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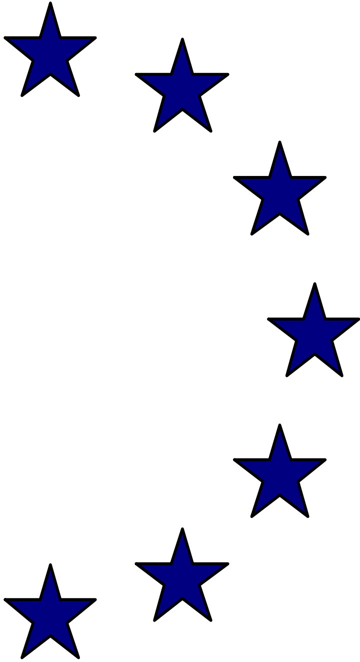

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Fiscal effects of accession in the new Member States

by
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Abstract
The paper looks at the evidence on the widespread hypothesis in the academic literature and by some of the new Member States' governments that accession will bring about fiscal strains and requires higher budget deficits. It starts by calculating the expected new Member States' payments from the EU budget and looks at the issues of additionality and national co-financing of EU funds. Other possible fiscal effects from accession are briefly discussed. Based on the results, the paper concludes that - on balance and in contrast to what the literature often maintains - accession should rather reduce the fiscal strains in the new Member States. Changes in the new Member States' budgets will certainly be necessary and the transition year 2004 could be particularly difficult in that budgetary and administrative procedures have to be adapted in order to actually absorb the payments as projected by the Copenhagen package. However, this should not be a fundamental problem unless there are built-in inflexibilities in the budget, arising from a weak political system, different fiscal layers or a strong fiscal autonomy of sectoral ministries.

1. Introduction

Since their accession to the EU in May 2004, the 10 new Member States have to apply all existing EU rules, including the Stability and Growth Pact and the obligation to work towards nominal convergence in order to eventually adopt the euro. Since the most well-known of these rules is to respect a 3%-ceiling on the budget deficit, the new Member States' budgetary position is increasingly attracting attention since many of them are still close to or above that ceiling and some of the new Member States expect higher deficits in 2004 (see Table 1). A frequently voiced argument is that accession itself triggers substantial additional public expenditure in the new Member States and therefore brings about higher budget deficits. The required national co-financing of EU Structural Funds and Cohesion Fund projects is claimed to pose a particular difficulty. While the focus of this paper is on the first part of the argument, i.e. whether accession brings about substantially higher public expenditure, it should be borne in mind that, even if it were so, higher deficits are only one way of financing higher expenditure, the alternatives being higher taxation or expenditure cuts elsewhere. Furthermore, it must be remembered that not every transfer from the EU budget to a Member State is recorded in the general government account since some funding goes directly to private beneficiaries where the government functions only as a "postman". Hence, this paper will not take an accounting approach which would allow deriving an equivalent change in the general government position of a new Member State, but rather an

economic approach in the sense of the net position of a new Member State vis-à-vis the EU. However, the two approaches are not completely unrelated because even a direct transfer from the EU budget to a private beneficiary could substitute previous funding from the general government budget.

Table 1: General government net borrowing (-) and net lending (+) in the new Member States in % of GDP, 2000-2006

	2000	2001	2002	2003	2004	2005	2006
Czech Republic	-4.5	-6.4	-6.4	-12.9	-5.9	-5.1	-4.0
Estonia	-0.3	0.3	1.8	2.6	0.7	0.0	0.0
Cyprus	-2.4	-2.4	-4.6	-6.3	-4.6	-4.1	-2.2
Latvia	-2.7	-1.6	-2.7	-1.8	-2.2	-2.0	-2.0
Lithuania	-2.6	-2.1	-1.4	-1.7	-2.8	-2.6	-1.8
Hungary	-3.0	-4.4	-9.3	-5.9	-4.9	-4.3	-2.5
Malta	-6.5	-6.4	-5.7	-9.7	-5.9	-4.5	-3.4
Poland	-1.8	-3.5	-3.6	-4.1	-6.0	-4.5	-3.4
Slovenia	-3.0	-2.7	-1.9	-1.8	-1.7	-1.7	-1.3
Slovak Republic	-12.3	-6.0	-5.7	-3.6	-4.1	-3.9	-2.9

Source: Eurostat (based on fiscal notifications) for 2000-2003, Commission forecasts for 2004 and 2005, and Pre-accession Economic Programmes for 2006. Figures are provisional for 2003 and “constant policy” forecasts for 2004 and 2005; methodology in principle according to ESA 95 national accounts.

The literature is far from conclusive on the issue. While it is often stated that accession will imply further budgetary challenges in addition to those already arising from economic transition,[1] there are very few quantitative indications. One exception is Kopits/Székely (2002) who, after estimating the size of a long list of potential direct and indirect fiscal effects, arrive at an estimate of a negative net budgetary effect “conservatively estimated in the range of 3 to 4¾% of GDP” for the Czech Republic, Estonia, Hungary, Poland and Slovenia. They maintain that these effects could at best be compensated by positive longer-term indirect effects which are difficult to quantify. Based on almost the same list of items, Backé (2002) makes a similar – albeit more cautious - estimate (see Table 2) and concludes that “in the short run, membership in the European Union will add to the fiscal strains on accession countries. In the medium run, overall effects can be expected to be broadly neutral or slightly positive, while some uncertainty prevails on the magnitude of several individual effects, in particular on future public investment needs.” On the basis of the same methodology, and emphasizing the importance of the absorption capacity, Antczak (2003) foresees “fiscal deficits deteriorating by up to 3 percent of GDP in the first few years after accession”.

[1] See for example European Commission 2002a, pp. 131ff., or Feldman/Watson 2002, pp.141ff.

Table 2: Backé's estimate of fiscal effects of EU membership – annual effects on the fiscal balance over the medium term following EU accession

	% of GDP
Direct effects	
Contribution to EU budget	-1.0 to –1.2
EU structural operations	-0.9 to 1.3
Infrastructural expenditure	?
Public administration reform and acquis implementation	+/-0?
Realignment of customs duties	+0.2 to –0.5
Tax harmonisation	+0.5
Phase-out of production subsidies	+0.2 to +2
Indirect effects	
Positive growth effects	+(+/-0 to +1?)
Structural reforms	+(minor?)
Tax competition	-(minor?)
Reduced risk premia	+(anticipated?)

