 2003; EU12: Eurozone's M2 was distributed acc. to "national contributions" to M2, average is of Eurozone (12)

EU integration and convergence

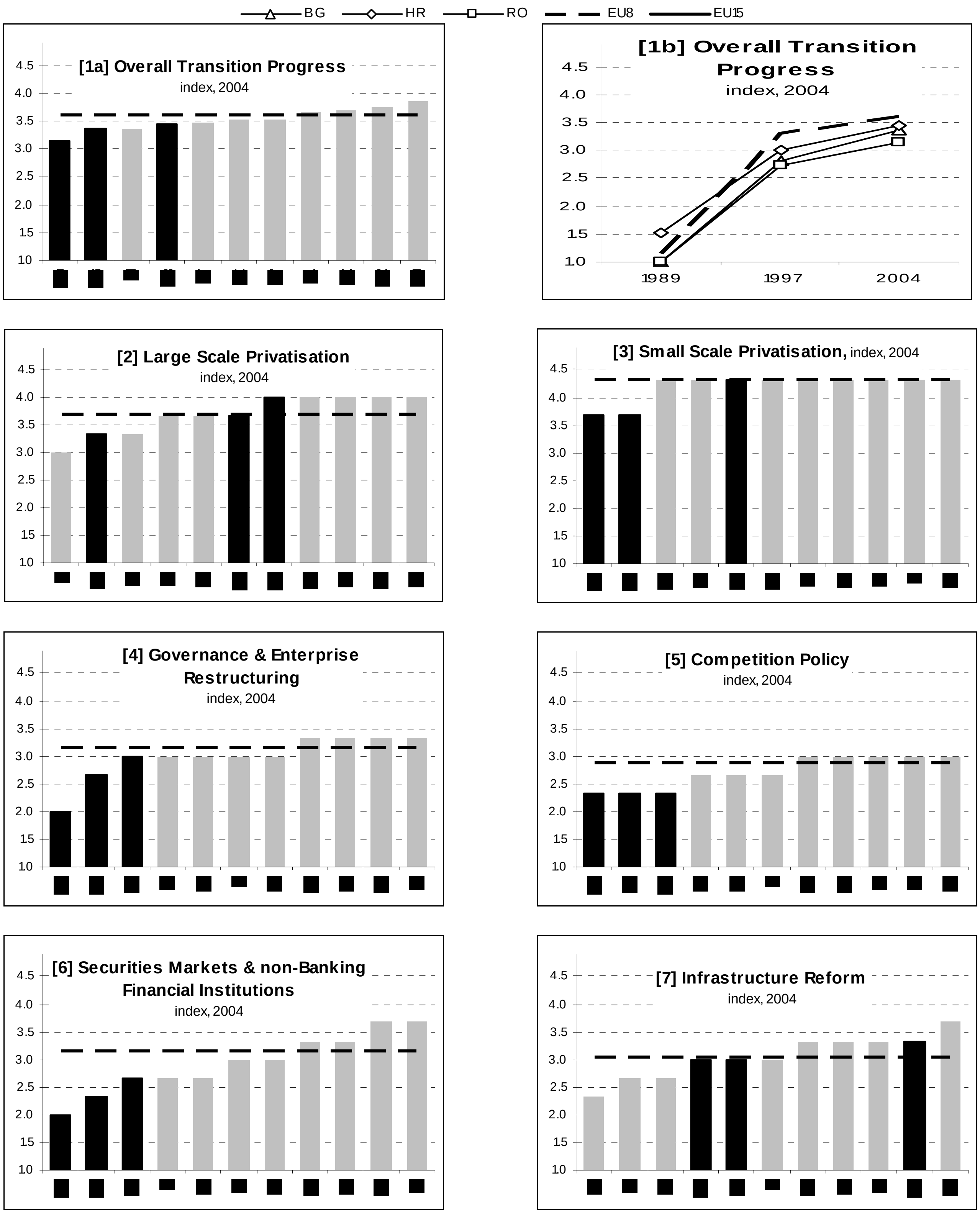


Compliance with Maastricht criteria



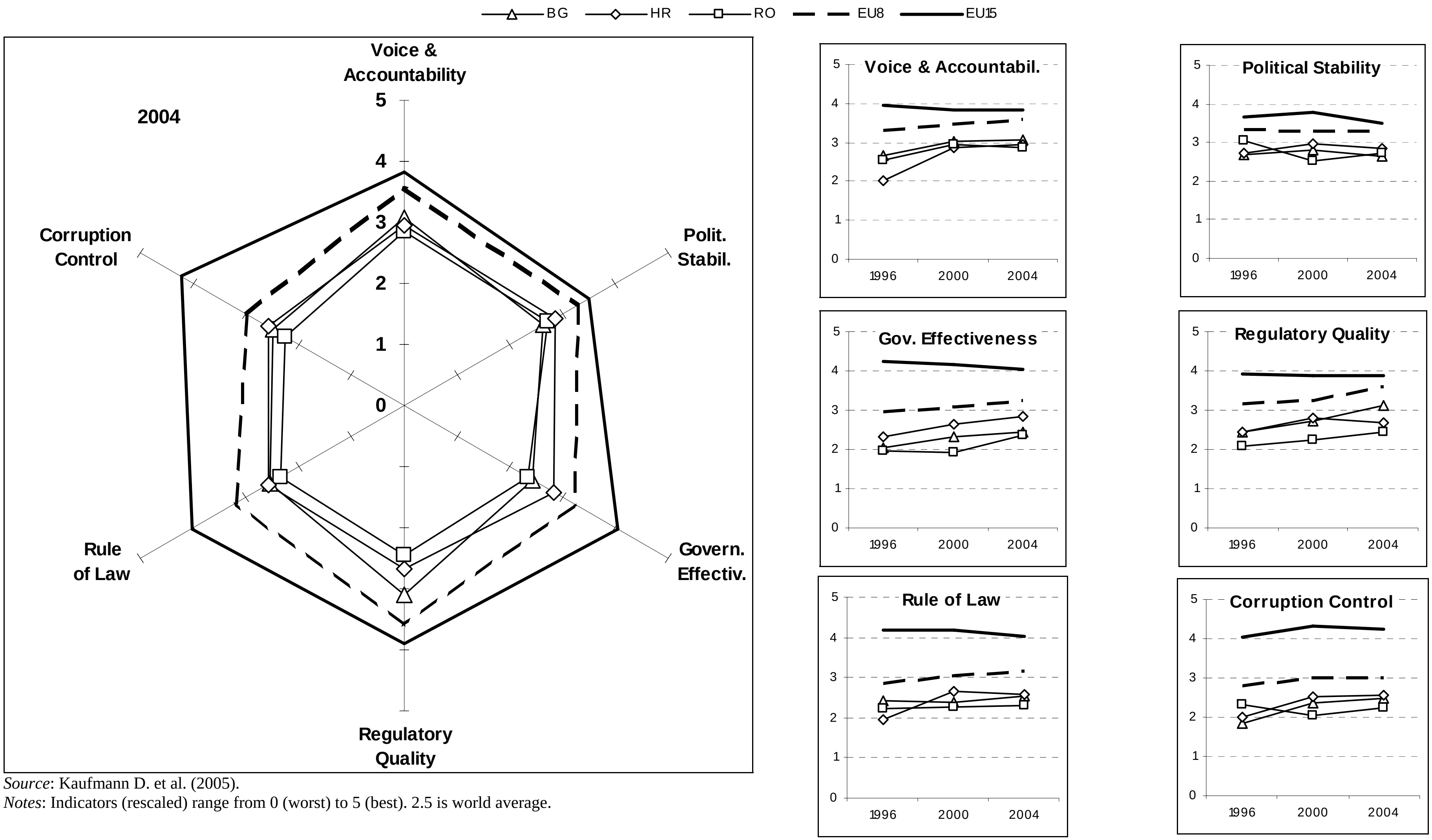
Sources: [1] Eurobarometer Aut 2004; [2] EC 2005; [3,6] Eurostat 2005; [4,5] CER 2005 *Notes:* [2] Luxembourg group: CY, CZ, EE, HU, PL, SI, Helsinki group: LT, LV, MT, SK; [6] see notes page 8; HR Int. Rate 5y, May 2005. Maastricht criteria: (1) Gov. Deficit <= 3 percent GDP, (2) Gov. Debt <= 60 percent GDP, (3) Inflation <= average inflation in 3 lowest-infl. cntr. in EU25 + 1.5 percent point. (4) Interest Rate <= average in those 3 countries + 2 percent point., (E) FX fluctuations <= ±15 percent

Transition indicators



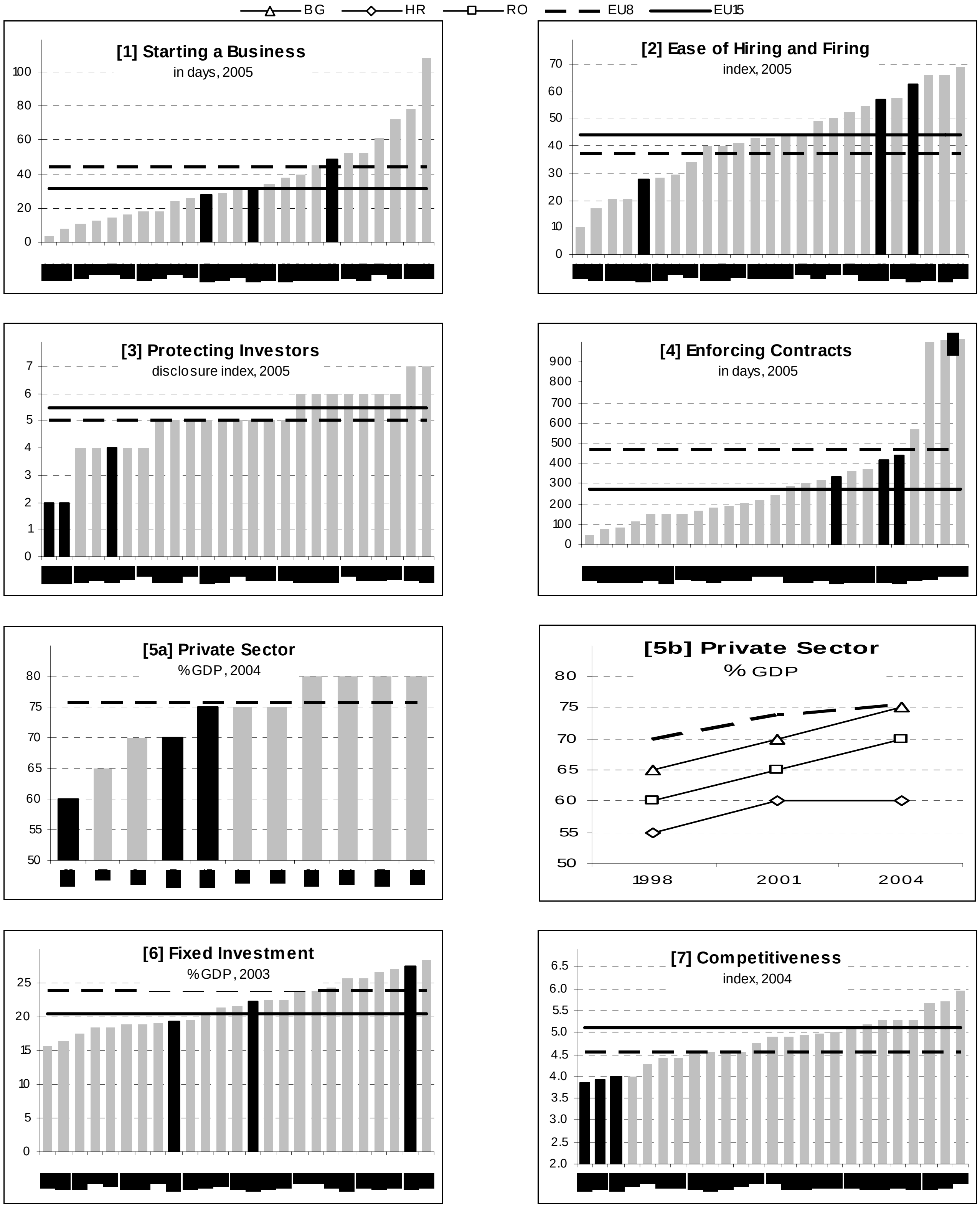
Source: EBRD Transition Report (2004). *Note:* Indicators range from 1 (worst) to 4.5 (best).

Governance indicators



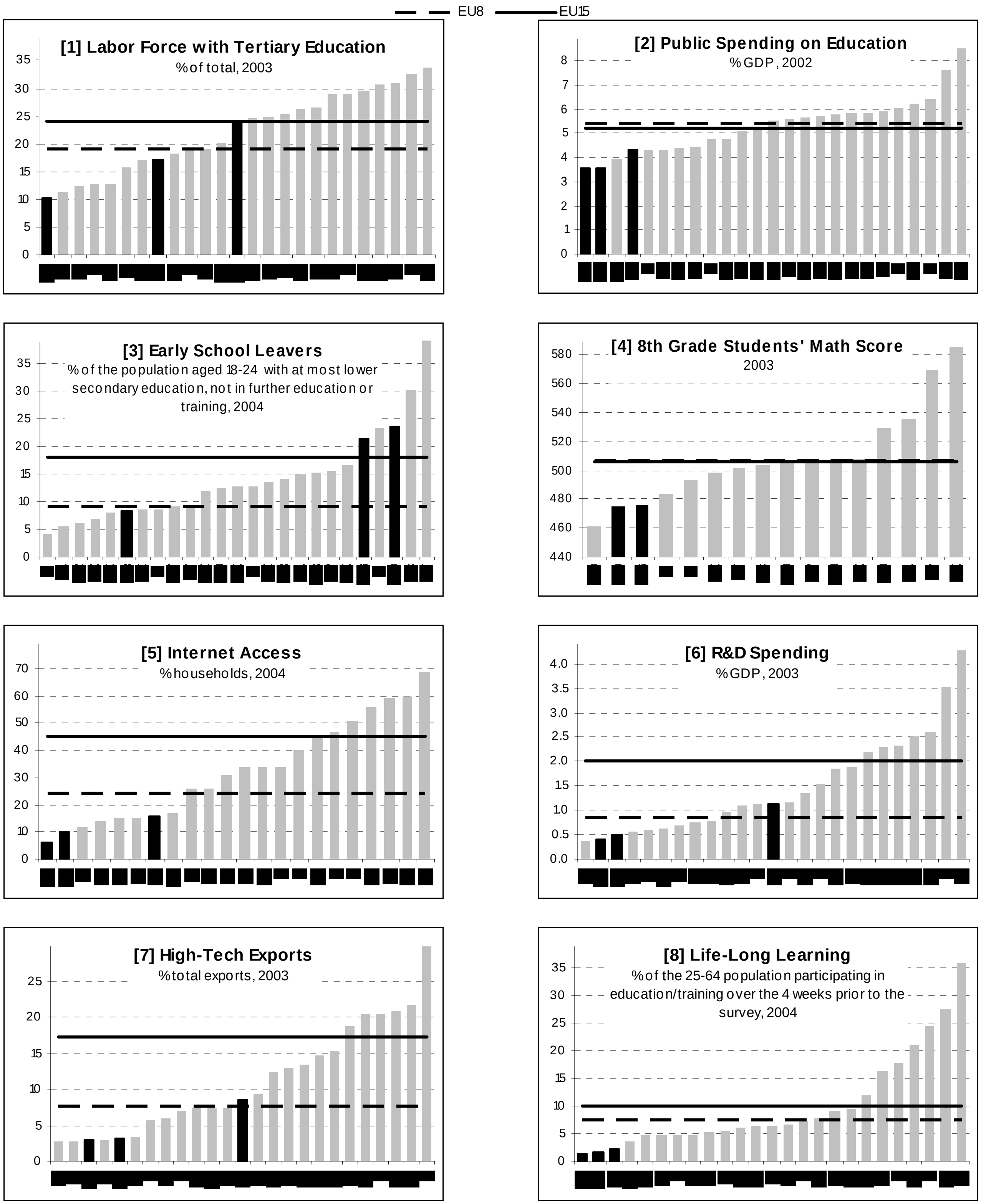
Source: Kaufmann D. et al. (2005).
Notes: Indicators (rescaled) range from 0 (worst) to 5 (best). 2.5 is world average.

Business environment



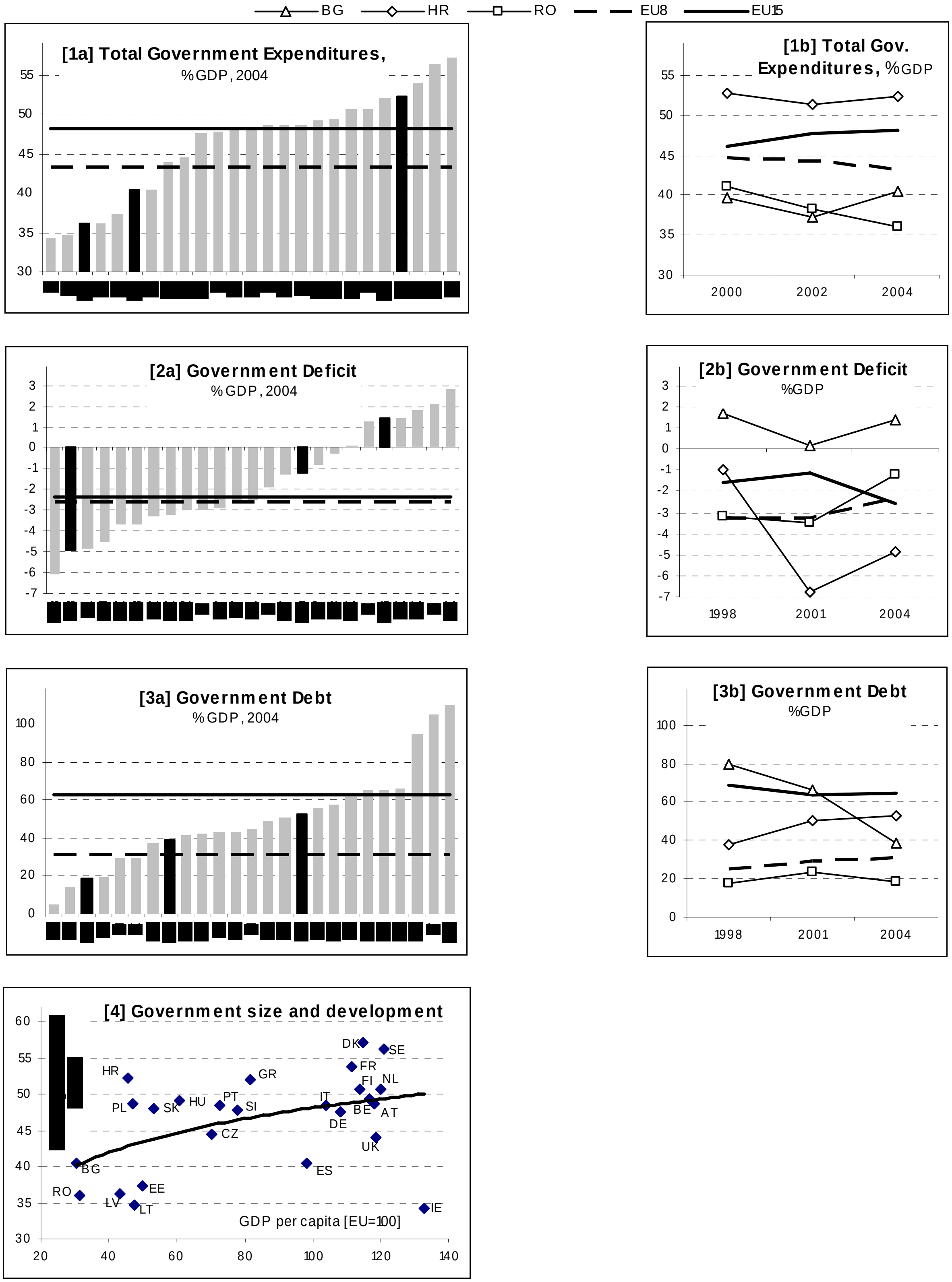
Sources: [1-4] World Bank Doing Business (2005); [5] EBRD 2004; [6] Eurostat 2005; [7] World Economic Forum, Growth Competitiveness Index rankings 2004-05.

Knowledge based economy



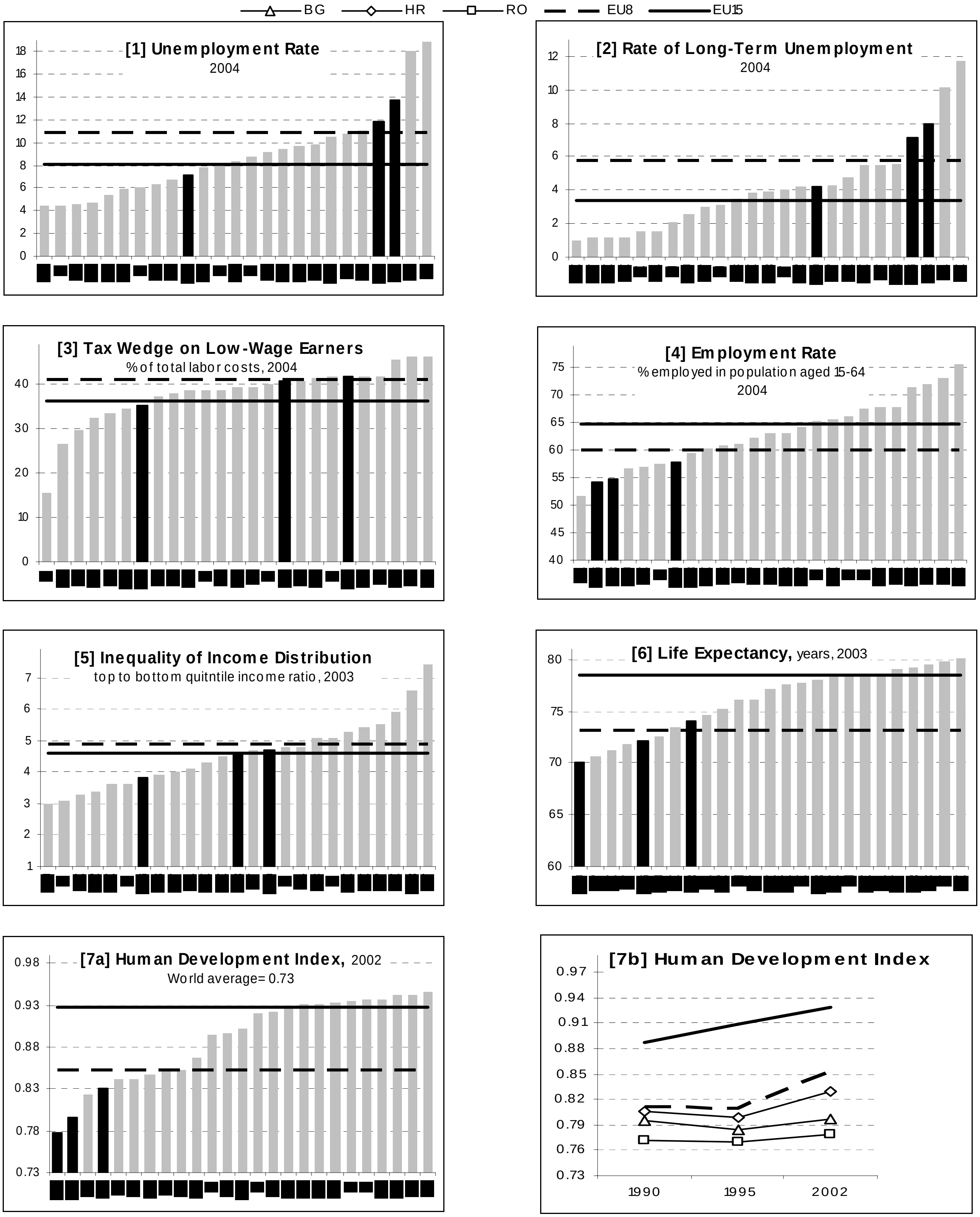
Sources: [1-3,5-8] Eurostat 2005; [4] TIMSS NCES 2003; *Notes*: [1] NL: 2002; FR, HR 2001, from WDI 2004; [3] HR, NL: 2003; [5] CZ, NL: 2003; HR, RO: est. from WDI 2004; [6] AT: 2004, HR, IT, UK: 2002, NL, SE:2001; [7] HR: est. from WDI 2004; [8] HR: 2003.

