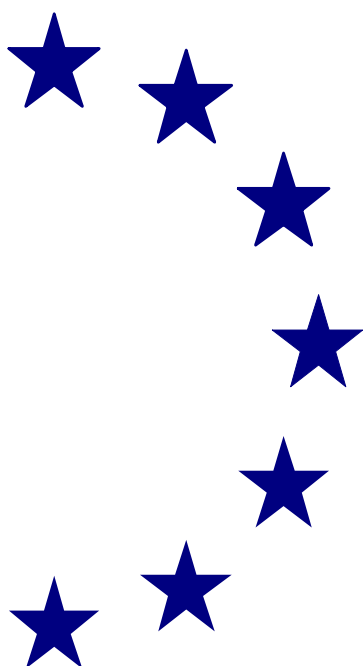


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**The structural challenges facing the  
candidate countries (Bulgaria, Romania,  
Turkey) - A comparative perspective**

by  
Economic Policy Committee

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## Key messages

The economic gap between the EU and the three candidate countries, Bulgaria, Romania and Turkey, is significant. Living standards, as measured by GDP per capita at PPP, are less than one third of the level prevailing in the former EU-15 – and about half of the average level in the new Member States. Catching up with the rest of Europe in terms of income levels and productivity will thus be a very long-term process.

The growth performance in the three candidate countries in the most recent years has been solid, after crises and turbulences in the second half of the 1990s. In 2003 real GDP growth reached 4.5% of GDP in Bulgaria, 4.9% in Romania and 5.8% in Turkey. Growth in Turkey has, for many years, been fluctuating sharply.

So as to preserve stability and prevent any recurrence of the crises of the past, the candidate countries will need to manage the remaining macroeconomic imbalances - relating mainly to inflation, government deficits and current account deficits -, and complement that by addressing the remaining deep-rooted structural problems that may impair their capacity to stay on a path of strong growth, paving the way for improved allocation of resources in the economy at large.

**There has been considerable progress on structural reforms in all three countries. It is vital at this stage that the authorities avoid the risk of backtracking on individual reforms already achieved, and that they maintain a momentum in securing effective implementation, in particular in terms of privatisation and restructuring, institution building, the improvement of the business environment, the upgrading of the legal system (including contract enforcement), the labour market, agricultural reform and the integration of the shadow economy into the formal sector. Also the financial sector remains a challenge.**

**The following key structural challenges have been identified in Bulgaria:**

- 1. The level and structure of unemployment.** Bulgaria had a very high unemployment rate of around 14% in 2003, down from 18% in 2002. Youth unemployment (35.5% in 2002) and the long-term unemployment rate (11.9%) are exceptionally high. The employment rate (50.6% in 2002) is lower than on average in the new and other Member States. The regional variation of unemployment has tended to rise. Employment protection legislation as defined in the labour code includes some provisions which may prevent employers from hiring at all or at least on the basis of a labour contract. These restrictions are providing incentives to work in the informal sector. Non-wage labour costs are high and the result of a growing burden of social security payments related to the unfavourable old-age dependency ratio, high unemployment and high levels of tax evasion.
- 2. The business environment.** Bulgaria has made considerable progress in its business environment. The framework of business regulation is advancing, although market entry is still hampered by various administrative procedures and a complex system of registration, which slow down start-ups and tie up considerable amounts of enterprises' and public administrations' resources. Insolvency procedures have remained slow. Judicial procedures can be slow and cumbersome, and there appear to be excessive delays in court processes.
- 3. Competition and network industries.** Bulgaria made good progress with privatisation, and the process should be seen through to completion as a few major companies still need to be sold. The implementation of competition policy and the

restructuring of network industries should now be a top priority. The institutional separation of the railway infrastructure from railway services has been made, but further restructuring is needed to reduce subsidies on operations and introduce actual competition. Efficiency is still low for the energy sector.

#### **In Romania:**

1. **Business environment.** The efficiency of the public administration and of the judicial system needs further improvements so as to substantially improve the business environment. The legal framework to date has been subject to frequent changes and law enforcement is uneven while the judiciary suffers from a lack of trained staff, low levels of funding, and poor infrastructure and conditions of service. The predictability of the legal system, contract enforcement, and the functioning of courts should be strengthened. Corruption remains a serious concern. Despite the important progress made, the persistent failure to impose financial discipline on all enterprises coupled with deficiencies in the bankruptcy legislation and procedures acts as an impediment to market entry and exit.

2. **Financial discipline, restructuring and privatisation in the business sector.** Despite recent progress, there is scope for further restructuring in important areas of the economy. In key sectors, such as energy, mining and transport, restructuring in preparation for privatisation must be advanced, and efforts to improve the workings of the market mechanism be strengthened. An urgent issue remains the continued accumulation of arrears to the budget and energy-sector enterprises. The now somewhat greater readiness to disconnect energy users in arrears and to enforce bill collection should be maintained, and strengthened further with regard to district heating as part of a comprehensive reform strategy. In network industries, further reforms to promote competition and strengthen regulation should be pursued. As part of a clear medium-term strategy for the energy sector, steps should be taken to ensure that energy prices are set so as to cover costs and to include a sufficient margin for long-term investments and liabilities. The faster pace at which large state-owned enterprises are being sold should be complemented by restructuring or closing down loss-making enterprises.

3. **Tax compliance and expenditure reform.** Continued strengthening of the revenue side by broadening the tax base and improving the collection of taxes, social security contributions and excise duties remain important in view of the lower revenue-to-GDP and higher expenditure-to-GDP ratios incorporated in the medium-term fiscal programming. Ensuring that no further arrears to the general government are allowed to accumulate is crucial. Lower-than-budgeted expenditures in the medium-term would be conducive to expenditure reform, which is needed in order to redirect public expenditure towards areas that strengthen the country's human capital, infrastructure and administrative capacity. Reform of the health and pension systems is crucial to counter the expenditure pressures of an ageing population, but since reforms are still at an early stage, medium-term budgetary prospects should be strengthened also with this view in mind.

4. **Flexibility in the labour market.** The employment rate has fallen markedly in recent years. The unemployment rate remained relatively stable, at around 7% in 2003, but substantial upward pressure on the unemployment level can be expected from the restructuring that still needs to be carried out. Reforms aimed at increasing the simplicity and transparency of employment protection legislation, which appears to be very rigid, would act as an incentive for employment creation. The burden on labour from high social security contributions in Romania is one of the largest in Europe. The shadow economy appears extensive by any standards. Given the ongoing economic restructuring and low labour productivity, labour market flexibility

is instrumental in improving the reallocation of resources and strengthening the economy's resilience to adverse shocks. The wage-setting process, which is still largely influenced by the economy-wide definition of minimum wages, could be more flexible. In light of the demographic and labour market developments, the weak financial state of the public pension system constitutes a major risk.

### **In Turkey:**

**1. Fiscal sustainability.** Strict budgetary discipline and attainment of the government's primary surplus target agreed with the IMF are essential for underpinning macroeconomic stabilisation, as a large proportion of Turkey's economic potential is tied up in servicing the high level of government debt. The poor state of public finances has been a key factor in Turkey's chronically high inflation and its high degree of economic volatility. There are also important quality issues in the fiscal adjustment. As a result of huge tax exemptions, the tax base is narrow and payment arrears are substantial. Despite a relatively favourable demographic structure, the pension system currently is financially unsustainable. The authorities are working with the World Bank to design a comprehensive reform of the existing first-pillar system.

**2. Privatisation.** Despite being of relatively limited size in absolute terms, state-owned enterprises still play an important role in key sectors of the economy such as banking and telecommunications and in basic industries such as mining and steel processing. Owing to overstaffing and underinvestment, many of them are not profitable and depend heavily on state support. During recent years, progress in privatization has remained very limited, reflecting insufficient political support and weak interest of potential investors. Closing down non-viable state enterprises would free valuable budgetary resources and reduce distortions in Turkey's economy. While key problems in the banking sector have been addressed since the 2001 financial crisis, the privatization of state banks is among the issues that still need to be tackled.

**3. Business environment.** Progress has been made with the institutional framework for market development and the business environment, and market entry and exit barriers have been lowered. The problem here lies less with the formal framework than with practical implementation. The efficiency of the judiciary system is a major concern to investors and weighs heavily on the business climate. The regulatory system is based on a highly centralised state bureaucracy. The legal uncertainty remains a fundamental weakness. This stems from the lack of stability of the legal framework, and from weak legal enforcement. The quality of public institutions at all levels needs to be improved. Corruption remains a very serious problem. Improvements in these areas will enhance the prospects for attracting more foreign direct investment, which is currently very low.

**4. Problems in the labour market.** The low level of employment, at around 44%, demonstrates the scale of the structural weaknesses of the Turkish labour market. Employment in Turkey has still not benefited from the healthy growth performance since 2002. The existence of pronounced social and regional disparities poses major problems for Turkey. As a result of the sharp recession in 2001, unemployment rose further to 10.5% in 2003, despite a strong recovery of economic activity. The employment rate for women remains at a level less than half of the former EU-15. A substantial part of the labour force is employed in the shadow economy. The low employment rates among both young and older workers, as well among women, require special attention. Further efforts to adapt the education and training systems, especially in the secondary and tertiary sectors, will hold the key to sustaining competitive pressures in the medium term. In addition, further efforts are

required to rationalise the tax and benefit system in order to improve incentives for people to seek work in the formal sector.

### **Statistics**

For all three countries, statistics are improving, but considerable gaps remain. The Economic and Financial Committee in May 2003 adopted an Action Plan on economic, monetary and financial statistics for the candidate countries to help them step up their efforts including in the field of structural indicators so as to ensure best possible coverage, timeliness and quality of data. The EPC considers that meeting the requirements laid down in the action plan should be accorded top priority.

## Report

The Ecofin Council on 4 November 2003 gave a mandate to the Economic Policy Committee (EPC) to provide a report on the key structural challenges in the candidate countries (Bulgaria, Romania and Turkey, hereinafter the “candidate countries”). Following up on this mandate, the Committee has prepared the present Report, which is based on available material and underpinned by fact-finding missions to all three countries.<sup>1</sup>

### I. The macroeconomic context

All three candidate countries have suffered from severe economic and financial crises over the past decade. They have also experienced periods of high inflation at some stage over the past six to seven years. In Bulgaria, during its 1996-97 financial crisis, output fell by 15%. In Romania, output declined by 12% between 1997 and 1999. Turkey, the most recent country to suffer a crisis, saw output fall by 7.5% in 2001. However, each country, with the backing of IMF programmes, has enjoyed successful post-crisis recoveries: Bulgaria and Romania over the last four to five years, while in Turkey’s case a recovery has taken root over the last two years. The improved growth performance of all three economies in recent years demonstrates the gains to be made from pursuing credible and sound macroeconomic policies.

Although all three countries have emerged successfully from their crises, some macroeconomic vulnerabilities remain. While the level of public debt is relatively low in Romania and while Bulgaria has kept its budget close to balance over the last few years, allowing considerable progress to be made in reducing both public and external debt, the level and unfavourable structure of general government debt remain of great concern in the case of Turkey. The policies needed to maintain economic stability vary by country, but maintaining a prudent fiscal stance is key to preserving or achieving stability in all three of them.

The recent recoveries have caused some widening of external imbalances, particularly current-account deficits in Bulgaria and Romania, which is due in part to growth in domestic consumption fuelled by rapid credit expansion and in the case of Bulgaria in 2002 also by excessive wage growth. In Romania high wage-growth risks may become an obstacle to containing the current account deficit in 2004. The key challenge in the short run will be to prevent these imbalances getting out of control.

Encouraging inflows of foreign direct investment will provide a source of financing for current-account imbalances, as is already the case in Bulgaria, and also help to spur productivity growth.

#### *Real convergence*

Bulgaria, Romania and Turkey are at a different stage of development compared with the former EU-15, or even with the ten countries which acceded to the European Union on 1 May 2004 (hereinafter “the new Member States”). Despite solid economic growth in recent years (in 2003 4.3% in Bulgaria and 4.9% in Romania), Bulgaria and Romania have made limited progress in real convergence towards the EU, and catching up in terms of income and productivity levels remains a major challenge. The Turkish economy has been operating significantly below its potential, because of

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<sup>1</sup> It follows the report on key structural challenges in the acceding countries: The integration of the acceding countries into the Community’s economic policy co-ordination processes, Economic Policy Committee, July 2003: [http://europa.eu.int/comm/economy\\_finance/publications/occasional\\_papers/2003/ocp4en.pdf](http://europa.eu.int/comm/economy_finance/publications/occasional_papers/2003/ocp4en.pdf).

low average output growth and a continuous population increase, GDP per capita has declined during the last five years (GDP growth was 7.9% in 2002, and 5.8% in 2003). Living standards in the three candidate countries, as measured by GDP per capita at PPP, are less than one third of the level prevailing in the EU-15 and about half the average level in the new Member States.

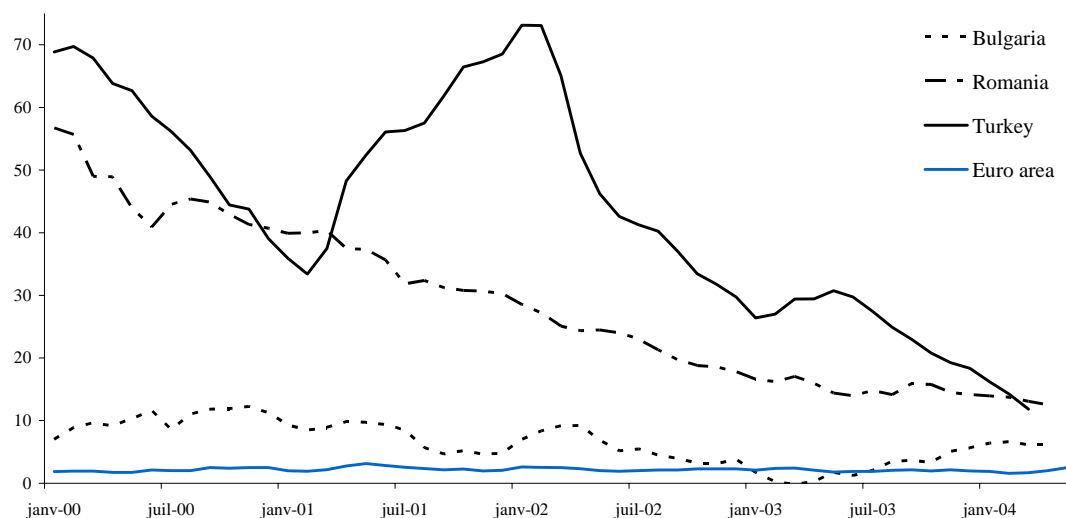
This backdrop offers the potential for a rapid catch-up in growth, especially as rural populations move to urban centres. It should be recognised, however, that catching-up in terms of income levels with the EU will probably be a very long-term process for the candidate countries. It is vital that the authorities maintain progress on the implementation of structural reforms, in particular on institution building, the business environment and the integration of the shadow economy into the formal sector. While structural reforms will focus on increasing the trend rate of growth, and aim at employment creation, they also need to continue strengthening the financial framework and architecture.

