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2007 Pre-accession Economic Programmes of candidate countries: EU Commission assessments

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2007 Pre-Accession Economic Programmes of candidate countries: EU Commission's assessments

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INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessments of the 2007 Pre-accession Economic Programmes of the candidate countries (Croatia, the former Yugoslav Republic of Macedonia and Turkey).

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

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

The PEPs were submitted around 1 December 2007. The three countries have published their programmes, which can be found on the web under following addresses:

Croatia	http://www.mfin.hr/str/120/
The former Yugoslav Republic of Macedonia	http://www.finance.gov.mk/gb/brochures/PEP_2008-2010_en.pdf
Turkey	http://ekutup.dpt.gov.tr/ab/kep/PEP2007.pdf

These assessments were prepared in the Directorate-General for Economic and Financial Affairs under the guidance and coordination of Peter Grasmann and Christophe Pavret de la Rochefordière. The principal authors were Uwe Stamm (Croatia), Bernhard Böhm (the former Yugoslav Republic of Macedonia) and Dirk Verbeken (Turkey).

The programmes and this assessment were discussed at experts' level in two multilateral meetings held in Brussels on 22 and 29 April 2008 and at ministerial level during the ECOFIN Council on 14 May. Representatives from EU Member States, the ECB, the Commission and the candidate countries attended this meeting.

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Part I

Overview

1. OVERVIEW

1.1. SUMMARY AND CONCLUSIONS

Croatia, the former Yugoslav Republic of Macedonia and Turkey were invited to submit by 1 December 2007 their annual *Pre-accession Economic Programmes* (PEPs). The drafting, assessing and discussing of these programmes serve to strengthen economic planning capacity in the countries as such and to prepare them for their eventual participation in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union (EMU).

The submitted programmes have made valuable contributions to this objective. They contain very useful overviews of economic policy plans over a broad range of issues until 2010. In particular they show the governments' determination to maintain stability and advance structural reforms, productivity gains and alignment with the EU acquis and EU best practices in order to allow sufficiently high growth in order to catch up with, and prepare for membership in, the European Union. However, the degree of ambition and precision in policy implementation across the programmes is not uniform.

This exercise of submitting, assessing and discussing annual PEPs will continue to support the countries in their preparation for accession. The EU provides an important anchor in this effort. A further integration of pre-accession economic and fiscal surveillance with other instruments of pre-accession economic policy communication, in particular the economic chapters of the Progress Reports and Accession Partnerships and the bilateral economic dialogues with the countries, can increase the EU's effectiveness in this respect. Technical assistance to candidate countries in the area of economic policy planning and implementation has proven powerful and should be continued.

1.2. BACKGROUND

The ECOFIN Council of 26/27 November 2000 requested that the Commission invites candidate countries to submit an annual PEP and an annual fiscal notification. This initiative gave birth to the so-called Pre-Accession Fiscal Surveillance Procedure, which aims at preparing countries for the participation in the multilateral surveillance and economic policy co-ordination procedures currently in place in the EU as part of the Economic and Monetary Union. The PEPs are part of this procedure. Since 2001, acceding and candidate countries have submitted such annual medium-term PEPs, comprising a macro-economic scenario, a fiscal framework, a structural reform agenda and supplementary information.

The assessment of these programmes complements the policy messages given by the Commission in its annual Enlargement package. While the economic chapters of the latter are backward-looking as they assess only past developments in the countries, the assessments of the PEPs are forward looking. They analyse government medium-term plans, crucial for eventual full compliance with the Copenhagen economic criteria for accession.

The PEPs have developed into increasingly important platforms for the authorities to develop and communicate consistent economic, fiscal and structural policies over the medium term. Their preparation serves a twofold purpose: to strengthen economic planning capacity in the countries as such and to specifically prepare them for participation in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union (EMU). Consequently, the timing, scope and methodology of the PEPs follow closely reporting obligations of Member States participating in EMU. The PEPs and their assessments are therefore discussed in a multilateral policy framework with Member States and candidate countries, ending with the annual policy dialogue of the ECOFIN Council with candidate countries. The development of the institutional capacity to co-ordinate between the various ministries, government agencies and the central bank is a particularly important aspect ensuring the success of the Pre-Accession Fiscal Surveillance Procedure.

The experience with the PEPs has shown that the positive results in terms of building up

administrative and policy planning capacity and of designing conducive and consistent policies are powerful, but that they take time to accumulate and to materialise.

1.2.1. The 2007 Programmes

Countries were requested to submit their programmes by 1 December 2007. Croatia and the former Yugoslav Republic of Macedonia complied with this deadline. All programmes have been made public by the countries ([1]).

In the case of the assessment of the 2007 PEPs two important remarks should be made:

- When analysing the programmes, the EU Commission assesses whether the provided information is in line with the required standards and whether the programme's overall scenario is plausible and consistent at the time of submission. In the case of the assessment of the 2007 programmes, the global economic environment departed quite significantly from what appeared plausible at the time of drafting those programmes: world market prices for energy, intermediate goods and food increased at much higher levels than expected and turbulences in the financial and banking sector continued much longer than foreseen. As a result, half a year after their submission, the programmes appear to be fairly optimistic. Taking into account the new economic environment will be part of the 2008 exercise and has not been included into the assessment of the 2007 programmes.

- In early 2008, Turkey revised significantly its macroeconomic data set, bringing its national accounting standards closer to EU levels. This upgrade led to an increase in nominal GDP figures by about one third, which by definition reduces all GDP-related ratios accordingly. Here again, the Commission assessment took only into account the data situation at the time of submitting the programme.

Table I.1.1:
Pre-accession Economic Programmes 2007: Key indicators

	2006	2007	2008	2009	2010
Real GDP growth (% change)					
Croatia	4.8	6.0	6.1	6.5	7.0
The former Yugoslav Republic of Macedonia	3.7	6.0	6.0	6.5	6.5
Turkey	6.1	5.0	5.5	5.7	5.7
Unemployment rate (%, LFS)					
Croatia	11.1	10.2	9.2	8.1	6.9
The former Yugoslav Republic of Macedonia	36.0	31.8	31.6	31.4	31.2
Turkey	9.9	9.7	9.7	9.7	9.7
Current account balance (% of GDP)					
Croatia	-7.7	-8.1	-7.6	-6.9	-6.5
The former Yugoslav Republic of Macedonia	-1.3	-1.2	-3.3	-2.5	-2.0
Turkey	-8.2	-7.4	-7.5	-7.2	-6.8
Inflation (CPI, annual % change)					
Croatia	3.2	2.5	3.1	2.6	2.5
The former Yugoslav Republic of Macedonia	3.2	2.0	3.0	2.5	2.5
Turkey	9.6	6.6	4.1	4.1	4.0
General government balance (% of GDP)					
Croatia	-2.2	-1.6	-1.5	-0.6	0.2
The former Yugoslav Republic of Macedonia	-0.8	-1.0	-1.5	-1.5	-1.5
Turkey	1.9	0.0	0.0	0.7	1.0
General government gross debt (% of GDP)					
Croatia	40.8	39.3	37.3	34.8	31.8
The former Yugoslav Republic of Macedonia	33.5	26.1	25.2	23.9	22.5
Turkey	60.9	56.8	52.5	49.6	45.6

Source: PEP 2007

With those limitations in mind, the overall assessment of the three programmes is the following:

- the three programmes present overall consistent and partly ambitious policy frameworks for economic stabilisation, fiscal consolidation and structural reforms. Their methodology and presentation has further improved in some areas compared to previous submissions. However, in all three programmes there is still room for further improvement, in particular in view of presenting more explicitly the link between the discussed reforms and the country's EU accession process. Overall, countries are committed to strengthen administrative capacities and to prepare for eventually joining the Economic and Monetary Union;

([1]) Croatia: http://www.mfin.hr/str/120/ ,
The former Yugoslav Republic of Macedonia: http://www.finance.gov.mk/gb/brochures/PEP_2008-2010_en.pdf
Turkey: http://ekutup.dpt.gov.tr/ab/kep/PEP2007.pdf

- all programmes are based on a fairly consistent macroeconomic and fiscal framework. Despite an expected growth moderation of the global economy, the PEPs of candidate countries are fairly optimistic and expect annual output growth of between 5.5% and 7% over the programme period (see table). The submitted programmes were prepared in summer and autumn 2007, when the magnitude of the crisis which erupted in the international banking and financial markets in the course of the summer was not yet fully explicit. As a result, growth projections may turn out to be rather optimistic. Croatia foresees annual economic growth of around 6% to 7%. The former Yugoslav Republic of Macedonia foresees a marked increase in output growth, from 6% in 2007 to 6.5% in 2010. The Turkish PEP foresees GDP growth to moderately improve from 5% in 2006 to 5.7% in 2010;

- the scenarios foresee that in all countries growth will be based mainly on capital deepening and overall efficiency gains. From the demand side, a strengthening domestic demand - in particular investment - will support growth, which is expected to mitigate consequences from the worsening external environment; however risks to the programmes are more significant than last year, mainly due to increased commodity prices weighing on the external accounts and triggering higher inflation rates, as well as possibly lower exports and reduced FDI.

- the monetary frameworks foresee no major changes to the current frameworks, which amount to inflation targeting and free float in the case of Turkey and a de-facto peg of the respective currency to the euro in the other two countries.

- the fiscal frameworks foresee for Croatia a continued narrowing of the deficits and an increasing surplus in Turkey, while the former Yugoslav Republic of Macedonia envisages a moderate rise in the deficits. In Croatia, the general government accounts are projected to improve from a deficit of -1.5% of GDP in 2007 to small surplus of 0.2% of GDP in 2010. The former Yugoslav Republic of Macedonia plans a moderate increase in the deficit from -1.0% of GDP in 2007 to -1.5% of GDP in 2010. Turkey intends to move from a balanced account in 2007 to a surplus of 1% of GDP. All countries expect a substantial reduction in their debt ratios, reaching, by the end of 2010, 23% of GDP in the former Yugoslav Republic of Macedonia, 32% in Croatia and 46% in Turkey;

- the structural reform agendas, as presented in the PEPs, cover a broad range of policies and reveal a varying degree of ambition. Croatia's emphasis is put on economic restructuring, and reform of labour markets, agriculture and the health system. The programme of the former Yugoslav Republic of Macedonia focuses on improving the business environment, transport and communication, agriculture and regional development. Key areas in the Turkish PEP are privatisation, social security reforms and labour market reforms. Often, however, the PEPs are very detailed when describing past developments and rather vague when explaining intended reform measures. Furthermore, the links between the structural reforms outlined and the macroeconomic and fiscal frameworks would have benefitted from a more explicit discussion. Overall, the full and determined implementation of those reforms should strengthen their economies, in particular in view of their increasing EU integration.

1.2.2. The PEPs and pre-accession strategy

The programmes lay out policy strategies, which are to a large degree compatible with and conducive to the economic priorities of the Accession Partnerships and, more widely, to the general objective of meeting the Copenhagen economic criteria for accession, i.e. establishing a functioning market economy and raising competitiveness to a level which would allow the countries to meet competitive pressure within the European Union ([1]). In some cases, though,

([1]) The Commission concluded in November 2007 in its enlargement package, that Croatia is a functioning market economy and that Turkey can be regarded as functioning market economies, while the former Yugoslav Republic of Macedonia is well advanced in,

clearer and more convincing information on the specific implementation of these objectives would have been useful.

Technical assistance to candidate countries in the area of economic policy planning and implementation has proven powerful and should be continued.

1.2.3. Follow-up

The programmes and their assessments by the Commission services were discussed within a multilateral policy dialogues between Member States and candidate countries. A special meeting of the Alternates of the Economic and Financial Committee with representatives of candidate countries was held on 22 April 2008 and discussed and assessed each individual programme. On 29 April, a High-level meeting between the EFC and representatives of the candidate countries reviewed and endorsed the draft conclusions prepared at Alternates level. The Ministerial Meeting between the ECOFIN and their counterparts from the candidate countries took place on 14 May 2008. The Council Presidency adopted and published the conclusions on the individual PEPs.

This exercise has been, since its start, an annual one. Therefore, the countries will again be invited to submit a programme, covering the period 2009-2011.

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and has further moved towards establishing a functioning market economy.

Part II

Country analysis

1. CROATIA

1.1. SUMMARY AND CONCLUSIONS

The ECOFIN Council of 26/27 November 2000 considered: *"...that a regular in-depth dialogue with accession countries on a large spectrum of macro-economic policy and financial stability issues will assist the accession process. It could be used both as a means to identify risks and vulnerabilities in these countries and as a way to help them define their strategy for economic integration into the EU. Such a dialogue would further enhance the cooperation and the exchange of information between existing and future Member States ahead of their accession. (...) The Commission is invited to report each year to the Council (Ecofin) on its assessment of the fiscal notification and the Pre-accession Economic Programmes*".

In December 2007, Croatia submitted its fourth Pre-Accession Economic Programme (the "2007 PEP"), covering the period 2008-2010. The document largely complies with the content, form and data requested. It presents a broadly coherent and rather optimistic macroeconomic framework; it appears consistent with earlier policy documents, such as the "Strategic Development Framework 2006-2013" and the "Fiscal Policy Guidelines 2008-2010".

The key economic objectives are to ensure solid and sustainable growth rates, reduce unemployment and improve the competitiveness of the Croatian economy. The programme retains the macroeconomic policy mix of previous submissions. A process of continued fiscal consolidation aims to achieve a small budget surplus in 2010. Monetary policy will continue to focus on exchange rate stability to keep inflationary expectations under control. Privatisation and enterprise restructuring, public administration reform and improving the quality and flexibility of the labour force through education and training remain key elements of the strategy.

The 2007 PEP projects a robust growth of real GDP. According to the scenario, GDP accelerates from 6% in 2007 to 7% in 2010, despite an expected lowering of growth of domestic demand. The growth of exports of goods and services is expected to gradually rise from 8% in 2007 to above 10% in 2010. GDP growth projections appear optimistic and markedly exceed the current rate of potential growth, commonly estimated at around 4.5-5%. Moreover, economic activity in 2007 was driven by specific factors which are likely to be smaller in 2008, such as debt repayments to pensioners. Also, the external environment may prove to be less benign. Therefore, a mild and temporary slowdown of growth in 2008 - as projected in the Commission's autumn forecast - cannot be excluded. It should be noted that, meanwhile, the authorities have revised downwards significantly the growth projection for 2008. The programme's employment and wage projections are broadly in line with the Commission's forecast.

The 2007 PEP projects a gradual lowering of the current account deficit from 8.1% of GDP in 2007 to 6.5% of GDP by 2010. Fiscal policy will help containing the savings-investment gap of the economy over the medium term. However, private sector balances are likely to remain important as stronger investment and consumption smoothing may reduce private sector savings. Therefore, external deficits may actually turn out to be higher than projected. The PEP assumes that financing requirements will be matched by a continuation of strong capital inflows, but does not discuss the potential impact of financial market turbulences on the Croatian balance of payments. Projections on FDI inflows appear slightly optimistic, given that no significant privatisation projects are foreseen over the PEP period. The scope for stronger Greenfield and other non-privatisation related investments appear to be limited, due to remaining difficulties in the overall business environment.

The PEP re-states that the tightly managed float remains the most appropriate policy framework to achieve the key objective of low inflation. Monetary policy remains indeed heavily

constrained, given the high degree of euroisation and direct recourse to external borrowing that limits the effectiveness of interest based transmission mechanisms. Large exchange rate fluctuations could imply significant risks to the stability of the financial sector due to sizeable un-hedged foreign exchange positions of the non-financial sector. The programme states that credit controls will remain in place through 2008, but recognises that some of the administrative measures in place to curb domestic credit growth may not be in line with EU requirements. In this context, the programme could have elaborated on a strategy to phase out those measures, a subject on which advance planning appears essential. The PEP projects annual average inflation to only slightly increase to 3.1% in 2008 and to gradually fall to 2.5% in 2010, which appears slightly optimistic. Possible spill-over effects from the recent acceleration of commodity prices, stronger than expected domestic demand as well as continued real appreciation pressures over the medium term could lead to somewhat higher than projected inflation. However, the stable policy framework should overall be conducive to avoiding a significant acceleration of inflation over the PEP horizon.

The fiscal programme of the 2007 PEP is presented as an integral part of the overall medium-term economic policy framework and is set to support the key economic objectives. The PEP envisages a gradual improvement of the consolidated general government balance, which turns from a projected deficit of 1.6% of GDP in 2007 to a small surplus of 0.2% of GDP in 2010. The primary surplus will gradually increase from 0.4% of GDP in 2007 to 2% of GDP in 2010. Fiscal consolidation is based on a major reduction of the public spending ratio (including net acquisition of non-financial assets) by around six percentage points of GDP in the three-year period (from 47.8% of GDP in 2007 to 41.6% in 2010). In particular, spending on transfers, subsidies, wages, and investments is programmed to be reduced relative to GDP. At the same time, the revenue-to-GDP ratio is planned to decline by 4.4 percentage points over 2007 to 2010. The public debt ratio is projected to fall significantly, by around 8 percentage points, from 39.3% of GDP in 2007 to 31.8% of GDP in 2010, mainly driven by an improvement of primary balances and an acceleration of GDP growth.

Table II.1.1:
Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP growth	COM	4.8	6.0	5.0	5.5	n.a.
(% change)	**PEP 2007**	**4.8**	**6.0**	**6.1**	**6.5**	**7.0**
Consumer price	COM	3.2	2.5	3.0	3.0	n.a.
inflation (%)	**PEP 2007**	**3.2**	**2.5**	**3.1**	**2.6**	**2.5**
General government	COM	-2.2	-2.2	-2.1	-2.0	n.a.
balance (% of GDP)	**PEP 2007**	**-2.2**	**-1.6**	**-1.5**	**-0.6**	**0.2**
Primary balance	COM	-0.1	-0.1	-0.1	0.0	n.a.
(% of GDP)	**PEP 2007**	**-0.1**	**0.4**	**0.5**	**1.3**	**2.0**
Government gross	COM	40.8	39.8	38.5	37.3	n.a.
debt (% of GDP)	**PEP 2007**	**40.8**	**39.3**	**37.3**	**34.8**	**31.8**

The fiscal objective of deficit reduction remains appropriate against the background of relatively high spending ratios and significant off-budget operations, in particular pension debt repayments. However, the programme remains somewhat vague on how a continuation of structural reforms and further expenditure control would lead to a reduction of spending relative to GDP. Some of the described measures will require additional budgetary resources (education, health, pensions, family support, shipyard restructuring and subsidies to agriculture), as confirmed by the economic policy matrix annexed to the programme. The fiscal effect of other important policy measures, such as the intended better protection of socially vulnerable groups and initiatives to promote entrepreneurship, are not quantified, but may imply additional spending, too. The programme would have benefited from a thorough explanation of the specific measures that will counterbalance additional spending pressures and support subsidy reduction, wage containment, and a streamlining of social transfers over the PEP horizon. The programme falls short in assessing revenue trends, and more details could have been presented on issues related to the elasticity of the tax system.

The PEP refers to some policies to improve the quality of public finances over the medium term. Contrary to last year, the programme does not envisage a lowering of the tax burden despite high payroll taxes. The declared objective is to simplify the tax system, but it remains unclear whether this would include addressing current weaknesses on income taxation resulting from numerous tax exemptions, allowances and relief

schemes. The fiscal strategy provides some indications that public finance will be shifted toward growth-enhancing expenditure, but redistributive spending will remain strong. The programme does not explicitly foresee additional reforms in the area of pension, health care or labour markets which would be conducive to improving the long term sustainability of public finance. The challenges arising from demographic pressures remain significant, also in view of an already relatively high public debt ratio and very low participation rate. Long-term sustainability could be eroded, if growth and productivity turn out to be lower and if participation rate may even fall below what is assumed under the programme. Given the risks and magnitude of challenges, the programme would have benefited from outlining a somewhat more thorough policy response to the challenges of an ageing society.

The programme covers a broad range of structural reforms related to the enterprise and financial sector, labour market, agricultural sector, public administration, education, health care, judiciary, and environment. The completion of privatisation of assets held by the Privatisation Fund until the end of the PEP period seems ambitious in light of the generally slow progress achieved recently, and the programme does not provide particular reasons for an acceleration of the process. The restructuring of the railway sector remains an important priority, but the programme remains rather vague on the restructuring objectives over the PEP horizon, in terms of operating ratios, number of employees and time frames for the privatisation of subsidiaries. With respect to the loss-making shipbuilding sector, the programme expects individual restructuring plans for each of the five shipyards to be adopted in the first quarter of 2008, which is unrealistic. Statements on the possible privatisation of (parts of) the shipyard sector remain rather vague, contrary to the previous submissions which targeted the completion of privatisation of the sector at 2010. Given the very low participation and employment rates and a still high level of unemployment, it is surprising that the programme does not touch upon reforms of the tax/benefit system (tax measures are explicitly ruled out), employment protection or wage bargaining. The programme should have devoted more attention to policies and measures aimed at improving the overall business environment, which remains an important challenge.