Public sector



Sources: [1a-4] Eurostat 2005; *Notes:*[1,1a] HR: EBRD, 2004: est; PL, RO, BG 2004: est; [2,2a] HR 1998,2002: EBRD; BG RO HR 2004: recent news releases; [3,3a] HR 1998,2002: Gov, 2004 est. from EBRD; BG, RO 2004: est. from EC's Candidate Countries Economies Quarterly Apr/2005;

Labor market and social indicators



Sources: [1-5] Eurostat 2005; [6] WDI 2004; [7] UNDP: HDR 2004. *Notes:* [1] HR : national sources; [2] HR: est.; [3] HR: 2003 est.; BG, LT, LV, RO, SI : 2003, EE : 2002 ; [5] most recent est., various years 2001-2003

C. Special Topics

Justice in Transition: Reform Experience in Bulgaria, Croatia and Romania

Introduction

Starting in early 1990s, the countries of Central and Eastern Europe, as well as the countries of the former Soviet Union, attempted an unprecedented transformation from a command-administrative form of economic organization to a market-based form. This entailed fundamental changes in political, social and legal institutions. The institutions inherited from socialist administrative system gave officials undue discretionary powers, were inefficient, inconsistent, and lacked transparency and accountability, and were thus poorly adapted to the needs of a market economy. In line with these broad trends judicial reforms were needed to transform the legal systems from ones geared to the passive and mechanical implementation of autocratic rule and a command-based economy, to systems that provide the basis for the rule of law and a free-market economy.

The three countries analyzed in this note – Bulgaria, Croatia and Romania – share some common features with the other countries in the Central and Eastern Europe which have all gone through similar processes of economic and legal transition. The common features include weaknesses in the general governance system, widespread corruption, court systems historically subordinated to party policy and subject to discretionary interventions, and an extraordinary volume and pace of legislative change with resultant inconsistencies and deficiencies.

From the end of World War II, 45 years of communist government left a deep imprint on the status and organization of judiciary in all three countries. Common features of the legal environment included political pressures on judges, a clear duty for judges to implement party and state policies (the concept of "unity of power", as opposed to the separation of powers doctrine), and a marginal role of courts in adjudicating disputes between economic actors.

At the same time, there were some differences in political and historical circumstances. In particular, variations in the role of private ownership and the scope of citizens' individual freedoms, gave rise to differences in the role and status of judiciaries in the three countries. For example, in Croatia, the destructive impact that communist party and the state had upon legal profession was somewhat less than in other socialist countries. With exception of a few "revolutionary" post-war years, the majority of courts and judges continued to perform their functions in a relatively professional fashion. There were two, parallel, systems of conflict resolution: one, informal, at the party level, tended to prevent and resolve every significant dispute by "political consultations"; the other, the court system, was primarily dedicated to less significant matters, such as small claims, protection of possession, and land-related issues. The introduction of the doctrine of economic self-management allowed limited market competition among "self-managed" companies. Other reforms enabled limited private ownership in agriculture and formation of small family businesses – and, consequently, legal expertise had some meaning and importance in these areas.[6]

[6] Uzelac, Role and Status of Judges in Croatia

Romania, on the other hand, suffered under a brutal autocratic regime led by President Ceausescu until December 1989. Ceausescu used a vast secret police force (the Securitate) to suppress individual rights and freedoms, and the courts were powerless instruments of the state machinery. Romania embarked on ambitious judicial reform in 2000, but despite constitutional and legislative provisions declaring the judiciary an independent branch, there remains a deep mistrust of courts among the public.

The EU Accession process.

As in other countries of Eastern and Central Europe, judicial reforms in Croatia, Bulgaria and Romania began in the early 1990s and included new democratic constitutions proclaiming the independence of the judiciary as a separate branch of government. The courts began embracing new concepts of private ownership, market competition and commercial freedom. Following this was a second wave of institutional reforms in the judiciaries. These changes are still underway and are closely linked with the EU accession process.

Both Bulgaria and Romania signed Accession Treaty with the EU on April 25, 2005. Croatia received a candidate status in June 2004, and is about to open the negotiations process with EU. For Romania, the Justice and Home Affairs chapter (JAI) was the last chapter to be agreed upon following two years and seven months of difficult negotiations. However, until 2007, when the entry date is set, Romania is obliged to meet 11 specific commitments regarding the reforms that must be accomplished, seven of which relate to the Justice and Home Affairs Chapter. Weak institutional safeguards for judicial independence and corruption remain the main concerns of the EU monitors with respect to Romania.

Although Bulgaria closed the JAI negotiations two years earlier than Romania, the EU is still highly critical of Bulgaria's pre-trial practices and procedures, an perceives an insufficient focus on organized crime and weak capacity of courts. For both countries, the Commission introduced safeguard clauses in the Accession Treaty which would allow the Commission to postpone the date of accession by one year to January 2008, if certain remaining membership criteria commitments are not fully met[7]. Efforts to enhance judicial capacity and combat corruption will be most closely monitored.

For Croatia, judicial reform will also be a focal point for the negotiation process with EU. In its preliminary opinion on Croatia's application for membership, the Commission highlighted five issues, which would be central in the negotiations framework: (i) relations of Croatia with the ICTY; (ii) minority rights and the return of refugees; (iii) judicial reform; (iv) regional cooperation; and (v) the fight against corruption.[8]

The Commission's focus on judicial reforms in EU candidate countries intensified with the so-called Copenhagen criteria of membership adopted by the European Council in June 1993. These criteria set out a number of conditions for full EU membership, including the existence of institutions able to guarantee the rule of law. Although they are nowhere explicitly defined, the requirements of the rule of law were extensively discussed at the June 1997 Noordwijk

[7] Strategy Paper of the European Commission on progress in the enlargement process, SEC(2004) 1199, 1200, Brussels, October 6, 2004.
[8] Strategy Paper – Ib.

Conference and include concepts such as judicial independence, controls on law enforcement, the capacity to hold fair and quick trials and to implement judicial decisions, and legal aid provisions.

The Copenhagen criteria imply a high degree of separation of powers and the presence of an independent judiciary to safeguard citizens' rights. In addition, following the EU's increased focus on creating an "area of freedom, security and justice", the candidate countries in Central and Eastern Europe were required to prepare for full adoption and implementation of the EU *acquis communautaire* in the field of justice and home affairs upon accession.

In practical terms, these requirements have led to increasingly concerted efforts to boost **judicial independence and administrative capacity of courts.** These are essential prerequisites for the implementation of the entire *acquis*, and are a necessary counterpart to political and economic liberalization. Accordingly, the analysis presented below focuses on achievements of the three countries these two critical areas.

Independence and Accountability

Judicial independence is essential for the protection of individual rights, safeguarding the supremacy of law and ensuring against the arbitrary exercise of power. Courts are often called upon to decide whether another branch of government has exceeded the limits placed on its authority by constitutional or other law. In ruling on such issues, the courts provide a most important, if not the only, credible means of challenging the abuse of governmental authority.

In Bulgaria, Croatia and Romania, a legacy of subordination of the judiciary to state interests and to the party apparatus, and exploitation of the judiciary by the state as an official device to validate such prerogatives, continues to cloud how judges and court systems are perceived. This legacy is particularly strong in Bulgaria and Romania where public distrust in, and contempt for the judiciary is still high.

The degree of independence of the judiciary from the political authorities is traditionally assessed by: (i) the ways in which judges are appointed, transferred, promoted or dismissed; (ii) the degree of judicial self-governance; and (iii) the degree of budgetary autonomy.

(a) Appointment/removal and disciplinary process

In all three countries the legislative framework for judicial appointments and dismissals, as well as judges' tenure and scope of immunity are considered to be adequate and essentially meet international standards. However, implementation of legal rules in practice is often inadequate, and the appointment process is still open to political influence (primarily through the role of the Ministry of Justice), and it may be compromised by vague and poorly defined professional criteria.

The table below summarizes the main elements of judicial appointment process, tenure and immunity for judges in Bulgaria, Croatia and Romania.

Bulgaria and Romania have recently carried out significant reforms in the process of judicial appointments in an attempt to address the criticism from EU and domestic constituencies about the excessive influence of the executive in the appointment process.

Table 1: Judicial appointments and dismissal, tenure, immunity

Countries	Body responsible for recruitment	Body responsible for disciplinary proceedings	Tenure	Judicial immunity
Bulgaria	Supreme Judicial Council (SJC)	Supreme Judicial Council	Life tenure until retirement age of 63 for men and 60 for women 3-year trail period	Functional immunity can only be lifted by SJC
Croatia	State Judicial Council (SJC)	State Judicial Council The Minister of Justice can initiate disc. proceedings	Life tenure, until retirement age of 70 5-year trial period for judges appoint. for the 1st time	Functional immunity can only be lifted by SJC
Romania	Superior Council of Magistracy (SCM)	Superior Council of Magistracy	Life tenure, until retirement age of 68 2-year trial period	Functional immunity Can only be lifted by SCM

In Romania, appointment of judges has by law been entrusted to the Supreme Council of Magistracy since 1994. However, in practice the Ministry of Justice played a significant role in the appointment, promotion and removal of judges from the bench. This has been changed with the new Law on Judicial Organization and the Law on the SCM, both adopted in summer 2004. According to the Law on SCM, matters of judges' careers, including examination, appointment, promotion and removal are within the authority of the SCM. Although the Minister of Justice remains an ex-officio member of the Council, the Minister is no longer able to influence decisions on judicial appointments. Judges have to take an exam and undergo 2-year mandatory training in order to join the bench.

In Croatia, judges are appointed by the State Judicial Council on the basis of opinions received from the judicial councils which are formed in each court. The Ministry of Justice examines whether the candidates comply with the formal requirements, while the relevant parliamentary committee and the president of the relevant court can also express their opinions. As regards the selection of candidate judges, no competitions are organized. The Ministry of Justice appoints court presidents.

In Bulgaria, the Supreme Judicial Council (SJC) appoints, promotes and dismisses from duty all judges, prosecutors and investigators. The recent amendments to the Judicial System Act[9] require open competitions for judges which are also administered by the SJC.

In sum, all three countries have introduced new procedures for selecting and promoting judges in an attempt to align them with international standards. Admission to the profession and subsequent promotion are based on legally defined minimum requirements and procedural rules of various degrees of specificity. Despite these clear improvements, there are still several issues that need to be addressed, including improved judicial examination processes, elimination of categories of legal professionals that can become judges without a transparent examination process (a

[9] Judicial System Act, State gazette, No. 59, July 22, 1994, last amended State Gazette No. 74, July 30 2002.

particularly problematic area in Romania), and more transparency and publicity in the appointment process.

Length of Tenure

The length of time a judge serves once appointed has a significant impact on judicial independence. In most countries, the constitution or judicial laws grant judges life tenure and protection against reduction of compensation in an effort to provide as much independence as possible.

In all three countries, judges enjoy life tenure limited by a retirement age only: in Bulgaria – 63 years for men, and 60 years for women, in Croatia – 70 years, and in Romania – 65 years for men, 60 for women (68 with the SCM's approval). Judges appointed for the first time normally serve a probationary period: 5 years in Croatia, 3 years in Bulgaria, and 2 years (or one year if a National Institute of Magistracy' candidate) in Romania.

Life tenure, however, has certain costs. Inevitably, there are judges who will abuse the privilege. The efficient administration of justice depends critically on the competence and professionalism of magistrates, but this should not imply that no control of their work is possible. Once judicial independence is ensured through constitutional, legislative and institutional measures, the issues of accountability of judges should get equal priority.

(b) The role and status of Judicial Councils

Although perhaps less obvious, judicial independence is also affected by the manner in which judicial systems are administered or governed, and the institutional context in which they operate. The separation of powers forms the foundation for democratic government and an independent judiciary, but the independence of judges is not guaranteed solely by what is set forth in the constitution. Among the institutional elements that work in tandem with the constitutional provisions to guarantee judicial independence is a self-governing framework by which the judiciary can define and administer its own financial and administrative needs.

Judicial councils have become familiar components of the judicial reform process in Eastern and Central Europe over the last two decades. Originating in Western Europe in the postwar period, the idea took hold in a number of the countries undergoing democratic reforms. Judicial councils in the countries of Eastern and Central Europe can be divided in three broad groups[10]

The first is the independent model, with examples in Hungary and Lithuania. Here Judicial Councils are policy-setting, representative and decision-making institutions. They approve draft budgets for courts, they provide a regulatory framework for court operations, they supervise court activities, they decide on matters related to judicial selection and careers, and they participate in disciplining judges. Independent national offices for court administration service the Councils by providing research, analysis and preparation of decisions and implementation of Councils' decisions, and they are responsible for the day-to-day operations of courts.

The second model is the intermediate or power-sharing system as found in Bulgaria, Estonia, Poland, Romania, Slovakia and Slovenia. Although the precise form of judicial organization in

[10] Monitoring the EU Accession Process – Judicial Capacity, 2002 pp.42-44.

these States varies significantly, in all of them the governing and administrative powers over the judiciary are to a certain degree shared between an autonomous Judicial Council and another body, usually the Minister of Justice. Judicial Councils generally have significant responsibility for personnel decisions such as judicial selection, promotion and discipline. Increasingly, Councils also give their consent or issue advisory opinions on matters such as draft budgets and draft legal acts relevant to the operation of the judiciary. However, the Ministries of Justice retain major or exclusive powers related to policy-making, the budget process and court administration.

The third model is the executive-centered model such as found in Czech Republic and Latvia. In this model the judiciary is not treated as a separate entity, but rather as an agency subordinated to the Ministry of Justice. The Ministry develops and supervises the policy of the judicial system and exercises governing, representative and administrative powers over it, with the exception of the self-governing Supreme Courts. Ministerial powers include drafting the budget for the judiciary, allocation of funds, determination of the numbers of judges and court personnel, selection and disciplining of judges, appointment and dismissal of court presidents, and the setting of standards such as caseload norms. Typically, the Ministry also exercises broad monitoring powers with regard to the organization and functioning of courts and judges.

In both Bulgaria and Romania, Judicial Councils include representatives of both judges and prosecutors, and in Bulgaria – also investigators. This practice stems from the legal concept of a *magistracy* inherited by these countries from their Southern neighbors – Italy and France – where judges and prosecutors (and in Bulgaria – investigators) are collectively referred to as magistrates. [11] In both countries, the presence of both judges and prosecutors in the judicial council has been a subject of heated debate among professionals of these countries, and has been frequently criticized by outside observers, particularly the EU monitors.[12]

In Romania, during discussions of the draft amendments to the Constitution in the summer of 2003, many legal practitioners, including the Romanian Association of Judges, insisted on separating prosecutors from judges, particularly in the structure of the judicial council. However, the Council preserved its name as the Superior Council of Magistracy and continues to include judges and prosecutors, as well as the President of the High Court of Cassation and the Prosecutor General.[13]

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[11] The concept of magistracy implies, among other things, that judges and prosecutors are recruited through a similar process and can move from one position to the other even recurrently in the course of their career.
[12] Monitoring the EU Accession – Ib., p. 44.
[13] The institutional framework of a democratically oriented government characteristically provides for law enforcement and prosecutorial functions within the executive arm under a Ministry of Justice or equivalent. To sustain tension between judge and prosecutor, judicial functions ideally are located in a separate branch or framework that is neither substantively nor administratively aligned with the prosecutorial and enforcement functions; nor is the judicial function supported by them. Some argue that this separation of powers model of effective democratic government is but one of several models and not necessarily the most desirable. These commentators suggest that, in the interest of efficiency, having a justice ministry exercise administrative oversight over the judicial and prosecutorial functions of the government is both logical and sensible and that such an arrangement neither violates nor undermines the objective of an independent judiciary. Indeed, in the continental civil law tradition, this is and accepted model.

This model also is a common model in the emerging democracies of Central and Eastern Europe, where, to varying degrees, justice ministries are tasked with the organizational functions of prosecution, to uphold the law and protect the interests of the government, and adjudication of disputes through analysis and interpretation of the law.

Table 2: Structure of Judicial Councils

	Name of the council	No. of Members	Composition	Role of MOJ	Term of appointment
Bulgaria	Supreme Judicial Council	25	--3 ex-officio (President of the Supreme Court, Pres. of Administrative Court, Prosecutor General); -- 6 judges -- 3 prosecutors -- 2 investigators -- 11 members elected by the parliament	Minister of Justice chairs SJC session, but does not have voting rights	7 years for ex-officio members; 5 years for other members
Croatia	State Judicial Council	11	--7 judges -- 2 legal professionals (attorney) --2 law professors	None	4-year term for all members
Romania	Superior Council of Magistracy	19	-- 3 ex-officio (Min.of Justice, President of the High Court and Attorney General); -- 9 judges -- 5 prosecutors -- 2 civil society representatives	Ex-officio member of the SCM; can participate in some sessions with the right to vote (but not for disciplinary proceedings)	6-year term for all members

Unlike Bulgaria or Romania, the Judicial Council in Croatia (called State Judicial Council) emerged as a powerful body almost right from its establishment (in 1995), but it proved to be very politicized and conservative, and gradually has lost some of its attributions and power. According to the 1991 Constitution, the Council was conceived as the guarantor of the autonomy of the judicial profession. However, five years later it has became an instrument of political intervention by the ruling party and one of the principal generators of the crisis in the judiciary. The SJC became a lever in the hands of the executive power during Franjo Tudjman rule. (Uzelac[14]).

According to the constitutional provisions, the majority of the Council was to consist of judges (8 out of 15); a second category were to be state attorneys (4 members); and members of other professions (law professors and lawyers) were in extreme minority (3 members). The 8-year mandates in the Council were given almost exclusively to presidents of the courts and the chief attorneys, who were willing to implement the administrative commands of other government bodies. The Council started its activities in early 1995, and was given a broad mandate to re-appoint all the judges throughout the country. Those who were not appointed lost their jobs.

The Council was also given the right to dismiss judges according to simplified interim procedures (which were abused). The process was conducted in a highly arbitrary and politicized way. Many dismissals have been appealed to the Constitutional Court, and in 2000 constitutional

[14] Uzelac, Reform of the Judiciary in Croatia and its limitations

amendments[15] were initiated to limit the power of SJC with regard to judicial appointments. Despite some suggestions that the Council be abolished, the SJC has been retained as the central body of judicial self-management. The process of appointment of the Council's members has been changed. Two key changes aimed at limiting political interventions. First, state attorneys were no longer to be members of the SJC (for them, another body was provided for by the constitution, the Council of State Attorneys). Thereby, the number of SJC members was decreased from 15 to 11, members being judges, lawyers and university professors. Secondly, court presidents were to be excluded from the membership on the SJC.

Another consequence of reforming the role of the SJC during the reforms in 2000 was the establishment of judicial councils at the level of courts which have assumed some administrative responsibilities.

Conclusion: Strong judicial councils were established in Bulgaria and Romania with extended powers and attributions provided by law, but weak administrative capacity. In Croatia court administration is still exclusively under the jurisdiction of the Ministry of Justice. The Judicial Council's power is limited to appointment, disciplining procedures and removal of judges, but not court presidents (executive-centered model).

(c) Budgetary autonomy

The institutional independence of judiciary is closely linked to its role in the budget formulation and management process. In most transition countries of Central and Eastern Europe, progress achieved by judiciaries in moving towards administrative autonomy is limited by restrictions on judges' participation in the budgetary process.

Judicial systems are not self-sustaining and their operating costs must be funded by sources under the control of elected representatives of the people (legislature) to ensure accountability. Such judicial subordination is more deeply entrenched when an additional layer of authority and control is imposed. The most common example of this is when the Ministry of Justice has authority over, and responsibility for, the judiciary's budget. This responsibility usually takes two forms: (i) the Ministry of Justice has a leading role in formulating draft budget for the judiciary and submitting it to the parliament for approval; and (ii) once the funding level is approved by the parliament, distribution and control of this funding is controlled by the ministry. In most transition countries, the focus of reform efforts has been less on reversing the roles of the judiciary and MOJ in the budgetary process and more on broadening the role of judiciary in formulating budget proposals and managing the approved budgets.

Bulgaria has adopted a model which gives the broadest role in the budgetary process to the judiciary, as represented by the Supreme Judicial Council. According to the latest amendments of the Judicial System Act (art. 27, 2003 -?), SJC submits the draft budget of the judiciary to the Council of Ministers and oversees its implementation. Both the Supreme Judicial Council and the National Institute of Justice have their own budgets[16].

[15] Although their original objectives lay elsewhere (limiting the possibility of the President of the Republic of Croatia exercising autocratic power and the introduction of the parliamentarian system of governance), the constitutional changes did not circumvent the judiciary.

[16] Among EU8 countries, only Hungary and Lithuania have transferred budgetary responsibility from the Ministry of Justice to the judicial system.

In Romania, the judiciary failed to obtain similar budgetary responsibility under the new organic laws on the judicial system adopted in 2004, and the Ministry of Justice has kept the right to formulate the budget for the court system and to submit it for parliamentary approval. Furthermore, the Ministry remains primarily responsible for allocating budgetary resources within the court system and monitoring implementation. However, important changes that have been introduced by the new Law on Judicial Organization include: (i) the obligation of the Ministry for Justice to consult with the SCM on the budgetary draft and obtain its consent; (ii) the right of the SCM to manage its own budget and the budget of the National Institute of Magistracy and the National School of Clerks which are subordinated to the SCM[17].

In Croatia, budgetary planning and management are firmly entrusted to the Ministry of Justice, except for the Supreme Court which manages its own budget. Court presidents have limited authority over reallocation of approved budgetary funds, and each change has to be approved by the Ministry. Although some court presidents have expressed concerns over their limited role in budget management, their resistance has been much less strong than in Romania due in part to the fact that judges' salaries, as well as the overall budget for courts, have been raised several times in the past five years.

Table 3: Public expenditure on courts and legal aid, per inhabitant (in Euro)[18]

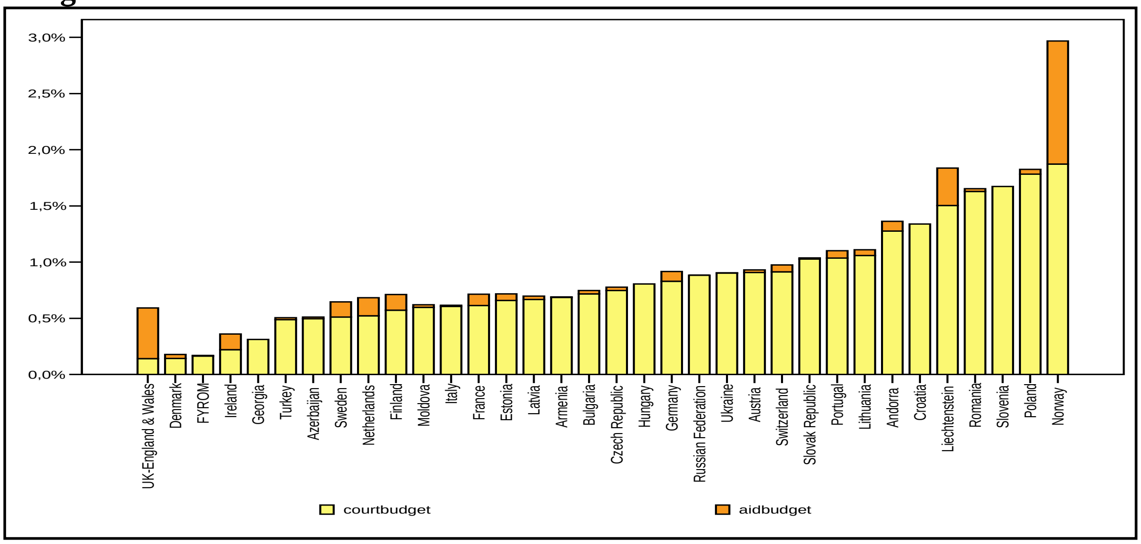
	Court budget per inhabitant (euro)	Legal aid budget per inhabitant
Austria	69.63	1.67
Belgium	64.41	3.90
Bulgaria	**3.53**	**0.14**
Croatia	**30.43**	**included in court budget**
Czech Republic	21.02	0.84
Denmark	29.80	7.25
Estonia	12.24	1.09
Finland	41.05	9.98
France	28.35	4.64
Hungary	27.00	not reported
Iceland	32.39	3.56
Ireland	22.21	13.96
Italy	45.98	0.78
Latvia	6.70	0.30
Lithuania	9.63	0.46
Netherlands	41.01	12.66
Norway	39.33	18.03
Poland	17.33	0.43
Portugal	46.98	2.94
Romania	**5.40**	**0.08**
Slovak	11.24	0.11
Slovenia	51.42	not reported
Spain	23.52	not reported
Sweden	44.44	11.59
Switzerland	102.66	7.00

[17] There was a recent proposal to transfer budgetary responsibility for courts to the High Court of Cassation and Justice.
[18] Sources: CEPEJ Report European Judicial Systems 2002, Strasbourg, CEPEJ (2004)30, December 10, 2004

The above table presents an overview of court budgets in selected countries, including Bulgaria, Croatia and Romania. It clearly shows a wide gap between the level of courts financing in Bulgaria and Romania, on one hand, and the other European countries, including the EU8 countries on the other hand. The level of funding in Croatia is quite similar to Denmark, France, Hungary, Ireland, and Spain.