The potential average annual growth rates of the candidate countries over a 5- to 10-year horizon are projected to be between 4% and 5% of GDP. Breaking down these potential growth rates into their component parts shows that key drivers behind potential output growth for all three countries will be relatively high total factor productivity (i.e. independent technical progress) and the contribution by fixed capital. The contribution of employment towards potential growth will be very weak or negligible or may even decline. This illustrates the essential characteristics of the economies of the candidate countries with their relatively low capital endowment and low level of technology. It also emphasises that their future speed of real convergence towards the EU depends very much on the rate of investment, including foreign direct investment, the growth in total factor productivity, and labour deepening.

#### *Nominal convergence*

Bulgaria has successfully maintained its currency board regime, which had been introduced following the severe crisis in 1997. It thus managed to keep inflation rates at relatively low levels. In contrast to this performance, Romania and particularly Turkey have until recently witnessed fairly high rates of inflation, which only recently have started to come down significantly (see Graph 1). Both countries are determined to pursue their disinflation strategy, which, if successful, should lead to inflation rates in 2005 of below 7% in Romania and below 10% in Turkey. These are relatively high levels compared with the EU, but represent a significant improvement on the high double-digit levels of past years.

**Graph 1: Inflation rates in the candidate countries, 2000-04 (annual percentage changes)**



Source: Eurostat, IMF.

**Source:** Commission services.

#### *Labour productivity, wage costs and competitiveness*

Labour productivity in the candidate countries per person employed, measured by PPPs, is very low, at approximately one third of the former EU-15 average. Out of the EU-25, only Latvia and Lithuania have comparably low levels. Overall, in Bulgaria and Romania labour productivity has moved from some 27% of the EU average in 1999 to 31% in 2002. In the case of Turkey, strong output fluctuations led to a decline in productivity in 1999 and 2001, while in 2002 a start was made on restoring its pre-crisis level.

**Bulgaria's** labour productivity in 2002 was only 31% of the former EU-15 average (see Table 1 and Graph 2). The improvement between 1997 and 2002 from 26.1% of the former EU-15 average to 31.1% was due partly to the decrease in employment, reflecting the period of transition and the restructuring of the economy. In **Romania** labour productivity in 2002 stood at just about one third of the EU-average, despite relatively swift catching-up equivalent to more than 4.5 percentage points since 1999. The driving force for this catching-up process was strong economic growth. **Turkey's** labour productivity in 2002 stood at 36% of the former EU-15 average. Labour productivity growth, like GDP, has been very volatile in recent years, reflecting the boom-and-bust performance of the Turkish economy. Having fallen by 6.5% in 2001, productivity rebounded by 7.6% in 2002. Since 2000 productivity has been determined by flat employment growth, in contrast to the late 1990s, when employment grew at an average rate of 1.6%.

**Table 1: Labour productivity, per person employed\*  
(former EU-15=100)**

	1997	1999	2002
<b>Bulgaria</b>	26.1	27.8	31.1
<b>Romania</b>	n.a.	27.2	30.9
<b>Turkey</b>	37.3	34.2	35.6

**Source:** Eurostat, New Cronos.

\***Note:** GDP in PPS per person employed.

Labour productivity developments in manufacturing industry show a similar pattern in Bulgaria and in Romania: in both countries steep declines in 1997 and 1998 were followed by strong recoveries in 1999 and particularly in 2000. In 2001 and 2002 there was a continuation of the positive growth trend in both countries.

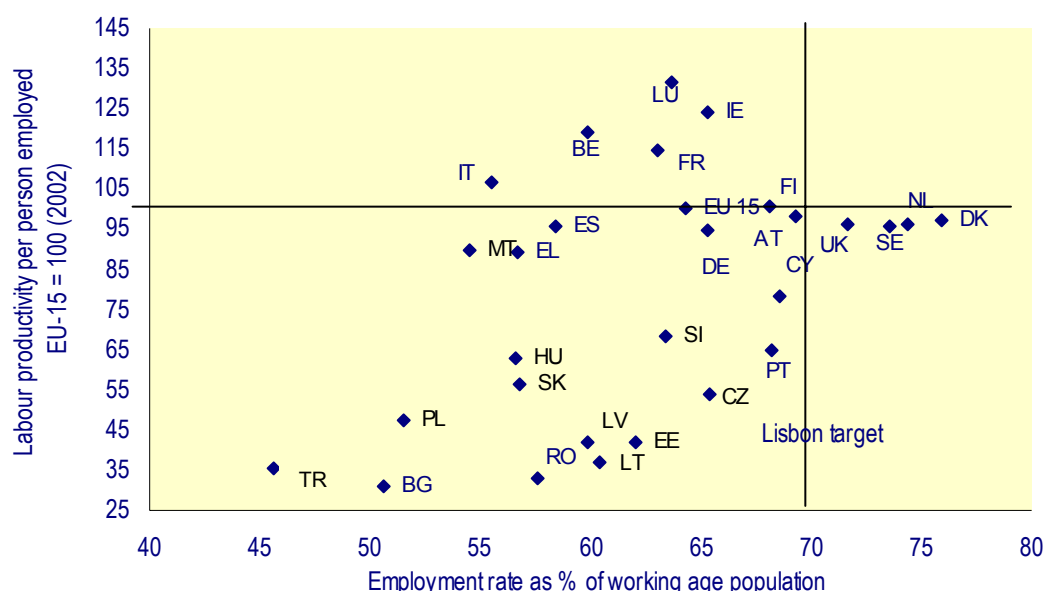
**Table 2: Labour productivity in manufacturing industry  
(annual growth rates as %)**

	1997	1998	1999	2000	2001	2002
<b>Bulgaria</b>	-10.9	-7.9	4.3	17.2	0.7	3.13
<b>Romania</b>	-1.3	-8.4	3.7	18.5	8.7	13.9
<b>Turkey*</b>	4.7	0.6	-8.1	4.0	-6.7	6.0

**Source:** Bulgaria, Romania: WIIW Handbook of Statistics, 2003; Turkey: Prime Ministry – Undersecretariat of Treasury.

**Note:** \* The figures for Turkey refer to annual growth of gross value added in 1995 prices per employee in the manufacturing industry and are not directly comparable to the figures for Bulgaria and Romania.

**Graph 2: Employment and productivity levels in the EU and the CC's**



The competitiveness of the **Bulgarian** economy, measured by unit labour costs adjusted by the exchange-rate (see Table 3), showed some improvement in 2000 after deteriorating sharply in 1998, when unit labour costs increased by 18.4%, mostly as the result of high "catch-up" growth of wages. Since then, wages have broadly reflected productivity developments, which resulted in unit labour costs remaining largely unchanged. In **Romania** real wages increased at a slower rate than productivity, making for a stable development in Romanian unit labour costs since 2001. However, the continuation of this trend depends on a rigorous implementation of a moderate wage policy and continuation of the restructuring process in the economy. The volatile nature of its economic performance also strongly influences the competitiveness of **Turkey's** economy. In spite of marked exchange rate appreciation in 2000, and the marked depreciation in the aftermath of the 2001 crisis, competitiveness improved between 2000 and 2002, when real unit labour costs fell by a cumulative 12%. Real exchange rate fluctuations have had a

considerable influence on relative unit labour cost developments in the case of Turkey and are expected to continue to do so in the future.

**Table 3: Real unit labour costs developments  
(annual percentage change)**

	2000	2001	2002	2003
<b>Bulgaria</b>	-5.4	0.8	0.2	2.5
<b>Romania</b>	0.6	0.9	-3.4	1.1
<b>Turkey</b>	-5.2	-2.9	-2.9	-1.1

*Sources:* Commission services.

*Note:* Unit labour costs are adjusted for prices and the exchange rate.

### *Risks to manage*

Against the background of moves to establish or confirm a track record of stability-oriented macroeconomic management, policies during the next few years will have to manage a number of existing imbalances.

In **Bulgaria**, the policy mix of sound fiscal policy and structural reform supporting the Currency Board Arrangement (CBA) has resulted in robust growth, low inflation and a declining unemployment rate in the last two years. The main macroeconomic imbalance is the high external *current account deficit*, which widened strongly in 2003 to around 8.5% of GDP (2002: 4.9%) and resulted from the sharp increase in domestic demand and which is expected to remain high in the medium term despite measures taken to restrict the credit growth. However, foreign direct investment (FDI) inflows in 2003 covered 82% of this deficit and reserves have increased. The main challenge is to finance it adequately also in the future by, in particular, attracting greenfield investment, and reducing the risk of overly rapid credit growth. In particular, attention should be paid to *the quality of banks' portfolios*, which has not yet shown signs of deterioration, and to continued efforts at reducing debt and attracting foreign investment. Moreover, to the extent that the deficit was a result of strong consumption, stemming from rapid growth of credit, an appropriate incomes policy will also help to narrow the deficit.

In **Romania**, despite considerable reductions since 2001, *inflation* is relatively high, at 14.1% at end-2003 (but on a decreasing path and in line with the target of 14% set for end-2003). Although not necessarily of a deep-rooted structural nature, the sharp widening of the *current account deficit* to 5.8% of GDP in 2003 (provisional figure; in 2002 it amounted to 3.4%) needs to be monitored closely. FDI in 2003 covered approximately 46% of this deficit. Against this background, the conduct of exchange rate policy will be challenging, as there may be a trade-off between the preservation of short term external competitiveness and the support of further disinflation. Whilst the fiscal stance at present is not of specific concern, two factors require attention: first, against the background of the current account dynamics, a further and sustained reduction of the fiscal deficit (including the quasi-fiscal deficit stemming from the accumulation of arrears) is needed; and, second, public expenditures related to structural reforms, in the context of economic reforms in general, exert considerable upward pressure on overall public expenditures. Therefore, overall strict expenditure control, a decline in the net increase of arrears, and further headway in expenditure reform will be required. In the labour market, substantial upward pressure on the unemployment rate can be expected as a result of restructuring.

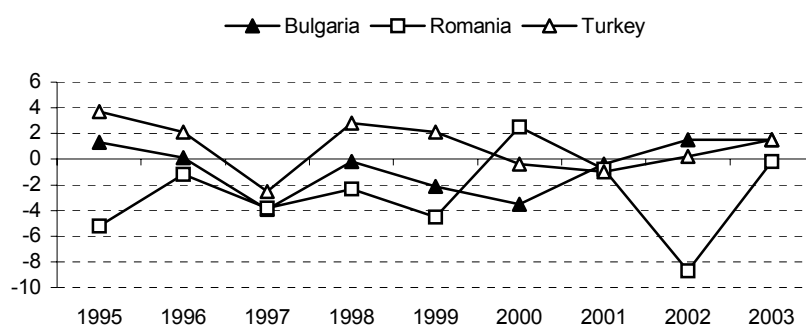
In **Turkey**, despite reductions in the debt burden, the size and composition of the public debt remains a source of vulnerability. In 2003, the costs of debt servicing amount to some 40% of public expenditures or around 18% of GDP. A high proportion of public debt is denominated in, or linked to, foreign currency. Indeed, 65% of domestic debt is linked to short-term interest rates or exchange-rate fluctuations. On account of the high share of short-term financing, interest expenditures are closely linked to exchange-rate and interest-rate fluctuations, introducing a high degree of uncertainty into the budgeting process. While a strengthening exchange rate helped reduce the debt burden in 2003, it would rise again if the lira were to weaken. Likewise, a large proportion of debt has short-term maturities, exposing the government both to roll-over risk and to the effects of movements in short-term interest rates. The current- account deficit was 2.8% of GDP in 2003, and is expected to widen to 3.4% of GDP in 2004. While this is not yet a matter of concern, it should be taken into account that only a small proportion of the deficit is financed by FDI. Risks may also arise from excessive exchange-rate fluctuations, and interest-rate movements due to changing inflation expectations.

## II. Labour market reforms

### *Employment*

Employment in **Bulgaria** and **Romania** between 1999 and 2003 declined cumulatively by 3.1% and 11.5%, respectively (see Graph 3). In **Turkey** employment remained broadly stable, notwithstanding favourable growth developments. Table 4 shows that total employment rates in Bulgaria, Romania and Turkey in 2003 were 52.5%, 57.6% and 44.4% of the working-age population, as compared with 55.9% on average in the new Member States (2002) and 64.3% in the former EU-15. In 2002 the employment rates of older workers in Bulgaria and Turkey were 30.0% and 33.8%, respectively, while the female employment rate ranged between 25.3% in Turkey and 49.0% in Bulgaria and 51.5% in Romania. Bulgaria and in particular Turkey have employment rates significantly below the present EU level and the EU Lisbon targets. Employment rates in Romania and Turkey between 2000 and 2003 decreased, notably for older workers and in the case of Romania for women. In Bulgaria the overall rate remained broadly stable, but there was a substantial net job creation in 2002 and 2003.

**Graph 3: Employment growth in the candidate countries 1995-2003  
(annual percentage growth)**



**Source:** European Commission (2003) *Employment in Europe 2003*.

**Note:** The break in the data for 2002 for Romania can be explained by a change in methodology.

**Table 4: Employment rates: Progress towards the Lisbon and Stockholm targets**

	Total employment rate			Female employment rate			Employment rate among older workers		
	2003	Gap below 2010	Change 2000-03	2003	Gap below 2010	Change 2000-03	2003	Gap below 2010	Change 2000-03
<b>Bulgaria</b>	52.5	17.5	2.1	49.0	11.0	2.7	30.0	20.0	9.2
<b>Romania</b>	57.6	12.4	-5.4	51.5	8.5	-6.0	38.1	11.9	-11.4
<b>Turkey</b>	44.4	25.6	-1.6	25.3	34.7	+0.4	35.3	14.7	-1.1
<b>New MS</b>	55.9*	14.1	-1.6*	50.2*	9.8	-1.2*	30.5*	19.5	1.0*
<b>Former EU-15</b>	64.3	5.7	0.9	56.0	4.0	1.9	41.7	8.3	3.9
<b>2010 target</b>	70%			More than 60%			50%		

**Source:** Bulgaria, Romania, EU: European Commission (2003) Employment in Europe 2003; Turkey: State Institute of Statistics.

**Note:** \* 2002.

**Bulgaria** had a double-digit unemployment rate of 13.6% in 2003 (see Table 5). Youth as well as long-term unemployment is particularly high in Bulgaria, above the average for the new Member States (AC-10). In **Romania**, overall unemployment, as well as youth and long-term unemployment are below the average for the new Member States and closer to the former EU-15 level (Table 6). This could be an indication of delayed restructuring, although wage restraint has also helped to stabilise employment. Unemployment in **Turkey** is still heavily influenced by the aftermath of the financial crisis in 2001 and increased by 4 percentage points in the period 2000-03.

**Table 5: Unemployment rates in 2003 (as % of labour force 15+)**

	Total		Men		Women	
	2003	Change 2000-03	2003	Change 2000-03	2003	Change 2000-03
<b>Bulgaria</b>	13.6	-2.8	13.9	-2.8	13.2	-3.0
<b>Romania</b>	6.6	-0.4	6.9	-0.3	6.2	-0.1
<b>Turkey</b>	10.5	4.0	10.7	4.1	10.1	3.8
<b>New MS</b>	14.3	0.7	13.7	0.9	15.1	0.3
<b>Former EU 15</b>	8.1	0.3	7.4	0.7	9.0	-0.2

**Source:** European Commission (2003), Employment in Europe 2003, SIS (2003).

**Note:** Data of the European Labour Force Survey. National data may be different, according to the methods and definitions used.