The relation between the structural reform agenda and the fiscal strategy could have been elaborated in more detail. Fiscal estimates of structural reform measures do not seem to be comprehensive and entirely consistent with the medium term budgetary scenario. Nonetheless, broad orientation of the structural reform agenda remains appropriate and is generally supportive to the fulfilment of the second Copenhagen economic criterion over the medium term. Its full implementation will however require intensified and ongoing efforts to accelerate reforms in a number of important policy areas.

It can thus be concluded:

- Croatia’s fourth Pre-Accession Economic Programme for 2008-2010 presents a largely coherent medium-term macroeconomic and fiscal policy framework. Its key objectives are to ensure solid growth, reduce unemployment and improve the competitiveness of the Croatian economy. The programme largely complies with content, form and data requested. It can provide important guidance for economic policy making, in particular with the view of fully meeting the Copenhagen economic criteria for accession.

- The Croatian economy has recently performed relatively well with robust growth, relatively low, though recently increasing, inflation and exchange rate stability. The process of fiscal consolidation has continued, but external imbalances remain relatively high. The programme’s macroeconomic scenario appears optimistic, in particular with respect to its projections of growth and inflation. Risks ensuing from a less benign international environment seem more pronounced than in last years' submission. Higher volatility of commodity prices, less buoyant export markets and a stronger impact of the international financial market turbulences could undermine growth prospects and increase external vulnerabilities.

- The policy mix of the programme, which puts considerable onus on continued fiscal consolidation, remains appropriate. The envisaged overall reduction of public spending over the medium term is welcome against the background of high spending ratios and significant off-budget operations, in particular debt repayments to pensioners. However, the credibility of the fiscal scenario would be enhanced by further clarifications of the underlying measures that will support subsidy reduction, wage containment and a streamlining of social benefits over the medium term. Moreover, the programme would have benefited from outlining a somewhat more thorough policy response to the challenges of an ageing society.

- The broad orientation of the structural reforms remains appropriate, although it may lack some vision and determination, in particular with respect to enterprise restructuring, labour market reforms and improvements of the overall business environment. The reform agenda would be supportive to the fulfilment of the second Copenhagen economic criteria over the medium term. Its full implementation will require intensified efforts to accelerate reforms in a number of important policy areas.

1.2. INTRODUCTION

On 1 December 2007, the Croatian Minister of Finance, Mr Ivan Suker, submitted the fourth Pre-Accession Economic Programme (the "2007 PEP") of Croatia to the Commission, following government adoption and earlier consultation of social partners. The programme covers the period 2008-2010 and represents an up-date of the previous years' submission. It builds on earlier policy documents, such as the "Strategic Development Framework for 2006-2013" and the "Economic and Fiscal Policy Guidelines 2008-2010". The document largely complies with the content, form and data requested. It takes into account comments and suggestions by the Commission made in its last years' PEP assessment. The 2007 PEP reflects continued progress in enhancing the institutional and analytical capacity of the relevant parts of administration. It presents a largely coherent and optimistic macroeconomic framework and ambitious targets for further fiscal consolidation. The programme's overarching objectives are ensuring solid and sustainable growth rates, reducing unemployment and improving the competitiveness of the Croatian economy. Like the last years' PEP, the structural reform agenda puts emphasis a continuation of enterprise restructuring and privatisation. The document follows the structure of the revised consolidated outline and provides the requested data in an overall accurate manner. Fiscal data are reported on the basis of ESA 95 methodology. While the programme is presented in a generally clear manner, some parts would have benefited from further editing.

Overall policy framework and objectives

The programme foresees a process of continued fiscal consolidation, namely a gradual reduction of the general government deficit in 2008 and 2009 and a switch to a small surplus in 2010. Deficit reduction is presented as the main policy tool to achieve a narrowing of the saving-investments gap of the economy and a reduction of the external debt-to-GDP ratio. A stability-oriented monetary policy framework aims at preserving exchange rate stability, which is seen essential to keep inflationary expectations under control. The structural reform agenda envisages the continuation of privatisation and enterprise restructuring and the completion of reforms in public administration and the judiciary. Fostering entrepreneurship and private sector development as well as improving the quality and flexibility of the labour force through education and training are presented as key elements of the strategy. Future investments are planned in transport and energy infrastructure. Under such a benign policy scenario, the real growth rate is projected to accelerate to 7% and the unemployment rate to fall to 7% by 2010. In a limited number of occasions, the programme explicitly refers to issues raised in the assessment in the Commission's progress report and to the priorities identified under the present Accession Partnership.

1.3. ECONOMIC OUTLOOK

1.3.1. Recent macroeconomic developments

In the first three quarters of 2007, real GDP growth accelerated to 6.2%, up from 4.8% in 2006. Growth continued to be accompanied by efficiency gains as well as accelerated employment growth. From the demand side, it is supported by strong domestic demand. Private and public consumption growth accelerated markedly and GFCF spending remained strong, supported by an expansion of private sector investments. Industrial production expanded by 5.6%. Consumer price inflation increased to 5.8% year on year in December 2007, on the back of higher energy and food prices. Average inflation stood at 2.9% in 2007, slowing somewhat from 3.2% a year before. Employment increased by around 1% and the unemployment rate dropped to 14.7%. Real wage growth remained broadly in line with productivity gains. The current account deficit stood at 7.7% of GDP in the twelve months to September 2007, unchanged compared to 2006. The merchandise trade deficit remained at 24.6% of GDP while the trade with services posted a surplus of 17% of GDP. Net inflows of FDI reached 9.3% of GDP, up from 7.6% in 2006, and were largely driven by privatisation and recapitalisation of banks.

The 2007 PEP gives a clear, concise and up-to-date overview of recent macroeconomic developments at the time of submission. In some cases it provides useful explanations for deviations of actual developments from estimates presented in the 2006 PEP. Comments provided in the last years' Commission assessment have been taken on board and the quality of this chapter has improved.

1.3.2. Medium-term macroeconomic scenario

The 2007 PEP assumes a continuation of a relatively favourable external environment with world and EU 27 real GDP growing by 4.9% and 2.2%, respectively, in both 2008 and 2009 and world import volumes increasing by 8.2%. The recent Commission's Autumn 2007 forecast projects a somewhat higher growth of world and EU 27 GDP, but a lower growth of world imports. Also, the PEP 2007 assumes somewhat lower oil prices compared to the Commission's assumptions. While the PEP assumptions seems generally reasonable, the programme does not explicitly discuss any alternative scenario or downside risks emanating from the world financial market turbulences and its possible effects on the PEP's macroeconomic programme.

The 2007 PEP presents a coherent and comprehensive medium-term macroeconomic programme with projections for key economic variables, covering real sector, employment, wage, inflation as well as external developments. Alternative scenarios are not developed. The main objectives of the programme seem

Table II.1.2:

Comparison of macroeconomic developments and forecasts

	2006		2007		2008		2009		2010	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	4.8	**4.8**	6.0	**6.0**	5.0	**6.1**	5.5	**6.5**	n.a.	**7.0**
Contributions:										
- Final domestic demand	5.7	**5.7**	7.7	**6.7**	5.4	**5.8**	6.1	**5.6**	n.a.	**5.5**
- Change in inventories	0.2	**0.2**	-0.1	**0.0**	-0.1	**0.1**	0.0	**0.1**	n.a.	**0.0**
- External balance of goods and services	-1.1	**-1.1**	-1.6	**-0.8**	-0.3	**0.2**	-0.6	**0.9**	n.a.	**1.4**
Employment (% change)	0.8	**0.8**	1.5	**1.1**	0.5	**1.1**	1.0	**1.2**	n.a.	**1.3**
Unemployment rate (%)	11.1	**11.1**	11.0	**10.2**	10.8	**9.2**	10.2	**8.1**	n.a.	**6.9**
GDP deflator (% change)	3.4	**3.4**	2.7	**3.1**	3.7	**3.9**	3.3	**3.3**	n.a.	**3.2**
CPI inflation (%)	3.2	**3.2**	2.5	**2.5**	3.0	**3.1**	3.0	**2.6**	n.a.	**2.5**
Current account balance (% of GDP)	-7.7	**-7.7**	-8.5	**-8.1**	-8.1	**-7.6**	-8.0	**-6.9**	n.a.	**-6.5**

Sources: Pre-Accession Economic Programme 2007; Commission services Autumn 2007 forecasts (COM)

ambitious and some projections appear very optimistic. The presented macroeconomic policy mix has not changed compared to the previous submission and remains largely appropriate.

Real sector

The 2007 PEP is based on a scenario of robust growth of real GDP. It accelerates from an expected rate of 6% in 2007 to 7% in 2010. As compared to the previous submission, real GDP growth projections have been significantly revised upwards, by around 1.4 percentage points per year on average despite an expected lowering of domestic demand growth over the PEP horizon. Following a relatively strong growth of 6%, private consumption is projected to moderate somewhat to a still solid 5%, as real wage and employment growth will mildly accelerate. Consumer optimism is projected to remain robust on the back of wealth effects stemming from price increases of financial assets and real estate. Annual investment growth is expected to slightly moderate and to remain at 7.2%, with the private sector being the main generator, resulting from an improved business climate. The growth of exports of goods and services is expected to gradually accelerate from 8% in 2007 to above 10% in 2010, due to a generally favourable external environment and in particular solid growth in the main EU trading partners combined with further regional integration. At the same time, import of goods and services are projected to slow down in line with lower domestic demand growth. As a result, the contribution of domestic demand to growth will decline from 6.7% in 2007 to 5.5% in 2010, whereas the contribution of net exports (2007: -0.8%) will turn positive in 2008 (0.2%) and further increase (to 1.4%) by 2010.

Medium-term projections on real GDP growth appear optimistic and significantly exceed the current rate of potential growth that is commonly estimated at around 4.5-5%. Moreover, there is likely to be a strong base effect in 2007. Economic activity in 2007 was driven by specific factors which are likely to be smaller or disappear altogether in 2008 and beyond, such as debt repayments to pensioners and strong government spending in the specific pre-election context. Finally, the external environment may prove to be less benign. For those reasons, the Commission in autumn 2007 projected a mild slowdown of growth for 2008 (to 5%). Its forecast foresees a slight acceleration in 2009, based on similar assumption as those presented in the PEP, notably continued strong consumer and investor confidence in the light of expected EU accession in a not too distant future and further improvements in the overall business environment. The programme's employment and wage projections are broadly in line with the Commission's forecast, although the latter expects a somewhat slower employment growth, particularly for 2008 in line with some growth moderation. Both the PEP 2007 and the Commission assume that productivity increases will outweigh real wage increases, leading to a reduction of real unit labours costs over the PEP period.

Inflation

Following significant price rises since August 2007, the PEP projects an increase in annual average inflation to 3.1% in 2008, from 2.5% in 2007 which mainly results from higher agricultural and food as well as energy prices. This broadly concurs with the recent Commission Autumn 2007 forecast. However, given the recent acceleration of annual inflation towards the end of 2007, average inflation will be significantly higher, due to considerable base effects. The PEP argues that price pressures will fade away over time. Recently introduced export duties on some agricultural products would increase domestic supply and increased competition in the retail sector would have dampening effects on prices. Moreover, a reduction of excises on petroleum products and an expected appreciation against the USD would help containing rises in energy prices. The PEP therefore projects annual average inflation to come down to 2.6 and 2.5% in 2009 and 2010, respectively. This appears slightly optimistic. The mentioned factors may not be strong enough to reduce inflation. Further price increases could also result from other factors, such as stronger than expected domestic demand and real appreciation pressures. The latter would naturally be expressed through higher inflation as the scope for nominal appreciation remains limited under the outlined monetary policy framework. At the same time it is reasonable to assume that a preservation of the stability-oriented monetary

policy framework will help preventing a significant re-acceleration of inflation over the medium term.

Monetary and exchange rate policy

Like in last years' submission, the 2007 PEP presents a concise description of the monetary and exchange rate policy framework. Its main features have been in place for more than a decade. The primary policy objective is price stability, and the exchange rate has traditionally and successfully been used as a stabilisation anchor. The PEP claims that the tightly managed float remains an appropriate policy framework. The focus of policies will remain on maintaining exchange rate stability in order to keep inflationary expectations under control. This policy choice appears appropriate, in particular against the background of widespread euroisation of the financial system which limits the scope for a more active monetary policy. Larger exchange rate flexibility could imply significant risks. A major depreciation would not only endanger price stability, but might have severe implications for financial sector stability, due to the large amount of un-hedged non-financial sector balances in foreign currency. The PEP explains measures taken by the central bank to contain external indebtedness and domestic credit growth. Subsequent increases in marginal reserve requirements on banks' foreign liabilities, de facto representing a tax on capital inflows, were meant to discourage banks' foreign borrowing. In order to curb domestic credit growth, additional credit controls in the form of compulsory purchases of central bank bills were introduced and later tightened. Interestingly, the document states that credit controls would remain in place throughout 2008. At the same time, the PEP recognises the need to abolish marginal reserve requirements for foreign borrowing in view of EU accession. In this context, the programme could have elaborated on a strategy to phase out those administrative measures, a subject on which advance planning would seem essential.

External sector

The 2007 PEP projects a gradual lowering of the current account deficit from 8.1% of GDP in 2007 to 6.5% by 2010, similar to last years' programme. Merchandise exports are set to increase on the back of solid EU demand, regional trade expansion, export promotion activities and better operating conditions for exporters. The growth of merchandise imports is expected to slow down in 2008 in line with lower consumption and investment growth and tight CNB measures), but imports remain nonetheless relatively strong over the medium term due to growth acceleration and high oil prices. Net income from trade in services will increase by more than three percentages of GDP, due to a favourable performance of tourism. The latter would result from ongoing investments in accommodation, a larger number of foreign visitors and a prolongation of the tourist season. The deficit in factor income from abroad declined in 2007, but is expected to widen by three percentage points of GDP over the PEP period, also driven by a large increase in re-invested earnings. Current account trend projections are generally plausible, but external deficits may actually turn out to be higher. Although fiscal policy will help containing external deficits over the medium term, private sector balances are likely to remain important as stronger investment and consumption smoothing may reduce private sector savings.

In 2007, net FDI inflows accelerated to 8.8% of GDP, largely driven by the ongoing recapitalisation of some banks and the sale of share of the Croatian telecommunication company. The programme assumes a continued strong net inflow of FDI, which on average would cover the size of the current account deficit over the programme period. Such a scenario would certainly require a strong growth of equity and Greenfield investment, as privatisation related inflows will naturally become smaller. This, in turn, would necessitate significant further improvements in the overall business environment, including a simplification and facilitation of land registration and licensing procedures.

Main risks to the programme

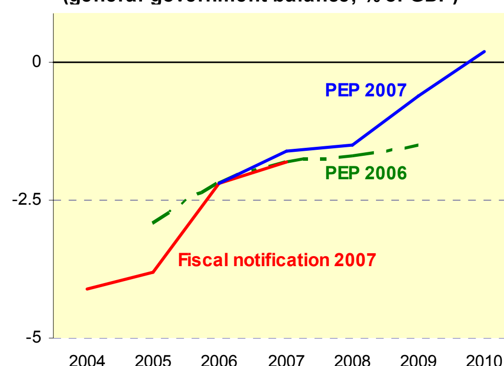
The main risks to the programme may derive from exogenous shocks, in the form further price increases of commodities. If those shocks prevail, inflationary expectations could rise and eventually lead to a price-wage spiral, also

undermining the export sectors' competitiveness and growth. However, a stable monetary policy framework and further fiscal consolidation should be conducive to containing these risks. A worsening of the external environment, and in particular less benign growth prospects in the main trading partners in the EU, may lead to lower external demand and export growth. The impact of the international financial market turbulences on the Croatian economy seem to have been rather limited so far. However, negative effects cannot be excluded in case of a further proliferation of the crisis, given the high degree of foreign ownership in the Croatian banking system and the significant exposure of the entire economy to external financing. In the event of a more risk adverse environment maturities of external finance could shorten and aggravate maturity mismatches in balance sheets of financial intermediaries. More difficult access to finance and a possible deterioration in financing conditions could on the other hand help containing foreign borrowing, credit growth and domestic demand funded by bank credit. On the domestic side, the newly elected government confirmed its commitment to the stability-oriented macroeconomic policy mix outlined in the programme. Thus, the risk of major policy reversal seems generally low. However, further delays in implementing important structural reforms, in particular in the area of enterprise restructuring, could undermine foreign investors' readiness to provide FDI which in turn would worsen the prospects for increasing total factor productivity and catching up over the medium term.

1.4. PUBLIC FINANCE

The fiscal programme of the 2007 PEP is presented as an integral part of the overall medium-term economic policy framework. It is set to support the key objectives of ensuring long-term sustainable growth, higher employment and increased competitiveness. Although there is no explicit reference to the European Commission's findings in the annual Progress Reports, the PEP argues that the direction of fiscal policy would be supportive to the development of a functioning market economy. The fiscal framework includes projections for the main categories on the revenue and expenditure side of the consolidated general government budget. The main fiscal objective remains a gradual deficit reduction, conducive to ensuring long-term sustainability of public finances. The programme emphasises that fiscal consolidation will be exclusively based on structural measures and a more efficient use of budget resources rather than on new or higher taxes. However, it unfortunately contains only limited information on concrete fiscal and other economic policy measures and their likely budgetary effects. Strengthening budget analysis, budget management and tax administration remain priority areas for further reform. A brief and preliminary assessment on the cyclical position of the economy and the cyclically adjusted profile of fiscal policy is very welcome as a start, but there is scope for a more in-depth analysis. The programme contains a fairly detailed analysis of fiscal risks and a risk sensitivity analysis, which both add to the quality of the fiscal programme. The programme makes an attempt to apply ESA 95 standards and fiscal data are consistent with those presented in the fiscal notification submitted in April 2007. However, important off-budget operations are not covered by the fiscal accounts presented in the PEP, in particular pension debt repayments. To be fully in line with ESA 95 standards, the latter should however be recorded as expenditure in the year of cash execution, as recently confirmed by Eurostat.

Graph II.1.1: **Budgetary developments (general government balance, % of GDP)**



The fiscal programme envisages a gradual improvement of the consolidated general government balance, turning from a deficit of 1.6% of GDP in 2007 to a small surplus of 0.2% of GDP in 2010. The primary surplus will

gradually increase from 0.4% of GDP to 2% of GDP. Fiscal consolidation is based on a major reduction of the public spending ratio (including net acquisition of non-financial assets) by around six percentage points of GDP in the three-year period (from 47.8% of GDP in 2007 to 41.6% in 2010). In particular, spending on transfers, subsidies, wages, and investments is, relative to GDP, programmed to be reduced. At the same time, the revenue-to-GDP ratio is planned to decline by 4.4 percentage points over 2007 to 2010. The general government debt ratio is projected to fall significantly, by around 8 percentage points, from a projected 39.3% of GDP in 2007 to 31.8% of GDP in 2010, mainly driven by an improvement of primary balances and an acceleration of GDP growth.

1.4.1. General government balances and debt

Actual balances and medium term perspectives

As for the year 2007, the original budget framework presented in last years' PEP (and adopted in late 2006) foresaw a deficit target for the consolidated general government sector of 1.8% of GDP, down from 2.2% in 2006. This deficit reduction was projected to be almost exclusively driven by a reduction of current spending relative to GDP, in particular on subsidies and social transfers. In mid-2007, the government proposed and the parliament adopted a revision of the 2007 budget. The revision was partly motivated by better than expected revenue performance, resulting from strong economic activity in the first half of the year. Total revenues were revised upwards by 1.4% of GDP. However, the revised budget resulted also from the government's intention to change the amount and structure of spending. Additional spending, which amounted to 1.2 percentage points of GDP, included one-off payments resulting from court decisions and the repayment of arrears of the health sector. But the revised budget also provided for an increase in spending on investment (notably road construction), social spending (maternity benefits), education, wages, pension and health. As a result, the deficit target was slightly lowered to 1.6% of GDP from 1.8% foreseen in the original budget. Preliminary data on budget execution of the consolidated general government in 2007 suggest that budget implementation has been broadly in line with the revised plan. However, official data are largely cash based, and do not contain changes in general government arrears, debt assumptions and other factors that in past years have had a significant impact on the deficit as defined under ESA 95. Moreover, a broader measure of the budget balance, including repayments of the so-called pensioners' debt and activities of the State Development Bank (HBOR), would suggest a more expansionary fiscal stance in 2007.