The Table below shows that the share of court's financing in the overall budget is higher in Croatia and Romania than in many of the countries of eastern and Western Europe:

Table 4: Public expenditure on courts and legal aid as a percentage of the national budget[19]



It is widely accepted that to validate its status as an independent arm of government, the judicial branch should represent itself and communicate its resource requirements directly to the legislative arm (not through the Ministry of Justice), and that it should play a leading role in the allocation of budgetary resources within the court system, and in implementation of the budget. In practice, however, a more pressing need is to develop a coherent methodology and standards for budget formulation and implementation.

In Bulgaria and Romania, and to a lesser extent in Croatia, the courts were chronically under-funded during the socialist regimes. Minimal funds were allocated for maintenance and rehabilitation costs of court buildings, utility bills, salaries for judges and court personnel and office supplies. It is not surprising, therefore, that even at the Ministry of Justice, the administrative staff dealing with court budgets lacked experience in economic management and budget planning. Such practical expertise is still lacking in recently established judicial councils and other self-governing bodies.

The judiciary must demonstrate that it is capable of managing its financial affairs and doing so in compliance with established standards. This would require the judiciaries to develop their own cadres of appropriately trained and experienced financial, accounting, statistical, planning, and budget specialists, administrators, and mangers to ensure that funds allocated to the judiciary are utilized according to the procurement and other regulations set forth by the government. Working

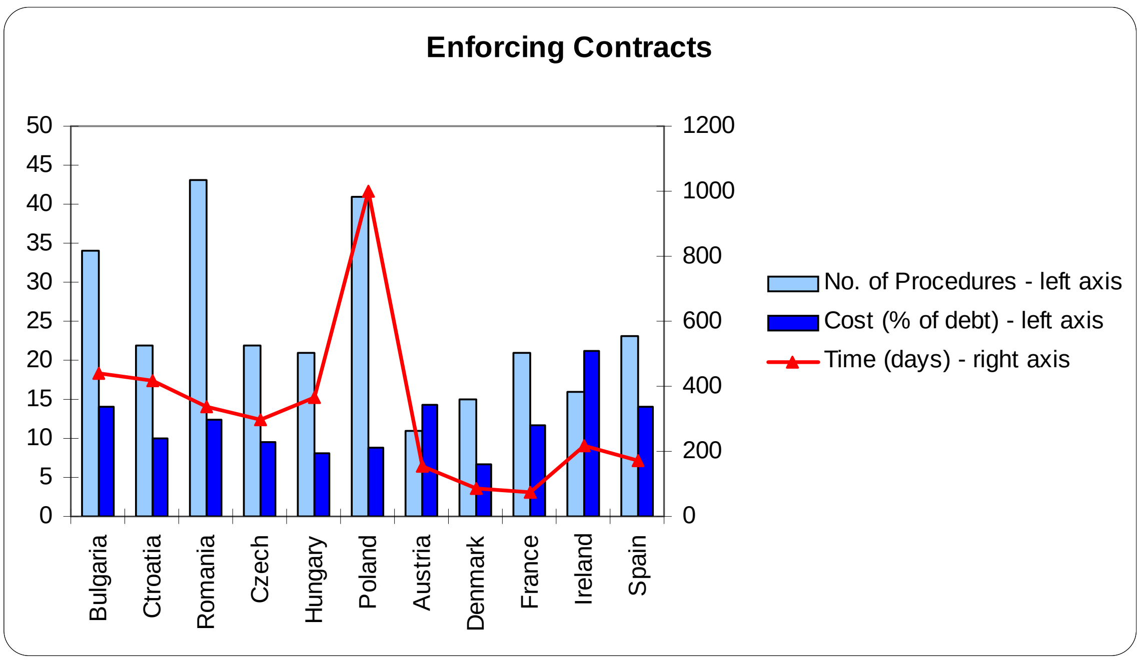
[19] Source: Ib.

together, these specialists should develop a formula that relates caseload to work units on the basis of statistically verified models of what is required to complete the hierarchy of tasks essential to court operations. By basing budgetary requests on quantifiable and validated standards and formulas, the judiciary will establish the credibility and legitimacy of its budgetary submissions.

Court Efficiency

Like most transition countries, Bulgaria, Croatia and Romania have all been struggling with increased caseloads that are swamping their court systems. Croatia appears to be facing the worst situation. It registered a case backlog of over 2.0 million in 2002; a huge figure for a country with a population just 4.5 million. In Romania, the courts have been criticized as well, particularly by business community, for excessively lengthy proceedings. In Bulgaria, the length of criminal proceedings has been a cause for concern, and a number of complaints have been filed with the European Court of Justice.

Table 5



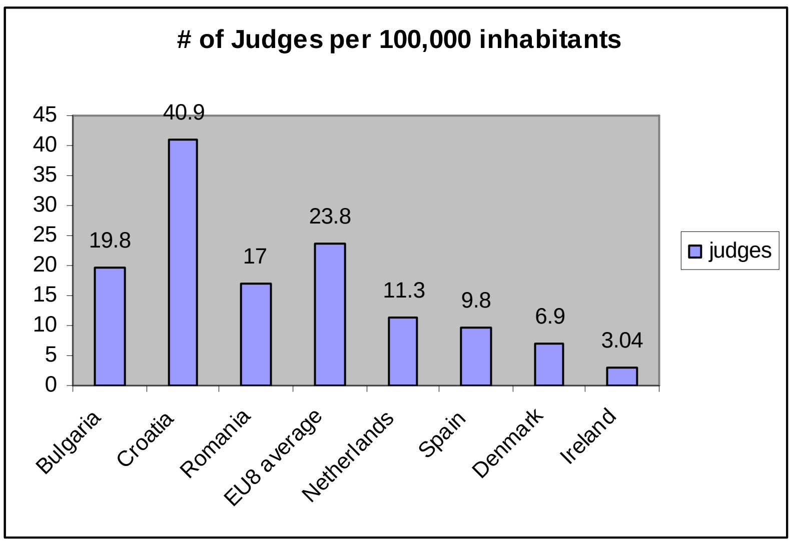
There are some common underlying causes of the case backlogs in all three countries. First, an initial explosion of cases dates back to early 90s, particularly, in civil and commercial area and has its roots in the economic and political changes including fundamental changes in ownership systems and transition to a market economy. These generated a large number of disputes about property rights and restitution, privatization, bankruptcy, land issues and damage compensation. Despite increasing demands on the court system, the courts remained under-funded, poorly managed through a hierarchical system of ministries of justice and they lost their best legal professionals to more competitive private sector jobs. The focus of the reformist governments was on re-writing laws and constitutions and redistributing powers in economic and political spheres. Realization that economic growth and development of the private sector are constrained by the lack of an independent, impartial and efficiently functioning court system came later and was particularly re-enforced by the EU accession agenda.

(a) Case loads, length of court proceedings

During the last three years, the reforms conducted in all three countries have attempted to stabilize the judicial environment and to increase the efficiency of courts. The Governments have strongly committed themselves to coping with the problem of backlogs and delays. However, the results are still modest, and the number of new cases still outstrips the number of cases completed.

In Croatia, the number of judges is relatively high, but at the same time judges have to cope with a lot of non-judicial tasks, like land registration, company registration, enforcement of judgments and observation of elections. Furthermore, the number of court support personnel is relatively low, which also explains the fact that judges spend on average 30 percent of their time on non-adjudication tasks which could be handled by trained personnel. The most significant reform carried out in Croatia in the past two years was re-assignment of responsibility for land title registration from judges to court clerks (registrars)[20]. As a result, statistics for land cases dramatically improved even during the first six months of the implementation of the new procedures.

Table 5: Number of judges



By the end of 2004, municipal courts had increased efficiency in resolving land registry cases by 26.5 percent (100,000 cases more than in 2003) and also the entire annual inflow of cases is being resolved. The backlog of cases has decreased by 35,000 land registry cases at the national level, and the annual inflow of cases increased by 16.52 percent.

In Bulgaria, a reform is underway which will transfer company registration from judges, thus relieving them of significant burden.

[20] Based on the amendment to the Land Registration Law, enacted in July 2004, court registrars have assumed responsibility for registering land titles and transactions. Registrars undergo mandatory training and certification, and judges conduct a limited supervision of their work.

In addition to the introduction of specific measures aimed at reducing court delays, policy makers in these countries realize that greater efficiency gains have to be achieved through a more systemic approach.

In Romania, the Government has initiated a comprehensive review of its court system with the goal of rationalizing the size and location of courts within the country, achieving a more even distribution of workloads and establishing rational allocation of resources throughout the system. Recent quantitative analysis of the judicial system suggests that inappropriate policy solutions have been followed for years: i.e. policies calling for increases in numbers of judges, judicial units and financial resources in response to growing litigation demand and increasing caseloads. The study argues that the overall number of judges might be sufficient for Romania, given its size and population and, in fact, some courts should be closed. Resources should be increased for those courts which service areas with large population and have the highest caseloads. The number of court personnel should be increased and they should relieve judges from mundane tasks, freeing their time for court proceedings.

A similar imbalance exists in Croatia, where the number of judges per inhabitant is one of the highest in Europe. The Government is presently conducting a similar analysis of the structure of the court system, and some preliminary recommendations call for significant reduction of small courts, cuts in the number of county courts (courts of the second instance) of almost 50 percent, and restructuring of misdemeanor courts.

(b) Specialization of courts

The issue of specialization within the court system has been on the agenda of the reformers in all three countries. The introduction of specialized judges or specialized courts is often seen as a remedy for the low quality of judicial decisions and low professional level of judges.

In Romania consistent criticism of poor quality of judgments issued by lower courts has led to suggestions for establishment of specialized courts for different types of cases – including fiscal and administrative, labor, juvenile and family and commercial. Judges in those courts would receive more in-depth training in subjects which would enable them to handle these types of cases more effectively. The new Law on Judicial Organization of 2004 provided for the establishment of four types of specialized courts which should become operational by January 1, 2008. The original plan was to establish 4 specialized tribunals in each county (Romania has 46 counties): one for commercial matters; one for juvenile and family matters; one for labor and social insurance; and one of administrative-fiscal cases. This would result in 168 in specialized tribunals by 2008. However, these plans are impractical because of a lack of public buildings to house courts, shortages of qualified judges and personnel, and financial requirements that cannot be met from the budget. Consequently policy makers have had to re-assess the idea of establishment of so many specialized courts at once. Statistical analysis carried out as part of the court rationalization study showed that establishment of specialized tribunals for commercial cases would be justified only in 21 (out of 46) countries, and specialized labor tribunals in only 4 counties. No county has enough family or administrative cases to validate the establishment of specialized tribunals in these areas. Instead, the decision was made to establish specialized panels of judges in those courts where there is a justifiable demand for certain types of cases, and to do more analysis on the needs for future specialized courts.

In Bulgaria, a decision was made to expand the network of administrative courts in the country. Until now, only one Supreme Administrative Court exists in Bulgaria, and the new Administrative Procedural Code calls for establishment of additional [12] administrative courts.

(c) Court management

The concept of court management is relatively new to all three countries, and is a fairly new phenomenon in Western Europe as well. It started with the establishment of Court Administration Authorities in countries that traditionally relied on the Ministry of Justice for conducting management and budgeting of courts and the judiciary as a whole. This development began in Scandinavian countries, Sweden as well as Denmark (1999), and proceeded from civil-law to common-law jurisdictions, Ireland first (1998), and then to the United Kingdom.[21] These trends in the structure of European court administration have made possible the emergence of a new group of professional court administrators in Europe.

Romania has introduced the position of court manager (or economic manager) through the new Law on Judicial Organization of 2004. The expectation of the policy makers was that that this would bring more professionalism to management of courts, would relieve judges and court presidents of burdensome administrative tasks and equip the judiciary with qualified experts who understand financial and personnel management, modern case flow management and strategic planning, and the importance of communication strategies.

However, implementation of these legal provisions has been delayed and is still facing serious difficulties. There is no clear concept of what responsibilities court managers should assume and how they would relate to court presidents and other court personnel. There is no experience on how to recruit and train court managers and what roles the Ministry of Justice and the Superior Council of Magistracy should play in defining a general framework for court managers. This is obviously an area where external assistance and institution building programs of donors could provide great benefit.

In Bulgaria and Croatia, there is also an increasing focus on the new system of court management. In Croatia, there are serious efforts to introduce modern IT support for better case management, but reforms in court administration (e.g. introduction of court managers, management role of court presidents, etc.) has not advanced equally. Similarly in Bulgaria, significant investments have been made in court automation, but changes in human resource policies have not followed.

Conclusions

The judicial systems in all three countries underwent serious structural changes during the past decade. These changes have resulted in a number of constitutional and legislative amendments, which provide a reasonably adequate framework for independent judiciaries. However, in addition to some further legal adjustments, implementation will remain a long-term task, if only because installing a properly functioning judiciary in the context of post-communist transition implies a social and cultural shift alongside technical changes. In addition, once Bulgaria, Croatia

[21] Voermans, Wim. Councils for the Judiciary in EU countries. European Commission/TAEX Tilburg University/Schoordijk Institute, June 1999.

and Romania join the EU, they will face the task of adapting to the EU's own evolving standards and the increasing volume of JHA cooperation within the Union.

In the immediate future, the focus should be on improved court administrative capacity, establishing more competent management, rationalizing the court systems, improving budgetary mechanisms and improving the public image of the judiciaries.

Lastly, continuing reforms require stronger systemic policies and analysis. Plans at the political level should be developed with continuous participation of experts and the wider public. A more rational approach to the efficiency of the court system would require a thorough re-defining of the criteria for monitoring judicial performance, and especially collecting and analyzing court statistics.

Pension Systems in Transition

Pensions and EU accession

Romania, Bulgaria and Croatia are committed to EU accession, and are seeking to make the institutional and economic adjustments necessary to achieve this goal. In many instances this means adopting new legislation and creating institutions that conform to specific requirements as laid out in the Acquis Communautaire negotiated with the EC. However, except for some minor items relating to the portability of occupational pension funds, the Acquis is largely silent on pensions. Moreover, there is no single "right" pension system and practices in fact vary considerably across existing EU member states. This does not mean pension reform is irrelevant to these countries' accession aspirations. It is crucial. Pension reform is first and foremost to ensure that workers do not fall into poverty and have adequate income during old age. However, pension reforms are required to address the fiscal issues that threaten the sustainability of the pension system. Without proper reforms, the pension system can create macroeconomic instability. Furthermore systems inherited from the pre-transition period entrench serious distortions in the labor market contributing the persistence of a large gray economy. This is not a solid foundation for establishing the convergence necessary for new members to integrate successfully into the Union.

Historical heritage.

All the three countries inherited similar mandatory PAYGO pensions systems that dominated the pensions market for the first years of transition. The same heritage affected all the other post communist countries included in the first wave of EU accession, however, the overall economic situation was better for most of them, and in most cases the structural reforms were launched earlier in transition and were implemented at an accelerated pace.

The older systems used to provide generous benefits with high replacement ratios to a wide range of pensioners (complete length of service, early retired, disability), plus several non-contributory benefits (sick leave, maternity leave, farmers). As the transition advanced, the PAYGO systems started suffering from various common and individual problems.

<u>Common Problems</u> .

- Sharp increase in the number of beneficiaries as a result of the aging population; (Bulgaria and Romania) and early retirement;
- Decline in economic growth (all three countries);
- Decrease of number contributors as a result of the high unemployment incidence and of the incidence of informal employment (all three countries);
- Increased number of disability pensioners;
- Poor revenue performance collection (all three countries);
- Weak institutional capacity of pension system administration.

Individual Problems:

- War (Croatia);
- Severe economic and banking crisis (Bulgaria);
- Generous, early retirement plans to compensate increasing unemployment (Bulgaria and Romania).

First Ten Years for Transition - Ad-hoc adjustments in the PAYGO systems.

The political sensitivity of pension reform prevented the approval of comprehensive reforms until the end of the first decade of transition. These reforms were only accepted when it was obvious that the ad-hoc measures introduced in the meantime had failed to produce sustainable results and the collapse of the public pillars became unavoidable.

Among the ad-hoc measures, the ones most frequently used were:
- Repeated increases in contribution rates (most aggressive in Romania, from 14.5% in 1990 to an average of 34% in 2000), with a negative impact on labor costs and on revenue collection;
- Various experiments in the benefit formulas (Croatia and Romania);
- Partial indexation of pension benefits and repeated ad-hoc increases granted to all beneficiaries (Bulgaria and Romania).

All these measures led to increased public pension fund deficits, worsening of dependency ratios, depreciation of net replacement rates, increased fiscal burden on employers, and an increase in pension expenditures as a share of GDP (Croatia, from 9.9% in 1990 to 13.5% in 2001 and Bulgaria from 8.4% in 1991 to 10.3% 1993). Romania’s pension expenditures remained fairly stable over the last years of transition (around 7% of GDP) although this meant declining replacement rates.

Comprehensive parametric reforms.

Although comprehensive multi-pillar[22] reform strategies were approved in the early phase of transition in Romania (1993 and 1997) and Bulgaria (1996 and 1998), the actual implementation of the reforms was delayed until April 2001 in Romania (for the first pillar) while in Bulgaria the time between the formulation of the strategy for a three-pillar system beginning and its actual implementation beginning in with 2000, was less than two years.

Croatia tried to cope with the hardship and delay caused by the War, embarking on a dynamic process of public pension reform complemented with particular restitution (reparatory) features. Following the approval of the Pensions Insurance Act (July 1998) setting the framework for the future multi-pillar pensions system, three other laws were approved subsequently in 1998 (the Restitution Law), 2000 (the Debt Repayment Law) and 2004 (new Pensions Insurance Act).

The main features of the first parametric reforms were more or less common to all three countries in terms of principles but with differences in timing and degree.

[22] Pillar 1 – public system
Pillar 2 – private mandatory
Pillar 3 – private voluntary

- A gradual increase of the retirement age from 55 to 60 for women and from 60 to 65 for men (Romania and Croatia) and form 60 to 63 for men in Bulgaria, with a faster increasing pace for Bulgaria and Croatia;
- A gradual increase in the minimum contribution period;
- A split of contributions between the employers and employees;
- New benefit formulas (adoption of the "German point formula", taking into account the entire work life, suddenly for Bulgaria and Romania and gradually for Croatia);
- A tightening the early retirement criteria for special work groups and occupations;
- Benefit indexation, using mixed wage-price indexation method;
- A better link between contributions and benefits by introducing ceilings on contributions (Romania);

Results of the first parametric reforms.

The short term results of the first parametric reforms were below initial expectations. The underlying reasons include the following:

- The gradual pace of implementation of the first parametric PAYGO reforms
- Introduction of the second private pension pillar
- Adoption of specific features not normally included as part of a pension package e.g. - restitution claims in Croatia, and retroactive recalculation of all pensions with new benefit formulas in Romania.

The 2004 net replacement rates (NRR) for state pensioners are 42% in Croatia (2004), 41.6% in Romania (2004) and 42% in Bulgaria (2004). These are actually higher than in some OECD countries. However, the dependency ratios (number of workers per pensioner) are still are very low (1.37 in Croatia-2004, 0.98 in Bulgaria-2002 and the worst of 0.96 in Romania-2004. It is this combination of moderate NRR and extreme dependency ratios obliges the state budgets to pay substantial subsidies to the public pension funds.

Although there has been some effort to lower the contribution rates, they continue to be high, which encourages tax evasion: Romania 31.5% (down from 34%), and Bulgaria 29% (down from 32%). Croatia had gone down to 20% in 2003 from 27% in 1993, but contributed to a higher deficit (4.7% of GDP) In fact there is compulsory coverage from the state budget for the pensions of special categories of beneficiaries, whose pensions are determined in separate laws (military, academia and veterans) which alone cost 3 percent of GDP)

Second round of PAYGO parametric reforms (2004).

A need for financially sustainable public pension systems as pre-requisites for the implementation of mandatory private pensions funds (second pillar), was perceived by all three countries. For this reason a second round of parametric reforms is currently being considered.

In 2004 Romania approved and launched the implementation of an Action Plan for the consolidation of its public pensions system. The main measures that will be implemented in the period to 2008 are the following:

- externalization of the short term and non-contributory benefits to other financing sources (farmer pensions and child raise allowances to the State Budget, and sick leave benefits to the Health Insurance Fund);
- faster increases in the retirement ages;
- equalization of the retirement ages for men and women;
- introduction of a new price indexation mechanism, to fully cover the inflation;
- diminishing the variation range of the pensions point value;
- recalculation of all current pensions using the new benefit formula approved in 2000 in order to restore the equity of the system for the pensioners retiring at different times;
- gradual decrease of the contribution rates

As agreed with the IMF, Romania followed, the Bulgarian and Croatian examples, and established (under the Ministry of Finance autonomy) a unified revenue collection agency for social contributions, aiming to improve the revenue collection performance.

The financial projections made in 2004 using the Bank's PROST model revealed that these actions are likely to improve the medium and long term financial sustainability and the predictability of the PAYGO system in Romania, *provided no other countermeasures are taken.* The PROST results show that the public pension fund deficit, including the future costs of transition to the second pillar, will be maintained at an affordable level of less that 1% of GDP, until 2008, with a potentially full consolidation over the next two decades.

Croatia amended in 2004 its Pensions Insurance Law with the stated objective of increasing the current replacement rates from 42% to 50% in 2005 and to 70% in later years, via:

- introduction of wage indexation instead of wage-price indexation;
- inclusion of the pension supplement in the amount of regular pension;
- one additional annual indexation increase based on the real GDP index increase (exceeding zero);
- calculation of "individual pensioner's debt" and its payment at a pace that could be sustained by the national economy.

Since then Croatia once again amended its pension legislation to address the fiscal impact of the 2004 changes. One of them is the return to the "Swiss indexation" which links pensions to the average of wage and price movements.

Some of the above mentioned measures may be seen as a reversal of the PAYGO system in Croatia (Holzmann and Hinz, 2005), that may lead to some increases in total pension expenditures. However it is estimated that they will remain in the vicinity of 13% of GDP until 2020.

Private pension pillars.

All the three countries embraced the multi-pillar reform approach, developing private pensions systems. Bulgaria and Croatia have already started implementing the second and third pillars, while Romania has proceeded more slowly and has begun by refining the legal framework for the 2nd and 3rd pillars in 2004 with a view to implementation at a later stage as financial market developments allow. It is important to consider that if the domestic capital markets are limited to government securities only and there is relatively little private equity, then contributions diverted from the public plan to the private accounts must end up being invested in treasury bills or other government debt anyway, and not much is accomplished.[23] The point is that the introduction of the second pillar needs to be done when private markets are ready and at a pace they can cope with.

The mandatory funded pillars became operational beginning in January 2002 both in Bulgaria and Croatia. In Bulgaria the contribution rates to the 2nd pillars are being introduced in a graduated manner rising from 2% in 2002 to 5% in 2005 and regulated by the budget legislation. Rates in Croatia are fixed at 5%.

Participation in the 2nd pillar is mandatory for the all persons below age of 42 in Bulgaria, while in Croatia all the insured individuals below age of 40 are obliged to participate and those between 40 and 50 can choose between 1st and 2nd pillars. The Bulgarian 2nd pillar (universal and occupational pension funds) covers 2,180,951 persons, while the 3rd pillar covers 535,415 persons. In Croatia, the coverage of the 2nd pillar reached the level of 1,170,000 persons (almost 80% of all insured individuals).

Currently, there are eight asset management companies operating in Bulgaria and seven in Croatia. The net returns in the 2nd pillar are around 11% in Bulgaria and 9% in Croatia (end of 2004). Both countries have established independent supervisory bodies of the private pension funds: focused on pension funds only (Croatia) or covering also the insurance market and securities.

Given the short time since the private pension pillars were introduced, the asset accumulation in the 2nd pillars reached modest levels of 3.8% of GDP in Croatia and 1.2 % of GDP in Bulgaria, end of 2004.

Lessons learned and thoughts for the future.

Late PAYGO reforms. Given the social and political sensitivity of the parametric adjustments of the PAYGO pillars, the implementation of these reforms was unduly delayed in Romania and Croatia countries. These delays were harmful to the fiscal sustainability of the pension systems, and created significant deficits, that in the end had to be covered by the state budgets.

PAYGO reforms have to continue. It is recognized that the PAYGO parametric reforms have to continue with an even higher pace, in order to be able to provide benefits to pensioners for the next two to three decades without creating fiscal instability.