**Table 6: Youth unemployment rate and long-term unemployment rate 2002 (% of labour force 15-24; % of labour force)**

	Youth unemployment rate			Long-term unemployment rate		
	Total	Men	Women	Total	Men	Women
<b>Bulgaria</b>	35.5	39.0	31.4	11.9	12.3	11.5
<b>Romania</b>	18.5	18.6	18.5	3.8	3.8	3.7
<b>Turkey</b>	19.2			3.7		
<b>Former New MS</b>	31.9	31.4	32.7	8.1	7.4	8.9
<b>EU-15</b>	15.1	14.8	15.5	3.0	2.6	3.9

**Source:** European Commission (2003), Employment in Europe 2003, OECD, Prime Ministry of Turkey – Undersecretariat of Treasury.

The issue of urban-rural migration is a case in point as regards delayed restructuring. In **Turkey** the declining trend of agricultural employment continued. Industry, construction and services will have to absorb a significant flow of fairly unskilled workers in future. In **Bulgaria** the regional unemployment gap between the highest and lowest regional unemployment rates has widened in recent years. In **Romania** urban-rural migration is still dormant but might become of topical relevance in the future. In all likelihood, direct and indirect subsidies as well as a lack of alternative employment opportunities have restricted the outflow from agriculture.

In the candidate countries, housing and the subsistence economy provide a large share of income. There are dual labour markets in urban and rural areas. Employment policy in the candidate countries should therefore set different priorities compared with the EU countries and distinguish clearly between rural and urban areas. In addition, the limited budgetary funds available in those countries call for a restrictive selection of affordable policy measures.

### *Wage-setting*

The wage-bargaining process has so far not assured a stable and foreseeable relationship between productivity and real wages. In **Turkey** and **Romania** unit labour costs have fallen or remained broadly stable since 1999 and have thereby boosted export competitiveness. With the stabilisation programme in Turkey, real wages grew at a slower rate than productivity. However, there have been signs of a reversal of this process recently. Nevertheless, the gap opening up between wage growth and productivity growth might not be a temporary, cyclical phenomenon but may well have a structural component given continuing migration from agriculture. In **Bulgaria** wage developments have followed productivity developments more widely.

In **Bulgaria** the parties to the wage-bargaining process during the transition process have managed to maintain de-facto centralised wage bargaining for almost all sectors. The number of branch/sector collective agreements rose by 12% in 2002/03 compared with 2001/02. Minimum wages in absolute terms are low compared with the new and other Member States. The wage system seems to be rather flexible in **Turkey**. Job turnover and sectoral wage differentiation are pronounced. However, the extreme differences between wages in sectors covered by collective bargaining agreements and those that are not, as well as the strong influence of the state on wage determination, might distort the wage structure. Apart from state enterprises, the degree of labour unionisation is low. The percentage of the labour force covered by collective agreements is estimated to be below 15%. In **Romania** the wage-setting mechanisms should increasingly allow differences in productivity across regions, sectors and skill profiles to be reflected in wages.

### *Tax-benefit system*

The tax burden on labour from high social security contributions in **Romania** is, in spite of significant reductions in recent years, well above the average in the enlarged EU. In **Bulgaria** it is also clearly above the former EU-15 level. Payroll taxes show the same trend: Romania with 52% on gross earnings at the top end and **Turkey** with 39.5% at the bottom end. However, the scope to reduce the tax burden is small given the tight national budgets. Social security expenditures account for 14% of GDP in Bulgaria and for 10% in Romania. Phasing out early retirement schemes and raising the retirement age would increase participation in **Turkey**.

Compliance with the principle "make work pay" is difficult to assess owing to lack of data, the existence of discretionary payments and the low level of incomes and social benefits. The government in **Bulgaria** estimates that 30-35% of welfare

recipients either work in the shadow economy or refuse to work. A programme designed to transfer people from social assistance to (municipal) work attempts to address the misuse of social assistance. **Romania** also links municipal work with social assistance and has reduced the maximum duration of unemployment benefits. In **Turkey** no average figures for social assistance are available, but unemployment benefits are low and are still received by only a small proportion of the unemployed. The level of social payments in **Bulgaria** and **Romania** is also sufficiently low compared with minimum wages. Altogether, the benefits do not seem to provide disincentives to work if they can be targeted to those eligible.

### *Employment protection*

If the new labour law regulations are implemented, **Turkey** will have a rather flexible body of legislation on employment protection which can be compared to that of Denmark, Hungary or the Czech Republic (measured by the EPL index of the OECD). In **Romania** a large part of the labour market is regulated by law. In **Bulgaria** the government encourages bilateral negotiations between employers and trade unions rather than more centralised arrangements for promoting flexible forms of employment and low hiring and firing costs. As in the case of labour costs, the relatively large size of the informal sector (see below) lowers *de facto* the standards of employment protection in **all three countries**.

### *Shadow economy*

**All three candidate countries** have a large shadow economy (estimated at 25-40% of GDP<sup>2</sup>) that may help to keep labour costs low. However, the existence of a large informal sector has significant short- and medium-term repercussions: unfair competition among enterprises, losses of budget revenues, and the creation of a stock of uninsured people, who will become a burden on the budget in future. To reduce the informal sector, a mix of standard measures can be applied with a view, for example, to: reducing the tax wedge on labour, lowering income tax for low-wage earners, taking administrative measures (e.g. compulsory registration of labour contracts) and strengthening accountability of social security benefits.

### *Migration*

Continuing high unemployment in **Bulgaria** contributed to ongoing net emigration. About 22 000 Bulgarian citizens settle abroad each year, although the flows are smaller than in the early 1990s. **Romania** has the highest migrant population after Poland, when compared with the EU. Emigration from Romania decreased in the late 1990s. According to Romanian statistics, 9 900 Romanians emigrated in 2001 (net migration). To a large extent, Romanian migration appears to be circular, with 11 000 citizens returning annually. In 2000 about 3.6 million **Turks** resided abroad, amounting to 5.1% of the Turkish population. In recent years about 1 000 highly skilled professional workers migrated annually to jobs abroad in IT, finance or management. In addition, about a quarter of students moving abroad do not consider returning to Turkey. The long-run magnitude of flows obviously depends on the

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<sup>2</sup> A variety of approaches are used to estimate the size of the shadow economy. For example, the electricity-method, which takes electricity consumption as a proxy of total production, counts the difference between official GDP and approximated GDP based on electricity consumption as shadow production. The “dynamic multiple -indicators multiple-causes” method (DYMIMIC) relates the informal sector as tax burden to the velocity of cash money or the participation rate as indicators of the shadow economy and deducts the size of the unobserved shadow economy from the estimation parameters.

speed of the catching-up process in the “sending” countries as well as on the development of their labour markets. Overall, the “brain drain” is a major problem in all three candidate countries.

### III. The business environment

#### *Business regulation*

In general, the Bulgarian, Romanian and Turkish authorities are working to simplify business regulation. Nonetheless, the complexity, the speed of regulatory procedures and a high degree of legal uncertainty remain a problem across the board.

For **Bulgaria**, the 2003 progress report of the European Commission recognises the improvement of its legal framework but also highlights the fact that “serious efforts are required to develop and implement reforms to ensure an efficient, transparent and accountable administration.” The framework of business regulation in Bulgaria is advancing, although it is still not seen as business-friendly by investors mainly because of unsupervised control by regulators and a complex system of registration; indeed, there is no central mechanism to supervise regulatory enforcement and, before autumn 1999, there was no information system or systematic effort to monitor the activities of regulatory agencies. However, the situation has been improving: for example, there has been a concerted effort to increase co-ordination with regional/local government so as to provide a more consistent view on laws, regulations and administrative procedures, as well as endeavour to involve industry association representatives by means of a framework agreement for co-ordination and co-operation; and a new law on licensing procedures attempts to reduce excessive regulation.

The regulatory framework in **Romania** is improving gradually. But a lack of clear and predictable procedures has to date had a negative influence on the business environment. This creates considerable uncertainty and administrative burdens for domestic companies and foreign investors. Efforts have continued to improve regulatory and administrative provisions. They were consolidated in an action plan for improving the business environment adopted in May 2003. However, further convergence of regulations towards EU standards, increasing amounts of FDI and improved implementation are important for improving the business environment. Employers’ associations have frequently also raised concerns about the lack of prior consultation of stakeholders, for example on the new labour code or the tax code, which have imposed large compliance costs. The new Labour Code, which came into force in March 2003, risks creating obstacles to entrepreneurship by introducing constraints on the labour market, as well as a number of new bureaucratic procedures. Romania has established a Single Control Register for SMEs, as well as a “tacit procedure” for most authorisations.

In **Turkey** economic stability and predictability in the business environment have increased. Transparency and efficiency of public finance management have been improved. The Turkish authorities have been working on the simplification of business regulation to create an environment conducive to private sector-led growth. Positive developments include the streamlining of start-up procedures, licence and permit systems, and limited progress in terms of on-line access to information and services. However, progress towards establishing “one-stop shops” for enterprises remains very limited and the costs of formal procedures for starting up a company are still too high. Nevertheless, a new Foreign Direct Investment Law has been passed, with the aim of making foreign investment in Turkey no longer subject to prior approval, and legislation has been adopted to improve the business climate in

poorer provinces by decreasing the burden of tax and social security contributions and by subsidising the energy costs of new investments.

#### *Market entry and exit*

Further progress has been made by the three candidate countries to bring down the barriers to market entry and exit. All three countries have addressed the issue of bankruptcy legislation. But important indicators like the number of procedures and the duration as well as the complexity of procedures often lie well above the OECD average (see box), but the situation is improving.

In **Bulgaria** figures indicate high, though falling, net creation of new firms, which may reflect both the overall business cycle and a lack of rigour in market exit procedures. Despite the growth of new private businesses in Bulgaria, the informal sector still seems to account for a sizeable share of activity, and so “formalising” the informal sector is crucial. Efforts have been made to streamline and simplify procedures, including the introduction of tacit consent in the area of administrative regulation and control. Market entry is still hampered by various administrative procedures, which slow down start-ups and tie up considerable amounts of enterprises’ and public administrations’ resources. Regarding market exit, insolvency procedures remain slow, although amendments were made to the Commercial Code in June 2003 to speed up the process. In addition, special legal chambers are being created at regional level to deal exclusively with bankruptcy cases.

Despite significant improvements, complex administrative procedures still hamper market entry and exit in **Romania**. The persistent failure to impose financial discipline on all enterprises is an indication that a number of non-viable enterprises are still allowed to survive, undermining payment discipline in the public sector. Efforts have been made to simplify market entry, including changes to the one-stop shops established in 2001 for registering and authorising firms. A tacit approval procedure for issuing and renewing most licences was introduced. The new bankruptcy law is also a step in the right direction, but deficiencies in legislation and procedures persist.

Barriers to market entry and exit in **Turkey** have decreased further, as demonstrated by the relatively high proportion of newly established companies, with the help of the simplification of registration procedures. Amendments to the Execution and Bankruptcy Act were adopted in July 2003 in order to facilitate the closure of non-viable companies. The amendments will also enhance the effective enforcement of creditor rights and should significantly improve the regime for corporate insolvency and creditor rights.

#### *Efficiency of the judiciary*

Despite reform of the judiciary and judicial procedures in all three countries, difficulties remain, including in terms of the speed of judicial procedures, capacity and enforcement capabilities. Reforms to judicial procedures and the judiciary under way in the three countries need to be backed up by proper training and resources to ensure their success.

In **Bulgaria** slow and inefficient proceedings within the judicial system often discourage parties from taking cases to court, which creates uncertainties in doing business owing to a lack of reliable enforcement of property rights. Although there have been moves to build up capacity and enforcement capabilities, legal certainty could benefit from improvements to the efficiency of the judiciary. However, a new judiciary law has been approved in early 2004. In spite of amendments to legislation

on intellectual property rights, the administrative capacity of enforcement bodies, including controls on cross-border trade in pirated goods, remains a matter of priority. Industrial property rights were enhanced in October 2002 and housing property is, for the most part, clearly defined and markets are working properly.

In **Romania** law enforcement is frequently seen as arbitrary and lengthy, and the legal framework is subject to frequent changes which weigh heavily on the business environment. With regard to the judiciary, companies in Romania are confronted with complex procedures. Enhancing the capacity and transparency of the judicial system is important for improving the business environment. These areas are undergoing rapid reforms in close co-operation with the World Bank, the Commission and others. In a major reform, the Supreme Court has been given exclusive competence in all appeals involving matters of law. A Judicial System Reform Strategy was also adopted. Industrial and intellectual property rights were improved slowly during 2003, especially in relation to copyright, customs and trademark provisions.

In **Turkey** the implementation of laws and contracts constitutes a fundamental weakness. The stability and implementation of the legal framework is a cause of concern to Turkish, as well as foreign, investors and businesses. The legislative process is relatively slow and the time lag between the adoption of framework legislation and the actual implementing regulations can be lengthy. There are still reports that the efficiency of the judiciary is hampered by a lack of impartiality and consistency. There are weaknesses in resources and in the training of judicial personnel. The functioning of the commercial judicial system seems a bottleneck for impeding foreign direct investment. Business opportunities in the field of the knowledge-based economy would be markedly promoted by an improved legal framework for the protection of intellectual property rights. However, efforts are under way to facilitate accession to the Trademark Law Treaty, the Patent Law Treaty and the Hague Agreement on Industrial Designs. A commitment has also been made to extend the personnel and corporate capacity of the Turkish Patent Institute and to establish an intellectual property rights authority.

#### *Governance issues*

Whilst serious efforts are being undertaken to combat corruption, the Regular Reports of the Commission continue to highlight the fact that corruption remains – to differing degrees - a matter of concern in the candidate countries.

In **Bulgaria**, the fight against corruption has remained high on the government's political agenda, with the adoption of a National Anti-Corruption Strategy (October 2001), which the 2003 implementation report concluded as being in need of strengthening and greater control – and of an Action Plan (February 2002), now being updated. The institutional set-up in the fight against corruption has been further consolidated at both ministerial and parliamentary levels. Other positive steps include the development of the collection and processing of statistical information on bribery and making the requirement that magistrates submit compulsory income and property declarations.

Despite a package of anti-corruption measures, corruption in **Romania** is perceived to be widespread and affects all aspects of society, undermining the effectiveness of state institutions, and playing a major role in deterring foreign direct investment. There have, however, been significant efforts to intensify the fight against corruption, including adoption of the National Programme for the Prevention of Corruption and the National Anti-Corruption Action Plan and the decision to make the National Anti-Corruption Prosecutor's Office operational. Moreover, a package of anti-corruption measures was adopted in April 2003, including the stipulation that tax and permit-

related controls should not occur more often than once every two years; however, current procedures still allow considerable room for manoeuvre in this respect.

For **Turkey**, some progress was achieved in 2003 in adopting anti-corruption measures. Parliament ratified in April 2003 the Council of Europe Civil Law Convention on Corruption, paving the way for Turkey's participation in the Group of States against Corruption, which monitors compliance with European anti-corruption standards. The judicial registration system has also been amended. The January 2003 action plan included several measures aimed at strengthening the fight against corruption, including a Public Information Act and a Civil Service Code of Conduct. However, many of the institutional mechanisms provided for in the plan are however not yet in place: the Inter-ministerial Commission was announced but has not yet met and the Steering Committee has not been established.