For the year 2008, the programme projects a "front-loading" of spending and revenue reduction, as measured as a percentage of GDP. General government expenditures and revenues are set to be reduced by roughly the same magnitude, i.e. by around 2.6 and 2.5 percentage points, respectively. Accordingly, the general government deficit will fall only slightly by 0.1 percentage points to 1.5% of GDP. The significant reduction on the revenue side is somewhat surprising against the background of a projected continuation of a favourable economic performance and in the absence of any major tax policy measures (e.g. lowering of tax rates or removal of specific taxes). It should be noted that under similar conditions, the revenue-to-GDP ratio increased significantly in 2007, though this was partly driven by one-off receipts. The programme falls short in explaining the switch in the revenue trend and more details could have been presented on issues related to the elasticity of the tax system.

The reduction of the expenditure-to-GDP ratio is largely driven by lower investment (by 0.9 percentage points), government consumption (by 0.7 percentage points) and transfers and subsidies (by 0.6 percentage points). Spending reduction is presented as a result of a continuation of structural reforms and expenditure control, but the programme provides only cursory information on specific measures which could lead to budgetary savings and thus support a spending reduction. Some of the policies foreseen may require additional budgetary resources (education, health, pensions), which is confirmed by the economic policy matrix annexed to the programme. Subsidies to shipyards are programmed to increase until 2009 and support to the

agricultural sector will also rise. The elimination of differences in pension payments to old and new pensioners has a significant expansionary fiscal effect, amounting to an annual 0.4% of GDP. Additional support to families, namely full wage compensation during maternity leave in the first six months also leads to additional spending. Subsidies to the railways are programmed to be reduced, however cost of railway modernisation and restructuring are programmed to be higher than the lowering of subsidies. Also, the intended better protection of socially vulnerable groups and initiatives to promote entrepreneurship are likely to require additional net resources, but this is not quantified in the programme. Generally, information about expenditure policies provided in the programme may suggest increase rather than a reduction of current spending in some areas, and this seems to be particular eminent in 2008. Against this background, and for the sake of the overall credibility of the fiscal programme, the PEP would have benefited from outlining the specific measures that will support subsidy reduction, wage containment, and a streamlining of social transfers in 2008.

The 2008 budget was only adopted in March 2008, following general elections last November and the formation of a new government. A comparison of the budget with the fiscal scenario of the PEP is difficult, as domestic budget reporting is based on GFS methodology (compared to ESA 95 used in the PEP). On the basis of available information, it appears that the budget 2008 appear broadly in line with the PEP's fiscal projections. The budget could be interpreted as a confirmation of the new government's continued commitment to the fiscal targets outlined in the PEP 2007, despite a significant downward revision of the real GDP growth projection for 2008 (from 6.1% in the PEP to 4.5%). However, in light of the revised growth outlook and given the significant spending pressures outlined above the actual budget outcome in 2008 could turn out to be less comfortable than envisaged.

In 2009, the general government deficit is projected to decline to 0.6% of GDP, before it turns into a small surplus of 0.2% of GDP in 2010. A major part of adjustment over these two years is planned to be realised through a reduction of primary spending with a particularly strong contribution of spending on transfers and subsidies (1.7 percentage points) and government consumption (0.9 percentage points). Public investment is programmed to be reduced from 3.3% of GDP in 2008 to 2.8% in 2010. Again, only limited information is provided on specific

Table II.1.3:
Composition of the budgetary adjustment (% of GDP)

	2006	2007	2008	2009	2010	Change: 2007-10
Revenues	44.8	46.2	43.7	42.8	41.8	-4.4
of which:						
- Taxes and social security contributions	40.2	40.2	39.3	38.5	37.7	-2.5
- Other (residual)	4.6	6.0	4.4	4.3	4.1	-1.9
Expenditure	47.0	47.8	45.2	43.4	41.6	-6.2
of which:						
- Primary expenditure	44.8	45.8	43.2	41.5	39.8	-6.0
of which:						
Gross fixed capital formation	3.5	4.4	3.3	3.0	2.8	-1.6
Consumption	16.7	17.2	16.5	16.1	15.6	-1.6
Transfers & subsidies	20.7	20.2	19.6	18.7	17.9	-2.3
Other (residual)	3.9	4.0	3.8	3.7	3.5	-0.5
- Interest payments	2.2	2.0	2.0	1.9	1.8	-0.2
Budget balance	-2.2	-1.6	-1.5	-0.6	0.2	1.8
- Cyclically adjusted	-0.3	-0.1	-0.1	-0.2	0.7	0.8
Primary balance	0.0	0.4	0.5	1.3	2.0	1.6
Gross debt level	40.8	39.3	37.3	34.8	31.8	-7.5

Sources: Pre-Accession Economic Programme 2007, ECFIN calculations

budget and structural measures to support fiscal adjustment and spending contraction over the latter part of the PEP period. An assessment of the quality of fiscal adjustment remains therefore difficult. In the absence of new tax policy measures, the revenue-to-GDP ratio is projected to decline by one percentage point of GDP per year. The reduction comes mostly on account of indirect taxes, which is somewhat surprising given the projected growth path and the need to adjust excise.

Structural balance

The PEP provides a short overview on the cyclical position of the economy and the impact of fiscal policy. The analysis could be further developed in future programmes. The programme reportedly used methods applied by the ECB in calculating cyclically adjusted primary balances. The following fiscal aggregates were included as cyclically sensitive items: private and corporate income taxes, excises, and social contributions on the revenue side as well as unemployment benefits on the on the spending side. Output gap calculations were done on the basis of an HP filter; a production function methodology has not yet been developed. Projected growth rates exceed estimates for potential growth rates in each year through 2007-2009. Nonetheless, total output remains still below potential, resulting in a small output gap of around 0.2% in each year. The cyclically adjusted primary balance follows a pattern similar to the general government deficit; it constantly improves over the PEP period. On this basis, the PEP concludes that fiscal policy has a slightly restrictive and pro-cyclical effect until 2009, which may appear slightly counter-intuitive. In 2010, fiscal policy is projected to turn countercyclical as actual GDP exceeds potential GDP and the cyclical adjusted primary balance continues to improve (by 0.4 percentage points of GDP). However, given the methodological weaknesses, these statements on the effects of fiscal policy certainly need to be taken with a great deal of caution.

Debt levels and development

Previous fiscal consolidation has had a positive effect on public debt. The general government debt ratio declined by 2.9 percentage points in 2006 to 40.8% of GDP. Also, the share of external in total public debt was reduced, as the government increasingly tapped the domestic bond market, also with a view to attracting institutional investors and developing the domestic financial market. A large share of general government debt (around 80%) remains denominated in foreign currency, mostly in euro. This makes debt very sensitive to exchange rate movements.

The PEP 2007 projects a baseline scenario of a gradual reduction of general government debt from 39.3% of GDP in 2007 to 31.8% of GDP in 2010. Projections on the decomposition of changes in the debt ratio appear largely comprehensive and consistent. Strong growth and a marked improvement of the primary balance over the PEP period have a strong effect of debt reduction. This effect is partially offset by interest payments which are projected to remain at 1.9 % of GDP on average. The privatisation process is also expected to impact favourably on the debt ratio, although ensuing revenues are projected to decline from 0.7% to 0.2 % of GDP in 2007 – 2009 (no revenues in 2010). Given the still sizeable remaining portfolio of the State Privatisation Fund, this seems realistic, provided that the privatisation process continues smoothly. Any deviation from a scenario of accelerating growth and improved fiscal balances will influence debt dynamics accordingly. The risk scenario presented in the PEP underlines that the public debt ratio would continue rising if key macroeconomic variables would be set at historical average levels. It also confirms that public debt dynamics are particularly sensitive to changes in the Kuna/euro exchange rate and in primary balances. While a marked devaluation of the Kuna does not appear likely under the current policy framework, a fiscal loosening and higher primary deficits would significantly impact on public debt developments. This confirms the need for continued fiscal restraint in order to ensure debt sustainability.

With respect to the debt management strategy, the PEP 2007 foresees a continuation of borrowing primarily on domestic markets and in kuna-denominated securities, also with a view to reducing exchange rate induced risks and developing a domestic capital market. However,

the recently adopted 2008 budget foresees significant foreign borrowing in 2008. The programme does not provide details on the future debt management strategy and envisaged changes to the institutional arrangements. Given existing shortcomings, it would have benefited from outlining measures to be taken with a view to bring the legal and institutional framework in line with EU best practice.

1.4.2. Budgetary implications of major structural reforms

As required, the programme (in its Annex) presents some estimates of the fiscal impact of reforms envisaged over the PEP horizon, which is a useful complement. A summary overview is presented in Table II.1.4 (chapter 1.5) of this assessment. It shows that structural reforms will have an important impact on the country's fiscal position. Namely, net spending is estimated to increase by 0.5% of GDP on average per year over the PEP period. This does not seem to be entirely consistent with the medium term budgetary scenario outlined in the fiscal programme.

1.4.3. Sensitivity analysis and comparison with previous programme

The 2007 PEP includes an update of the sensitivity analysis presented in last year's submission. In a first scenario, real growth rates in 2008 and 2009 are halved compared to the baseline scenario, caused by either a less favourable external environment or structural reform delays, leading to significantly higher fiscal deficits in each year over the reference period, by 1.8 percentage points on average per year. The second scenario assumes a 50% lower revenue growth in 2008 and 2009, while real GDP growth rates are left unchanged. This would lead to significant deviations from baseline fiscal deficits, by around one percentage point in 2008 and 2.4 percentage points in 2009 and 2010 each and would require a much longer adjustment period compared to the first scenario. Finally, the third scenario assumes a one-off increase in current spending by one billion kuna in 2008, leading to higher fiscal deficits by around 0.3 percentage points on average over the reference period. The analysis demonstrates the rather significant sensitivity of changes in real growth, revenues and spending to the fiscal balance. It should prepare the ground for the design of possible counterbalancing and contingency measures in the case risks actually occur. The document itself does not elaborate on possible counterbalancing measures to be taken in the event of risk occurrence. It thus remains unclear how precisely the fiscal strategy would respond in case the deficit needs to be reduced on short notice. Future submission would greatly benefit from an analysis of risks related to the existence of contingent liabilities and government guarantees, which is unfortunately not provided in the current programme.

1.4.4. Quality of public finance

The 2007 PEP refers in a very general way to some policies which are seen to improve the quality of public finances over the medium term. It emphasises recent improvements in budget management and expenditure control as well as the adoption of a new public procurement system in line with EU practice. The programme explicitly announces that no new taxes will be introduced and existing taxes will not be increased. Contrary to last years' submission, a lowering of the tax burden is not explicitly envisaged either, despite a heavy tax burden especially on labour. The declared objective is to simplify the tax system, but it remains unclear whether this would include addressing current weaknesses on income taxation resulting from numerous tax exemptions, allowances and relief schemes. Public finances are expected to contribute to creating a knowledge-based society through investments in science and education. Continued investments in road and rail infrastructure remain key priorities and the programme puts emphasis on a more balanced development across all regions of the country. Medium-term targets for spending on education, infrastructure development or research and development are not explicitly set in the programme. Overall, the fiscal strategy provides some indications that public finance will be shifted toward growth-enhancing expenditure, but redistributive spending will remain strong. According to the programme, this is partly related to the consequences of the war in the nineties.

1.4.5. Sustainability of public finance

The 2007 PEP contains a separate section on the long-term sustainability of public finances which is based on unchanged assumptions with respect to population trends. Long-term projections have been somewhat revised, largely due to the assumption of stronger GDP growth in the initial period. The programme projects labour productivity to drop accordingly from a peak of 5.7% in 2010 to 1.1% in 2050. The unemployment rate (ILO definition) is projected to decline from 12.7% to 7% by 2050. Participation rates for male and female are expected to remain unchanged over the long term. Total expenditures are projected to slightly increase from 41.6% of GDP in 2010 to 43.5% in 2050, while total revenues are set to stay at slightly below 42% during this period. Spending on old-age pensions is expected to decline from 8.9% of GDP in 2010 to 6.9% in 2050, as a larger share of pensions is expected to be paid by the second pillar. Pension contributions would stay at around 5.9% of GDP in 2050. Health care spending is set to increase markedly from 5.4% to 10.2% of GDP, mainly as a result of an ageing population.

The programme does not explicitly foresee additional reforms in the area of pension, health care or labour markets which would be conducive to improving the long term sustainability of public finance. In particular, the issues of early retirement (dis)incentives and adverse premium setting for additional health insurance are not addressed. The challenges arising from demographic pressures remain significant, also in view of an already relatively high public debt ratio and a very low participation rate. Long-term sustainability could be eroded, if growth and productivity trends turn out to be less comfortable and if participation rates fall below levels assumed under the programme. Given the risks and magnitude of challenges, the programme would have benefited from outlining a somewhat more thorough policy response to the challenges of an ageing society.

1.4.6. Institutional features of public finance

Further institutional reforms in public finance remain a government priority and will be based on a comprehensive strategy adopted in October 2007. The strategy takes into account requirements related to the EU accession process. Its full implementation would support a further strengthening of budget planning and execution and an effective spending control. Current weaknesses result from a generally weak link between strategic planning and the budget process. The reform of the treasury system is advanced, but an effective control over spending requires the full inclusion of public entities at all government levels. Although efforts are made to reconcile fiscal statistics with ESA 95, local government are only partially included in fiscal reporting. There is also scope to improve the multi-annual budget planning capacity, in particular with respect to the involvement and control of line ministries. While significant progress has been made in establishing medium-term economic fiscal frameworks, more resources would need to be invested in this area to improve the scope and quality of analysis. Given considerable weaknesses in debt management capacity, the programme should have devoted more attention to this important field.

1.5. STRUCTURAL REFORMS

The 2007 PEP covers a broad range of structural reforms related to the enterprise and financial sector, labour market, agricultural sector, public administration, education, health care, judiciary, and environment. The presentation is largely descriptive and provides information on past and ongoing reform initiatives with a strong emphasis on EU accession requirements in terms of legislative harmonisation and institution building. The links between measures envisaged and the overall policy objectives are not always made clear and could have been analysed in more detail. More emphasis could have been given to measures aimed at improving the business environment, given the pertaining administrative obstacles still in place. The links between structural reforms and the fiscal programme are elaborated in only a few cases. The programme could have been more explicit in demonstrating how structural reforms could underpin the implementation of the fiscal strategy. The overall reform agenda, if fully implemented, would be supportive to the fulfilment of the second Copenhagen economic

criteria over the medium term. This would, however, require intensified efforts to accelerate reforms, in particular in the areas of enterprise restructuring, education and labour markets.

1.5.1. Structural reforms and Accession Partnership

The 2007 PEP addresses most of the economic priorities under the Accession Partnership adopted in February 2008[1], such as institutional reforms in public finance, privatisation and enterprise restructuring, as well as social security, health care and pension reforms. As outlined below in more detail, the programme remains sometimes rather vague on the nature and sequencing of reform measures to be taken. Therefore, it remains unclear to what extend the policies under the programme could support the objectives of the Accession partnership, in particular with respect to ensuring the financial sustainability of the health care and pension system and increasing labour market employment and participation rates. In addition, the programme should have given more emphasis on the *key priorities* of the partnership. The programme does not sufficiently elaborate on measures to improve the overall business environment, to reduce state subsidies and to improve the efficiency of public spending. Overall, while broadly supportive of the economic Partnership priorities, the 2007 PEP would fall of fully delivering all of its objectives.

[1] Council Decision (2008/119/EC) of 12 February 2008 (Official Journal L42/51 of 16. February 2008)

1.5.2. Product and capital markets

The 2007 PEP touches upon the following main reform areas related to the functioning of product markets: privatisation, enterprise restructuring (railway sector, shipbuilding) and SME development. Contrary to previous years' submission, reforms related to the strengthening of competition policy and state aid control is not covered this time.

In September 2007, the privatisation fund's portfolio comprised of 880 companies, of which 665 firms were ready for sale, and privatisation tenders for 25 companies had been prepared. The programme's stated objective is to complete the privatisation of these assets until the end of the PEP period. This seems rather ambitious in light of the generally slow progress achieved recently, and the programme does not provide particular reasons for an acceleration of the privatisation process. Institutional reforms, notably a transformation of the Privatisation Fund, may support the process, but this could have been explored in more detail in the programme. It remains unclear on which basis estimates on privatisation revenues provided in the fiscal part of the document were made. The restructuring of the railway sector remains an important priority, but the programme remains rather vague on the restructuring objectives over the PEP horizon, in terms of operating ratios, number of employees and time frames for the privatisation of subsidiaries. It appears that wages and employment in the railway sector have recently increased. Estimates on the fiscal effects of subsidy reduction and railway modernisation are welcome. With respect to the loss-making shipbuilding sector, a National Restructuring Programme was adopted earlier

Table II.1.4:
Net direct budgetary impact of key reform commitments (in EUR)

Description of the Policy	2007	2008	2009	2010
Enterprise restructuring and state aid	-10.1	-75.4	-57.8	12.7
Labour market reforms	-34.8	-162.9	-43.4	-35.6
Agriculture sector reform	-63.4	-40.9	-11.5	-5.5
Health reforms	19.5	-0.9	-0.1	0.0
Other reforms	-19.0	-164.5	17.0	-25.6
Total impact on the budget	-107.8	-444.5	-95.8	-54.1
Total impact on the budget (% of GDP)	***-0.3***	***-1.1***	***-0.2***	***-0.1***

Source: 2007 Pre-accession Economic Programme, own calculations

and the programme expects individual restructuring plans for each of the five shipyards to be adopted in the first quarter of 2008, which is unrealistic. This framework is expected to guide a successful rehabilitation and lead to higher profitability, long-term sustainability and increased competitiveness. Statements on the possible privatisation of (parts of) the shipyard sector remain rather vague, contrary to the previous submissions which targeted the completion of privatisation of the sector at 2010. The support of SME sector remains an important priority, and the sector is likely to continue to benefit from various aid and subsidy schemes at different government levels. As further improvements in the overall business environment remain an important challenge, the programme should have also addressed more explicitly some policies and measures envisaged to overcome a still cumbersome regulatory framework and inefficiencies in public administration.

The Croatian financial sector is dominated by commercial banks, accounting for 74% of assets in mid-2007. 91% of banking assets are foreign owned and banks are generally very liquid, well capitalised and highly profitable. Banking supervision lies within the responsibility of the Croatian National Bank. The PEP 2007 provides useful information on recent and planned measures in the area of financial sector legislation, including anti-money laundering and payment systems, and it generally appears that the process of alignment with EU requirement is well on track. The document could have been more pronounced on financial sector related challenges and possible policy responses. A relatively strong credit growth remains a key concern which so far has been addressed with administrative measures, such as marginal reserve requirement for foreign borrowing and credit controls. Those measures have been only partly effective in managing credit growth and containing external debt, as they have been partly circumvented by direct borrowing and may have also led to undesirable effects on competition and access to credit for some borrowers. EU accession and EMU entry will eventually imply a removal of some of those measures. Against this background, the programme would benefit from outlining a clearly designed "exit" strategy and its effect on financial sector stability. Also, elements of an alternative policy framework to be implemented in the light of EU requirements would also be welcome as part of the PEP. In the non-banking sector, the key challenge will be the development of the securities market in order to sustain the growth of domestic institutional investors (pension and investment funds, insurance companies).

1.5.3. Labour market

Despite a recent decline in unemployment and moderate employment growth, the Croatian labour market continues to suffer from low employment and participation rates as well as high rates of youth and long-term unemployment. The policy response of the programme continues to focus on active labour market measures with a view to stimulating employment. For this purpose, budgetary resources are planned to be increased by HRK 50 million each year, unchanged from last years' PEP. Emphasis will be on training and education to improve the qualification of job seekers. While this may be supportive of addressing existing mismatches between labour supply and demand, a more comprehensive approach may be needed to address labour market challenges. However, the PEP does not foresee any policy measures related to the reform of the tax/benefit system (tax measures are explicitly ruled out), employment protection or wage bargaining system which would potentially be conducive to increasing the flexibility of the labour market. Labour costs are apparently not considered as a main impediment to stronger employment, which is somewhat surprising given the relatively high tax wedge in Croatia.