Source: Backé 2002, p. 163

Most of the new Member States' 2003 Pre-accession Economic Programmes (PEPs) provide some calculations of the effects of accession from a budget accounting point of view with very different approaches and results. The Czech PEP concludes that "in the short-term outlook EU accession will lead to an immediate increase of the government sector deficit by 0.3 – 1 per cent of GDP". The conclusion in the Hungarian PEP is that "as the direct financial result of accession, the balance of the central government is expected to deteriorate in 2004, while some of the indirect additional revenues arising from the various multiplicator effects will offset the negative effects in later years." The Polish authorities forecast that the EU budget will be a net payer to Poland's budget, although "a substantial share will be contributed to the private sector without intermediation of the state budget". The Slovakian PEP differentiates between the positive net position vis-à-vis the EU budget, which is +1.3% of GDP in all years, and the net budgetary impact of accession which is projected to be negative at -0.1% of GDP in 2004 and -0.7% of GDP in 2005 and 2006. This difference arises by considerations of which payments from the EU will also occur on the expenditure side of the national budget since they are not substituting already existing expenditure, which is seen to be only the case for some agricultural expenditure. The Slovenian authorities have calculated a positive net balance of +0.38% in 2004, +0.32% in 2005 and +0.31% in 2006.

A particular difficulty when analysing this issue lies in determining the counterfactual situation which implicitly assumes that non-membership is the alternative. Most economists would agree that this would have much wider economic implications with subsequent fiscal effects, not least in terms of adaptations of investors' expectations. However, the general economic impact of accession in the new Member States and the possible resulting indirect fiscal effects shall be ignored here in order to focus exclusively on direct budgetary aspects.[2] Neither will the expected economic impact of EU funding be taken

[2] Hence, in the terminology of Kopits and Székely 2002, we will only deal with "direct effects" here and neglect any "indirect effects".

into account. Thus we are only looking at fiscal effects in the strictest sense, not at the wider economic and fiscal impact of accession. This should not imply a fundamental methodological problem since accession did not come as a "big bang" from an economic point of view but is a rather smooth and long-term process which started in the first half of the 1990s. It comes on top of an already high degree of economic integration between old and new Member States which was brought about by the Europe Agreements and the implementation of commitments undertaken in the accession negotiations.

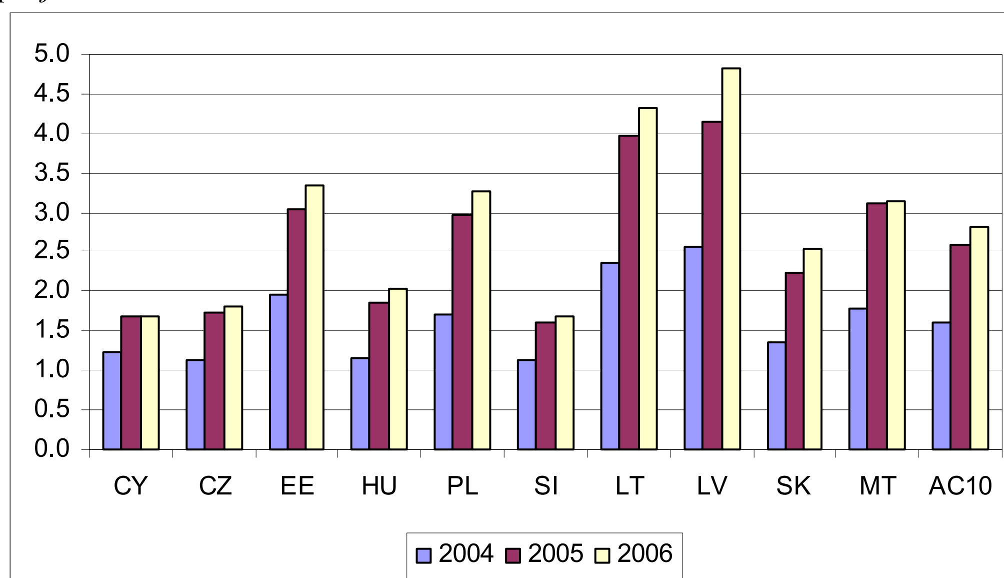
The paper starts by calculating the expected payments from the EU budget to the new Member States (section 2). Section 3 looks at the issues of additionality and national co-financing of EU funds. Section 4 discusses other possible fiscal effects from accession and section 5 concludes. In doing so, only publicly available information is used in the paper which does not benefit from any privileged access to Commission-internal information. The time horizon is that of the current financial framework of the EU, i.e. until the end of 2006, since anything beyond 2006 would be mere speculation. Sources and methodologies applied for the calculations in this paper are explained in further detail in the Annex.

2. Payments from the EU budget

The EU budget distinguishes between commitment appropriations and payments appropriations. While commitment appropriations make legal obligations during the financial year for activities whose implementation may extend over several financial years, payment appropriations make it possible to cover expenditure arising from commitments entered into legal obligations during current and preceding financial years. Although, from a budgetary planning perspective, commitments are the most important budget figures, actual payments are more relevant from an economic point of view and from the beneficiaries' perspective. For that reason, only payments figures are used here.

Figure 1 presents estimates on the payments from the EU budget to the new Member States relative to GDP from 2004 to 2006 on the basis of what was agreed at the European Council in Copenhagen in December 2002 and eventually inserted into the Accession Treaty (detailed figures are in Table A.1 in the Annex). In addition, estimates on payments related to EU pre-accession instruments (PHARE, ISPA and SAPARD) have been included because – in contrast to commitments –the new Member States will continue to receive payments also after accession which are related to commitments made before accession. According to our estimates, pre-accession funds have an average size relative to GDP of close to 0.4% in all years.

Figure 1: Total payments from the EU budget to the new Member States in % of projected GDP, 2004-2006



Source: own calculations; see Annex for explanations on methodology

Overall, the Baltic countries, Poland and Malta tend to be the largest recipients of EU payments relative to GDP (detailed figures can be found in Table A.2 in the Annex). In 2005 and 2006, these countries can be expected to receive EU payments amounting to 3% and more of their GDP. On average over the period 2004-2006 and for all new Member States, payments are 62% of commitments, with an ascending profile of 44% in 2004 and 68% in the years 2005 and 2006 respectively. Because of the relative importance of budgetary compensations, which are easier to absorb (further explained below), these percentages are substantially higher for Cyprus and Malta as well as, to a lesser degree, Slovenia. Apart from the technical point of a shorter EU budget year 2004 for the new Member States, this profile over time is to some extent driven by concerns about the absorption capacity of new Member States with a view to their administrative capacity to smoothly and efficiently manage EU funds under a new regulatory system, such as for example the fairly complex programming and control procedures under the Structural Funds.

