The World Bank

EU10
Regular Economic Report

Main Report
Sustaining Recovery

November 2010

Focus Notes:

Impact of the Global Financial Crisis on Local Government Finances

Doing Business in EU10 countries

This report is prepared by a team led by Kaspar Richter (krichter@worldbank.org) and including Stella Ilieva, Ewa Korczyc, Matija Laco, Sanja Madzarevic-Sujster, Catalin Pauna, Marcin Piątkowski, Lazar Sestovic, and Emilia Skrok.

The team is very grateful for the excellent inputs from the World Bank Global Prospect Group, coordinated by Annette De Kleine, and from Olga Vybornaia.

EU10 refers to Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

EU10 November 2010

Summary of Main Report

Half a year after Europe was shaken by a sovereign debt crisis, the recovery in the EU10 continued in 2010 and is set to strengthen in 2011. However, concerns over sovereign debt in some countries of the euro area persist and global growth could slow down somewhat from 2010 to 2011. Sustaining strong growth in the EU10 over the next years will depend on further difficult adjustments in financial markets, fiscal balances, and labor and product markets.

The rebound in global trade and industrial production and acceleration of EU15 growth lifted the EU10 economies, aided by close trade and production linkages within the EU, competitive production costs, a skilled workforce, and nimble entrepreneurs. The recovery in the real economy supported the return of financial market confidence, stabilized fiscal outcomes, and generated jobs.

- Yields on sovereign debt of EU10 countries have moderated, stock markets have risen, and interbank spreads have narrowed. Gross capital inflows to EU10 countries have picked up thanks to strong public bond inflows. External vulnerabilities are sharply reduced in view of the large improvements in current account balances.
- EU10 government bond spreads have come down noticeably since the peak of the crisis, and government interest payments on debt in 2010 are broadly in line with plans. Many EU10 countries have increased public investments to enhance growth prospects with the help of EU structural funds. These transfers have also played a crucial role in stabilizing local government finances and maintaining local public debt at low levels.
- Unemployment dropped from the first to the second quarter of 2010 in most EU10 countries.

However, with private demand remaining weak in many countries, the pace of the recovery in the EU10 is sluggish compared to the rebound in the early 2000s. Growth is set to continue to vary across the region, and is subject to a number of risks.

- Credit growth to enterprises remained negative in most EU10 countries. The recovery in credit growth could be derailed by a weak recovery in the EU15, as the phasing out of fiscal stimulus, the end of inventory accumulation and a strong euro could dampen economic activity. Renewed financial sector stress could spread to the EU10 through cross-border linkages, as parent banks could shrink the balance sheets of subsidiaries.
- Fiscal consolidation has slowed in a number of EU10 countries. Fiscal deficits are set to decline only moderately in 2010 in the EU10.
- Unemployment rates remain in double-digits for six of the EU10 countries. Job market conditions stay difficult for young and low-skilled workers and long-term job seekers.

Addressing these challenges through policies to strengthen financial markets, fiscal frameworks and structural reforms remains essential for sustained growth.

- Monetary policy is set to remain supportive of the recovery as inflation pressures continue to be moderate. Central banks and financial authorities should pursue efforts to reinforce the resilience of the financial sector at the national and European level.
- The implementation of credible medium term fiscal strategies is crucial in the light of volatile financial markets, rising public debt ratios and large structural fiscal deficits. While EU10 countries have gone a long way to spell out measures to bring about short-term fiscal adjustments, some countries still need to clarify long term targets for public debt, the size of government and structural reforms to meet these targets. Priorities include rationalizing benefit entitlements and stabilizing age-related spending, strengthening broad-based taxes and tax compliance, and enhancing fiscal institutions, including fiscal rules.
- Removing structural barriers can strengthen growth without bringing back unsustainable domestic demand booms fuelled by excessive credit expansion. The reform agenda includes easing regulations for doing business; increasing incentives for labor force participation and skill acquisition; and facilitating technology absorption and market integration.

EU10 November 2010

Summary of "In Focus" Notes

Focus Note # 1 Impact of the Global Financial Crisis on Local Government Finances

Local governments account for a large share of total government spending and revenues across the EU10 countries. They play an essential role in providing public services to citizens and facilitating investments of businesses. The crisis worsened fiscal positions of local governments, but less than of central governments and social security funds. The debt of local governments increased only moderately and was still less than 3 percent of GDP in the EU10 in 2009. The main reason for the limited impact of the crisis on local government deficits and debt is that they operate, to varying degrees, under borrowing rules that impose limits on the ability to borrow and own source revenues comprise only a minor part of their budgets. In addition, EU funds and central government transfers linked to mandated expenditures played an important role in stabilizing revenues at the local level. As fiscal consolidation has become the national priority in many countries, local governments will have to strengthen their fiscal positions through reforms of intergovernmental financial relations and improving cost and output efficiency in service delivery.

Focus Note # 2 Doing Business in EU10 countries

EU10 countries rank 43 out of 183 economies in terms of overall ease of doing business according to 2011 Doing Business report. This is around ten ranking positions behind the EU15 countries. The performance of the EU10 across indicators is uneven. While in the areas of registering property, getting credit and starting a business the EU10 tends to perform better than the EU15, there is significant room for improvement in regulations related to enforcing contracts, dealing with construction permits, paying taxes and closing a business. While Estonia, Latvia and Lithuania remain the most business friendly countries in the region, Hungary's reform progress last year was recognized and enabled Hungary to be in the group of top 10 Doing Business reformers in the world.

Recent Developments and Future Prospects

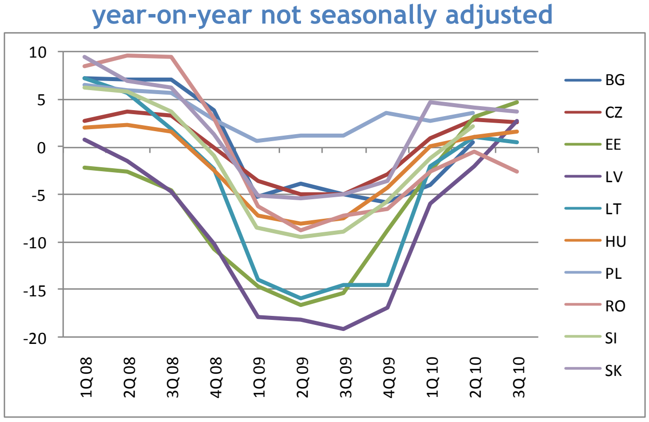
Output

The global recovery accelerated, although the rebound phase is drawing to a close. Global exports expanded 24 percent and global industrial production 11 percent year-on-year in the first eight months of 2010. This fuelled an export-driven industrial rebound in Europe in spite of the eruption of sovereign debt concerns in spring 2010. The EU is now projected to grow by 1.7 to 1.8 percent in 2010, some 0.7 to 0.8 percentage points higher than estimated in the summer. Going forward, global growth is expected to slow somewhat from 2010 to 2011 as inventory accumulation is coming to an end and fiscal stimulus is being faced out.

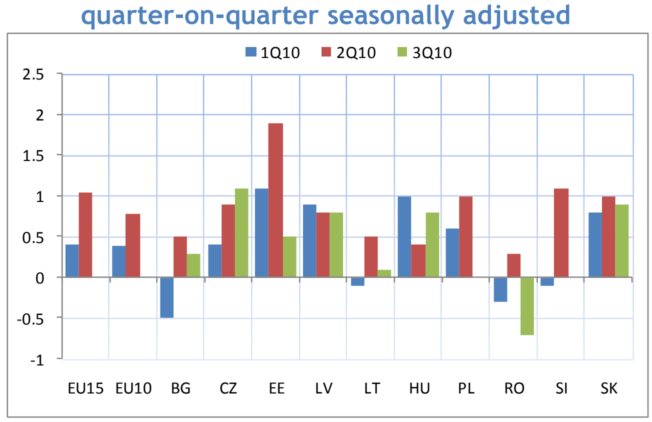
The rebound is also visible in the EU10. Year-on-year output growth in EU10 increased from 0.6 percent in the first quarter of 2010 to 2.2 percent in the second quarter of 2010. Growth improved not only due to the base effect —the second quarter of 2009 was the trough of the crisis — but also due a strong dynamism of the economies, with quarter-on-quarter growth rising from 0.4 percent to 0.8 percent (Figure 1). The upswing is taking root across the region. Slovakia and Poland, which managed to avoid much overheating in the run up to the crisis, were growing fastest in the region in the second quarter 2010. Estonia returned to growth after nine quarters of year-on-year contractions in the second quarter 2010 and was the fastest growing country in the EU in the third quarter according to Eurostat flash estimates. Latvia returned to year-on-year growth in the third quarter of 2010. Romania is the only EU10 country in recession in the third quarter of 2010.

Figure 1. GDP growth in EU10 countries and EU15, percent

year-on-year not seasonally adjusted



quarter-on-quarter seasonally adjusted

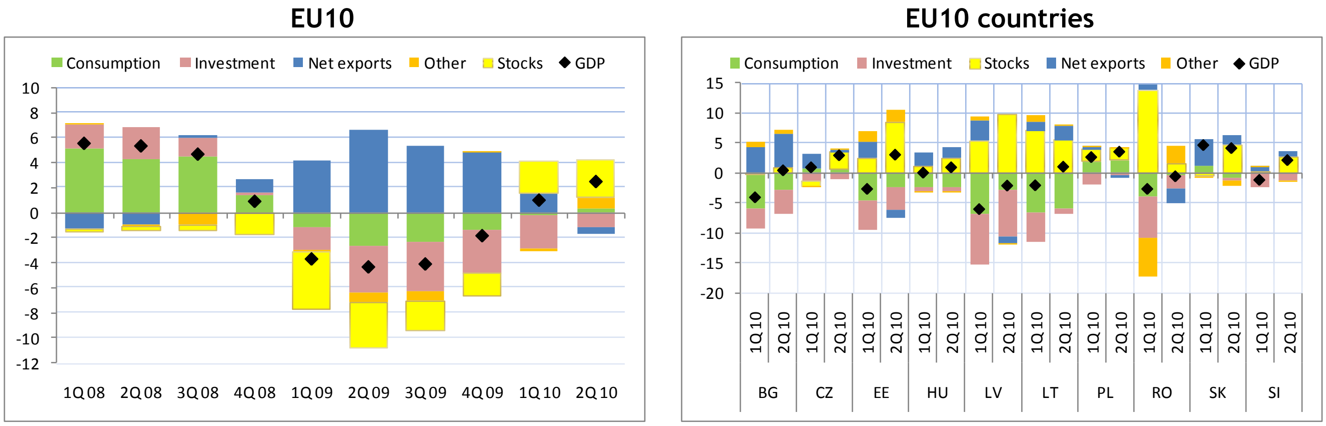


Source: Eurostat, World Bank staff calculations

Notes: 3Q data are flash estimates of Central Statistical Offices, data for PL and SI is not yet available (as of November 15), data for Bulgaria for 3Q 2010 is available only on seasonally adjusted basis.

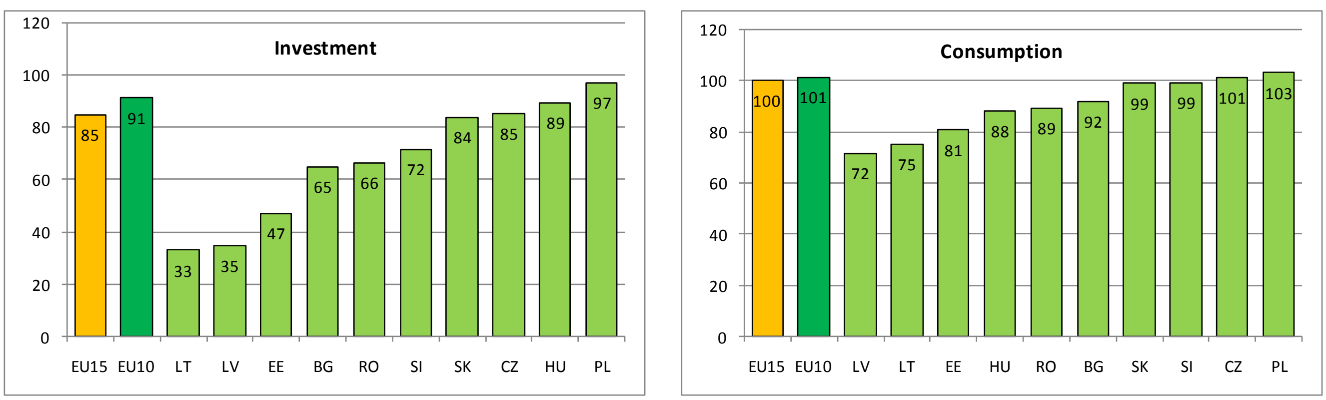
The recovery was driven by a surge in inventory and exports, whereas consumption and gross fixed capital formation remained weak. Restocking emerged as the principal growth factor in the first half of 2010 in both the EU10 and EU15 (Figure 2). This is a stark turnaround from 2009, when destocking added to the contraction. Inventory rebuilding often contributes to the initial phases of a recovery, as companies become more confident about the economy and capacity utilization. Restocking was large in Estonia, Latvia, Slovakia and Poland in the second quarter of 2010 in line with solid growth performances. In addition to restocking, net exports lifted growth in the EU10 early in the year. In late 2008 and early 2009, imports contracted faster than exports, improving net exports. Subsequently, both export and import growth turned positive, but exports grew faster than imports, so that net exports continued to lift growth up to the first quarter of 2010. In the second quarter, the growth contribution of net exports declined in view of rising import growth but remained positive in all EU10 countries apart from Estonia and Romania. In contrast, aside from inventory adjustments, domestic demand still lags behind external demand. Investment continued to contract in all EU10 countries, helped back by weak capital inflows and low capacity utilization. While consumption picked up in the EU15, it remained subdued in most EU10 countries in view of high unemployment, low wage growth, tight credit markets, and fiscal adjustments. Consumption expanded only in the Czech Republic and Poland, which had experienced relatively modest consumption growth in the run-up to the crisis. Overall, gross fixed capital formation remained below pre-crisis peaks in all EU10 countries, and consumption in all EU10 countries with the exception of Poland and the Czech Republic (Figure 3).

Figure 2. Contribution to GDP growth in the EU10 and the EU10 countries, percent, year-on-year, not seasonally adjusted



Source: Eurostat, Central Statistical Offices, World Bank staff calculations

Figure 3. Recovery in gross fixed investment and final consumption from pre-crisis peak to 2Q 2010, index, peak = 100, seasonally adjusted

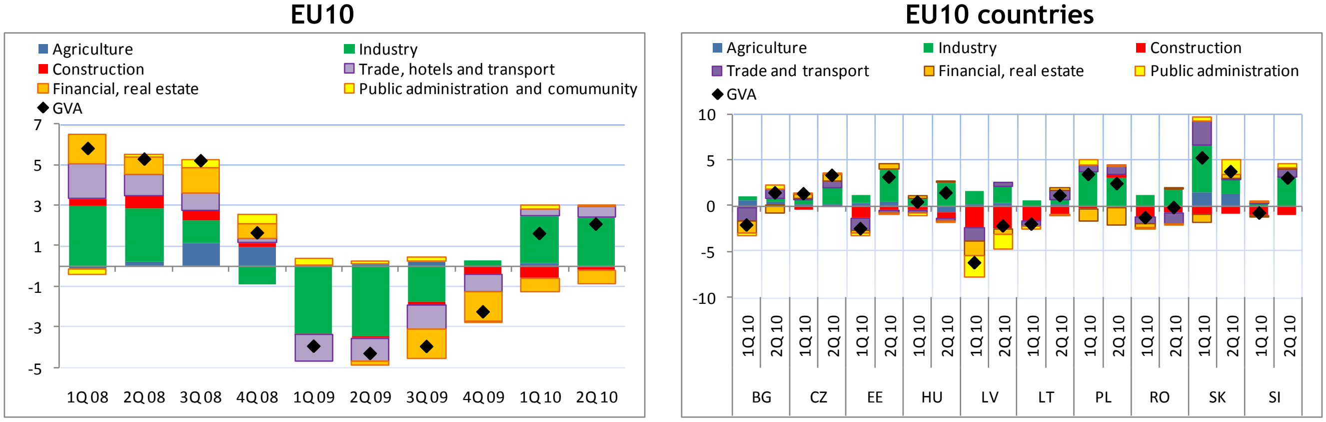


Source: Eurostat, World Bank staff calculations

Notes: Pre-crisis peak refers to the best quarter within the period 2006-2008.

Industry is leading the recovery, while finance and construction are lagging. Industry benefits most from the rebound in global demand for capital goods and durables, helped by its deep integration into European production chains (Figure 4). The revival of industry supported a return to growth of trade and transport, although at modest rates compared to before the crisis. Other service sectors remain muted constrained by weak domestic demand and sharp adjustments in finance and construction. However, partly helped by public projects, construction activity is slowly recovering, and returned to growth in Poland.

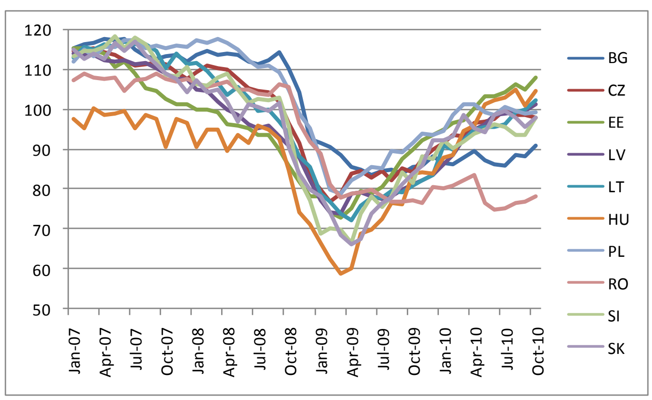
Figure 4. Contribution to gross value added (GVA) growth in the EU10 and the EU10 countries, percent, year-on-year, not seasonally adjusted



Source: Eurostat, World Bank staff calculations

The growth momentum in the EU10 continued in the second half of 2010. Industrial production expanded around 11 percent in July and August 2010. This pace was last seen in early 2007. Growth was positive in all EU10 countries for the fourth months running. It accelerated to over 20 percent in Slovakia, helped by the boom in the automobile sector, and Estonia, fuelled by a strong performance in exports of electronic products and wood manufacturing. Retail sales return to growth over the summer, with only Lithuania and Bulgaria still showing modest contractions in August 2010. The economic sentiment stabilized over the last months, remaining just below its long-term average (Figure 5). Confidence of businesses and consumers is highest in Estonia, boosted by euro adoption in January 2011, and lowest in Romania, dampened by concerns over the pace of the recovery.

Figure 5. EU10 economic sentiment indicator (long term average = 100)



Source: European Commission, World Bank staff calculations

Trade and External Developments

External imbalances remained low due to weak domestic demand. During the boom years, a domestic demand boom fueled by large capital inflows had boosted current account deficits to over 7 percent of GDP in the EU10 just prior to the crisis. The sharp compression of domestic demand, along with the drop in capital inflows, led to a stark reduction in current account deficit in 2009. This year, the current account deficit declined further from 2.5 percent of GDP in the second half of 2009 to 1.6 percent of GDP in the first half of 2010 (Figure 6). This reflects sluggish domestic demand, which, outside of Poland, Slovakia and the Czech Republic, remained more than 10 percent below the pre-crisis level in the EU10 countries in the second quarter of 2010. The large differences in current account balances from prior to the crisis have disappeared, as the sharpest adjustments have taken place in countries with the largest pre-crisis imbalances, often in combination with substantial reductions in GDP (Figure 7). In Latvia, Lithuania, Estonia, and Hungary, the current account balances are in surplus, in line with anemic domestic demand and the rebounding exports. In most countries, the current account adjustment appears to have played out, as imports are recovering. However in Bulgaria, due to the slowdown of new capital inflows and import demand, the strong adjustment continued, as the trade deficit declined further and surpluses on transfer and services accounts increased.

Figure 6. Current account developments in EU10 countries (% of GDP)

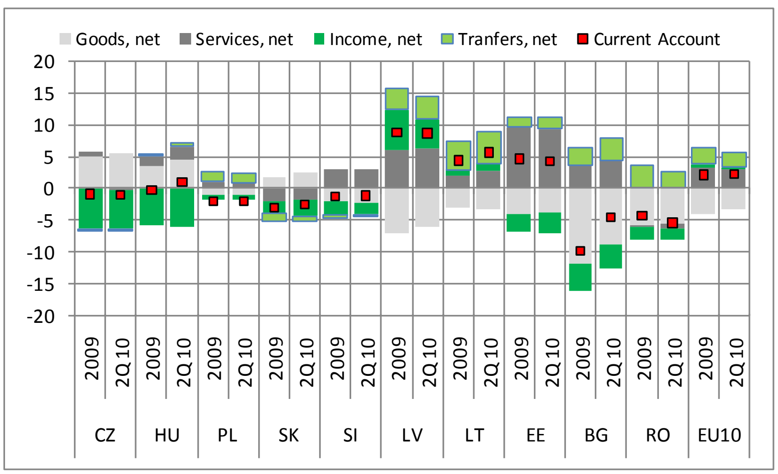
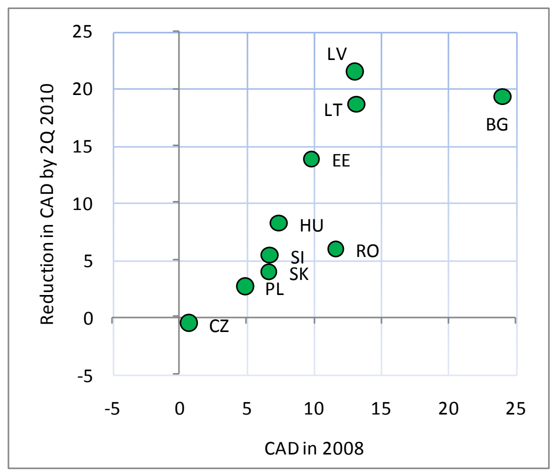


Figure 7.Change in current account deficit 2008 - 2Q 2010, (% of GDP)

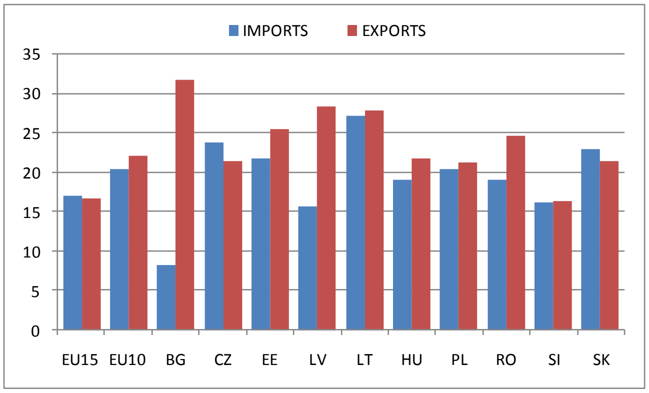


Source: Eurostat, Central Banks, World Bank staff calculations
Note: 2Q 10 refers to the period of 3rd quarter 2009 to 2st quarter 2010.