1.5.4. Other reform areas

The continuation of the reform of the social benefit system remains a priority of the structural reform agenda, but the programme remains vague on the current status of reforms and precise steps to be envisaged over the medium term. Last years' programme put much emphasis on improving the efficiency of social benefit spending through a better targeting, but it remains unclear to which extent objectives have been met. It seems that an important element in that respect, namely the establishment of a single registry of social benefits, has been further

delayed. The programme foresees additional funds to protect families, in addition to recent measures adopted in the context of a new population policy. On the reform of health care financing, the PEP would have benefited to address more explicitly the fiscal situation and challenges. Given that the sector has been accumulating payment arrears and does not yet appear to be on a sound financial footing, it is surprising that the reform strategy does not programme additional structural measures aimed at further restoring the sectors' fiscal discipline. With respect to the agricultural sector, the programme's objective is to increase the competitiveness through restructuring and modernisation. Given considerable delays in the privatisation of the main agricultural companies, which partly resulted from the resistance of strong constituencies, the intended completion of privatisation scheduled for 2008 appears rather ambitious. State aid to agriculture is programmed to be markedly increased. The continuation of education reform on the basis of an Educational System Development Plan (2005-2010) is welcome and should be supportive of the development of a knowledge-based economy. As in the previous PEP, emphasis on judicial reform is appropriate and the successful implementation of envisaged measures could be conducive to improving the overall business environment, which remains an important challenge

Table II.1.5:

Annex: Structural indicators

	CROATIA					EU 27				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
General economic background										
Real GDP [1]	5.3	4.3	4.3	4.8	5.6	1.3	2.5	1.9	3.0	2.9
Labour productivity [2]	60.2	61.0	62.2	64.3	65.7	100	100	100	100	100
Real unit labour cost [3]	2.4	-2.9	n.a.	n.a.	n.a.	-0.2	-1.5	-0.5	-0.8	-0.8
Real effective exchange rate [4]	n.a.	n.a.	n.a.	n.a.	n.a.	101.2	107.5	106.4	107.9	114.0
Inflation rate [5]	1.8	2.0	3.3	3.2	2.9	2.1	2.3	2.3	n.a.	n.a.
Unemployment rate [6]	14.1	13.6	12.6	11.1	9.1	8.9	9.0	8.9	8.2	7.1
Employment										
Employment rate [7]	53.1	54.5	54.8	54.8	55.4	62.6	62.9	63.5	64.5	n.a.
Employment rate - females [8]	46.7	47.8	48.6	49.4	n.a.	54.9	55.5	56.3	57.3	n.a.
Employment rate of older workers [9]	28.4	30.1	32.6	34.3	n.a.	40.0	40.7	42.4	43.5	n.a.
Long term unemployment [10]	8.4	7.3	7.4	6.7	n.a.	4.1	4.2	4.1	3.7	n.a.
Product market reforms										
Relative price levels [11]	64.8	66.5	69.0	69.9	n.a.	100	100	100	100	n.a.
Total trade-to-GDP ratio [12]	n.a.	53.0	52.3	53.2	n.a.	n.a.	12.4	13.3	14.3	n.a.
Net FDI [13]	3.6	2.0	2.6	4.2	n.a.	n.a.	0.9	1.6	1.8	n.a.
Market share electricity [14]	82.0	86.0	87.0	83.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aid [15]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Business investment [16]	28.6	29.1	29.0	30.8	n.a.	17.1	17.3	17.8	18.2	n.a.
Knowledge based economy										
Tertiary graduates [17]	5.6	5.4	5.7	n.a.	n.a.	12.3	12.5	12.9	n.a.	n.a.
Spending on human resources [18]	4.5	4.5	n.a.	n.a.	n.a.	5.2	5.1	n.a.	n.a.	n.a.
Educational attainment [19]	91.0	93.5	93.8	94.6	n.a.	76.9	77.2	77.5	77.9	n.a.
R&D expenditure [20]	1.1	1.2	1.0	0.9	n.a.	1.9	1.8	1.8	1.8	n.a.
Internet access [21]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	40.0	48.0	49.0	54.0

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-25 (EU-25=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC36 (1995 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs), Croatia = CPI. 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU25) or 50-64 (Croatia) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population aged 15-64. 11. comparative price levels of final consumption by private households including indirect taxes (EU-25=100). 12. Trade integration - Average value of imports and exports of goods&services divided by GDP. 13. Average value of inward and outward FDIs flows in % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Total tertiary graduates in science and technology per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Percentage of households who have Internet access at home.

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

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

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

2.1. SUMMARY AND CONCLUSIONS

The ECOFIN Council of 26/27 November 2000 considered: ...”*that a regular in-depth dialogue with accession countries on a large spectrum of macro-economic policy and financial stability issues will assist the accession process. It could be used both as a means to identify risks and vulnerabilities in these countries and as a way to help them define their strategy for economic integration into the EU. Such a dialogue would further enhance the cooperation and the exchange of information between existing and future Member States ahead of their accession. ... The Commission is invited to report each year to the Council (Ecofin) on its assessment of the fiscal notification and the Pre-accession Economic Programmes*.”

The former Yugoslav Republic of Macedonia submitted its second Pre-Accession Economic Programme (the “2007 PEP”) on 1 December 2007. The document covers the period 2008-2010 and presents a fairly optimistic macroeconomic framework, including medium-term fiscal targets and projections for key macroeconomic variables. The programme partly complies with the content, form and data requested. It is consistent with earlier policy documents, such as the Government’s Economic Programme, presented in August 2006, the budget for 2007 and takes into account commitment towards the International Financial Institutions. However, the structural reform part of the programme would have benefited from a closer reference to the analysis in the Commission’s Progress Report and to the economic priorities spelled out in the Accession Partnership for the country.

The key objectives of the 2007 PEP are to foster economic growth by improving the business environment and by reducing the share of the public sector in the economy while maintaining public sector accounts close to balance. Monetary policy targets the continuation of price stability and of the de-facto currency peg towards the euro.

The macroeconomic scenario envisages a marked acceleration of economic growth from an average growth of 4% during the last years towards 6% and 6½% during 2008-2010. This scenario appears optimistic in view of the country’s track record of relatively low growth but is not implausible when comparing with the experience of other candidate countries. Growth acceleration is mainly driven by domestic components, such as private consumption and in particular investment. This scenario is broadly in line the Commission’s recent forecast, although the Commission’s forecast expects a more moderate pace of growth acceleration. In contrast to last year, the document does not provide an alternative scenario.

The programme expects a rather stable development of the external balances; the trade balance is seen to deteriorate in 2008 but to subsequently improve in the remaining part of the programme period (reaching a deficit of 23% of GDP in 2010) and a deterioration in the current account (from close to 2% of GDP in 2007 to 5% in 2010). Inflows of foreign direct investment (FDI) are expected reach some 5% of GDP annually. Overall, the most important source for financing the substantial trade deficit will be private transfers, consisting of workers' remittances or cash exchanges at the country’s exchange offices.

The monetary and exchange rate policies continue to be oriented towards price stability and the maintenance of the de-facto peg towards to euro, which is in place since 1995. Inflation is expected to remain under control, reaching some 2½% in 2010. The long-term interest rate differential with corresponding rates in the euro area is still substantial, but has started to decline over the last few years. Given the country’s good track record of low inflation and exchange rate stability, the programme’s approach appears plausible and credible in this respect. In particular in view of the high degree of euroisation in the country, a change in the exchange rate policy, abandoning the current anchor to the euro, appears unlikely.

The overall fiscal strategy of the 2007 PEP consists of reducing the country's tax burden while maintaining public sector accounts close to balance. A key element in this strategy is to maintaining the growth of government expenditures below nominal GDP growth, among others by limiting discretionary spending in the areas of public consumption and investment. As a result, public sector revenues and expenditures are expected to decline by some 2 percentage points of GDP, each. The decline in the share of the public sector in GDP is foreseen to accelerate over the programme period. In the context of fiscal decentralisation the programme envisages the transfer of some additional 2% of GDP in terms of revenues and expenditures from the central government accounts to the local governments. This measure is seen to improve the efficiency of public administration but to be neutral with respect to the general government balances.

The general government deficit is expected to increase to 1.5% of GDP. Interest payments are expected to remain slightly below 1% of GDP. This results in a primary deficit of about ¾% of GDP. However, when correcting for the contribution of the business cycle, the deficit increases to 3% of GDP in 2010. The general government debt ratio is foreseen to continue declining, from 26.1% of GDP at the end of 2007 to 22.5% at the end of 2010. The main factor for this continued decline will be strong nominal GDP growth of around 9% during the programme period. Overall, the fiscal scenario with low deficits and a low and declining debt ratio is plausible and well based on a sound track record with a usually better than expected budgetary performance. Fiscal risks appear to be evenly distributed. On the revenue side the assumed tax elasticities are on the cautious side and actually in line with a significantly lower growth performance at around 4% annually. On the expenditure side, the assumptions on lowering the growth of expenditures could be seen as being optimistic. However, in recent years, the tax administration built up a track record of not being able to implement its spending targets.

Table II.2.1:

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP growth	COM	3.1	5.0	5.5	5.3	n. a.
(% change)	**PEP 2007**	**3.7**	**6.0**	**6.0**	**6.5**	**6.5**
Consumer price	COM	3.2	1.8	2.3	2.7	n. a.
inflation (%)	**PEP 2007**	**3.2**	**2.0**	**3.0**	**2.5**	**2.5**
General government	COM	-0.6	-0.9	-1.5	-1.3	n. a.
balance (% of GDP)	**PEP 2007**	**-0.8**	**-1.0**	**-1.5**	**-1.5**	**-1.5**
Primary balance	COM	0.5	-0.4	-0.9	-0.8	n. a.
(% of GDP)	**PEP 2007**	**0.3**	**-0.2**	**-0.9**	**-0.8**	**-0.8**
Government gross	COM	39.4	27.0	25.0	23.0	n. a.
debt (% of GDP)	**PEP 2007**	**33.5**	**26.1**	**25.2**	**23.9**	**22.5**

Sources: Pre-Accession Economic Programme (PEP), Commission services Autumn 2007 forecasts (COM)

The programme contains a comprehensive description of a vast area of reform efforts. The described measures are expected to have a fiscal net-impact of increasing net-expenditures by up to 2% of GDP, with a strong emphasis on infrastructure and agriculture. In terms of regulatory activities, the range of reforms is more widespread. Important areas are the improvement of the business environment, the modernisation of infrastructure, judiciary reform, fiscal decentralisation, health care, education, etc. The link of the various reform projects with accession related priorities spelled out in the Progress Report and the Accession Partnership could have been presented in a more elaborated way. Furthermore, references to the Lisbon agenda would have been welcome. The prominent role of support for the agricultural sector is somewhat surprising and would have deserved a fuller explanation.

Overall, the intended reforms of the tax system and of public administration should improve the quality of public finances, leading to a simpler tax system, a lower tax burden in combination with a broader tax base and more efficient institutions. However, the programme could have devoted more attention to improve the quality of public expenditures, channelling public resources to areas of strategic importance, such as human capital. In view of the relatively favourable situation of the country's public finances, with a low deficit and a low and declining debt ratio, long-term sustainability of the financial system appears not to be at risk. Recently, the pension system has been transformed into a three pillar system, which should over time help to improve the sustainability of this branch of the social security system. The current risks with respect to

the sustainability of the health system are higher. However, reforms of this system are under way.

It can thus be concluded:

- The Pre-Accession Economic Programme for 2008 - 2010 of the former Yugoslav Republic of Macedonia is a comprehensive economic policy document, containing an optimistic economic scenario, an ambitious fiscal strategy and a description of a wide area of structural reforms. Concerning content, form and data, the programme partly complies with the requested standard. The document could help to align the country's policy mix with the economic conditions and the country's orientation towards meeting the economic Copenhagen criteria for EU membership.

- The recent economic performance has shown higher economic growth, low inflation, narrowing external deficits and largely balanced public sector accounts and a low and declining debt ratio. The programme's scenario of strong growth appears optimistic in view of the country's historic trend growth and the worsening international environment. However, when taking into account the experience of other candidate countries, the scenario is not implausible. The programme's expectations concerning inflation, the stability of the exchange rate regime and the maintenance of sound public finances are more in line with the country's track record and the Commission's forecast. Risks to the macro-economic programme are however significant and more pronounced than in last years' submission. In particular, the international environment is likely to increase risks in the form of a higher volatility of prices for energy and raw materials and a less buoyant export markets, reflecting the uncertainties related to the impact of the subprime mortgage crisis on the global economy and an overall slowdown of global demand after the boom during the recent years. Overall, the document suffers from a lack of reliable statistical data, impeding the analysis of the country's position in the business cycle and the assessment of reform measures.

- The PEP's public finance agenda consists of a substantial project of reducing the tax burden while maintaining the general government deficit at around 1½% of GDP. The lower tax burden is expected to stimulate investment and to strengthen disposable incomes, and, thereby, economic growth and employment. The estimates of expected public revenues are based on cautious assumptions, compatible with significantly lower nominal growth. Like last year, the fiscal part would have benefited from a more detailed presentation of the development of the various expenditure and revenue elements. Furthermore, more information on measures to improve the quality of public finances would have been welcome.

- The country's structural reform programme aims to support the establishment of a functioning market economy, particularly by improving the business climate and strengthening the competitiveness of the country's enterprises. The programme's reform agenda is broadly in line with the fiscal scenario, but would have benefited from a closer alignment with the reform requirements in view of the country's EU accession perspectives, as spelled out in the latest Progress Report and the Accession Partnership. It would also have gained from a more in-depth assessment of key challenges to the economy, such as the very ill-performing labour markets.

2.2. INTRODUCTION

On 1 December 2007, the Ministry of Finance of the former Yugoslav Republic of Macedonia, submitted the country's second Pre-Accession Economic Programme (the "2007 PEP") to the Commission. The programme covers the period 2008-2010 and contains a presentation of the macroeconomic framework, a discussion of public finances and debt dynamics and a chapter on structural reforms. The programme has been adopted by the government. It is the result of contributions from various line ministries and the Central Bank. Social partners have been invited to participate in the programme's formulation process. The overall coordination took place at

the Ministry of Finance. The document is broadly in line with the country's National Development Plan, the fiscal strategy for 2007-2009, the National Plan for the Adoption of the Acquis (NPAA) and the Economic priorities of the country's Accession Partnership. It also takes into account the county's obligations towards IMF and World Bank.

The document partly complies with the content, form and data required. It contains a general overview over recent economic developments and presents a parsimonious macroeconomic framework. The document describes key medium-term fiscal and other policy objectives and provides an overall presentation of structural reforms of product and capital markets in the light of EU-integration. Concerning the form, the 2007 PEP follows the structure of the outline and represents a stand-alone document, providing required information on the macroeconomic and fiscal framework and on structural reforms. The document also includes the quantitative information required for the data appendix. The data presented appears to be complete and largely meets the required standard. However, the majority of the data is not yet in line with ESA 95 requirements.

The programme is designed to foster economic growth, while maintaining overall macroeconomic stability. Key objectives are to maintain - in line with Maastricht requirements - a sound fiscal position and to support the private sector development, which should have positive implications for the labour market. Membership to the EU and NATO are further key policy objectives. Preparing for the eventual participation in ERM II is seen as an important challenge. The main instruments to achieve those objectives are fiscal discipline, a reduction of the tax burden, improving the efficiency of the public sector and proceeding with administrative decentralisation. After a strong decline in public debt in 2007 owing to early repayments, the debt ratio is envisaged to decline further, from 26% of GDP in 2007 to 23% of GDP by 2010. The structural reform agenda covers a wide range of areas. While the programme's priorities are not very clearly spelled out, in terms of intended expenditures, a clear emphasis is de facto put on agriculture and infrastructure, amounting to about half of additional spending.

Overall policy framework and objectives

Like in the previous programme, the 2007 PEP intends to foster economic growth and employment by a supply side oriented policy approach, focussing on promoting private sector activity by improvements in the investment climate. A sound fiscal policy, a declining tax burden and price stability should contribute to an overall favourable investment climate and consumer confidence. Overall, the discussion of policy priorities would have benefited from a more detailed discussion and more explicit references to the challenges related to the EU accession, as described in the various EU documents, such as the Progress Report or the EU Accession Partnership priorities.

2.3. ECONOMIC OUTLOOK

2.3.1. Recent macroeconomic developments

During 2006 and 2007, growth of economic activity accelerated from 3.7% in 2006 to 5% in 2007. A key contribution to this acceleration came from external demand for steel and metals. Consumer price inflation was around 1% during most of 2007, after rises in excise duties had raised the price level by 3.2% in 2006. However, in the last months of 2007, inflation rose markedly, bringing average annual price increases to 2.3%. Core inflation remained significantly below 2%.

Public finances continued to remain close to balance in 2006 and 2007, registering a general government deficit of 0.6% of GDP in 2006 and fiscal surpluses during most of 2007. For the whole year, the authorities envisaged a deficit of 1% of GDP. Like in the recent past, revenues performed markedly better than expected, which resulted in a surplus of the general government accounts of some 0.6% of GDP in 2007. The trend of a favourable performance of the current account continued in 2006 and most of 2007, with a further decline in the deficit from 0.9% of GDP in 2006 to a largely balanced account during the first 10 months of 2007. However, during the last few months, imports rose strongly, while private transfers declined, leading to a deterioration in the current account to about

3% of GDP by end-2007. The situation in the labour markets has continued to improve, with a strong increase in employment and decline in the number of unemployed. However, the official level of unemployment is still very high, at some 35% of the labour force.

Overall, the programme presents a clear and concise picture of past economic developments and covers all relevant data available at the time of submission.

2.3.2. Medium-term macroeconomic scenario

The medium-term macroeconomic scenario shares the Commission's view on the development of the international environment, expecting decelerating, but solid growth in the country's main export markets and the continuation of a relatively low inflation. Interest rates are expected to increase moderately from relatively low levels. Overall, this environment should have a supportive impact on the country's economy.

The programme gives a brief overview about expected developments of key macroeconomic variables. The presentation would have benefited from a more systematic and detailed description of the country's macroeconomic scenario. Furthermore, a discussion of an alternative scenario would have provided more insights into the government's contingency planning. The programme's objectives are ambitious, but not implausible. Unfortunately, the description of policy instruments and their impact on the economy remained rather rudimentary. The policy mix in the programme is compatible with the macroeconomic scenario. The overall thrust of the programme is very much in line with last year's submission. Compared to the Commission's forecast, the PEP continues to be more optimistic with respect to economic growth, labour market developments, while being more pessimistic concerning inflation and the external balance in 2007 and 2008.

Real sector

The macroeconomic scenario envisages a marked acceleration of economic activity, with real output growth improving from expected 5% in 2007 to 6.5% annually in 2010. The main driving forces for this favourable development are private consumption, supported by increased real disposable income and strong investment, improving labour productivity. On the supply side, the service sector will be the main contributor to growth. The country's de facto fixed exchange rate regime is expected to keep inflationary pressures close to EU levels, with consumer price inflation coming down to 2.5% in 2010. The general government deficit is expected to increase from close to balance in the past to 1.5% of GDP during 2008-2010. The level of public debt is seen to continue declining. Early debt repayments during 2007 brought down the debt ratio from 33.5% of GDP end of 2006 to about 26% of GDP by the end of 2007. The current account deficit is expected to deteriorate to nearly 6% of GDP in 2008 but to improve to a deficit of 5% of GDP by 2010. Substantial inflows of private transfers are expected to support the financing of imports. Overall, the programme's growth projections appear to be on the optimistic side. Unfortunately, in contrast to last year, no alternative scenario has been presented.

Econometric estimates based on historic data confirm last year's estimate of a potential growth rate of 3.7%. However, in view of the currently low labour force participation the country's actual growth potential is probably higher.

Inflation

Inflation is expected to accelerate to 3% in 2008 but to come back to about 2.5 in the remaining period. In the past, the country experienced rather low inflationary pressures. In view of the relatively low recent economic growth, no demand driven price pressures took place in the past, with inflation rates close to zero. In 2006, one of the main determinants for the sharp increase in consumer prices (from 0.5% in 2005 to 3.2% in 2006) was the alignment of excise duties with EU requirements, contributing about one percentage point to consumer price inflation. Furthermore, significantly higher energy prices contributed to the relatively strong price increases in 2006.

Monetary and exchange rate policy

The monetary framework continues to consider price stability as the overriding monetary policy objective. To this end, the central bank maintains a de-facto fixed peg towards the euro. In view of the high share of euro-denominated imports (some 60% of total imports) this helps to contain price pressures through imports. As a result of the recent strength of the euro and of particularly low domestic inflation rates during the last years, the nominal effective exchange rate slightly appreciated during the last years. So far, no changes to the current exchange rate regime are envisaged. The central bank has started to upgrade the institution's analytical and forward-looking capacities and also initiated early stage preparations in view of an eventual entry to ERM-II, once the country has become member to the EU. Overall, the monetary framework is in line with the programme's supply side approach to stimulate economic growth by improving the business environment and reducing the tax burden.