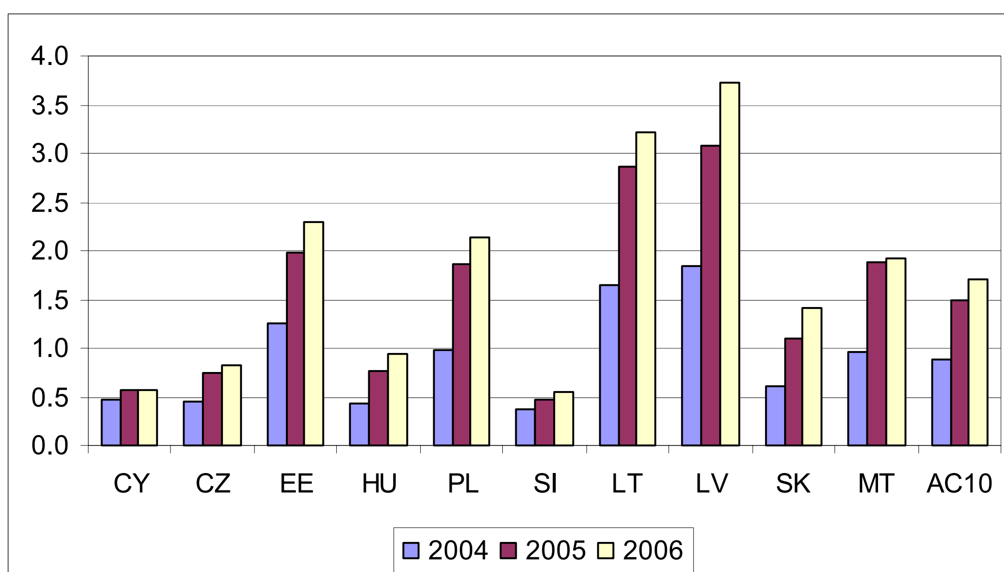
As the own resources system is fully applied to the new Member States from May 2004 on, it was decided that, as in previous rounds of enlargement, all new Member States will benefit from transitional arrangements on their financial obligations towards the EU budget through budgetary compensations.[3] The purpose of these compensations is to offset a possible deterioration of the net budgetary position of the new Member States in comparison with their situation in 2003 as beneficiaries of pre-accession funds for mainly two reasons. First, a deterioration could have resulted from the fact that the new Member States will have to pay immediately full contributions to the budget, while the level of payments for differentiated appropriations will lag the corresponding level of

[3] Cf. the original proposal in European Commission 2002b.

commitments. Second, it could have been an outcome of the fact that reimbursements from the EU budget for Member States' expenditure on direct payments in the context of the Common Agricultural Policy are only made the year after their payment to farmers. Articles 29 and 30 of the Accession Treaty define the amounts of the "temporary budgetary compensation" for the Czech Republic, Cyprus, Malta and Slovenia and the "special lump-sum cash-flow facility" for all new Member States. The relative size of these budgetary compensations is particularly substantial in the cases of Malta (above 2% of GDP in 2005 and 2006) and Cyprus (around 1% in 2005 and 2006), whereas for the other eight new Member States they are the highest in 2004 (between 0.2% and 0.4%) and are diminishing afterwards.

Estimates for the new Member States' contributions to the EU budget are available in the EU Budget 2004 (cf. European Commission 2004). As a percentage of GDP, the new Member States will contribute in a range between 0.66% (Czech Republic) and 0.82% (Malta) in 2004. The difference between total payments presented in Figure 1 and these estimates of contributions in 2004 gives the net payments in Figure 2. In order to get an estimate for the years 2005 and 2006, we increased by half the GDP ratios of contributions estimated for 2004 (i.e. 1.1% of GDP on average) because the new Member States only participate in – and only contribute for - two thirds of the budget year 2004. On average, the new Member States will receive net payments in the order of 0.87% of GDP in 2004, 1.49% of GDP in 2005 and 1.62% of GDP in 2006. The Baltic countries, Poland and Malta will receive higher net payments than others in a range of 1.9% to 3.7% of GDP in 2006.

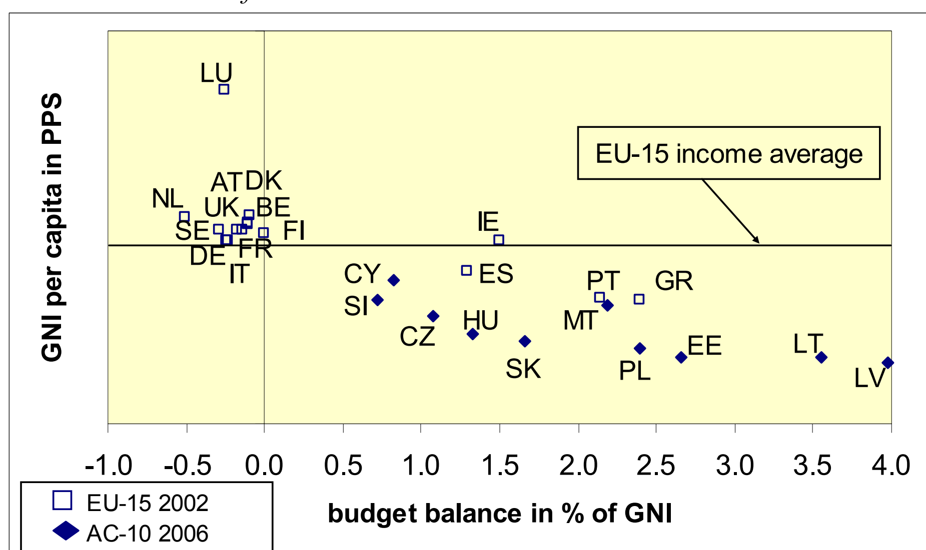
Figure 2: Estimated net payments from EU budget to the new Member States in % of projected GDP, 2004-2006



