



Part II. Addendum: EU Accession—One Year After

EU8

1. Introduction

This addendum presents a brief analysis of economic developments in the eight new Central European and Baltic EU member countries (EU8) from 2002 to 2005, including to see if there may be lessons for the next group of accession countries (Bulgaria and Romania).

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.

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 borne 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 suck in jobs through unfair tax competition causing a surge in unemployment, ruining the standards and “quality” of the Union, abusing the welfare state, draining the Common Agricultural Policy and, finally, bringing a deadlock to the EU decision-making process.

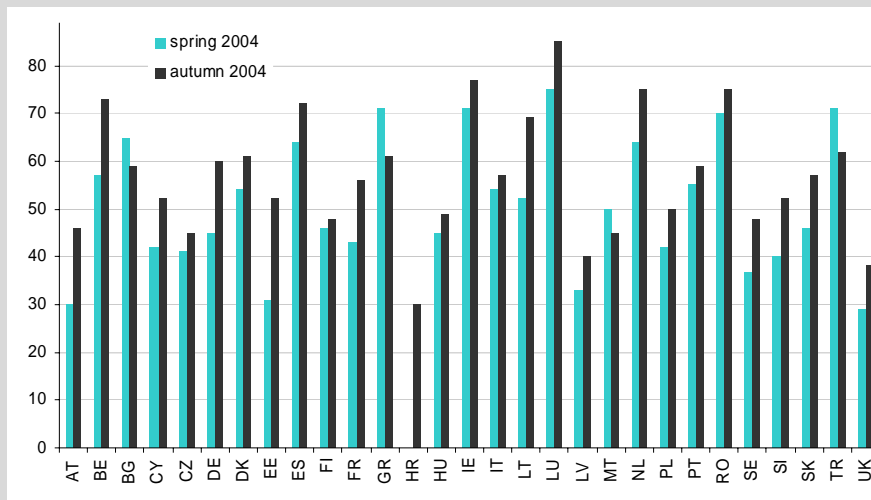
These pessimistic predictions have not been validated. The EU8 economies have revealed a strong capacity to cope with the additional competitive pressures within the Union. Domestic firms and farms have been capable of adapting themselves, farmers’ incomes have surged, foreign direct investment has increased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

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.

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.

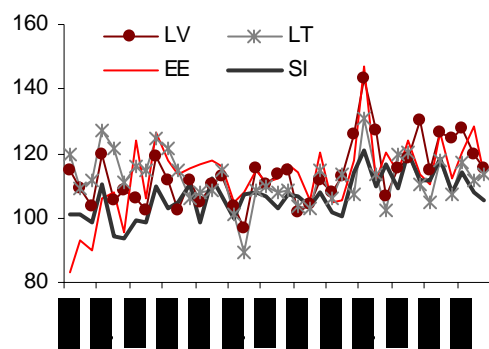
3. Coping in the Single Market

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.

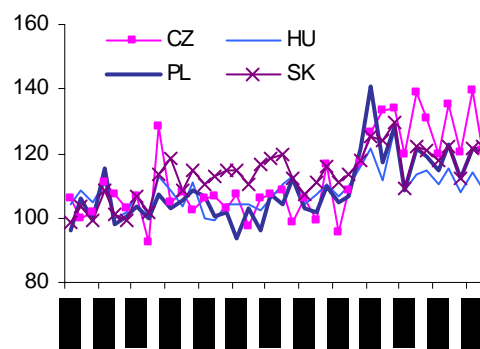
After EU accession, regional trade integration accelerated further. The EU15 share of EU8 trade rose to roughly 70% in 2004 (highest in the Czech Republic and Hungary). Export growth from the EU8 surged to 19% yoy in 2004, outpacing also rapid import growth of 17% yoy reflecting the high import intensity 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 (%).



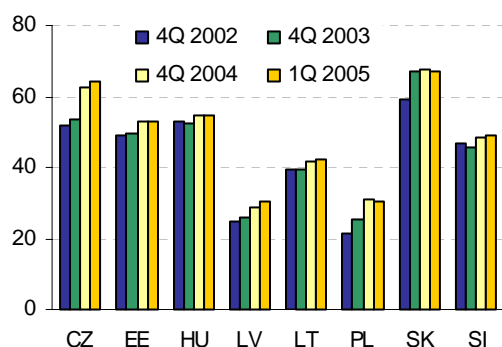
Source: WIIW, CSOs, staff calculations.

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



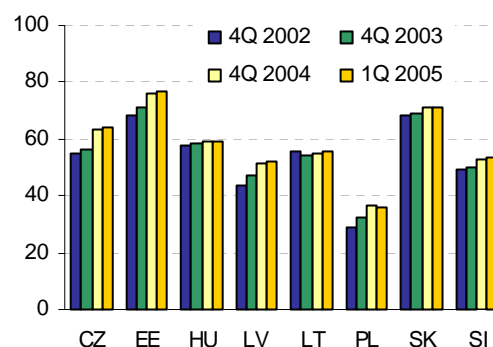
Source: WIIW, CSOs, staff calculations.

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



Source: WIIW, CSOs, staff calculations.

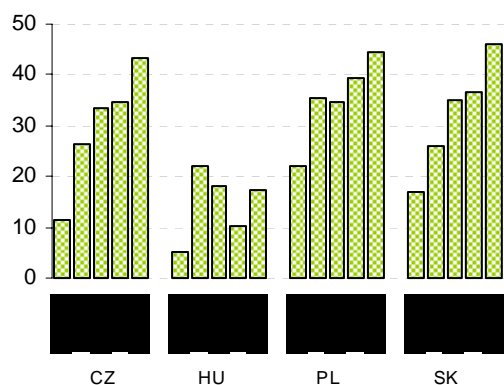
Chart 5. Import as % of GDP, 4Q cumulative.



Source: WIIW, CSOs, staff calculations.