External sector

The programme expects a moderate deceleration of global demand, which should allow the country to maintain rather strong export growth. FDI inflows are expected to remain on a much higher level than in the past, benefitting from improved attractiveness to foreign investors. Private transfers in the form of workers remittances and cash exchanges at foreign exchange offices are expected to remain on their relatively high level.

The 2007 PEP expects a marked widening of the current account deficit from 2.3% of GDP in 2007 to 5.8% of GDP in 2008, mainly as a result of a decrease of export growth to less exceptional levels. In the following 2 years, decelerating import growth should contribute to bring back the current account deficit to some 5% of GDP. The main driving force behind this profile is the trade balance, which is expected to deteriorate by 5 percentage points in 2008 (to 25% of GDP in 2008) and to improve by 3 percentage points during 2009-2010.

Concerning the financial account, FDI inflows are expected to continue to play an important role. In 2006, privatisation related inflows of FDI rose to 6.3% of GDP, compared to 1.7% of GDP the year before. However, a large share of those inflows in 2006 was exceptional and was due to a single privatisation project. In 2007, FDI inflows are expected to reach a level of about 4% of GDP, which is about twice the level of FDI inflows in recent years. In 2008 and 2009, as a result of continued capital inflows, foreign exchange reserves are expected to increase, from 28% in 2006 to 31% of GDP in 2010.

Main risks to the programme

Overall, the programme is based on a benign, but not unrealistic economic scenario. The main risks to the programme might ensue from

Table II.2.2:

Comparison of macroeconomic developments and forecasts

	2006		2007		2008		2009		2010	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	3.1	**3.7**	5.0	**6.0**	5.5	**6.0**	5.3	**6.5**	n.a.	**6.5**
Contributions:										
- Final domestic demand	5.0	**-**	6.2	**9.0**	8.6	**9.5**	6.7	**9.2**	-	**9.7**
- Change in inventories	0.3	**-**	0.0	**0.1**	0.0	**0.1**	0.0	**0.1**	-	**0.1**
- External balance of goods and services	-7.0	**-**	-1.2	**-3.1**	-3.1	**-3.5**	-1.4	**-2.8**	-	**-3.3**
Employment (% change)	4.7	**4.6**	3.7	**4.0**	4.1	**4.0**	3.5	**4.0**	n.a.	**4.0**
Unemployment rate (%)	36.0	**36.0**	34.4	**31.8**	33.2	**31.6**	32.7	**31.4**	n.a.	**31.2**
GDP deflator (% change)	3.1	**3.8**	2.1	**2.0**	2.8	**3.0**	2.9	**2.5**	n.a.	**2.5**
CPI inflation (%)	3.2	**3.2**	1.8	**2.0**	2.3	**3.0**	2.7	**2.5**	n.a.	**2.5**
Current account balance (% of GDP)	-0.4	**-0.4**	-2.8	**-2.3**	-4.1	**-5.8**	-3.9	**-5.5**	n.a.	**-4.9**

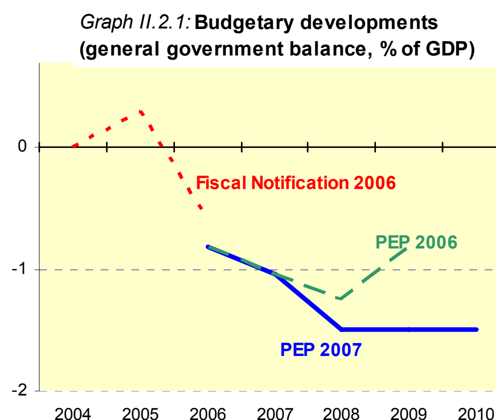
Sources: Pre-Accession Economic Programme (PEP); Commission services Autumn 2007 forecasts (COM)

exogenous shocks, in the form further price increases of energy and raw materials or of declining external demand reflecting weaker growth of important export markets, such as Germany or Italy. Increased competition on the global market for textiles or steel through low wage producers such as China or Ukraine could further impede export driven growth. The risks of negative direct effects of the financial crisis appear to be limited, in view of the relatively low degree of monetisation of the economy and the low exposure of the country's banking sector to international financial markets. A possible deterioration in financing conditions could even help to contain the high credit growth, which, starting from a low level, had reached 20-30% annually in recent years. On the domestic side, the recent hike in public sector wages might create pressure on wages in the private sector, which could trigger inflationary pressures and also deteriorate the export sector's competitiveness. As a result, the country could face higher inflation and lower growth as an outcome of lower disposable income and a less buoyant export performance.

2.4. PUBLIC FINANCE

The programme describes the main features of the country's fiscal framework in a coherent and consistent way. However, like in the last submission, the integration of the fiscal framework with the macroeconomic part and the overall accession process remains rather rudimentary and the presentation would have benefited from a more detailed exposition of the expected development of various elements of the country's public finances. The projected fiscal path appears not to endanger the country's long-run sustainability, in particular in view of the relatively low and declining debt ratio. Overall, the envisaged fiscal stance appears to be pro-cyclical. The envisaged deficit targets are slightly higher than those targets in the previous year. The programme also contains an assessment of the cyclical position of the economy, indicating that, while in 2006 economic growth was below potential, from 2007 onwards growth will be above potential, starting with a growth differential of one percentage point in 2007 which will decline to 0.6 percentage points by 2010. Unfortunately the programme does not express the output gap in terms of potential output. Due to the cyclical position, the cyclically adjusted fiscal position shows higher deficits during the programme period, with a sharp increase in the cyclically adjusted deficit from 1.2% of GDP in 2007 to 2.5% of GDP in 2008 and up to 3% of GDP in 2010. Unfortunately, like in the 2006 PEP, the programme does not present estimates on the quantitative impact of the various revenue and expenditure measures. Furthermore, the presented data are neither in line with ESA 95 in general nor with the 2007 Fiscal Notification in particular.

Graph II.2.1: **Budgetary developments (general government balance, % of GDP)**



The overall fiscal strategy envisages revenue and expenditure increases to remain below nominal GDP growth, resulting in a slightly accelerating decline in the share of the public sector in the economy. The share of revenues is planned to be brought down by nearly 2 percentage points of GDP, while the share of expenditures is seen to decline by about 1 ½ percentage points of GDP. As a result, the general government deficit is planned to increase from 1% of GDP in 2007 to a deficit of 1.5% during 2008-2010. The main adjustment is expected to take place during the last 2 years of the programme, while in 2008 a rise in public expenditures by nearly ½ % of GDP is planned. Overall, the share of public revenues in GDP is expected to decline from 37.6% of GDP in 2007 to 35.7% in 2010. Total expenditures are expected to decline from 38.6% of GDP in 2007 to 37.2% of GDP in 2010. The share of public debt interest payments is expected to decline slightly, from 0.8% of GDP in 2007 to 0.7% in 2010. As a result, the impact of changes in interest rate payments on the

primary balance will be marginal. When compared to the fiscal scenario in the 2006 PEP, both the size of the reduction in the share of the public sector and the fiscal adjustment are more moderate, but also more realistic.

2.4.1. General government balances and debt

Actual balances and medium-term perspectives

The 2007 budget target of the PEP envisages a general government deficit of 1.0% of GDP (based on GFS 1986 standards). However, like last year, latest fiscal data suggest that the final outcome for the year 2007 will probably be better than envisaged. The main factor for this better than expected performance seems to have been higher than expected tax revenues during most of the year. In contrast to last year, public spending seems to be closer to the targets. Unfortunately the document does not present more details on the fiscal development during the year of submission.

For 2008, the PEP targets a general government deficit of 1.5% of GDP. This deficit target is in line with IMF assumptions under the current stand-by arrangement. The main budgetary measures for 2008 are a further lowering of the corporate profit and of the personal income tax from the previous single rate of 12% to a unique single rate of 10%. The overall impact of the further lowering of direct tax rates on total revenues has been estimated to be rather neutral, as revenue losses due to the lower rate should be more than compensated by a higher degree of collection. No major privatisation revenues are expected. Furthermore, some minor budgetary revenues in the form of donations and disbursements from EU funds are included in the fiscal framework. Overall, nominal revenues are expected to decline moderately as a share of GDP. Revenues from taxes on income and wealth are expected to increase by 11.7%, which will raise the share of this tax category by ¼ percentage point of GDP (from 12.0% of GDP), while revenues from capital taxes are set to decline by a similar amount, resulting from a rather low nominal increase of 5.5%. Capital taxes and property income tax revenues are also expected to increase at a lower rate than nominal GDP growth, resulting in a drop of these two revenue categories by some 0.2 percentage points of GDP. Total expenditures are expected to increase above nominal GDP growth (by 10.4%), mainly due to a strong increase in gross fixed capital formation by nearly 1½ percent points of GDP, increasing the share of this expenditure category from 5.7% of GDP in 2007 to 7.1% in 2008. Public consumption is planned to increase by 10.5% in nominal terms in 2008, raising the share of expenditures by about ¼ percentage point of GDP. This expansion is largely compensated by low growth of social transfers and lower interest payments, reducing expenditures by about ½ percentage point of GDP each.

In the years 2009 and 2010, the share of the public sector in the economy – as measured by government revenue and expenditure in percent of GDP - is envisaged to decline at a faster pace, with revenues declining by 0.8 and 1.0 percentage points in 2009 and 2010, respectively. In contrast to 2008, the largest contribution to the decline in revenues will come from capital taxes, declining by about ½ percentage point during 2009-2010. On the expenditure side, the biggest reduction will be through lower growth of social transfers, leading to a decline in the share of this expenditure category by nearly 1 percentage point of GDP during 2009-2010. Furthermore, gross fixed capital formation is set to expand at a slower pace, reducing the share by ¾ percentage points of GDP. Overall, the fiscal strategy for 2009-2010 seems to consist in a strong deceleration of capital taxation, combined with subdued increases of social transfers and capital formation.

The main risks to this programme relate to possibly lower than expected growth and ambitious expenditure stabilisation targets, in particular in the area of social transfers. Unfortunately the document does not contain sufficiently concrete details on expenditure reducing measures. With respect to the expenditure profile, the strong increase of gross fixed capital formation in 2008 and rather low investment activity in the following years raises doubts about the planning capacity and time consistency of government investment spending. The assumptions on the revenue side appear to be in general on the cautious side, in particular

when taking into consideration the rather optimistic growth scenario. The Commission forecast envisages a similar level and profile of the public sector deficit, but is more conservative with respect to the decline in the public sector's share in GDP.

Overall, the risk of realising a deficit beyond -3% of GDP appears to be relatively low, given the cautious revenue assumptions incorporated into the fiscal framework and taking into account the country's track record of over-performing fiscal targets. Given the rather optimistic growth profile, the presentation of an alternative scenario would have been useful.

Structural balance

The programme expects the economy to grow above potential, albeit the differential between potential and realised growth is seen to decline. Given the fiscal expansion during the programme period, the fact of above potential growth points to an even higher cyclically adjusted fiscal deficit, reaching some 3% of GDP in 2010. As a result, the fiscal stance can be seen as being pro-cyclical. However, in view of still very high unemployment and increasing investment, the risk of accelerated inflation due to overheating appears to be limited.

Debt levels and developments

Overall, the current debt level is relatively low, amounting at the end of 2007 to some 26% of the estimated GDP. Over the programme period, the debt ratio is expected to decline further, reaching a level of 22.5% of GDP end of 2010. The main driving force for this decline will be strong nominal GDP growth of around 9% annually. This factor will reduce the debt ratio by some 2 percentage points during 2008-2010.

The country's debt strategy consists of maintaining the debt-to-GDP ratio on a declining trend by supporting strong GDP growth, early debt repayments and improving the structure of public debt, by replacing external debt through domestic debt and by increasing the share of the euro-denominated debt in the foreign exchange denominated debt. In order to improve debt management, the Ministry of Finance established a central public debt management department in 2005 and adopted a medium-term public debt strategy, currently covering the years 2007-2009. By June 2007, the share of foreign debt in total debt had declined to 53%, while debt denominated in foreign currency amounted to 74% of total debt. The currency composition of debt is dominated by the euro, amounting to 54% of total debt, followed by the SDRs (15%) and USD (4%). The interest rate structure is

Table II.2.3:
Composition of the budgetary adjustment (% of GDP)

	2006	2007	2008	2009	2010	Change: 2008-10
Revenues	38.1	37.6	37.5	36.7	35.7	-1.9
of which:						
- Taxes and social security contributions	30.1	30.6	30.3	29.7	29.5	-1.1
- Other (residual)	8.0	7.0	7.2	7.0	6.2	-0.8
Expenditure	38.9	38.6	39.0	38.2	37.2	-1.4
of which:						
- Primary expenditure	37.8	37.8	38.4	37.5	36.5	-1.3
of which:						
Gross fixed capital formation	5.4	5.7	7.1	6.6	6.3	0.6
Consumption	14.4	14.8	15.0	15.1	14.8	0.0
Transfers & subsidies	18.0	17.3	16.3	15.8	15.4	-1.9
Other (residual)	0.0	0.0	0.0	0.0	0.0	0.0
- Interest payments	1.1	0.8	0.6	0.7	0.7	-0.1
Budget balance	-0.8	-1.0	-1.5	-1.5	-1.5	-0.5
- Cyclically adjusted	-0.3	0.2	1.0	1.2	1.5	1.3
Primary balance	0.3	-0.2	-0.9	-0.8	-0.8	-0.6
Gross debt level	33.5	26.1	25.2	23.9	22.5	-3.6

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

characterised by a relatively high share of 58% in debt with variable rates. The average maturity of external public debt was about 9 years end of 2007, while domestic debt has an average maturity of some 3 years only. Debt servicing costs are expected to remain below 1% of GDP during the programme period. The programme is very cautious with respect to expected privatisation revenues. Thus, the decline in the debt ratio might be faster than anticipated, taking into account those potential additional funds, which might be used for early debt redemption.

2.4.2. Budgetary implications of major structural reforms

The PEP provides a broad and comprehensive overview of the country's structural reform agenda. The document also contains a detailed and comprehensive matrix of policy commitments, with quantitative information on the impact of various reform measures on budgetary expenditures and revenues. The presentation also contains information on the time schedule of the various measures. However, the presentation would have benefited from a more explicit description of the government's policy priorities and the policy mix which results from its priorities. The policy mix contains measures, which are in line with the Lisbon agenda and the priorities derived from the Commission's Progress Report and spelled out as economic priorities in the Accession Partnership. However, when looking at the fiscal commitments, the policy mix is highly focussed on a few areas, such as strengthening infrastructure and supporting the agricultural sector, while the financial commitments related to other policy objectives, such as measures to address the labour market imbalances, education and improving the efficiency of public administration, are still very limited. The overall level of reform oriented spending will increase during the programme period, albeit at a relatively low level, increasing from 0.9% of GDP in 2007 to 1.8% of GDP in 2010.

Overall, the main structural reforms will have a limited but important impact on the country's fiscal position, with an increase in net-public spending by nearly 2% of GDP towards the end of the programme period. These measures address important structural weaknesses and are therefore likely to add to the country's growth potential. However, a stronger focus on areas with positive effects on the growth potential would have been welcome.

2.4.3. Sensitivity analysis and comparison with previous programme

Unfortunately, the programme does not contain a sensitivity analysis.

2.4.4. Quality of public finances

The country enrolled in May 2000 in a major reform of public administration, which - with support from the IFIs – intended to reduce the public sector to its core activities and to improve the transparency and efficiency of public administration in general. Another impulse for public sector reform is based on the Ohrid framework agreement from 2001. In line with this agreement, the authorities endorsed a major programme of administrative decentralisation, which envisages transferring the competence and the financial means in a number of communal areas (such as education, health, local cultural institutions, urban planning and construction, fire brigades, etc.) to the local communities. So far, mainly the responsibilities have been transferred, while financial competences are more gradually transferred. Overall, the institutional and legal changes over the last years should to lead to a strengthening of the country's capacities to administer public finances.

The government's implementation of a flat tax on corporate profits and income will have an important impact on the level and composition of public revenues. The lowering of direct taxes might help to stimulate consumption and investment. But at the same time, it might shift the tax burden to lower income households. Furthermore, the tax wedge on labour will remain high, impeding efforts to reduce unemployment.

2.4.5. Sustainability of public finances

The programme contains a table with long-term (2000-2050) estimates on the sustainability of public finances. Based on an economic scenario with a decelerating trend in growth (from 6.5% in 2010 to 4.5% in 2050) and a rather moderate

decline in unemployment (from 37% in 2005 to 12% by 2050), the programme expects revenues and expenditures to remain constant as share in GDP, at 33% and 32%, respectively. Expenditures for pensions are expected to decline relative to GDP, from 5.3% in 2005 to 3.1% of GDP in 2050. Health expenditures are also set to relatively decline, from 5.5% of GDP in 2005 to 4 in 2050. Spending for education is seen to increase, from 4.7% of GDP in 2005 to 6.7% in 2050.

Overall, there appear to be no major and immediate threats to the long-term sustainability of the country's public finances, in particular in view of the country's relatively low debt level. Demographic pressures seem to pose no major threats, although a continued reform of the social security system appears to be necessary to keep public sector health spending under control. Provided that the current public sector reform agenda is fully implemented, the former Yugoslav Republic of Macedonia is relatively well placed to meet the costs of an aging population. Nevertheless, costs in relation to the reform of the pension and health-care systems should be monitored carefully.

2.4.6. Institutional features of public finances

The programme presents a series of measures to improve the efficiency of public administration. Current reform projects are related to improve tax collection, to increase the attractiveness of the public sector by increasing the level of public sector wages, and to improve the qualification of staff. Furthermore, programmes to move to ESA 95 accounting standards have been prepared and should be implemented by 2010.

2.5. STRUCTURAL REFORMS

The 2007 PEP provides a broad and comprehensive overview of the country's structural reform agenda. The document also contains a detailed and comprehensive matrix of policy commitments, with quantitative information on impact of the various reform measures on budgetary expenditures and revenues. The presentation also includes information on the time schedule of the various measures. However, like last year, the presentation would have benefited from a more explicit discussion of the government's policy priorities and the policy mix which results from its priorities. The policy mix contains measures, which are in line with the Lisbon agenda and the priorities derived from the Commission's Progress Report and spelled out as economic priorities in the Accession Partnership.

However, when looking at the fiscal commitments, striking features are the relatively low volume of additional spending (increasing from 0.9% of GDP in 2007 to 1.8% in 2010) and the dominance of planned expenditures in infrastructure projects, agriculture and regional development, while only a minor part of expenditures is devoted to labour market policies, education and health. Another interesting point is the fact that when compared to last year's reform programme, envisaged expenditures for structural reforms in 2007 are only about half of what had been originally planned for 2007.

2.5.1. Structural reforms and Accession Partnership

The 2007 PEP addresses important economic priorities under the Accession Partnership, such as improving the business environment and strengthening administrative capacities. However, the programme is surprisingly short with respect to one key area, namely on the country's chronic labour market imbalances, such as particularly high unemployment. The programme suggests addressing labour market issues by supply side measures and thus improving labour demand. Furthermore, the size of active labour market measures appears to be rather limited, in particular in view of the dimension of, for example youth unemployment. On the other hand, significant support is devoted to areas, such as agriculture, which - so far - is not considered to represent key a reform challenges with respect to country's accession

process. In this respect, the programme would have benefitted from a more detailed discussion on the authorities' policy priorities, in particular in view of the country's accession process.

2.5.2. Product and capital markets

Like the previous submission, the 2007 PEP contains a long and comprehensive description of a large number of structural reform areas targeted to improve the efficiency of product and capital markets. The main reform areas mentioned in the document are supporting the agricultural sector, strengthening infrastructure, proceeding with privatisation, strengthening the competitiveness of the industrial sector, strengthening competition policy and state aid control, promoting industrial clusters, improving business environment, supporting SMEs and liberalising network industries (energy, telecommunication, transport). With respect to financial commitments, the focus appears to be on agriculture and infrastructure.

Overall, the pace of structural reforms outlined in the programme appears to be relatively moderate. Furthermore, a considerable share of the available funds seems to be devoted to areas, which in terms of meeting the Copenhagen criteria are unlikely to be the most effective ones. With respect to the timing of reforms, the programme presents a back-loaded approach with respect to improving infrastructure, while the support for agriculture is more concentrated towards the immediate future.

With respect to the reform of capital markets, the programme envisages a further alignment with the EU acquis and a further strengthening of the regulatory and supervisory institutions. In contrast to the product market reforms, the information provided in this respect is more concrete and operational.