Source: own calculations; see Annex for explanations on methodology

Because of the importance of the national income as a basis to calculate the contributions and to allocate Structural Funds payments, the net position tends to be negatively correlated with countries' income per capita. In this perspective it is interesting to compare the new Member States' future EU budget position with the old Member States' current EU budget position. The European Commission (2003c, p.126) provides a calculation of the old Member States' "operational budgetary balance after UK correction" relative to Gross National Income (GNI) with 2002 as the latest available year. The Commission's methodological approach is to exclude both traditional own resources and administrative expenditure since they can not be directly attributed to a Member State. The same methodology has been applied here to the new Member States for the year 2006, although necessarily somewhat simpler and based on projections, and therefore not fully comparable to the figures for the 15 Member States in 2002 (see Annex for more detailed methodological explanations). Taking the EU-15 income average and a neutral EU budget position as a benchmark, as indicated by the ordinates in Figure 3, it can be seen that all countries - except marginally Ireland and Italy - are in the expected quadrants, i.e. wealthier countries are net contributors and poorer countries are net recipients. As for the net recipients there is a negative slope which means that the poorer a country the higher its EU budget balance relative to income. Compared to the current Cohesion Countries (Greece, Spain Ireland and Portugal), the new Member States seem to have a less favourable position in 2006 than the Cohesion Countries have currently. However, it has to be remembered that there is no full comparability of data and that Ireland is set to see a deterioration of its position due to less payments from Structural and Cohesion Funds and higher contributions to the EU budget in the coming years.

Figure 3: Gross National Income (GNI) per capita in PPS in 2001 and operational EU budget balance in % of GNI, in 2002 for the 15 old Member States and in 2006 for the 10 new Member States



Note: Data for the 15 old Member States on the one hand and for the 10 new Member States on the other hand are not fully comparable

Source: European Commission 2003d, p.126, for 15 Member States and own calculations for the new Member States (see Annex for explanations on methodology)

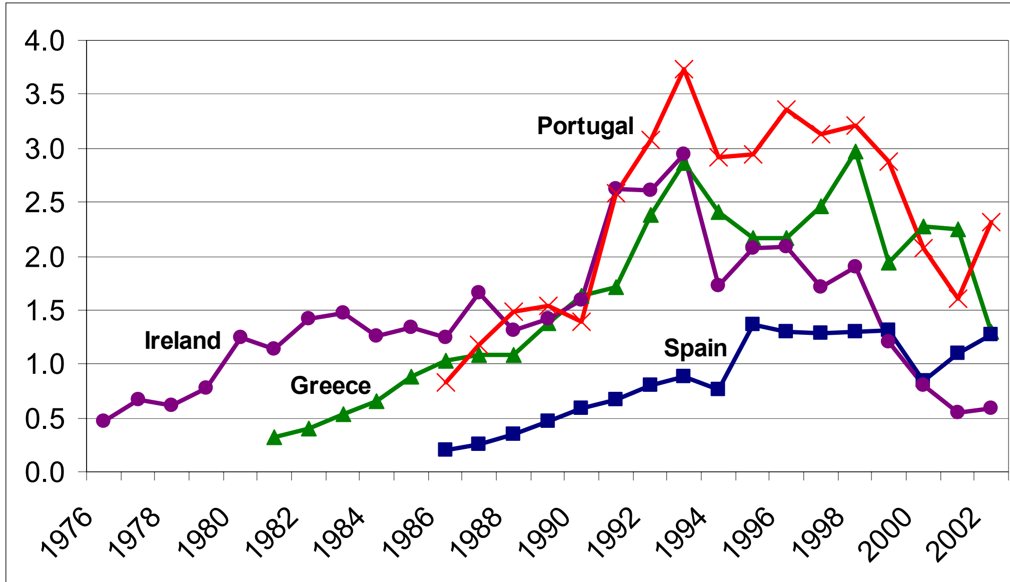
In view of these considerable net payments from the EU budget, in particular to some of the poorer new Member States, it is further explored below whether they could be offset by other fiscal effects such as requirements of additionality and national co-financing of EU structural assistance (section 3) or other indirect fiscal effects arising from accession (section 4).

3. Additionality and co-financing of EU funds

From the new Member States' budget point of view, a crucial question is how much of the payments from the EU budget have to be additional and which may substitute already existing expenditure. Furthermore, some EU programmes also require a national complementary funding, so-called co-financing. Going through the lines of the Copenhagen package, it is obvious that the budgetary compensations are specifically designed to improve the new Member States' budget position and do not trigger any national expenditure. Existing internal policies and transitional expenditure (heading 3) are not explicitly additional and usually do not require co-financing. Under the Common Agricultural Policy (heading 1a), a national top-up of direct payments to farmers is possible, though not obligatory, because they will be gradually phased in over the next years until they reach the current EU level. However, this expenditure can not be directly attributed to accession, but is due to the political decision of a New Member State. Rural development (heading 1b) and structural actions (heading 2) as well as pre-accession funds usually require national co-financing, public or private, at varying rates. While pre-accession funds also have a requirement of project additionality, this is in practice rather theoretical. Only Structural Funds, however, have an explicit additionality requirement and should not substitute national expenditure which will be further explained below.

During the 1990s, the importance of Structural Funds and the Cohesion Fund has increased substantially both as a share of the EU's budget, which accounts now for about one third of the total budget, and relative to the size of some Member States' economies. The biggest beneficiaries in relative terms were the Cohesion Countries - Greece, Spain, Ireland and Portugal - which are eligible to the Cohesion Fund to finance projects on environment and transport and where large areas are eligible to Objective 1 assistance under the Structural Funds to finance programmes for the least developed regions. Figure 4, which presents these payments relative to GDP peaking at above 3½% for Portugal in 1993, shows that there is a cycle across the programming periods (1989-93, 1994-99, 2000-06) with payments being rather low at the beginning of the period because of "teething problems" whereas payments are fairly high towards the end of the period when programmes have achieved "cruising speed". The drop in 2000/2001 in Spain and Portugal and in Greece in 2002 should thus not be seen as a continuous declining trend and has already seen a reversal for Spain and Portugal in 2002. However, in Ireland the decrease of funds could be more permanent.

