Economic and Fiscal Trends in Central and Eastern Europe

Conference on International Taxation in CEE

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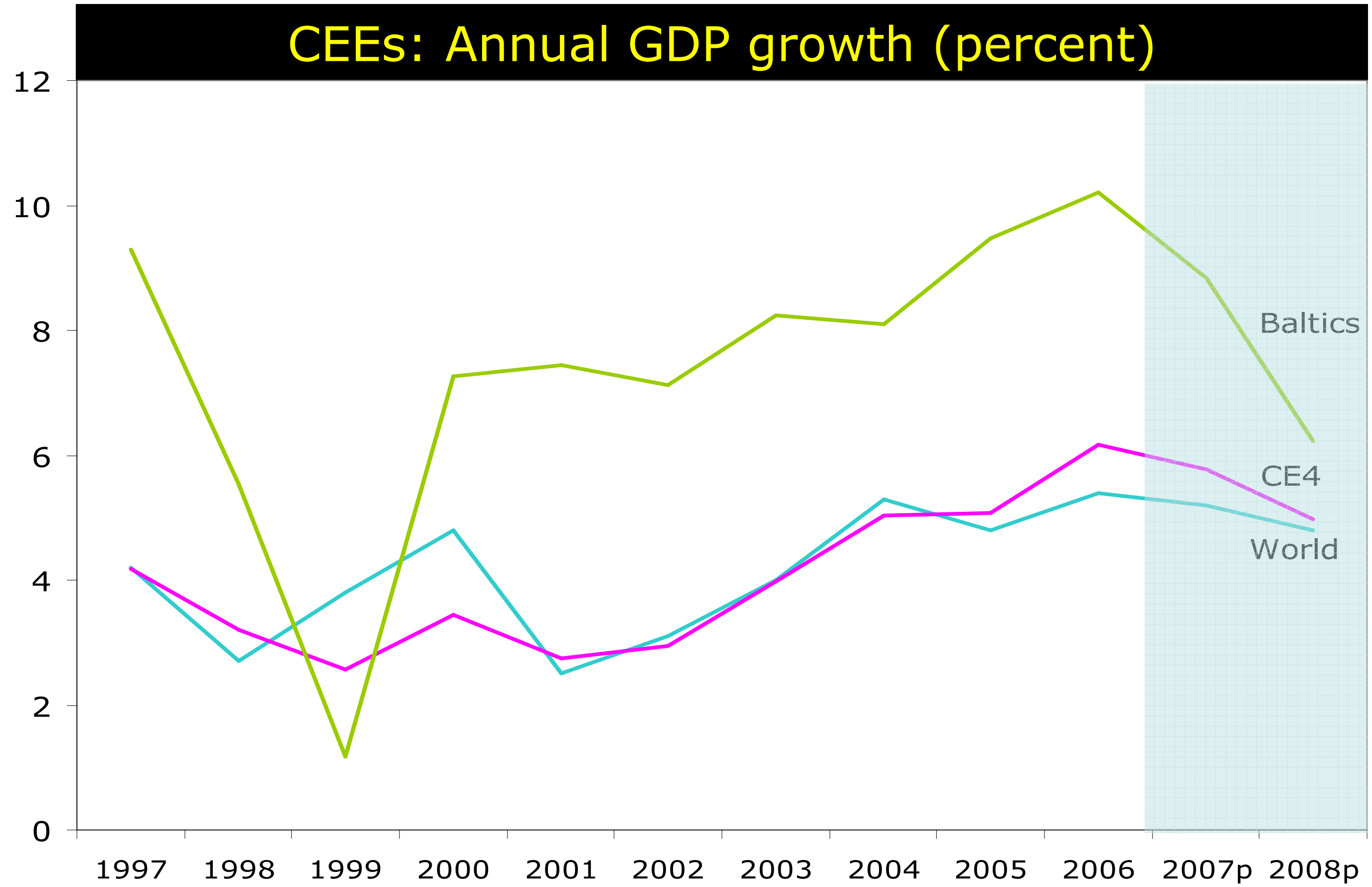
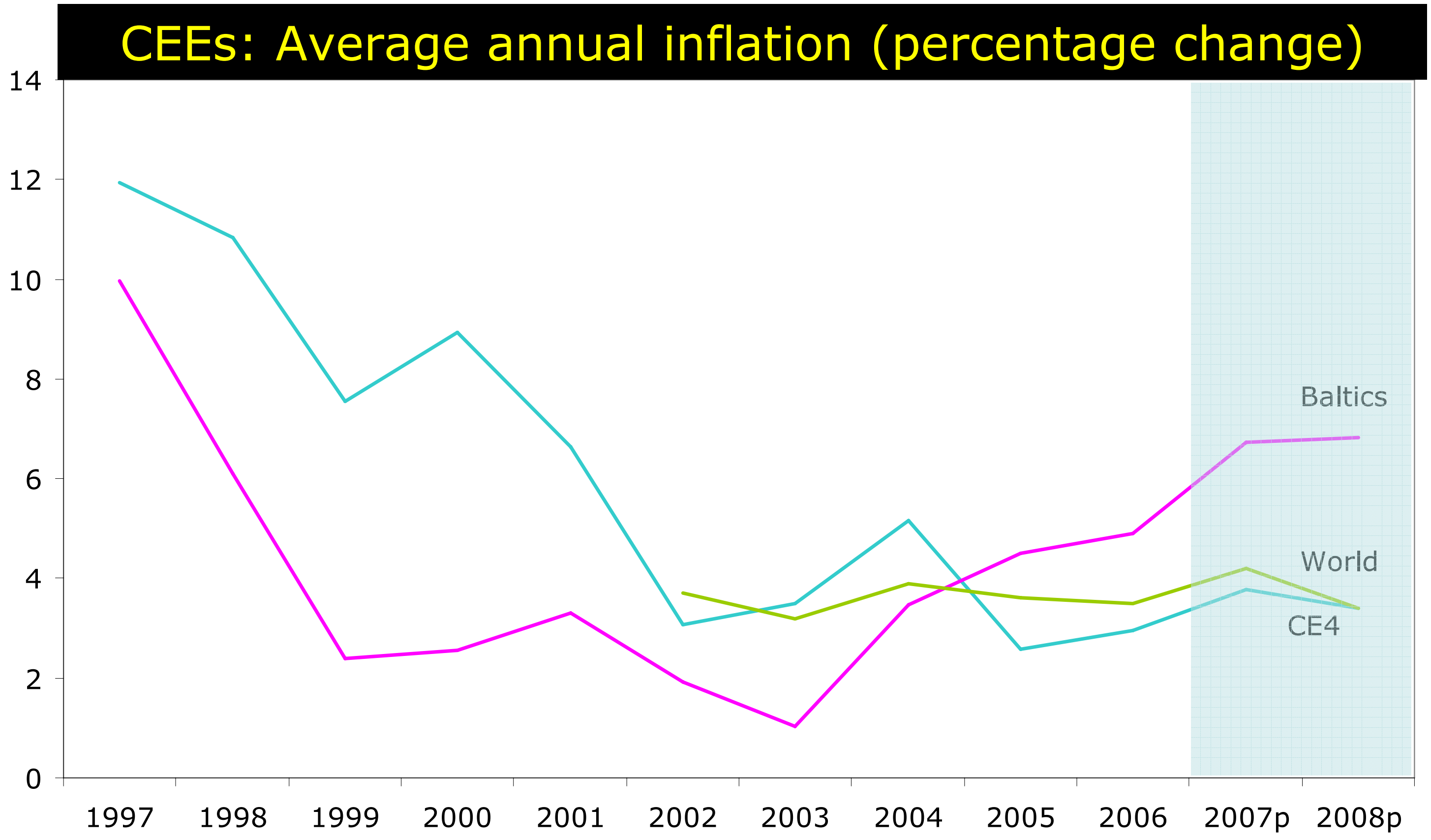
Growth in CEEs is high, albeit expected to slow in the near term