2.5.3. Labour market

With respect to labour market reforms, the document is very brief, describing recent developments and referring to the adoption of an operational action plan in order to implement the current employment strategy. As regards the financial implications of labour market reforms, the matrix of policy commitments points to measures with a net budgetary impact of EUR 5 million in 2007 (10% of the net fiscal implications in 2007), which will increase in nominal terms (to EUR 10 million by 2010) but decrease in relative terms (to 8% of the net fiscal implication in 2009). Compared to the 2006 PEP, this represents a doubling of committed funds. However, in view of an unemployment rate of some 35%, these commitments appear to be insufficient.

2.5.4. Other reform areas

Concerning other reform areas, the most noteworthy additional reform projects are related to the judiciary, health and education, public administration, including a reform of the financial system and the decentralisation of competences from the central government to the local administrations, IT, environment and

Table II.2.4:
Net direct budgetary impact of key reform commitments (in EUR million)

Description of the Policy	2007	2008	2009	2010
Transport and communication	-4.5	-25.2	-38.1	-45.4
Agriculture sector reform	-16.4	-21.8	-26.1	-21.5
Regional development	0.0	-9.1	-17.9	-27.7
Education	-13.3	-17.9	-6.8	-5.6
Labour market reform	-4.9	-6.5	-9.7	-10.0
Health	-6.2	-6.3	-4.8	-4.8
Other reforms	-5.7	-9.8	-9.5	-10.0
Total impact on the budget	-51.0	-96.6	-112.8	-125.0
Total impact on the budget (in % of GDP)	**0.9**	**1.6**	**1.7**	**1.8**

Source: 2007 Pre-accession Economic Programme (PEP), ECFIN calculations

regional development. Overall, the presentations tend to devote much attention to past developments and often remain relatively vague with respect to concrete plans for the programme period. Like in the other reform areas, the conceptual link to the EU accession process, notably the Accession Partnership, is rather limited.

Table II.2.5:

Annex table 1: Structural indicators

	The former Yugoslav Republic of Macedonia					EU 27				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
General economic background										
Real GDP [1]	2.8	4.1	4.1	4.0	5.0	1.3	2.5	1.9	3.0	2.9
Labour productivity [2]	n.a.	n.a.	n.a.	n.a.	n.a.	100	100	100	100	100
Real unit labour cost [3]	n.a.	n.a.	n.a.	n.a.	n.a.	-0.2	-1.5	-0.5	-0.8	-0.8
Real effective exchange rate [4]	n.a.	n.a.	n.a.	n.a.	n.a.	101.2	107.5	106.4	107.9	114.0
Inflation rate [5]	1.1	-0.4	0.5	3.2	2.3	2.1	2.3	2.3	n.a.	n.a.
Unemployment rate [6]	36.7	37.2	37.3	36.0	34.9	8.9	9.0	8.9	8.2	7.1
Employment										
Employment rate [7]	34.3	33.8	34.1	35.2	36.2	62.6	62.9	63.5	64.5	n.a.
Employment rate - females [8]	26.0	25.7	25.4	27.0	28.0	54.9	55.5	56.3	57.3	n.a.
Employment rate of older workers [9]	24.4	21.9	23.2	n.a.	n.a.	40.0	40.7	42.4	43.5	n.a.
Long term unemployment [10]	n.a.	n.a.	n.a.	n.a.	n.a.	4.1	4.2	4.1	3.7	n.a.
Product market reforms										
Relative price levels [11]	43.9	44.4	44.0	44.5	n.a.	100	100	100	100	n.a.
Total trade-to-GDP ratio [12]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	12.4	13.3	14.3	n.a.
Net FDI [13]	2.4	6.0	1.6	6.8	4.3	n.a.	0.9	1.6	1.8	n.a.
Market share electricity [14]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aid [15]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Business investment [16]	16.7	17.8	n.a.	n.a.	n.a.	17.1	17.3	17.8	18.2	n.a.
Knowledge based economy										
Tertiary graduates [17]	3.3	3.7	4.0	n.a.	n.a.	12.3	12.5	12.9	n.a.	n.a.
Spending on human resources [18]	3.4	n.a.	n.a.	n.a.	n.a.	5.2	5.1	n.a.	n.a.	n.a.
Educational attainment [19]	n.a.	n.a.	n.a.	n.a.	n.a.	76.9	77.2	77.5	77.9	n.a.
R&D expenditure [20]	0.2	n.a.	n.a.	n.a.	n.a.	1.9	1.8	1.8	1.8	n.a.
Internet access [21]	n.a.	11.0	11.2	14.0	n.a.	n.a.	40.0	48.0	49.0	54.0

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-25 (EU-25=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC36 (1995 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs), tFYRoM = CPI. 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU27) or 50-64 (tFYRoM)) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population aged 15-64. 11. comparative price levels of final consumption by private households including indirect taxes (EU-25=100). 12. Trade integration - Average value of imports and exports of goods&services divided by GDP.

13. Average value of inward and outward FDIs flows in % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Total tertiary graduates in science and technology per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Percentage of households who have Internet access at home.

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

Source: Commission services, national sources

3. TURKEY

3.1. SUMMARY AND CONCLUSIONS

The ECOFIN Council of 26/27 November 2000 considered*: "...that a regular in-depth dialogue with accession countries on a large spectrum of macro-economic policy and financial stability issues will assist the accession process. It could be used both as a means to identify risks and vulnerabilities in these countries and as a way to help them define their strategy for economic integration into the EU. Such a dialogue would further enhance the cooperation and the exchange of information between existing and future Member States ahead of their accession. (...) The Commission is invited to report each year to the Council (Ecofin) on its assessment of the fiscal notification and the Pre-accession Economic Programmes".*

In early December 2007, Turkey submitted the 2007 Pre-Accession Economic Programme (PEP)[1] to the European Commission, covering the 2008-2010 period. It is Turkey's seventh PEP after the ECOFIN Council of 26/27 November 2000 expressed its wish for a regular in-depth dialogue with accession countries. The programme largely complies with the requirements of the consolidated outline in terms of content, form and data. The PEP is broadly consistent with other economic policy documents, such as the ninth National Development Plan (2007-2013), the Memoranda related to the Stand-By Arrangement with the International Monetary Fund and the revised World Bank's Country Assistance Strategy. The medium-term budget framework is largely in line with what is indicated in the PEP. The 2007 PEP has been adopted by a decision of the High Planning Council[2]. As in the previous year, the structure and content of the PEP demonstrates a high degree of familiarity with the technical tools and analytical requirements of this exercise, in particular on the macroeconomic issues. Yet, most of the methodological issues raised in the assessment of the 2006 PEP have not yet been taken into account. The basic objective of the PEP is to create an environment conducive to economic growth, through ensuring price stability, maintaining fiscal discipline and implementing an income policy compatible with macroeconomic stability. The main differences from last year relate to changes in the external environment (financial markets volatility, high energy and food prices) and to a fiscal loosening in 2007. The relatively high growth performance recorded in the Turkish economy in recent years is expected to continue in the forthcoming period. However, in parallel with the increasing uncertainty in the international markets and concomitant downward adjustment for world growth forecasts[3], it is projected that the average annual growth rate in the 2007 PEP period will be less than that of the 2006 PEP.

The programme estimates that the Turkish economy will grow at rates around potential, which will be close to 5.6% in 2008-2010. Growth is expected to be driven by private sector investments and exports in the 2007 PEP period, and external demand will have a positive contribution to growth. Tight monetary and fiscal policies implementation will be continued in the 2008-2010 period. Assuming that the real exchange rate will not continue to appreciate as observed since 2002, the pace of private sector consumption growth is forecasted to be below economic growth rate, 4.8% annually on average. The decrease in the debt stock and the fall in interest rates as a result of tight fiscal policy are estimated to have a positive impact on

[1] In March 2008, the Turkish statistical office published revised national accounts data, and announced that major changes have been made in methodology, coverage, consistency and comparability of macroeconomic statistics. This assessment is based on the national accounts data available by December 2007, when Turkey has submitted the PEP to the Commission.

[2] The High Planning Council is a board composed of the Prime Minister as chair and eight Ministers and the Undersecretary of the State Planning Organization.

[3] Due to the rapidly changing global environment, the macroeconomic framework, which is put together in autumn 2007, may read out of date, in particular with respect to projections for growth and inflation.

private fixed capital formation. The increase in productivity is expected to be sustained. Real exchange rates, which have appreciated by over 10% in 2007, will depreciate slightly in 2008-2010. Conversely, exports of goods and services will maintain their recent strong performance. On the other hand, in parallel with the increase in investments and exports, it is foreseen that the share of capital goods and intermediate goods in total imports of goods and services will be high. Overall, macroeconomic projections appear realistic. They are broadly in line with the stability-oriented policy mix presented in the programme, and do largely concur with the European Commission's autumn 2007 forecast.

The favourable rise in terms of trade and an increase in tourism revenues are expected to reduce the current account deficit. Exports rose by 22% on an annual average over 2002-2007. This increase is due to more macroeconomic stability and productivity increases in the tradable sectors. Furthermore, due to the significant share of the euro area in total exports, the strength of the euro has supported export price competitiveness. The current account deficit is expected to fall from 7.4% of GDP in 2007 to 6.8% in 2010. Reflecting recent years' high liquidity in global financial markets and improved macroeconomic stability and investment environment, capital inflows to Turkey have been very high. High capital inflows are estimated to continue until 2010. Therefore, the PEP rules out any problems in financing the current account deficit, though net EUR 4.1 billion repayments to the IMF in 2008-2010 period. Furthermore, the capital inflows are expected to result in reserve build up in the 2007 PEP period, and the reserve accumulation is projected to be of EUR 4.6 billion in the period of 2008-2010.

According to the programme, the floating exchange rate regime will over the PEP period be continued. Barring extraordinary changes in foreign exchange liquidity conditions, the Central Bank (CBRT) will continue to hold foreign currency purchase auctions aiming reserve accumulation within the disclosed program. On the other hand, the CBRT may, with prior notice, suspend the auctions for a short or a long term when there is excessive volatility in exchange rates observed due to a serious exogenous shock or unforeseen extraordinary developments. In the event of excessive exchange rate volatility the CBRT will make direct interventions.

The disinflation pace was reversed in 2006 and inflation picked up to 11% in spring 2007. However, lagged effects of strong monetary tightening have subdued the rise in inflation and brought it back to about 7% in late summer. In the last quarter of 2007, supply side shocks such as drought and hikes in energy prices as well as changes in administrated prices made inflation rates increase again to 8.4% in December. Non-food inflation fell from 10% at the end of 2006 to 7% in December 2007. Food prices account for 28% of the CPI basket. The government's CPI target for 2008-2010 is 4%.

The overall objective of Turkey’s fiscal policy is to contribute to establishing a sustainable growth environment and to support disinflation. Achieving substantial primary surpluses is the main fiscal tool in this respect, contributing not only to disinflation but also to debt sustainability. The document does not describe in great detail how those targets will be achieved and therefore lacks some transparency. The programme states in rather general terms that fiscal transparency will be strengthened, and that regulations and practices that would conflict with fiscal transparency will be avoided. Weak tax collection and election related spending made fiscal discipline loosening in 2007. According to government estimates the general government primary budget surplus amounted to about 4% of GDP, significantly below the 6.5% target. Deficits in the social security systems alone amounted to over 4% of GDP. The 2007 general government deficit is therefore likely to amount to more than 1% of GDP, compared to a surplus of 0.4% in 2006. The high primary surplus projected during the 2008-2010 period will result in sustaining the confidence created in the markets and continuing to lower borrowing requirements. It is projected that the positive impact of the decreasing borrowing requirements and the confidence environment in domestic and foreign markets on the expectations will keep borrowing costs on their downward trend. In line with these developments, the ratio of the public debt to GDP will continue to decrease from 61% of GDP in 2006 to 45.6% of GDP in

2010. Within the framework of these benchmarks that are taken as basis in debt management, the risks to which the Treasury debt stock is exposed are falling gradually and the sensitivity of the debt stock to fluctuations in exchange rate and interest rates will be alleviated. The share of foreign currency denominated/indexed debts within the domestic debt stock of the central government budget, which was 15% as of the end of 2005, receded back to the level of 13.8% as of the end of 2006 and reached the level of 11.2% as of September 2007. While the share of fixed rate debt stock in the domestic debt stock was 45.4% in 2005, it increased to 48.1% in the end of 2006 and remained at the level of 48% as of September 2007.

Table II.3.1:

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP growth	COM	6.1	5.1	5.8	6.5	n. a.
(% change)	PEP	**6.1**	**5.0**	**5.5**	**5.7**	**5.7**
Consumer price	COM	9.3	7.6	5.9	5.0	n. a.
inflation (%)	PEP	**9.6**	**6.6**	**4.1**	**4.1**	**4.0**
General government	COM	0.4	-0.7	0.2	1.3	n. a.
balance (% of GDP) (*)	PEP	**1.9**	**0.0**	**0.0**	**0.7**	**1.0**
Primary balance	COM	n. a.	n. a.	n. a.	n. a.	n. a.
(% of GDP) (*)	PEP	**10.1**	**7.7**	**7.9**	**7.1**	**6.5**
Government gross	COM	60.7	54.1	50.0	46.8	n. a.
debt (% of GDP) (*)	PEP	**60.9**	**56.8**	**52.5**	**49.6**	**45.6**

Source: PEP, Commission services Autumn 2007 forecasts (COM)

In the past, the Turkish government has often turned to ad-hoc measures to achieve its fiscal targets. The programme states that, in order to reduce the need for such practices in the future, public expenditures will be prioritized with respect to resource scarcity and their impact on potential growth in the context of economic and social benefits. Public agencies and institutions will revise their resource allocations under the specified priorities considering the budgetary means. The newly created fiscal space will be allocated to expenditure priorities with growth potential. Turkey has accomplished a remarkable effort of fiscal consolidation but ensuring a high-quality fiscal adjustment will be a key challenge on the way to the EU. Thereby, expenditure restraint – in particular by containing transfers and wages – needs to be the cornerstone of fiscal policy. If Turkey wants to meet public debt targets while at the same time reducing taxes on labour and financial transactions, spending restraint needs to be complemented by efficiency gains in expenditure.

The structural reform agenda largely aims at a continuation of the plans put in place over the previous years. The general aim is increasing the efficiency in the private sector and in the public administration and supporting the strengthening of market forces. The agenda covers a broad range of issues. The outlined reforms are at different stages of implementation in several important areas, such as privatisation and social security reform. In most areas, and in particular in the labour markets area, Turkey is far away from reaching the Lisbon targets.

It can thus be concluded that:

- Turkey's Pre-Accession Economic Programme for 2008-2010 is a comprehensive economic policy document, which presents a sound and coherent medium-term framework of macroeconomic developments, fiscal policy and structural reforms. The programme largely complies with content, form and data requested, even if it contains very limited methodological improvements over previous years' submissions. In particular some imperfections persist concerning the use of the European System of Accounts (ESA 95). Overall, the programme can provide good guidance for economic policy making, in particular towards fully meeting the economic Copenhagen economic criteria for accession.

- In 2007, the Turkish economy was faced with financial market turbulences, in particular following the subprime mortgage crisis in the US. This brought about increased stock exchange and exchange rate volatility and some further inflationary pressures. In addition, weak tax collection and election related spending made fiscal discipline loosening in the first half of 2007. The authorities reacted appropriately and firmly by tightening fiscal and monetary policies. Therefore, the programme's macroeconomic projections seem plausible in the context of the announced policy mix and given the assumption of a stable and benign external environment. However, the inflation and growth outlook have deteriorated significantly. The current global financial

turmoil and disruptions in financial markets put the macroeconomic framework at risk. Turkey's reliance on short-term capital inflows to cover its substantial financing needs makes it vulnerable to the global credit crunch and a waning of confidence. Risks would however have been substantially higher in the absence of the significant improvements in macroeconomic conditions and institutional reforms in all key areas implemented in recent years.

- The programme's fiscal tightening and stability-oriented monetary policies remain appropriate to address challenges arising from considerable external imbalances. While the envisaged reduction of public spending is necessary, the programme remains rather vague and not very comprehensive on the underlying fiscal and structural measures and their respective budgetary effects. The PEP would benefit from a more precise monitoring of long-term fiscal sustainability. Fiscal imbalances might emerge over the medium term, either as a result of past policy commitments, for example in education and access to the universal health insurance, or owing to a still pending reform agenda. Besides, supplementary infrastructure investment may need to be budgeted particularly in less developed regions, given the persistence of large regional disparities in Turkey.

- The PEP's structural reform agenda covers a broad range of measures, including in the areas of the labour market, energy sector, social security reforms and privatisation. The programme broadly supports Turkey's efforts to enhance its capacity to cope with competitive pressures and market forces in the context of EU accession. However, strong focus on timely implementation of the outlined plans will be of paramount importance. In addition, more emphasis might be put on key labour market reforms, in particular to support job creation during the economic transformation process, and to improving state aid monitoring. The PEP might have also benefited from a clearer presentation of the reform plans in the areas of R&D and innovation. The programme's reform agenda is largely consistent with the fiscal scenario and partly aligned with the reform requirements in view of the country's EU accession perspective, as spelled out in the latest Progress Report and the Accession Partnership.

3.2. INTRODUCTION

The Turkish authorities submitted the 2007 Pre-Accession Economic Programme (PEP) covering the period 2008 to 2010 to the European Commission in the first weeks of December 2007. Like in previous years, the Pre-accession Economic Programme was prepared under the lead of the State Planning Organisation and benefited from contributions by and consultations with all relevant institutions, in particular the Treasury, the Ministry of Finance, the Ministry of Agriculture, the Central Bank, the Privatisation Agency, the Banking Regulation and Supervision Agency, etc. The document has been formally approved by the "High Planning Board", which comprises the Prime Minister and representatives of key ministries. The programme’s overall objectives are to maintain macroeconomic stability, to ensure sustainable growth, and to improve the income of living of Turkish citizens. It presents a rather coherent macroeconomic framework and a fiscal consolidation programme which aims at gradual reduction of the general government deficit over the PEP period, also with a view to reducing public and external indebtedness. The structural reform agenda puts emphasis on increasing the efficiency both in the private sector and the public administration and to support the strengthening of market forces. The agenda covers a broad range of issues, with reforms being at different stages of implementation in several important areas, such as privatisation and social security reform.

Overall Policy Framework and Objectives

The PEP 2007 lays out the economic policy framework that aims at ensuring macroeconomic stability and growth as well as a detailed structural reform agenda. Policies to be followed and reforms to be realized in the EU accession process are stated in the PEP and in line with the National Programme and the Strategic

Coherence Framework[1] (SCF). Real sector reforms aim at a continuation of the privatization process and encourage private entrepreneurship by improving the investment climate, and by strengthening the regulatory and supervisory agencies in energy and telecommunication sectors, within a framework aiming at strengthening the market economy and expanding the role of the private sector by downsizing the share of state in the economy. The financial reforms focus (in the banking sector) on privatising the public banks, dissolving the banks under the SDIF and on adopting secondary legislation for full harmonization with the EU acquis and international principles and standards. In the capital markets area, they aim at better protecting investors in a framework tailored towards EU-examples, and at creating a dynamic market structure. As for the insurance sector, reforms are intended to harmonise the legislative regulations with the EU acquis and international standards. Labour market reforms focus on improving the quality of labour and strengthening the link between the labour market and the education system. In this context, it is envisioned to develop and implement projects towards making the curricula in line with today's conditions, lowering informal employment, disseminating flexible working practices, increasing educational level of the labour, establishing a professional qualifications system, increasing the employability of women and youth, strengthening social dialogue, providing social support to privatization process and joint diploma programs of domestic and foreign education institutions and making the vocational and technical education system efficient.

[1] SCF takes into account both Turkey's priorities and the EU's priorities. In this context, the Ninth Development Plan, the main policy document of Turkey for 2007-2013 period, serves as the basis for SCF. Furthermore, the Medium-Term Programme, Annual Programme and sectoral strategic documents were utilized in preparing SCF. In addition, inputs were made to SCF considering EU's priorities and particularly the Multi-Annual Indicative Planning Document prepared by the EU. SCF is in line with the EU Regulation No.1085/2006 of 17 July 2006 that regulates the Instrument for Pre-Accession Assistance (IPA), Lisbon Strategy, European Employment Strategy, Accession Partnership Document and Progress Reports.

The programme largely takes into account the assessment in the Commission's progress reports and the priorities defined in the Accession Partnerships.

3.3. ECONOMIC OUTLOOK

3.3.1. Recent macroeconomic developments

In March 2008, Turkish authorities significantly revised the country's data set on national income, leading to a marked change in key macroeconomic indicators. As a result, Turkey's GDP data are now better in line with the European System of Accounts (ESA95). With this revision, the Turkish authorities aimed at (i) improving the measurement of Turkey's economic activity; (ii) enhancing international comparability of Turkey's statistics; and (iii) meeting data requirements of the Commission and international institutions.