#### *Tax regime*

In **Bulgaria**, tax reporting has been improving rapidly. Even though this area has benefited from particularly intensive legal reform efforts, investors still seem to face a number of major difficulties. Definitions with regard to VAT and income tax remain unclear, resulting in non-transparent and unpredictable treatment. The review of tax legislation should be continued in order to comply with the Code of Conduct for Business Taxation. Significant further efforts are also still needed to strengthen tax administration capacities.

**Romania** has recently put in place a new fiscal code and accompanying implementing provisions, which, together with institutional changes, constitute major steps forward for the tax regime and would be expected to yield results in terms of a better business environment. Although steps have been taken recently to increase compliance and simplify tax and registration procedures for both foreign and domestic businesses, there is still some way to go in the implementation of a stable and transparent tax system.

The precision and stability of laws relating to the tax system in **Turkey** should be further improved. Attention should be focused on the Code of Conduct for business taxation and the intensification of efforts to modernise and strengthen its tax administration, in order to increase taxpayers' compliance and to enable the Code of Conduct to be implemented.

### Box: "Doing Business" in Bulgaria, Romania and Turkey

The World Bank has measured the **levels of market entry and exit** between countries by using indicators such as the procedures required to establish a business, the associated time and cost, and the minimum capital requirement on the one hand, and the cost and time associated with resolving an insolvency, the observance of absolute priority of claims, and the outcome (reorganizing viable companies and closing down unviable ones, for example). The results are shown in the following tables, although these should not be taken as hard-and-fast indications:

**Table A: Starting a business in 2004**

<i>Indicator</i>	<i>Bulgaria</i>	<i>Romania</i>	<i>Turkey</i>	<i>OECD Average</i>
Number of procedures	10	5	8	6
Duration (days)	32	28	9	25
Cost (% of GNI per capita)	10.3	7.7	26.1	8.1
Min. Capital (% of GNI per capita)	123.8	0.0	0.0	47.0

Source: World Bank, Doing Business  
<http://rru.worldbank.org/DoingBusiness>

**Table B: Closing a business in 2003**

<i>Indicator</i>	<i>Bulgaria</i>	<i>Romania</i>	<i>Turkey</i>	<i>OECD Average</i>
Actual time (in years)	3.8	3.2	1.8	1.8
Actual cost (% of estate)	18	8	8	7
Goals of Insolvency Index <sup>a</sup>	48	39	51	77
Court Powers Index <sup>b</sup>	67	33	67	36

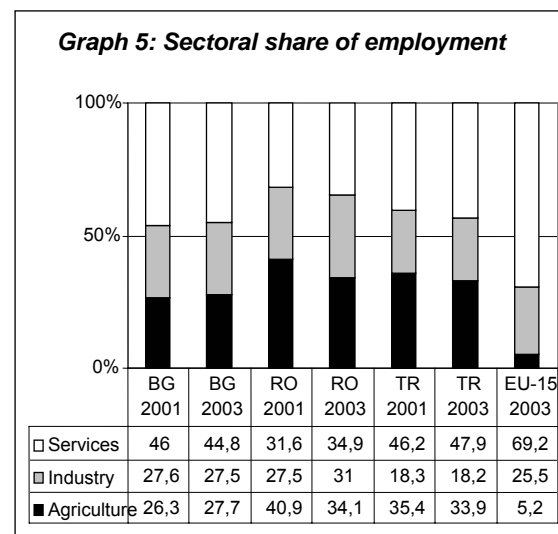
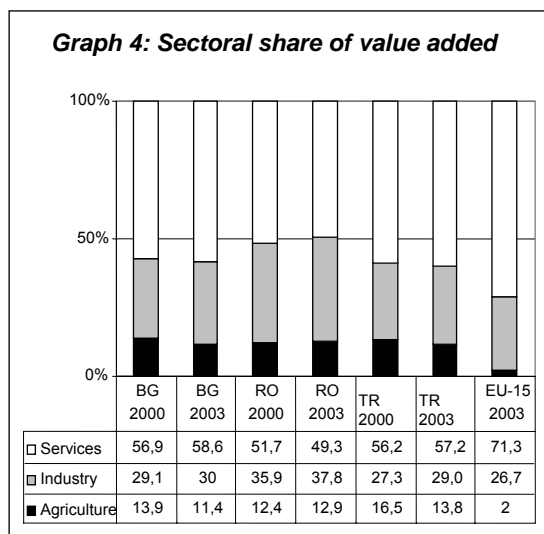
Source: World Bank, Doing Business  
<http://rru.worldbank.org/DoingBusiness>

<sup>a</sup> This measure documents the success in reaching the three goals of insolvency, as stated in Hart (1999). It is calculated as the simple average of the cost of insolvency (rescaled from 0 to 100, where higher scores indicate less cost), time of insolvency (rescaled from 0 to 100, where higher scores indicate less time), the observance of absolute priority of claims, and the efficient outcome achieved. The total Goals-of-Insolvency Index ranges from 0 to 100: a score 100 on the index means perfect efficiency, a 0 means that the insolvency system does not function at all.

<sup>b</sup> This measure documents the degree to which the court drives insolvency proceedings. It is an average of three indicators: whether the court appoints and replaces the insolvency administrator with no restrictions imposed by law, whether the reports of the administrator are accessible only to the court and not creditors, and whether the court decides on the adoption of the rehabilitation plan. The index is scaled from 0 to 100, where higher values indicate more court involvement in the insolvency process.

#### IV. Product markets

One particular feature of the **sectoral composition** of the candidate countries' economies is a relatively large agricultural sector, which in 2003 accounted for 11.4% of gross value added in Bulgaria, for 12.9% in Romania and for 13.8% in Turkey (compared with the EU average of 2.0%). Employment in the agricultural sector in 2003 represented 34.1% of total employment in Romania, 27.7% in Bulgaria and 33.9% in Turkey. The share of services is also much smaller than in the present EU countries. Modernising the agricultural sector and providing adequate employment for those leaving the sector will be one of the key policy challenges in the medium term in all three candidate countries.



Source: Eurostat, State Institute of Statistics of Turkey.

#### Privatisation

The private-sector share of GDP in 2002 was 74.3% in Bulgaria, 66.8% in Romania and above 80% in Turkey. Privatisation and restructuring are crucial to increasing competition in product markets.

Good progress has been made in privatising public assets in **Bulgaria** (see Table 7). A large proportion of the formerly state-owned enterprises and farm assets are now in private hands and corporate governance of these enterprises has improved significantly. Some major companies still need to be sold to complete the privatisation programme and the pace of the privatisation process should be stepped up. A total of 254 privatisation deals were sealed in 2003, bringing the percentage of privatised assets that were state-owned in 1995 (excluding infrastructure) to 83.1%.

In **Romania**, the faster pace at which large state-owned enterprises have been sold must be complemented by restructuring or closing down loss-making enterprises. Under the new privatisation law, the Authority for the Realisation of State Assets (AVAS)<sup>3</sup> has been established as a privatisation agency. The active portfolio of larger state-owned companies under AVAS, which is responsible for monitoring and improving the financial performance of state-owned companies prior to privatisation, was reduced at a rapid rate in 2003, leaving approximately 100 enterprises still to be

<sup>3</sup> Up to April 2004 the Authority for Privatisation and Administration of State Assets (APAPS).

sold or liquidated. Following intervention by the Ministry of Industry and Trade and the Ministry of Finance, a considerable number of enterprises, in particular in energy, mining, transport and defence, remain under state ownership. Energy utilities represent around 70% of the total share capital held by the State. An acceleration in the modest pace of privatisation in this sector to date is important. Preparations for planned sales have moved forward slower than originally envisaged. The privatisation of the first two electricity distribution companies was launched in January 2003 and is expected to be concluded in June 2004. A readiness to increase energy prices will be an important factor in the successful completion of these privatisations. For most loss-making industrial companies, the prospects of successful privatisation are often bleak and, in some cases, even a substantial restructuring would not make the companies viable. More than 25% of the assets of large-scale enterprises are in private hands or in the process of being privatised, but major issues linked to corporate governance are still unresolved.

In **Turkey** the role of the State in a number of sectors, while declining, is still important. In 2003 19 of the 39 state-owned enterprises were covered by the ongoing privatisation programme. Since 1985, 169 companies have been privatised. Nevertheless, the privatisation process in Turkey lags behind. Overall, the limited progress in privatisation also seems to reflect insufficient political support and weak interest on the part of investors. Some of the state-owned enterprises are very difficult to privatise, given their notorious lack of investments and overstaffing. State enterprises have a significant position in banking, telecommunication and energy. To some extent, there is also state involvement in the food, mining and steel sector.

In all three countries, information on the results of the audit of past privatisation projects and follow-up measures is not widely available. The same goes for the use of future privatisation receipts.

**Table 7: Privatisation receipts (as % of GDP)**

	1996	1997	1998	1999	2000	2001	2002	2003
<b>Bulgaria</b>	0.8	3.1	1.6	2.1	1.3	2.2	:	:
<b>Romania</b>	1	2.4	1.8	3.2	0.6	0.7	0.1	:
<b>Turkey</b>	0.2	0.2	0.6	0.02	1.8	0.1	0.2	0.1*

Source: EBRD Transition Report 2003, PEP 2003, own calculations, Turkish privatisation administration.

Note : \* The Turkish authorities expect government revenues from privatisation of 1.6 percent in 2004.

#### *Framework conditions for network industries*

- **Telecommunications.** In **Bulgaria** substantial progress has been achieved in the commercialisation and regulation of the telecommunications sector. A new telecoms law has been adopted in 2003. There is full separation of telecommunications from postal services, and cross-subsidisation has been reduced. Liberalisation has taken place in the mobile segment and in value-added services. The fixed-line monopoly expired in 2002, although the regulatory framework was not yet fully in place and the privatised telecoms company will undergo restructuring. The modernisation of the fixed telephone network is making only slow progress. In **Romania** telecommunications are fully detached from postal services, and reductions have been made in the extent of cross-subsidisation. Some liberalisation has taken place in the mobile segment and in value-added services. In **Turkey** an independent telecommunications regulator was set up in 2000. The remaining monopolies of the telecoms operator Turk Telekom (terrestrial infrastructure and fixed-line services) expired in 2003. The telecoms markets is to be fully liberalised in 2004.

- **Energy and electricity.** In **Bulgaria** efficiency is still low for the energy sector, but important steps have already been taken to introduce competition and attract private investment and some of these are enshrined in the new Energy Law adopted in 2003. The law provides for full-scale restructuring of the industry, including vertical unbundling through account separation and the setting-up of a regulator. Some tariff reform and improvements in revenue collection have been achieved, and there is some private-sector involvement. In **Romania** the functioning of the energy sector continues to present a major problem. Complex issues such as enterprises' large stock of arrears, the pricing system and the valuation of past environmental liabilities are hampering privatisation. While some progress has been made, e.g. a law providing for full-scale restructuring of the industry and covering vertical unbundling through account separation and the setting-up of a regulator, as well as considerable tariff reform and some improvements in revenue collection, including from large industrial customers following the government's threat to cut off the major non-payers, there are major outstanding difficulties, especially as regards the scale of arrears and the still mounting payment arrears for household heating. Moreover, the thermal generating plants, which produce about 60% of domestic electricity, are ageing and in critical need of rehabilitation and investment to meet EU environmental requirements. Despite some recent improvements in its financial performance, the Romanian state-owned power company, which supplies more than half of the country's electricity production, made losses as a result of increasing input costs, delayed price adjustments and low bill-collection rates, and the risk remains that the government will need to assume part of the company's debt in order to avoid default. The highly complex pricing system does not facilitate improvements in financial discipline, but new improved pricing arrangements will be implemented from 2005. The **Turkish** energy sector is characterised by a strong public sector presence, with many state enterprises holding monopoly positions. A regulatory authority was established in 2001. In March 2004 the government adopted a new strategy envisaging the full privatisation of energy generation and distribution by 2006.
- **Railways.** In **Bulgaria** new laws have been passed that restructure the railways and introduce a commercial approach. Although the state monopoly of rail transport ended in principle, this has not led to actual competition. Some divestment of ancillary businesses has taken place. Budgetary compensation is available to some extent for passenger services. Business plans have been designed with clear investment and rehabilitation targets. However, funding is unsecured. Institutional separation of the railway infrastructure from railway services has been carried out, but further restructuring is needed to reduce subsidies on operations and introduce actual competition. Two requests from private operators were received last year, and one licence for rail cargo has been awarded recently. In **Romania** two new laws have been passed that restructure the railways and introduce a commercial approach. Freight and passenger services have been separated and marketing groups have been grafted onto traditional structures. Some divestment of ancillary businesses has taken place. Although business plans have been designed with clear investment and rehabilitation targets, funding is unsecured and state subsidies are still large. Continued accumulation of arrears to general government remains a problem. In **Turkey** reforms in the railways sector are lagging in terms of moving away from a production-oriented sector to a sector responding to market needs. The railways are among the public-sector enterprises with the highest subsidies. The sector will have to be reduced markedly in size, services improved, and prices increased. The World Bank urges, among other things, a complete recasting of the books of the Turkish railways company to show the results of each activity

separately and clearly, an end to cross subsidies and the elimination of excess labour.

#### *State aid*

The European Community's policy centres around the principle of reducing and redirecting state- towards clearly identified market failures or horizontal objectives. In **Bulgaria**, the burden of state aid is being gradually reduced. In the mining, district heating and railway sectors, some companies still receive generous state aid. Further restructuring is needed to reduce state operating aid and to introduce actual competition. Hidden subsidies in the form of tax and social security arrears decreased from 2.3 % of GDP in 2001 to 1.3 % in 2002, and sectoral and ad-hoc state aid amounted to 3.7 % of GDP in 2001 (compared with 0.8% for the former EU-15). In **Romania** the share of state aid as percentage of GDP stands at a still relatively high 1.9%. The reduction of state interference in the economy has continued. The situation is aggravated by the state of arrears as set out above. Romanian legislation is broadly in line with EC law, albeit not fully implemented. In **Turkey** state-owned enterprises still play an important role in key sectors, such as banking and telecommunications and in basic industries such as mining and steel processing. Many of those enterprises are dependent on state aid. Precise figures are not available but, in view of budgetary pressures, the size of those transfers has declined substantially (and is estimated to be in the range of 1-2% of GDP).

#### *Competition policy*

All three countries have a national independent competition authority but, in each case, its capacities and powers should be strengthened. Institutions are in place, but there is more progress to be made, notably as regards the consistent implementation of competition rules.

The European Commission's overall assessment regarding anti-trust in **Bulgaria** is positive. The national independent Commission for the Protection of Competition has continued to develop its anti-trust enforcement record, although it could be strengthened further. The law on the protection of competition now contains the main principles of Community anti-trust rules as regards restrictive agreements, abuse of dominant position and merger control. Implementing legislation in the form of two block exemptions for R&D agreements and specialisation agreements were also adopted in June 2003. Nevertheless, further fine-tuning of the rules appears to be necessary in order to ensure more efficient enforcement practice.