The success of the private pillars is dependent on the development private capital markets. The multi-pillar approach was embraced by all countries, and the actual implementation of the 2nd and 3rd pillars started just recently, being also conditioned by the beginning of the financial consolidation of the 1st pillar. However the future performance of the private pension funds will depend on the deepening and diversification of capital markets and parallel refinement of regulatory systems including legislation that will be needed to regulate the future annuities industry.

[23] If the pension funds are allowed to invest in foreign assets they may have an alternative to buying government paper.

D. Lessons from EU8 Accession Experience [24]

1. Introduction and Summary

This section describes EU8 countries' experience during the run up to accession and their first year of membership, and draws lessons from this experience for the current candidate countries.

Enlargement has had far-reaching implications for all aspects of the European Union, be they political, institutional, economic, budgetary or social. The current study focuses on the economic aspects of the enlargement and seeks to analyze its impact on the NMS. However, in view of the complexity of the subject the study looks only at selected economic issues. Moreover, existing evidence of the impact of EU accession on the EU8 is rather fragmentary and often anecdotal, due to the relatively short period under investigation. Furthermore, any potential adverse circumstances and problems may have been masked by the high growth environment, and the ultimate results of many enlargement-related processes will only be visible in the long run. Finally, the analysis looks at the big picture in the region rather than more narrow country developments and any lessons are thus inevitably of a general character.

Facts so far do not seem to support the fears expressed ahead of EU8 accession (Box 1):

- Investment, exports, and output growth all received a boost related to EU accession on the back of strong competitiveness, and the price level jumped as a result of needed adjustments in administered prices and indirect taxes. Nevertheless, these factors all appear temporary in nature, and economic developments have generally returned to trend.
- Trade expansion was not accompanied by trade diversion. This favorable outcome was perhaps the result of lower trade barriers both between new members and vis-à-vis the rest of the world, including because of the expiration of the multi-fiber agreement that had contained imports from Asia. The increase in agricultural trade and some services was particularly strong as liberalization affected mainly these sectors.
- Farmers appear to have been the main winners so far, due to a combination of higher prices of agricultural goods and increased sales as well as support under the Common Agricultural Policy.
- With spreads declining, there were no problems financing even sizable current account deficits. Capital inflows, including FDI, to the NMS gained strength albeit from a slump in the pre-accession period. Meanwhile, cross-border labor mobility remained modest, in part reflecting transitory restrictions in most existing EU member countries.
- Fiscal developments were on the whole favorable. Membership of the EU and associated institutions for fiscal discipline may have facilitated fiscal consolidation where needed (the Visegrad countries). Also, most EU8 countries were net recipients of EU transfers. However, failure in several countries to reform key unsustainable spending programs (notably in the social area) ahead of EU accession poses continued risks for stability and growth.
- The pre-accession period was a crucial window of reform opportunity that seems to close quickly after accession as vested interests again take the upper hand from external forces. Countries that did not take adequate advantage of this opportunity may face an even longer period of catching up to average EU living standards. Access to much larger EU transfers will be no panacea in this regard, including because of limited absorption capacities in the NMS.

[24] This section is drawn from the World Bank's EU8 Quarterly Economic Report.

Box 1. Fears and Facts

Although experts had few doubts that EU accession would ultimately lead to economic gains for both EU15 and EU8 parties, there were nevertheless popular fears related to EU enlargement. These fears have not been born out so far.

Some in the EU8 feared that EU would lead to the demise of domestic industry and agriculture, buying out of land and businesses, brain-drain for the best and poverty for the rest, hyperinflation, cultural domination and second-class citizenship. At the same time EU8 would be contributing to the EU in net terms, as new member states would be unable to absorb the large amounts of EU aid.

Some in the EU15 feared that EU8 would flood it with cheap labor or draw away jobs through unfair tax competition causing a surge in unemployment. Further fears centered on the potential for a reduction of standards and “quality” of the Union, abuse the welfare state, a drain on the Common Agricultural Policy resources and, finally, a deadlock in the EU decision-making process.

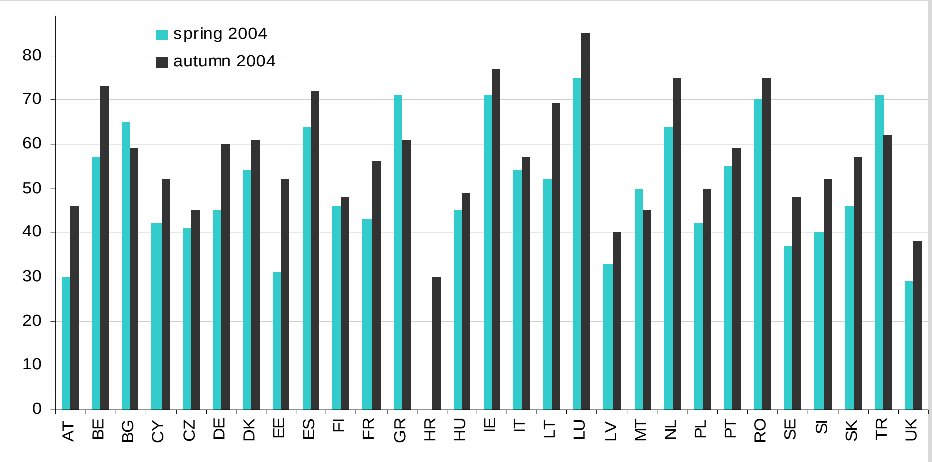
These pessimistic predictions have not been validated. The EU8 economies have revealed a strong capacity to cope with the additional competitive pressures within the Union. Domestic firms and farms have been capable of adapting themselves, farmers’ incomes have surged, foreign direct investment has increased significantly, and growth has been boosted.*

Data for Poland suggests that SMEs have done well in the EU. About half of these perceive accession as having been beneficial and only 20% as negative. Exporters report the biggest benefits (dramatic simplification of procedures), along with food processing companies (increased demand, abolishing of trade barriers). Medium-sized firms seem to have fared better than small (or micro) enterprises. Firms have not yet noticed the competition from large EU multinationals. Rather, they are concerned with strong competition domestically and an increasingly aggressive competition from Asia.*

Furthermore foreigners have not been buying EU8 land any faster than previously. The initial spike of inflation has generally been contained. Labor flows to EU15 countries that opened their labor markets were noticeable, but not massive. The EU did survive the enlargement financially and at the same time, in the first year, EU8 got out more of the EU vaults than they paid in. None of the safeguard clauses have been invoked. EU8 administrations are making progress in adapting to EU decision-making processes.

Finally EU citizens have become increasingly confident in the EU. The share of persons perceiving EU membership to be beneficial to their home countries grew from old-time lows of 46-48% in 2003/2004 to a high of 53% at the end of 2004. Interestingly, even major skeptics like Polish farmers became converts. Support for the EU in this group grew from 20% in January 2004 to over 70% in February 2005.

Chart 1. Benefits of EU membership, opinion polls: EU membership is a good thing, % of respondents



Source: EC, Eurobarometer 62, December 2004.

* Office of the Committee for European Integration (2005).

2. Main Legal Impact in Economic Sphere of EU Accession

The point of accession was neither the beginning nor the end to EU integration, although there were important changes. For EU8 countries the story began a long time ago, when Europe Agreements were signed and went into force in the mid-1990s. These initiated a process of institutional adjustment, including liberalization of trade, harmonization of legislation and standards, capacity building, etc. In the course of the protracted accession negotiations, an ever increasing number of acquis regulations entered into force in the accession countries, which increased the similarity of the legal setting with that in the incumbent EU member states long before formal accession. However, the accession treaties introduced provisional regulations in several areas of the legal EU framework (discussed in more detail below). By 2004 this synchronization went deep enough for these countries to be deemed "almost a part of the EU", which paved the way for a smooth transition to formal membership. Even though accession is a process, for which the actual date of the Accession Treaty entering into force should not matter much, there were nevertheless some significant changes that happened on that date (Box 2).

Box 2. Main Legal Changes in the Economic Sphere of EU Accession

Removal of remaining barriers to trade. Accession to the EU implied a movement from an almost free-trade area to a customs union. All remaining formal bilateral trade barriers were abolished (especially those in agriculture and food processing, that were not covered by the Europe agreements) and the external tariffs in the EU8 with respect to third countries were set equal to the common external tariffs. Accession to the internal market also resulted in the elimination of a number of administrative barriers and reduction in technical barriers to trade (by means of mutual recognition of different technical regulations, minimum requirements and harmonization of rules and regulations). Some fiscal regulations with regard to trade were also changed, such as different systems of tax collection and settlement.

Freedom to provide services and access to EU public procurement. After accession, EU8 nationals (or firms) were free to provide services and register their own company, regardless of legal status, in any other EU country. All citizenship or residence requirements are abolished, while technical qualifications of one country were recognized in another. However, the free provision of services from EU8 to the EU15 remains hindered by an inconsistency between the liberalization of "services" and liberalization of labor markets and uncertainty remains regarding the obligation to comply with "work standards" prevailing in the old member states. Most of the demand for services is from countries that applied transition periods for labor market access, and as a result EU8 firms cannot employ its own nationals and fully exploit the competitive advantage.

Moreover, the internal EU service market remains constrained by numerous administrative and legal regulations, many of which hinder the supply of cross-border services (mutual recognition of labor force qualifications, time and cost consuming licensing procedures for starting up an extra-national business, access to information about national regulations, etc.). To address these concerns, the Services Directive is now under discussion in the Council and Parliament, (the Spring 2004 Council called for its adoption before the end of 2005).

While people are now free to move around the Union, most countries have applied transitional restrictions on working rights. Any EU8 national is now free to travel and settle in any other EU country (over three months requires registration while obtaining permanent residence requires proof of a minimum income). At the same time, transitional arrangements for nationals migrating from the new member states (NMS) have substantially limited the possibilities of workers and service providers from the EU8s to move and reside in EU15 countries (Ireland, the UK and Sweden are the only three EU15 members that have immediately opened their labor markets; the longest possible delays (7 years) were imposed by Germany and Austria). The derogations apply only to the free movement of workers and not to the freedom of establishment or self-employment (nor does it apply to students, pensioners, tourists or others of independent means). EU8 countries, on their part, fully opened their labor markets.

Further, emigrant workers are subject to certain provisions of the EU labor law (maximum work periods and minimum rest periods; minimum paid annual holidays; minimum rates of pay, including overtime rates, and health and safety standards) to the extent that it is more favorable than the regulations applied in the EU8.

Box 2 cont'd

Capital movements had largely been liberalized before accession, but some restrictions remain. With the exception of Slovenia, the NMS had largely liberalized their capital movements in well ahead of EU accession, but cross-border real estate investments remain protected. The NMS continue to restrict the acquisition of different types of real estate, including agricultural land and forests, during transitory periods (7-12 years for the purchase of agricultural land and 5 years for real estate in most of the new members).

Indirect taxes were subject to harmonization. All member states must apply a VAT rate on goods and services of at least 15%, with the option of a reduced rate (not lower than 5%) on selected items. EU also imposes a minimum excise tax on mineral oils, alcohol and tobacco, for which there are transition periods negotiated by the EU8.

NMS gained full access to EU regional aid funds, but support to farmers is only phased in. These transfers are partly non-project related (direct payments, market interventions in agriculture, internal actions and additional expenditures) and partly project-related (structural and cohesion funds, rural development, and residuals from pre-accession aid). In the context of the Common Agricultural Policy (CAP), direct payments to farmers are only reimbursed retroactively (in the year after spending) and thus require pre-financing. Further, for the NMS direct payments are phased in over 10 years starting at 25% of EU-15 rates and rising by five percentage points per year. NMS are free to top-up payments to farmers. Finally, the EU8 receive budgetary compensations designed to ensure a net positive transfer from the EU budget (the NMS also pay a contribution to the EU budget based on the so-called traditional own resources: agricultural levies, custom duties, VAT receipts, and gross national income) and a share in the UK rebate.

NMS must prepare to join the euro-zone. EU accession brought the unconditional obligation to maintain sustainable public finances, including subjection to the (subsequently revised) Stability and Growth Pact (SGP) and provisions of the Excessive Deficit Procedure (EDP). At the same time, NMS must satisfy the Maastricht criteria (on not just fiscal deficits and debts but also inflation, interest rates and exchange rates) before they can adopt the euro and are required to prepare regular convergence programs in this regard.

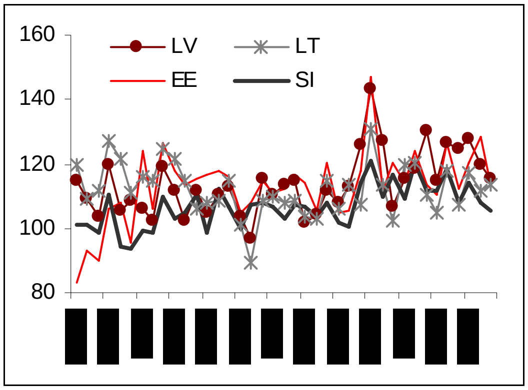
3. Coping in the Single Market

A. Trade in goods

Accession was preceded by a rapid expansion of free trade between the EU8 and the EU15 countries. Trade integration between the EU and the EU8 progressed with remarkable speed after sweeping liberalizations at the beginning of the 1990s. The Europe Agreements between the two groups of countries and the corresponding mutual agreements between the EU8 countries had liberalized trade in industrial products and, in part, also in foodstuffs. The EU became the most important trading partner for all EU8 countries, accounting for 50-55% (Lithuania and Slovenia) to above 70% (Hungary) of their total exports in 2003. Import shares as a rule have been lower, largely because energy and raw materials are imported from outside the EU.

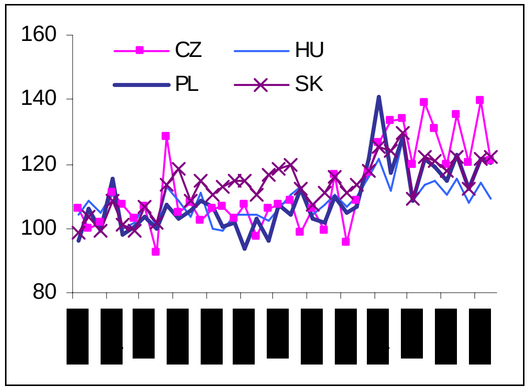
After EU accession, regional trade integration accelerated further. The EU15 share of EU8 trade rose to roughly 70% in 2004 (highest in the Czech Republic and Hungary). Export growth from the EU8 surged to 19% yoy in 2004, outpacing also rapid import growth of 17% yoy reflecting the high import intensity of exports and new investment imports (Chart 2 and Chart 3). Imports of goods (including cars) were advanced up to April 2004 reflecting fears of price increases following accession. Foreign trade was most dynamic in the Czech Republic, Poland, and the Baltic countries. The rapid expansion of exports took place against the background of generally strong competitive positions in the EU8 (Box 3).

Chart 2. Import growth in Latvia, Lithuania Estonia and Slovenia, EUR nominal, y/y (%).



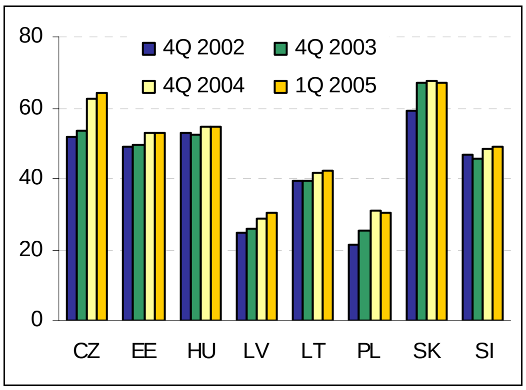
Source: WIIW, CSOs, staff calculations..

Chart 3. Import growth in the Czech Republic, Hungary, Poland and Slovakia, EUR nominal, y/y (%).



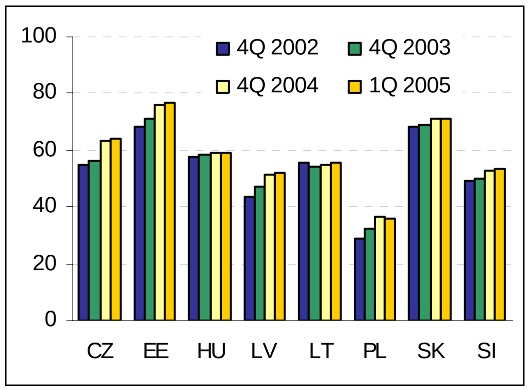
Source: WIIW, CSOs, staff calculations..

Chart 4. Export as % of GDP, 4Q cumulative.



Source: WIIW, CSOs, staff calculations..

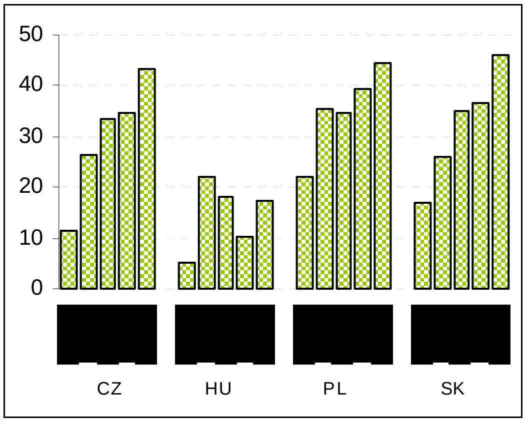
Chart 5. Import as % of GDP, 4Q cumulative.



Source: WIIW, CSOs, staff calculations..

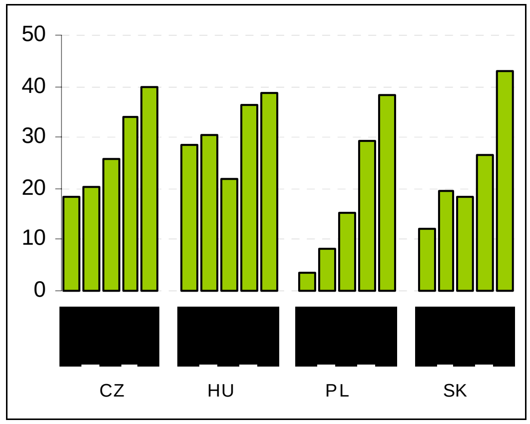
The stellar export performance was broad based. Manufacturing (notably machinery and transport equipment) exports surged (except in Slovakia), but there was also a dramatic expansion in agricultural exports (from a low base) as the EU market was opened to the NMS and these were included in the Common Agricultural Policy. Indeed, exports of food and live animals rose by some 30% yoy in the Czech Republic, Poland and Slovakia) (Chart 6). At the same time, imports of food rose relatively rapidly (Chart 7). On the whole, the structure of NMS trade has been fairly stable in the three last years (Chart 8).

Chart 6. Export growth of SITC 0+1 (food, live animal, beverages and tobacco), EUR nominal, 12 months cumulative (%).



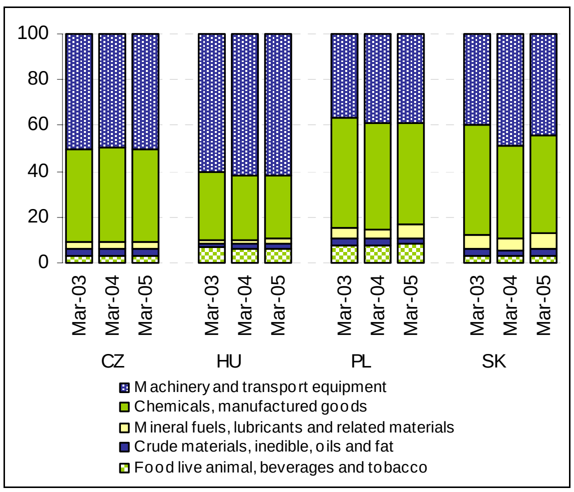
Source: OECD, International Trade Statistics..

Chart 7. Import growth of SITC 0+1 (food, live animal, beverages and tobacco), EUR nominal, 12 months cumulative (%).



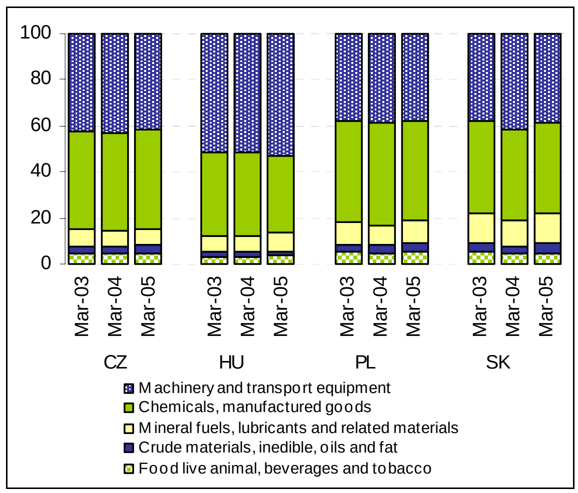
Source: OECD, International Trade Statistics..

Chart 8. Composition of export by sections of SITC, EUR nominal, 12 months cumulative (%).



Source: OECD, International Trade Statistics..

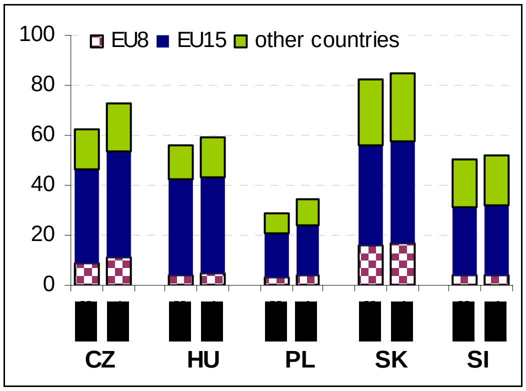
Chart 9. Composition of import by sections of SITC, EUR nominal, 12 months cumulative (%).



Source: OECD, International Trade Statistics..

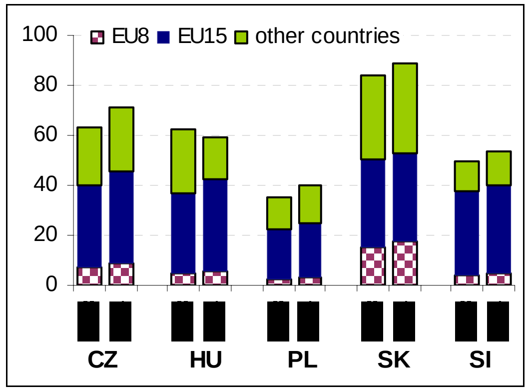
Integration not only contributed to increases in total trade volumes but also redirected trade flows. However, growth in trade between the EU25 countries did not take place at the expense of trade with third countries. The regional composition of EU8 trade in 2004 reveals strong gains in intra-EU25 trade, and particularly in intra-EU8 trade (Chart 10) This is because the implementation of EU trade rules and full liberalization of intra-EU trade improved EU8 access not only to the EU15 market, but also to that of their peers, further supporting trade creation. In all Visegrad countries and Slovenia the yoy gain in EU8 markets was higher than in EU15 markets, with the Czech Republic, Poland and Slovakia achieving the largest gains in regional market shares. At the same time, there was no clear evidence of trade diversion away from non-EU25 countries. The non-EU25 trade has been characterized by growing importance of trade with China, South Korea and Russia.

Chart 10. Export of selected EU8 countries by regions, % of GDP.



Source: WIIW, CSOs, staff calculations..

Chart 11. Import of selected EU8 countries by regions, % of GDP.

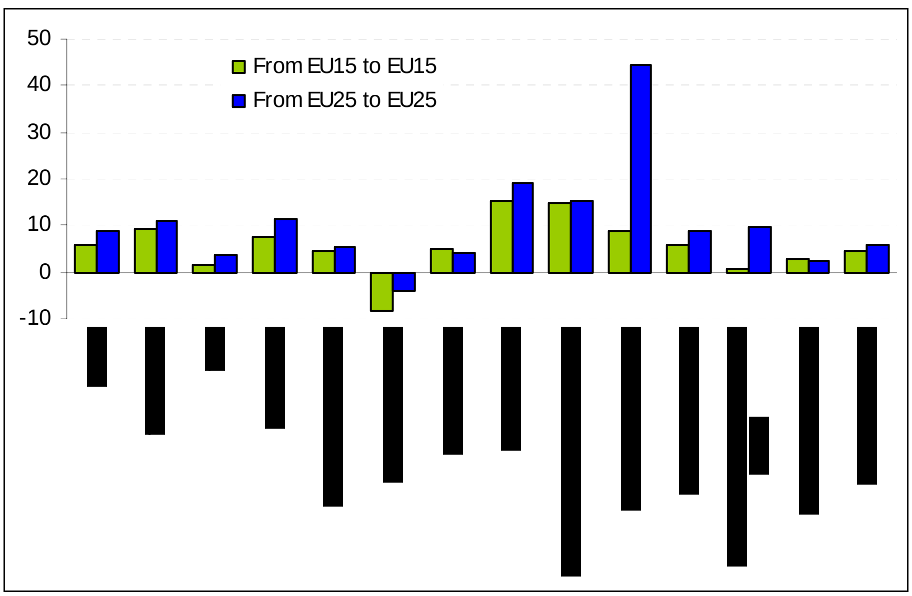


Source: WIIW, CSOs, staff calculations..