Changes associated with this revision have not been reflected in the PEP, and hence not in this PEP assessment. However, trends have remained broadly unchanged, and policy recommendations to a large extent prove valid.

Furthermore, in the meantime the Turkish authorities have announced a new medium-term fiscal framework, modifying key parameters of the previous framework. For example, a significant increase in infrastructure investment will markedly raise public spending. In combination with the national accounts revision, those new measures led to a marked downward revision of the primary surplus target for 2008, down from a level of 4.2% of GDP (5.5% of GDP before the national accounts revision) presented in the 2007 PEP to 3.5 %, which is planned to further decline to 2.7 % of GDP by 2010. Like in the case of the less benign international environment, this new development will be reflected in future Commission documents on Turkey, such as the assessment of the 2008 PEP.

Box II.3.1: Turkey: recent changes following the programme's submission

Since the submission of the PEP, Turkey's key macroeconomic indicators have changed significantly as a result of a revision to national income data in March 2008. Due to this revision, Turkey's GDP data are better harmonized with the European System of Accounts (ESA95). With this revision, the Turkish authorities aimed at (i) improving the measurement of Turkey's economic activity; (ii) enhancing international comparability of Turkey's statistics; and (iii) meeting data requirements of the Commission and international institutions.

Changes associated with this revision have not been reflected in the PEP, and hence not in this PEP assessment. However, trends have remained broadly unchanged, and policy recommendations to a large extent prove valid.

Table 1:
Revised GDP Statistics[1]

	After the GDP revision					Before the GDP revision				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
Real GDP growth	5.3	9.4	8.4	6.9	4.5	5.8	8.9	7.4	6.1	n.a.
Nominal GDP (billion TRY)	455	559	648	758	856	359	431	487	576	n.a.
Current account deficit	-2.6	-4.0	-4.7	-6.1	-5.8	-3.3	-5.2	-6.3	-8.1	n.a.
Budget Deficit	-8.3	-4.5	-0.6	-0.1	-1.2	-11.3	-5.9	-0.8	-0.1	n.a.
General government debt	60.1	59.2	52.3	46.1	38.8	81.5	76.8	69.6	60.7	n.a.

[1] "% of GDP" unless otherwise stated
Source: Commission services.

Furthermore, in early May 2008 the Turkish authorities announced a new medium-term fiscal framework, modifying key parameters of the previous framework. A significant increase in infrastructure investment will markedly raise public spending. In combination with the national accounts revision, those new measures lead to a marked downward revision of the primary surplus target for 2008, down from a level of 4.2% of GDP (5.5% of GDP before the national accounts revision) presented in the 2007 PEP to 3.5 %. It is planned to further decline to 2.7 % of GDP by 2010. Like in the case of the less benign international environment, these new development will be reflected in future Commission documents on Turkey, such as the assessment of the 2008 PEP.

At the time of programme submission, available data pointed to a slowdown of annual real GDP growth from 6.9% in the first quarter of 2007 to 1.5% in the third quarter. The growth rate in the first nine months of 2007 stood at 3.8%. This slowdown can be partly explained by the base effect (growth was 6.4% in the first three quarters of 2006). Private consumption growth, which was very weak in the first half of 2007, accelerated to 3.6%. The public sector purchased significantly less goods and services and markedly reduced construction after sizeable spending hikes in these areas in the run-up to the July 2007 elections. The contribution of the external sector to growth fell substantially, as imports grew by 16.8% year-on-year in the third quarter of 2007 up from 4.8% in the first quarter, while export growth amounted to 7.5%, down slightly from 14.7% in the first quarter of 2007. The slowdown of domestic demand was mainly driven by the tighter monetary stance, leading to higher interest rates and less lending. On the supply side, the agricultural sector suffered from the severe drought in the summer months and its output fell by 5.6% in the first nine months of 2007 over 2006. This slowdown has spread to hotel and restaurant services, which contracted by 3.3% year-on-year in the same period. Private building and dwelling construction slowed down from an annual growth of over 20% 2006 to 11.5% in the first three quarters of 2007. Industrial production, trade and transport

growth grew at rates around 5%. The trade deficit slightly decreased in the first nine months of 2007 to 9.7% of GDP, compared to 9.9% in the same period of 2006. The current account deficit decreased in tandem with the trade deficit to 7.5% of GDP.

The programme largely complies with the requirements in terms of content, form and data. It provides evidence of the Turkish administration's strong institutional and analytical capacity, although it might have benefited from more closely addressing the specific issues raised in last year's assessment. The underpinning macroeconomic framework appears broadly coherent and consistent. As in previous years, a medium-term fiscal framework is presented. The PEP is also largely consistent with other policy documents, and is providing much more detail on economic policy priorities than in previous years.

3.3.2. Medium-term macroeconomic scenario

The assumptions regarding the world economy used in macroeconomic analyses and forecasts are based on the EC's autumn forecast. It is assumed that the world imports will grow by 7.2% annually on average in the period of 2008-2010. The world import price index is assumed to increase by 1.5% in 2007 and in the period of 2008-2010 by 1.2% annually. Over 2007-2010, it is assumed that the EU and the US consumer price indices will rise by 1.2% and by 2.4%, respectively, annually on average. On the other hand, over 2008-2010, the dollar/euro parity is assumed to be 1.42, slightly higher than in 2007.

As in previous years, the quantitative framework for the period 2008-2010 is well presented and comprises detailed information on key variables. The link between the macroeconomic framework and the impact of structural reforms described in sections 3 and 4 received more attention than in past years. Alternative scenarios are not developed. The document provides ample reasons for divergences from the previous submission. The key macroeconomic challenges and objectives of the programme could have been specified more explicitly from the start. Projections for key macroeconomic variables seem overall plausible, in particular since the policy mix has been adapted (i. a. by the revised fiscal programme) for the changes compared with the previous submission. .

Real sector

The real sector scenario in the programme is close to the market consensus and broadly in line with the Commission autumn 2007 forecast. The PEP and the Commission forecast assume that the Turkish economy will grow at rates - close to potential - of around 5½-6% per annum through the programme period, driven by continuous rapid productivity growth. However, while the Commission assumes that growth will mainly come from private consumption and investment, with a negative contribution by the external balance, the PEP assumes that net exports will increase substantially over coming years. Job

Table II.3.2:

Comparison of macroeconomic developments and forecasts

	2006		2007		2008		2009		2010	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	6.1	**6.1**	5.1	**5.0**	5.8	**5.5**	6.5	**5.7**	n. a.	**5.7**
Contributions:										
- Final domestic demand	7.9	**7.9**	4.7	**5.0**	6.5	**5.0**	7.1	**5.4**	n. a.	**5.2**
- Change in inventories	-2.1	**-2.1**	0.1	**0.5**	-0.2	**0.1**	-0.3	**-0.4**	n. a.	**-0.2**
- External balance of goods and services	0.3	**0.3**	0.3	**-0.2**	-0.5	**0.5**	-0.3	**0.7**	n. a.	**0.6**
Employment (% change)	1.3	**1.3**	1.5	**2.8**	1.5	**2.1**	1.6	**2.1**	n. a.	**1.9**
Unemployment rate (%)	9.9	**9.9**	9.7	**9.7**	9.5	**9.7**	8.9	**9.7**	n. a.	**9.7**
GDP deflator (% change)	11.2	**11.2**	4.9	**7.2**	2.7	**4.9**	3.1	**4.4**	n. a.	**3.9**
CPI inflation (%)	9.6	**9.6**	7.6	**6.6**	5.9	**4.1**	5.0	**4.1**	n. a.	**4.0**
Current account balance (% of GDP)	-8.2	**-8.2**	-7.9	**-7.4**	-8.6	**-7.5**	-9.3	**-7.2**	n. a.	**-6.8**

Sources: Pre-Accession Economic Programme (PEP); Commission services Autumn 2007 forecasts (COM)

creation is expected to be modest in both scenarios. However, the 2007 PEP is significantly more optimistic than the Commission in this area. The disinflation process is set to continue, but the Commission projects a slower fall. The already mentioned different views on exports translate in the projection by the PEP assumes that the current account deficit will fall from a peak in 2006, while the Commission forecasts that the gap will slowly grow further to around 9% of GDP.

Based on two of the three different methods used to calculate potential output, the programme considers that the economy has reached potential output in 2006 and will remain close to potential in 2008-2010. The main reasons for the favourable growth performance are the effects of structural reforms. Compared to the 2006 PEP, the current programme is somewhat less optimistic concerning GDP growth for 2008-2010. Concerning the demand components of growth, the 2007 programme assumes a weakening reliance on investment and private consumption, while the expectations concerning exports are more optimistic. This growth pattern appears plausible, given a higher negative impact of the stricter fiscal policy on public consumption and disposable income. No major rising inflationary pressures are expected from this growth pattern. Furthermore, the programme seems reasonable in assuming a positive effect of decreasing interest rates, declining economic volatility and the diminishing crowding out of private investment through public sector borrowing on private investment. However, the lower growth rates of imports observed since mid-2007 would have deserved a more detailed explanation.

Regarding the contribution of the various production factors to growth, Turkey's output has been mainly driven by capital deepening, which contributed by 45% to total growth in 2007 and by around 40% in 2006-2010. The share of labour was 33% in 2007 and falls dramatically to a contribution of 20% in 2006-2010. The increase in total factor productivity was 22% in 2007 and will increase to 40% annually in 2008-2010. During the programme period, this distribution is expected to become less even. The investment ratio would remain stable at around 24-25% of GDP and would be increasingly financed by public savings, reflecting increasing fiscal space.

Inflation

Establishing price stability, i.e. a low level of inflation, will remain the main objective of the monetary policy in the 2007 PEP period. The Central Bank will continue to implement the explicit inflation targeting policy that was started at the beginning of 2006. The Central Bank will use short-term interest rates as the main policy instrument, to direct expectations and affect funding costs and will continue to focus on the medium-term inflation outlook when formulating monetary policy decisions. An inflation target of about 4% has been deemed appropriate, considering the structural transformation in the economy, from high to low inflation and the EU convergence process. The Central Bank responds to the deviation of inflation from the medium term targets, not to the temporary fluctuations in inflation. In its inflation reports, the Central Bank perceives it as possible to achieve the 4% target by the end of 2008. However, these forecasts are made under the assumptions that the support provided by the demand conditions to the decline of inflation will continue in the medium term, that food price inflation will gradually decelerate, and that oil prices will hover around 70 dollars per barrel, while the risk premium will remain fixed around its recent levels. If any deviation from the mentioned assumptions occurs, significant changes in the inflation outlook may be necessary.

Monetary and exchange rate policy

The programme indicates that the floating exchange rate regime will be continued. Unless extraordinary changes emerge in foreign exchange liquidity conditions, the Central Bank will continue to hold foreign currency purchase auctions aiming at reserve accumulation within the disclosed program. On the other hand, the CBRT may, with prior notice, suspend the auctions for a short or a long term when there is excessive volatility in exchange rates observed due to a serious exogenous shock or unforeseen extraordinary developments. Meanwhile, the volatility in exchange rates will continue to be closely monitored by the Central Bank and in the

event of excessive volatility in exchange rates, direct intervention will be considered. The programme's monetary policy framework seems adequate in relation to the stated prime PEP objectives of price and macroeconomic stability, provided that its implementation will be timely, and flexible. In particular, sings of cyclical turnarounds of the Turkish economy must feed without delay into the decision-making process and policy stance of the central bank.

External sector

Turkey's current account deficit has continuously widened since the 2001 financial crisis. For the programme period, a reversal of this trend, i.e. a decrease in the current account deficit is expected. The underpinning scenario seems somewhat optimistic about growth of merchandise exports and on tourism revenues. The expected volume of workers remittances is forecasted to stabilize at around USD 1 billion. As a result, the current account deficit is expected to decline from 7.4% of GDP in 2007 to 6.8% in 2010. The programme does not anticipate any difficulties in financing the current account deficit, despite a very constrained capital account outlook with considerable repayment obligations towards the IMF during 2008-2010.

The PEP uses the Commission's autumn 2007 forecast on oil price assumptions. In contrast to some previous year's PEPs, no alternative scenarios are included on energy. The PEP uses the Commission's autumn 2007 forecast on oil price assumptions. Given the high sensitivity of the Turkish current account to oil prices, the programme would have benefited from an in-depth analysis of the effect of a shift in oil demand combined with energy price volatility. In addition, and again like last year, the programme does not include a scenario whereby the TRY real exchange rate shows significant instability relative to the baseline scenario and its effect on the current account.

Main risks to the programme

The key assumptions of the programme appear slightly outdated, since the effects of recent global financial turmoil could not be taken into account. Risks mainly stem from exogenous supply shocks, namely from further price increases of food and energy and from slowing external demand reflecting weaker growth in important export markets. The Turkish situation is aggravated by political instability stemming from a lawsuit against the governing party.

The risks of negative direct effects of the financial crisis appear to be relatively well contained, in view of the country's improved resilience to shocks, in particular as regards public debt and financial sector stability. Conversely, a possible deterioration in financing conditions could affect the corporate sector financial soundness, since it appears that part of the sizeable private sector external liabilities in foreign currency may not be sufficiently hedged. Domestic demand is subdued, partly due to a tight monetary policy stance. However, in the context of current price pressures, there is no possibility of faster monetary relaxation. In particular should the exchange rate further weaken and create significant exchange rate pass-through effects, the country may face higher inflation and lower growth stemming from a fall in disposable income.

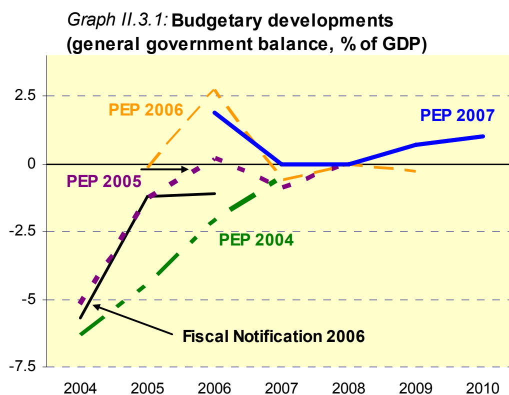
3.4. PUBLIC FINANCE

The overall objective of Turkey’s fiscal policy is twofold, to contribute to establishing a sustainable growth environment and at the same time to support disinflation. Achieving substantial primary surpluses is the main fiscal tool in this respect, contributing not only to disinflation but also to debt sustainability. As in previous years, the document does not describe in great detail how those targets to be achieved and therefore lacks some transparency. The presentation of the public finances would have gained significantly from a more in-depth discussion of the various measures, in particular the social security reform, and their impact on the presented objectives. Main revenue-related measures are an improvement of efficiency in tax collection and a broadening of the tax base. These should neutralise the fiscal effects of the reductions in private and corporate income taxes. On the expenditure side, emphasis is put on reducing the social security deficits. Unfortunately, like in previous years, no quantitative estimates of the budgetary effects of the individually described measures are given.

Budgetary objectives appear broadly achievable, in particular if real interest rates will fall as rapidly as foreseen in the PEP in a context of high growth.

The 2007 programme presents, as in previous years, cyclically adjusted budgetary balances. As the estimates see Turkey close to potential output, the results point to a relatively low weight of the cyclical component in Turkish fiscal balances. Therefore, also, the decline in actual government deficits is largely driven by a corresponding fall in the structural component, due to lower interest rates in combination with high primary budget surpluses. The calculations also indicate that the growth of the Turkish economy during most of the programme period is very close to potential. Given the strong volatility in the last decade the present cyclical position of the Turkish economy remains very difficult to ascertain. The programme would benefit from some clarifications on the methodology used in the individual sections. Indeed, it is not always clearly stated when and why non-ESA 95 compatible data are used. Historic data are largely compatible with the data provided in the fiscal notifications.

Graph II.3.1: **Budgetary developments (general government balance, % of GDP)**



3.4.1. General government balances and debt

Actual balances and medium-term perspectives

According to the PEP, the public sector borrowing requirement (general government deficit) amounted to 2.7% of GDP in 2007 which compared with a 0.1% surplus in the 2006 PEP. Real interest rates rose marginally more slowly fell more projected in the 2006 PEP, and both the expenditure and the revenue sides underperformed. The budget is forecasted to converge to balance in 2008-2010 with the projection that interest rates will decline starting from 2008 and fiscal policy implementation will tighten significantly.

The key objective of the medium-term fiscal framework is to achieve primary surpluses (ESA95) of around 7% of GDP in 2008-2010. The ratio of general government revenues to GDP is expected to decline over the programme period from 46.2% in 2006 to 40.6% in 2010, reflecting changes to the health system, the phasing out of a number of temporary revenue measures and the effect of the reduction in income taxes. To some extent, these revenue-reducing measures will be compensated by the intended widening of the tax base and the improved efficiency of tax collection. In contrast with previous years, no straightforward reduction in the tax burden is foreseen. A fall in general government expenditure is programmed, from 43.6% of GDP in 2007 to 39.6% in 2010. The main driving forces for this foreseen decline are the effects of efficiency increasing measures. The largest contribution to the decline in total general government expenditures, however, is stemming from a decline in interest payments, decreasing by over 2 percentage points of GDP, from 7.6% of GDP in 2007 to 5.6% in 2010. The projected fall in interest rates is plausible, but remains highly dependent on exogenous factors, such as overall sentiment vis-à-vis emerging markets and global interest rates. However, the sensitivity analysis made in the programme suggests that the overall picture is rather realistic, in particular as from mid-2008.

Up to 2006, fiscal consolidation was largely based on revenue-increasing measures, in particular from higher indirect taxes. Indirect tax revenues increased from 11.7% of GDP in 1999 to 17.2% of GDP in 2006. In contrast to primary revenues, non-interest expenditures reflect no major changes during the period, with expenditures for personnel, goods and services and current transfers largely unaffected by fiscal consolidation. Primary expenditures hovered at around 35% of GDP. Therefore, despite recently high growth primary expenditure, on aggregate, were not used as a policy tool to achieve fiscal

Table II.3.3:
Composition of the budgetary adjustment (% of GDP)

	2006	2007	2008	2009	2010	Change: 2007-10
Revenues	46.2	43.7	43.2	42.0	40.6	-3.1
of which:						
- Taxes and social security contributions	32.0	31.3	31.9	31.2	30.3	-1.0
- Other (residual)	14.2	12.4	11.3	10.8	10.3	-2.1
Expenditure	44.3	43.6	43.3	41.3	39.6	-4.0
of which:						
- Primary expenditure	36.2	35.9	35.4	34.9	34.1	-1.8
of which:						
Gross fixed capital formation	4.3	4.1	3.7	3.8	3.7	-0.4
Consumption	19.0	19.4	19.0	18.7	18.1	-1.3
Transfers & subsidies	9.1	9.4	9.3	9.2	9.1	-0.3
Other (residual)	3.8	2.9	3.3	3.1	3.0	0.1
- Interest payments	8.1	7.7	7.9	6.4	5.5	-2.2
Budget balance	1.9	0.1	-0.1	0.7	1.0	0.9
- Cyclically adjusted	-1.6	-2.6	-2.5	-1.9	-1.1	1.5
Primary balance	10.0	7.8	7.8	7.1	6.5	-1.3
Gross debt level	60.9	56.8	52.5	49.6	45.6	-11.2

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

consolidation. In order to prepare for EU accession and contribute to the catching up of income levels, Turkey would need to achieve efficiency gains in public expenditures in order to make appropriate room in the budget for growth public expenditures and lower taxes, for example on public investment in education or infrastructure.

The Treasury is in charge of the debt management. The basic principles of public debt and risk management include:

- to follow a sustainable, transparent and accountable borrowing policy that is in line with monetary and fiscal policies by considering macroeconomic balances,
- to meet financing requirements at the lowest possible cost in the medium and long-run, within the framework of the risk level determined by considering domestic and foreign market conditions and cost elements.

The borrowing limit is defined as the amount of the difference between the total commencement appropriations that are specified in the budget law of a certain fiscal year and estimated revenues. Within the framework of the same article of the mentioned Law, the net borrowing limit may be increased by 5% taking the requirements and development of debt management into account.

The share of fixed-rate borrowing in the central government's external debt stock continued its increasing trend starting from 2002 and realized as 74% in September 2007. Furthermore, concerning the foreign currency composition of debt, the share of USD and EUR-denominated debt in the total external debt stock that was 40% and 26%, respectively at the end of 2002, increased to 54% and 30%, respectively, as of the end of September 2007. The share of the SDR-denominated debt fell to 11%, i.e. by 13.3 percentage points.