Trade balance adjustments contributed to improving current account balances. The recovery in the EU10 region has been boosted by the resurgence of the world trade. For example, the World Economic Outlook projection for global trade volumes in 2010 increased from 9 percent in July 2010 to 11.4 percent in October 2010. Export growth is especially strong in countries that produce trade-intensive capital and durable goods, which had seen a steep drop in external demand during the crisis. While both export and import flows are recovering, the revival in exports was faster than the recovery in imports. In the first eight months of 2010, the year-on-year growth was 22.2 percent for exports and 20 percent for imports (Figure 8). As a result, trade balances improved from -1 percent in the last quarter of 2009 to -0.5 in the first half of 2010. Still, imports have been steadily rising since mid-2009, and are beginning to outpace the export growth in the Czech Republic, Lithuania and Slovenia, in part driven by imported inputs for manufacturing exports, and, in the Czech Republic, by imports for solar electricity-producing units as subsidies are being phased out by year-end. Exports from the EU10 region remain overwhelmingly tied to demand conditions within Europe. The euro area accounts for some 50 percent of total exports, and intraregional trade for one-third of total exports.

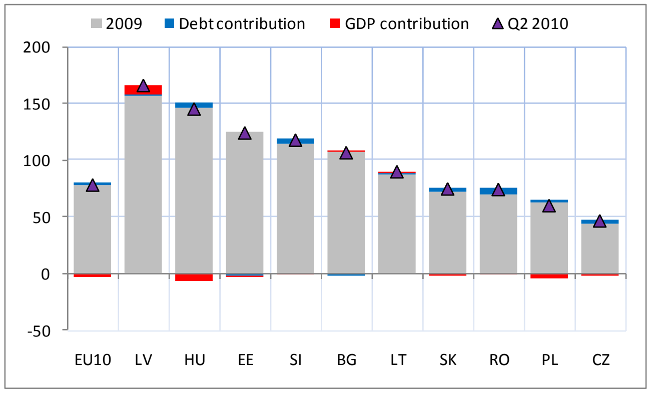
Gross external debt-to-GDP ratios contracted, helped by lower external borrowing due to improved current account balances and the rebound in growth. For the EU10 region, external debt slightly increased from 77.6 percent of GDP in end 2009 to 78 percent of GDP at the end of the second quarter of 2010, and it remains some 9 percentage points of GDP above the end 2008 level. Gross external debt-to-GDP ratios ranged from 46 percent in Czech Republic, to 90 percent in Lithuania, and to over 100 percent in Latvia, Hungary, Estonia, Slovenia and Bulgaria. In Bulgaria and Estonia, the external debt fell, as banks reduced their indebtedness. In Latvia, the only country along with Bulgaria and Lithuania where GDP in euro terms declined in the first half of 2010, the contraction in GDP led to a rise in gross external debt-to-GDP ratio by 9 percent in spite of moderately lower debt levels (Figure 9).

Figure 8. January to August import and export growth for EU10 countries, year-on-year



Source: Central Banks, World Bank staff calculations

Figure 9. Gross external debt developments 2009 - 2Q 2010, percent of GDP



Source: Central Banks, World Bank staff calculations

Notes: Calculations refer to data in EUR.

Inflation and Exchange Rates

Inflation edged upwards but inflationary pressures remain moderate. Headline inflation in the EU10 region rose year-on-year for the fourth month in a row to reach 3.2 percent in September 2010, the highest level since August 2009. The main reason for the increase is the surge of international prices of raw materials, energy and food. In the third quarter 2010, the year-on-year increase was 35.8 percent for raw materials, 12.9 percent for energy, and 7.4 percent for food. However, core inflation, which excludes energy and unprocessed food, was 2.2 percent in the EU10 region in September 2010, broadly unchanged since March 2010, as negative output gaps, weak domestic demand and high unemployment continue to keep price pressures low (Figure 10). In the euro area, inflation expectations continue to be well anchored in line with the European Central Bank's aim of keeping inflation rates close to but below 2 percent over the medium term.

The picture is varied across the region reflecting differences in exchange rate regimes and country specific factors. Latvia's inflation turned positive, after the severe contraction in output led to downward adjustments in prices for eleven months in a row to improve competitiveness against the backdrop of a pegged exchange rate. Inflation in Estonia increased compared to early in the year in part because corporations aim to restore profit margins after large losses in previous years and a reduction in domestic food supply due to a rise in food exports to Russia. Inflation increased noticeably in Romania as a result of an increase in the VAT rate from 19 percent to 24 percent in July 2010. Two countries saw moderating price pressures. Headline inflation declined in Hungary because of the base effect from tax increases in the last year and a large output gap (Figure 11).

Figure 10. HICP overall index and core index for EU10 and EU15, annual rate of change, percent

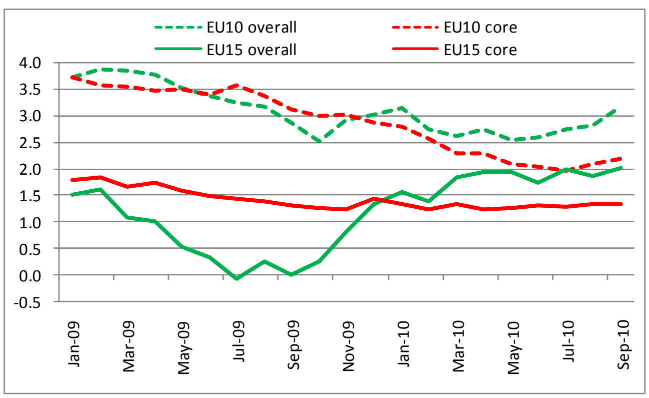
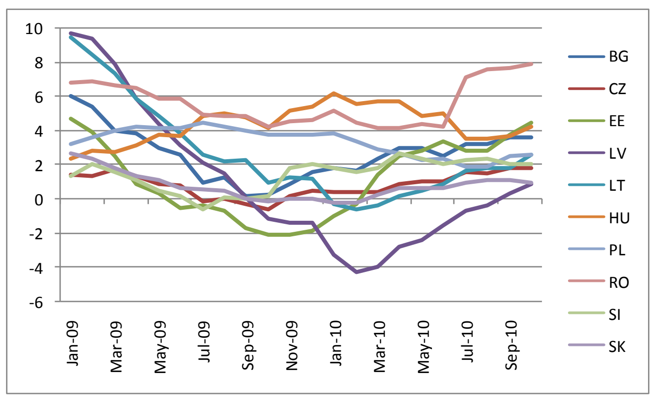


Figure 11. HICP overall index for EU10, annual rate of change, percent

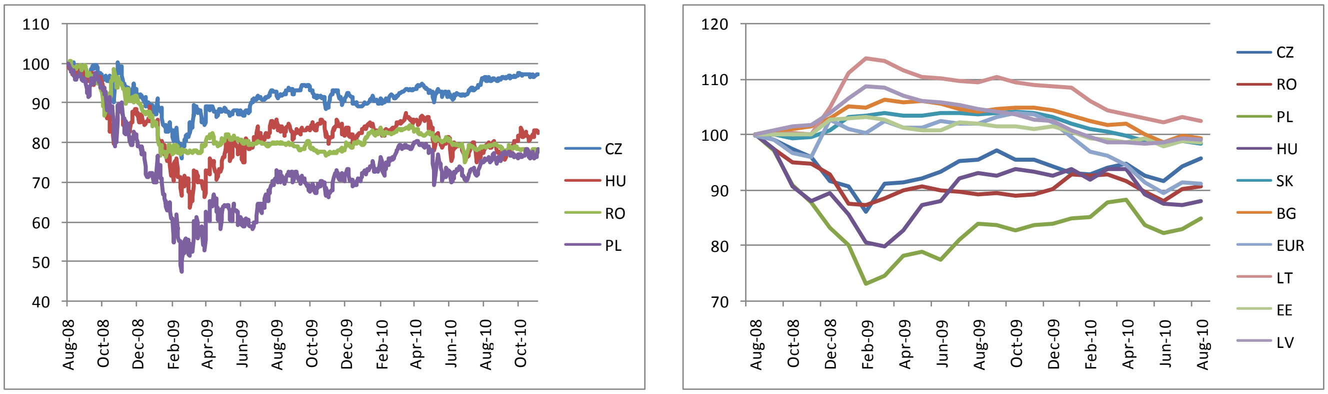


Source: Eurostat, World Bank staff calculations

Note: HICP is a harmonized index of consumer prices.

As the sovereign debt crisis in Europe eased, several regional currencies strengthened over the last months. In September and October, the euro experienced a broad-based appreciation across all major currencies, reversing some of the losses since end 2009. Supported by a rebound in capital flows, the Polish zloty, the Czech koruna and the Hungarian forint appreciated vis-à-vis the euro by around 3 to 4 percent to the euro since early July. The Romanian leu remained broadly unchanged in line with Romania's delayed economic recovery. Overall, real effective exchange rates for Poland, Hungary, Romania and the Czech Republic remain visibly below pre-crisis levels in contrast to countries with pegged exchange rates, which are close to the level from August 2008 (Figure 12).

Figure 12. Nominal exchange rates to EUR and real effective exchange rates, August 2008=100



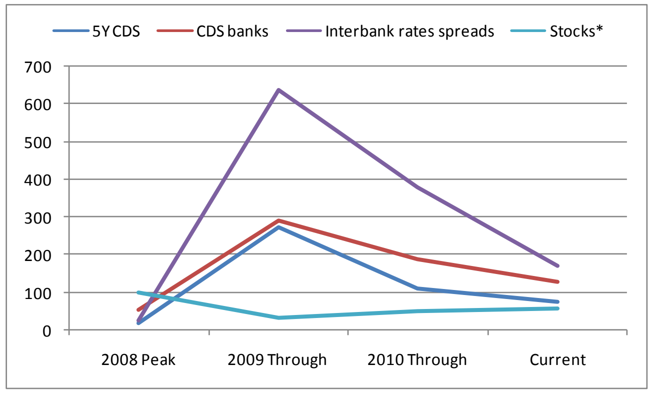
Source: Eurostat, World Bank staff calculations

Notes: Downward movement denotes depreciation.

Finance

Financial markets have stabilized as strong reform momentum in Europe helped to ease market risk aversion from the high level recorded in spring 2010. Policy measures included public finance reforms in vulnerable euro area countries, the establishment of the European Financial Stability Facility with over EUR440 billion made operational in August, and steps by the European Central Bank to preserve financial stability, including through purchases of private and public securities in secondary markets. The ongoing recovery in the real economy, fuelled by increasing global trade flows, was also helpful to strengthen financial market confidence. As a result, sovereign and banking group risk spreads have stabilized, stock prices increased, and the euro appreciated, especially against the dollar. As global investors look for attractive yield differentials, yields on sovereign debts EU10 countries have moderated, stock markets have risen, and interbank spreads have narrowed (Figure 13). A number of regional currencies have also appreciated (Figure 12). Nevertheless, risk spreads remain elevated in view of continued concerns about the robustness of the recovery and the strength of fiscal balance sheets in some countries of the euro area.

Figure 13. Asset class performance in the EU10 region

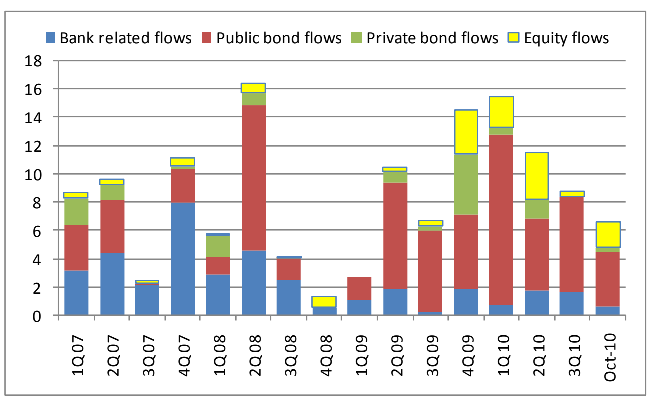


Source: Reuters, Bloomberg, World Bank staff calculations

Notes: 5Y CDS, CDS banks, interbank rates spreads - actual levels in bps.
For stocks percentage change since peak 2008 =100

Gross capital inflows to EU10 countries have picked up with the return of confidence, as strong public bond inflows compensated for weak bank-related inflows. Higher risk appetite, increasing search for yield, and improving health of the European banking groups, as reflected in the strong results from the EU-wide banking sector stress-tests conducted in July 2010, supported recovery in capital inflows to the EU10 region (Figure 14). In the third quarter capital inflows to EU10 countries have almost tripled relative to the first quarter 2009, and are roughly in line with pre-crisis levels. However, the composition of capital inflows has changed. Bank-related flows continue to be weak in view of continued deleveraging of European banking groups. This reflects a number of factors, including weak credit demand, funding constrains, and regulatory changes to increase capital adequacy ratios. Public bond inflows account for the bulk of capital inflows, as large fiscal deficits elevate governments financing needs. For example, while quarterly public bond flows amounted to USD11 billion during the first quarter 2007 to the first quarter 2008, they totaled USD35 billion from the third quarter 2009 to the third quarter 2010. Going forward, the low-interest rate policy in advanced economies and the stabilizing European

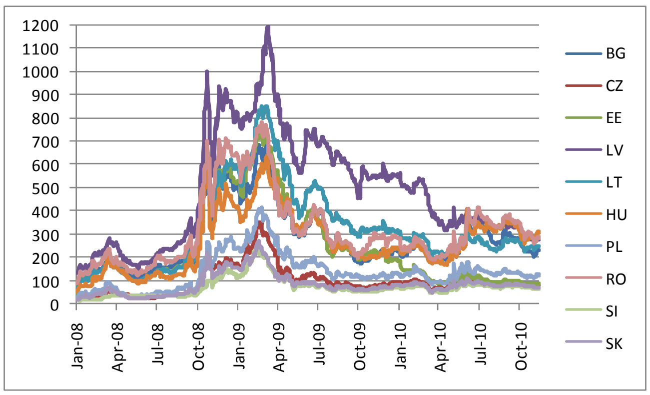
Figure 14. Gross capital inflows to EU10 markets, USD billions



Source: DECPG, World Bank staff calculations banking sector risks are likely to support capital inflows to the EU10 region in the near future, especially to countries with attractive risk-return profiles such as Poland and the Czech Republic. However, tail risks will remain high, including those ensuing from the euro zone banking system, which in the next 12 months will need to refinance large amounts of debt.

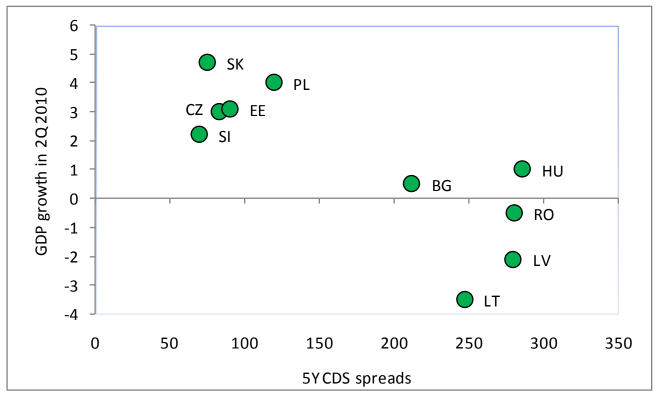
Spreads on sovereign and banking debt have stabilized. After peaking in June, improved market risk appetite led to a consolidation of credit default swap (CDS) spreads on sovereign debt in EU10 (Figure 15). EU10 CDS spreads remained stable in spite of the renewed concerns over sovereign debt in some euro area countries in the first half of November. Countries with solid growth performances enjoy lower CDS spreads than countries where the recovery is delayed (Figure 16). Spreads have also moderated for the major European banking groups operating in the EU10 region, supported by stabilized sovereign risks, delayed prospects for monetary tightening and positive results of the July stress-test of 91 European banks, which only seven banks failed, none of which involved in the EU10. The reduced regulatory uncertainty following the October agreement on the Basel III rules on capital and liquidity was also helpful.

Figure 15. 5Y CDS spreads for EU10 countries (basis points)



Source: Bloomberg, World Bank staff calculations

Figure 16. CDS spreads vs. GDP growth in 2Q 10



Source: Eurostat, Reuters, World Bank staff calculations

Note: GDP year on year growth, CDS in bps as of end of Oct. 2010.

Yield curves and money market spreads have continued to normalize. Yield curves in Bulgaria, the Czech Republic, Poland, Romania and Hungary were unchanged or lower in early November than in July at the short end (Figure 17), and remain far below levels in March 2009. Money markets in the EU10 countries also continue to consolidate, as reflected in the stable interbank interest rates spreads.

Stock market prices have picked up, largely offsetting losses from the mid-year sovereign risk turbulence. After the stock prices declines in May and June, stock markets in EU10 and EU15 have largely recovered. Stock prices in Estonia, Poland, and Romania exceed levels from July 2008. However, stock markets continue to languish in Bulgaria and Slovenia (Figure 18).

Figure 17. Yield curves in the Czech Republic, Hungary, Poland and Romania, percent

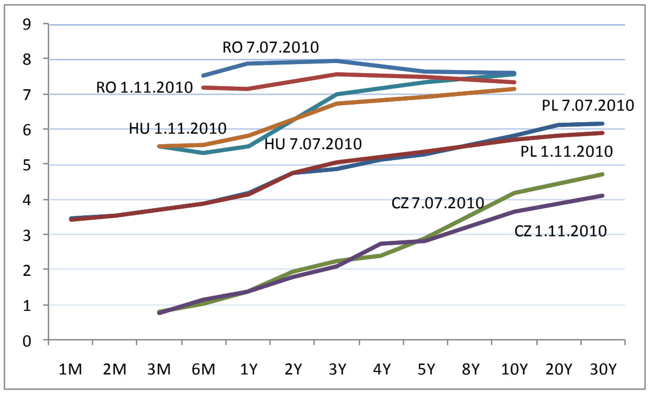
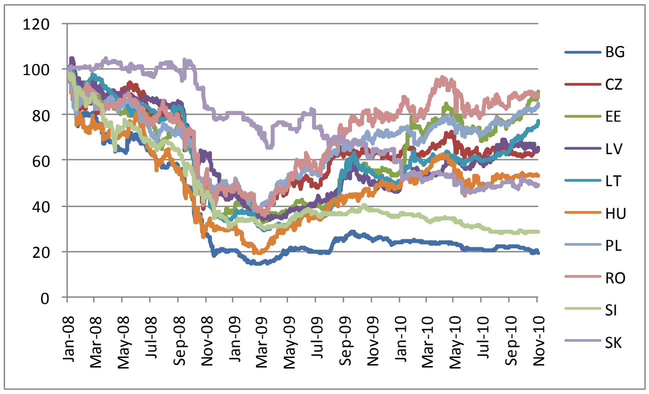


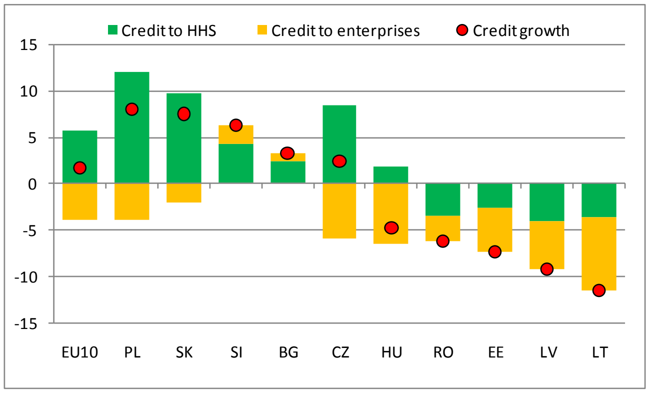
Figure 18. Stock exchange indices in EU10 countries and selected countries from the EU5, January 2008=100



Source: Reuters, World Bank staff calculations

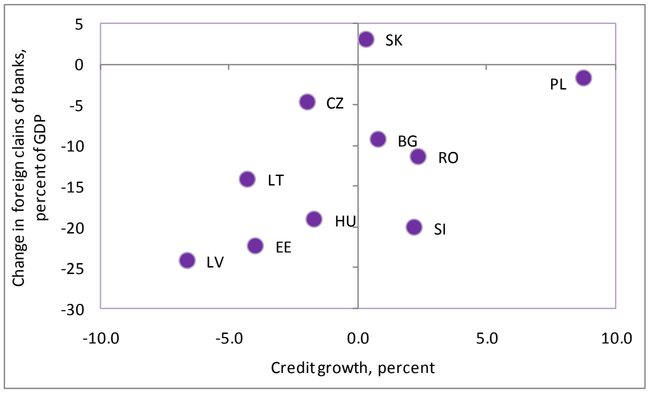
Credit growth to the private sector continued to be sluggish. While the contraction in credit provision has bottomed out, credit growth to the private sector in the EU10 region has not yet picked up momentum. Lithuania, Latvia, Estonia and Hungary continued to post negative growth rates as banks continued to deleverage, while demand for credit among enterprises and—to a lesser extent—among households continued to stagnate. Importantly, with the exception of Slovenia and Bulgaria, credit to enterprises declined in the EU10, suggesting risks to the private sector recovery (Figure 19). Poland and Slovakia experienced positive credit growth due to credit expansion to households. The recovery in credit growth is in part delayed due to the reduction in bank-related inflows (Figure 20) and the rise in non-performing loans (Figure 21, Figure 23). However, demand side factors are also playing a role, as credit and GDP growth are closely linked (Figure 24). Credit growth could accelerate from 2011 onwards, as banks' capital position becomes stronger and non-performing loans stabilize (Figure 22), especially in countries with solid banking sector fundamentals and strong economic prospects. For example, in Estonia, the decline in the stock of loans to households and companies bottomed out in recent months, reflecting a positive trend in new housing loans in the context of declining real interest rates.