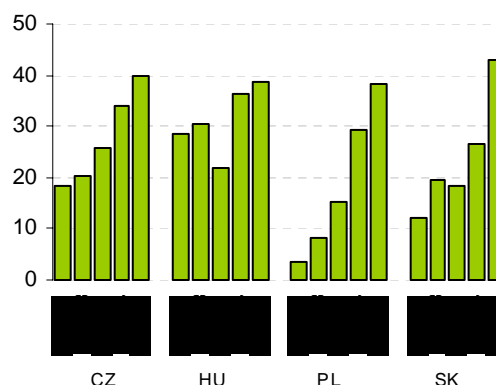
The stellar export performance was broad based. Manufacturing (notably machinery and transport equipment) exports surged (except in Slovakia), but there was also a dramatic expansion in agricultural exports (from a low base) as the EU market was opened to the NMS and these were included in the Common 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 (%).



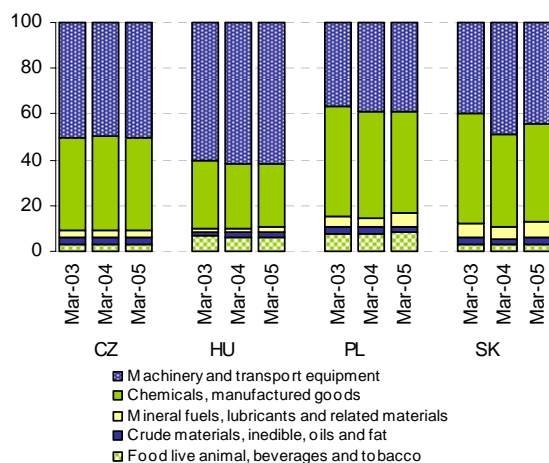
Source: OECD, **International Trade Statistics**.

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



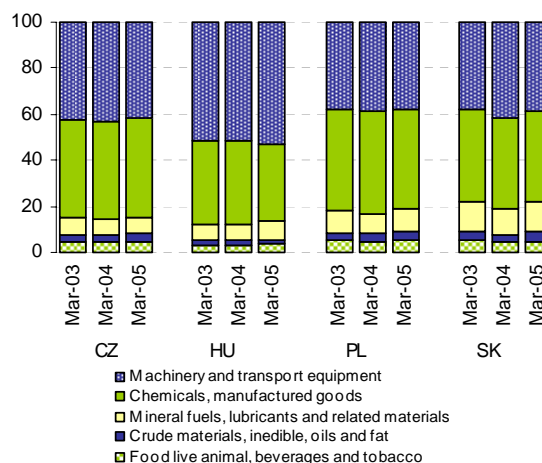
Source: OECD, **International Trade Statistics**.

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



Source: OECD, **International Trade Statistics**.

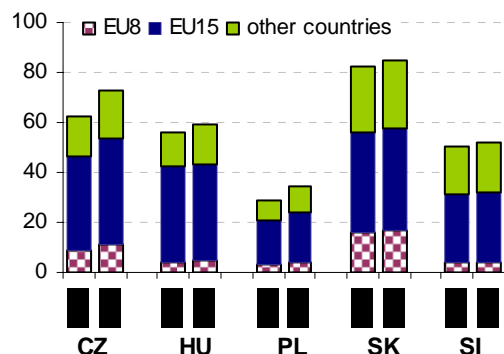
Chart 9. Composition of import by sections of SITC, EUR nominal, 12 months cumulative (%).



Source: OECD, **International Trade Statistics**.

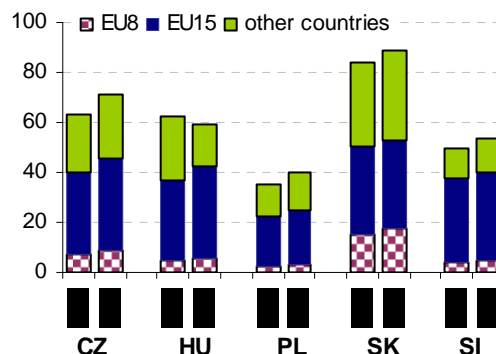
Integration not only contributed to increases in total trade volumes but also redirected trade flows. However, growth in trade between the EU25 countries did not take place at the expense of trade with third countries. The regional composition of EU8 trade in 2004 reveals strong gains in intra-EU25 trade, 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.

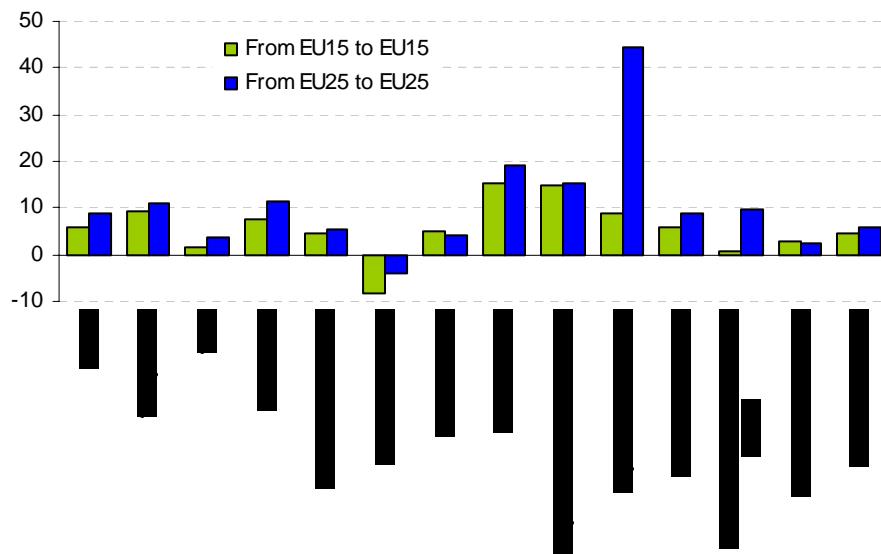


Source: WIIW, CSOs, staff calculations.