As regards **Romania**, despite satisfactory anti-trust performance and the adoption of sector-specific regulations and guidelines and amendments to the Competition Law, more efforts are needed to ensure fair competition for both local and foreign companies in light of concerns expressed by leading foreign investors. More uniform enforcement of existing legislation is needed, with special emphasis on strict and equal enforcement of tax collection. The Competition Council has continued to develop its anti-trust enforcement record over the reporting period, although further efforts should be made to implement sanctions that carry a greater deterrent effect and to place more emphasis on preventing serious distortions of competition.

New implementing legislation and some modernised rules reflecting the principles of the *acquis* have been adopted by **Turkey**, but rules are not yet effectively enforced with regard to public enterprises, state monopolies and companies with special rights, despite the existence of an independent competition authority. New implementing legislation and modernised rules on vertical restraints have been

adopted. Large conglomerates appear to have an important hold in parts of the Turkish economy. In this respect, the Competition Authority should be strengthened.

While the procurement rules in the three countries generally meet the requirements of the *acquis*, an effective framework for their implementation is lagging behind. Improvement in this area is needed, especially in Romania and Turkey, where there have been temporary exemptions for specific cases in the form of emergency decrees.

### *Price systems*

The candidate countries made considerable progress with the liberalisation of prices. In particular, virtually all the prices that were to be liberalised in full have actually been liberalised. The emphasis has now shifted towards the implementation of a proper approach towards regulated prices (network industries, monopolies, etc). Much progress has been made here too, but some tasks still lie ahead, both in terms of the adjustment of prices and the establishment of appropriate regulatory and supervisory structures. Prices liberalisation in **Bulgaria** has progressed, in particular in energy and telecoms, but is not yet complete. As regards tobacco, water supply, waste disposal, electricity, district heating, medicines, certain hospital and medical services, passenger rail transport, postal services as well as fixed phone subscriptions and calls, prices are administered or regulated. In July 2003 there were average increases of 15% for electricity prices, 10% for district heating prices and 14% for local phone calls. State procurement at non-market prices has now been largely phased out. In **Romania** most product prices have been liberalised. In 2003 the prices of 18 goods and services remained subject to special regulatory provisions, mainly because of the existence of natural or legal monopolies.<sup>4</sup> Regulated prices are linked to CPI inflation, the exchange rate of the US dollar or a combination of the two. In **Turkey** the share of administered prices in the CPI basket has declined steadily. Overall, in 2003 23%, 21%, and 20.7% of the consumer price index (CPI) basket were still accounted for by administered prices in Bulgaria Romania and Turkey respectively.

### *Export structure and foreign direct investment*

Trade openness in the candidate countries is generally high. Trade with the EU in general represents more than half of their trade and has been expanding strongly in Bulgaria and Romania. In Turkey it has remained fairly stable. For Turkey, since the conclusion of the customs union in 1996, integration in terms of export and import shares with the EU has remained limited (in some areas there are technical barriers to trade and shortcomings with regard to controls of origin). The export structure of Bulgaria and Romania differs somewhat from that in the eight new Eastern European Member States. Whilst many of the new Member States have already over time witnessed a significant increase in the shares of capital-intensive, R&D-intensive and skill-intensive exports, such tendencies are only recently discernible in Romania and Bulgaria. The picture for Turkey is slightly better, although the changes in the composition of exports more closely follow those for Bulgaria and Romania than those for the new Member States. However, in Turkey a slight adjustment towards the EU-import structure was achieved in R&D-intensive and skill-intensive exports. The dominance of labour-intensive products was also somewhat reduced.

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<sup>4</sup> Including prices for heating, end-user prices for natural gas and prices for electricity, medicines, city transport, passenger railway transport, basic telephone services, postal services, water and sewerage.

Reaching or sustaining a high level of foreign direct investment holds the key to an accelerated catching-up process vis-à-vis the EU countries. In 2003 net foreign direct investment (FDI) to **Bulgaria** reached a record level of 6.7% of GDP. Net FDI has been important not only in quantitative terms, but also for the restructuring of the economy by bringing in technological know-how. **Romania** has yet to see a strong increase in FDI, even if FDI flows increased by 17.4% year-on-year in 2003. Since 1999 the annual net inflow has remained around 2.7% of GDP. This is a low figure compared with more advanced transition economies. In **Turkey** FDI has so far remained very low. In view of the still high degree of economic uncertainty and cumbersome procedures, the annual inflow of FDI has continued to remain well below 1% of GDP. In 2002 and 2003 FDI in Turkey amounted to 0.3% and 0.2% of GDP, respectively. In 2003 a new Foreign Direct Investment Law was passed with the main aim of no longer subjecting foreign direct investment in Turkey to prior approval. This lack of foreign investment hinders the modernisation of the Turkish capital stock, hampers access to international export markets and thus is an important brake on realising Turkey's economic potential.

**Table 8: Foreign direct investment (inflows in % of GDP)**

	1997	1998	1999	2000	2001	2002	2003 <sup>p</sup>
<b>Bulgaria</b>	4.1	4.2	6.1	8.1	5.0	5.6	6.7
<b>Romania</b>	-	5.4	3.1	2.6	2.6	2.3	2.7
<b>Turkey</b>	0.4	0.5	0.4	0.9	2.3	0.3	0.2

*Source:* Bulgaria, Romania: Eurostat (balance of payments data); Turkey: Prime Ministry of Turkey – Undersecretariat of Treasury.

*Note:* p = provisional figures.

## V. Financial sector reforms

In comparison with the former EU-15 and most new Member States, indicators of financial development in the candidate countries, including in the banking sector, are low. Comparing the banking sector in the candidate countries (measured by domestic credit in proportion of GDP) with the size of the financial market (using stock market capitalisation as a proportion of GDP as a proxy) reveals that in all three countries the financial system is dominated by banks, while the financial market is underdeveloped. In Bulgaria and Romania foreign-owned banks account for the majority of banking assets. However, financial market development in Turkey, albeit low, significantly exceeds that of Bulgaria and Romania and even many new Member States. In 2003 total banking assets in Bulgaria, Romania and Turkey amounted to 45.4%, 28.4% and 69% of GDP respectively. Given the importance of the banking sector, further reinforcement of its efficiency is of utmost importance.

The financial sector in Bulgaria and in Turkey is recovering from outright banking crises (1997 in Bulgaria, 2000/01 in Turkey), with a number of banks facing bankruptcy and eventually being closed down or sold. Romania faced substantial systemic risks following the liquidation of the largest state-owned bank in 2000 but managed to avoid an outright crisis thanks to substantial government intervention. In Turkey the health of the sector was undermined by successive governments' use of the state banks for political purposes, while connected lending affected private banks. The difficult macroeconomic environment overall (fiscal dominance, volatile growth, high and volatile inflation) contributed to the weaknesses.

Despite these considerable achievements in the candidate countries in reforming their banking sectors and in developing other financial sectors, a number of issues still need to be addressed if the challenges entailed by the EU integration process as well as by the countries' convergence processes are to be fully met:

## *Credit growth*

Whilst domestic credit in relation to GDP in the three candidate countries is lower than in all EU-25 Member States, its rapid expansion will need to be carefully monitored, also with regard to preserving overall macroeconomic stability. While it has started from very low levels, growth of credit to the private sector has been very strong in Bulgaria and Romania (Table 9). However, most indicators assessing qualitative aspects, such as the share of non-performing loans to total loans, maturity of deposits and loans, or the share of foreign-currency-denominated deposits, to total deposits suggest an improvement compared with the periods of crisis. In **Bulgaria** credit to the private sector grew at an annual rate (in real terms) of around 35% in 2003 and expanded at an even faster rate in the first few months of 2004 (it is projected to decline again by the end of 2004). In **Romania** it grew by around 50% (in real terms) in 2003 and is projected to decelerate to around 25% in 2004. In **Turkey** there is evidence that consumer lending and corporate lending are now rising rapidly, albeit from very low levels.

**Table 9: Credit growth (annual percentage change in real terms, 1998-2003) and credit-to-GDP ratios**

	1998	1999	2000	2001	2002	2003	Credit / GDP (2003)
<b>Bulgaria</b>	-13.2	2.4	-1.5	21.5	34.5	35.5	33%
<b>Romania</b>	4.2	-22.9	-16.4	8.9	16.2	29.3	18%
<b>Turkey*</b>	5.7	14.4	3.4	-2.9	-15.5	11.7	43%

**Source and notes:** IFS (IMF). Total credit includes claims on private sector, on other financial institutions, on non-banking financial institutions, on central and local government, and on non-public enterprises. \* figures until November 2003. Credit growth represents the year-on-year real growth rate as of November 2003, while credit to GDP ratio represents the total stock of credit as of November 2003 divided by 2003 GDP figure.

## *Privatisation and restructuring*

Bulgaria and Romania responded to the banking crisis by privatising state-owned banks and selling them to fit and proper foreign investors, mainly euro area banks. In Turkey the authorities reacted by setting in motion a consolidation process leading to a substantial reduction in the number of banks, while state-owned banks have been restructured and re-capitalised but – until now – not privatised. In **Bulgaria** the privatisation of the banking sector is virtually completed but its consolidation has yet to take place. In **Romania** the process is less advanced, with private (majority foreign-owned) banks accounting for only around 60% of banking-sector assets and with two large banks holding nearly one third of the market still to be privatised. In particular, the successful further privatisation and restructuring of the largest bank in Romania will be important for increasing competition and the dynamics of financial markets. In **Turkey** the banking sector has undergone significant restructuring, but private banks account for only 57% of total assets, with foreign banks holding less than 3% of total assets.

## *Supervision and regulation*

All three countries saw a considerable strengthening of the supervisory and regulatory framework. However, weaknesses in some supervisory functions remain which the authorities are currently working to address. In **Bulgaria** the independence of the State Supervisory Commission for Securities appears to be upheld in practice. In **Romania**, while banking supervision is largely in compliance with nearly all the Basle Core Principles, supervision over the non-banking sector (capital markets and the insurance sector) is still in a developmental phase. The regulatory environment in

securities' and insurance supervision needs to be further developed, including by strengthening internal controls, reinsurance, and prudential rules on assets and liabilities. In **Turkey** the regulatory framework still needs to be further strengthened. The independence of the Banking Regulation and Surveillance Agency (BRSA) has to be maintained and a sufficient resource endowment guaranteed. Whilst by law the BRSA is independent, its independence and functionality have been subject to various challenges. In particular, court cases in which the BRSA's intervention in insolvent banks has been contested could undermine its effectiveness. Furthermore, issues that have to be dealt with are: resolution of the bad assets of the Savings and Deposits Insurance Fund (SDIF), and further alignment of the banking regulations with EU standards..

Rising real incomes will lead to increased demand for financial services, such as loans, mortgages, insurance and investment products. Capital markets have so far played a limited role as a source of finance for companies in all three countries. In all of them access to non-bank financing is still limited, as alternative forms of financing such as venture capital or micro-lending are not widely available.

## VI. The quality and sustainability of public finances

Table 10 shows that government finances have improved in recent years both in Romania and in Bulgaria. Economic growth remained robust in both countries during the international economic downturn, and debt ratios are now lower than at the start of the century. The budgetary situation in Turkey has deteriorated significantly owing to the severe economic crisis in 2001. Since then, the fiscal position of Turkey has improved slowly (as the public sector primary surplus amounted to more than 6% of GDP in 2003), and the country now faces the challenge of bringing net borrowing back on a more sustainable path so to render fiscal policy sustainable in the medium term.

**Table 10. Fiscal developments (percentage of GDP)**

	Government balance				Gross debt ratio			
	2000	2001	2002	2003	2000	2001	2002	2003
<b>Bulgaria</b>	-0.5	0.2	-0.8	-0.1	73.6	66.2	53.2	46.2
<b>Romania</b>	-4.4	-3.5	-2.0	-2.0	23.9	23.2	23.3	21.8
<b>Turkey</b>	-6.1	-29.8	-12.6	-8.8	57.4	105.2	94.3	87.4
<b>New MS</b>	-3.2	-4.1	-4.9	-5.7	36.4	38.5	39.4	42.2
<b>Former EU-15</b>	1.0	-1.0	-2.0	-2.6	64.0	63.2	62.5	64.0
<b>Euro area</b>	0.1	-1.6	-2.3	-2.7	70.4	69.4	69.2	70.4

*Source:* Commission services, Eurostat.

*Note:* ESA95 data.

### *Bulgaria*

The fiscal position in Bulgaria has been kept close to balance over the last years, leading to a high primary surplus and considerable progress in reducing both public and external debt. The general government deficit has been at or below 1% of GDP in the last five years – a performance which is better than in all the new Member States and also better than in most of the former EU-15. According to present estimates, the general government budget showed a small surplus in 2003. Fiscal policy is the main instrument for stabilising the economy. The strong growth in domestic demand in recent years has led to a widening current-account deficit, and so a tight fiscal policy is warranted to contain the external imbalance. In addition, declining debt and interest rates led to a significant reduction in government interest

expenditures (as a percentage of GDP). Government debt declined rapidly from over 80% of GDP at the start of 2000 to below 50% by end-2003, as nominal GDP increased at a constant rapid rate and, more recently, the dollar has weakened against the Bulgarian lev.

### *Romania*

Over the last few years, the Romanian government has generally implemented a credible medium-term path of fiscal consolidation, with the budget deficit declining from 4.4% of GDP in 2000 to 2.0% in 2002. The authorities no longer aim to reduce expenditures as a percentage of GDP but, on the contrary, plan to increase them temporarily during the period 2004-06. Much of the higher expenditure is aimed at transfers and subsidies in order to finance one-off measures related to structural reform, such as compensation packages. The revenue-to-GDP ratio is still projected to fall, but not as sharply as described in the 2002 PEP. The fiscal programming presented by the authorities in the most recent PEP projects an increasing level of government deficit from 2004 onwards, and a significant worsening of the primary balance as well as a deteriorating cyclically-adjusted balance. The recent budgetary rectifications following the IMF precautionary arrangement is expected to limit the budget deficit and improve the primary balance. Given that a relaxation of the budget stance should be avoided, these rectifications are welcome, since the current account deficit (5.8% of GDP in 2003) needs to be contained to ensure sustainability and further disinflation remains a challenge. The quasi-fiscal deficit should be reduced.

### *Turkey*

As Table 10 illustrates, Turkey still has some way to go with its fiscal adjustment efforts. Its public finances are confronted with the results of a fiscal policy geared to the short term, with a general government deficit of close to 9% of GDP and a gross debt ratio of around 87% of GDP in 2003. The costs of the banking crisis in 2000 and 2001 still impose a considerable burden on Turkey's public finances and severely restrict any fiscal policy leeway. In 2003 the costs of debt servicing amounted to some 40% of public expenditure or nearly 20% of GDP. It will be crucial to reaffirm and maintain the authorities' commitment to the primary surplus target of 6.5% of GDP and to render fiscal policy sustainable in the medium term. According to the 2003 PEP the main objectives of Turkish fiscal policy are to contribute to the establishment of a sustainable growth environment, to support the efforts towards disinflation and to achieve a substantial level of primary budget surplus each year so as to ensure the sustainability of the debt stock. In 2002 the primary surplus target was missed by some 2.5% of GDP, largely on account of additional spending related to early elections. In 2003 the target was missed by only 0.5% of GDP. To safeguard the primary surplus target, several measures have recently been taken by the Turkish authorities. For instance, military spending, which is running below budget appropriations, has been reduced, some investment projects have been cancelled, and excise duties on alcohol and tobacco have been raised. The year 2004 will be a challenging fiscal year. Turkey has asked for technical assistance from the World Bank and from the IMF to help guide the budget process, beginning with the 2005 budget.