B. Trade in non-factor services

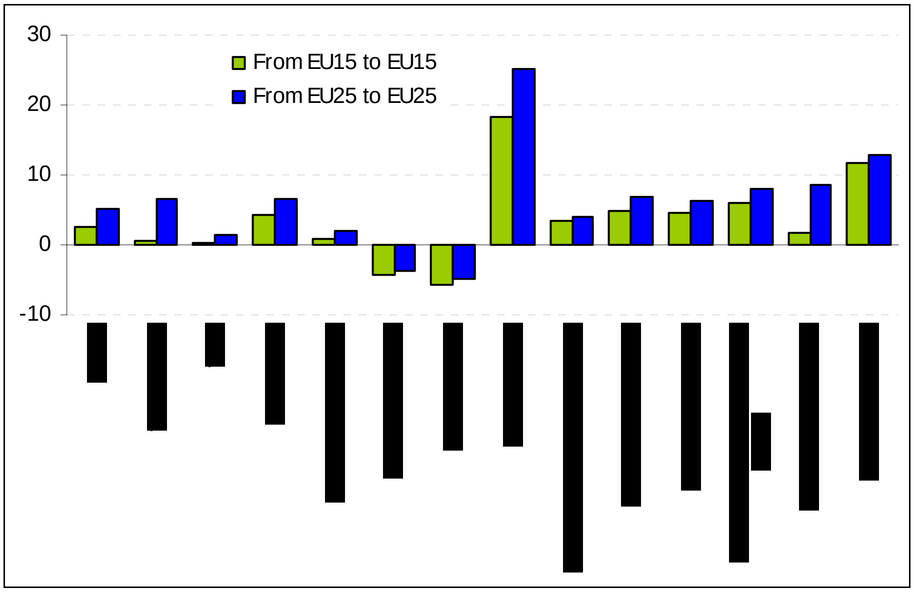
Service trade also expanded under the more liberal market conditions following accession (Chart 12). In 2004, trade in services among the EU25 faster than among the EU15, suggesting a stronger increase in intra-EU8 trade in services or relatively high growth between the EU15 and the NMS. Service trade in the enlarged Union expanded particularly fast in the areas of royalties and license fees, financial services, computer and information services and transport.

Chart 12. Statistics of services, credit, rate of growth in 2004 (%).



Source: Eurostat, staff calculations.

Chart 13. Statistics of services, debit, rate of growth in 2004 (%).

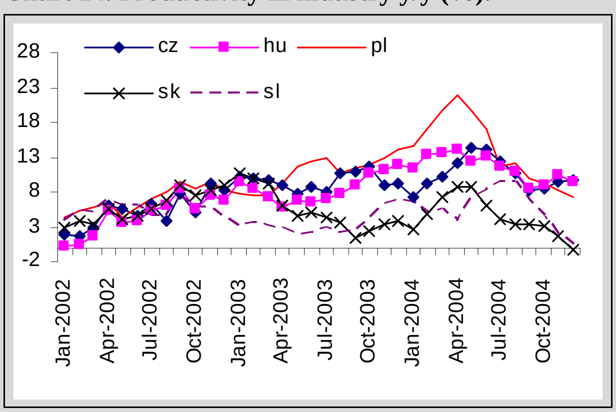


Source: Eurostat, staff calculations..

Box 3. EU8 Competitiveness

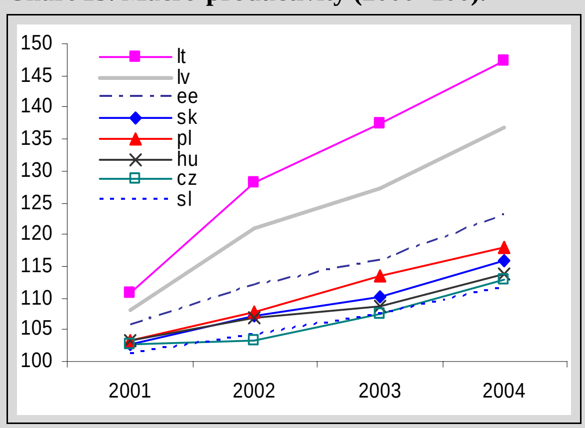
The impressive trade performance should be viewed on the background of strong productivity growth and competitive positions that allowed the NMS to exploit new market opportunities.[25] Strong productivity growth started before accession but was mainly based on labor shedding (with the notable exceptions of Estonia and Slovenia) (Chart 14). However, in 2004 most of the EU8 countries managed to increase the number of jobs and only in the Czech Republic, Hungary and Lithuania were productivity gains associated with further lay-offs. During the period 2000-2004, labor productivity in industry grew even more strongly than macro-productivity in all NMS. Industrial restructuring, FDI inflows in the last years as well as increased foreign demand and competition have fueled these productivity gains.

Chart 14. Productivity in industry y/y (%).



Source: WIIW, CSOs, World Bank, staff calculations..

Chart 15. Macro-productivity (2000=100).



Source: WIIW, CSOs, World Bank, staff calculations..

Meanwhile, wage growth has remained modest reflecting slack in labor markets, and unit labor costs (ULC) have thus been contained (Chart 16).

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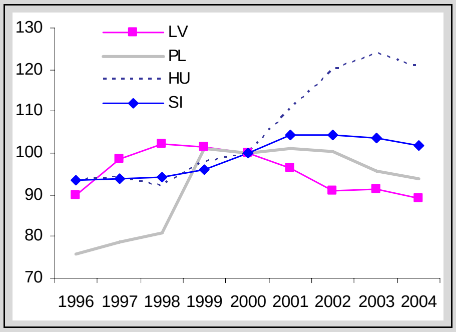
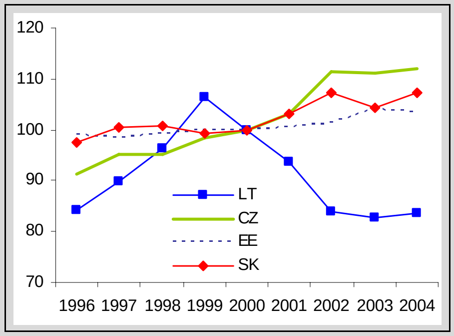
[25] In line with the „Casella-effect". Casella (1996) postulated that 'if economies of scale imply that firms located in large countries enjoy lower costs then the gains from enlarging the bloc will accrue mostly to small countries, because the entrance of new members diminishes the importance of the domestic market and improves the small countries' relative competitiveness."

Chart 16. Macro ULC PPP (2000=100). Latvia, Poland, Hungary and Slovenia.



Source: WIIW, CSOs, World Bank, staff calculations.

Chart 17. Macro ULC PPP (2000=100). Lithuania, Estonia, Slovakia and Czech Republic).



Source: WIIW, CSOs, World Bank, staff calculations.

While there are significant problems in comparing ULC levels across countries, studies suggest that in the EU8 they generally remain below one-half of the average level in Western Europe (WIIW 2005). The highest relative levels prevail in Slovenia and Poland (around 60% and 45%, respectively, of the level in Austria in 2004). Data on hourly labor costs (Table 1) confirm the relatively low wage costs in the NMS (e.g. in Western Germany, the hourly labor cost was about 30 euro in 2004, nearly six times the Polish and ten times the Slovak labor cost).

Table 1. Hourly labor costs relative to EU15.

Hourly labour costs	1997	1998	1999	2000	2001	2002	2003
			in EUR				
EU (15 countries)	19.95	20.51	21.34	22.73	22.59	23.51	24.53
			EU15 = 100, in %				
Czech Republic	*14.9*	*16.2*	*17.1*	*19.3*	*23.3*	*27.0*	*27.3*
Estonia	*10.7*	*12.1*	*13.0*	*14.3*	*16.1*	*18.4*	*20.1*
Latvia	*8.0*	*8.6*	*9.3*	*11.1*	*11.5*	*12.0*	*11.9*
Lithuania	*8.4*	*9.8*	*10.8*	*13.2*	*13.8*	*14.5*	*15.5*
Hungary	*15.8*	*15.1*	*15.7*	*18.2*	*20.3*	*24.6*	*25.6*
Poland	*16.9*	*18.7*	*20.3*	*22.5*	*26.6*	*26.4*	*26.7*
Slovenia	*39.6*	*42.7*	*44.8*	*45.0*	*48.0*	*48.6*	*52.8*
Slovakia	*13.1*	*14.6*	*13.8*	*15.4*	*16.3*	*18.0*	*20.2*

Source: Eurostat, CSOs, staff calculations..

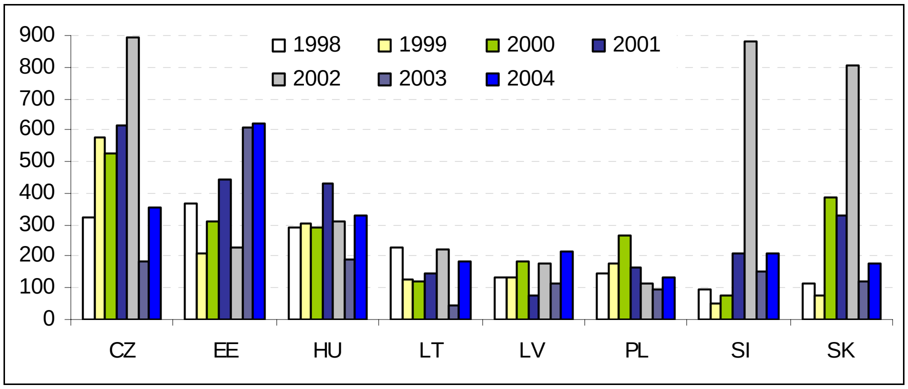
Moreover, deregulation of labor markets has yielded positive results in most of EU8 countries. These now generally have less rigid employment regulation (i.e. more flexibility of firing/hiring) than EU15 countries, with Slovakia the most advanced but also important progress in the Czech Republic, Estonia, Hungary, and Poland (World Bank "Doing Business 2005").

C. Capital flows

EU accession appeared to be associated with a "second wave" of FDI inflows to EU8 countries. While investors may have become more confident in the region following EU membership, it is difficult to separate the impact of this from the effects of "announcement" and liberalization ahead of actual membership. After a drop in 2003 to euro 9.6bn, FDI inflows to the EU8 increased to 15.2bn in 2004, although still below records from 2002 FDI increased in all EU8 countries, and more than 70% in the Czech Republic, Latvia and Hungary. Among the NMS, Poland was the largest recipient of FDI, followed by the Czech Republic and Hungary, but in per capita terms the leader remained Estonia (Chart 18). The FDI stock/GDP ratio in the EU8 reached 50-70% in Estonia, the Czech Republic and Hungary (Chart 19).

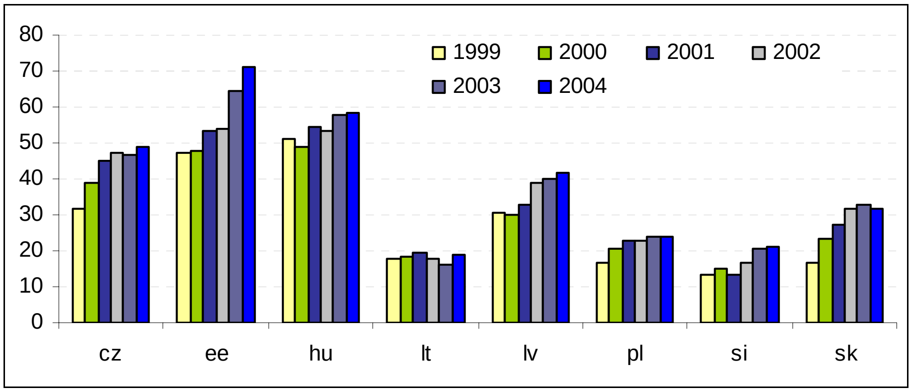
FDI inflows have to a significant extent been linked to privatization and greenfield investments (Slovakia, Latvia, Lithuania, and Poland), with the share of the former gradually decreasing. In the more mature FDI host countries such as the Czech, Republic, Hungary and Estonia mergers and acquisitions have been playing an increasing role in FDI inflows.

Chart 18. FDI inflow per capita, EUR



Source: CNBs, WIIW, Eurostat, staff calculations..

Chart 19. FDI stock, % of GDP



Source: CNBs, CSOs, WIIW, staff calculations..

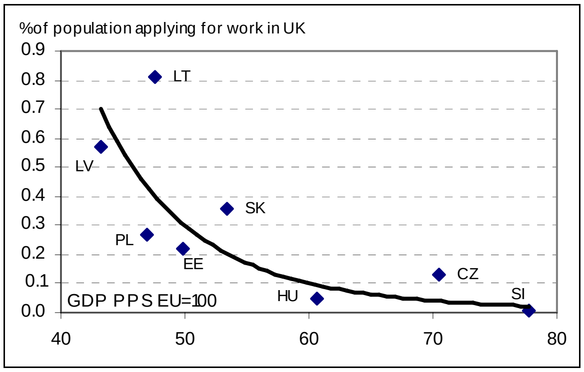
In 2004 some EU8 countries recorded an increasing interest of Asian investors (notably Korea, China, and Singapore) and Russian investors. Moreover, US multinationals have been shifting their focus from Western Europe to cheaper destinations in the East, including the EU8 economies. Also, FDI inflows among the NMS themselves increased in 2004.

The majority of foreign investments is flowing into the manufacturing sectors, in particular the automotive sector. Investors have also targeted the real estate sector (shopping centres, cross-border retailers, office buildings) and financial services. Further, some European service centers (e.g. accounting services and call centers) are transferring to the NMS (Poland, Czech Republic, Hungary). As companies seek to gain competitive advantage by reducing their cost base and streamlining processes, there has been a drive towards separating out non-core operations, such as IT, payroll, estate management or back office processing, with an increasing number of companies locating these functions in internally owned, shared service centers based in the EU8 to exploit relatively inexpensive medium-skill labor.

D. Labor mobility

Cross-border labor mobility appears to has been increasing, but to a much lesser extent than expected. However, the evidence is still fragmentary and/or anecdotal. Wage differentials are no doubt important motives for some EU8 labor groups to seek employment in Western Europe, but high labor transition costs are a constraint. EU8 nationals are typical Europeans when it come to their attachment to domicile and localized social networks—only 2-3% of EU15 nationals work in another country of the Union, and it seems that EU8 citizens will be no exception (Chart 20). Cross-border regions are likely to be more affected than more distant regions, and single young workers are more likely to search for a job abroad than married older workers. There is some evidence that EU8 countries have seen a significant outflow of doctors. Evidence from Poland also suggests significant labor mobility towards seasonal work in sectors like agriculture, gardening, fruit-growing, forestry, catering, and construction.

Chart 20. Job application in UK, by EU8 countries



Evidence from the UK suggests that labor inflow from the EU8 is positively related to income differentials. Between May 2004 and March 2005 about 176 thousand people from the EU8 applied for workers registration, out of which one third had already been in the UK before accession (with accession mainly meaning legalization of already existing work). Most of them, as predicted, were single and young. Initial indications suggest that these people work hard, often at the minimum wage, and make few claims on the UK welfare system.[26] Taking jobs that locals are reluctant to do, they fill gaps in the local labor market, particularly in administration, business and management, hospitality and catering, agriculture, health and construction.

There is also some indirect evidence of increased intra-EU8 labor migration, occasionally causing tensions in cross-border regions. For example, there appears to have been some pick-up in migration of workers from Slovakia to Hungary after EU accession, with the unemployment rate rising in the Northern part of Hungary and declining in the Southern part of Slovakia.

E. EU transfers

On the whole, EU8 countries have remained net recipients of funds from the EU budget following accession. While the NMS are large potential recipients of EU regional aid funds, they now also have to make contributions to the EU budget and there were some concerns that low absorptive capacity would result in net transfers to the EU. Poland, Slovakia, the Czech Republic and Estonia were net beneficiaries in 2004, while Hungary appeared to be a net contributor (Chart 21 and Chart 22). For the group as a whole, estimates suggest that average net EU transfers would amount to 1.1% of GDP per year in 2004-2006 (1.3% of GDP in 2006 ranging from 0.4% of GDP for Slovenia to 3.2% of GDP for Latvia and Lithuania).27 However, the available data excludes outstanding claims on the EU, notably for the prepayments of CAP support), and adjusting for this the net receipts would be higher for all the countries (e.g. 26% higher in the case of Slovakia).

[26] Source: Portes J, ansd S. French (2005)

[27] Source: Martin Hallet and Filip Keereman (2005), "Budgetary transfers between the EU and the new Member States: manna from Brussels or a fiscal drag?" ECFIN Country Focus, vol. 2, issue 2, February 3.

Chart 21. Net income from the EU budget, 2004.

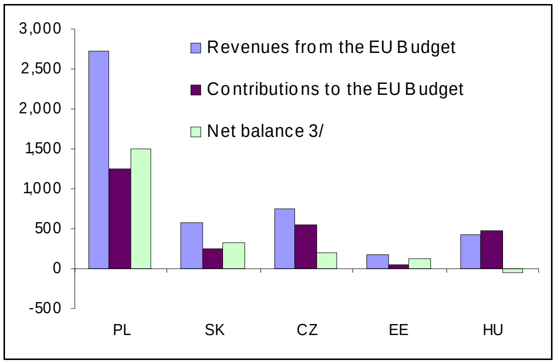
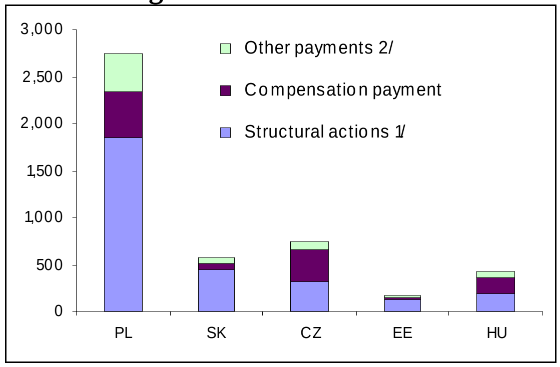


Chart 22. Composition of revenues from the EU budget



Notes:

1/ Guarantee section EAGGF, Structural operations, Structural funds (INTERREG IIIB and IIIC), and Pre-entry assistance

2/ Internal policies of EU, and Financial instrument EEA and Norwegian financial instrument

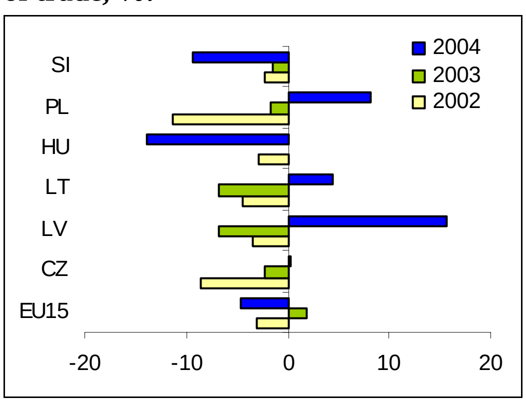
3/ does not include claims outstanding

Source: PL, CZ, HU, EE MOF, SK State budget 2005-07..

EU8 farmers appear to have been the main beneficiaries in the EU so far. Before EU accession, farmers in the EU8 worried that they would suffer from open competition in the single market, especially in light of the only gradual phasing in of direct payments under the Common Agricultural Policy. However, early evidence suggests a smooth integration of the NMS' agricultural sectors into the EU and a sizeable rise in agricultural incomes. For farm products, EU enlargement removed agricultural trade barriers and the CAP brought guarantee prices for the most important agricultural products such as grain, rice, sugar and milk. In some cases, the guarantee prices are higher than pre-accession farm prices. The results of boosted support through direct payments, top-ups and price support, combined with improved market conditions, boosted agricultural incomes in the EU8 countries, not least the Czech Republic and Poland (Chart 24). Evidence show that medium-sized farms producing both for market and self-consumption benefited the most. Small and subsistence farming also benefited but to a much smaller extent.

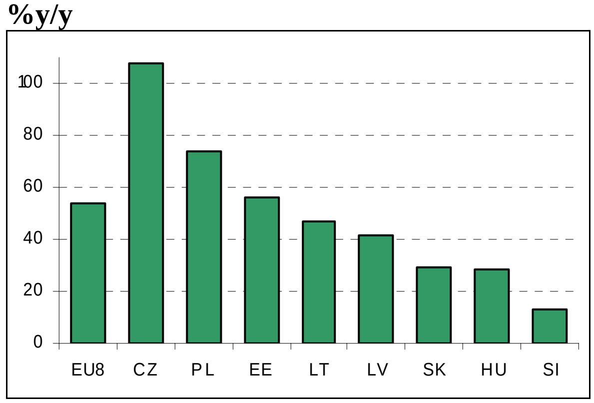
Improved agricultural terms of trade boosted welfare in Lithuania, Poland and Latvia (Chart 23). The gains in Latvia were the highest as output price increases were combined with lower prices for inputs to agricultural production. In other NMS countries for which information is available, input prices increased (mainly due to higher prices for energy, fertilizers and soil improvers).

Chart 23. Annual change in agricultural terms of trade, %.



Source: Eurostat.

Chart 24. Increase in farm's income in 2004, %y/y



Source: Eurostat, 2005.

Modernization of agriculture continued throughout the period. Compliance with EU quality, phytosanitary, veterinary and environmental standards required large investments, partly financed by the EU. Meanwhile, restructuring of agriculture as reduced its share in GDP and in the total labor force (although agricultural employment in Poland edged back up in 2004) (Table 2).

Table 2. Agriculture sector in the EU8

	Gross value added in agriculture						Agricultural employment					
	mEUR			%GDP			(000)			as % of total employment		
	2002	2003	2004	2002	2003	2004	2002	2003	2004	2002	2003	2004
CZ	2246	2072	2129	3.1	2.8	2.7	229	213	174	4.8	4.5	3.7
EE	329	318	360	4.9	4.4	4.5	40	36	34	6.9	6.1	5.7
HU	2255	2103		3.7	3.3		240	228	207	6.2	5.8	5.3
LV	405	378	424	4.6	4.3	4.3	149	134	126	15.1	13.4	12.5
LT	942	914	926	7.0	6.2	5.7	248	257	228	17.6	17.8	15.8
PL	5488	4832	4942	3.1	3.0	2.9	2887	2408	2526	19.3	18.4	19.3
SK	1033	1064	1195	4.4	4.0	3.9	101	91	80	5.0	4.4	3.9
SI	649	568		3.1	2.6		100	97	93	11.2	10.9	10.4

Source: Eurostat.

4. Macroeconomic Developments and Policies

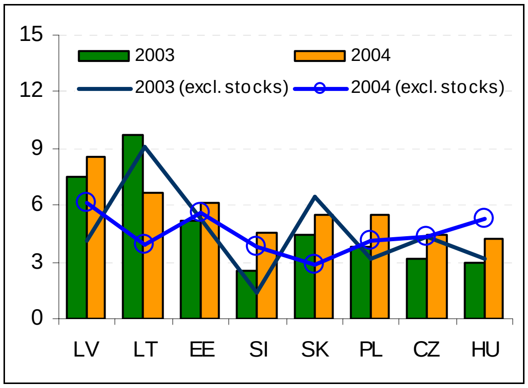
A. Output and employment

The process of EU accession may well have stimulated growth in the EU8 through trade creation, increased factor mobility (including FDI) and other dynamic effects such as capital accumulation, technology transfer and increased competition. However, growth is a very complex process and it is difficult to disentangle the impact of the EU accession process from what would otherwise have happened. Whatever the reasons, most EU8 countries have a long period of catching up to average EU living standards ahead of them (Box 4).

Output growth accelerated across the region in 2004. Real GDP growth in 2004 in the EU8 reached nearly 6% (simple average), significantly higher than in the preceding years (Chart 25). The Baltic countries recorded the highest growth rates in the range of 6-8½%, while the larger economies were led by Poland (5.4%), and the Czech Republic and Hungary (both 4%). Output growth almost doubled in Slovenia, while Lithuania was the only country to see its growth rate reduced albeit but from a very high level.

At the same time, the pattern of growth became more balanced. In all countries investment contributed significantly to overall GDP growth, but varied widely across countries (from high in Latvia and Lithuania to fairly low in Hungary and Poland). Interestingly, stock building contributed importantly to growth (1.2pp in 2004 after 0.3pp in 2003). Inventory build-up ahead of EU accession might be explained by a mini inventory cycle, with firms accumulating goods due to anticipated increase in demand.