B. Trade in non-factor services

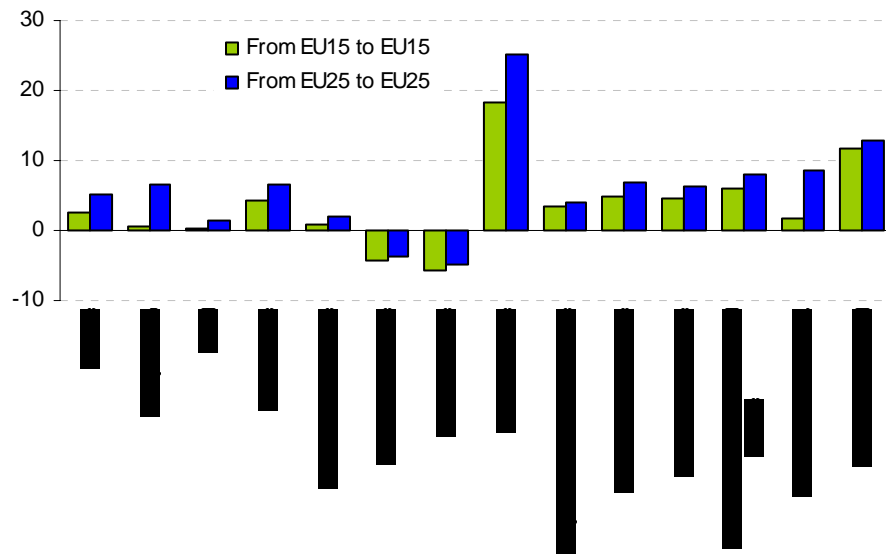
Service trade also expanded under the more liberal market conditions following accession (Chart 12). In 2004, trade in services among the EU25 faster than among the EU15, suggesting a stronger increase in intra-EU8 trade in services or relatively high growth between the EU15 and the NMS. Service trade 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 (%).

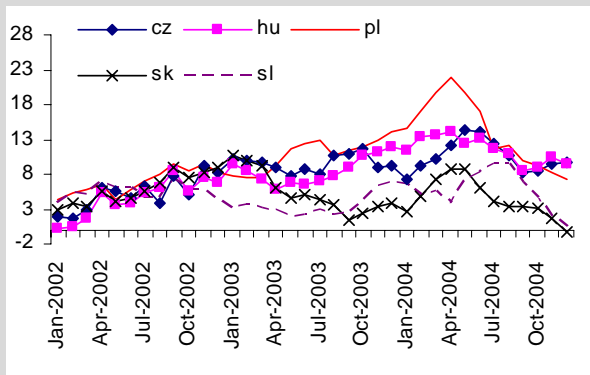


Source: Eurostat, staff calculations..

Box 3. EU8 Competitiveness

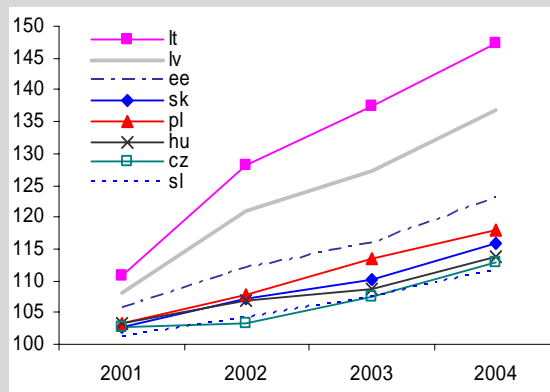
The impressive trade performance should be viewed on the background of strong productivity growth and competitive positions that allowed the NMS to exploit new market opportunities.¹ Strong productivity growth started before accession but was mainly based on labor shedding (with the notable exceptions 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).

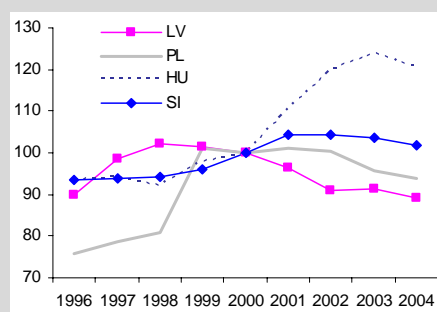


Source: WIIW, CSOs, World Bank, staff calculations.

¹ 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.’

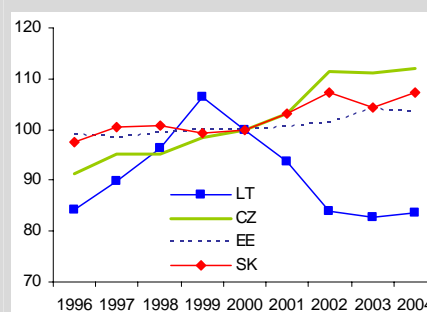
Meanwhile, wage growth has remained modest reflecting slack in labor markets, and unit labor costs (ULC) have thus been contained (Chart 16).

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").

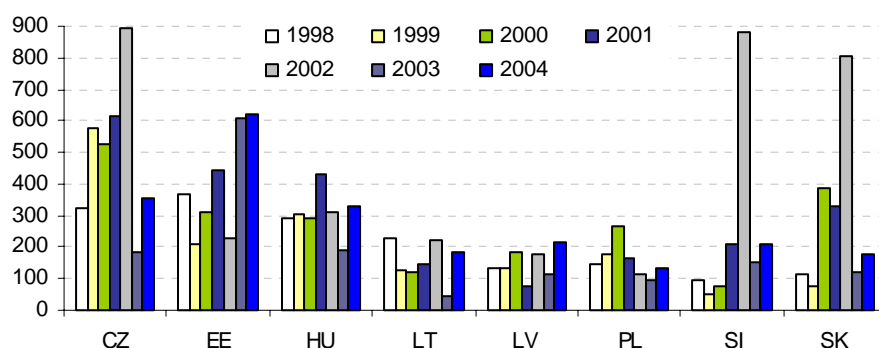
C. Capital flows

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).