Figure 19. Contribution to credit growth from Oct 2008 to August 2010



Source: European Central Bank, World Bank staff calculations

Figure 20. Change in consolidated foreign claims of banks and credit growth, Sep 2009 - Jun 2010



Source: BIS, ECB, World Bank staff calculations

Figure 21. Non-performing loans of banks in EU10 countries (% of loans)

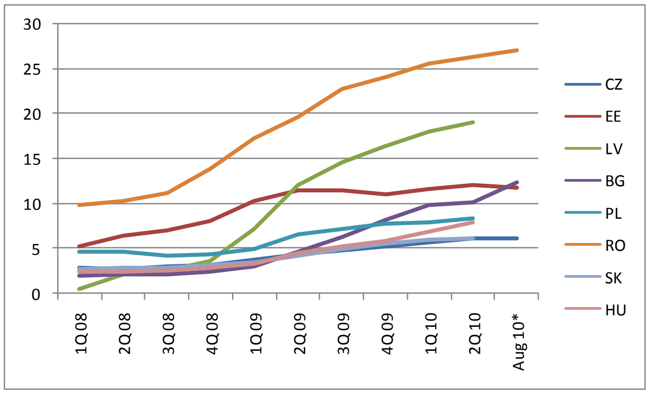
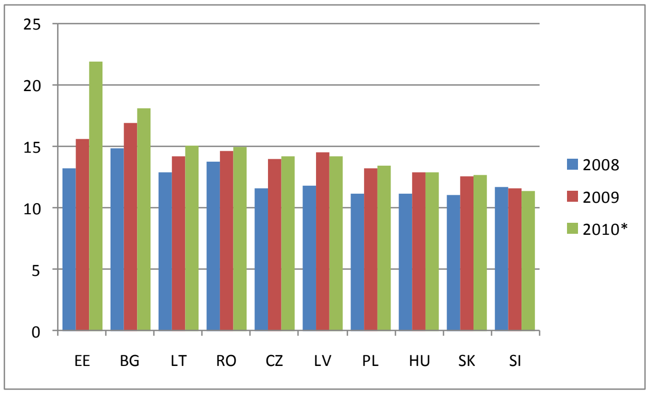


Figure 22. Bank regulatory capital to risk-weighted assets (%)



Source: Central Banks, Financial Supervisory Committees, Global Financial Stability Report, World Bank staff calculations

Figure 23. Credit growth vs. increase in non-performing loans, percent

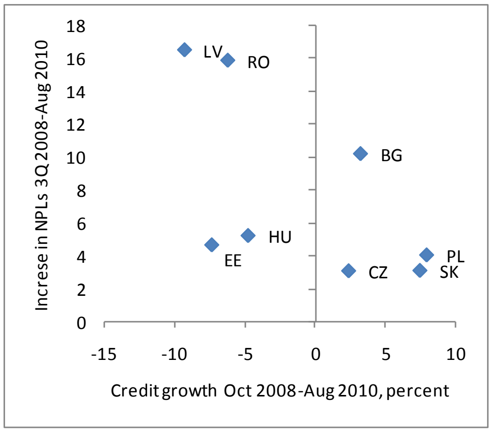
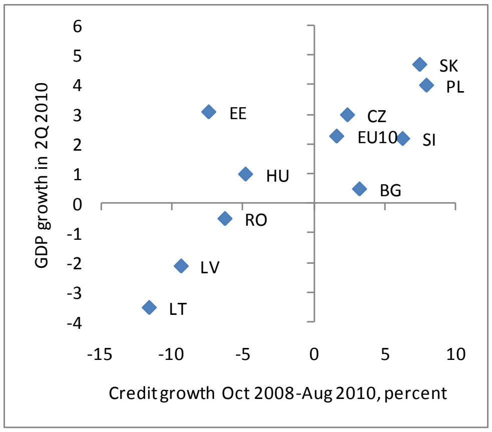


Figure 24. Credit growth vs. GDP growth, percent



Source: Eurostat, European Central Bank, Financial Supervisory Committees, World Bank staff calculations

Employment

The recovery has reached the labor market. Employment increased from the first to the second quarter of 2010 in all EU10 countries with the exception of Lithuania, raising the number of employed workers from 42.5 million to 43.6 million (Figure 25). Compared to the pre-crisis level of the second quarter of 2008, employment remained 1.3 million lower. This translates into a drop by 1.8 percent of the share of employed workers among the working-age population, compared to a drop by 1.9 percent for the EU15 (Figure 26). The performance of the EU10 was aided by a drop of the share of inactive people. Other indicators confirm the robust employment performance in the EU10. Employment in Poland expanded along with output, supported by the recent tightening in early retirement provisions, demographic trends and return migration. In other EU10 countries with the exception of Bulgaria and Slovakia, the contraction of economic activity was larger than that of employment between the second quarter of 2008 and the second quarter of 2010 (Figure 27). In Bulgaria, the employment losses reflect the large downsizing of construction, which continues at double-digit rates, along with industry. In Slovakia, the rebound in the manufacturing sector has only recently started to translate into employment gains, as labor hoarding during the crisis has delayed the re-hiring of workers.

Figure 25.Employed population in EU10 and EU15 countries, 20 - 64, million

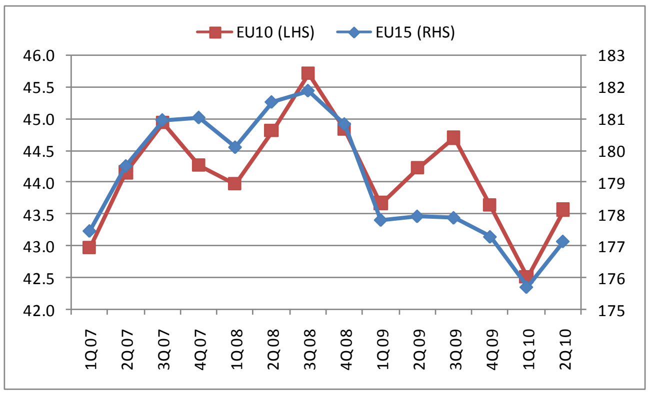
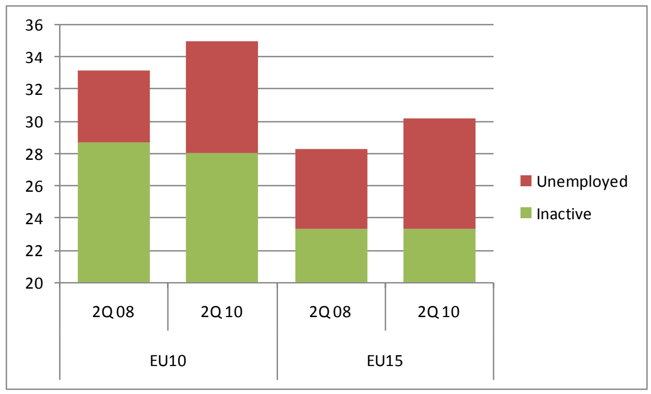
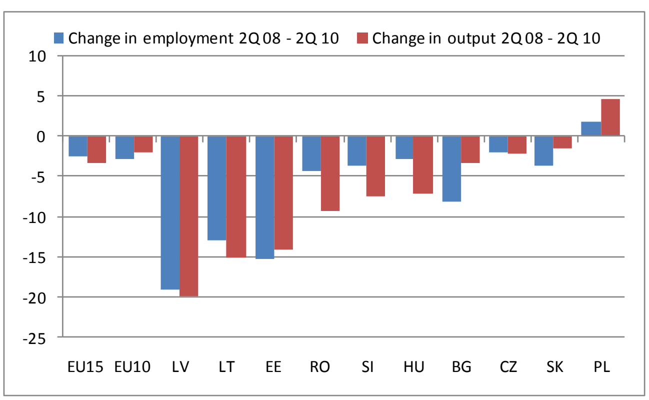


Figure 26. Share of unemployed and inactive in working age population in EU10 and EU15



Source: Eurostat, US Bureau of Labor Statistics, World Bank staff calculations

Figure 27. Change in employment vs. change in output, 2Q 08 - 2Q 10, percent



Source: Eurostat, World Bank staff calculations

Increases in fixed-term contracts and part-time work helped to moderate the reduction in employment during the downturn (Figure 28, Figure 29). The share of fixed-time contracts in employment in the EU10 increased from 9.8 percent in the second quarter of 2008 to 10.4

percent in the second quarter of 2010, while it remained at around 11 percent in the EU15. The share increased in all EU10 countries with the exception of Bulgaria and Romania where job losses were high among workers on fixed-term contracts. Fixed-term employment is especially high in Poland, as it was facilitated through legislation in the past and remains a tool for companies to reduce labor costs. Part-time work increased across all EU10 countries. Its share increased across the EU10 from 6.1 percent to 7.1 percent over the two-year period. It remains far lower than in the EU15 where legislative efforts to encourage such employment are more advanced.

Figure 28.Fixed-term employed as percent of total employed, percent

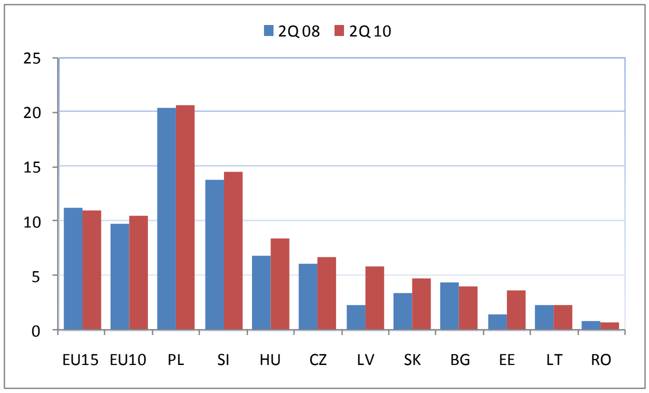
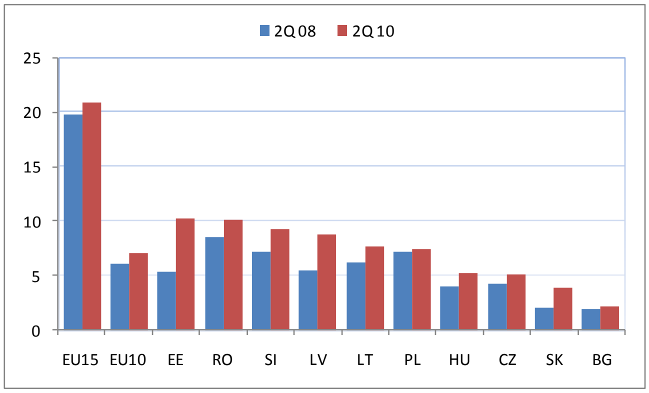


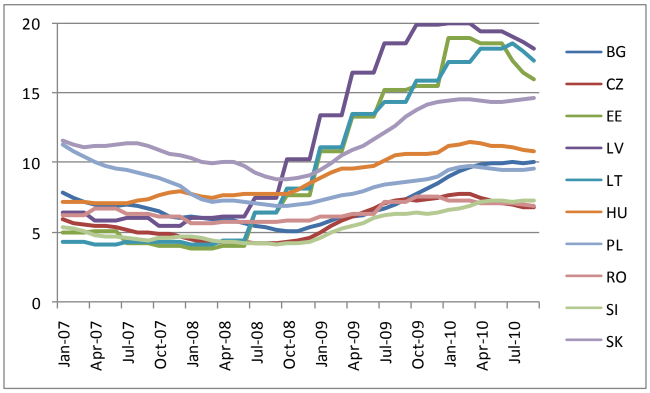
Figure 29. Part-time employed as percent of total employed, percent



Source: Eurostat, World Bank staff calculations

Unemployment has begun to decline but remain elevated in a number of countries. The number of unemployed dropped from around 4.8 million in March 2010 to 4.6 million in September 2010, reducing the unemployment rate from 10.1 percent to 9.7 percent. Unemployment rates fell across the region since early 2010, with the exception of Bulgaria, Slovakia and Slovenia. Nevertheless, large differences persist between countries. Unemployment rates in Latvia, Lithuania and Estonia although went down in the last two months, they still exceeded 17 percent, fuelled by large output reduction during the crisis, and 10 percent in Slovakia, Hungary and Bulgaria (Figure 30).

Figure 30. Harmonized monthly unemployment rates, percent



Source: Eurostat, World Bank staff calculations

Notes: For Estonia, Lithuania and Romania monthly figures starting July 2010 are derived based on registered unemployment rates.

The reduction in unemployment was supported by fairly smooth job search process. The number of unemployed per vacancy declined from 32 in the first quarter to 30 in the second quarter of 2010, although it remains far above the pre-crisis level of 6 two-years ago. It ranged from 129 unemployed per vacancy in Latvia to 14.6 in the Czech Republic (Figure 31). The drop in unemployment did not lead to a worsening in the job matching process. This is demonstrated by the Beveridge curve, which shows the relationship between job openings (vacancies) and unemployment. In advanced economies like the US or the EU15, the Beveridge curve has generally followed a pattern of shifting to the right during a recovery, as the matching of unemployed to vacancies becomes less efficient. One potential reason for this could be that even though unemployed workers take up job offers, workers who had left the labor force might resume looking for a job, and thereby keeping the unemployment high. Fortunately, the recovery in the EU10 labor market has so far not followed this pattern (Figure 32). The drop in unemployment and vacancies from the first to the second quarter was a movement along the curve. One reason might be that in the EU10 the crisis did not induce many workers to drop out of the labor force, with inactivity rates among the working age population remaining unchanged compared to pre-crisis. As a result, unemployment rates might respond faster to the recovery.

Figure 31.Unemployed per vacancy ratio

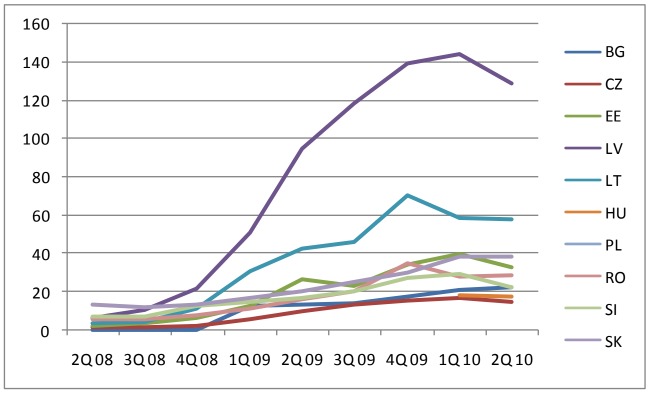
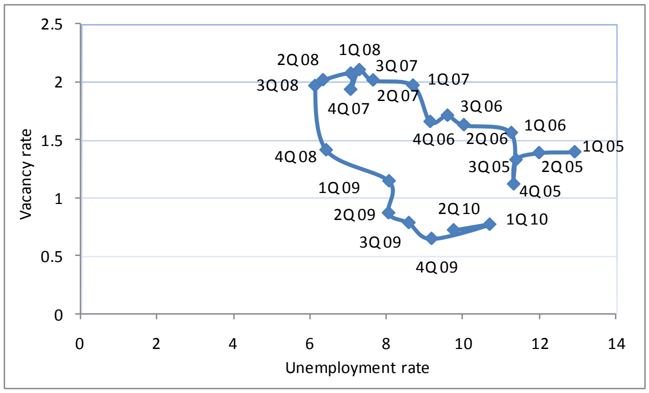


Figure 32. Beveridge curve for EU10 countries, 1Q 05 - 2Q 10



Source: Eurostat, World Bank staff calculations

However, job market conditions remain difficult for workers with low education and little work experience and long-term job seekers. Unemployment rates in EU10 countries for workers aged 20 to 24 reached 22 percent in the second quarter of 2010, more than twice as high as overall unemployment rates (Figure 33). Low skilled workers are also more affected from unemployment, in part because sectors like constructions underwent large downward adjustments. Finally, the crisis made it much harder for workers who had lost their job to return to employment. The share of the labor force unemployed for 12 months or more increased from 6.2 percent in the second quarter of 2008 to around 10 percent in the second quarter of 2010. The incidence of long-term unemployment is higher in countries with large output contractions (Figure 34).

Figure 33.Unemployment rates for 20-24 and 20-64 year-olds in 2Q 10, percent

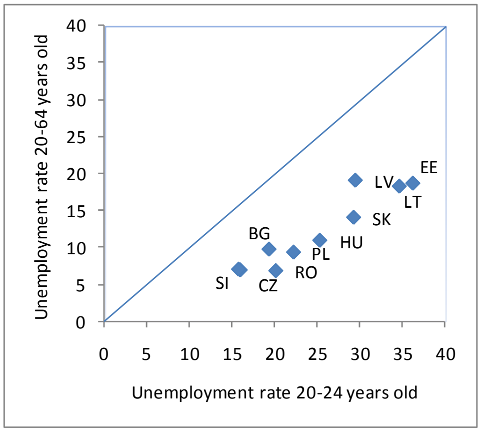
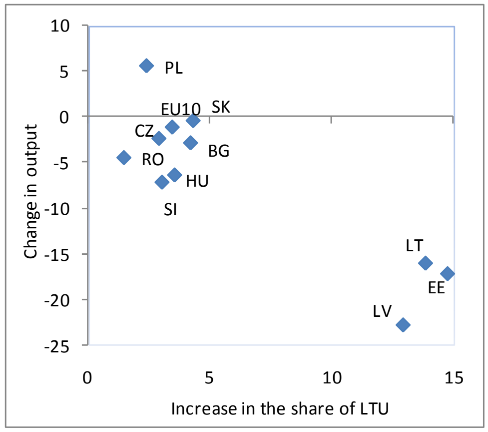


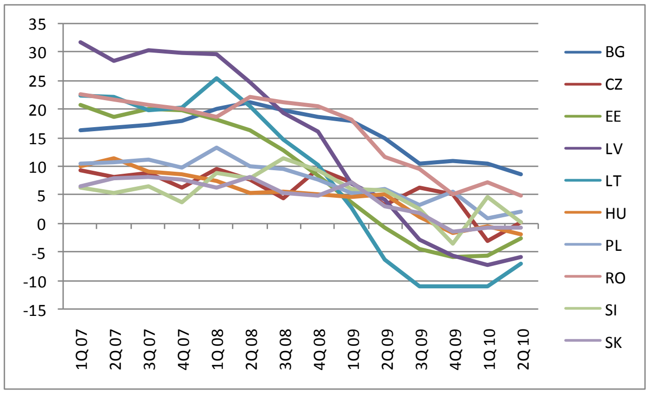
Figure 34. Increase in long-term unemployed vs. change in output 2Q 08 - 2Q 10, percent



Source: Eurostat, World Bank staff calculations

Wage pressures remain subdued across the region. Hourly labor costs continued to decline in the second quarter of 2010 relative to the previous year. The reductions were largest in countries with pegged exchange rate regimes, where wage adjustment alongside with productivity enhancement is important for restoring external competitiveness. In Romania and Bulgaria, the growth of hourly labor costs slowed down relative to the first quarter in 2010. Poland and the Czech Republic experienced increases in line with the strengthening economic recovery and falling unemployment (Figure 35).

Figure 35. Labor cost index , % change



Source: Eurostat, World Bank staff calculations

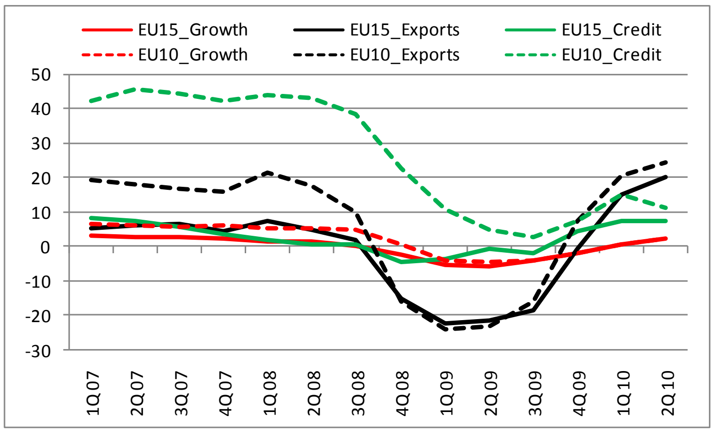
Note: The labor cost index shows the short-term evolution of the total cost of labor, on an hourly basis for employers, including gross wages and salaries, employers' social contributions and taxes net of subsidies connected to employment.

Outlook

The rebound phase of the global recovery is drawing to a close. Some of the very high growth rates of the past few quarters are expected to give way to more sustainable but still close to potential growth rates. As a result, global growth is expected to slow somewhat in 2011 as compared with 2010. The recovery in high-income Europe, which has lagged that of the United States and especially that of the developing world appears to be strengthening and becoming more broadly based which should be good for EU-10 countries, partially offsetting the somewhat weaker growth anticipated for other parts of the world.

The recovery in the EU10 continued in 2010. The rebound in global trade and industrial production has lifted economic activity in Europe which only half a year ago was threatened by a profound crisis. European economies benefit from the upswing in trade, the return of confidence in financial markets in response to decisive policy action, low interest rates, and positive feedback effects between the real and financial sectors. Growth in the EU15 is expected to improve from minus 4.2 percent of GDP in 2009 to 1.6 percent in 2010. The EU10 countries are well placed to make the most from this uplift through close trade and production linkages, competitive production costs, a skilled workforce, and nimble entrepreneurs (Figure 36). The pace of the recovery in the EU10 will accelerate once firms raise investment and households resume consumption in response to the improved external environment and normalized financial conditions.