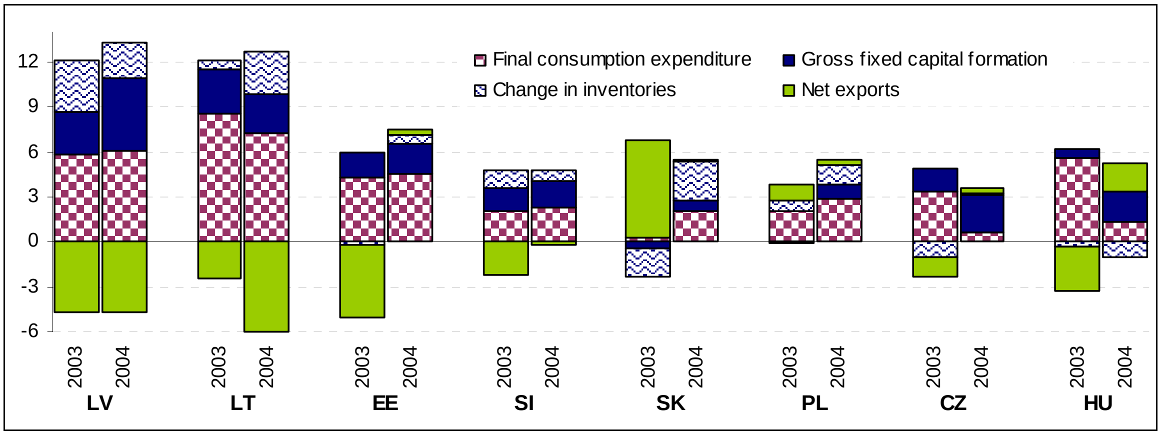
Chart 25. GDP real growth, %.



Source: CSOs, staff calculations..

Gross capital formation was the main driving factor for growth in the Czech Republic, Latvia, Slovakia and Slovenia with an average contribution of 4pp (Chart 26). On the other hand, the contribution of consumption to overall growth was the most important in Estonia, Lithuania and Poland On the external side, robust trade in 2004 resulted in a somewhat stronger contribution from net exports to EU8 GDP growth as compared to 2003 (Hungary, Czech, Estonia, Slovenia), although it was only the principal driver of growth in Hungary.

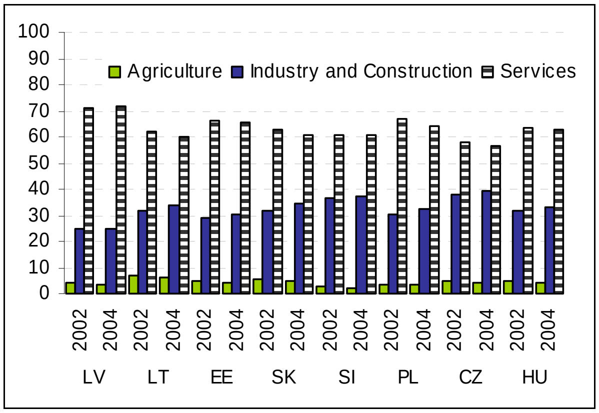
Chart 26. GDP contribution, %.



Source: CSOs, staff calculations..

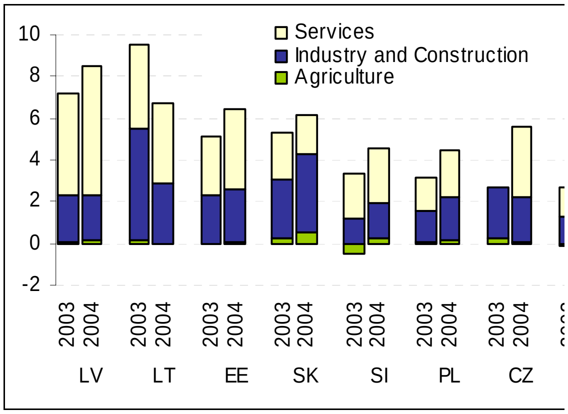
Economic developments in 2004 were also characterized by a further alignment of the sectoral composition of GDP towards that of the EU15. Services and industry provided the main impetus to output growth in the EU8 in 2004, with value added contributing 3.2 pp and 2.3 pp to growth, respectively (Chart 27). Industry (including construction) was the biggest driver of growth only in Slovakia, while services did the best in the Czech Republic, Latvia and Estonia. The strong contribution of agriculture in Hungary stands out. At the same, the shares of services and industry in total output generally tended higher.

Chart 27. EU8 value added structures in 2002 and 2004 %.



ource: CSOs, staff calculations..

Chart 28. GDP contribution in 2003 and 2004, %.

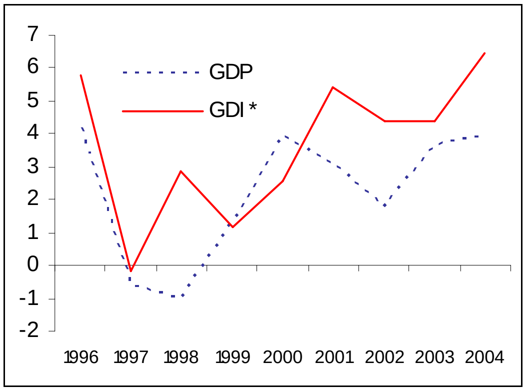


Source: CSOs, staff calculations.

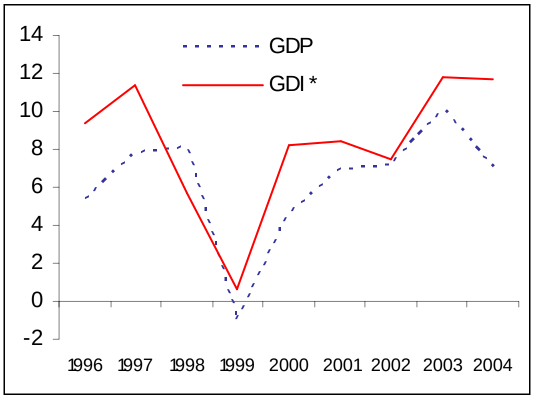
Adjusting real GDP growth for changes in terms of trade, suggests that real incomes increased even more rapidly than real output in at least some of the EU8 countries. Thus, in recent years the positive effect of an improvement in the terms of trade on real income growth could be observed in for example the Czech Republic and Lithuania (Chart 29).

Chart 29. GDP and GDI* per head of population, % y/y

Czech Republic



Lithuania



* GDP adjusted for the impact of terms of trade

Source: AMECO, staff calculations.

EU accession was also associated with signs on improving conditions in EU8 labor markets. Both the boost to output growth and improved job opportunities abroad were accompanied by a decline in unemployment in almost all EU8 countries, while employment rates were mostly unchanged (Chart 31). Employment rates increased notably in Slovenia, but also Poland and Latvia, while other countries saw their employment rates falling. The employment rate is influenced by changes in the active labor force—in Slovenia, the latter increased by 5% and Slovakia also saw an increase. In contrast the active labor force shrank in Estonia.

Box 4. Catching Up to Average EU Income Levels

Strong growth in the EU8 was associated with a further catching up in average EU living standards, but there is a long way to go. The relative position of EU8 countries (measured in PPS terms, as a percentage of average GDP per capita in the EU15) improved appreciably in 2004, especially in the Czech Republic and Baltic countries (Chart 30). In 2004, average GDP per capita for the EU8 amounted to 46.6% of the EU15 level. Within the NMS, major differences are still visible: Latvia currently has the lowest GDP per capita among the EU8 (only 40% of the EU15 average) while Slovenia and the Czech Republic have the highest per capita income levels (almost 70% of the EU15 average).

Most EU8 countries would reach average EU15 income levels only in two decades. Assuming that the EU15 will grow at 3% p.a. in the future (somewhat faster than in the period 2002-2004) while NMS grow at their average rate for the past three years, most EU8 countries would need more than 10 years to achieve 75% of the average EU15 level and about 20 years to reach average income levels (Table 3). Within the EU8, Slovenia and the Czech Republic would likely be the first to catch up, while Poland might be the last.

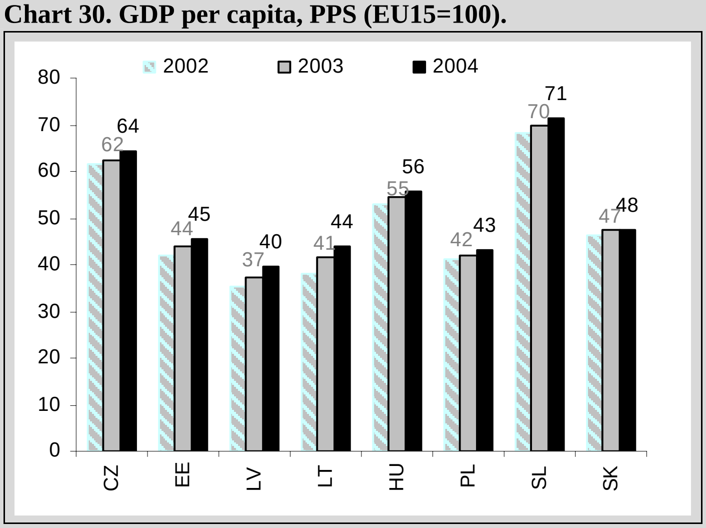
Table 3. Catching-up: numbers of years the EU8s need to reach 75%, 100% of the EU15 GDP per capita

	SI	CZ	LT	HU	LV	EE	SK	PL	average
	Years								
75% of EU15 average	**3**	8	**56**	11	21	14	16	**29**	19.8
100% of EU15 average	**18**	**23**	86	**21**	31	**21**	26	44	33.8

*) assuming a 3% growth rate for EU15, last 3 years average growth rates for NMS (with the exception of Latvia and Lithuania: GDP PPS per capita was calculated using potential GDP) and stagnant population in all countries

Source: Eurostat, AMECO, CSOs, staff calculations.

Chart 30. GDP per capita, PPS (EU15=100).



Source: Eurostat.

Chart 31. Employment rates, 1Q 03 – 4Q 04

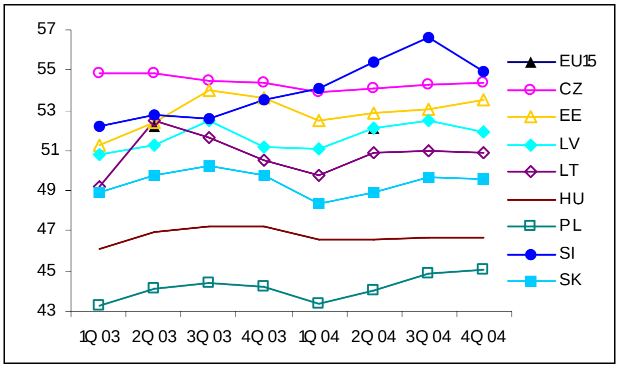


Chart 32. Average employment rates, 2H 2003 and 2H 2004

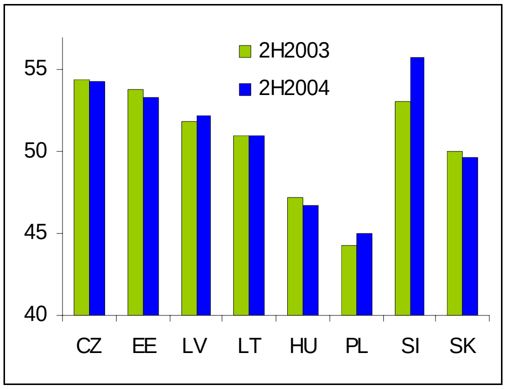
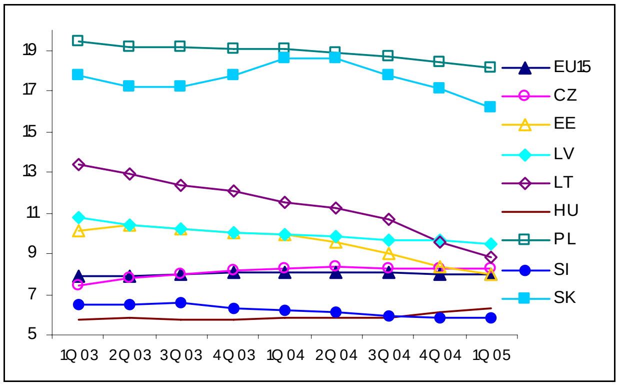
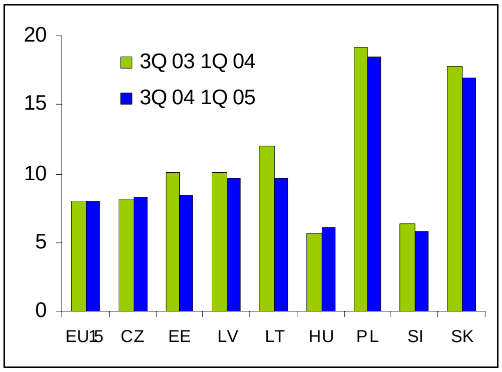


Chart 33. Unemployment rates, harmonized and seasonally adjusted, 1Q 03 - 1Q 05



Source: EUROSTAT, July 7, 2005.

Chart 34. Average unemployment rates, 3Q 03 – 1Q 04 and 3Q 04 – 1Q 05



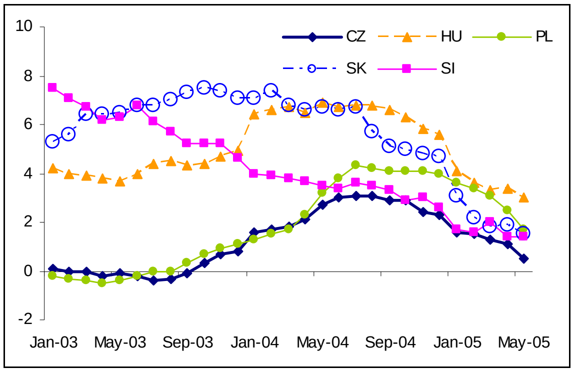
B. Wages and inflation

The price level spiked up in the immediate aftermath of EU accession (mainly reflecting adjustment of indirect taxes), but underlying inflation was held in check through slack in labor markets and tighter monetary conditions. Inflation was generally low in most EU8 countries during 2003 (except Slovakia), but increased significantly in 2004 (Chart 42) This was driven mainly by increases in indirect taxes and regulated prices linked with accession to the EU and with the governments' reform of public finances (Chart 42—Annex). The rise in oil and other commodity prices (including food) and rapidly closing output gaps also played a role.

Further, prices of food products (both processed and unprocessed) surged in all EU8 countries, except Slovenia (Charts 43-46—Annex), as they adjusted to EU15 levels. Products whose prices grew most sharply between end-March and end-September 2004 included sugar (up more than 10% in Estonia, Poland, Hungary, and Czech Republic), meat (15% in Poland, Hungary, and Latvia) and milk/dairy products (Latvia, Estonia).

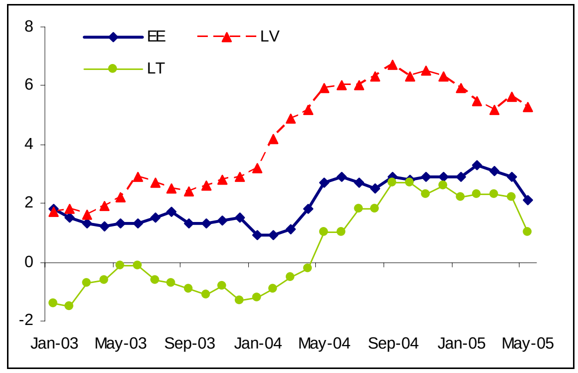
Hovever, in the latter part of 2004, in Visegrad countries and Slovenia, EU-related inflation impulses were contained and second round effects were limited. Following the EU accession-related spike, core inflation has been gradually receding in these countries as higher interest rates and not least appreciating currencies led to a significant tightening of monetary conditions while wage pressures were held in check. The disinflation process was also facilitated by declining food and in some countries transport prices, and supported by enhanced competition in the Single Market. Strengthening market competition also affected alcohol and tobacco prices.

Chart 35. HICP - Overall index excluding energy and seasonal food, % yoy.



Source: Eurostat.

Chart 36. HICP - Overall index excluding energy and seasonal food, % yoy.

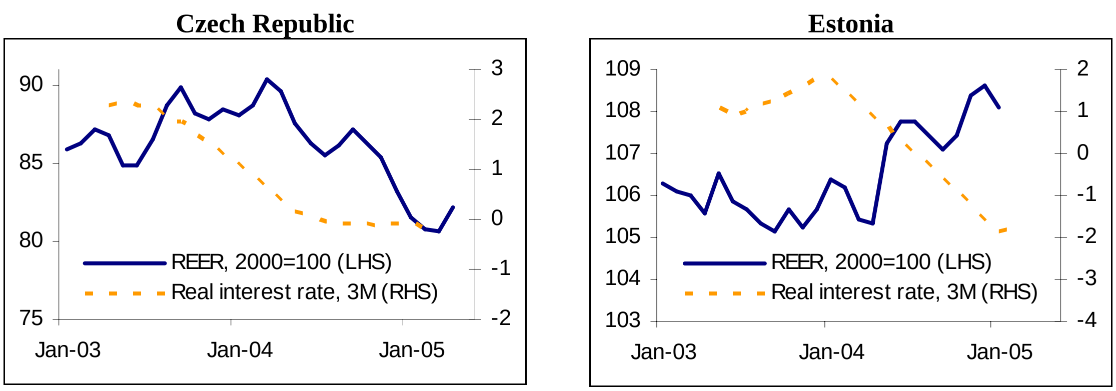


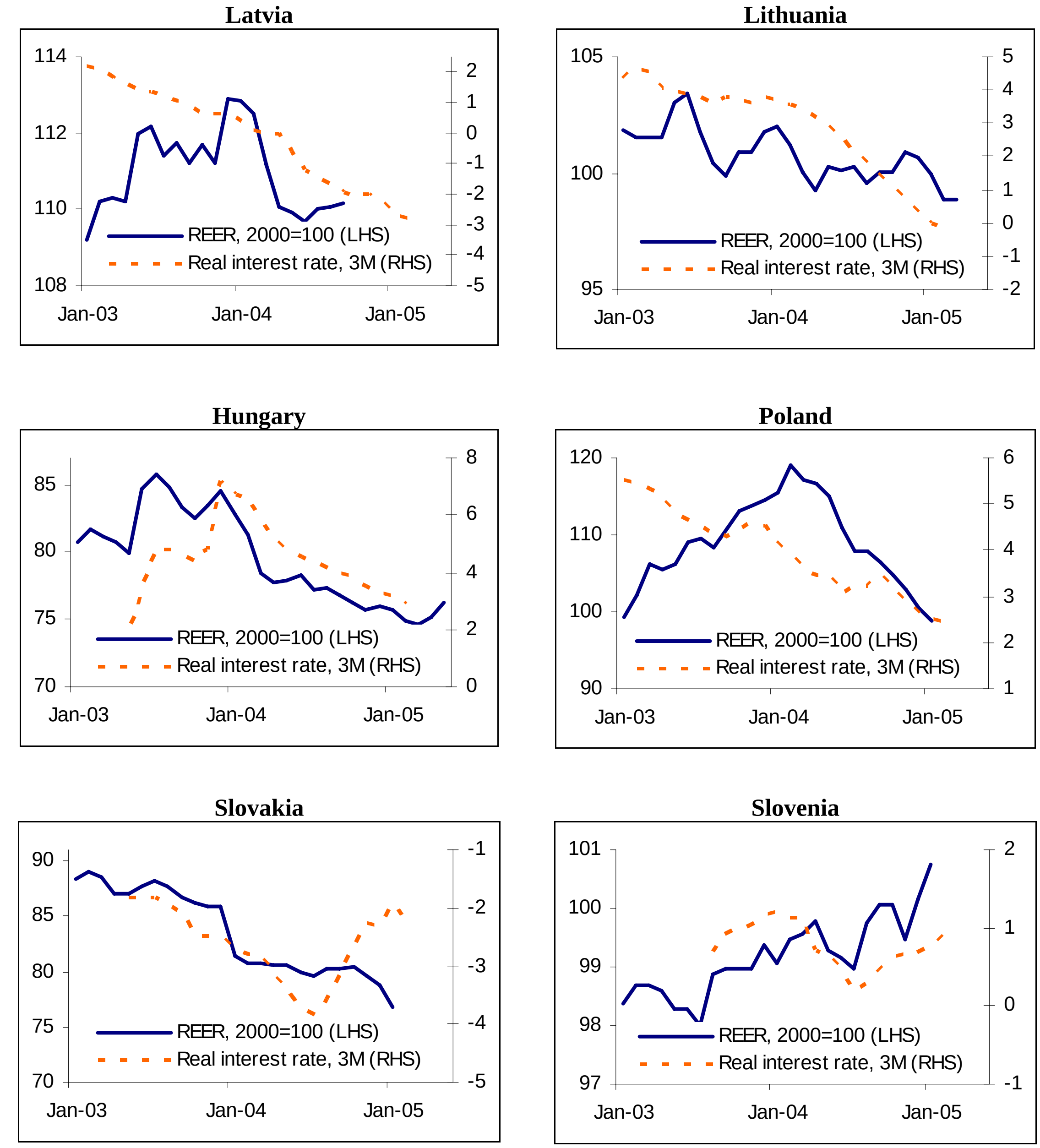
Source: Eurostat.

In contrast, in the Baltic countries higher inflation continued into 2005. There are several reasons for this. First, the Baltic countries, by imposing only minimum EU excises on fuel, are more sensitive to world oil price changes. The fact that the currencies in Estonia, Lithuania and Latvia (since 2005) are pegged to the Euro has also put some upward pressure on price developments with the weakening of the Euro and rise in dollar-denominated oil prices. Second, domestic demand, underpinned by the favorable outlook and optimistic household expectations, has remained fairly strong. Third, unemployment is declining rapidly, bottlenecks emerging in the labor markets—including because of intensified migration has intensified, and wage pressures intensifying. However, only Latvia is experiencing serious problems so far with inflation.

In reaction to the surge in consumer prices in mid-2004 across the region, several central banks moved to raise interest rates (or in some cases paused or slowed down further easing). However, the monetary policy tightening cycle was over by the third quarter of 2004 with appreciating currencies adding further restraint to monetary conditions in all Visegrad countries. In 2005, easing inflation and appreciating currencies allowed for further easing of monetary conditions in Hungary, Poland and the Czech Republic, where central banks continued lowering interest rates. Real interest rates in first months of 2005 were negative in the whole region with the exception of Hungary, Poland (where they remained at comparatively high levels of 2.9% and 2.5%, respectively) and Slovenia (Chart 37).

Chart 37. Real interest rate and real effective exchange rate in the EU8.





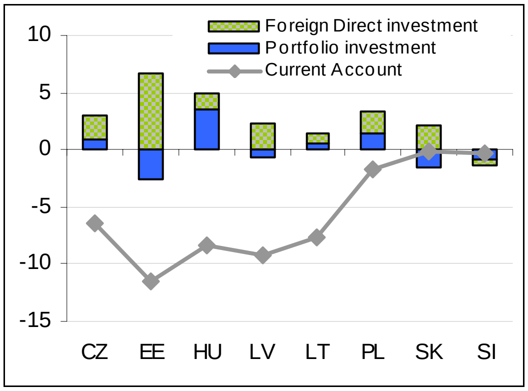
Source: Reuters, WIIW, NCBs, CSOs, staff calculations.

C. Balance of payments

Strong export performance has generally been associated with an improvement in external current account balance. The current account balance strengthened in the Czech Republic, Poland, and Lithuania, although there was no improvement in Hungary and the current account deficit widened in Slovakia (Chart 39). Overall, the region's current account deficit amounted to 6.3% of GDP (12 month rolling average) in Q1 2005, reflecting large deficits in the Baltic countries and Hungary and a situation close to balance in Poland and Slovenia.

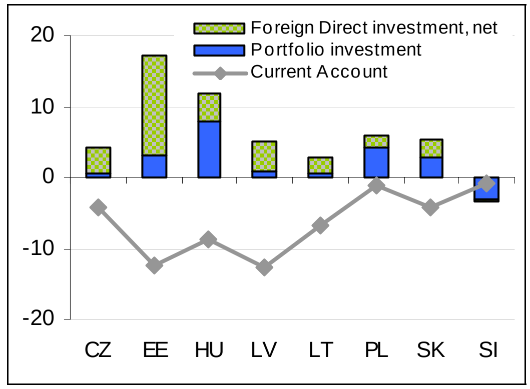
Meanwhile, financing of the current account gap has strengthened. Net FDI inflows in the region recovered throughout 2004 and Q1 2005, reaching over 4% of GDP (12moths rolling average) in Q1 2005 (nearly 14% of GDP in Estonia!). The recovery in FDI was across the board (except for Poland were inflows remained stable at 2% of GDP). After falling to a very low level in 2003, portfolio investment inflows rebounded strongly in last 12 months, reaching 2% of GDP in Q1 2005 (12 month rolling average). Inflows picked up notably in Estonia and Hungary but also in Poland and Slovakia. Inflows were mainly directed to bond markets, while investments in equity eased off.