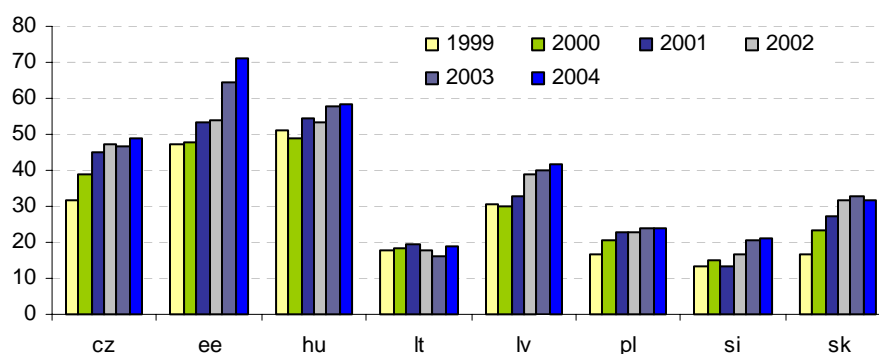
FDI inflows have to a significant extent been linked to privatization and greenfield investments (Slovakia, Latvia, Lithuania, and Poland), with the share of the former gradually decreasing. In the more mature FDI host countries such as the Czech Republic, Hungary and Estonia mergers and acquisitions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

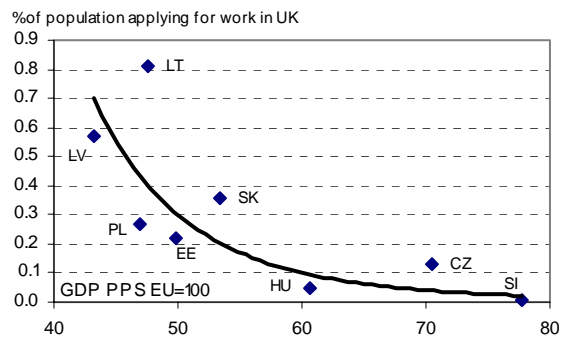
In 2004 some EU8 countries recorded an increasing interest of Asian investors (notably Korea, China, and Singapore) and Russian investors. Moreover, US multinationals have been shifting their focus from Western Europe to cheaper destinations in the East, including the EU8 economies. Also, FDI inflows 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 have 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 comes 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.² 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).³ 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).

² Source: Portes J, and S. French (2005), "The impact of free movement of workers from central and eastern Europe on the UK labor market: early evidence," Department. for Work and Pensions, UK, WP18.

³ 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.

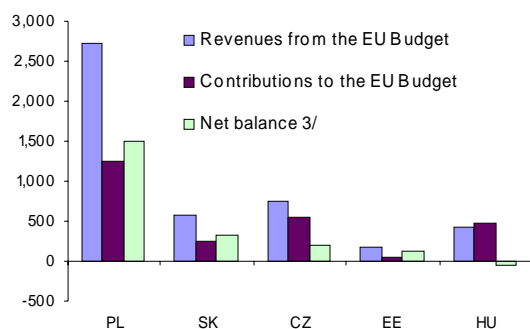
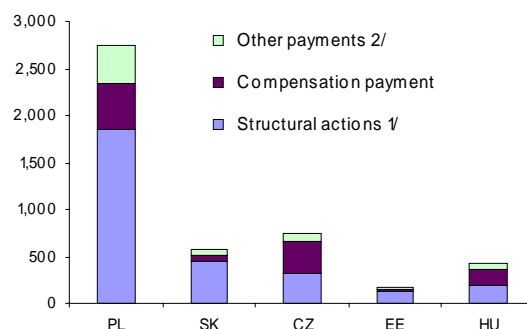


Chart 22. Composition of revenues from the EU budget



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

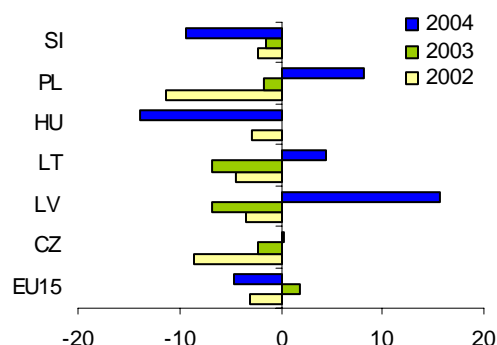
Source: PL, CZ, HU, EE MOF, SK State budget 2005-07.

F. Main winners in the first year of EU membership

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.

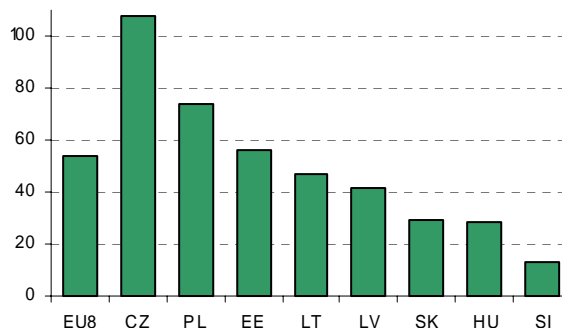
Improved agricultural terms of trade boosted welfare in Lithuania, Poland and Latvia (Chart 23). The gains in Latvia were the highest as output price increases were combined with lower prices for inputs to agricultural production. In other NMS countries for which information is available, input prices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



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	2245.9	2071.5	2128.6	3.1	2.8	2.7	228.5	212.9	174.1	4.8	4.5	3.7
EE	329	318	359.97	4.9	4.4	4.5	40	36	34	6.9	6.1	5.7
HU	2255	2102.6	:	3.7	3.3	:	240	227.5	206.7	6.2	5.8	5.3
LV	405	378	424	4.6	4.3	4.3	149	133.6	125.9	15.1	13.4	12.5
LT	942	914	926	7	6.2	5.7	247.9	256.6	227.7	17.6	17.8	15.8
PL	5487.8	4831.8	4941.7	3.1	3	2.9	2887	2408	2526	19.3	18.4	19.3
SK	1032.7	1064	1194.9	4.4	4	3.9	101.3	91	80	5.0	4.4	3.9
SI	649	568	:	3.1	2.6	:	100.3	97	93	11.2	10.9	10.4

Source: Eurostat

4. Macroeconomic Developments and Policies

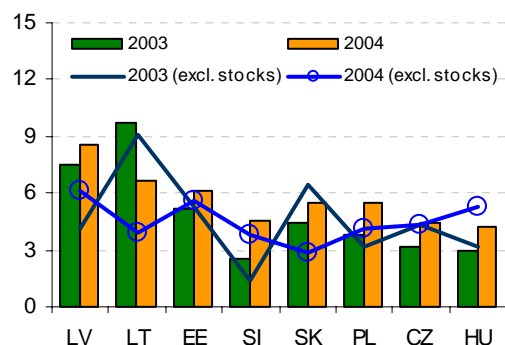
A. Output and employment

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.