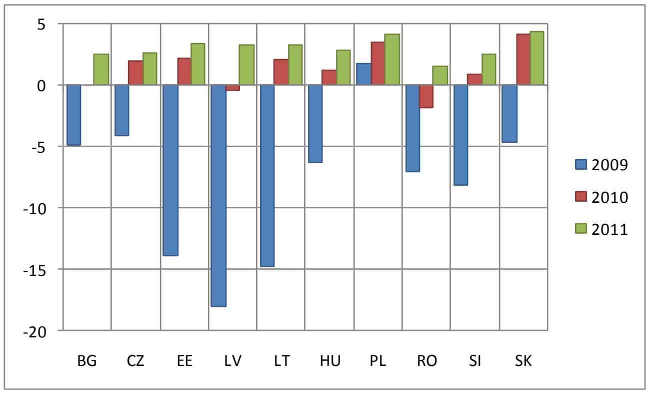
Figure 36. EU10 and EU15 GDP growth, exports growth, credit growth, percent



Source: Eurostat, World Bank staff calculations

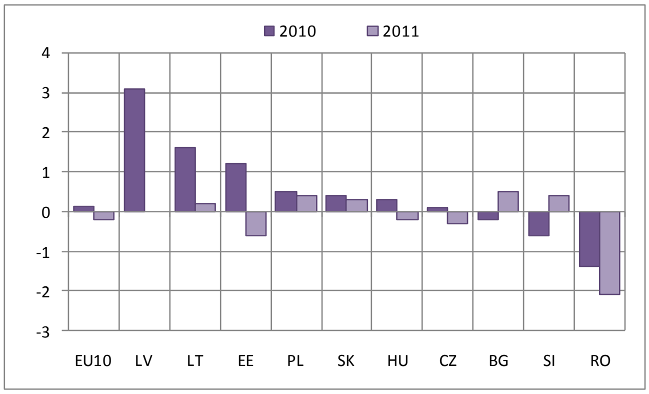
The EU10 is set for a recovery at varied speed. The EU10 is projected to see an expansion of 1.8 percent in 2010 compared to a contraction of 3.5 percent in 2009. Relative to the forecast from July 2010, the growth forecasts in Latvia, Lithuania and Estonia have been revised upwards in view of the stronger-than-expected rebound in exports. Romania's growth forecast has been revised downwards as the sharper-than-expected decline in domestic demand. In 2010, Slovakia and Poland are leading in the region with growth of 3.5 percent or more, helped by modest adjustment needs during the crisis, a normalization of global trade and capital flows, and – in the case of Poland – solid consumption (Figure 37 and Figure 38). Estonia and Lithuania, which undertook large adjustments during the crisis, are set for a turnaround from a contraction of around 15 percent in 2009 to an expansion of around 2 percent in 2010. Growth in the Czech Republic, Bulgaria, Hungary, and Slovenia is likely to be more modest, ranging from 0 to 2.0 percent, as domestic demand remains weak. Only Latvia and Romania are projected to contract in 2010, reflecting the large adjustment needs from unsustainable domestic booms in the run-up to the crisis.

Figure 37. Projected growth in EU10 countries, 2009-2011



Source: World Bank staff
Note: For EU15 countries forecasts were done by the International Monetary Fund.

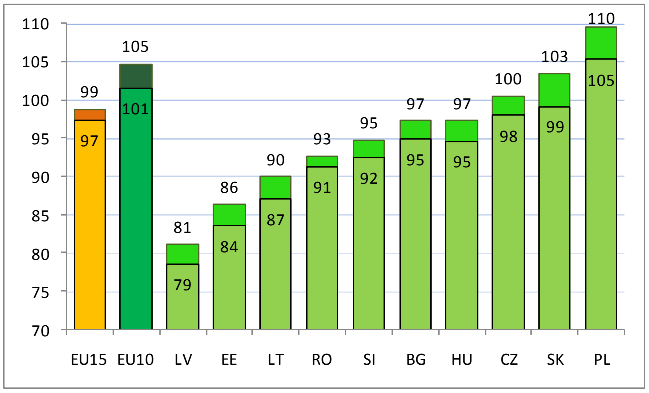
Figure 38. Change in growth forecasts from July 2010 for EU10 countries



Source: World Bank staff

Growth is projected to accelerate gradually in 2011. Assuming stable financial markets and a sustained global recovery, the pace of the recovery in EU10 economies is set to increase to 3.2 percent, restoring part of the historic growth differential between EU10 and EU15. All countries are projected to record positive growth. In addition to Poland, which did not experience recession, Slovakia and Czech Republic are projected to exceed pre-crisis output levels in 2011 (Figure 39). These three countries had the lowest domestic vulnerabilities among the EU10 prior to the crisis, because they succeeded in avoiding excessive credit growth, domestic demand booms and high inflation. Furthermore, EU10's growth is supported by sustainable macroeconomic balances. The composition of growth in the EU10 is projected to shift next year. Export growth is projected to slow, but this will be more than compensated by strengthening of domestic demand. With actual output still below potential, inflation is projected to be moderate in the medium term.

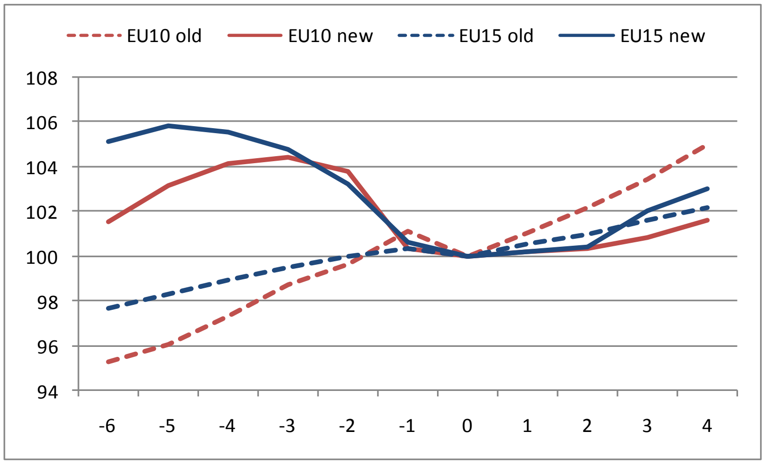
Figure 39. Level output in 2010 and 2011 as percent of the pre-crisis peak output



Source: World Bank staff calculations

However, the rebound in the EU10 faces a number of risks. The pace of the recovery from the crisis the EU10 is slow compared to the rebound from the economic slowdown in the late 1990s/early 2000s (Figure 40). The main risk is a weak recovery in Europe, as prospects for exports, credit and jobs in the EU10 depend foremost on a strong recovery in the EU15. The EU15's recovery from the global financial crisis could be sluggish and may still be followed by a relapse. The short-term outlook is modest, as growth in the EU is expected to moderate in 2011. Fiscal consolidation in a number of EU15 countries, the end of the inventory cycle and the recent appreciation of the euro will dampen economic activity. And in most countries, private demand is not strong enough to take the lead and sustain the expansion. Another risk is the return of heightened financial strains in the euro area, in spite of the recent improvements in European financial markets. A renewed deterioration of growth prospects, especially in euro area countries with high fiscal deficits and weak competitiveness, could increase non-performing loans and undermine credit growth. Renewed financial sector stress could spread quickly to the EU10 countries through cross-border linkages, as parent banks could shrink their subsidiaries' balance sheets.

Figure 40. Recovery in GDP levels during the late 1990s/early 2000s and the global financial crisis



Source: Eurostat, World Bank staff calculations

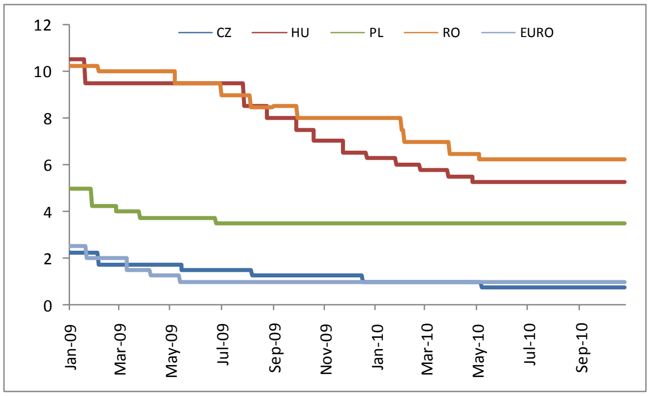
Notes: "Old" refers to the slowdown in the late 1990s/early 2000s. "New" refers to the slowdown in the global financial crisis. The x axis gives the number of quarters relative to the trough of the economic cycle, with 0 indicating the trough. GDP levels are indexed as 100 at the trough of the cycle.

Policies for Recovery

Monetary and Financial Policy

Monetary policy is set to remain accommodative. Price developments are expected to remain moderate over the medium-term horizon, as money and credit growth remains weak and the recovery proceeds at a moderate pace. In the euro area, the key policy rate of the euro area remained unchanged at 1 percent since May 2009, reflecting well anchored inflationary expectations and stepped-up fiscal consolidation in some euro area countries (Figure 41). Central banks in the EU10 region have kept policy rates unchanged since May 2010. While headline inflation has risen with growing food and energy prices, wage pressures remain limited, private domestic demand weak, and downside risks to the global recovery significant. In addition, low interest rates can help to prevent surges in capital flows followed by sudden stops. Nevertheless, with economic slack diminishing, monetary policy should be prepared to respond to signs of inflationary pressures. Active communication of EU10 central banks can help to firmly anchor inflation expectations going forward.

Figure 41. Policy rates in selected EU countries and euro area, percent



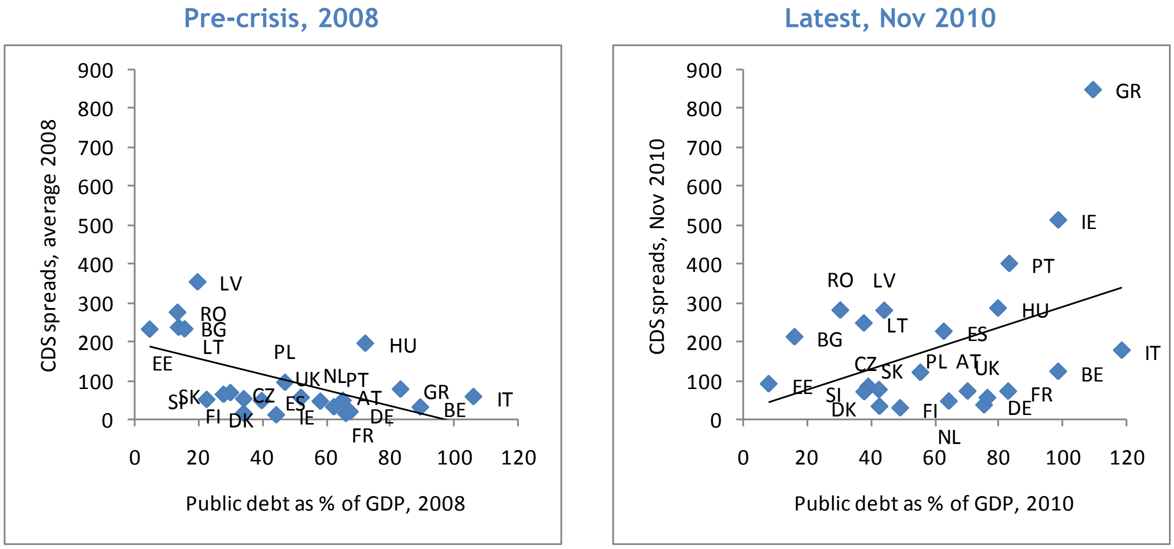
Source: Central Banks, World Bank staff calculations

Bolstering the resilience of the financial sector remains essential to safeguarding the recovery. Fortunately, financial markets in Europe have overcome the setback in spring 2010 thanks to strong policy measures and improved balance sheets due to the recovery in stock markets, rebound in corporate profitability, and a resumption of growth. The stabilization of financial markets in EU15 countries was central to financial stability also in EU10 countries due to the strong cross-border linkages. Nevertheless, market uncertainties persist in light sovereign and banking sector vulnerabilities. Governments have to tackle rising public debt burdens. Banks face the task of absorbing credit losses, raise additional capital needed to sustain the recovery under the proposed new Basel capital adequacy standards and support the recovery of credit, and ensure smooth rollover of funding. Foreign-exchange related risks, especially in the mortgage segment, remain important in a number of countries. Further measures are needed to reduce refinancing risks, facilitate loss recognition and bank restructuring, and strengthen the resilience of the financial system through macro-prudential regulation and cross-border prudential arrangements.

Fiscal Policy

Shoring up fiscal sustainability remains central for macroeconomic stability. Markets pay close attention to fiscal deficits and public debt burdens. While government bond spreads in the EU bore little relation to public debt prior to the crisis, bond spreads are now rising with higher public debt (Figure 42). The volatility in sovereign debt markets in spring 2010 was a reminder how quickly doubts over fiscal solvency can trigger a loss of confidence in financial markets. Government financing needs are expected to stay high in the coming years in view of high fiscal deficits and large maturing debts. The supply of government bonds could increase further in high-income countries once central banks unwind extraordinary monetary policies. Banks would face a double blow through losses in assets due to lower sovereign debt prices and increases in liabilities through higher interest rates. Such balance sheet pressures could spread quickly from advanced to emerging markets and undermine the nascent recovery.

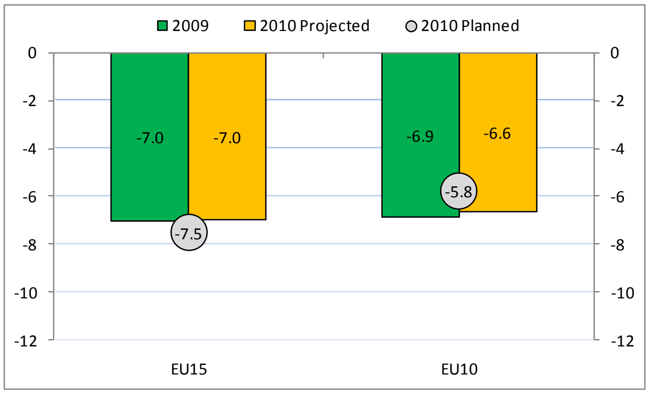
Figure 42. 5Y CDS spreads and public debt

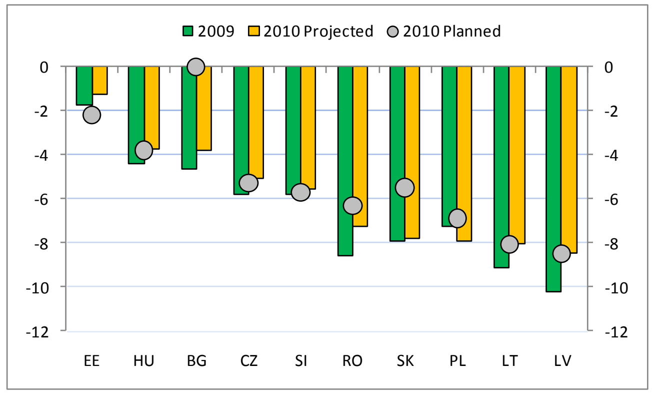


Source: Eurostat, EDP notification October 2010, Bloomberg, World Bank staff calculations

Fiscal deficits in the EU10 are set to decline only moderately in 2010. At the beginning of 2010, EU15 countries envisioned increases in fiscal deficits from 2009 to 2010, and EU10 countries decreases in fiscal deficits. This reflected larger fiscal space and more benign financial market in the EU15 than the EU10. However, based on the notifications to the European Commission from late October 2010, fiscal deficits are set to be almost unchanged in the EU15 and only moderately reduced in the EU10 (Figure 43). With the exception of Greece and Ireland, fiscal deficits in all EU15 countries are likely to be no higher than the targets announced in the convergence programs from early 2010. For example, Portugal and Spain have front-loaded consolidation efforts in response to financial market pressures. Germany and Sweden benefit from an unexpectedly fast improvement of tax revenues on the back of fast recovery. Among EU10 countries, Bulgaria, Poland, Romania, and Slovakia are expecting higher fiscal deficits than planned in early 2010. In Romania and Bulgaria, the slow pace of the recovery contributes to large fiscal deficits. In Bulgaria, Poland and Slovakia, growth is largely export-driven and hence less conducive for tax collection. In addition, loss carry-over provisions reduce corporate tax revenues.

Figure 43. Planned and projected general government fiscal deficits in EU10 and EU15 countries, 2009-10

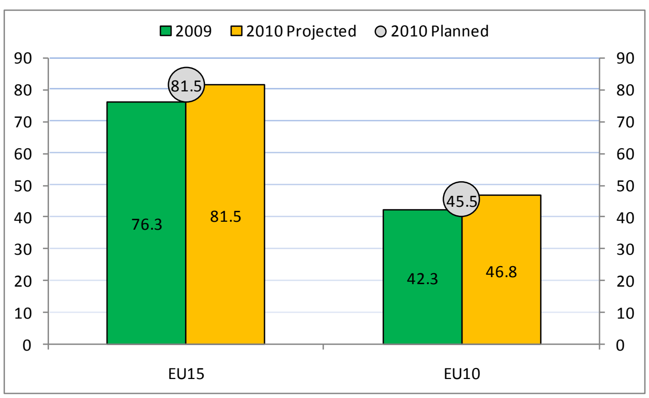


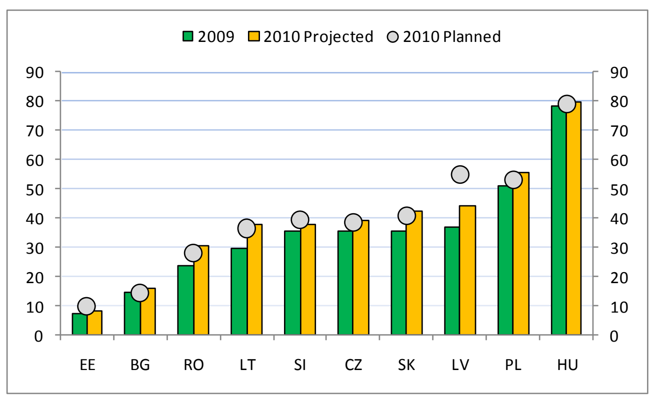


Source: Eurostat, October 2010 EDP notifications, March/April 2010 Updates of Stability/Convergence Programs, World Bank staff calculations

Nevertheless, markets continue to look favorably at most EU10 countries. Government bond spreads have come down noticeably since the peak of the crisis, and interest payments on debt in 2010 are broadly in line with plans. This suggests that market recognize that in spite of high budget deficits, the fiscal position in many EU10 countries is bolstered through a number of factors. In particular, public debt levels in the EU10 are far lower than in the EU15 (Figure 44). In Hungary and Poland, the two EU10 countries with public debt in excess over 50 percent of GDP, public debt includes the costs of pension reforms that have enhanced the long-term sustainability of public finances. These pension reforms also lead to higher fiscal deficits. In addition, overall external vulnerabilities are sharply reduced in view of the large improvements in current account balances. Finally, many EU10 countries have succeeded to protect public investments from fiscal cuts (Figure 45). This helps to enhance growth prospects without undermining fiscal balances as a large part of these investments is co-financed through EU structural funds.

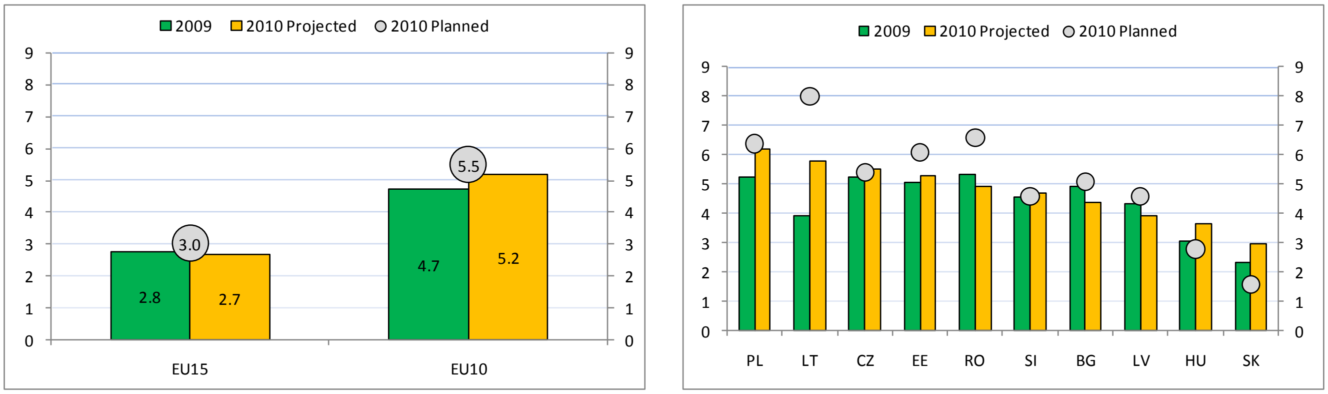
Figure 44. Planned and projected general government public debt in EU10 and EU15 countries, 2009-10





Source: Eurostat, October 2010 EDP notifications, March/April 2010 Updates of Stability/Convergence Programs, World Bank staff calculations

Figure 45. Planned and projected public investment in EU10 and EU15 countries, 2009-10



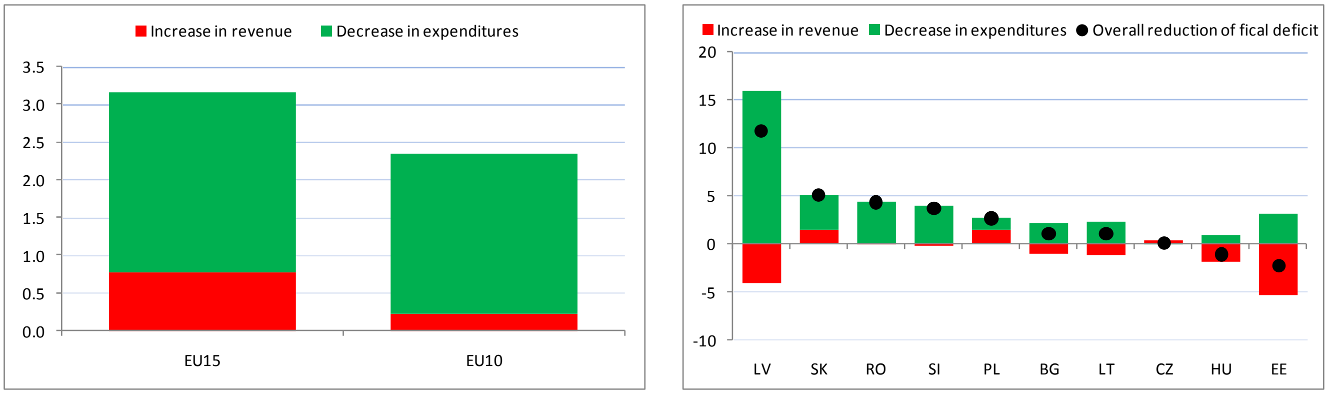
Source: Eurostat, October 2010 EDP notifications, March/April 2010 Updates of Stability/Convergence Programs, World Bank staff calculations

Notes: EU15 data does not include Belgium and Greece for which data was not available.