Chart 38. External balance in 1Q 2004*, % of GDP.



* 4Qs cumulative
4Q 2003 for Slovenia
Source: NCBs, staff calculations.

Chart 39. External balance in 1Q 2005*, % of GDP.



* 4Qs cumulative

Source: NCBs, staff calculations.

D. Fiscal policy

Fiscal developments in the year of accession varied significantly. As discussed above, in most countries the direct impact of EU accession on fiscal balances was positive, but overall changes in fiscal balances were dominated by domestic policies. The general government budget position improved in 2004 in the Czech Republic, Hungary, Slovakia, and Latvia, remained roughly unchanged in Slovenia, and deteriorated in Estonia, Lithuania and Poland. In countries where the fiscal balance improved, this reflected mostly better revenue collection (on the back of robust growth and indirect tax rate increases) or one-off measures such as revenue carryovers (Czech Republic) and spending postponements, including related to co-payments for EU-funds (Slovakia).

The new members will not participate immediately in the euro-zone. The new members do not have an opportunity to opt out however; they will all have to adopt the euro at a later date (Table 4). Slovenia, Estonia and Lithuania joined the ERM II on 28 June 2004 and may adopt the euro in 2007. Latvia joined the ERM II at the beginning of 2005, after switching its peg from the SDR to the Euro, and may adopt the Euro in 2008. The other NMS plan to join the euro-zone in 2009-2010. The concrete timetable will depend mainly on each country's ability to achieve and maintain a large degree of monetary and fiscal stability. Putting government finances on a track that meets the criteria for euro entry seems to be by far the most urgent challenge for the Visegrad countries. However, with the revised SGP and based on assumptions from the 2004 Convergence Programs, Hungary, Poland and Slovakia would fulfill the Maastricht fiscal deficit criterion in 2007.

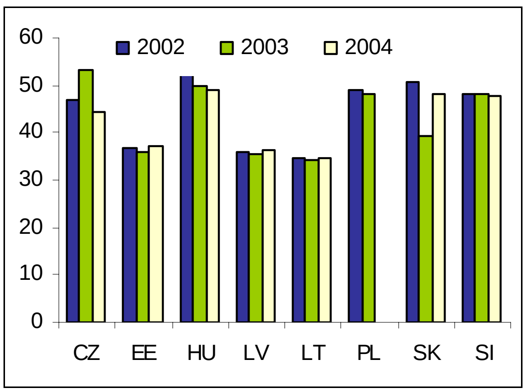
Table 4. Planned EMU membership dates

Country	ERM-2 membership	Planned time for adoption of EURO
Czech Republic	no concrete timetable	2009-2010 provided that the Maastricht criteria are met and there is sufficient real convergance
Estonia	June 2004	no official data reported, probably 2007
Hungary	no concrete timetable	2010 (2009 provided that economic conditions are better than expected)
Latvia	April 2005	2008
Lithuania	June 2004	2007
Poland	no concrete timetable	no official data reported, probably 2009-2010
Slovak Republic	before June 2006	2009
Slovenia	June 2004	2007

Source: CPs, MOFs, CB for Lithuania.

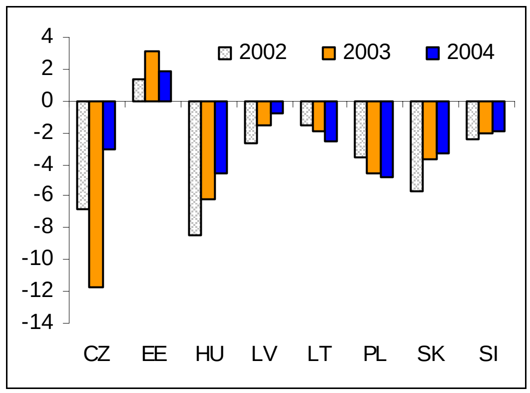
Some countries have renewed their interest in Public-Private Partnerships for the financing of infrastructure investments and other public services. This interest seems to be positively related to countries' difficulties in achieving fiscal consolidation, although there may well be other good reasons for pursuing such arrangements. These issues are discussed in more detail in the Special Topic.

Chart 40. Expenditure GG (ESA95, % of GDP) in 2002-2004



Source: Eurostat.

Chart 41. GG balance (ESA95, % of GDP) in 2002-2004



Source: Eurostat.

5. Reforms and Bottlenecks

A. Focus on the Acquis

Much of the effort in the EU8 countries in recent years was focused on negotiating and implementing the *acquis communautaire*. Negotiations on the acquis, which were officially launched in 1998, were finally closed during the EU summit in Copenhagen in December 2002. Over this period the 30 chapters of the acquis were negotiated, requiring an enormous harmonization effort by the candidate countries of their legislative bodies along with a number of individually tailored transition arrangements that aimed at temporarily protecting certain country-specific needs.

The greatest concerns related to competition policy and financial and budgetary provisions, with negotiations spanning several years in most countries and important transition arrangements needed. Some of these were discussed above.

- *competition policy* – phasing-out or converting incompatible fiscal aid measures (Hungary, Malta, Poland, Slovakia) and setting final dates for completion of restructuring of steel industries (the Czech Republic and Poland) with transition periods until 2011);

- *environment* – recovery and recycling of waste packaging (until 2005), treatment of urban waste water (until 2010), quality of drinking water (until 2015), air pollution from large combustion plants (until 2015), emission of volatile organic compounds from storage of petrol (until 2008), and integrated pollution and prevention control (until 2011); transition arrangements for most countries;
- *energy* – build up of oil stocks to the required level in all countries except Hungary (until 2009);
- *taxation and customs union* – loosened VAT and/or excise regime on certain products in all countries (until 2007/2009), specific import regulations in Hungary (up to 5 years);
- *agriculture and fisheries* – phasing in of agricultural direct payments (until 2013), introduction of certain additional rural development measures and upgrading of certain establishments to meet veterinary and phytosanitary requirements (in the first years of membership) in all new member states, detailed transitional fisheries regulations in Latvia, Lithuania and Poland;
- *free movement of goods* – renewal of marketing authorization for pharmaceuticals in Lithuania, Poland, and Slovenia (until 2007);
- *freedom of movement for persons* – application of national regulations concerning movement of workers by the old member states toward the new members (allowed for a period of 2-7 years);
- *freedom to provide services* – lower levels of investor compensation and in some cases also capital requirements for carrying out specific financial activities in all new member states excluding the Czech Republic (until 2007); provisional regulations also apply to the provision of transport services between two locations in one domestic market by firms from another EU member country (cabotage);
- *free movement of capital* – acquisition of secondary residences and/or agricultural and forestry land in all new member countries (up to 5 years).

While all chapters were closed at end-2004, implementation (including revisions to domestic legislation) was not fully completed and will be monitored regularly during the early phase of membership. In the final event, countries that fail to comply fully with the acquis would be subject to litigation in the EU court system. Thus, countries are still busy with the final implementation of both the closed chapters and, of course, addressing the outstanding transitional agenda.

B. Public Finance Reform

In most EU8 countries, public finance reforms over the last couple of years have focused on tax reforms. This reflects the countries' desire to streamline tax systems and reduce disincentives, lower the tax burden on labor (especially low-income wage earners), and last but not least efforts to stimulate the investment climate and attract foreign investors. The tendency has generally been to lower tax rates while broadening tax bases and tax sources, and in several of the countries, in the direction of flat tax systems (notably Estonia and Slovakia).

Regarding the corporate income tax regimes in the EU8 countries, developments in the last few years can be summarized as follows: (i) statutory rates were reduced (Table 5); (ii) tax bases were broadened, mainly through the reduction of favorable special tax regimes including in the context of EU accession negotiations; (iii) effective tax rates fell or at least stabilized; and (iv) tax revenues remained stable or rose as proportion of GDP. However, at the same time, effective tax rates in EU15 declined at an even faster pace than in the EU8. Although corporate taxation remains within the competence of individual member states, there have been various attempts over the years to seek harmonization also in this area. While proposals so far have all been rejected at the political level, progress has been made to prevent double taxation of profits and abolish taxation of interest and royalty payments between associated undertakings in different member states (three corporate tax directives have been adopted). These issues were discussed in more detail in the EU8 Quarterly Economic Report Q3-2004.

Regarding personal income taxes in the EU-8 countries, reforms included mainly adjustments in tax allowances and exemptions aimed at social assistance (the Czech Republic, Estonia, Lithuania, and Slovakia), including raising the basic allowance and child allowances, and reduction of tax progressivity (Slovakia, Lithuania, and Hungary). However, statutory income tax rates remain significantly higher than effective rates due to numerous deductions, exceptions, tax credits and other country specific regulations concerning the calculation of taxable incomes and tax liabilities. Labor taxes were discussed in more detail in the EU8 Quarterly Economic Report Q1-2005.

Table 5. Top statutory tax rates.

	1998	2003	2004	2005	1998	2003	2004	2005
	Corporate income tax				Personal income tax			
CZ	35	31	28	26	40	32	32	32
EE	26	26	26	26	26	26	26	24
LV	25	19	15	15	25	25	25	25
LT	29	15	15	15	33	33	33	33
HU	19.6	19.6	17.7	17.7	44	40	38	38
PL	36	27	19	19	40	40	40	40
SI	25	25	25	25	50	50	50	50
SK	40	25	19	19	42	38	19	19

Source: CSOs, staff calculations.

With regard to indirect taxes, bases and rates have been harmonized in order to secure internal market competition and reduce major distortions. Following EU regulation, selected goods and services were transferred from the reduced to the standard rate in 2004. The lower rate remains unchanged and covers only a narrowly defined list of socially sensitive commodities (food, drugs, construction works for housing, heat etc.). Excise duties on commodities have also been raised, although certain provisional arrangements are in place.

Meanwhile, progress in comprehensive reform of social expenditures needed to ensure medium-term fiscal sustainability has been uneven. Slovakia has made the greatest stride by overhauling its social insurance system, including the pension system, health care financing, sickness benefits, and social assistance programs (e.g. child benefits). In the Czech Republic, reforms included downsizing of the civil service, reductions in discretionary spending of individual ministries, and rationalization of sickness benefits. However, comprehensive pension and health care reforms remain on hold. Both countries have strengthened their fiscal management system, putting in place effective medium-term budget frameworks. In Hungary, measures to control spending in 2003-04 focused mainly on administrative savings and tended to be of an ad hoc nature. In Poland, an ambitious social spending reform program launched in early 2004 suffered a poor fate in Parliament.

C. Selected other reforms

Privatization got a further push in some EU8 countries. Notably, the Visegrad countries made some progress on the outstanding privatization agenda, in some cases seemingly driven more by concerns to raise revenues for the budget than concerns about efficiency improvements. The major privatizations occurred in banking, telecommunications, energy, and transportation.

Most countries also undertook further reforms to deregulate markets and improve the overall business climate. According to the World Bank's Doing Business in 2005, Slovakia became the top reformer in the world in 2003. The country introduced more flexible working hours, eased the hiring of first-time workers, opened a private credit registry, cut the time to start a business in half, and, thanks to a new collateral law, reduced the time to recover debt by three-quarters. Two other EU8 economies—Lithuania and Poland—significantly lightened the burden on businesses and counted among the top 10 reformers. Banking and financial market reform was also advanced in the Czech Republic, Estonia, and Slovakia—the only upgrades on the EBRD Transition Indicators.

Table 6 below provides a broad overview of EU8 reforms in 2004.

Table 6. Progress on structural reforms in 2004.

Reforms Initiatives	Pension Reform	Education Reform	Tax Policy	Expenditure policy	Business environment	Labor market reform	Others
CZECH REPUBLIC	Eexperts group to prepare different proposals of pension reform have been set up. Goverment intends to decide on one of the proposals before the 2006 parliamentary elections.	A new Education Act covering primary and elementary education has been approved. However, reform of tertiary education was postponed.	Reduction of the corporate income tax rate (from 31% in 2003 to 24% in 2006), increase of social security contribution base of selfemployed persons (to 50% of the difference between revenues and costs, instead of the previous 35%). Introduction of accelerated depreciation of movables and tax support of corporate research and development.	Reduction in sickness benefits, cuts in discretionary spending of individual ministries (mainly cuts in military expenditures, state subsidy for housing savings programmes, subsidies to businesses, and in the operating costs of ministries). Reduction of employment in central goverment.	Several proposals to tackle barriers to market entry and exit and to reduce administrative burden are being discussed. Also, a completely new Bankruptcy Act is being prepared. However, very few measures have actually been implemented.	In October 2004, a new Employment Law entered into force. However, many of structural shortcomings, such as low labour force mobility, have not yet been tackled.	Progress in banking and financial market reform: capital market legislation has been improved.
ESTONIA		In 2004, a new vocational education development plan for 2005-2008 was prepared. Actions include the assessment of businesses' needs and demands for vocational training and maintaining the school network.				A legal package addressing structural problems in the labor market was adopted by the Government in 2004.	Move towards increasing competition in telecommunication (introduction of number portability for fixed lines in 2004 and for mobile lines in 2005). Progress in banking and financial market reform: significant expansion of domestic credit to the private sector and further strengthening of prudential supervision and competition in the banking sector have been achieved.
HUNGARY		Measures have been taken to develop vocational training and the new act on higher education also encourages positive developments in the educational field.	Changes in the tax and social security system. Cuts in rates and extension of brackets in personal income tax, combined with elimination of numerous tax allowances and credits. Decrease of corporate tax rate from 18% to 16%.	The government has adopted specific measures to enhance effective financial management of central budgetary institutions' expenditures and introduced a zero-base planning system for chapter-managed appropriations. Some spending measures in order to strengthen fiscal discipline as reduction of employment in central government, reduction of housing loan subsidies, freezing of subsidised drug prices have been envisaged.			Measures have been taken to open up the energy market for competition (e.g. the gas and electricity markets were liberalised for non-household users).
LATVIA	Some parametric changes in the PAYG pension pillar.	The reform of the basic education system was completed, while the reforms of secondary and tertiary education are ongoing.	Reduction of the corporate income tax rate (from 22% in 2003 to 15% in 2004) and social insurance payments base rate (from 35.09% to 33.09%) were adopted. They may contribute to higher motivation to enter the labour market. Completion of social security reform may, inter alia, increase disincentives towards the informal sector.		Considerable progress has been achieved with improvements in company registration procedures, tax policy and in access to capital for entrepreneurs.		Reforms to liberalise network industries have been pushed forward, including improvement of interconnection capacities.
LITHUANIA	Preparation for the introduction of the third pension pillars (from January 1, 2005)	Actions have been taken to improve vocational training. In response to low R&D performance, the government adopted a new strategy to promote R&D and innovation and to increase the cooperation between research and business.				New measures aimed at reducing skill mismatches were taken in 2004 (i.e promotion of the vocational training).	A set of reforms have been taken to further liberalise network industries. Considerable progress has been made in the Lithuanian financial sector in regulation and transparency, as well as in the restructuring and privatisation of the banking sector.
POLAND			Reduction of the corporate income tax rate from 27% to 19%. Introduction of the possibility to pay the corporate income tax rate of 19% for small companieswhich paid so far taxes according to the personal income tax thresholds, if they renounce all tax exemptions and rebates.	The "Programme of Public Spending Rationalisation and Reduction" (Hausner plan), prepared in late 2003, assumes a reduction of social and administrative spending over the period 2004-2007 - not implemented, most of the proposals have been watered down.			Local governments' reform: gradual transfer of personal and corporate income tax revenues from the Central Budget to local authorities (self-governments) and a simultaneous reduction of subsidies.
SLOVAK REPUBLIC	Changes in key parameters of the pay-as-you-go pillar of the pension system (e.g. benefit formula, indexation, retirement age) have been introduced.	Per-capita financing was introduced for elementary schools, and schools were decentralized to local and regional self-governments. On the other, major reform on a substance (i.e. curriculum) is still waited for, as well as introduction of tuition fees for secondary education.	Far-reaching tax reforms have taken effect, including: introduction of a flat tax rate of 19% for both individual and corporate income taxation, coupled with the removal of tax exemptions, introduction of a unified VAT tax rate of 19%, and abolition of some less significant taxes (inheritance tax, gift tax) and amendments to some others (real estate tax, vehicle tax). The health and social insurance contribution rates have been reduced.	The reforms on the expenditure side affect in particular the area of social transfers: changes in the social insurance system (e.g. sickness benefits), social assistance and social benefits (e.g. child benefits), changes in the health care system (e.g. full impact of introduction of co-payments).	There has been significant progress in improving the business environment. Measures to enhance the business climate were aimed at improving the entry to and exit from the market and easing the administrative burden on business. (New framework for bankruptcies was approved in December 2004). However, weak enforcement remains a problem as changes are slow.		Progress in banking and financial market reform: significant expansion of domestic credit to the private sector and further strengthening of prudential supervision and competition in the banking sector have been achieved.
SLOVENIA			New tax incentives to companies investing in new equipment, especially equipment for research and technological development, were approved.	Further restructuring (reallocation of expenditure items favouring investment in education and research and promoting regional cohesion).	Two new Acts were adopted to reduce the administrative burdens facing new businesses. The one-stopshop system for SMEs has been partially completed.		

Source: EC: "Public Finance in EMU - 2004", "Annual Report on Structural Reforms 2005."

6. Possible Lessons for Next EU member countries

The analysis above and general impressions from observing economic developments in the EU8 prior to and after EU accession, suggest the following main lessons for future member EU countries:

1. **Careful management of expectations is important**.
    - Policy makers are well advised to manage expectations relating to EU membership carefully, including a balanced presentation of potential benefits and new challenges.
    - Convincing the broad spectrum of stakeholders that membership can bring important economic benefits and higher living standards, and that these gains are sufficient to compensate for inevitable costs, is paramount to securing broad support for both the political process and the policies needed to maximize potential benefits.
2. **Policies and reforms should be anchored in a clear long-term vision and strategic national development plan for the country**.
    - The general experience of cohesion countries suggests that there may be a trade-off between rapid external and internal convergence. Identifying such trade-offs and gearing policies to minimize these, consistent with national welfare objectives, is the best place to start.
    - EU regional aid funds are no panacea for rapid convergence. They may help provide sustained benefits when carefully targeted to high-yielding investments in human and physical capital, but domestic economic policies matter more.
    - Securing macroeconomic stability, stimulating the investment climate, strengthening human capital, and enhancing labor market flexibility are the core prerequisites for high and sustainable growth rates.
    - FDI plays an important role for economic development through facilitating economic restructuring and transfer of knowledge. While corporate income taxes and incentives may matter at the margin for attracting FDI, the experience from the EU8 and other countries suggests that market size, gravity factors, skills and natural resource endowments, labor costs, general reform progress (including rule of law and secure property rights), and economic and political stability are much more important.
3. **An efficient and technically strong public administration is essential to manage the reform process in general and EU aid in particular**.
    - Public administration reform is perhaps the most urgent of all reforms as failure in this area will slow and hinder any other reforms and lead to waste of EU funds. Few EU8 countries have made sufficient headway in this area.
    - Building administrative and technical capacity is needed not only at the central government level but perhaps even more importantly at the local government level. All EU8 countries are now feeling this constraint.
4. **Set priorities and undertake as much reform as possible before accession**.
    - The pre-accession period provides a unique window of opportunity to carry out reforms. The prospect of EU membership underpinned popular support for reform, but after accession efforts were focused on implementing the acquis, some reform fatigue seemed to set in, and the political and economic room for reform narrowed, not least where political cycles were more advanced. Slovakia took full advantage of this window of opportunity and is now reaping the benefits.
    - Fiscal reforms that may have short term costs become more difficult under the constraints of the SGP. Such reforms include introduction of fully funded pension pillars, and bank and enterprise restructuring (for example, in the run up to accession the Czech and Slovak Republics recapitalized (and privatized) their banking sectors while Poland made efforts to efforts to clean up the books the coal and steel sectors ahead of planned privatization). It is also important to

effectively capture contingent liabilities and fiscal risks, including possibly through setting aside resources to finance future costs of these.

- Any outstanding price liberalization and indirect tax adjustment agenda will complicate inflation management in the EU and could erode competitiveness under fixed exchange rate regimes. Some countries such as Latvia are now struggling with these problems.
- It should also be a priority to ensure that sectors most exposed to competition after EU accession are prepared to confront it. In this regard, new member countries should not focus just on competition from the EU, but also each other and the rest of the world. In particular, traditional low-skill, labor intensive industries will come under heavy pressure from emerging Asian countries, and sustaining relatively low labor costs will be crucial to extend the life of such industries. The failure to lower labor taxes in the EU8 is now an important concern. At the same time, efforts to promote knowledge-based economies (education, innovation, etc.) cannot be started soon enough—the Irish experience shows that these are high-yielding but long-term investments.

5. **Develop an ambitious but credible plan for fiscal consolidation and/or reform and Euro adoption**.

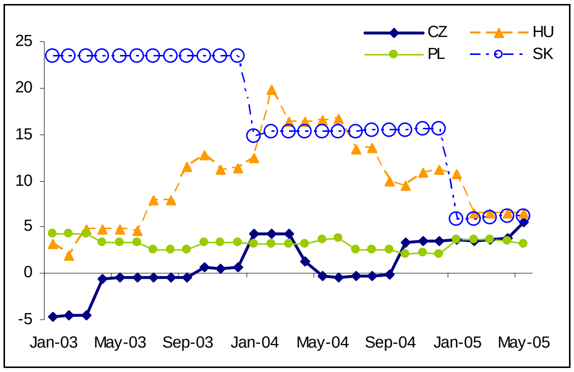
   - There is ample evidence from both the EU8 and other countries that excessive fiscal deficits crowd out private investment, complicate absorption of EU aid funds, and hinder growth. The lessons from fiscal consolidation in Spain and Ireland are useful to keep in mind.
   - Nevertheless, there are likely to be difficult trade-offs between the need for fiscal restraint and additional investments needed in especially infrastructure and the environment. Also, there will be other pressures on public finances, including from population aging and tax competition. At the same time, most countries have ample scope for rationalizing inefficient spending and widening tax bases and/or sources.
   - Develop a medium-term fiscal framework and target realistic euro adoption date. Manage fiscal risks, avoid accounting tricks, and stick to plans.
   - Be prepared to also use fiscal policy for achieving inflation and exchange rate targets. The Baltic countries may be learning this the hard way.
   - Don’t forget the importance of strong public finance management for the allocation of resources according to strategic priorities, focus on outcomes, efficient provision of public services, and achievement of fiscal targets. Again, Slovakia has taken these reforms seriously while others are only now embarking on this path.

6. **Macro-policies need to be carefully managed in the volatile period surrounding accession**.

   - Accession of the EU8 countries was associated with a jump in inventories, investment, exports, output, and prices. These turned out to be largely one-time factors, but there was a great deal of uncertainty among policy-makers that may have unduly affected expectations and policy responses. For example, monetary conditions may have tightened too much in some countries to contain potential secondary effects of the hike in prices, while budgets for 2005 may in some cases have rested on overly optimistic output growth assumptions following the boost in the accession year.

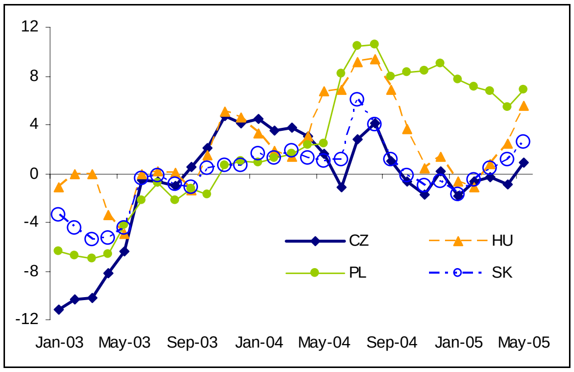
ANNEX CHARTS

Chart 42. HICP - Electricity, gas, solid fuels and heat energy, % yoy.



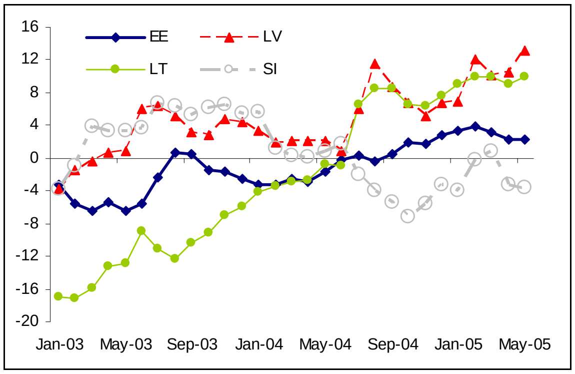
Source: Eurostat.