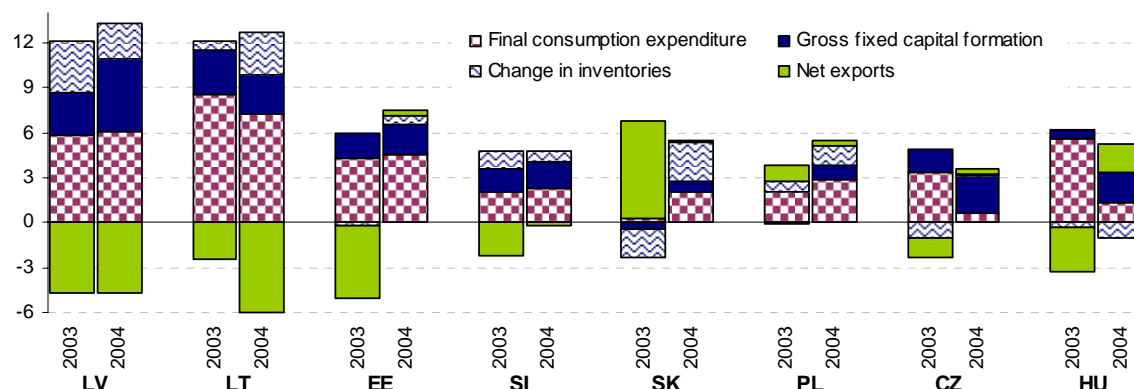
Chart 25. GDP real growth, %.



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.

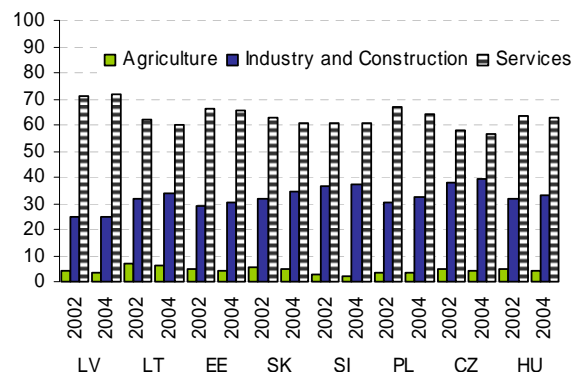
Chart 26. GDP contribution, %.



Source: CSOs, staff calculations.

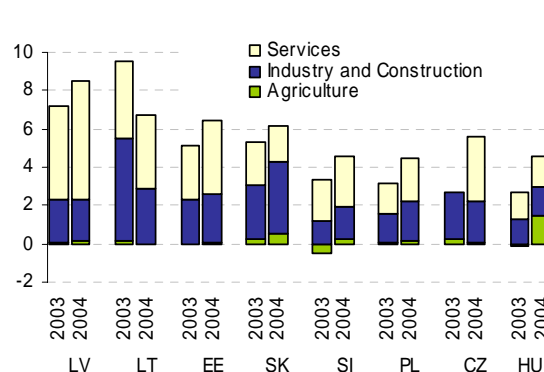
Economic developments in 2004 were also characterized by a further alignment of the sectoral composition of GDP towards that of the EU15. Services and industry provided the main impetus to output growth in the EU8 in 2004, with value added contributing 3.2 pp and 2.3 pp to growth, respectively (Chart 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 %.



Source: CSOs, staff calculations.

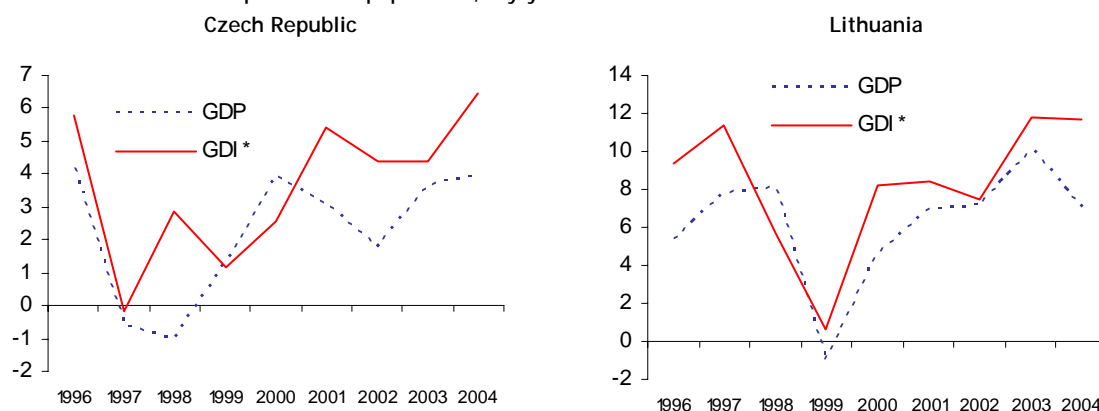
Chart 28. GDP contribution in 2003 and 2004, %.



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



* GDP adjusted for the impact of terms of trade

Source: AMECO, staff calculations

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).

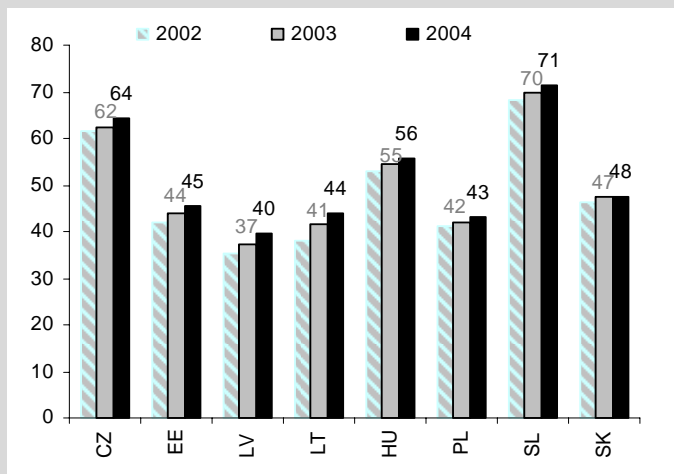
Most EU8 countries would reach average EU15 income levels only in two decades. Assuming that the EU15 will grow at 3% p.a. in the future (somewhat faster than in the period 2002-2004) while NMS grow at their average rate for the past three years, most EU8 countries would need more than 10 years to achieve 75% of the average EU15 level and about 20 years to reach average income levels. 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	7	12	15	11	12	14	27	12.6
100% of EU15 average	17	18	18	29	16	18	23	41	22.5

*) assuming average of last 3 years' real GDP growth rates for each country (with the exception of the Czech Republic, Estonia and Lithuania, where we used potential GDP growth estimates as these differed significantly from last 3 years' averages). Needless to say, these scenarios are only illustrative given the uncertainty about future growth rates.