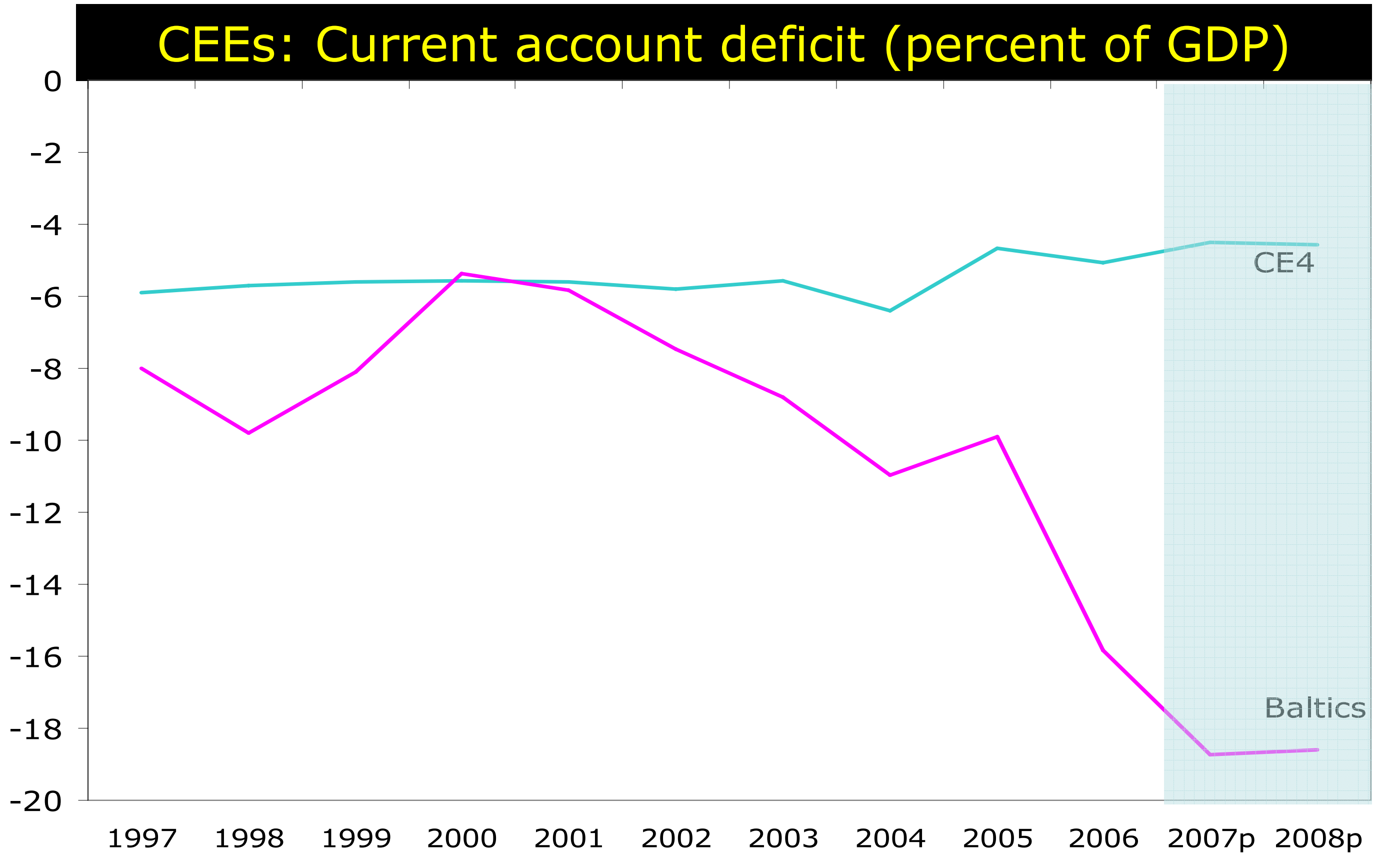
Source: WEO Oct 2007

Inflation pressures are evident in the Baltics



Source: WEO Oct 2007

…and external imbalances are growing



Source: WEO Oct 2007

Strong growth hides underlying macro vulnerabilities

Key Macro Indicators 2006 (in percent of GDP)