### **Quality of public finances**

The expenditure level of the candidate countries is below the level in all the new and other Member States. The overall level of government revenue as a percentage of GDP in **Romania** and **Turkey** is sharply below that of all the new and other Member States. (Table 11)

**Table 11: Size of general government spending (% of GDP)**

	Revenue		Expenditure	
	2000	2003	2000	2003
<b>Romania*</b>	31.2	30.4	35.3	33.1
<b>Bulgaria</b>	38.7	36.8	39.7	36.8
<b>Turkey*</b>	27.1	27.9	37.4	38.9
<b>New MS</b>	n.a.	41.0	n.a.	46.0
<b>Former EU-15</b>	47.0	45.7	47.7	48.4
<b>Euro area</b>	47.6	46.2	48.9	49.0

*Sources:* New Member States, former EU-15 and euro area: European Commission; Bulgaria, Romania: IMF (2003, 2004); Turkey: Prime Ministry – Undersecretariat of Treasury.

*Note:* General government is defined as comprising central government, state government, local government and social security funds. \* Romania indicates the figures for central government and social security for revenues at 33.4% of GDP in 2000 and 29.8% of GDP in 2003, and for expenditures at 38.1% of GDP in 2000 and 31.8% in 2003.

\*\* Central government.

### *Government revenue*

The level of current revenue in the candidate countries is significantly lower than in the existing Member States, as is the tax-base, including in most new Member States, which poses a problem given the existing scale of public expenditure. The broadening of the tax base, and a significant improvement in tax administration and the effectiveness of tax collection are priority tasks for all three countries.

**Table 12: Current budget revenues (% of GDP)**

	Direct tax		Indirect tax		Non-tax revenue	
	2000	2003	2000	2003	2000	2003
<b>Romania</b>	17.7	16.2	11.7	12.2	1.9	2.0
<b>Bulgaria</b>	15.3	13.6	14.6	14.9	8.8	7.9
<b>Turkey*</b>	8.6	7.8	12.5	15.7	5.4	3.9
<b>Former EU-15</b>	28.5	27.4	14.0	13.6	3.4	3.4
<b>Euro area</b>	29.2	28.0	13.8	13.3	3.4	3.4

*Sources:* IMF (2003, 2004), European Commission and Prime Ministry of Turkey – Undersecretariat of Treasury.

*Note:* \* Central government.

All three candidate countries show a tendency to shift the tax burden from direct to indirect taxation (i.e. from income to consumption). Direct tax revenue, already well below European average in 2000, has diminished further in the last few years. Revenue from indirect taxes has risen in all three countries and is now broadly comparable to the former EU-15 ratio. No further increases in VAT rates are planned for the near future in Romania and Turkey, whereas Bulgaria will continue to shift the tax burden towards indirect taxation. Bulgaria will lower company taxation in 2004 and 2005.

In **Romania** a large taxpayers unit was set up in 2003 and the authorities have unified the collection, audit and enforcement of social security contributions. These steps are estimated to improve tax collections by some 1.5-1.9% of GDP by 2006. **Bulgaria** too intends to improve tax collection and reduce tax evasion. The efforts of the authorities to reinforce tax administration, including the establishment of the National Revenue Agency, are therefore warmly welcomed. **Turkey's** tax base needs to be broadened, as the marginal tax rates are prohibitively high while tax evasion is rife, and depends too much on indirect taxation. As part of the 7<sup>th</sup> IMF review, in order to compensate on a lasting basis for the larger-than-budgeted increases in pensions and social security costs, Turkey is committed to increase excise taxes, and to a comprehensive structural reform programme to control

expenditures, to broaden the tax base, and to shrink the unregistered economy over the medium term. Turkey is also planning to upgrade revenue collection through tax administration reform.

#### *Government expenditure*

In **Romania** and **Bulgaria** (and most of the new Member States) public investment is well above the European average. In **Turkey** the availability of financial resources for the government may be an effective constraint as the level of public investment is well below the European average.

**Table 13: Government consumption and investment (% of GDP)**

	Total public investment		Government consumption	
	2000	2003	2000	2003
<b>Romania</b>	3.0	3.8	6.2	6.9
<b>Bulgaria</b>	4.2	3.5	9.7	10.0*
<b>Turkey**</b>	2.0	2.0	10.9	10.7
<b>New MS</b>	n.a.	3.0	16.6	17.9
<b>Former EU-15</b>	2.3	2.4	20.0	21.0
<b>Euro area</b>	2.5	2.6	19.9	20.6

*Sources:* European Commission; Bulgaria and Romania: IMF (2003, 2004); Turkey: Prime Ministry – Undersecretariat of Treasury.

*Notes:* \* 4th quarter 2002 to 3rd quarter 2003. \*\* Central government.

On the investment side, the need for public investment expenditure in all three countries will remain high in the foreseeable future in the light of their development and convergence. Also, the state of infrastructure is often ill-suited to current needs. In order to accelerate the catching-up process, the candidate countries should devote particular attention to public spending on human capital. Investment in human capital (health care, education) is assessed in specific chapters of this report. The *level* of government consumption as measured by the consumption ratio as a percentage of GDP in all three countries is below the average for the new and other Member States.

**Romania** plans to increase investment further to 4.2% of GDP in 2006 in order to speed up structural reforms and to sustain investment in areas such as education, infrastructure and environment. However, currently much of the higher expenditure is aimed at transfers linked to business restructuring (i.e. compensation packages for laid-off workers). Given this policy and the need for overall spending restraint, little emphasis seems to be placed to date on establishing a longer-term strategy to improve the quality of public expenditure (although the Romanian authorities state that they are now following a consolidation strategy for the public finances based on a coherent set of priorities, including consideration of future challenges such as EU accession). Expenditure on wages and salaries has decreased from 5.5% of GDP in 2000 to 5% of GDP in 2003. In **Bulgaria** defence and security expenditures are high compared with other countries, at around 4% of GDP in 2003. Over the medium term, it is expected to remain at about 3.5% of GDP. However, the government has taken different measures to curtail expenditures, which should allow the ratio of defence expenditures to fall by 0.6% of GDP by 2006. For the time being, interest payments remain by far the largest expenditure category for **Turkey's** central government. Overall defence expenditures in 2003 are estimated to amount above 4% of GDP. Public investment is stable at below 2% thanks to pressures deriving from the tight fiscal situation. The still relatively large amount spent on defence and security is noteworthy, although it is on a slowly declining trend. Expenditure on wages and salaries has increased from 7.9% of GDP in 2000 to 8.4% in 2003

(expenditure for social security institutions from 2.6% to 4.6%). The March 2004 agreement with the IMF envisages a further reduction in social security expenditures and a review of other public expenditures.

As regards the fiscal relations between the State and sub-state levels, the size of sub-national government in **Bulgaria** and **Romania** is modest compared with former EU-15. In Bulgaria, the share is around 15-20%. In Romania, local government expenditure (including public institutions under local authority control, partially- or fully-financed by own resources) has increased from 10.6% of total government spending in 2000 to 19.2% in 2003 (and local budget procedures are subject to new legislation effective from 2004 designed to improve their stability and efficiency). In most EU countries, the share of local government is above 25%. This smaller sub-national government is a feature shared with most new Member States and may at least partly reflect the fact that the countries are economies in transition.

### Sustainability of public finances: pension and health care reforms

As in the existing Member States, large changes in the size and composition of the population will take place in the three candidate countries:

- For the period 2000-50, Table 14 shows that **Bulgaria** and **Romania** are expected to encounter a sharp decrease in their working-age population (-46.4% and -31.1% respectively). Table 15 illustrates that this will lead to sharp increases in the old-age dependency ratio (elderly as a percentage of the working-age population), which will follow a trend broadly similar to that in the new and the other Member States. The economic dependency ratio, which expresses the actual number of inactive persons as a percentage of the number of persons employed, i.e. the balance between economically active persons and economically inactive persons who must be supported in Bulgaria and Romania in 2001 is currently similar to that in a number of Member States<sup>5</sup>.
- **Turkey's** working-age population is projected to increase from now to 2050 (by 47.1%). However, while the demographic structure is still favourable, the upward dynamics in the economic dependency ratios are strong indeed, suggesting that in, say, 20 years' time Turkey may face similar relative demographic pressures as the new and the other Member States.

**Table 14: Working-age population aged 15-64**

	Millions		% of total population		Change 2000-50	
	2000	2050	2000	2050	Absolute	in %
<b>Bulgaria</b>	5.517	2.955	68.1	56.2	-2.562	-46.4
<b>Romania</b>	15.377	10.601	68.4	58.7	-4.776	-31.1
<b>Turkey</b>	42.877	63.052	62.8	64.5	20.175	47.1
<b>New MS</b>	51.261	34.852	68.6	56.7	-16.409	-32.0
<b>Former EU-15</b>	252.446	209.847	66.9	56.8	-42.599	-16.9

*Source:* Population Division of the Department of Economic and Social Affairs of the UN Secretariat – Population projections revision 2002.

<sup>5</sup> Compare: Economic Policy Committee 2001.

**Table 15: Old-age dependency ratio**  
(persons aged 65 or over as a percentage of persons aged 15-64)

	2000	2050	Change 2000/50	
			Absolute	%
<b>Bulgaria</b>	23.7	53.2	29.6	124.9
<b>Romania</b>	19.5	45.3	25.8	132.2
<b>Turkey</b>	8.7	28.3	19.6	224.6
<b>New MS</b>	18.8	50.9	32.1	170.4
<b>Former EU-15</b>	24.4	49.8	25.4	103.9

Source: UN Secretariat – Population projections revision 2002.

Higher participation rates, among men as well as among women and especially among older workers, and lower unemployment rates could help mitigate the challenges of ageing populations. Compared with the former EU-15 (72.2% in 2001) and the new Member States (66.5%), labour market participation is lower in the candidate countries. In **Bulgaria** the participation rate at 67.4% is slightly above the average in the new Member States. In **Romania** it fell sharply over the period 1991-2001 (from 70.8% in 1991 to 60.4% in 2001). **Turkey** shows a particularly low participation rate (49.8% in 2001) that has been declining steadily since 1990 (56.6%).

Table 16 gives the size of current public spending on public pensions (as far as information is available).

**Table 16: Public pension expenditures in 2000 – 2050**  
(% of GDP)

	2000	2030	2050
<b>Bulgaria</b>	9.7	--	--
<b>Romania</b>	6.3	7.8	8.2
<b>Turkey</b>	7.4*	--	--
<b>Former EU-15</b>	10.4	13.0	13.3

Source: Bulgaria and Turkey: 2003 PEPs. Romania: Ministry of Public Finance.

Note: \* 2003 figure; Turkey has done some internal simulation together with the World Bank in the context of the planned pension reform. Under these simulations the current deficit of the pension system, some 3 1/2 percent of GNP, would more than double over the next 50 years.

The statutory retirement ages in the candidate countries are low compared with the average in the EU (Table 17). It is several years lower than in most EU countries (it is close to 65 for men in most Member States). Almost no information is available on the role of funding within the publicly financed pensions systems in the candidate countries. The effective retirement age is an item that should be monitored in all three countries.

**Table 17: Main parameters of the pension system**

	Statutory retirement age in 2003		Benefit calculation base	Indexation rules (P=prices; W=wages)
	Men	Women		
<b>Bulgaria</b>	63	60	Earnings	P/W
<b>Romania</b>	62 yrs 4 mths	57 yrs 4 mths	Earnings	Inflation rate
<b>Turkey</b>	60 (only for new entrants)	58	Earnings	n.a.

Source: Bulgaria and Turkey: GVG (Gesellschaft für Versicherungswissenschaft und –gestaltung e.V.), "Study on the social protection systems in the 13 applicant countries", October 2002; Turkey: Commission services; Romania: Ministry of Public Finance.

The long-term sustainability of public finance in **Bulgaria** has been improved by reforms over the last years. In 1999 Bulgaria enacted a three-pillar pension system. The first pillar is generating deficits which are expected to remain until 2006. These are the result of ageing and a high dependency ratio (1:1 at present), large emigration, high unemployment, low contribution compliance before 2001, unreported incomes and employment, early retirement eligibility and the gradual diversion of contributions to the second pillar. Recently there has been a slight decrease in the dependency ratio and better level of contribution compliance, but a larger number of pensioners and an increase in the average pension benefit are also factors. The legal age for retirement will be extended by six months every year until it reaches 65 and 60 years old for men and women respectively in 2009. In 2003 contributions to the second pillar increased from 2 to 3 percentage points costing an additional 0.1% of GDP. Overall, reform measures seem to be still insufficient to address the demographic challenge.

In **Romania** the weak financial state of the public pension system represents an important risk in the light of demographic and labour market developments. The system has experienced a serious crisis as a result of a large increase in beneficiaries from 3.4 million in 1990 to 6.2 million in 2002. With 0.7 employees per pensioner in 2002 compared with 3.4 employees per pensioner in 1990, the challenges to financial sustainability are already severe<sup>6</sup>. A number of pension reforms have been introduced but some of them imply even higher costs. The legal age for retirement will within a period of 13 years gradually be extended to 65 and 60 years old for men and women respectively. For Romania, raising the employment rates and the effective retirement age are crucial in countering the consequences of ageing populations. Reforming the system in the direction of better financial sustainability is essential to ensure the sustainability of public finances, which at present is under threat.

In **Turkey** the retirement age is very low. The contribution period is very short, and contribution compliance is poor. The benefit formulae are generous and have perverse financial effects. Turkey has three different social security organisations, and this impedes the efficient functioning of the pension system.<sup>7</sup> Restoring the solvency of the three social security funds, which suffer from considerable non-

<sup>6</sup> See Romania's 2003 PEP (p. 113), based on the following figures. 1990: 8.156 thousand employed, 2.380 thousands pensioners. 2002: 4.373 thousand employed, 6.212 thousands pensioners. The deterioration occurred mainly in the first part of the period.

<sup>7</sup> For complete information and suggestions, see 'The 1998-1999 annual review – Turkey' of the OECD and its annexes.

compliance, is the first priority of the authorities. The arrears of those funds can date from five years back or more and the system records huge deficits. The authorities will introduce a new system to enforce payment by way of sanctions and only a limited amnesty. Turkey does not have a three-pillar pension system. Turkey has the good fortune that it will face the demographic upsurge only as regards the next generation. This should provide the extra time needed to launch another comprehensive reform of the existing schemes, notably by adapting the parameters in the first mandatory pillar, and to tackle the budgetary implications of ageing populations and thereby ensure long-term fiscal sustainability.

### Health care reforms

Health care spending in the candidate countries as a share of GDP, in line with convergence towards higher living standards, has been rising steadily over the last decade. Current expenditures reflect the lower development level compared with the EU (Table 18). It can be expected that owing to general increases in welfare, ageing, technical progress and product innovation, public health care expenditures will converge further on EU levels in the coming years, and for the candidate countries this may imply considerable budgetary pressures.