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



Source: Eurostat

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.

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

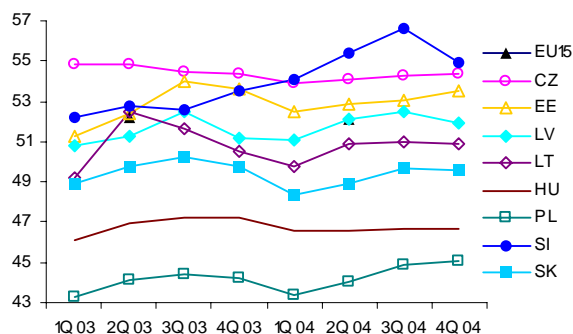


Chart 32. Average employment rates, 2H 2003 and 2H 2004

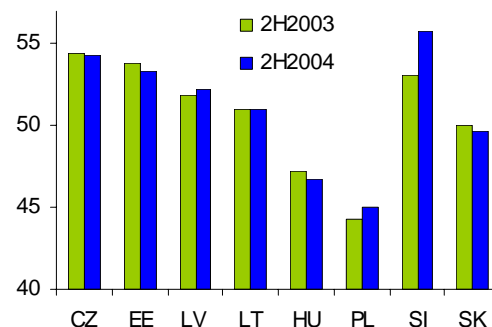
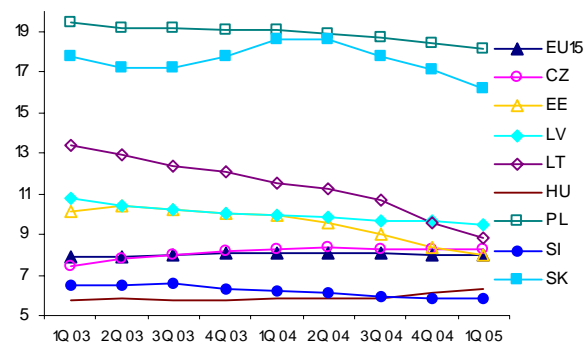
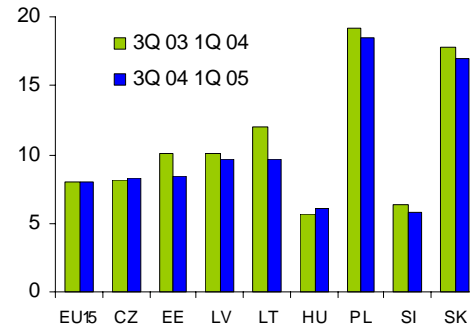


Chart 33. Unemployment rates, harmonized and seasonally adjusted, 1Q 03 - 1Q 05



Source: EUROSTAT, July 7, 2005

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



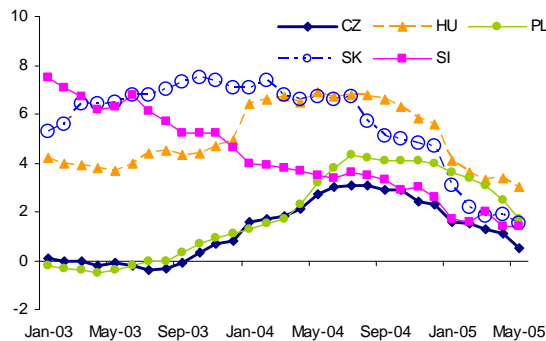
B. Wages and inflation

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).

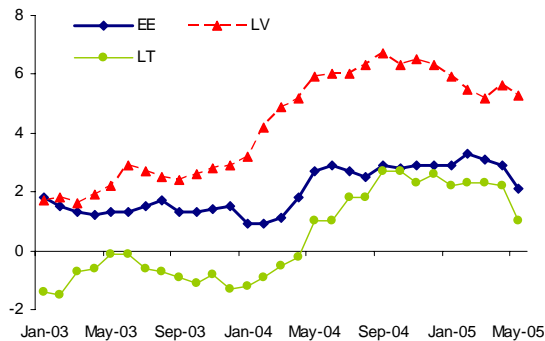
However, in the latter part of 2004, in Visegrad countries and Slovenia, EU-related inflation impulses were contained and second round effects were limited. Following the EU accession-related spike, core inflation has been gradually receding in these countries as higher interest rates and not least appreciating 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.