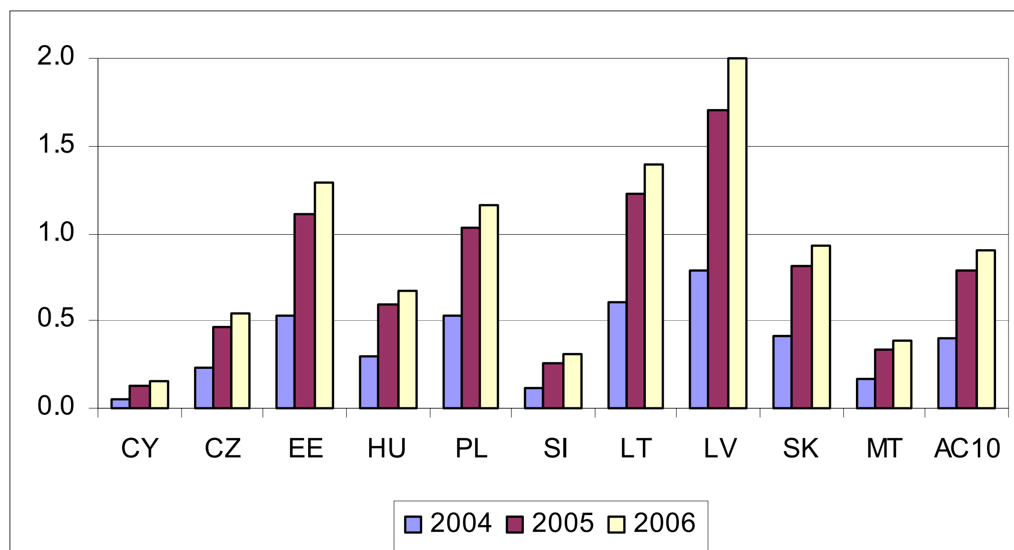
Figure 4: Structural Funds and Cohesion Fund payments in Cohesion Countries in % of GDP, 1976-2002



Source: own calculations; European Commission for Cohesion Fund and Court of Auditor's Annual Report for Structural Funds

All the new Member States will be eligible to the Cohesion Fund, while Cyprus and the regions of Prague and Bratislava will not be eligible to Objective 1 assistance but only to assistance under Objectives 2 and 3. In terms of commitments, Cohesion Fund spending will be one third of all structural spending in the new Member States from 2004 to 2006. The profile of payments to the new Member States foreseen under Structural Funds and Cohesion Fund take account of the current Cohesion Countries' experience with programming cycles and are therefore rather low in 2004 and increase stronger in 2005 and 2006. Even for the largest beneficiary, Latvia, payments are not expected to achieve in 2006 the relative size of what Greece, Ireland and Greece had received in the mid-1990s when their income relative to the EU average was higher that of the new Member States (Figure 5).

Figure 5: EU payments to the new Member States for Structural Funds and Cohesion Fund in % of projected GDP, 2004 to 2006



Source: own calculations; see Annex for explanations on methodology

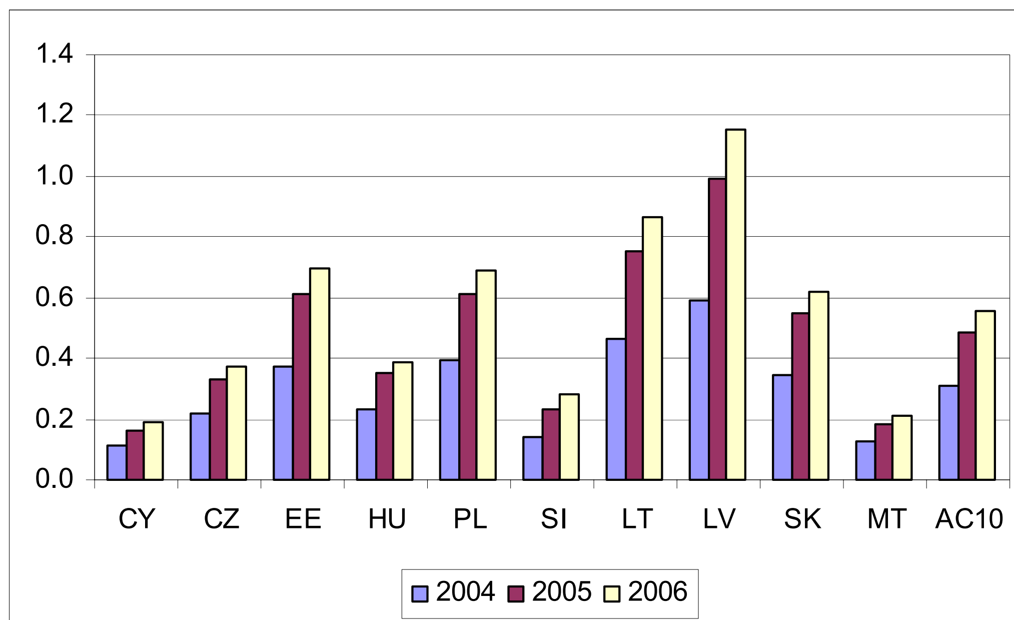
In order to increase the incentives for their efficient use, EU structural assistance only finances less than the total costs of a programme or project, which means that there is a need for national co-financing. Such co-financing requirements also exist for the pre-accession funds (PHARE, SAPARD and ISPA) and rural development measures (EAGGF Guarantee) with a maximum EU contribution of, as a general rule with some exceptions, 75% of total public expenditure. Article 29, §3, of the Structural Funds Regulation and Article 7, §1, of the Cohesion Fund Regulation stipulate that the EU funds contribute:

- a maximum of 75% of the total eligible cost of measures carried out in Objective 1 regions which may rise to a maximum of 80% in Cohesion Fund countries in exceptional and duly justified cases;
- a maximum of 50% of the total eligible cost in Objective 2 and 3 regions;
- 80% to 85% of public or equivalent expenditure of a Cohesion Fund project.

In Figure 6, the standard national co-financing rates of 25% for the pre-accession instruments and rural development measures, 25% for Structural Funds (Objective 1) and 20% for the Cohesion Fund have been assumed; these rates can be lower in some cases. For Cyprus, Prague, and Bratislava, a 50% co-financing rate has been assumed for the non-Objective 1 share of Structural Funds. This implies two simplifying assumptions which might offset each other to some degree: On the one hand, this assumes that the maximum contribution of EU funds is used for all measures whereas there might be an interest not do so in order to increase the number of EU-financed projects. On the other hand, this also assumes that all co-financing involves public expenditure although co-financing may also come from private sources. On average, the estimate for the

new Member States' co-financing requirements equal 0.31% of GDP in 2004, 0.49% in 2005 and 0.55% in 2006. For the largest beneficiary, Latvia, the ratio increases from 0.59% in 2004 to 1.16% in 2006.