However, volatile financial markets, rising public debt ratios and large structural fiscal deficits make progress on implementing credible medium term strategies crucial. Such action is required to comply with the Stability and Growth Pact and prepare countries for euro adoption. Public finance reforms can also ultimately enhance the flexibility of government to sustain growth. They include rationalizing benefit entitlements and stabilizing age-related spending, strengthening broad-based taxes and tax compliance, and enhancing fiscal institutions, including fiscal rules (Box 1). While EU10 countries have gone a long way to spell out measures to bring about short-term fiscal adjustments, more progress is needed in some countries to clarify long term targets for public debt and the size of government and detail structural reforms to meet these targets.

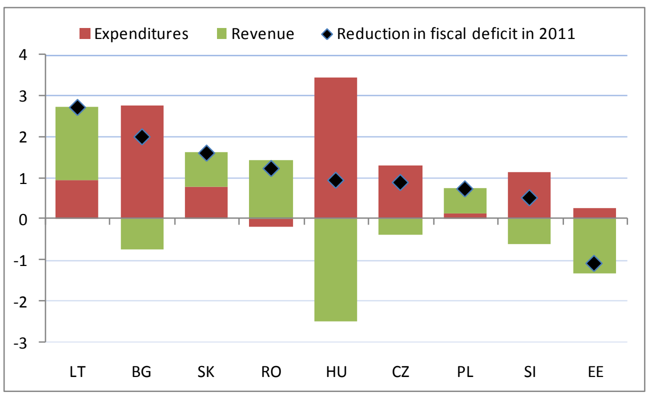
In order to reduce fiscal deficits in 2011, governments in EU10 countries have presented draft budgets to parliaments containing substantial fiscal consolidation measures. The fiscal deficit reductions rely predominantly on downward adjustments in public expenditures (Figure 47). This helps to ensuring that countries do not emerge from the crisis with large public sectors that are a drag on growth. In many countries, key proposed expenditure measures for bringing about the reduction in fiscal deficits are freezes or reductions in public sector wages and pensions, consolidation of discretionary spending and increases in the flexibility of government expenditures. All EU10 members have proposed freezing, or cutting, public wages in 2011, and Bulgaria, Lithuania and Slovenia have taken steps to limit increases in public pension. Public employment cuts have been operated or planned in Bulgaria, Czech Republic, Hungary, Lithuania and Slovakia. Hungary has proposed envisaged winding down of the second pillar of the pension system to improve the headline fiscal deficit. Efforts on the expenditure side are in some countries complemented through measures to broaden the tax base and strengthen tax administration. Since the crisis has undermined the tax base and weakened tax compliance, such policies are crucial to bolster revenue collection. In particular, Poland and Slovakia have proposed increases in VAT rates, and all EU10 countries apart from Estonia, Romania and Slovenia have tabled additional revenue measures (Table 1).

Figure 46. Decomposition of fiscal deficit adjustment into revenue and expenditures 2010 vs. 2013, percent of GDP



Source: IMF WEO database, World Bank staff calculations

Figure 47. Reduction in fiscal deficit* in EU10 countries in 2011, percent of GDP



Source: World Bank staff calculations based on draft 2011 budgets

Table 1. Government measures in 2011 draft budgets

	Pensions	Public wages	New revenue measures		
	Freeze	Freeze (or cut)	VAT	Direct Tax	Others
BG	✔	✔			✔
CZ		✔		✔	✔
EE		✔			
HU		✔		✔	✔
LT	✔	✔	✔		✔
PL		✔	✔		✔
RO		✔			
SK		✔	✔		✔
SI	✔	✔			

*Notes: *data on cash basis according to national methodologies; <u>state budget</u> data for CZ, EE, SK, SI, PL and RO; <u>consolidated general government</u> data for BG, <u>national budget</u> (state and municipal budget) data for LT, <u>general government budget excluding local governments</u> for Hungary.*

Budget draft for Latvia was not publicly available at the time of the preparation of this report.

Some countries have strengthened fiscal institutions. Medium-term budgetary frameworks, effective budget process to implement these frameworks, and independent fiscal agencies that monitor policy design and implementation can all make fiscal policy more credible, For example, fiscal rules that limit public expenditure increases during an economic upturn could, together with multi-year and performance-based budgeting, contribute to sustainable fiscal finances over the long-term. A number of EU10 countries have moved in this direction (Table 2). For example, Poland has prepared legislation to limit the growth of discretionary expenditures in the state budget, equal to about 15 percent of state budget expenditures, to no more than inflation plus one percent until Poland exits from the EU's excessive deficit procedure. Hungary's fiscal responsibility law requires a reduction of the budget deficit as percent of GDP and a cap on expenditure growth in 2010 and 2011. Romania's fiscal responsibility law from 2010 set up a binding medium-term fiscal framework, establishes limits on budget revisions during the year, and lays out fiscal rules in order to improve budget implementation. Latvia is also preparing a new fiscal responsibility law, and Lithuania a new deficit rule. In addition, the European Council has decided to strengthen economic governance in the EU in order to increase fiscal discipline, broaden economic surveillance and deepen coordination (Table 2).

Box 1. Fiscal policy choices during the crisis

Looking across countries in Europe and Central Asia, a variety of policies have aimed to mitigate the decline in aggregate demand (through tax cuts, increased transfers and public works for example), to reduce financial sector weaknesses (through bank recapitalization and deposit insurance enhancement for example), enhance confidence in long-term government policies (through wage bill and pension containment and the adoption of fiscal rules) and/or to protect the vulnerable in society (through increased wage subsidies, training, tax cuts, and transfers). The fiscal policy response became more urgent in countries where monetary policy was constrained (e.g. countries with fixed exchange rates) or ineffective in raising aggregate demand (lowering interest rates did not or could not help), or where it could not be properly targeted as per governments' objectives. Some of the policies that countries adopted during the crisis to contain expenditures and maintain revenues are not sustainable over the longer run. Expenditure rationalization has tended to take the form of ad-hoc constraints on spending rather than expenditure reductions resulting from effective prioritization driving budgeting or enhanced efficiency in the public sector. For example, wage freezes in the public sector, cuts in capital expenditures, expanded social and employment programs (if employment does not pick up), may not be consistent with effective public sector performance or with fiscal sustainability. Countries may also need to revisit their tax policies. A number of countries changed tax rates in response to the crisis (such as selective lowering or increase of VAT rates) and these actions may need to be revised. If growth rates are indeed lower in the next few years, expenditure priorities will need to be rethought and in some cases, so will taxes. Many countries have rationalized tax policy over the last few years. In the boom of the pre-2008 period, this rationalization has resulted in tax policies (or tax rates) that have sustained high expenditures but when growth remained at high levels.

Source: Roumeen Islam, To Spend or Not To Spend: Fiscal Choices for ECA in the Crisis and its Aftermath, World Bank 2010, Luca Barbone, Roumeen Islam, Luis Alvaro Sanchez, The Great Crisis and Fiscal Institutions in Eastern and Central Europe and Central Asia, World Bank Policy Research Working Paper No. 5453, 2010

Table 2. Recent changes in fiscal frameworks

	Date	Type of rule	Medium term	Coverage	Binding character	Monitoring	Sanctions
Austria	1999, 2005, 2009	E, B	Y	GG	L	Gov, MF	R
Germany	1990, 2007, 2009	B, E, D	Y	GG	C, L	I	O
Hungary	1996, 2007, 2010	E, D, B	Y	GG	L	I	O
Latvia 3)	*1994. 2010*	B, D	Y	GG	L	Gov	R
Poland 1)	1997, 2006, 2010	D, B, E		NG, SG	C,L	MF, Gov	R
Romania	1990, 2000,2010	E, B	Y	GG	L	I	O
Slovenia	1990, 2000, 2009	D, *E*	Y	GG	L	I	O
Spain 2)	1990, 2006 ,2009	B, D	Y	GG	L	MF, Gov, P	R
United Kingdom	1997, 2010	B, D	Y	GG	L	I (P)	O

Source: WB staff ,Kopits 2007, IMF 2005, EC 2010.

Notes: 1) The introduction of permanent expenditure rule is envisaged, 2) No details on number and type of rules adopted in 2010 3) New FRL prepared. Note: General government (GG), national (central, federal) government (NG) or subnational governments (SG); Legal act (Public finance Act, Fiscal Responsibility Law (L)), Constitutional base (C); Debt rule (D), Expenditure rule (E), Balance rule (B), Non-oil Balance (NOB); Other Sanctions (O), Reputational (R); Parliament (P), Government (Gov), Finance Ministry (MF); in italic not approved.

Box 2. Economic Governance Reform in the EU

On October 29, 2010, the EU27 leaders adopted two measures to advance reforms of European economic governance in light of the challenges revealed by the recent financial crisis.

First, the European Council agreed on the need to establish a permanent debt-crisis mechanism to safeguard the financial stability of the euro area by 2013. This will replace the EUR440 billion European Financial Stability Facility and the EUR110 billion three-year aid program, both of which were created in May in response to the Greek sovereign debt crisis and expire in 2013. This will require a limited treaty change without modifying article 125 that bans member states from bailing each other out.

Second, the European Council endorsed the Task Force report on economic governance, prepared under the chairmanship of EU President Van Rompuy. The Council specified the objective for the Council and the European Parliament to reach agreement by summer 2011 on the Commission's legislative proposals on economic governance.

The Task Force report presented on October 21, 2010 included the following proposals:

1. Economic Surveillance: A mechanism for macro-economic surveillance is to be created, which will serves as an early warning system detecting the risk of real estate bubbles or of unsustainable patterns in the balance of payments or strong divergences in competitiveness.

2. Budgetary Discipline: The Stability and Growth Pact (SPG) is to be strengthened with introduction of a wider range of sanctions for non-compliance and introduction of the new set of additional benchmarks with particular focus on debt position. For all decisions on sanctions, the so-called reversed majority rule will apply: a Commission recommendation on sanctions will be adopted unless a qualified majority of Member States in the Council votes against.

3. Coordination: The coordination of economic policies will be improved through the introduction of the “European Semester”, to be launched from January 2011 onwards. National budgetary plans and underlying macroeconomic assumptions are to be presented to the Commission and the Council for strategic advice.

4. Crisis Mechanisms: A more robust framework for crisis management is to be introduced in order to replace the temporary European Financial Stability Facility. This new mechanism should be capable of addressing financial difficulties and preventing contagion from one country to another.

5. National Fiscal Institutions: Fiscal institutions, including fiscal councils, debt management agencies, statistics offices and others, are to be enhanced in order to be able to provide independent analysis and forecasts on domestic fiscal policy.

The European Commission adopted a package of six pieces of proposed legislation on September 29, 2010:

1. Preventive part of the SGP: The monitoring of public finances is to be based on the new concept of prudent fiscal policy-making that should ensure convergence towards the medium-term objective of the government deficit.

2. Corrective part of the SGP: Debt developments are to be followed more closely and put on an equal footing with deficit developments as regards decisions linked to the excessive deficit procedure. Member states whose debt exceed 60 percent of GDP should take steps to reduce it at a satisfactory pace, defined as a reduction of 1/20th of the difference with the 60 percent threshold over the last three years.

3. Effective enforcement of budgetary surveillance: A new set of gradual financial sanctions for euro-area member states is to be introduced and enforced through a reverse voting mechanism. For the preventive part, an interest-bearing deposit would be imposed in response to significant deviations from prudent fiscal policy making. For the corrective part, a non-interest bearing deposit amounting to 0.2 percent of GDP would apply upon a decision to place a country in excessive deficit procedure. This would be converted into a fine in case of non-compliance with the recommendation to correct the excessive deficit.

4. National budgetary frameworks: The objectives of the SGP are to be reflected in the national budgetary frameworks.

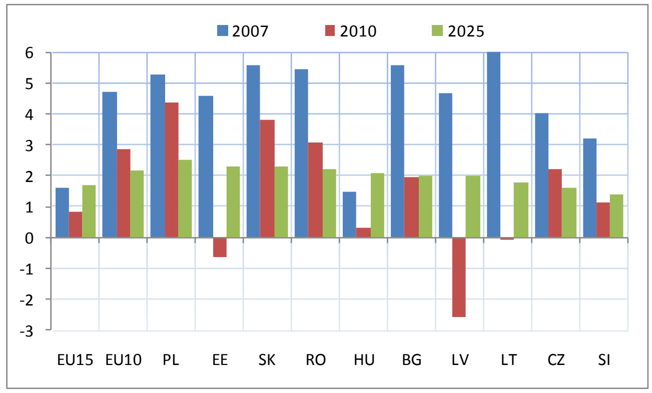
5. Excessive Imbalance Procedure (EIP): To strengthen the prevention and correction of macroeconomic imbalances, a regular assessment of the risks of imbalances is be introduced based on a scoreboard composed of economic indicators. For member states with severe excessive imbalances the Council may open an "excessive imbalance procedure". A member state under EIP would have to present a corrective action plan that will be vetted by the Council, which will set deadline for corrective action.

6. Enforcement of EIP: Failure to repeatedly act on the Council EIP recommendations to address excessive imbalances would leader to a financial fine (equal to 1 percent of country’s GDP) for a euro area member state. The fine would be enforced through a reverse voting mechanism.

Structural Policy

Policies to strengthen financial markets and fiscal frameworks require complementary measures to promote strong and inclusive growth. Bright growth prospects bolster private and public balance sheets, and thereby support credit expansion and fiscal consolidation. Two years after the outbreak of the global financial crisis, the EU10 has managed to return to growth, strengthen financial markets, and start reducing unemployment. Now the EU10 faces the challenge of building on this record in the uncertain post-crisis environment. In a world of financial market fragilities, sovereign vulnerabilities, and global imbalances, economic growth is harder to come by across the region. The crisis has damaged the productive capacity of the economies through higher cost of capital, lower capital inflows, higher unemployment, and downsizing of sectors like finance and construction. This has lowered potential growth in the EU10, far more than in the EU15. Aging will also be a drag on growth through shrinking labor forces. According to EC estimates, potential growth in the EU10 is set to decline from 2.8 percent in 2010 to 2.2 percent in 2025 (Figure 48).

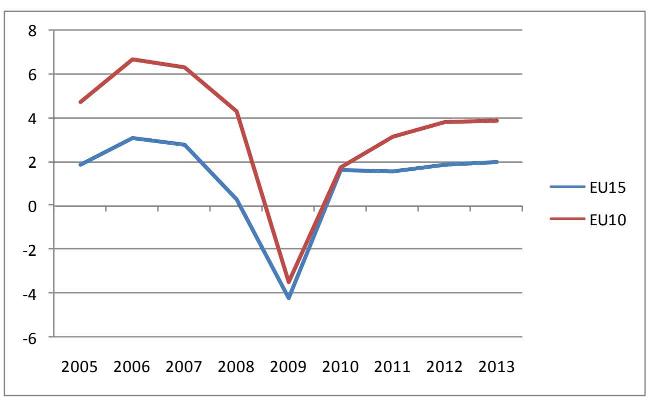
Figure 48. Potential growth in 2007, 2010 and 2025, percent



Source: Ameco database, European Commission 2009 Ageing Report, World Bank staff calculations

Reinforcing convergence to EU living standards is central for growth. After two decade of transition, the EU10 is halfway to EU15 in terms of living standards. EU10 grew faster than the EU15 every single year from 1993 to 2008, apart from 1998 and 1999. The average growth differential was around 3 percentage points. By contrast, in 2009 and 2010, the EU10's growth differential dropped to 0.6 percent of GDP (Figure 50).

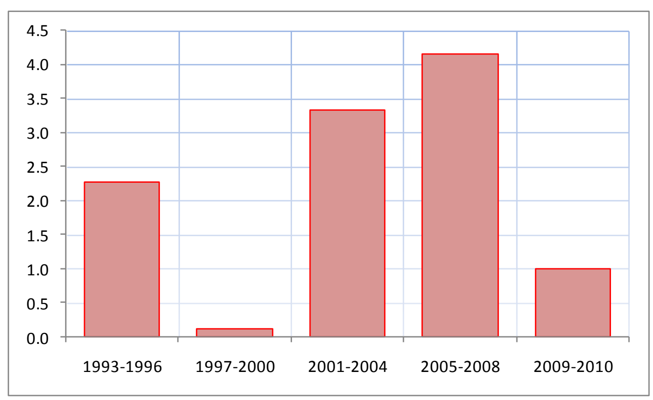
Figure 49. EU10 and EU15 projected growth, percent, year-over-year



Source: World Bank staff

Note: For EU15 countries forecasts were done by the International Monetary Fund.

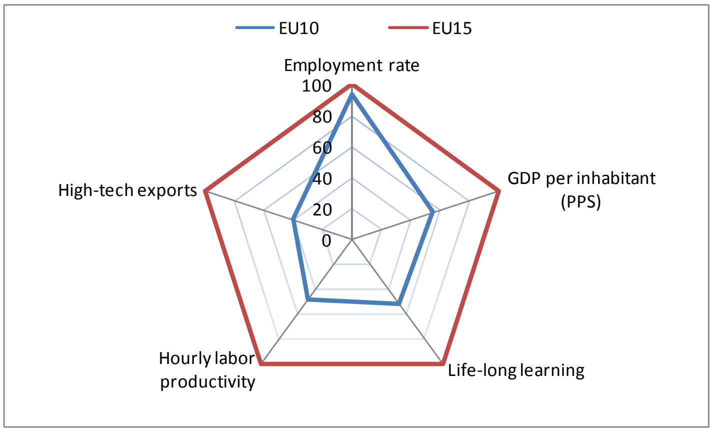
Figure 50. Average PPS per capita growth differential to EU15 by period, percentage points



Source: Ameco database, World Bank staff calculations

Removing structural barriers can strengthen growth without bringing back unsustainable domestic demand booms fuelled by excessive credit expansion. As envisioned in the EU's new Europe 2020 strategy, many growth-oriented reforms are designed to foster the microeconomics of creation and destruction and aid structural change and innovation. While the growth challenge varies across the EU10 as countries have followed different trajectories in terms of GDP growth and its components, three structural reform areas are likely to be relevant in all EU10 economies. The reform agenda ranges from absorbing EU flows and promoting FDI flows; increasing labor force participation and strengthening skills; and improving technology and market integration.

Figure 51. Structural indicators - EU10 average as percent of EU15, EU15 = 100, 2009 or latest



Source: Eurostat, World Bank staff calculations

Table 3. Selected structural indicators for EU10 countries

	Employment rate	GDP per person in PPS, 2009, EU27 = 100	Life-long learning	Hourly labor productivity	High-tech exports
BG	62.6	41	1.4	33.7	3.3
CZ	65.4	80	7.8	55.2	12.7
EE	63.5	62	9.8	50.6	8.0
HU	55.4	63	3.1	51.8	20.3
LT	60.1	53	4.9	43	4.7
LV	60.9	49	6.8	37.2	4.2
PL	59.3	61	4.7	44.1	3.1
RO	58.6	45	1.5	36.5	3.8
SI	67.5	86	13.9	73.6	4.7
SK	60.2	72	3.3	67.7	5.8
EU15	65.9	111	10.9	100	17.5
EU27	64.6	100	9.5	87.5	16.6

Source: Eurostat, World Bank staff calculations

Notes: Life-long learning refers to the percentage of the population aged 25-64 participating in education and training over the four weeks prior to the survey; Hourly labor productivity is expressed in relation to the EU-15; High-tech exports is a share of high technology products in total exports.

First, the stock of productive capital is lower in the EU10 than in the EU15. The estimated capital stock is about three times the size of GDP in the EU15, but only two times the size of GDP in EU10 countries. This difference in capital endowment means that EU10 countries are less productive than EU15 countries. Hence, capital accumulation is crucial for raising productivity in the EU10. Tapping foreign savings can accelerate this process. The EU10 can draw on large EU funds to overcome infrastructure and human capital bottlenecks at a time when the global financial crisis has reduced private capital inflows. In addition, FDI can boost growth through higher investment, production, and exports, as well as higher productivity and competitiveness of domestic firms, thanks to spillovers and more intense competition. However, EU funds and FDI benefit the economy only when inflows are matched by the capacity to absorb them. This requires a strong administration, skilled workers, and a friendly business environment.

Second, despite progress over the last decade, labor market participation remains relatively low. In particular, the employment rate is only 61 percent in the EU10 compared to 66 percent in the EU15. Key reforms include increasing the legal retirement age, especially for women; fostering live-long learning; providing incentives for employment through integrated social protection, social assistance and labor market policies; and enabling parents to meet the demands of both work and home.

Box 3. Why is the employment rate lower in Hungary than in the Czech Republic?

In 2009, Hungary had the lowest employment rate in the EU region, barely exceeding 60 percent, while the Czech Republic's employment rate was the second highest in the region, exceeding the EU-27 average. What explains the difference? The difference in employment rates in the two countries is likely due to the three following factors:

- Tax wedge: There is a broad consensus in the literature that a high tax wedge reduces reported employment, especially of the low-skilled young and older workers, and increases unreported employment (OECD 2010b). Until recently, Hungary's tax wedge is the highest among OECD countries, while that of the Czech Republic is below the OECD average.
- Access to Preretirement and Disability Benefits: Access to disability benefits in Hungary, as measured by the number of recipients, is the easiest among all OECD countries. According to the latest data, 12 percent of the Hungarian population was receiving disability benefits compared to only 7 percent in the Czech Republic.
- Skills: In as much as educational outcomes can be used as a proxy for labor force skills, the quality of education in the Czech Republic, normalized by spending per student, is slightly better than in Hungary.