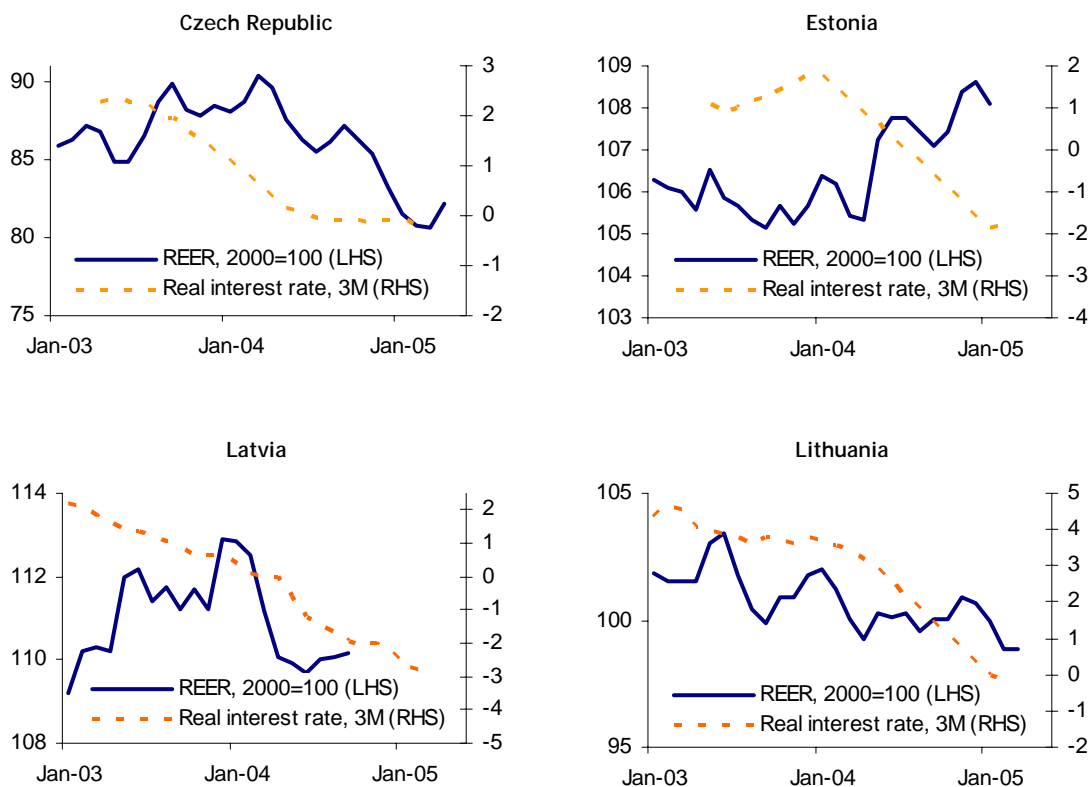


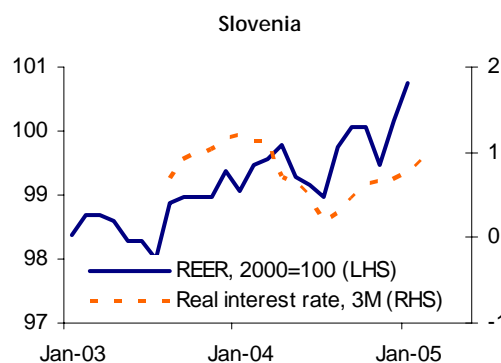
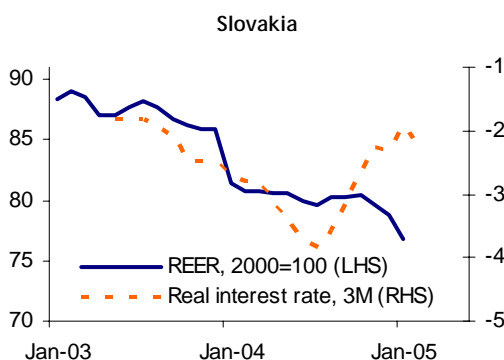
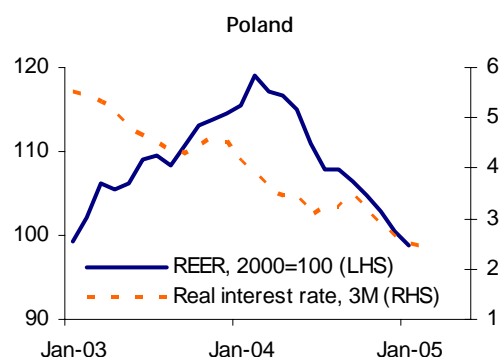
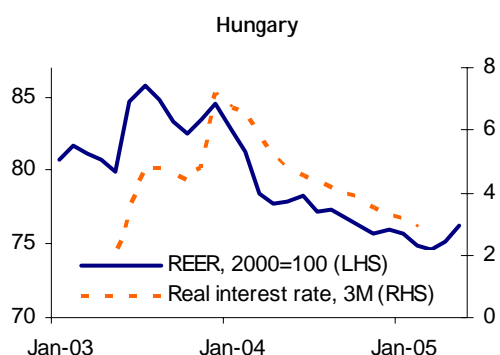
Source: Eurostat.

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.





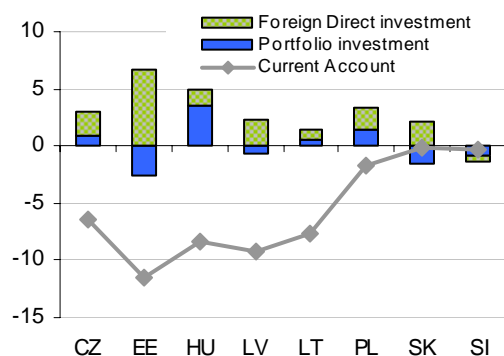
Source: Reuters, WIIW, NCBs, CSOs, staff calculations.

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.

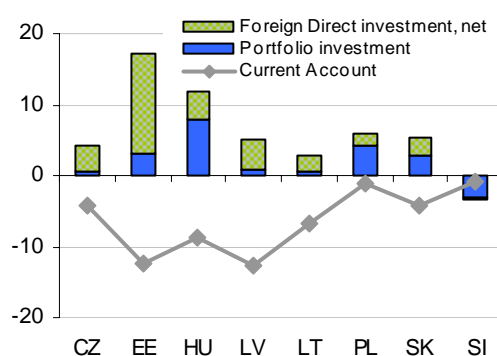
Meanwhile, financing of the current account gap has strengthened. Net FDI inflows in the region recovered throughout 2004 and Q1 2005, reaching over 4% of GDP (12 months rolling average) in Q1 2005 (nearly 14% of GDP in Estonia!). The recovery in FDI was across the board (except for Poland where inflows 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.