The Bulgarian and Romanian health care systems are characterized by over-capacity in some areas and by low efficiency. In Turkey the number of beds and physicians per inhabitant is low compared with the present Member States. In **Bulgaria** the aim of recent reforms was to tackle inefficiency, poor conditions and deteriorating trends in public health. According to the recent Commission report on "The social protection systems in the 13 applicant countries", progress on healthcare reform has been slow, the implementation of planned measures has been delayed, and the reform parameters have been frequently changed. Proposed amendments may lead to significant deviations from the original framework and the health reform strategy. In **Romania** the social health insurance fund has difficulties in achieving a balanced budget. More generally, the system can be considered as under-financed, and the infrastructure is in urgent need of modernisation. In **Turkey** the increasing deficits of the social security institutions have constantly been offset by transfers from the general budget, imposing a heavy burden on Turkey's fiscal policy. The health sector constitutes one of the priorities for the present government and is actually being restructured. In general, Turkey has to move towards international norms and standards in the health sector.

The candidate countries should be encouraged to take proper action to ensure financial sustainability. Containing future expenditure growth while providing effective coverage and modernizing the infrastructure or bringing it up to European standards will necessitate further coherent reform efforts.

**Table 18: Public health expenditures (as % of GDP)**

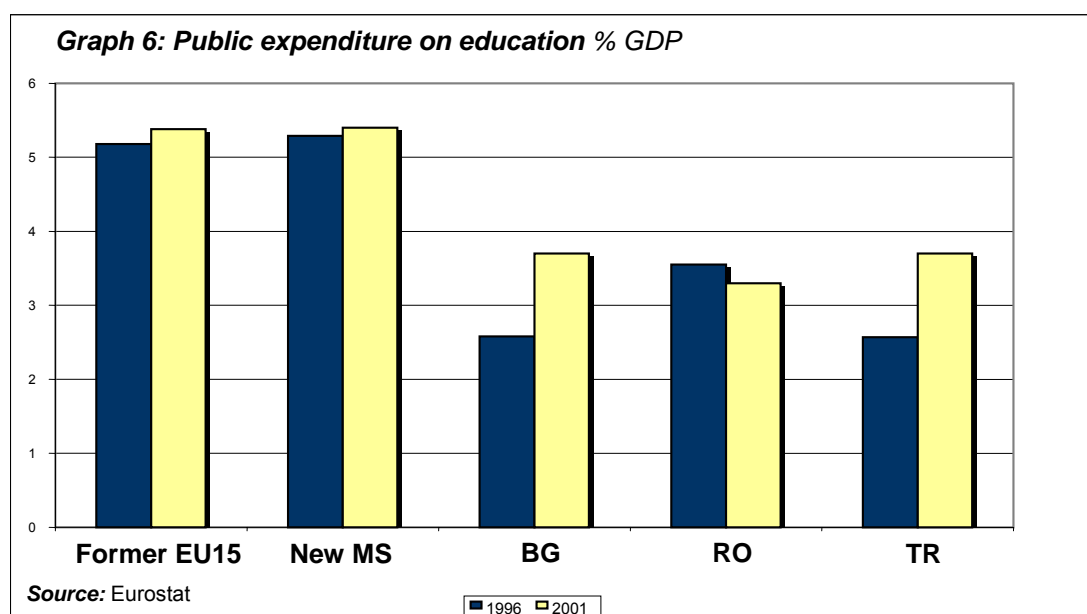
	1996	1997	1998	1999	2000	2001	2002	2003
<b>Bulgaria</b>	2.9	3.3	3.5	4.1	4.1	4.3	4.6	5
<b>Romania</b>	2.9	2.8	3.2	3.9	4.1			
<b>Turkey</b>	2.4	2.3	2.3	3.3	3.5	3.1	3.4	3.7
<b>Former EU-15</b>	6.1	5.9	5.9	6	6	6.2		

*Sources:* Bulgaria : National Health Strategy, 2001, Romania : Ministry of Public Finances, Turkey : SPO, Economic and Social Indicators 1950-2003, Developments in Social Sectors.

## VII. The knowledge-based economy

### *Education and training systems*

Graph 6 below shows that **public expenditure on education** is low in the three candidate countries. In 2001 Bulgaria spent 3.66% of GDP on education; Romania 3.28%<sup>8</sup>, and Turkey 3.65%. This compares with 5.15% in the former EU-15 and 5.33% in the new Member States. By level of education, they spend less in primary and secondary education than the former EU-15 and the new Member States. Bulgaria invests roughly 1.8% of GDP in primary and secondary education (41% of total expenditure on education). Romania invests the same proportion of GDP (62% of total expenditure) while Turkey allocates 2.4% of GDP (69% of the total). This compares with 3.4% of GDP in the former EU-15 (70% of the total) and 3.6% in the new Member States. No information is available on private funding.



As regards **participation in the education system**, the EPC assessed the retention capacity (school life expectancy) and the number of early leavers. In Bulgaria and Romania school life expectancy is lower than in the EU and the new Member States. In Bulgaria and in Romania pupils are expected to spend 13 and 12 years in education respectively, as compared with 15 and 14 years in the former EU-15 and the new Member States respectively. The number of years spent in education is even lower in Turkey (as demonstrated by a range of indicators). The retention capacity of Turkey's education system is very weak. The number of early school leavers (persons aged 18 to 24 with primary education as the highest level achieved and not in further education) is a matter of concern in the case of Bulgaria and Romania. While the rate of early school leavers is 18% in the former EU-15 and 13.8% in the new Member States, it is 22.4% in Bulgaria and 23.2% in Romania. For Turkey (defined as the percentage of those aged 20-24 not in education and with an education level below upper secondary education) it is 58.7%, this being a matter of some concern. This is the highest rate of early school leavers in all the countries examined in this report, even when factoring in problems of comparability.

<sup>8</sup> Excluding own revenues of education institutions (0.3% of GDP in 2001).

Educational attainment of the adult population in broad terms is relatively high in Bulgaria and Romania. In Bulgaria, 71.5% of those aged 25-64 in 2002 had completed at least **upper secondary education**. In Romania that percentage is 71.1%, compared with 64.6% in the former EU-15 and 81% in the new Member States. The percentage in the youngest age group rises to 75% and 72% respectively, which is similar to the former EU-15 average (but lower than in the new Member States). In Turkey the levels of education attained by the adult population are low. Only 24% of those aged 25-64 in 2001 had completed at least upper secondary education; this is consistent with the conclusions provided by the indicators on the retention capacity of the education system. However, the education levels attained improve somewhat in the younger age groups, with 30% of those aged 20-35 having completed at least upper secondary education. The **gross enrolment rate**<sup>9</sup> in secondary education in Romania and Turkey is low in comparison with the former EU-15 and the new Member States, where the figure is 115 and 95, respectively. In Bulgaria it stands at 94, which is in line with the average in the new Member States. In Romania and Turkey, however, it is only 82 and 58 respectively, and this is a long way from ensuring universal access to secondary education.

The percentage of people that have completed **tertiary education** in Romania and Turkey is lower than in the former EU-15 and the new Member States. In Bulgaria 21.2% of those aged 25-64 in 2004 had completed tertiary education, compared with 21.2% in the EU-15 and 18.1% in the new Member States. In Romania and Turkey the picture is much worse: only 9% and 8.5% of the adult population in 2001 had completed tertiary education, much lower figures than the average for the former EU-15 and the new Member States. While for tertiary education the gross enrolment rate in the former EU-15 and the new Member States stands at 53% and 43% respectively, it is only 41% in Bulgaria, and sharply lower in Turkey and Romania with 24% and 27% respectively.

Bulgaria has 8 **tertiary graduates in science and technology** per 1 000 of the population and Romania 5, compared with 11 in the former EU-15 and 6 in the new Member States. For Turkey a broader indicator has been used (number of graduates in engineering, maths, computing and physical science) and, with nearly 20 graduates in science and maths shows a better situation.

Participation in **vocational education and training** is rather low, especially in Romania, where practically until the latest reform it did not exist, and in Turkey where the lack of social prestige appears to discourage participation. This does not compare very favourably with many former EU-15 countries and the growing support given to vocational education in the new Member States.

In all three countries the education system does not seem to respond appropriately to **the needs of the business sector**. This appears to be particularly the case for primary and secondary schooling, but also in regard of tertiary graduates. Drop-outs and limited access to quality education in terms of education material, teacher qualifications and the facilities of school buildings are a particular problem in rural areas.

#### *R&D and innovation*

Overall, the candidate countries and the new Members States lag significantly behind the existing EU Member States in the transition to the knowledge-based

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<sup>9</sup> Defined as the number of students in a specific level of education (it includes those repeating a year, and the indicator may exceed 100%).

economy. Low levels of investments in research and development (R&D) and IT may slow down the speed at which they are catching up with the EU and perhaps also hamper their rise in productivity levels. However, one of the most important channels for modernising these economies will be technology transfer via FDI. Those countries may well benefit most from improving the general framework conditions, including the effective implementation of competition policies, and from pushing ahead forcefully with their reforms of educational and research institutions, with a focus on technology transfer.

The three candidate countries (and most of the new Member States) have considerable leeway to make up. The candidate countries on average spend less than 1% of GDP on R&D compared with almost 2% of GDP at EU level (in 2000: 0.52% in Bulgaria, a level practically unchanged since 1996; 0.37% in Romania; 0.64% in Turkey, up from 0.45% in 1996).

In **Bulgaria**, 0.48% of the labour force in 2000 was R&D personnel (down from 0.86% in 1996, but with almost the same level of total expenditures on R&D). The corresponding figures were 0.39% for **Romania** (down from 0.62% in 1996) and 0.13% in **Turkey**, easily the lowest figure amongst EU-25 plus the candidate countries and one that has remained almost unchanged over the last five years. A challenge facing all three countries is to improve the governance of public research institutions.

Neither the candidate countries nor most of the new Member States can match the growth of ICT in the EU Member States (in **Romania** expenditure on ICT is only a third of the EU level). As an example, the number of personal computers per 100 inhabitants is quite low in the three candidate countries, compared with the EU-25.

### **VIII. Social sustainability**

Per capita income in PPPs in the three candidate countries is about a quarter of the EU-15 level. Poverty as measured by the World Bank (Table 19) is significantly higher in Bulgaria and Romania than in the poorest new Member States. Poverty in Turkey in 2000 was close to (but still somewhat higher than) the level in Latvia in 1998. Minimum wages in PPPs were around €200 in Bulgaria and Romania and about twice that level in Turkey. High unemployment in Bulgaria and Turkey, with low unemployment benefits and a small base of eligible people (in Turkey), are also factors contributing to poverty in the three countries, where social transfers are low and have only a small impact on poverty rates.<sup>10</sup> The level of pensions in the mid-1990s was about 35% of per capita income in Bulgaria and Romania and 56% in Turkey. Average monthly pensions in Bulgaria and Romania in 2002 were slightly above €150 measured in PPPs.

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<sup>10</sup> Social transfers reduce the poverty rate in Bulgaria by 3 percentage points, in Romania by 5 percentage points and in Turkey by 4 percentage points, while poverty is reduced in the EU-15 by 9 percentage points and in the new Member States by 12 percentage points through social transfers. The poverty rate is measured by the share of persons below the threshold of 60% of national disposable income. See: EU Structural indicators 2004.

**Table 19: Poverty**

	Population below		
	Survey year	\$ 1 a day (%)	\$ 2 a day (%)
Bulgaria	2001	4.7	23.7
Romania	2000	2.1	20.5
Turkey	2000	< 2	10.3

**Source:** World Development Indicators 2003.

Poverty and a high share of agricultural employment are central to development problems, which might require specific policy measures to overcome misallocation and market rigidities. A large part of the rural population receives its main income from the subsistence economy and housing (i.e. imputed rents). In addition, much of the agricultural work is carried out along traditional lines within extended family units. Income sharing is likely to be the dominant form of payment among family members. Thus, incomes are determined by average as opposed to marginal productivity. This might also apply to other forms of work such as family-run, small retail trading, etc. The existence of a sector based on income sharing as well as of other sectors where activity is dominated by profit maximisation is a sign of dualism in the economy.

The countries concerned have quite different rural-urban migration flows. In Turkey the trend of migration from rural to urban areas continued, driven by large differences in wage levels and living standards but also triggered by political tensions in the 1980s 1990s. The reduction in agricultural subsidies as part of the Turkish stabilisation programme might further contribute to this process. By contrast, a flow from urban to rural areas is observed in Romania. This is explained at least in part by social need and insufficient earnings possibilities in urban areas. Continuing direct or indirect subsidisation of agriculture might also play a role. In Bulgaria, the share of agricultural employment does not seem to be declining. In any case, if traditional employment and labour market policies are considered, the appropriate target should be the non-agricultural labour force.

In the medium term, if a catching-up process were to take place, a shrinking of the agricultural sector in all countries is likely to be necessary. This process might need policy support designed to achieve an efficient allocation of labour but to avoid oversupply and the creation of large informal sectors in urban areas. The existence of a large number of people without social insurance in agriculture as well as in the informal sector will place a large burden on future state budgets and give rise to far-reaching social problems.

## Annex 1:

**A. Bulgaria**

<b>Table A/1. Economic indicators</b>								
	<b>BULGARIA</b>				<b>EU-15</b>			
	2000	2001	2002	2003 f	2000	2001	2002	2003 f
<b>General economic background</b>								
Real GDP <sup>1</sup>	5.4	4.1	4.9	4.3	3.6	1.7	1.0	0.7
Labour productivity <sup>2</sup>	9.2	5.5	3.4	0.8	1.6	0.5	0.7	0.7
Real unit labour cost <sup>3</sup>	-5.4	0.8	-0.8	0.1f	0.4	0.4	-0.2	0.1
Real effective exchange rate <sup>4</sup>	111.6	119.2	122.4	123.5	81	84	88	98
Inflation rate <sup>5</sup>	10.3	7.4	5.8	2.3	1.9	2.2	2.1	2.0
Unemployment rate <sup>6</sup>	16.4	19.2	17.8	13.6	7.8	7.4	7.7	8.0
<b>Employment</b>								
Employment rate <sup>7</sup>	50.4	49.6	50.6	52.5	63.4	64.1	64.3	64.3
Employment rate - women <sup>8</sup>	46.3	46.8	47.5	49.0	54.1	55.0	55.6	56.1
Employment rate of older workers <sup>9</sup>	20.8	24.0	27.0	30.0	37.8	38.8	40.1	41.0
Long-term unemployment <sup>10</sup>	9.3	11.9	11.7	8.9	3.5	3.1	3.0	:
<b>Product market reforms</b>								
Relative price levels <sup>11</sup>	36.5	38.3	40.3		100	100	100	100
Total trade-to-GDP ratio <sup>12</sup>	58.4	59.4	56.4	58.1	59.6	59.0	58.1	
Total FDI inflows <sup>13</sup>	8.1	4.9	5.5	6.8	10.4	4.7	4.4	:
Market share : electricity <sup>14</sup>					46.7	45.0	:	:
Sectoral and ad hoc state aid <sup>15</sup>	1.0				0.7	0.8	:	:
Business investment <sup>16</sup>	12.0	14.7	15.3	16.8	18.3	17.9	17.2	:
<b>Knowledge-based economy</b>								
Tertiary graduates <sup>17</sup>	46.7	47.5			38.4	40.0 e	:	:
Spending on human resources <sup>18</sup>	4.41	3.66			4.94 e	:	:	:
Educational attainment <sup>19</sup>	74.9	78.2 b	77.5	75.6	73.6	73.2	73.6	74.0
R&D expenditure <sup>20</sup>	0.52	0.47			1.95 s	1.98 s	1.99 s	:
Internet access <sup>21</sup>	20.0				18.3	36.1	38.9	46.8
<p>1. Growth rate of real GDP as %. 2. Growth rate of real GDP per person employed as %. 3. Ratio of compensation per employee to nominal GDP per person employed, total economy, annual percentage change. 4. Vs IC24 (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 % of the total active population. 7. Employed persons aged 15-64 as % of total population of the same age group. 8. Employed women aged 15-64 as % of total female population of the same age group. 9. Employed persons aged 55-64 as % of total population of the same age group. 10. Long-term unemployed (over 12 months) as % of total active population aged 15-64.</p> <p>11. Of private final consumption (EU-15=100). 12. Average value of imports and exports of goods and services as % of GDP; the value for EU-15 is the total for the small Member States. 13. As % of GDP. 14. Market share of the largest generator (% of total net generation). 15. As % of GDP. 16. Gross fixed capital formation in the private sector as % of GDP. 17. Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29. 18. Public expenditure on education as % of GDP. 19. Percentage of the population aged 20 - 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&amp;D) – as % of GDP. 21. Percentage of households who have Internet access at home.</p> <p>f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value, q: estimated from quarterly values.</p>								
<b>Source:</b> Commission.								