Thus, Hungary could significantly increase its overall employment rate by lowering the tax wedge, reducing access to pre-retirement and disability benefits, and improving workforce skills through better education. As part of the 2011 draft budget, Hungary proposes the phased introduction of a flat personal income tax, which would lower its tax wedge considerably.

Source: Nina Arnold: Europe 2020 Engagement Note, World Bank, forthcoming.

Third, despite the rapid convergence to EU living standards over the last decade or so, the EU10 still faces a large productivity gap relative to advanced economies. Hourly labor productivity in the EU10 is only half the level of the EU15 (Box 4). Addressing the scarcity of capital and raising skills can bridge part of the gap. In addition, a number of sectors are still subject to stringent regulation, including network industries, retail services, and professional services. Finally, raising productivity requires emulating the good practices of management, using technologies available in advanced economies, finding new market for new products and integration in the global economy.

Box 4. Why is growth of labor productivity low in Poland?

In the last two decades, improvements in the business climate, EU integration and a growing role of cross-border production brought about an upgrading of Poland's export basket. The share of labor-intensive exports of total exports dropped from 34 percent in 1999 to 22 percent in 2006, while the share of research-intensive exports increased from 27 percent to 35 percent. Similarly, in manufacturing exports, the share of low-technology exports declined over this period from 37 percent to 26 percent. Trade integration and export expansion changed Poland's value added sectoral composition. The gross value added growth rate in Poland reached 4.4 percent over the period 1995–2008, higher than in the Czech Republic and Hungary. Growth was driven mainly by manufacturing, finance, transport, communication, and wholesale and retail trade. However, the growth in manufacturing relied on higher labor input. Hours worked in manufacturing increased in Poland from 1995 to 2008 by 45 percent, and remained constant or declined in other Visegrad countries. As a result, gross value added per hour increased in Poland just on par with the EU15, and far slower than in the Slovak Republic, the Czech Republic, and Hungary. In addition, Poland's manufacturing sector contributed in 2008 only 25 percent of gross value added, compared to 32 percent in the Czech Republic and 39 percent in the Slovak Republic. One reason for Poland's low growth in labor productivity is low investment. Poland's investment rate was about 7 percent of GDP lower than in Slovakia and the Czech Republic, mainly because of lower private savings and lower private foreign investments. In particular, the private savings-investment gap from 1999 to 2008 was zero in Poland, but minus 2.8 to minus 3.7 percent of GDP in the Czech Republic, Hungary, and Slovakia. This translates to over 30 percent lower investment in machinery and equipment in Poland than in the Czech Republic and Slovakia.

Source: Kaspar Richter and Maciek Krzak: Poland: From crisis resilience to robust growth, in Mustapha Nabli (editor): The great recession and the developing countries: economic impact and growth prospects, World Bank, 2010.

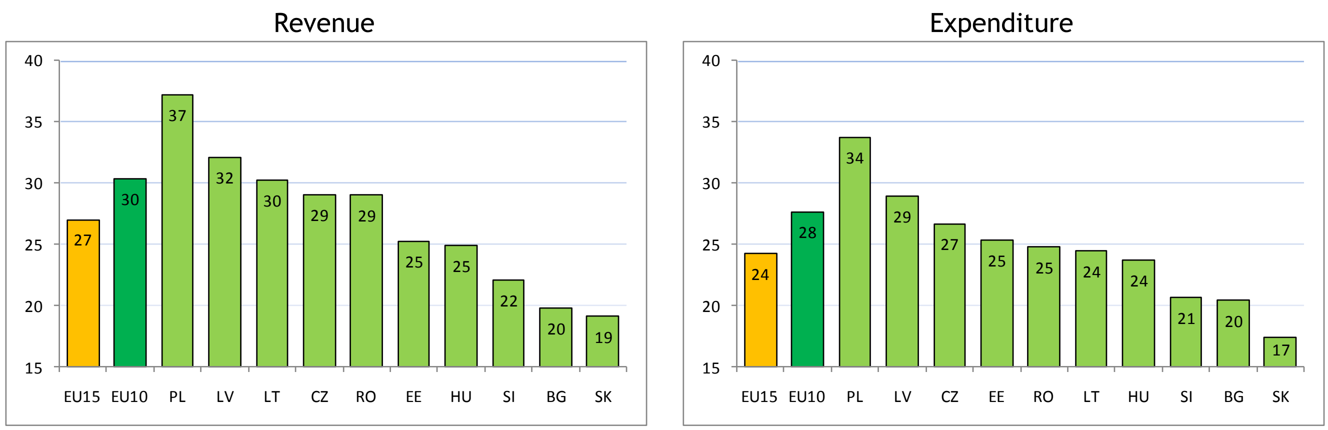
EU10 November 2010

In Focus: Impact of the Global Financial Crisis on Local Government Finances

Introduction

Local governments account for a large share of total government spending and revenues across the EU10 countries.[1] They amounted to about 30 percent of general government expenditures and revenues, a higher share than in the EU15. According to these indicators, local governments are more important in Poland, and less important in Slovenia, Bulgaria and Slovakia (Figure 52). In all EU10 countries, they play an essential role in providing public services to citizens and facilitating investments of businesses. Their fiscal policies also have significant macroeconomic implications. This focus note provides a brief overview of how the global financial crisis affected local government finances in the EU10, with particular attention to Hungary, Poland and Romania. It discusses the impact of the crisis on fiscal deficits and public debt, describes the policy responses to revenue losses and spending pressures at the local level, and the implications of reforms of local public finances in the future.

Figure 52. Local governments expenditure and revenue as percent of general government in 2009



Source: Eurostat, World Bank staff calculations

Increase in fiscal deficits

The crisis worsened fiscal positions of local governments, but less than of central governments and social security funds. All EU10 countries run general government deficits in 2009, with balances deteriorating 4.5 percentage points of GDP from 2007, the last pre-crisis year, to 2009, at the peak of the crisis (Figure 53). Hungary is the notable exception, where fiscal deficits declined in line with requirements of the excessive deficit procedure under the EU Stability and Growth Pact. While local government balances worsened as percent of GDP in 8 of the 10 EU10 countries, the deterioration was more than 0.5 percent of GDP only in the Czech Republic, Poland, Bulgaria and Latvia. Local governments in Estonia and Slovenia even improved fiscal balances. In all EU10 countries apart from Hungary, the deterioration of central government balances was far more significant than of local government balances. Similarly, social security funds experienced a sharper worsening in fiscal balances than local governments, with the exception of Bulgaria. Fiscal deficits increased from 2007 to 2009 on average 0.8 percent of GDP at the local level, compared to more than 2 percent of GDP at the central level, and around 1.6 percent of GDP for social security funds (Figure 54). Most local governments are also projected to reduce fiscal deficits in 2010.

---

[1] Prepared by Ewa Korczyc, Kaspar Richter and Emilia Skrok. In this focus note, the term local government is used to comprise local governments (S.1313) according to ESA 95 methodology.

Figure 53. Increase in general government deficit by subsector 2007 to 2009, percent of GDP

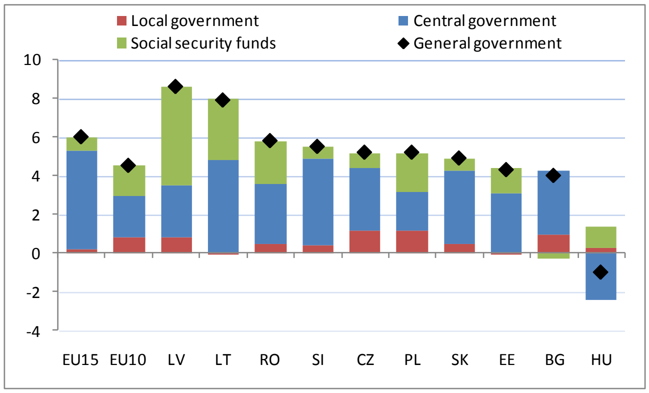
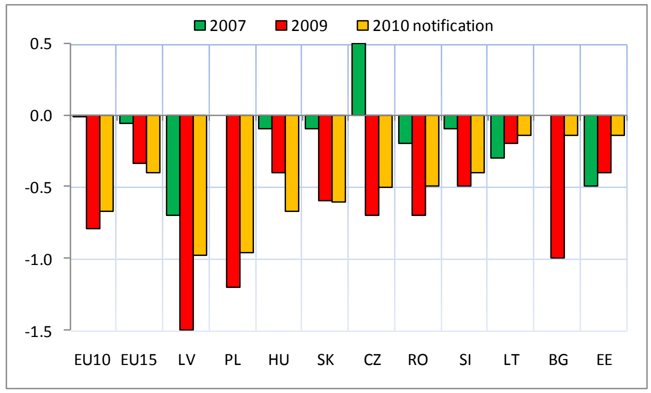


Figure 54. EU15 and EU10 local governments fiscal deficit in 2007, 2009 and 2010, percent of GDP



Source: Eurostat, World Bank staff calculations

The main reason for the moderate worsening in local government finances is that they operate, to varying degrees, within a fiscal straitjacket. Local governments bear the risk of any shortfall in revenues, as typically borrowing rules impose limits on the ability to borrow (Table 4), own source revenues comprise only a minor part of their budgets, and central governments are reluctant to cover budget gaps through higher transfers. Local governments also have almost no control over their revenues, either because they are fixed annually at the discretion of the central government (e.g., the education subvention) or are based on fixed shares of central revenues (e.g., the personal income tax). As they also have limited control over their expenditures, including centrally mandated salary increases, their ability to manage these risks is constrained. This forces local governments to take substantive measures to balance their books, by drawing down accumulated reserves; cutting spending in categories they do control, principally capital works, eliminating tax exemptions, broadening tax bases, or increasing rates; and increase absorption of EU funds.

Table 4. Fiscal rules for local governments in EU10 countries

Country	Borrowing constraints			Budget balance requirements	Expenditure limits
	Limitation on Stock of Debt (Limits on Total Outstanding Debt)	***Limitation on Flow of Debt*** (Limits on Debt Service Payments)	Requirement to use Long Term Borrowing only for Capital Investments		
Bulgaria	✔	✔			
Czech Republic		✔			✔
Hungary		✔	✔		
Estonia*	✔	✔		✔	
Latvia**	✔			✔	
Lithuania	✔	✔	✔		
Poland ***	✔	✔			
Romania		✔		✔	✔
Slovakia	✔	✔	✔	✔	
Slovenia		✔			

Source: World Bank staff

*Notes: *Estonia: the current debt rule for local governments is now more stringent requiring the authorization of the Ministry of Finance for new borrowing plans; **Latvia: Fiscal Responsibility Law is currently under preparation; ***Poland: The Public Finance Law from 27 August 2009 will change LGs' debt limits starting 2014. There will not be any absolute legal ceiling on LGs' debt. LGs' ability to incur new debt will depend on a debt-servicing ratio.*

Box 5. Fiscal policy responses to the crisis in Hungary, Poland, and Romania

In Hungary, the local government deficit increased from 2007 to 2009 moderately, and this increase was more than compensated by the improvement at the central level. This trend is set to continue in 2010. The continued deterioration in local government finances is in part due to time lags of the tax system. For example, receipts of shares in personal income tax in 2010 are based on collections in2008. Similarly, the Hungarian business tax, levied retrospectively on turnover, will show the effects of the crisis mainly in 2010.

Early in the crisis, Poland's local governments allowed fiscal deficits to increase, aided by tax reductions adopted prior to the crisis at the central level. Both central and local government deficits increased from 2007 to 2009. Local governments in Poland increased borrowing to sustain increases in capital spending and centrally mandated salary increases. In 2010, government deficits are projected to increase at the central level, but decrease at the local level.

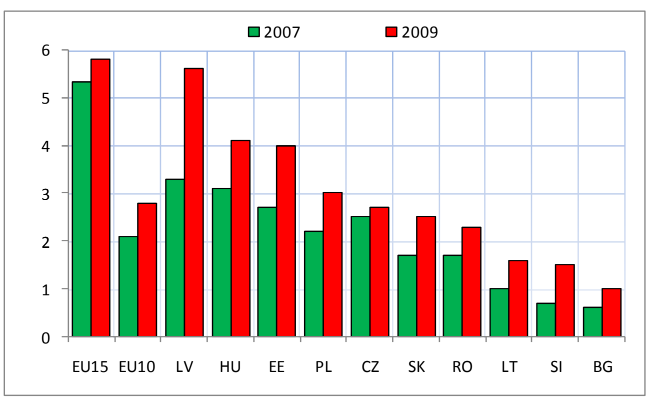
Like Poland, Romania experienced a significant deterioration in the central government deficit from 2007 to 2009, although the rise in local government deficit remained more modest. In 2010, both central and local governments are projected to consolidate.

	POLAND		HUNGARY		ROMANIA	
	2009	2010	2009	2010	2009	2010
Pro-cyclical reactions			Investment cuts	Local tax increases (new wealth tax only 1st half)	Investment cuts	Reductions in investment and current spending Increases of local taxes rates and fees
Counter-cyclical reactions	Investment increases Centrally-mandated tax cuts adopted prior to the crisis	Investment increases		Investment increases Local business tax cut Centrally-mandated tax cuts		

Modest increase in public debts

The increase in local government deficits translated into a modest rise in local government debt. Local government debt increased less than one percent of GDP from 2007 to 2009, although the rise was noticeably larger in Latvia and Estonia, in part due to sharp contractions of GDP in these countries (Figure 55). The increase in public debt in the EU10 was almost exclusively due to higher central government debt (Figure 56). Overall, local government debt was only 7 percent of general government debt in 2009, which reflects mainly balanced budgets prior to the crisis. The local share in public debt was far higher in Estonia, but Estonia's overall general government debt was only 7 percent of GDP in 2009, by far the lowest in the EU (Figure 57).

Figure 55. EU10 and EU15 local governments debt in 2007 and 2009, percent of GDP



Source: Eurostat, World Bank staff calculations

Figure 56. Increase in general government debt by subsector 2007 to 2009, percent of GDP

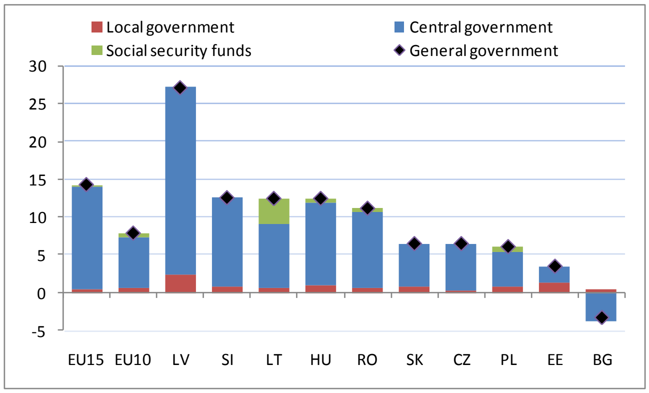
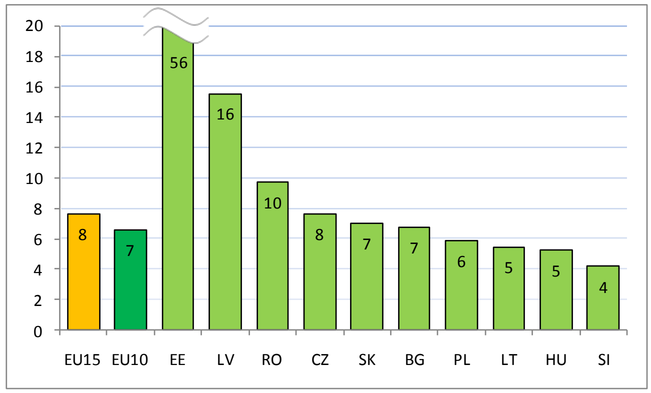


Figure 57. Local governments debt as percent of general government debt in 2009



Source: Eurostat, World Bank staff calculations

Box 6. Crisis impact on public debt in Hungary, Poland and Romania

Local government debt increased from 2008 to 2009 by about 0.7 percent of GDP in Poland and 0.5 percent of GDP in Romania, and 0.2 percent of GDP in Hungary. Local government debt remained below 5 percent of GDP in all three countries.[2] The debt increase resulted mainly from an increase in the deficit (Poland and Hungary), and only to a limited extent from higher costs of servicing debt (rises in bank lending rates and depreciation of national currencies). Although the debt indicators look favorably at the aggregate level, the individual debt situation of local governments units differ substantially within the countries. For instance, the number of local governments in Poland that are getting close to the statutory debt's limits has increased importantly since end of 2008.[3] Debt of the central government rose by about 3.0 percent of GDP in Poland, 4.8 percent of GDP in Hungary and 9.7 percent of GDP in Romania.

While the crisis has reduced or depleted operating surpluses of local governments, the private sector continues to supply credit, primarily in the form of municipal bonds. In addition, European financial institutions such as EIB, CEB or EBRD have increased lending to countries in the Central Europe. Some national governments, such as Hungary, have provided bridging financing for municipalities faced with heavy costs of EU pre-financing or non-eligible expenditure. As a result the crisis has not altered considerably the debt structure of local governments. The share of foreign borrowing in total debt declined somewhat for Romania, while the share of bond financing increased somewhat in Hungary. In Hungary, the stock of local government securities increased almost ten times from the first quarter of 2007 to the last quarter of 2008, while the amount of loans remained relatively stable. This reflects the ease of managing local bond issuance (private placements with no public procurement involved) and the sustained demand for municipal bonds. The growth of bond financing, however, came to halt in the beginning of 2009.

[2] However, general problem in all three countries is that the definition of local government debt does not in all cases fully cover all of their obligations, as sometimes promissory notes, financial leasing, and given guarantees are not monetized in debt service limits, nor do they appear in debt inventories neither at face value nor discounted. Romania still confronts with the problem of unpaid bills, especially to utility companies, which are not fully reflected by the public accounting system.

[3] The Public Finance Act states that the total amount of any LG's debt must not exceed 60 percent of its total revenue at end of each reporting period, nor at year-end. These rules do not cover debt issued for pre-financing (bridge financing) projects co-financed from EU funds. In addition, annual debt-servicing expenditure, which includes debt repayment plus interest paid and guarantees due in a current year, must not exceed 15 percent of total revenue. This ratio includes interest to be paid in a current year from pre-financing loans The new debt-management regulations is to be implemented from 2014 onwards.

Figure58. Hungary: local government debt, millions of local currency

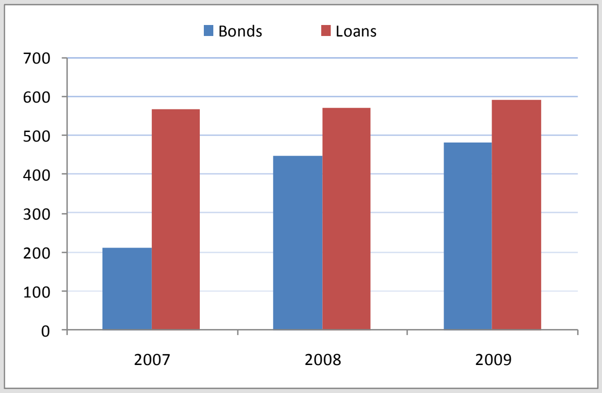
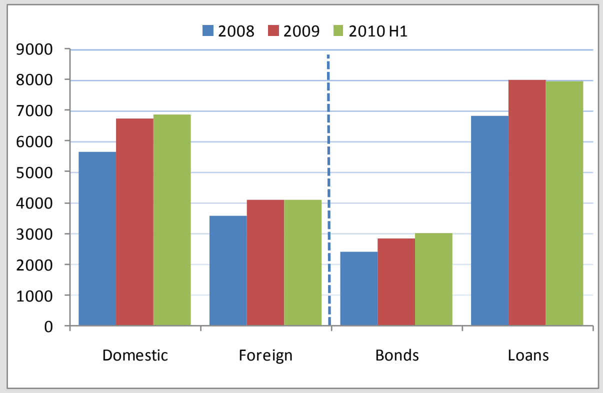


Figure 59. Romania: local government debt, millions of local currency

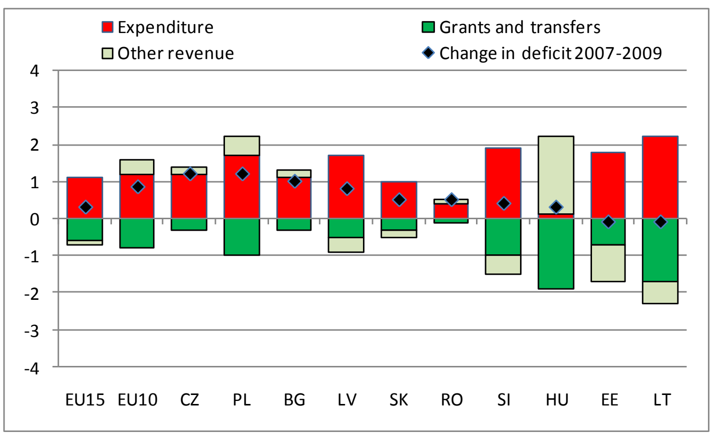


Source: Ministries of Finance, World Bank staff calculations

Decline in tax revenues, increase in transfers

Local government deficits increased from 2007 to 2009 due to lower tax revenues and higher expenditures. The reduction in tax revenues was large in many countries as local government typically rely more on cyclically sensitive income taxes. Local budget balances also worsened due to increased spending. However, EU funds and central transfers linked to mandated expenditures, such as education transfers and social assistance payments, played an important role in stabilizing revenues at the local level (Figure 60), which moderated the rise in fiscal deficits.