Figure 6: Estimated national co-financing of pre-accession instruments, rural development programmes, Structural Funds and Cohesion Fund in the new Member States in % of projected GDP, 2004 to 2006



Source: own calculations; see Annex for explanations on methodology

There is a widespread confusion in the literature to equate the Structural Funds co-financing requirement with the principle of additionality. According to Article 11 of the Structural Funds Regulation, "the Funds may not replace public or other equivalent structural expenditure by the Member State". This is made operational by determining at the beginning of the programming period "the level of public or equivalent structural expenditure that the Member State is to maintain in the sum of its regions covered by Objective 1 during the programming period" which is verified at the end of 2003 and at the end of 2005.[4] The concept applied is that the relevant national public expenditure must be eligible to financing by Structural Funds and is the sum of, firstly, the national public co-financing of EU funded programmes and, secondly, other public expenditure on projects which - although in principle eligible – do not benefit from a contribution from EU Structural Funds.[5] Hence, the additionality requirement only relates to EU funding, not to national co-financing. If a Member State managed to shift funds from potentially EU-financed expenditure towards actual national public co-financing of EU projects, this is in compliance with the principle of additionality and does not imply any additional national

[4] For Objectives 2 and 3, the relevant variable is expenditure on active labour market policy at national level.
[5] Cf. European Commission 1999.

expenditure. However, this requires some restructuring of budgets which – in particular in more decentralised fiscal systems and young democracies with a fragmented political landscape – may indeed face political and technical restrictions to reallocate between ministries and budgetary authorities which can after all give rise to additional national expenditure. In view of gross fixed capital formation of general government of close to 3% of GDP or above in all new Member States in 2001/2002 (according to Eurostat figures) and the substantial overlap with projects eligible to Structural Funds and Cohesion Fund (the main exception being spending on human resources), there might not even be the need for a substantial restructuring of the national budget.

4. Other fiscal effects from accession

Candidate Countries have presented their own estimates on the fiscal "cost" of accession in the pre-accession period (see Table 3). However, these estimates might be upward-biased for at least three reasons (cf. Funck 2003): First, the expenditure estimates may not always reflect the available least cost options. Second, the extent to which those "accession-related" expenditures indeed represent additional expenditures or would have taken place irrespective of accession is a matter of debate. Thirdly, there is a possibility that some of the underlying estimates have been inflated to support the cases of a larger state budget or of more EU funds.

Table 3: Fiscal cost of EU accession and sources of financing: national estimates, annual average in % of GDP

	Total	Local Financing	O.W. State Budget	Other Local Sources	EU Financing	Other Financing	Period
Bulgaria[1]	7.6	3.6	3.3	0.3	2.2	1.9	2000-06
Czech Republic	3.2	2.4	1.1	1.2	0.3	0.5	2001-02
Hungary	2.1	1.2	1.2	0.0	0.5	0.4	2000-02
Latvia	3.3	1.6	1.4	0.2	1.1	0.6	2002-02
Lithuania	1.7	1.0	0.6	0.4	0.4	0.2	2001-09
Poland	1.0	0.4	0.2	0.2	0.6	0.0	2000-03
Romania	3.8	1.2	1.2	0.0	0.9	1.6	2001-04
Slovak Republic	3.6	1.3	1.3	0.0	0.9	1.4	2000-02
Slovenia	2.6	2.2	2.2	0.0	0.4	0.0	1999-03

1/ Excluding private sources.
Source: Funck 2003 based on CEECs' National Program for Adopting the Acquis and 2000 GDP to calculate financial needs for EU accession in terms of GDP.

Among the many possible fiscal effects (see Kopits/Székely 2002 and Backé 2002), four seem to be potentially more serious:

- The pre-financing of direct payments to farmers, in the context of the Common Agricultural Policy (CAP), which are only reimbursed from the EU budget in the subsequent year.

- The implementation of the *acquis communautaire*, in particular in the areas of EU environmental policies and social policies as well as the harmonisation of technical standards;

- The building-up of administrative capacity to implement EU policies and to effectively participate in the EU decision-making bodies;

- The alignment of excise tax rates, VAT collection and custom tariffs.

The pre-financing of direct payments to farmers with reimbursement only in the subsequent year will have two ways of affecting the new Member States' budgets. First, payments in 2004 will have to be fully pre-financed. Second, the phasing-in of direct payments in the new Member States over 10 years starting at 25% of the amounts paid in the EU-15 Member States in 2004 and rising by five percentage points per year implies that for a given year the reimbursements are likely to be short of actual payments in this transitory phase. Based on the 2005 figure from the Copenhagen table, the new Member States will have to advance 0.27% of GDP in 2004, the highest figures being 0.40% for Lithuania, 0.35% for Hungary and 0.31% for Poland. Assuming the difference between EU payments in 2006 and 2005 as the required national pre-financing in 2005 and the difference between 2007 (assumed to be the 40/35th or 8/7th of the 2006 figure) and 2006 as the required pre-financing in 2006, these amounts decrease to average 0.05% and 0.04% of GDP respectively with little variation across countries. Hence, there can only be a sizeable effect in 2004 and only for those countries where no similar support scheme existed before so that expenditure would be truly additional.

In principle, the national implementation of the *acquis communautaire* should already have been in place or entered into force at the time of accession. However, there are areas where transition periods have been agreed in the negotiations (e.g. environmental policies). In most of these cases, the largest part of the costs will fall on the private sector and should not trigger substantial public expenditure. The major exception is environmental policies, in particular the rehabilitation of polluted industrial sites, water treatment and waste management, which usually require considerable public investment. However, these areas are eligible to financing from Structural Funds and Cohesion Fund and therefore do not necessarily require substantial national public funding.

The implementation of EU policies and the participation in the EU decision-making bodies require a non-negligible administrative capacity. A major part of this capacity has already been built up before accession, also in the context of pre-accession assistance which has institution-building as one of its main objectives and also attempts to build up structures necessary for the management of Structural Funds and Cohesion Fund. Furthermore, the new Member States already started to participate in the meetings of EU decision-making bodies on an observatory basis after the signing of the Accession Treaty. Finally, heading 3 of the Copenhagen package includes transitory funding for institution-building and for preparations to participate in the Schengen agreement.