Chart 43. HICP - Unprocessed food, % yoy.



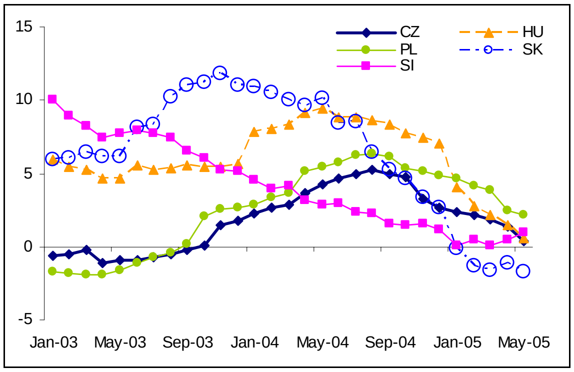
Source: Eurostat.

Chart 44. HICP - Unprocessed food, % yoy.



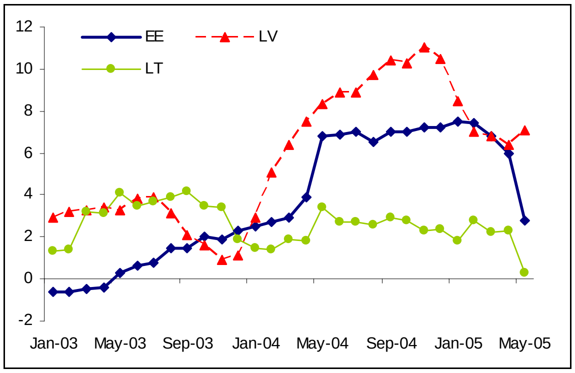
Source: Eurostat.

Chart 45. HICP – Processed food including alcohol and tobacco, % yoy.



Source: Eurostat.

Chart 46. HICP - Processed food including alcohol and tobacco, % yoy.



Source: Eurostat.

Annex 1: Drivers of the long-run economic growth in Bulgaria, Croatia and Romania

This annex uses the growth accounting framework to identify the structural determinants of long term growth and show how their influence has shifted during the transition period in Bulgaria, Croatia and Romania. The growth accounting exercise decomposes the real GDP growth into the contributions of the factors of production and a growth rate of the total factor productivity (TFP). The TFP, also known as the Solow residual, is generally interpreted in the literature as a measure of structural change in an economic system, which can not be attributable to or explained by the dynamics of the measurable input factors.

The growth accounting framework was used in a series of studies focusing on the transitional economies of Central and Eastern Europe in recent years. Boldrin and Canova (2003) [28], Dobrinsky (2001)[29] are examples. The current work contributes to this body of literature by (i) decomposing the overall analysis period into sub-intervals relevant for the specific dynamics of each economy, such as the pre-and post financial crisis period in Bulgaria, or the alternating boom-and-bust periods in Romania; and (ii) by refining the definitions of the input variables, for example by taking account of the quality (level of education) of the labor force. To allow for comparisons across the three countries, a similar methodological framework has been used.

Total Factor Productivity (TFP) estimations

The total factor productivity (TFP) has been estimated using the standard Cob-Douglas production function:

$$Y_t = A_t \left(K_t^{\alpha} L_t^{1-\alpha}\right)^{\beta} \quad (1)$$

where Y_t is the aggregate output at time t, K_t is the stock of productive capital, and L_t is labor or the productive human capital. α is the share of capital in GDP and β captures the returns to scale. The total factor productivity is measured by A_t and represents the unexplained portion of growth after decomposing it into inputs of production—labor and capital. A caveat of this approach is that, by construction, the measurement errors in GDP, labor and capital variables will be reflected in the estimate of the TFP.

Differentiating (1) gives the growth in aggregate output Y as a function of the dynamics of input factors and TFP:

$$dY/Y = dA/A + \beta[\alpha\ dK/K + (1-\alpha)\ dL/L] \quad (2)$$

[28] Paper published in Funck and Pizzati, *European Integration, Regional Policy and Growth,* the World Bank, Washington D.C., 2003.
[29] Dobrinsky, R. (2001). "Convergence in per Capita Income Levels, Productivity Dynamics and Real Exchange Rates in the Candidate Countries on the Way to EU Accession," *International Institute for Applied Systems Analysis* Working Paper, Laxenbourg.

To construct the dynamics of the capital stock variable we employ the perpetual inventory model, by accumulating the annual investments, net of depreciation. The productive capital stock is estimated using assumptions for initial capital stock adjusted with the change in gross domestic fixed investment (GFCF), expressed in constant prices, and assumption for the depreciation rate of the capital stock:

$$K_1 = K_0 + I_{net} = K_0 + (I - D) \qquad (3)$$

where K_0 and K_1 measure the capital stock in the two periods, I is investment and D is depreciation.

We believe that there are no major concerns regarding the accuracy of the measurement of the flow variables, including investment, since variables such as gross domestic investment (GDI) or gross fixed capital formation (GFCF) are computed by all three statistical offices using relatively reliable standardized methodological norms. In turn, measuring the capital stock poses substantial challenges. This is characteristic not only to Bulgaria, Croatia or Romania, but remains a general problem in most of the transitional economies of Central and Eastern Europe. It is well evidenced that measures such as the "social capital" of an enterprise or its book value, as reported traditionally for fiscal purposes, are poor proxies for the size of the physical capital stock of a company. This has been exacerbated by problems specific to each country. For Croatia, for example, reliable data for the period before 1994 is unavailable due to the war and the breakaway from the former Yugoslavia. For Bulgaria, the 1997 financial crisis was likely to have eroded a significant share of the obsolete physical capital, which found its way in the pre-crisis records.

To circumvent some of the obstacles erected by the absence of convincing data on the size of the capital stock, and given the existence of a relatively not-so-long GFCF time series, covering the period 1990-2004, we assume for the purpose of this exercise that the initial stock of capital is adjusted by a capital output ratio of 0.66[30]. Hence, K(1990)= 0.66*GDP (1990). This allows us to construct a K series.

The TFP estimates are computed using two alternative capital depreciation rates: 6.0%, respectively 7.5 % p.a. The latter is similar to Dobrinski (2001). These rates are slightly higher than the 4.0% used for example by Boldrin and Canova (2003). We assume this way that in the slower reforming CEE countries, such as Bulgaria and Romania, the sluggish accumulation of new productive capital and the state of the capital stock inherited from the pre-transition period have resulted in a higher depreciation rate than in other CEE countries, such as the Baltics or the Visegrad countries.

Human capital is computed employing three methods, by taking into account the educational attainment of the working population.

(a) The standard method, where labor is proxied by the growth of the labor force. Labor force consists of civilian employment, including the self-employed, and no adjustments are made for the quality of labor.

(b) Human capital is computed as a weighted average, grouping labor by the level of educational attainment and weighting with a coefficient expressing the quality of labor

[30] A common assumption in the literature.

for different levels of education (following Loayza[31]). Labor force is divided into four categories: higher, semi-higher, secondary and basic or lower education. For all three countries, we use the same returns to education for each of the groups. We assume this way that the education systems are not significantly different in the three countries in terms of returns to education[32]. The formula employed is coeff(level n) = coeff(level 0)*(1+x)^(difference of schooling years between level n average and level 0 average), where x is the wage increase brought by an extra year of schooling. The coefficient is 1 for basic or lower education. For the higher levels, the coefficients are based on the average number of years per level of education.

(c) This method is similar to Gosh- Kraay[33]. For each category (level of education) an average number of years of schooling[34] and an adjusted labor force level are computed. Labor force is derived from the formula L*exp(y*s), where the annual return to schooling, s, is 6%, and y represents the average number of years of schooling. The overall size of the labor force is then the weighted sum of each category of education.

The Cobb-Douglas production function is estimated, first, as a constant returns to scale ($\beta = 1$) and, second, as an increasing returns to scale ($\beta = 1.2$). Technical change is considered autonomous and neutral.

Results and Conclusions

Table 1 and Table 2 in the Annex report the results of the estimations. Output and employment data are available at constant prices for the period 1992-2004. To capture, to the extent possible, the complexities of growth dynamics in the three countries, driven in general by country-specific factors, but allow, at the same time, for cross-comparisons, the analysis period was divided into several intervals, for which alternative TFP estimates were calculated. A first period is between 1992-97, when the three countries gradually emerged from the sharp initial contraction in output and labor force. Characterized by major output swings, and occasional unsustainable accelerations in growth, the hesitant, stop-and-go approaches to addressing structural weaknesses, in all three countries, ultimately led to slowdown and even subsequent contraction in economic activity. During this period Bulgaria had a negative growth rate averaging 3.3 percent per year, culminating with the 1997 crisis, which profoundly affected the functioning of the economy, but also marked the beginning of a sustainable recovery. Croatia registered a sharp initial recovery and several years of robust economic expansion, after the end of the war, only to later run out of steam. In the case of Romania, the initial good start was equally sharply reversed after 1996 in the absence of major structural adjustments. The second period covers the recovery years[35], 1998-2000, characterized by the acceleration of growth and the implementation of important structural reforms. The third interval is the consolidation period, 2001-04, when the all three countries

[31] Norman Loayza, Pablo Fajnzylber, César Calderón, *Economic Growth in Latin America and the Caribbean: Stylized Facts, Explanations and Forecasts*, Central Bank of Chile Working Papers N° 265 June 2004.
[32] The figures for returns to education are taken from Joliffe, Dean (2002) "The Gender Gap in Bulgaria: A Semiparametric Estimation of Discrimination." Journal of Comparative Economics, 30: 276-295. Comprehensive assessments of the returns to education in Croatia and Romania are unavailable.
[33] Swati R. Gosh, Aart Kraay (2000), Measuring Growth in Total Factor Productivity. PREM Notes Economic Policy, No.42.
[34] We have taken the same average number of school years for all three countries in each category.
[35] Or the upturn in the case of Romania, which continued to contract for one more year, before recovering in 2000.

enjoyed high and sustained growth rates, exceeding 4 percent per year on average, and a marked reduction in inflation. To complete the picture, aggregate estimates for the period 1998-2004 and for the whole interval, 1992-04, are also reported.

The results highlight the important role that the renewal of the productive capital stock has played, in general, as a driver of economic growth in Bulgaria, Croatia and Romania. During the period 1992-2004, in all three countries, the capital stock increased faster than the economy overall. Leaving aside the inevitable measurement errors, sometimes probably large, such as during the 1997 crises in Bulgaria, the analysis points towards the central role of investment to economic turnaround. Unsurprisingly, the contribution of labor is in general negative, even after controlling for the quality of the labor force, especially in the first period. This is explained by the massive drop in participation as a result of the output collapse at the beginning of transition. All three countries, similarly to virtually all formerly socialist economies, started the transition with high employment rates, to compensate for the productivity gap with the West. The analysis also captures the close alignment between output and TFP fluctuations. TFP is therefore a main determinant of growth dynamics, with a large negative contribution in the first part of the transition and a strongly positive one during the consolidation period. However, in the later years, despite the TFP acceleration, the contribution of the physical capital has continued to increase, as a result of the important investments made after 1998. These patterns are more pronounced in the first years of transition, and are not dissimilar to dynamics in most of the CEE countries.

Table 1. Growth accounting for Romanian, Croatian and Bulgarian economies, 1992-2004 - Constant Returns

	avg 92-97	avg 98-00	avg 01-04	avg 98-04	avg 92-04
Bulgaria					
GDP growth	**-3.29%**	**3.89%**	**4.77%**	**4.39%**	**0.78%**
Baseline 1: Initial capital K/Y = 1.5, d = 6%					
Physical capital stock growth	3.12%	8.00%	9.03%	8.59%	6.03%
LF growth	-2.00%	-1.91%	0.69%	-0.43%	-1.16%
TFP growth with: Alpha = 0.3	-2.82%	2.83%	1.58%	2.12%	-0.22%
Alpha = 0.4	-3.34%	1.84%	0.75%	1.22%	-0.94%
Human capital stock growth (Loayza)	-1.65%	-1.64%	1.63%	0.22%	-0.65%
TFP growth with: Alpha = 0.3	-3.07%	2.64%	0.92%	1.67%	-0.58%
Alpha = 0.4	-3.55%	1.68%	0.18%	0.83%	-1.25%
Human capital stock growth (Gosh-Kraay)	-1.63%	-1.62%	1.62%	0.22%	-0.64%
TFP growth with: Alpha = 0.3	-3.08%	2.63%	0.93%	1.66%	-0.58%
Alpha = 0.4	-3.56%	1.66%	0.19%	0.83%	-1.25%
Baseline 2: Initial capital K/Y = 1.5, d = 7.5%					
Physical capital stock growth	2.00%	7.71%	8.93%	8.40%	5.40%
LF growth	-2.00%	-1.91%	0.69%	-0.43%	-1.16%
TFP growth with: Alpha = 0.3	-2.49%	2.92%	1.61%	2.18%	-0.03%
Alpha = 0.4	-2.89%	1.95%	0.79%	1.29%	-0.69%
Human capital stock growth (Loayza)	-1.65%	-1.64%	1.63%	0.22%	-0.65%
TFP growth with: Alpha = 0.3	-2.73%	2.73%	0.95%	1.72%	-0.39%
Alpha = 0.4	-3.10%	1.79%	0.22%	0.90%	-0.99%
Human capital stock growth (Gosh-Kraay)	-1.63%	-1.62%	1.62%	0.22%	-0.64%
TFP growth with: Alpha = 0.3	-2.74%	2.71%	0.96%	1.72%	-0.40%
Alpha = 0.4	-3.11%	1.78%	0.23%	0.90%	-1.00%
Croatia					
GDP growth	**0.64%**	**1.49%**	**4.40%**	**3.14%**	**1.98%**
Baseline 1: Initial capital K/Y = 1.5, d = 6%					
Physical capital stock growth	2.26%	4.87%	5.35%	5.14%	3.80%
LF growth	-0.40%	1.55%	-0.52%	0.36%	0.01%
TFP growth with: Alpha = 0.3	0.24%	-1.06%	3.16%	1.35%	0.83%
Alpha = 0.4	-0.02%	-1.39%	2.57%	0.87%	0.45%
Human capital stock growth (Loayza)	0.07%	2.26%	-0.66%	0.58%	0.35%
TFP growth with: Alpha = 0.3	-0.09%	-1.55%	3.26%	1.19%	0.60%
Alpha = 0.4	-0.31%	-1.81%	2.66%	0.74%	0.25%
Human capital stock growth (Gosh-Kraay)	0.11%	2.29%	-0.66%	0.60%	0.37%
TFP growth with: Alpha = 0.3	-0.11%	-1.57%	3.25%	1.18%	0.58%
Alpha = 0.4	-0.33%	-1.83%	2.65%	0.73%	0.24%
Baseline 2: Initial capital K/Y = 1.5, d = 7.5%					
Physical capital stock growth	1.19%	4.31%	5.04%	4.73%	3.08%
LF growth	-0.40%	1.55%	-0.52%	0.36%	0.01%
TFP growth with: Alpha = 0.3	0.56%	-0.89%	3.25%	1.47%	1.05%
Alpha = 0.4	0.40%	-1.16%	2.69%	1.03%	0.74%
Human capital stock growth (Loayza)	0.07%	2.26%	-0.66%	0.58%	0.35%
TFP growth with: Alpha = 0.3	0.23%	-1.38%	3.35%	1.32%	0.81%
Alpha = 0.4	0.12%	-1.59%	2.78%	0.90%	0.54%
Human capital stock growth (Gosh-Kraay)	0.11%	2.29%	-0.66%	0.60%	0.37%
TFP growth with: Alpha = 0.3	0.21%	-1.40%	3.34%	1.31%	0.80%
Alpha = 0.4	0.10%	-1.60%	2.78%	0.89%	0.53%

Romania					
GDP growth	**0.22%**	**-1.34%**	**5.97%**	**2.77%**	**1.59%**
Baseline 1: Initial capital K/Y = 1.5, d = 6%					
Physical capital stock growth	4.35%	1.57%	2.61%	2.16%	3.16%
LF growth	-2.93%	-1.48%	-0.99%	-1.20%	-2.00%
TFP growth with: Alpha = 0.3	0.97%	-0.78%	5.88%	2.96%	2.04%
Alpha = 0.4	0.24%	-1.08%	5.52%	2.63%	1.52%
Human capital stock growth (Loayza)	-3.03%	-1.34%	-0.56%	-0.90%	-1.89%
TFP growth with: Alpha = 0.3	1.04%	-0.87%	5.58%	2.75%	1.96%
Alpha = 0.4	0.30%	-1.16%	5.26%	2.45%	1.46%
Human capital stock growth (Gosh-Kraay)	-3.03%	-1.35%	-0.54%	-0.89%	-1.88%
TFP growth with: Alpha = 0.3	1.04%	-0.86%	5.56%	2.75%	1.96%
Alpha = 0.4	0.30%	-1.16%	5.25%	2.44%	1.45%
Baseline 2: Initial capital K/Y = 1.5, d = 7.5%					
Physical capital stock growth	3.31%	0.73%	2.07%	1.49%	2.33%
LF growth	-2.93%	-1.48%	-0.99%	-1.20%	-2.00%
TFP growth with: Alpha = 0.3	1.28%	-0.52%	6.04%	3.16%	2.29%
Alpha = 0.4	0.66%	-0.74%	5.73%	2.89%	1.86%
Human capital stock growth (Loayza)	-3.03%	-1.34%	-0.56%	-0.90%	-1.89%
TFP growth with: Alpha = 0.3	1.35%	-0.62%	5.74%	2.95%	2.21%
Alpha = 0.4	0.72%	-0.82%	5.48%	2.71%	1.79%
Human capital stock growth (Gosh-Kraay)	-3.03%	-1.35%	-0.54%	-0.89%	-1.88%
TFP growth with: Alpha = 0.3	1.35%	-0.61%	5.73%	2.95%	2.21%
Alpha = 0.4	0.71%	-0.82%	5.46%	2.71%	1.78%

Table 2. Growth accounting for Romanian, Croatian and Bulgarian economies, 1992-2004 - Increasing Returns

1.2	**avg 92-97**	**avg 98-00**	**avg 01-04**	**avg 98-04**	**avg 92-04**
Bulgaria					
GDP growth	**-3.29%**	**3.89%**	**4.77%**	**4.39%**	**0.78%**
Baseline 1: Initial capital K/Y = 1.5, d = 6%					
Physical capital stock growth	3.12%	8.00%	9.03%	8.59%	6.03%
LF growth	-2.00%	-1.91%	0.69%	-0.43%	-1.16%
TFP growth with: Alpha = 0.3	-2.73%	2.61%	0.94%	1.67%	-0.42%
Alpha = 0.4	-3.35%	1.43%	-0.06%	0.58%	-1.28%
Human capital stock growth (Loayza)	-1.65%	-1.64%	1.63%	0.22%	-0.65%
TFP growth with: Alpha = 0.3	-3.02%	2.39%	0.15%	1.12%	-0.85%
Alpha = 0.4	-3.60%	1.23%	-0.74%	0.12%	-1.65%
Human capital stock growth (Gosh-Kraay)	-1.63%	-1.62%	1.62%	0.22%	-0.64%
TFP growth with: Alpha = 0.3	-3.04%	2.37%	0.16%	1.12%	-0.86%
Alpha = 0.4	-3.61%	1.22%	-0.73%	0.11%	-1.66%
Baseline 2: Initial capital K/Y = 1.5, d = 7.5%					
Physical capital stock growth	2.00%	7.71%	8.93%	8.40%	5.40%
LF growth	-2.00%	-1.91%	0.69%	-0.43%	-1.16%
TFP growth with: Alpha = 0.3	-2.33%	2.72%	0.98%	1.73%	-0.20%
Alpha = 0.4	-2.81%	1.57%	-0.01%	0.67%	-0.98%
Human capital stock growth (Loayza)	-1.65%	-1.64%	1.63%	0.22%	-0.65%
TFP growth with: Alpha = 0.3	-2.62%	2.49%	0.19%	1.19%	-0.62%
Alpha = 0.4	-3.06%	1.37%	-0.69%	0.20%	-1.35%
Human capital stock growth (Gosh-Kraay)	-1.63%	-1.62%	1.62%	0.22%	-0.64%
TFP growth with: Alpha = 0.3	-2.64%	2.48%	0.20%	1.18%	-0.63%
Alpha = 0.4	-3.07%	1.36%	-0.68%	0.20%	-1.36%

Croatia

GDP growth	**0.64%**	**1.49%**	**4.40%**	**3.14%**	**1.98%**
Baseline 1: Initial capital K/Y = 1.5, d = 6%					
Physical capital stock growth	2.26%	4.87%	5.35%	5.14%	3.80%
LF growth	-0.40%	1.55%	-0.52%	0.36%	0.01%
TFP growth with: Alpha = 0.3	0.16%	-1.57%	2.91%	0.99%	0.60%
Alpha = 0.4	-0.16%	-1.96%	2.21%	0.41%	0.15%
Human capital stock growth (Loayza)	0.07%	2.26%	-0.66%	0.58%	0.35%
TFP growth with: Alpha = 0.3	-0.23%	-2.16%	3.03%	0.80%	0.32%
Alpha = 0.4	-0.50%	-2.47%	2.31%	0.26%	-0.09%
Human capital stock growth (Gosh-Kraay)	0.11%	2.29%	-0.66%	0.60%	0.37%
TFP growth with: Alpha = 0.3	-0.26%	-2.18%	3.02%	0.79%	0.30%
Alpha = 0.4	-0.52%	-2.49%	2.30%	0.25%	-0.11%
Baseline 2: Initial capital K/Y = 1.5, d = 7.5%					
Physical capital stock growth	1.19%	4.31%	5.04%	4.73%	3.08%
LF growth	-0.40%	1.55%	-0.52%	0.36%	0.01%
TFP growth with: Alpha = 0.3	0.55%	-1.36%	3.02%	1.14%	0.86%
Alpha = 0.4	0.36%	-1.70%	2.35%	0.61%	0.49%
Human capital stock growth (Loayza)	0.07%	2.26%	-0.66%	0.58%	0.35%
TFP growth with: Alpha = 0.3	0.15%	-1.96%	3.14%	0.95%	0.58%
Alpha = 0.4	0.02%	-2.21%	2.46%	0.46%	0.25%
Human capital stock growth (Gosh-Kraay)	0.11%	2.29%	-0.66%	0.60%	0.37%
TFP growth with: Alpha = 0.3	0.12%	-1.98%	3.13%	0.94%	0.56%
Alpha = 0.4	-0.01%	-2.22%	2.45%	0.45%	0.24%

Romania

GDP growth	**0.22%**	**-1.34%**	**5.97%**	**2.77%**	**1.59%**
Baseline 1: Initial capital K/Y = 1.5, d = 6%					
Physical capital stock growth	4.35%	1.57%	2.61%	2.16%	3.16%
LF growth	-2.93%	-1.48%	-0.99%	-1.20%	-2.00%
TFP growth with: Alpha = 0.3	1.12%	-0.66%	5.86%	3.00%	2.13%
Alpha = 0.4	0.24%	-1.03%	5.43%	2.60%	1.51%
Human capital stock growth (Loayza)	-3.03%	-1.34%	-0.56%	-0.90%	-1.89%
TFP growth with: Alpha = 0.3	1.20%	-0.78%	5.50%	2.75%	2.04%
Alpha = 0.4	0.32%	-1.12%	5.12%	2.38%	1.43%
Human capital stock growth (Gosh-Kraay)	-3.03%	-1.35%	-0.54%	-0.89%	-1.88%
TFP growth with: Alpha = 0.3	1.20%	-0.77%	5.48%	2.74%	2.03%
Alpha = 0.4	0.31%	-1.12%	5.11%	2.38%	1.42%
Baseline 2: Initial capital K/Y = 1.5, d = 7.5%					
Physical capital stock growth	3.31%	0.73%	2.07%	1.49%	2.33%
LF growth	-2.93%	-1.48%	-0.99%	-1.20%	-2.00%
TFP growth with: Alpha = 0.3	1.49%	-0.36%	6.05%	3.24%	2.43%
Alpha = 0.4	0.74%	-0.63%	5.69%	2.92%	1.91%
Human capital stock growth (Loayza)	-3.03%	-1.34%	-0.56%	-0.90%	-1.89%
TFP growth with: Alpha = 0.3	1.58%	-0.47%	5.69%	2.99%	2.34%
Alpha = 0.4	0.82%	-0.72%	5.38%	2.70%	1.83%
Human capital stock growth (Gosh-Kraay)	-3.03%	-1.35%	-0.54%	-0.89%	-1.88%
TFP growth with: Alpha = 0.3	1.57%	-0.46%	5.68%	2.98%	2.33%
Alpha = 0.4	0.81%	-0.71%	5.36%	2.70%	1.82%

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