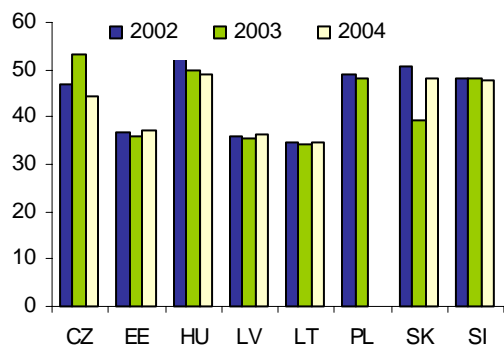
Table 4. Planned EMU membership dates

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 convergence
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

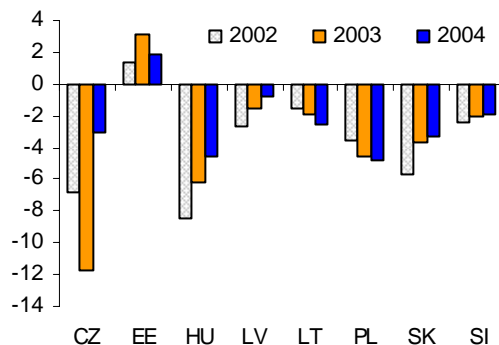
Some countries have renewed their interest in Public-Private Partnerships for the financing of infrastructure investments and other public services. This interest seems to be positively related to countries' difficulties in achieving fiscal consolidation, although there may well be other good reasons 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	Experts group to prepare different proposals of pension reform have been set up. Government intends 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 self-employed persons (to 50% of the previous level), reduction of the corporate income tax rates and losses, instead of the previous 55%, introduction of accelerated depreciation of movables and tax support of corporate research and development.	Reduction in sickness benefits, cuts in discretionary expenditures of individual ministries (mainly cuts in military expenditures, state subsidy for housing savings programmes, subsidies to the employment of disabled persons, etc.), reduction of employment in central government. Reduction of employment in central government.	Several proposals to tackle barriers to market entry and exit and to reduce administrative burden are being discussed. Also, a completely new regulatory framework for business has been developed. However, very few measures have actually been implemented.	In October 2004, a new Employment Law entered into force. However, many of structural shortcomings, notably, 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.	More 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 control 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 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 33.04%) has adopted. They may be reduced to 30% by 2006. The reform of 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 entrepreneurship.		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 (a 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 15% for small companies which 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. the retirement age) have been introduced.	Per-capita financing was introduced for elementary schools, and schools were decentralised to local authorities. 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.	Pre-reaching tax reforms have taken effect, including: introduction of a flat tax rate of 19% to all companies, introduction of a new tax regime for small businesses (15% rate), introduction of the exemptions, introduction of a unified VAT tax rate of 15%, 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 areas of social transfers, changes in the social security system (e.g. sickness benefits), social services (e.g. day care for children), health care (e.g. 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 environment to and exit from the market and easing the administrative burden on businesses. (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 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-stop-shop 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

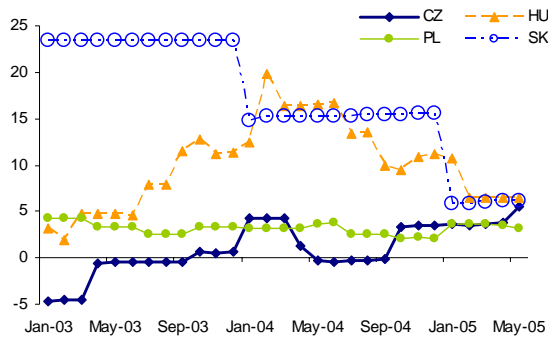
The analysis above and general impressions from observing economic developments in the EU8 prior to and after EU accession, suggest the following main lessons for future member EU countries:

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 clean up the books in 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 countries like China and India, 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.

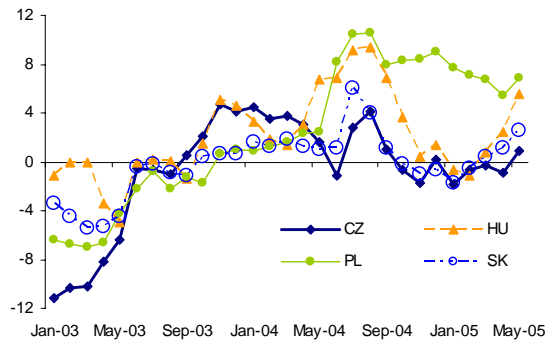
ANNEX CHARTS

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



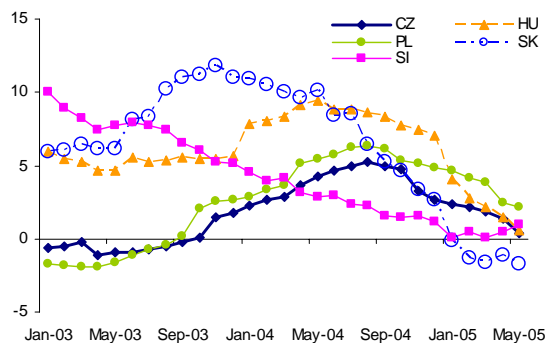
Source: Eurostat.

Chart 43. HICP - Unprocessed food, % yoy.



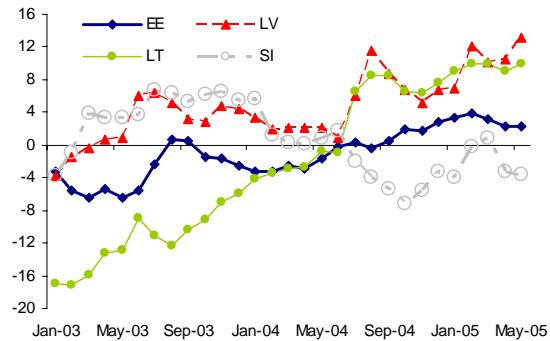
Source: Eurostat.

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



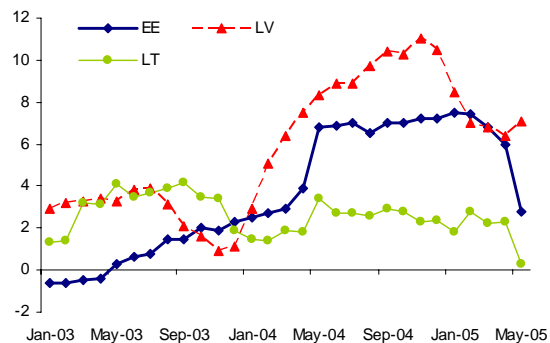
Source: Eurostat.

Chart 44. HICP - Unprocessed food, % yoy.



Source: Eurostat.

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



Source: Eurostat.