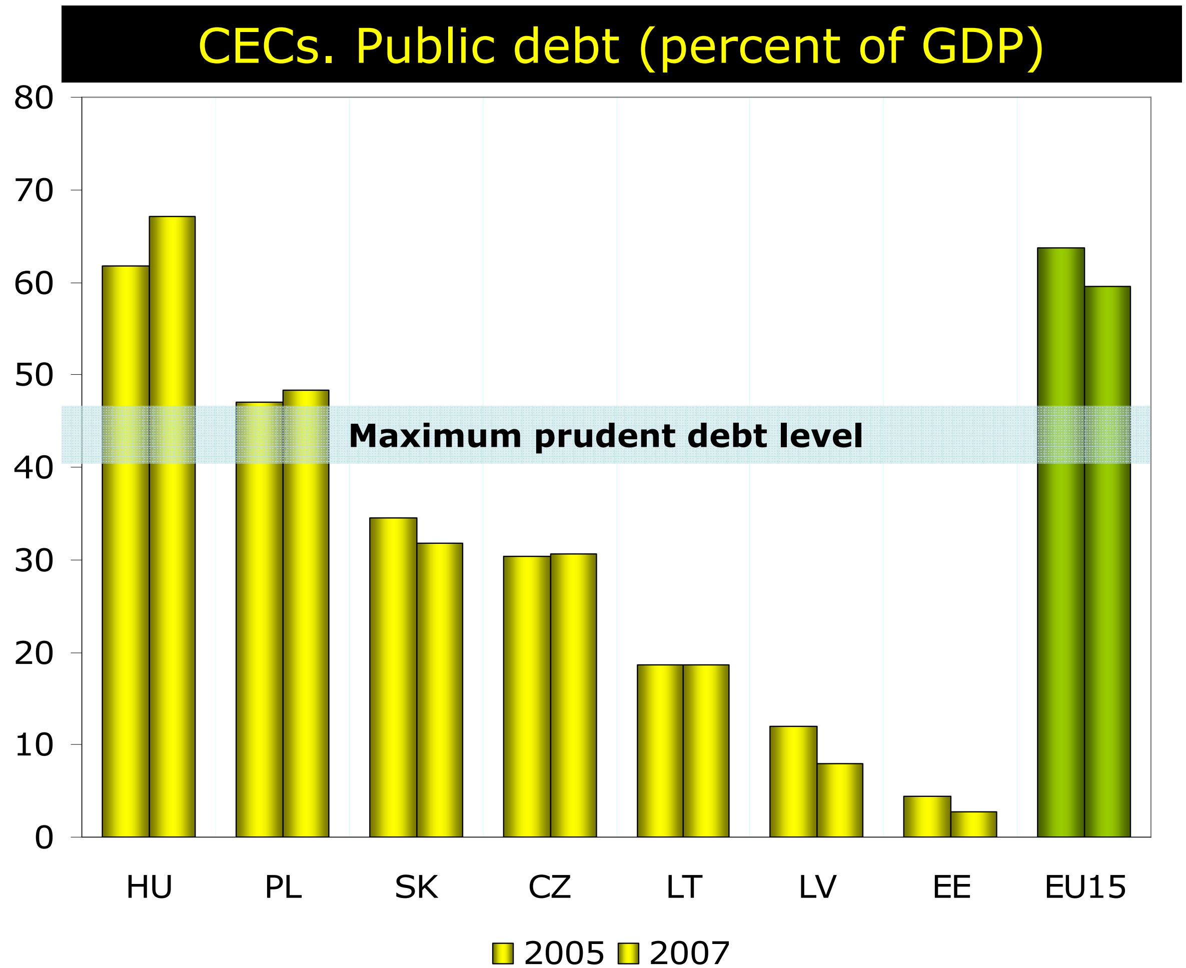
	CE4	Baltics	EM countries*	Asia 1997**
General government deficit	-4.9	0.9	1.1	-1.8
C/A balance	-5.2	-15.6	2.7	-3.3
External debt	57.7	89.8	51.9	66.5
Public debt	43.4	10.9	42.2	18.5
Reserves/ST debt	115.1	54.8	175.8	20.1
Credit growth (in percent)	8.4	37.6	2.5	13.9

* EM countries - Argentina,Brazil, Chile, China, Colombia, Indonesia, Peru, Russia, Singapore, Thailand, data for 2005.