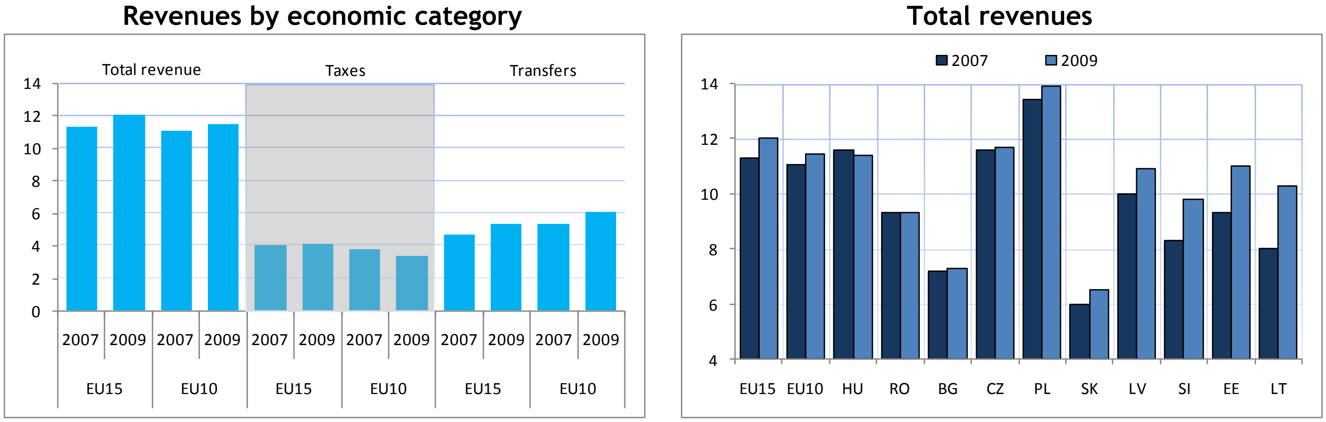
Figure 60. Composition of local government fiscal deficit increase 2007-2009, percent of GDP



Source: Eurostat, World Bank staff calculations

Transfers from the central and the EU budget were vital in bolstering revenues. As a share of GDP, revenues increased moderately across the region from 2007 to 2009. Only Hungary saw a modest decline (Figure 61). This remarkably strong performance reflects two factors. First, the reductions in GDP led to increases in the tax-to-GDP ratio in some countries. Second, while revenues from taxes declined, local governments benefited from increased transfers from the center and especially higher EU funds. All EU10 countries experienced an increase in such transfers from 2007 to 2009 as percent of GDP. The rise amounted to almost one percent of GDP.

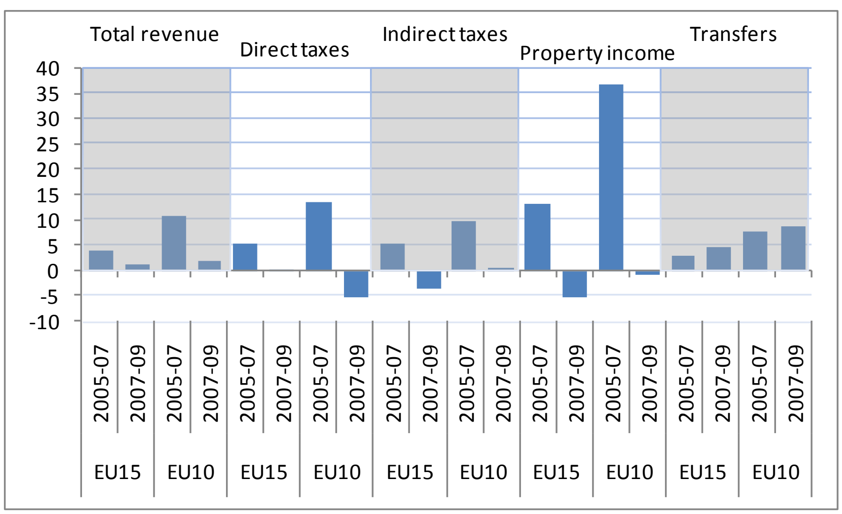
Figure 61. Local governments revenue in 2007 and 2009 as percent of GDP



Source: Eurostat, World Bank staff calculations

The growth of revenue sources other than transfers declined sharply during the crisis. To net out the impact of changes in GDP, it is worthwhile to study trends in revenues growth rates. Overall revenue growth in the EU10 in real terms declined from over 10 percent from 2005 to 2007 to just around 2 percent from 2007 to 2009 (Figure 62). This was a larger reduction than the one experienced in the EU15. This matches the sharper deterioration in economic growth for the EU10 than the EU15 during the crisis. Separating the sources of revenues, the decline in growth was larger for direct taxes, including income from property, than for indirect taxes. This confirms the standard expectation that income taxes are more sensitive to the business cycle than indirect taxes. The impact on direct taxes was so large that the growth turned negative. The poor performance of property income is indicative of reduced local economic activity.

Figure 62. Average real growth of revenue for EU10 and EU15 in 2005-07 and 2007-09, percent



Source: Eurostat, World Bank staff calculations

By contrast, the growth of transfers and grants accelerated over the four-year period. This is consistent with the large increase in EU funds to the EU10 as part of the 2007 to 2013 perspective. In addition, disbursement of EU funds accelerated, thanks to the efforts by national government and the European Commission to simplify the procedures for approving, disbursing and managing funds. Furthermore, some local governments profited from higher central government transfers, for example as an automatic result of equalization formula. In Romania, the central government has assumed the full funding of minimum income guarantees, which previously were co-financed by local governments. In addition, in countries like Poland, earmarked grants for public investment increased and the appropriations were used more fully. Local governments of EU15 countries also benefited from an increase in transfers from central governments, mainly as a result of higher funding for social benefits.

Box 7. The crisis impact on revenues in Hungary, Poland and Romania

The main source of fiscal stress for local governments was the revenue decline from shared taxes. In case of shared taxes (i.e. personal or corporate income taxes), the local governments in the selected countries have no control over their bases and rates and are exposed to central government decisions. Therefore they were not able to increase rates, or to change tax bases to compensate for declines in their tax bases. In particular, the revenues from shared taxes dropped significantly in Poland, in part because of a tax cut enacted pre-crisis, and Romania, although in the latter with important lag (Figure 1 and Figure 2). In addition, in personal income tax revenue of Polish local governments declined due to the state government's decision to reduce taxes. The central level granted tax relief for this tax to families with children in 2008 and reduced rates for individuals to 18 percent and 32 percent in 2009. Hungary's good performance of shared taxes in 2009 results from the increased share of personal income taxes transferred from central level introduced in 2007 as well as the stability in the personal income tax sharing ratio.

The local authorities faced with a decline in shared tax revenues have put more effort into improving the collection of local taxes, such as property and local business taxes. The local taxes, fees and charges are dependent on more stable bases and the local authorities usually do have substantial autonomy to influence their tax bases or rates. Particularly, Romania, reports substantial rise in property and land tax yields. Many Romanian local councils took action at the beginning of 2010, when the local budgets were approved, to increase the yield of the property tax, by raising the rates and improving fiscal zoning. In turn, this demonstrated that this type of local tax was previously underutilized. In contrast, local governments in Poland have not managed to increase local taxes intake as both the base and rate of property taxes are subject to a centrally-determined ceiling, which is relatively low and adjusted annually for inflation.

The reactions to the economic downturn differed not only among countries but also within these countries, depending on the degree of fiscal autonomy enjoyed by particular type of local governments. Generally, the villages, smallest town and cities, towns which predominantly rely on the central government transfers and benefit from the equalization mechanisms have been hit the least by the economic crisis. For example, the localities and counties in Romania that benefited from the economic boost prior to 2008 were the hardest hit on own revenues in crisis, while the economically weakest units were affected less. In Poland, city-powiats and voivodship appear to be the most vulnerable to economic downturns. Their main revenue sources (share in personal and corporate income taxes) are sensitive to economic situation. Moreover, in case of the city-powiats, an important part of their other revenue comes from an asset transfer tax and real property sales, which are also strongly dependent on the economic situation. At the same time, the ability to increase revenues from locally-administered property tax is severely constrained. In the case of voivodship, local taxes and fees could not play a stabilization role as this local government level does not collect local taxes. In addition, the local government obligations to the fraternal equalization mechanism, which are based on tax revenues from two years earlier, has constituted a large burden, at a time when current revenues from shared taxes have been subdued. In Hungary, similar to Poland, large cities and the county local governments were hit the most by the economic crisis.

Figure 63. Poland: LGs revenue, constant prices 2008, millions of local currency

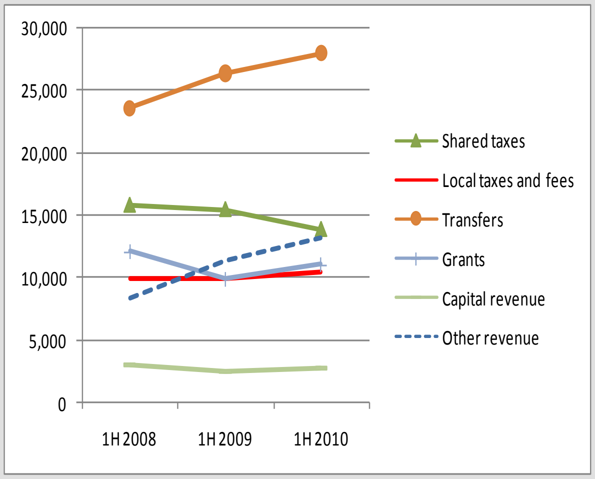
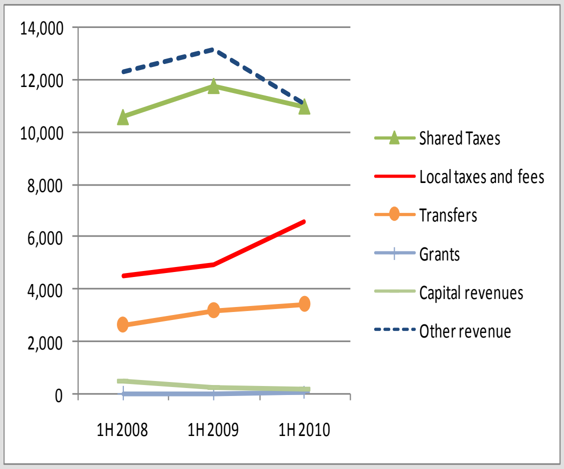


Figure 64. Romania: LGs revenue, constant prices 2008, millions of local currency

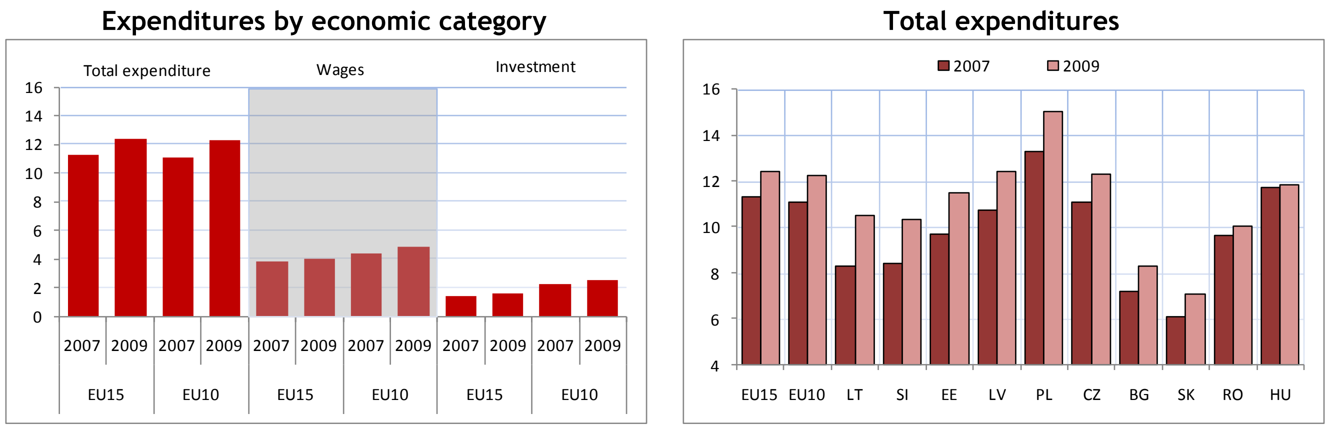


Source: Ministries of Finance, World Bank staff calculations

Increase in current expenditures, selected declines in capital expenditures

Current spending of local governments increased as percent of GDP during the crisis, while capital spending fell in a number of countries. Similar to the EU15, local government expenditure expanded from 2007 to 2009 about one percent of GDP (Figure 65). All EU10 countries experienced an increase. As for revenues, this reflects two factors. Some countries saw a reduction in GDP, raising spending ratios relative to GDP. Plus, all countries utilized increased transfers from EU funds and the central government to bolster expenditures. All EU10 countries boosted spending on wages and salaries of public sector employees. By contrast, investment increased as percent of GDP only in Bulgaria, the Czech Republic, Poland, Slovakia and Slovenia. Estonia, Latvia, and Lithuania reduced investments in order to support fiscal consolidation in line with the goal of early euro adoption. Likewise, Hungary and Romania cut investments to reduce fiscal deficits.

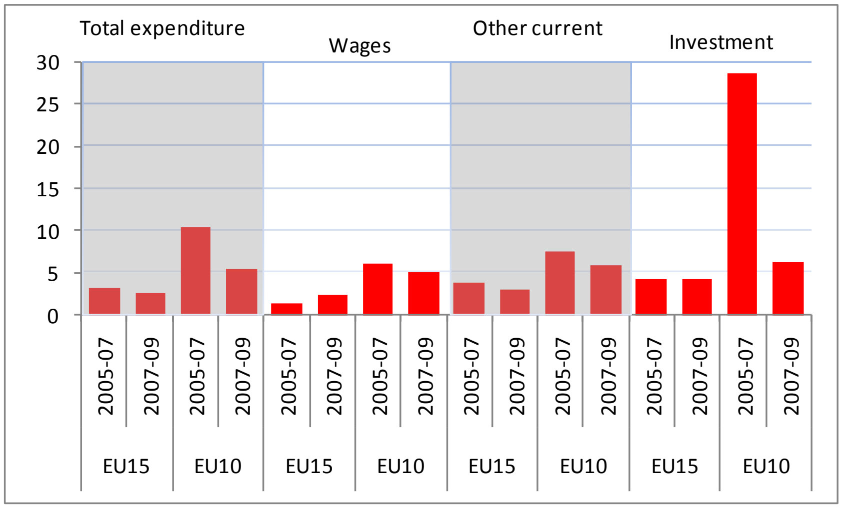
Figure 65. Local governments expenditure in 2007 and 2009 as percent of GDP



Source: Eurostat, World Bank staff calculations

Growth in expenditures slowed down, especially for investment. In view of the large changes in GDP, it is useful to look at expenditure growth trends. Expenditures increased 10 percent in real terms from 2005 to 2007 prior to the crisis in the EU10, and at half this rate from 2007 to 2009. Expenditure growth matched revenue growth prior to the crisis, leading to overall balanced budgets of local governments. During the crisis, expenditure growth exceeded revenue growth, triggering local government deficits in the EU10. While expenditures on wages and other current spending moderated only somewhat over this four-year period, growth on investment spending contracted sharply. The growth rate declined from close to 28 percent from 2005 to 2007 to 6 percent from 2007 to 2009. The stability of current expenditures reflects the mandatory nature of the bulk of expenditures, including wages and salaries. Likewise, local government have great discretion to adjust capital spending, resulting in a sharper downward adjustment. At the same time, EU funds ensured that capital spending growth remained positive from 2007 to 2009.

Figure 66. Average real growth of expenditures for EU10 and EU15 in 2005-07 and 2007-09 , percent



Source: Eurostat, World Bank staff calculations

Box 8. The crisis impact on expenditures in Hungary, Poland and Romania

In 2009, local governments were able to sustain or even increase expenditures thanks to availability of central and EU transfers and increased borrowing. In Poland, the economic slowdown of 2009-2010 has had fair modest impact on the trend of local expenditures. Current expenditures grow steadily, capital expenditures even more. The capital outlays rose by 8 percent in 2008 and 12 percent in 2009 year-on-year in real terms. During the first half of 2010, the spending on investment grew more slowly, but still far above output growth. In contrast, overall spending in Romania increased little in 2009, and declined in the first half of 2010.

In the face of budget constraints, local investment was easier to curtail than largely mandated current spending. Capital expenditure was the first casualty of a fiscal squeeze in both Romania and Hungary. In 2009, capital spending in Romania declined by more than 10 percent year-on-year in real terms. Romania introduced only in late 2009 sizeable and targeted reductions of current spending, primarily of the wage bill. As a result, local personnel spending was cut by more than 15 percent year-on-year in real terms in the first half of 2010. In Hungary, local government outlays for capital investment were reduced by about 10 percent year-on-year in real terms in 2008 and 2009. However, they increased subsequently, reflecting perhaps political pressures ahead of municipal elections.

In contrast, Poland reported strong increases in spending on investment purposes in 2009 and first half of 2010, although the rate of growth declined. Despite the strong investment growth, local authorities substantially undershoot their capital budgets in 2009, and are likely to do so again this year. Such under-spending is not just the result of the changed fiscal outlook. It also reflects weaknesses in the ability of local governments to prepare credible capital budget plans, and to manage well the implementation of their investments programs. At the same time, current spending of local governments grew throughout the crisis. During the first half of 2010, the wage bill, which constitute the largest and the least flexible component of local current spending in Poland, continued to grow by over 5 percent year-over-year in real terms.

Figure 67. Poland: LGs spending, constant prices 2008, millions of local currency

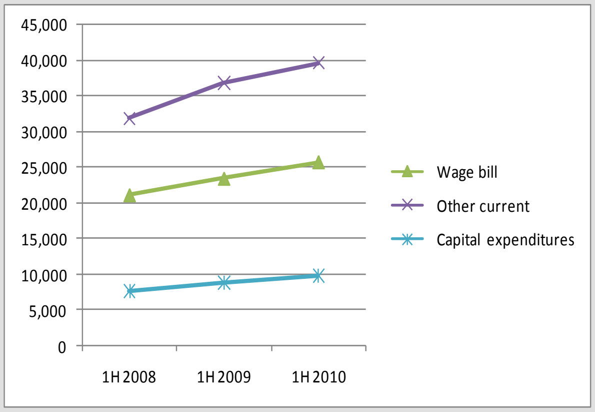
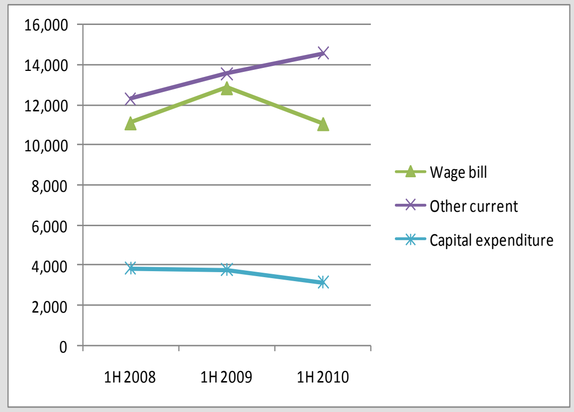


Figure 68. Romania: LGs spending, constant prices 2008, millions of local currency



Source: Ministries of Finance, World Bank staff calculations

Implications for Reforms

The state of local government finances will need to be considered when implementing fiscal consolidation strategies. The impacts of the crisis on local government finances differ across individual countries, and administrations within countries, depending on the severity of the crisis, policy responses of central and local governments, the nature of local government finances, and the structure of local economies. Nevertheless, the crisis has affected local governments across the EU10 region. Falling revenues and rules limiting the scope for local budget deficits led to moderations or contractions of spending across all EU10 countries compared to before the crisis. As fiscal consolidation has become the national priority in many countries, local governments will also need to start strengthening their fiscal positions. Limiting capital spending and borrowing on a large scale seems not to be sustainable. The consolidation at the local level could be even more difficult than at the central level, as local governments might see reduced transfers from the center, a slow rebound in own-source revenues, and lower EU financing in a few years from now.

Both central and local governments could consider structural reforms to ensure a sound local finance system in the medium term. Reforms could be envisioned in two areas:[4]

- *Reform of intergovernmental financial relations*
- *Improving cost and output efficiency in service delivery*

Reform of intergovernmental financial relations

First, structural reforms of intergovernmental fiscal relations could help to loosen the straitjacket in which local governments operate. These could take at least two forms. The first would be to increase revenue autonomy. For example, in Poland the most attractive candidate for liberalization would be the personal income tax. This liberalization would merely require that local governments be allowed to adjust the rate of the tax; specifically the rate on that proportion of the tax retained in their jurisdictions. This is already the practice in countries in Western Europe. Local governments in Scandinavia have long had the power to adjust the rate of local personal income taxes. This practice has more recently spread to Spanish regions, Italian regions and municipalities, and counties and municipalities in Croatia. In principle, local autonomy over PIT rates could complicate the task of revenue equalization. But this problem is readily solved. For purposes of calculating equalization transfers, PIT revenues could be assumed to be imposed at a nationally standardized rate. An individual local government could then be given the authority to impose a surcharge on the gross PIT receipts collected within its jurisdiction, with the revenues retained in the municipality rather than being subject to equalization.

[4] This section draws on three sources: Davey (2010). The Impact of the Economic Downturn on Local Governments, What is Happening and What Can Be Done About It? Report by the Open Society Institute to the Council of Europe 2010. Dillinger (2010). Poland: Mazowieckie Public Expenditure Review Local Responses to the Global Economic Crisis, World Bank, April 2010. Latvia Public Expencititure Review. From Exuberance to Prudence, World Bank, August 2010 (forthcoming).

The second form would be to relax central regulations on expenditures—particularly on personnel. This could include facilitating dismissal of redundant staff and allowing individual municipalities to adjust wage levels according to local economic conditions and spending priorities, rather than conforming to the terms of nationally-negotiated collective bargaining agreements. Such measures are likely to be controversial but reform is nevertheless possible. Approaches, for example, could include to adjust staff levels downwards through natural attrition limiting the need for involuntary redundancies, or to reduce job protection only for newly hired staff.

Improving cost and output efficiency in service delivery

Local authorities could also consider improving incentives for rationing and redesigning services delivery to lower costs and reduce variations in efficiency across the local governments. This may be assisted by several value-for-money and benchmarking techniques that have been developed in individual countries and the Council of Europe. The Ontario Municipal Benchmarking Initiative (OMBI) is one such benchmarking exercise that resulted from a voluntary imitative established by the Ontario Ministry of Municipal Affairs and Housing (Canada), regional chief administrative officers from across the province and 15 municipalities in 2000.