<b>Table A/2. Public finances</b>										
	<b>BULGARIA</b>					<b>EU-15</b>				
	2000	2001	2002	2003	2004 f	2000	2001	2002	2003 f	2004 f
Government balance <sup>1</sup>	-0.5	0.2	-0.8	-0.1		1.0	-0.9	-2.0	-2.7	-2.6
General government receipts <sup>2</sup>			38.7	38.6	37.5	46.7	46.2	45.5	45.7	45.4
General government expenditures <sup>3</sup>			39.4	39.4	38.2	45.7	47.2	47.5	48.4	48.0
Primary balance <sup>4</sup>	3.6	3.9	1.4	2.0		4.8	2.7	1.4	0.6	0.6
Cyclically adjusted balance <sup>5</sup>						-1.2	-1.7	-2.2	-2.3	-2.2
Government debt <sup>6</sup>	73.6	66.2	53.2	46.2		63.9	63.0	62.3	:	:
Old-age dependency ratio <sup>7</sup>	23.8	24.7	24.9	24.9		24	:	:	:	:
Public pension expenditures <sup>8</sup>	9.7	9.0				10.4	:	:	:	:

1. Government balance - Net borrowing(-)/lending of consolidated general government sector as % of GDP. 2. General government receipts - receipts of consolidated general government sector as % of GDP. 3. General government expenditure - expenditure of consolidated general government sector as % of GDP. 4. Primary balance - Net borrowing(-)/lending excluding interest of consolidated general government sector as % of GDP. 5. Cyclically adjusted balance - government balance adjusted for the cyclical component as %. 6. General government consolidated gross debt as % of GDP. 7. Persons aged over 65 as % of the working-age population aged 15-64. 8. As % of GDP.

i: International Monetary Fund, e: estimated value

**Source:** Commission (except cyclically adjusted balance: national sources).

<b>Table A/3. Performance</b>	
	2003
GDP per capita in PPS	6520
Labour productivity per person employed	31.7
Employment rate	52.5

<b>B. Romania</b>								
<b>Table B/1. Economic indicators</b>								
	<b>ROMANIA</b>				<b>EU-15</b>			
	2000	2001	2002	2003 f	2000	2001	2002	2003 f
<b>General economic background</b>								
Real GDP <sup>1</sup>	2.1	5.7	5.0	4.9	3.6	1.7	1.0	0.7
Labour productivity <sup>2</sup>	-0.3	6.6	15.9		1.6	0.5	0.7	0.7
Real unit labour cost <sup>3</sup>	0.6	0.9	-3.4	-1.1	0.4	0.4	-0.2	0.1
Real effective exchange rate <sup>4</sup>	128	132	132	126	81	84	88	98
Inflation rate <sup>5</sup>	45.7	34.5	22.5	15.3	1.9	2.2	2.1	2.0
Unemployment rate <sup>6</sup>	6.8	6.6	7.5	6.6	7.8	7.4	7.7	8.0
<b>Employment</b>								
Employment rate <sup>7</sup>	63.0	62.4	57.6	57.9 q	63.4	64.1	64.3	64.3
Employment rate - women <sup>8</sup>	57.5	57.1	51.8	51.8 q	54.1	55.0	55.6	56.1
Employment rate of older workers <sup>9</sup>	49.5	48.2	37.3	38.3 q	37.8	38.8	40.1	41.0
Long-term unemployment <sup>10</sup>	3.5	3.3	3.8		3.5	3.1	3.0	:
<b>Product market reforms</b>								
Relative price levels <sup>11</sup>	40	41	39		100	100	100	100
Total trade-to-GDP ratio <sup>12</sup>	51.2	56.0	61.0	66.4	59.6	59.0	58.1	:
Total FDI inflows <sup>13</sup>	2.6	2.6	2.3	2.7	10.4	4.7	4.4	:
Market share : electricity <sup>14</sup>	100.0				46.7	45.0	:	:
Sectoral and ad hoc state aid <sup>15</sup>	0.8				0.7	0.8	:	:
Business investment <sup>16</sup>	17.0	18.1	19.1e		18.3	17.9	17.2	:
<b>Knowledge-based economy</b>								
Tertiary graduates <sup>17</sup>	67.9	76.2			38.4	40.0 e	:	:
Spending on human resources <sup>18</sup>	2.9	3.3	3.0		4.94 e	:	:	:
Educational attainment <sup>19</sup>	75.8	77.3	75.3	73.8	73.6	73.2	73.6	74.0
R&D expenditure <sup>20</sup>	0.4	0.4			1.95 s	1.98 s	1.99 s	:
Internet access <sup>21</sup>	13.0				18.3	36.1	38.9	46.8
<p>1. Growth rate of real GDP as %. 2. Growth rate of real GDP per person employed as %. 3. Ratio of compensation per employee to nominal GDP per person employed, total economy, annual percentage change. 4. Vs IC24 (1995 = 100), current year's values are based on Commission's forecast deflator figures, CPI deflator. 5. Annual average rate of change in Interim Harmonized Indices of Consumer Prices (HICPs). 6. Unemployed persons as % of the total active population. 7. Employed persons aged 15-64 as % of total population of the same age group. 8. Employed women aged 15-64 as % of total female population of the same age group. 9. Employed persons aged 55-64 as % of total population of the same age group. 10. Long-term unemployed (over 12 months) as % of total active population aged 15-64.</p> <p>11. Of private final consumption (EU-15=100). 12. Average value of imports and exports of goods and services as % of GDP; the value for EU-15 is the total for the small Member States. 13. As % of GDP. 14. Market share of the largest generator (% of total net generation). 15. As % of GDP. 16. Gross fixed capital formation by the private sector as % of GDP. 17. Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29. 18. Public expenditure on education as % of GDP. 19. Percentage of the population aged 20 - 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&amp;D) - as % of GDP. 21. Percentage of households who have Internet access at home.</p>								
f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value, q: estimated from quarterly values.								
<b>Source:</b> Commission.								

<b>Table B/2. Public finances</b>								
	<b>ROMANIA</b>					2000	2001	2002
	2000	2001	2002	2003 f	2004 f			
Government balance <sup>1</sup>	-4.4	-3.5	-2.0	-2.0	-3.0	1.0	-0.9	-2.0
General government receipts <sup>2</sup>		36.4	34.9	31.1p		46.7	46.2	45.5
General government expenditures <sup>3</sup>		38.8	34.6	33.5p		45.7	47.2	47.5
Primary balance <sup>4</sup>	-0.7	-0.3	0.2	-0.4	-1.4	4.8	2.7	1.4
Cyclically adjusted balance <sup>5</sup>			-2.47p	-2.44p	-2.87p	-1.2	-1.7	-2.2
Government debt <sup>6</sup>	23.9	23.2	23.3	21.8	23.5	63.9	63.0	62.3
Old age dependency ratio <sup>7</sup>	19.3	19.6	20.4	20.6		24	:	:
Public pension expenditures <sup>8</sup>	7.1	7.3	7.7e			10.4	:	:

i: International Monetary Fund, e: estimated value, p: National authorities estimation.

**Source:** Commission services, IMF, national sources

<b>Table B/3. Performance</b>	
	2003
GDP per capita in PPS	6960 f
Labour productivity per person employed	34.4 (f)
Employment rate	57.9q

GFCF per capita in PPS

## C. Turkey

Table C/1. Economic indicators								
	TURKEY				EU-15			
	2000	2001	2002	2003	2000	2001	2002	2003 f
<b>General economic background</b>								
Real GDP <sup>1</sup>	7.4	-7.5	7.9	5.8	3.6	1.7	1.0	0.7
Labour productivity <sup>2</sup>	-5.2	-2.9	-5.5	7.6 q	1.6	0.5	0.7	0.7
Real unit labour cost <sup>3</sup>	-5.2	-2.9	-6.6	1.1	0.4	0.4	-0.2	0.1
Real effective exchange rate <sup>4</sup>	118.4	95.5	97.4	104.7	81	84	88	98
Inflation rate <sup>5</sup>	54.9	54.4	45.0	25.3	1.9	2.2	2.1	2.0
Unemployment rate <sup>6</sup>	6.5	8.3	10.3	10.5	7.8	7.4	7.7	8.0
<b>Employment</b>								
Employment rate <sup>7</sup>	50.4	48.9	47.5	46.8	63.4	64.1	64.3	64.3
Employment rate - women <sup>8</sup>	25.1	25.4	25.5	26.0 f	54.1	55.0	55.6	56.1
Employment rate of older workers <sup>9</sup>	35.3	34.7	33.8	34.0 f	37.8	38.8	40.1	41.0
Long-term unemployment <sup>10</sup>	1.4	1.8	3.2	1.4 f	3.5	3.1	3.0	:
<b>Product market reforms</b>								
Relative price levels <sup>11</sup>	58.3	46.4	49.0		100	100	100	100
Total trade-to-GDP ratio <sup>12</sup>	27.8	32.5	29.6	30.8	30.2	29.9	29.1	:
Total FDI inflows <sup>13</sup>	0.9	2.3	0.3	0.2	10.4	4.7	4.4	:
Market share electricity <sup>14</sup>	8.4	10.2			46.7	45.0	:	:
Sectoral and ad hoc State aids <sup>15</sup>					0.7	0.8	:	:
Business investment <sup>16</sup>	20.7	14.6	12.8	14.5	18.3	17.9	17.2	:
<b>Knowledge-based economy</b>								
Tertiary graduates <sup>17</sup>	2.9	3.6			38.4	40.0 e	:	:
Spending on human resources <sup>18</sup>	3.49	3.65			4.94 e	:	:	:
Educational attainment <sup>19</sup>					73.6	73.2	73.6	74.0
R&D expenditure <sup>20</sup>	0.64				1.95 s	1.98 s	1.99 s	:
Internet access <sup>21</sup>	44.0				18.3	36.1	38.9	46.8
<p>1. Growth rate of real GDP as %. 2. Growth rate of real GDP per person employed as %. 3. Ratio of compensation per employee to nominal GDP per person employed, total economy, annual percentage change. 4. Vs IC24 (1995 = 100), current year's values are based on Commission's forecast deflator figures, CPI deflator. 5. Annual average rate of change in Consumer Price Index (national definition). 6. Unemployed persons as % of the total active population. 7. Employed persons aged 15-64 as % of total population of the same age group. 8. Employed women aged 15-64 as % of total female population of the same age group. 9. Employed persons aged 55-64 as % of total population of the same age group. 10. Long-term unemployed (over 12 months) as % of the total active population aged 15-64.</p> <p>11. Of private final consumption (EU15=100). 12. Average value of imports and exports of goods and services as % of GDP. The value for EU-15 is the total for the small Member States. 13. As % of GDP. 14. Market share of the largest generator (% of total net generation). 15. As % of GDP. 16. Gross fixed capital formation in the private sector as % of GDP. 17. Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29. 18. Public expenditure on education as % of GDP. 19. In % of the population aged 20 - 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&amp;D - as % of GDP. 21. Percentage of households who have Internet access at home.</p> <p>f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value, q: estimated from quarterly values.</p> <p><b>Source:</b> Commission and Prime Ministry of Turkey – Undersecretariat of Treasury..</p>								

<b>Table C/2. Public finances</b>										
	<b>TURKEY</b>					<b>EU-15</b>				
	2000	2001	2002	2003	2004 f	2000	2001	2002	2003 f	2004 f
Government balance <sup>1</sup>	-6.1	-29.8	-12.7	-8.7	-8.0	1.0	-0.9	-2.0	-2.7	-2.6
General government receipts <sup>2</sup>	41.9	43.6	42.7			46.7	46.2	45.5	45.7	45.4
General government expenditures <sup>3</sup>	55.1	54.1	52.2			45.7	47.2	47.5	48.4	48.0
Primary balance <sup>4</sup>	7.9	-2.7	7.1	9.6	7.6	4.8	2.7	1.4	0.6	0.6
Cyclically adjusted balance <sup>5</sup>			-13.3 f	-11.9 f	-11.4 f	-1.2	-1.7	-2.2	-2.3	-2.2
Government debt <sup>6</sup>	57.4	105.2	94.9	87.1		63.9	63.0	62.3	:	:
Old age dependency ratio <sup>7</sup>	8	8				24	:	:	:	:
Public pension expenditures <sup>8</sup>						10.4	:	:	:	:

1. Government balance - Net borrowing(-)/lending of consolidated general government sector as % of GDP. 2. General government receipts - receipts of consolidated general government sector as % of GDP. 3. General government expenditure - expenditure of consolidated general government sector as % of GDP. 4. Primary balance - Net borrowing(-)/lending excluding interest of consolidated general government sector as % of GDP. 5. Cyclically adjusted balance - government balance adjusted for the cyclical component as % of GDP. 6. General government consolidated gross debt as % of GDP. 7. Persons aged over 65 as % of the working-age population aged 15-64. 8. As % of GDP.

<b>Table C/3. Performance</b>	
	2003
GDP per capita in PPS	5930.0
Labour productivity per person employed	37.
Employment rate	46.8

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### **Bulgaria**

- Ministry of Finance
- Bulgarian National Bank
- Office of the Prime Minister
- Ministry of Transport and Communications
- Ministry of the Economy
- Representatives of the World Bank and the IMF

### **Romania**

- Ministry of Finance
- National Bank of Romania
- National Commission for Prognosis
- Foreign Investors Council
- National Council of Private SMEs and Cooperatives
- Representatives of the World Bank and the IMF

### **Turkey**

- Treasury
- Ministry of Finance
- State Planning Organisation (SPO)
- Central Bank of Turkey
- Banking Regulation and Supervision Agency (BRSA)
- Turkish Industrialists and Businessmen's Association (TÜSİAD)
- Representatives of the World Bank and the IMF

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