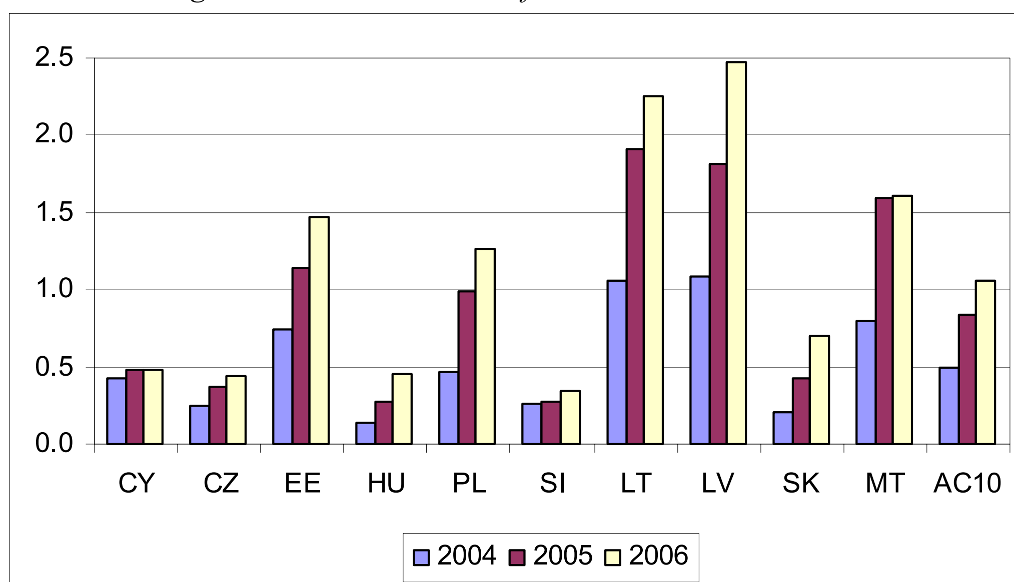
Indirect taxes are usually considerably lower in the new Member States than required by EU legislation, in particular regarding excise tax rates on fuel, alcohol and tobacco as well as the applied VAT rates. In view of the social implications of sudden strong increases in these rates, all the new Member States have negotiated transition periods mostly until the end of 2007. Gradual adjustment to higher rates should increase budget revenues already before the end of the transition periods unless consumers react with strong substitution to avoid taxes. On the other hand, adapting the VAT collection system to the EU system, which does not rely on border controls, could imply lower revenues where VAT collection was fairly efficient before accession.[6] Furthermore, custom tariffs will often need a downward adjustment to the Common External Tariff of the EU. After accession, 75% of the custom revenues go directly to the EU budget while Member States keep 25% to cover collection costs. However, given the already low tariff rates for most industrial goods in the new Member States before accession, custom revenues are no longer an important part of total revenues. Accession should thus not have significant effects on this revenue item.

5. Conclusions

Looking at the balance of fiscal effects of accession from the new Member States' budget point of view, it would be difficult to argue that accession will substantially increase fiscal pressure in the new Member States. In Figure 7 the Structural Funds (because of the additionality requirement) were subtracted from the net payments received by the new Member States. On average, this balance is close to 0.5% of GDP in 2004 and exceeds 1% of GDP in 2006; in Latvia it could reach 2.5% of GDP in 2006. In conformity with the principle of additionality for the Structural Funds, the national co-financing is not necessarily additional spending but could come from already existing budget lines for similar spending purposes. Even if co-financing were additional, the overall balance would turn only marginally negative for some of the countries. The pre-financing of direct payments to farmers, the implementation of the *acquis communautaire*, the building-up of the administrative capacity and the net effects of the alignment of indirect tax rates and custom tariffs are unlikely to have dimensions which could offset the positive net payments from the EU budget.

[6] See Mrak (2003) pointing to this problem for the case of Slovenia.

Figure 7: Estimated net payments from the EU budget to the new Member States excluding Structural Funds in % of GDP, 2004-2006



Source: own calculations; see Annex for explanations on methodology

On balance, and in contrast to what the literature often concludes, accession should rather reduce the fiscal strains in the new Member States. No doubt, changes in the new Member States' budgets will be necessary and the transition year 2004 could be particularly difficult in that budgetary and administrative procedures have to be adapted in order to actually absorb the payments as projected by the Copenhagen package. However, this should not be a fundamental problem unless there are built-in inflexibilities in the budget, possibly arising from a weak political system, different fiscal layers or a strong fiscal autonomy of sectoral ministries. Even in this case, there is no need to have a higher deficit or to decrease capital expenditure, given the potential for cuts in current expenditure which are however politically more difficult to decide. Accession should thus be seen as an opportunity to further enhance the efficiency of public spending in the new Member States. Furthermore, given their focus on improving conditions for private investment, EU expenditure can be expected to have a wider positive economic impact. Therefore, accession itself is not a very convincing justification for higher budget deficits in the new Member States after accession.

Annex

METHODOLOGY APPLIED TO CALCULATE EU BUDGET PAYMENTS TO THE NEW MEMBER STATES

EU budget figures used here have been taken from European Commission (2003a) which gives the indicative allocation in the financial framework for enlargement 2004 to 2006 (the so-called "Copenhagen Package" which allowed to conclude accession negotiations with the 10 new Member States in December 2002). Figures there are presented as commitment and payment appropriations, in million € in 1999 prices by each year and country.

Commitments and payments:[7] While from a budget planning point of view appropriations for commitments are the most important budget figures, actual payments are more relevant from the economic point of view of beneficiaries. Table A.1 gives the total indicative payments for the years 2004 to 2006. Compared to the original source, there are some minor rounding errors.

From 1999 prices to current prices: As indicated in the EU Budget 2004, a 2% deflator is used for headings 1 and 2 and the GNI deflator for the other headings. The respective values given there are 10.41% and 10.72624% for the period until 2004. For the years 2005 and 2006 a GNI deflator of 2% has been assumed here.

EU pre-accession aid: The EU Budget 2004 gives expected payments data for pre-accession aid (PHARE, ISPA and SAPARD) in the years 2004 to 2006 for Malta and Cyprus together and for the other eight new Member States together. Payments for each individual country have been estimated here on the basis of the share in January 2003 population in the respective country group.

GDP 2004 to 2006: GDP figures in € in current prices have been taken from the European Commission's forecasts published in spring 2004 (available in the AMECO database on DG ECFIN's website). Since the last year included in the forecasts is 2005, the nominal GDP growth rate of 2005 has been used to project GDP in 2006. Projections for GNI per capita in PPS apply the real GDP growth rates of the Commission forecast (and the 2005 growth rate to calculate the figure for 2006), thus assuming the absence of changes in population and Purchasing Power Standards (PPS).