Local authorities could also consider improving incentives for rationing and redesigning services delivery to lower costs and reduce variations in efficiency across the local governments. Local governments should search for efficiency gains, i.e. by consolidating under enrolled classrooms, abandoning under-used bus routes, etc. This may be assisted by several value-for-money and benchmarking techniques that have been developed in individual countries.

In some countries, central and local governments may want to think about territorial reorganizations. They could reduce expenditure on administrative overheads, increase economies of scale, particularly in highly fragmented systems of local government. Such reorganizations may open the way to redesign service delivery and help to drive down costs and improve service quality. For example, Hungary has introduced greater co-operation between local authorities, both in operating services and undertaking administrative tasks, and thereby generated fiscal savings. However, territorial consolidation is not a panacea. What drives up costs in small jurisdictions is low population density, since small jurisdictions are typically in rural areas. As such, territorial consolidation does not make people live closer together.

References:

"Subnational governments and the crisis: fiscal impact and policy responses" by Ionita-Jokay-Peteri, LGID Ltd. June 2010

"Poland: Mazowieckie Public Expenditure Review Local Responses to the Global Economic Crisis", World Bank, April 2010

"Selected Issues in Fiscal Reform in Central Europe and the Baltic Countries 2005", World Bank 2006

Draft of Concept Note Romania Fiscal Decentralization TA Report, September 2010

"Assessment of the Status of Supply and Demand for Medium-long term Municipal Credit in Poland" Charles Jokay, June 2010 (unpublished)

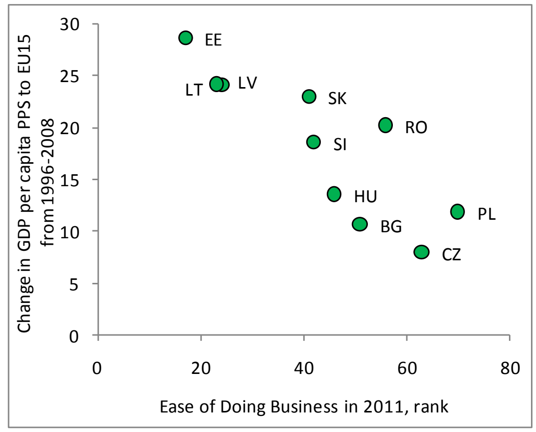
EU10 November 2010

In Focus: Doing Business in EU10 countries

Introduction

Improving a country's investment climate helps firms save time and money.[5] It also has positive effects on - among other things - creation of new firms, investment, exports and job creation. Since its launch in 2004, the Doing Business report has tracked reforms aimed at simplifying business regulations, strengthening property rights, opening up access to credit and enforcing contracts, among other areas of the investment climate. A higher ranking on the report's overall ease of doing business index corresponds to a more business-friendly regulatory environment.

Figure 69. Ease of Doing Business rank vs. change in GDP (PPS) in EU10 countries 1996-2008



Source: Eurostat, Doing Business in 2011 Report, World Bank staff calculations

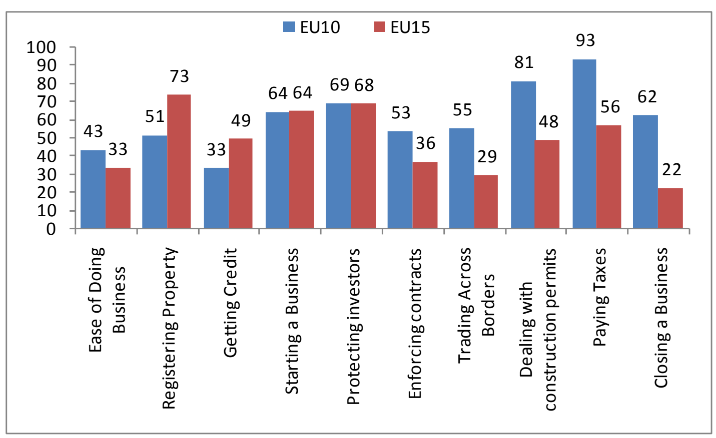
Reforming business environment removes obstacles to growth. Figure 69 shows that the ease of doing business is closely related to the pace of income convergence from the 1996 until 2008. While the crisis has shown that in some countries part of the income gains relied on unsustainable domestic demand booms, this suggests that doing business measures are relevant for long term growth performance. This note looks at the progress of the EU10 since 2008 in easing the business environment for a small or medium-size domestic company through its life cycle, highlights Hungary's reforms to become one of the top 10 doing business reformers in 2011, and looks at regulatory reform priorities for Poland.

Recent progress

In spite of the progress in reforming business environment in the last years, EU10 countries still have room for further improvements. In terms of overall Ease of Doing Business, EU10 countries rank 43 out of 183 economies assessed by the Doing Business report. This is around ten ranking positions behind the EU15 countries.

The performance of the EU10 across indicators is uneven. While in the areas of registering property, getting credit and starting a business the EU10 tends to perform better than the EU15, there is significant room for improvement in regulations related to enforcing contracts, dealing with construction permits, paying taxes and closing a business (Figure 70).

Figure 70. Average EU10 and EU15 ranks in Doing Business 2011



Source: Doing Business Report, World Bank staff calculations

[5] Prepared by Massimiliano Santini, with contributions from Ewa Korczyc and Marcin Piatkowski.

Estonia, Latvia and Lithuania remain the most business friendly countries in the region. All three countries perform far better than the EU15 average. Estonia ranks the highest at 17th place among 183 countries. Estonia is the EU10 best-performer in trading across borders, dealing with construction permits and paying taxes. Latvia scores the highest in contract enforcing and, together with Bulgaria, in regulations for getting credit. Lithuania is the regional leader in registering property (Figure 72).

Figure 71. Ease of Doing Business rank in 2011 and the change since 2010

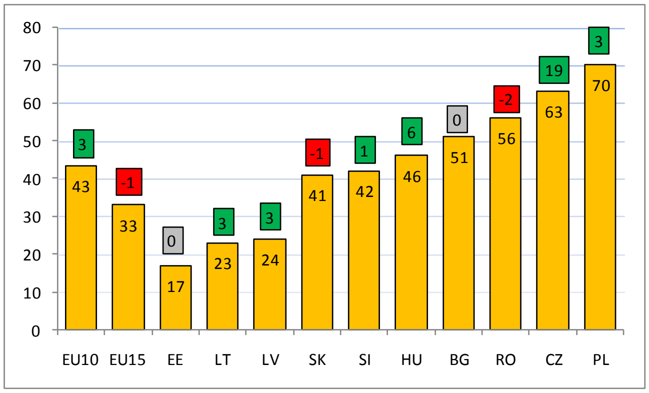
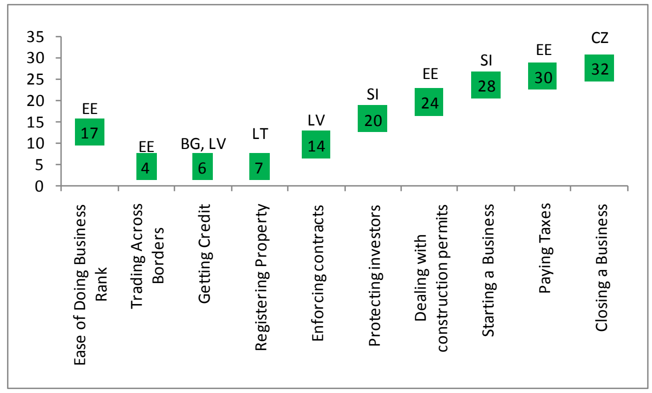


Figure 72. Best performers in EU 10 by reform area



Source: *World Bank, www.doingbusiness.org, World Bank staff calculations*

EU10 countries have been persistent reformers in the past few years. Since 2008, a total of 69 reforms have been introduced, improving business environment in the EU10 region. Countries have focused their efforts especially on removing obstacles faced by entrepreneurs trying to set up a business. In the last three years 15 reforms in this area have been implemented, with Bulgaria, the Czech Republic, Hungary and Slovenia being the most active reformers (Table 4). Registering property, closing a business and paying taxes have been the other areas of focus.

Table 5. Doing Business reforms in EU10 countries, 2008-2011

	BG	CZ	EE	HU	LV	LT	PL	RO	SK	SI	Total
Starting a Business	✔✔✔	✔✔	✔	✔✔✔		✔	✔		✔	✔✔✔	15
Dealing with construction permits	✔	✔✔		✔				✔		✔	6
Registering Property	✔	✔	✔	✔✔✔	✔✔	✔	✔✔	✔		✔	13
Getting Credit			✔		✔	✔	✔				4
Protecting investors										✔✔	2
Paying Taxes	✔✔✔	✔✔		✔		✔	✔			✔✔	10
Trading Across Borders					✔	✔			✔		3
Enforcing contracts	✔✔						✔	✔			4
Closing a Business	✔	✔	✔✔	✔	✔✔	✔✔	✔✔	✔			12
Total	**11**	**8**	**5**	**9**	**6**	**7**	**8**	**4**	**2**	**9**	**69**

Source: World Bank, www.doingbusiness.org

Notes: For Latvia, Lithuania, Romania and Slovak Republic data refer to 2009-2011 rankings.

Last year was not an exception. A total of 23 reforms in improving the ease of doing business were implemented in EU10 countries in 2009/10, which was the second best aggregate achievement since 2007, when prior to joining the EU, especially Bulgaria has implemented a number of business regulatory reforms. In terms of the number of reforms implemented this year, Lithuania took the lead with five reforms, followed by Hungary and Slovenia, with respectively four and three reforms (Figure 10). Hungary's progress in reforming business environment last year was recognized and enabled Hungary to be in the group of top 10 Doing Business reformers (Box 2).

Most reforms took place in the area of closing a business. The global financial crisis caused a surge in insolvency filings, mostly in Eastern Europe and Central Asia countries and the OECD high-income countries. Sixteen economies in these regions reformed their insolvency regimes. Most of these reforms focused on improving or introducing reorganization procedures to ensure that viable firms could continue operating. Among the EU10 economies, the Czech Republic, Latvia, Lithuania and Hungary reformed in this area. In addition, as in the past years, the countries focused their efforts in the areas of paying taxes as well as business start-up (Figure 11).

Figure 73. Number of reforms implemented in EU10 in 2010 by country

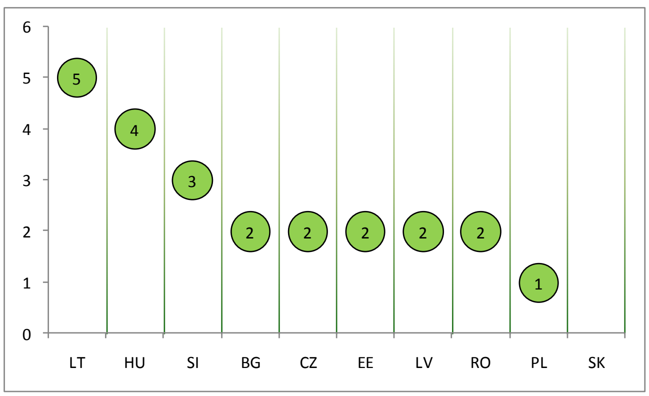
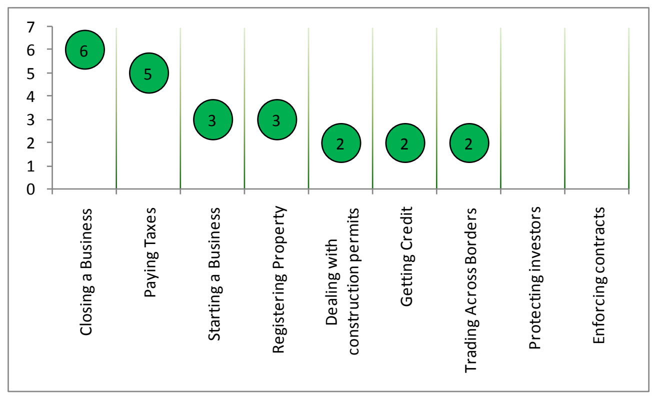


Figure 74. Number of reforms implemented in EU10 in 2010 by area



Source: World Bank, www.doingbusiness.org

Box 9. Hungary among top 10 reformers in Ease of Doing Business 2011

Every year Doing Business recognizes the 10 economies that improved the most in the ease of doing business in the previous year and introduced policy changes in 3 or more areas. This year the most dynamic reformers were Kazakhstan, Rwanda, followed by Peru and Vietnam (Table 6).

Table 6. Doing Business 10 top reformers in 2011

Economy	Starting a Business	Dealing with construction permits	Registering Property	Getting Credit	Protecting investors	Paying Taxes	Trading Across Borders	Enforcing contracts	Closing a Business
Kazakhstan	✔	✔			✔		✔		
Rwanda		✔		✔			✔		
Peru	✔	✔	✔				✔		
Vietnam	✔	✔		✔					
Cape Verde	✔		✔			✔			
Tajikistan	✔				✔	✔			
Zambia	✔						✔	✔	
Hungary		✔	✔			✔			✔
Grenada	✔		✔				✔		
Brunei Darussalam	✔					✔	✔		

With four reforms in areas of dealing with construction permits, registering property, paying taxes and closing a business, Hungary is ranked 8th in the world's top 10 economies that improved the most in the ease of doing business.

- ✔ ***Dealing with Construction Permits***: Hungary implemented a time limit for the issuance of building permits.

		DB2010		DB2011	
		HU	EU10	HU	EU10
Dealing with Construction Permits	Rank	86	81	86	81
	Procedures (number)	31	22	31	22
	Time (days)	204	201	189	199
	Cost (% of income per capita)	10	88	10	88

In June 2009 the Parliament approved a package of laws on the restructuring of the construction industry and the improvement of the building process. The package was drafted in full compliance with the EU Directives on the construction industry. The purpose of reforms was to better enforce contracts between contractors and subcontractors, to make the investment process in the building industry more transparent and to reduce bureaucracy in managing construction. The adopted rules raised the role of the Building Construction Authority (BCA) in the central and regional offices, simplified the construction permitting process and introduced the "integrated process" as an option to the existing step-by-step approval of permits. The integrated process gives the builder the right to submit the application for a construction permits with supporting documentation in several copies to the local BCA, which in turn has to accept all the documents and send them to the authorities participating in the approval process and then collect their opinions on issuing a permit. The process also gives applicants an opportunity for redress, or legal remedy, which upholds the citizens' constitutional rights to appeal decisions of the authorities - but in some case it slowed down the approval process. The simplification of the procedures resulted in many types of constructions taken out of the permitting process, thus separating applications into groups according to risk: (a) some small structures not requiring notification nor a permit; (b) minor buildings for which submission of notification and supporting documentation is required, and (c) all other buildings which should comply with the whole permitting process.

- ✔ ***Registering Property:*** Hungary reduced the property registration fee by 6 percent of the property value.

		DB2010		DB2011	
		HU	EU10	HU	EU10
Registering Property	Rank	60	56	41	51
	Procedures (number)	4	5	4	5
	Time (days)	17	83	17	47
	Cost (% of property value)	11	2	5	2

In 2010 Doing Business Report, Hungary ranked 60th out of 183 countries on the ease of registering property. Its low performance was mainly due to high cost of registration (stamp duty is 11 percent of the transaction value.) This cost has been reduced to 5 percent and as a result Hungary moved to rank 41st according to Doing Business Report 2011.

- ✔ ***Paying Taxes***: Hungary simplified taxes and tax bases.

		DB2010		DB2011	
		HU	EU10	HU	EU10
Paying Taxes	Rank	118	97	109	93
	Payments (number per year)	14	28	14	26
	Time (hours per year)	330	320	277	306
	Total tax rate (% profit)	58	44	53	43

In 2010 Hungary reduced employers' social security contribution rate from 29 percent of gross salaries to 26 percent, which brought the total tax rate as percent of profits down by 4.2 percentage points from 57.5 percent to 53.3 percent.

- ✔ ***Closing a Business***: Amendments to Hungary's bankruptcy law encourage insolvent companies to consider reaching agreements with creditors out of court so as to avoid bankruptcy.

		DB2010		DB2011	
		HU	EU10	HU	EU10
Closing a Business	Rank	58	70	62	62
	Recovery rate (cents on the dollar)	38	36	38	41
	Time (years)	2	3	2	3
	Cost (% of estate)	15	13	15	12

In 2009 the government passed amendments to the law on Bankruptcy and Insolvency Proceedings. Among other things, the amendments: shortened deadlines in the law; imposed an immediate 90-day moratorium during restructurings; eliminated set-off in restructurings; gave greater powers to creditor committees; set out a voting scheme for restructuring plans; increased personal liability for officers and directors in cases of malfeasance; and allowed creditors to dismiss the insolvency administrator. As a result, Hungary's insolvency law now possesses many of the hallmarks of a modern restructuring law, including provisions for the preparation and voting on a plan of reorganization, as well as the ability to bind dissenting creditors ('cram-down') and the conversion of proceedings from reorganization to liquidation. Moreover, the priority rules in the law are clear and understandable, placing secured creditors ahead of all claims other than costs of liquidation.

Major reforms in EU10 countries in Doing Business 2011

- Closing a business: The EU10 countries introduced a total of six reforms in this area. The Czech Republic made it easier to deal with insolvency procedures by introducing further legal amendments to restrict setoffs in insolvency cases and suspending for some insolvent debtors the obligation to file for bankruptcy. Latvia introduced a mechanism for out-of-court settlement of insolvencies to alleviate pressure on courts and tightened some procedural deadlines. Lithuania introduced regulations relating to insolvency administrators that set out clear rules of liability for violations of law. Amendments to Hungary's bankruptcy law encourage insolvent companies to consider reaching agreements with creditors out-of-court in order to avoid bankruptcy.

- Paying taxes: In the area of paying taxes, EU10 economies have implemented a total of five reforms in 2009/10. Bulgaria reduced employer contribution rates for social security. Hungary simplified taxes and tax bases. The Czech Republic simplified its labor tax processes and reduced employer contribution rates for social security. Lithuania reduced corporate tax rates. Slovenia abolished its payroll tax and reduced its corporate income tax rate.

- Registering property: Three reforms were implemented in EU10 countries. Among them, Hungary reduced the property registration fee by 6 percent of the property value. Greater computerization in Slovenia's land registry reduced delays in property registration by 75 percent.

- Dealing with construction permits: Hungary implemented a time limit for the issuance of building permits. Romania amended regulations related to construction permitting to reduce fees and expedite the process.

- Trading across borders: Latvia reduced the time to export and import by introducing electronic submission of customs declarations. Lithuania reduced the time to import by introducing, in compliance with EU law, an electronic system for submitting customs declarations.

- Getting credit: Estonia improved access to credit by amending the Code of Enforcement Procedure and allowing out-of-court enforcement of collateral by secured creditors. Lithuania's private credit bureau now collects and distributes positive information on borrowers.

- Starting a business: Bulgaria eased business start-up by reducing the minimum capital requirement from 5,000 leva ($3,250) to 2 leva ($1.30). Lithuania tightened the time limit for completing the registration of a company. Slovenia made starting a business easier through improvements to its one-stop shop that allowed more online services.

Future challenges

EU 10 countries have progressed well in reforming their business regulatory environment. However, there are areas were further efforts are needed. In particular, EU10 countries should aim to simplify regulations related to paying taxes, dealing with construction permits, protecting investors as well as starting and closing business. The World Bank Group's Investment Climate Advisory team has provided reform recommendations to both Poland and Hungary on how to improve business environment in those areas (Box 10).

Box 10. Making it easier to do business in Poland

In the new Doing Business 2011 report, Poland is ranked in the 70th position, three places higher than last year. However, since other economies in the region have reformed faster, especially the Czech Republic, which has improved its ranking by 19 places, Poland now scores the lowest among EU10 countries. In addition, for the whole European Union only Italy and Greece score lower.

Poland's business environment lags the EU average in seven out of nine Doing Business indicators. Dealing with construction permits (164th position globally) and paying taxes (121st position) are especially problematic.

To improve the business environment in Poland, the Ministry of Economy requested the World Bank to prepare a "Doing Business Reform Memorandum" focused on five areas covered by the Doing Business ranking: starting a business, dealing with construction permits, registering property, protecting investors and paying taxes. The Reform Memorandum, completed in June 2010, provided the following selected recommendations:

Starting a business

- ✔ Unify all identification numbers into one universal number issued by the Registration Court
- ✔ Make available standard incorporation documents and empower registration officials to verify signatures
- ✔ Eliminate separate registrations for the National Sanitary and National Work Inspections
- ✔ Combine registration for VAT at the Registration Court
- ✔ Eliminate the minimum capital requirement

Dealing with construction permits

- ✔ Pro-actively use the risk-based approach when processing applications for construction and occupancy permits
- ✔ Shorten and enforce statutory approval limits when processing construction and occupancy permits
- ✔ Cautiously use "silence is consent" principle for construction permitting
- ✔ Rationalize and consolidate post-completion inspections
- ✔ Streamline and re-engineer procedures to issue construction permits to save time and cost of investors using delegation and notification

Registering property

- ✔ Offer standardized contracts for property transfers
- ✔ Conduct an internal mapping of processes at several registry courts to identify bottlenecks and best practice solutions
- ✔ Offer expedited processing services at the Land Registry
- ✔ Use best practices from well-performing registry courts to resolve the delays at the Warsaw registry courts
- ✔ Consolidate land records in one place

Paying taxes

- ✔ Make online payment mandatory for medium to large companies over a defined threshold of turnover
- ✔ Legalize the use of tax intermediaries
- ✔ Simplify tax forms and introduce user-friendly software to encourage electronic filing and payment
- ✔ Align thresholds and ensure truly micro/small firms benefit from simplified regimes
- ✔ Align corporate income tax laws more closely with EU provisions

Protecting investors

- ✔ Increase directors' disclosure obligations in case of related-party transactions
- ✔ Require a review of the transaction by an external body
- ✔ Make directors liable for the violation of their duties
- ✔ Allow courts to void the transaction
- ✔ Allow minority shareholders to inspect company documents before filing suit