The share of total domestic public debt stock, which reached the level of 66% due to the bonds issued for duty losses and capital injection to public banks in 2001 and those issued to the Savings Deposit Insurance Fund for the restructuring in the banking sector, continued to decrease and declined to 30.8% in 2005, 28.4% in 2006 and 27% as of September 2007.

3.4.2. Budgetary implications of major structural reforms

The social security reform, if coming into effect with the currently specified parameters, is expected to impose an additional burden of 203 million YTL, 338 million YTL and 379 million YTL in 2008, 2009 and 2010, respectively, on the budget. This burden, which initially arises from the expansion of the scope of the health services, is expected to turn to savings in the long term as a result of the effective functioning of the health system with the observed impact of the health transformation programme and the reflection of parametric changes in the retirement system.

As to be implemented from January 2009, a 5 point decrease in the employers' pension premium share for the wage earners is envisaged to decrease the financial liabilities on employment, in the context of fighting against unregistered employment. The impact of this reduction on social security balances will be observed by March 2009, with a two months lag due to the notification and payment period. This implementation is expected to create an additional burden of 4.2 and 5.5 billion YTL on social security system in the years of 2009 and 2010, respectively.

If the personnel reform aiming to simplify the wage system in the public sector, to balance the imbalances and inequities in financial and other remuneration of the public personnel, to reduce the number of existing status, and to adhere to flexible employment principles were implemented as set out in the 2007 PEP, the central government budget personnel expenditures would increase by 0.4% of the GDP.

The draft law strengthening the financial structure of the local administrations and rearranging the revenues of provincial special administrations and municipalities is assumed to be enacted in the 2007 PEP period. It is estimated that the funds to be allocated from the general budget tax revenues to local administrations will rise by 0.3% of GDP in 2009 and 2010.

The net effect of major structural reforms will have an important impact on the country's fiscal position. The programme expects a temporary increase in public spending by 2% of GDP in 2009-1010 following the introduction of changes in the social security system. Overall, these measures address important structural weaknesses and therefore are likely to contribute to the country's growth potential

3.4.3. Sensitivity analysis and comparison with previous programme

Like in last year's PEP, various sensitivity analyses were presented. One examined the sensitivity of public finances to lower growth and higher interest rates. According to calculations presented in the PEP, the debt situation appears to be sustainable. The most critical scenario is that of an increase/decrease of real interest rates for TRL-denominated debt to be 5 percentage points over the baseline scenario, whereby the gross debt level would rise/fall by 1.7 percentage points. While the analysis concludes plausibly that the sensitivity of the debt stock has fallen, this argument could be strengthened by the inclusion of more critical scenarios.

3.4.4. Quality of public finances

The programme foresees that, in order to reduce the need for ad-hoc measures to reach fiscal targets, efforts to widen the tax base, better capture the unregistered economy, and decrease the number of tax exemptions will be intensified. Turkey has accomplished a remarkable effort of fiscal consolidation but ensuring a high-quality fiscal adjustment will be a key challenge on the way to the EU. Indeed, fiscal imbalances might emerge over the medium term, either as a result of past policy commitments, for example in education and access to the universal health insurance, or owing to a still pending reform agenda. In addition, infrastructure investment may need to increase in less developed regions, given the persistence of regional disparities in Turkey.

As public expenditures are already relatively high there is limited scope for Turkey to increase expenditure in order to meet pressing convergence challenges. Expenditure will also

be contained in order to make room for lower taxes in the long run while preserving a sound fiscal framework. Fiscal policy would thus need to focus on trade-offs in expenditure allocations, possibly by reducing spending in functional areas (such as general public services and defence, public order and safety) where it appears to be oversized in comparison with other similar countries. At the same time, reforms will be implemented with the aim of improving the efficiency of expenditure programmes in areas where expenditure pressures are being felt, such as health care, education, social protection. Reforms focused on the modernization of civil service pay and employment system and the rationalization of the investment programme, will also help contain pressures on the wage bill as well as investment spending and thus contribute to better control public expenditure across functional areas. Efficiency considerations are considered to be the main priority in public expenditure policies. However, the civil service reform has not been implemented in full, and the PEP does not give clear information about the total cost of this modification.

Conversely, the Turkish authorities have embarked on an ambitious reform by establishing a revenue administration. This reform intends to increase the efficiency of tax collection, by means of enhancing automation, training staff and improving all underpinning facilities. In addition, tax laws and regulations will be amended in order to re-assess tax exemptions with the objective of simplification and rationalization of the tax system. Public expenditures will be prioritized with respect to resource scarcity and their impact on potential growth in the context of economic and social benefits. Public agencies and institutions will revise their resource allocations under the specified priorities considering the budgetary means. In this context, some activities and projects of lower priority will be eliminated and the thereby created fiscal space will be allocated to expenditure priorities with assumed growth potential.

The basic objective of the tax policies to be implemented is to contribute to supporting growth and employment in accordance with macroeconomic policies, reducing informality in the economy, and creating a tax system that is simpler, fairer and with wider base. The Corporate Income Tax Law was redrafted considering such priorities as simplifying the tax legislation, expanding the tax base and fighting with informal economy, and legislated accordingly. In this context, the corporate income tax rate was reduced to 20%, and the tax burden on the corporate profits was receded to a level of 34%. Furthermore, the number of income tax tariffs was reduced from 5 to 4. The Major Taxpayers Office was established in order to provide major taxpayers with efficient services. By legal regulations related to VAT, tax rates in certain sectors including mainly education, health, food and tourism were reduced.

3.4.5. The sustainability of public finances

Like in the previous years, the 2007 PEP does not contain a separate section on the long-term sustainability of public finances. It would greatly benefit from some medium-term analysis, which should be predominantly based on demographic and macroeconomic scenarios. Turkey's situation differs dramatically from the EU Member States. With its very young population (the average age is just 28), falling birth rates, and significant in- and outward migration, some more in-depth analysis appears a crucial section in a the context of a PEP, in particular since the Turkish authorities are moving to new health and pension systems, whereby key indicators, like for example retirement age, dependency ratio and overall labour market participation might significantly change.

Indeed, even in case of a full implementation of the reform proposals, Turkey is presently not so well placed to meet the costs of an ageing population. The introduction of a new and responsible social security system, and more generally, the future costs of the pension and health-care systems should therefore be monitored very carefully. In addition, in order to create the necessary fiscal space for the long run, the PEP should have, apart from the reform of the social security system, also outlined clear and ambitious measures for an. in-depth civil service reforms and improvements of the tax administration.

3.4.6. Institutional features of public finances

The institutional capacity in the public financial management has been significantly increased. Financial service specialists and internal auditors have been recruited, and efforts are being made to recruit more specialists in this area and make them operational as soon as possible. The 2006 General Activities Report, which was prepared as a requirement of fiscal transparency and accountability, includes for the first time the fiscal year activity results of public administrations and social security institutions under the central government and overall assessments of financial structure of local administrations. In addition, the 2007 Central Government Budget Realizations and Expectations Report, which includes the first half implementation results of the central government budget, financial positions, expectations, targets and activities of the second half, was announced. A new By-Law on Central Government Accounting covers the special budget public administrations and regulatory and supervisory agencies in addition to the general budget public administrations.

Cash-based budget tables and accrual based financial statements of local administrations are published quarterly and annually. Efforts are continuing to improve the implementation and auditing capacity of the Revenue Administration. In this context, the Major Taxpayers Office was activated in the beginning of 2007. Efforts to improve the basis of revenue administration's technological infrastructure are continuing, and it is planned to include all its units under the scope of the system in 2009, and in parallel, to strengthen information systems and infrastructure as well as establish a disaster recovery centre. The new Social Security Institution Law abolished the general directorates of SSK, BAĞ-KUR and Pension Fund for Government Employees and merged them into the new Social Security Institution. The new institution comprises the General Directorates of Social Insurances, of Universal Health Insurance, of Non-Premium Payments and of Service Provision. Thereby, the retirement services, health financing and non-premium payments were united. In the same Law, it is envisaged that by establishing social security centres with full automation and organized at local level with one-stop service, the retirement and health services will be delivered more rapidly. The institutional and administrative capacity was enhanced and a new institution, which will be collecting premiums and preventing abuses in retirement and health services, was established. The described institutional features are in line with the country's accession perspective.

3.5. STRUCTURAL REFORMS

The general aim of the PEP's structural reform agenda is to increase the efficiency in the private sector and the public administration and to support the strengthening of market forces. It's a mere update from the plans put in place over the last years, and covers various issues. The outlined reforms are at different stages in their implementation. The programme is quite clear on results and delays compared with what was outlined in the 2006 PEP. In some areas, however, e.g. competition policy, investment climate, the programme would benefit from some explanation on the targeted results and on the speed of operation. In the area of privatisation, the government has modified its plans after the submission of the PEP, thereby delaying some key privatisations. The budgetary effects of reforms to be implemented are outlined for all major reform areas, although cost estimates beyond 2008 are often lacking. Overall, the structural reform agenda should be broadly supportive of further enhancement of Turkey's capacity of cope with competitive pressures and market forces within the EU. More emphasis should be put on labour market reforms in order to support job creation during the economic transformation process. As in previous years, the PEP also lacks clear policies and descriptions concerning research and development and innovation, an area which would be important to support a transformation to a knowledge-based economy, as laid out in the Lisbon agenda.

3.5.1. Structural reforms and Accession Partnership[1]

The 2007 PEP adequately addresses some of the economic priorities stipulated in the Accession Partnership, in particular in the areas of privatisation and enterprise reform. Measures to tackle labour market imbalances, to improve the business climate and to facilitate to sectoral shift away from the agricultural sector have been addressed. However, in these sections the programme lacks detail on how the objectives could be achieved. In the long term, Turkey is not well placed to meet the costs of an aging population (rising health and social security costs). The PEP should more explicitly stress the importance of creating fiscal space, not only through social security reform, but for example also through civil service reform and tax administration improvements. Price reforms have not been addressed. In spite of significant price increases in early 2008, a largely state owned electricity sector is suffering from inadequate price setting. A reliable price mechanism should ensure that end-user electricity prices are automatically adjusted without political interference. In this vein, the 2007 PEP falls short in fully and appropriately addressing the economic priorities under the Accession Partnership.

3.5.2. Product and capital markets

The PEP rightly highlights the successful continuation of the privatisation process during 2007. Privatisation revenues amounted to USD 7.5 billion[2] in year to November 2007. Such strong continuation of privatisation inflows constitutes a real achievement and is in stark contrast to the low levels attained in earlier years. However, despite strong inflows, delays have been encountered in certain sectors compared to what was envisaged in the 2006 PEP. For several companies the sales procedures have taken longer than expected. The PEP outlines sectors and companies for which privatisation efforts are envisaged to continue during the programme period. These are, for example, banks, games of chance, ports and activities related to the sugar and petrochemical industry.

There is a risk that further delays will occur during the programme period compared to the outlined plans. After two years of relatively intensive privatisation, the remaining portfolio of state-owned enterprises is likely to be more challenging to privatise: it is concentrated in areas where privatisation can be seen as more sensitive. This seems to be for example the case for the energy sector, where tenders were launched in August 2006 for the privatisation of electricity distribution companies through transfer of operation rights. In addition, efforts

[1] http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressdata/en/misc/98784.pdf

[2] This currency denomination is the choice of the programme itself.

Table II.3.4:

Net direct budgetary impact of key reform commitments (EUR million)

Description of the Policy	2007	2008	2009	2010
1. Labour market	-696.8	-791.7	-897.0	-950.0
2. Agriculture	-1953.9	-1818.0	-11.5	0.0
3. Regional Development	-29.2	-66.1	-58.7	-54.9
4. Health and social security	33.6	75.5	100.0	100.0
5. Info and Com. Technologies		-	-	-
5. Transportation	-2.1	-2.2	-0.4	-143.0
6. Energy	0.0	-	-	-
Total impact on the budget	-2648.4	-2602.5	-867.6	-1047.9
Total impact on the budget (in % of GDP)	**-0.7**	**-0.7**	**-0.2**	**-0.2**

Source: 2007 Pre-accession Economic Programme (PEP), ECFIN calculations

are made to privatise power distribution and generation simultaneously, which may be complicated by the fact that the sector is characterised by cross-subsidising and that the privatisation of the distribution network may suffer from low profitability caused by inadequate pricing policy.

Concerning the area of competition law and policies, no progress since the 2006 PEP has been achieved in putting in place monitoring of state aids. The lack of regulation and monitoring of state aids continue to affect transparency and the overall competitive environment negatively. Further steps have been taken to improve the business environment. One positive development is the facilitation and simplification of the sectoral licensing process. A well-established policy framework, including for example via the Investment Advisory Council, is continuing to support the reform process and to identify the problematic issues for investors. However, the PEP contains very limited information on issues that will be addressed over the programme period.

In the field of banking, the harmonisation with EU and Basel II regulatory frameworks has been advanced. A 25% share of Halkbank's capital has been sold to private investors in February 2007. However, a concrete time schedule for the privatisation of the largest state bank, Ziraat Bank, has not yet been announced. But overall, the past and planned measures are supportive of the overall positive developments in the sector. Despite the demonstrated improved resilience of the Turkish banking sector to severe market fluctuations, a continued strengthening of supervision will be important to further decrease risks in particular in the context of the still rapidly growing banking operations. Concerning capital markets, several legal acts were put into effect in order to protect investors in capital markets and create a more stable and efficient market in line with the EU acquis.

3.5.3. Labour market

Like in previous years, the programme underlines the main problems and challenges in the Turkish labour market, such as the very low participation rates, the contraction of employment in the agricultural sector and the growing young population. It also shows that there has been no significant improvement in unemployment or participation rates since the last PEP. The programme strongly emphasises the link between the labour market and the education sector and the need to reduce the skills mismatch between labour demand and supply. The overall educational attainment levels of the labour force are still low, despite improvements during the past decade. Since the submission of the last PEP, some measures have been taken, for example to allow graduates from vocational high schools to switch to specific baccalaureate programmes more smoothly and to increase the availability of higher education. Looking forward over the programme period, the PEP is quite vague on concrete measures that will be taken to further improve educational standards, apart from continuing the Privatisation and Social Support Project and the Basic Education Programme. There is insufficient information about the planned scope for active labour market policies or resources which will be put aside for this purpose.

Non-wage labour costs remain high and the regulations of the labour market rigid, protecting jobs rather than workers. Rigidities could be reduced and formal employment promoted by easing severance pay requirements, which are high by all international standards. Tackling these issues in a more systematic way would be supportive of addressing the identified challenges in the labour market, reduce informality, and support the creation of jobs in the challenging transformation period ahead. The programme proposes to reduce the cost of employment by introduction of some measures, but these seem rather minor and the timing is not clear.

3.5.4. Other reform areas

The PEP outlines a wide range of areas where reform efforts have been ongoing and are foreseen to continue over the programme period. Further efforts have been made to improve efficiencies in the agricultural sector, the public administration, the health and social security system, transportation, and some other smaller areas, which are yielding positive results, e.g. for the budgeting process and transparency. However, the information provided in the PEP

appears in many cases rather piecemeal and often further steps to be taken in these areas remain vague. Local governments' reform is important in order to strengthen their role and abilities to perform the needed services. Legal reforms have proceeded, but the PEP acknowledges that there are deficiencies in the capacity to implement laws at the local level.

A large number of efforts have been ongoing aiming to raise the efficiency and production standards in the agricultural sector, in particular in the period 2001-2005. For example, further reforms took place concerning agricultural support policies (especially the introduction the DIS instrument, consisting of decoupled area payments) and support for rural development investments. Nevertheless, after 2005 the introduction and progressive increase of deficiency payments and other payments coupled to production is not helping to increase efficiency and this trend is contrary to the reformed CAP post-2003. Work continued within the pre-accession project to prepare for the implementation of the EU's Common Agricultural Policy. The agricultural sector remains relatively inefficient and highly labour intensive, implying a large scope for reforms yielding improvements. The significant reduction in agricultural employment over the past year highlights that the transformation process is continuing, partly supported by policies but also driven by market forces. The PEP outlines the budgetary effects of a number of planned reforms in the agricultural sector. Several projects are estimated to carry relatively large positive net effects on the budget, thereby limiting the overall net costs for agricultural reforms, but it is unclear from the programme how these funds will be generated. With regard to the second pillar of the CAP, rural development, the PEP does not sufficiently take into account the necessity to reinforce the capacity to implement Community standards while at the same time using the EU rural development funds to further contribute to the sustainable adaptation of the agricultural sector. Moreover, urgently needed structural reforms to counteract rural out-migration and to target the development of the rural economy as a whole are not addressed systematically also taking into account the pre-accession strategic context as laid down in the Multi-annual Indicative Planning Document (MIPD).

The PEP highlights some consequences of the adoption of the comprehensive social security and health insurance reform package. This is a very important reform package, particularly given that the large deficits in the social security contributions (4% of GDP in 2007) have strongly contributed to Turkey's fiscal problems. In addition, due to demographic change, without reforms the situation would significantly worsen over the coming years. The adopted laws would, if implemented, significantly improve the future situation of public finances. However, the implementation has been delayed. Instead, some ad hoc measures have been introduced to generate budgetary savings in 2007, primarily from the Health Transformation Project. As in the 2006 PEP, the programme assumes a positive budgetary impact from the health care and social security reform in 2008, which is in the light of the delays quite unlikely. In addition, even assuming the adoption of the package in mid-2008, the budgetary impact might actually be much smaller than the amounts presented in the PEP 2007.

Table II.3.5:

Annex table 1: Structural indicators

	TURKEY					EU 27				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
General economic background										
Real GDP [1]	5.8	8.9	7.4	6.1	5.0	1.3	2.5	1.9	3.0	2.9
Labour productivity [2]	38.2	38.5	39.4	40.6	n.a.	100	100	100	100	100
Real unit labour cost [3]	n.a.	n.a.	n.a.	n.a.	n.a.	-0.2	-1.5	-0.5	-0.8	-0.8
Real effective exchange rate [4]	108.1	113.8	123.2	120.6	130.3	101.2	107.5	106.4	107.9	114.0
Inflation rate [5]	25.3	10.1	8.1	9.3	8.8	2.1	2.3	2.3	n.a.	n.a.
Unemployment rate [6]	9.3	9.0	8.8	8.4	n.a.	8.9	9.0	8.9	8.2	7.1
Employment										
Employment rate [7]	45.8	46.1	46.0	45.9	n.a.	62.6	62.9	63.5	64.5	n.a.
Employment rate - females [8]	25.7	24.3	23.8	23.9	n.a.	54.9	55.5	56.3	57.3	n.a.
Employment rate of older workers [9]	33.5	33.2	31.0	30.1	n.a.	40.0	40.7	42.4	43.5	n.a.
Long-term unemployment [10]	2.2	3.5	3.5	2.5	n.a.	4.1	4.2	4.1	3.7	n.a.
Product market reforms										
Relative price levels [11]	57.7	58.5	67.3	n.a.	n.a.	100	100	100	100	n.a.
Total trade-to-GDP ratio [12]	29.7	31.7	31.2	n.a.	n.a.	n.a.	12.4	13.3	14.3	n.a.
Net FDI [13]	0.5	0.7	2.4	n.a.	n.a.	n.a.	0.9	1.6	1.8	n.a.
Market share electricity [14]	45.0	39.0	38.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral and ad-hoc state aid [15]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Business investment [16]	15.5	18.0	19.8	n.a.	n.a.	17.1	17.3	17.8	18.2	n.a.
Knowledge-based economy										
Tertiary graduates [17]	5.2	5.6	5.7	n.a.	n.a.	12.3	12.5	12.9	n.a.	n.a.
Spending on human resources [18]	3.7	n.a.	n.a.	n.a.	n.a.	5.2	5.1	n.a.	n.a.	n.a.
Educational attainment [19]	44.2	42.0	44.0	44.7	n.a.	76.9	77.2	77.5	77.9	n.a.
R&D expenditure [20]	n.a.	n.a.	n.a.	n.a.	n.a.	1.9	1.8	1.8	1.8	n.a.
Internet access [21]	n.a.	7.0	8.0	n.a.	n.a.	n.a.	40.0	48.0	49.0	54.0

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-25 (EU-25=100). 3. Ratio of compensation per employee to nominal GDP per person employed, total economy, annual percentage change. 4. Vs IC36 (1995 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs). 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population aged 15-64. 11. Comparative price levels of final consumption by private households including indirect taxes (EU-25=100). 12. Trade integration - Average value of imports and exports of goods&services divided by GDP. 13. In % of GDP, EU-25 = Average value of inward and outward FDIs flows in % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Tertiary graduates in science and technology per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Percentage of households who have Internet access at home.

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