Net payments from the EU budget (Figure 2): New Member States' contributions to the EU budget in 2004 have been taken from the EU Budget 2004 (European Commission 2004). For the years 2005 and 2006, the contributions to the EU budget relative to GDP have been assumed to be 50% higher than in 2004. The latter takes into account that the new Member States only participate in two thirds of the budget year 2004 also with their

[7] Commitment appropriations make it possible to enter into legal obligations during the financial year for activities whose implementation extends over several financial years. Payment appropriations make it possible to cover expenditure arising from commitments entered into legal obligations during current and preceding financial years.

contributions. Relating it to GDP takes the possible effects of nominal GDP growth into account.

Operational budget balance of the new Member States in 2006 (Figure 3): The methodology applied by the European Commission (1998, Annex 3, and 2003c, p.125) has been used as far as possible. Main methodological elements are excluding traditional own resources and administrative expenditure as well as taking into account the UK rebate. However, it was not possible to make the same adjustments as in European Commission (2003d) in order to make the balances sum up to zero since this would require knowing current Member States budget balance in 2006. The results are thus not fully comparable between old and new Member States not only because of different years (2002 and 2006) but also because of slightly different methodologies. Gross National Income (GNI) for 2006 has been calculated in the same way as GDP, i.e. by using the 2005 nominal GDP growth rate (see above).

The co-financing of EU structural assistance (Figure 6): The standard co-financing rates of 25% for pre-accession instruments, rural development measures (EAGGF Guarantee) and the Structural Funds (Objective 1) as well as 20% for the Cohesion Fund have been assumed. For Cyprus, Prague and Bratislava, which are not eligible to Objective 1 funding, a 50% co-financing rate has been used for the non-Objective 1 share of Structural Funds as indicated in European Commission (2003b), Annex, Table 11.

Table A.1: Financial framework for enlargement 2004-2006 (Copenhagen package) - Indicative allocation of payment appropriations in million € 1999 prices

	CY	CZ	EE	HU	PL	SI	LT	LV	SK	MT	not allo-cated	Total
Heading 1 - Agriculture	**94.9**	**975.1**	**213.8**	**1,321.9**	**3,871.2**	**326.2**	**594.1**	**313.8**	**521.6**	**21.2**	**0.0**	**8,253.8**
Of which:												
1a - Common Agricultural Policy	48.7	638.4	120.4	948.3	2,093.4	151.7	290.6	110.3	275.4	4.5	0.0	4,681.7
1b - Rural development	46.2	336.7	93.4	373.6	1,777.8	174.5	303.5	203.5	246.2	16.7	0.0	3,572.1
Heading 2 - Structural actions after capping	**37.7**	**950.4**	**237.0**	**1,170.9**	**4,742.5**	**159.1**	**544.9**	**406.1**	**651.4**	**34.6**	**19.6**	**8,954.2**
Of which:												
Structural Funds	26.8	760.2	174.2	944.9	3,893.5	120.7	419.3	292.7	535.5	30.2	19.6	7,217.6
Cohesion Fund	10.9	190.2	62.8	226.0	849.0	38.4	125.6	113.4	115.9	4.4	0.0	1,736.6
Heading 3 - Internal Policies	**28.0**	**247.0**	**103.9**	**391.5**	**1,190.7**	**175.0**	**374.0**	**133.3**	**221.1**	**11.8**	**0.0**	**2,876.3**
Of which:												
Existing policies	26.3	222.1	26.1	211.6	779.3	61.2	53.6	48.7	97.1	11.2	0.0	1,537.2
Nuclear safety	0.5	0.0	0.0	0.0	0.0	0.0	167.4	0.0	60.0	0.0	0.0	227.9
Institution building	1.2	24.9	9.1	32.0	131.5	7.0	17.2	13.5	16.3	0.6	0.0	253.3
Schengen	0.0	0.0	68.7	147.9	279.9	106.8	135.8	71.1	47.7	0.0	0.0	857.9
Heading 5 - Administration												1,673.0
Budgetary compensations	**338.3**	**746.4**	**21.6**	**211.3**	**1,442.8**	**232.6**	**47.4**	**26.3**	**86.0**	**232.9**	**0.0**	**3,385.6**
Total	**498.9**	**2,918.9**	**576.3**	**3,095.6**	**11,247.2**	**892.9**	**1,560.4**	**879.5**	**1,480.1**	**300.5**	**19.6**	**25,142.9**

Source: European Commission 2003a; differences from original source are rounding errors.

Table A.2: Estimates of contributions to and payments from the EU budget in % of projected GDP, 2004-2006

		CY	CZ	EE	HU	PL	SI	LT	LV	SK	MT	average
contribution to the EU budget	**2004**	0.75	0.66	0.70	0.73	0.74	0.76	0.73	0.72	0.75	0.82	0.73
	2005	1.12	0.99	1.06	1.10	1.11	1.14	1.10	1.09	1.13	1.23	1.09
	2006	1.12	0.99	1.06	1.10	1.11	1.14	1.10	1.09	1.13	1.23	1.09
payments from the EU budget	**2004**	1.22	1.12	1.95	1.16	1.72	1.13	2.37	2.56	1.35	1.78	1.60
	2005	1.70	1.74	3.03	1.86	2.97	1.61	3.97	4.16	2.23	3.11	2.58
	2006	1.69	1.82	3.35	2.04	3.25	1.69	4.31	4.82	2.53	3.14	2.80
net payments	**2004**	0.48	0.46	1.25	0.43	0.98	0.37	1.64	1.84	0.60	0.96	0.87
	2005	0.58	0.75	1.97	0.76	1.86	0.47	2.87	3.07	1.10	1.89	1.49
	2006	0.57	0.82	2.29	0.93	2.14	0.55	3.21	3.73	1.40	1.92	1.71
co-financing of EU programmes	**2004**	0.11	0.22	0.37	0.23	0.40	0.14	0.46	0.59	0.34	0.13	0.31
	2005	0.16	0.33	0.61	0.35	0.61	0.23	0.75	0.99	0.55	0.19	0.49
	2006	0.19	0.37	0.70	0.39	0.69	0.28	0.86	1.16	0.62	0.21	0.55
Structural Funds (excl. Cohesion Fund)	**2004**	0.05	0.22	0.51	0.29	0.51	0.11	0.58	0.75	0.40	0.17	0.38
	2005	0.09	0.38	0.84	0.49	0.86	0.20	0.96	1.25	0.68	0.30	0.65
	2006	0.09	0.39	0.83	0.49	0.87	0.21	0.96	1.26	0.70	0.31	0.66

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