** Korea, Indonesia, Thailand.

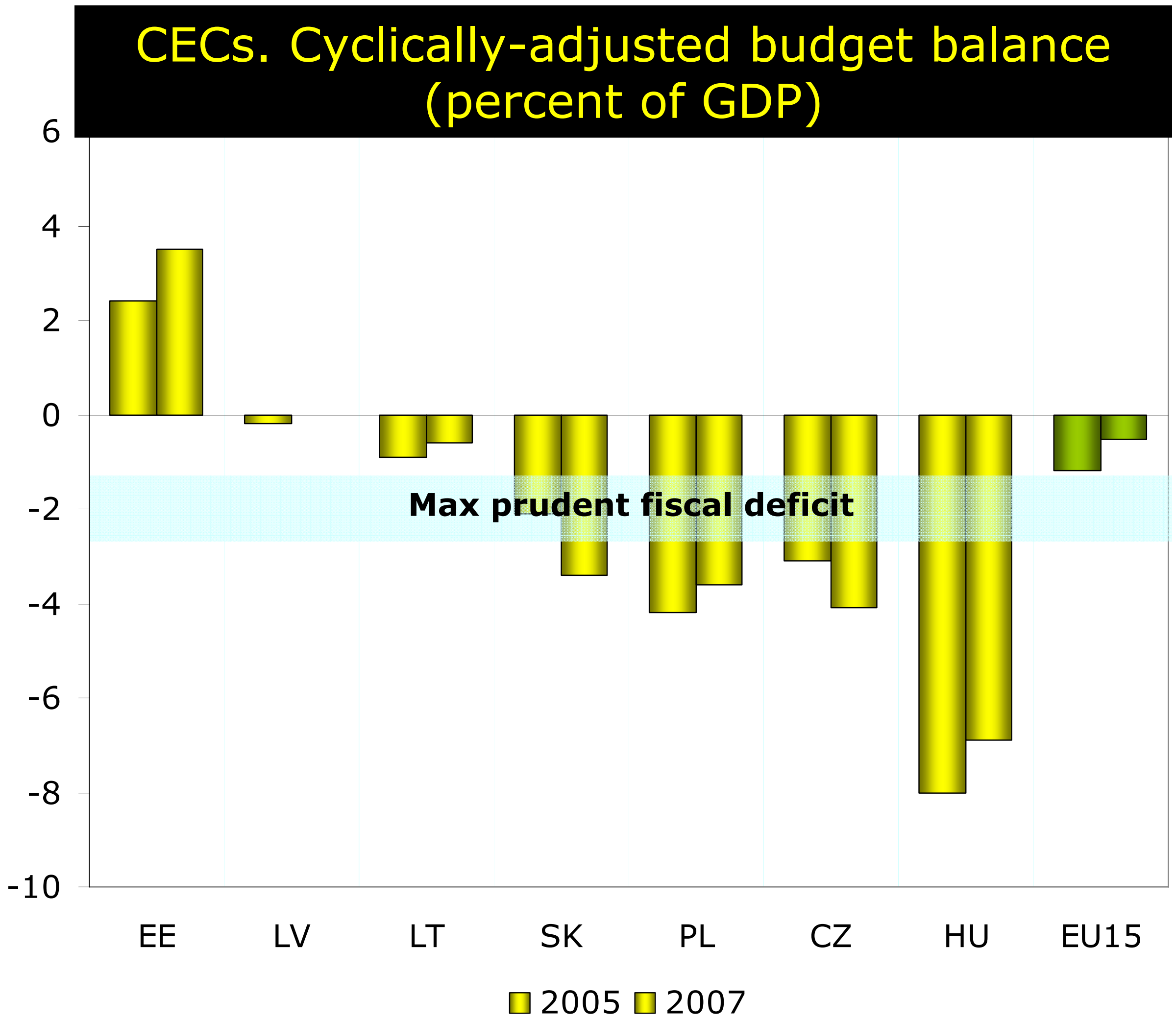
Source: IMF GFS, IMF IFS, IMF Article IV Consultations

Despite buoyant growth, public debt is not declining fast…



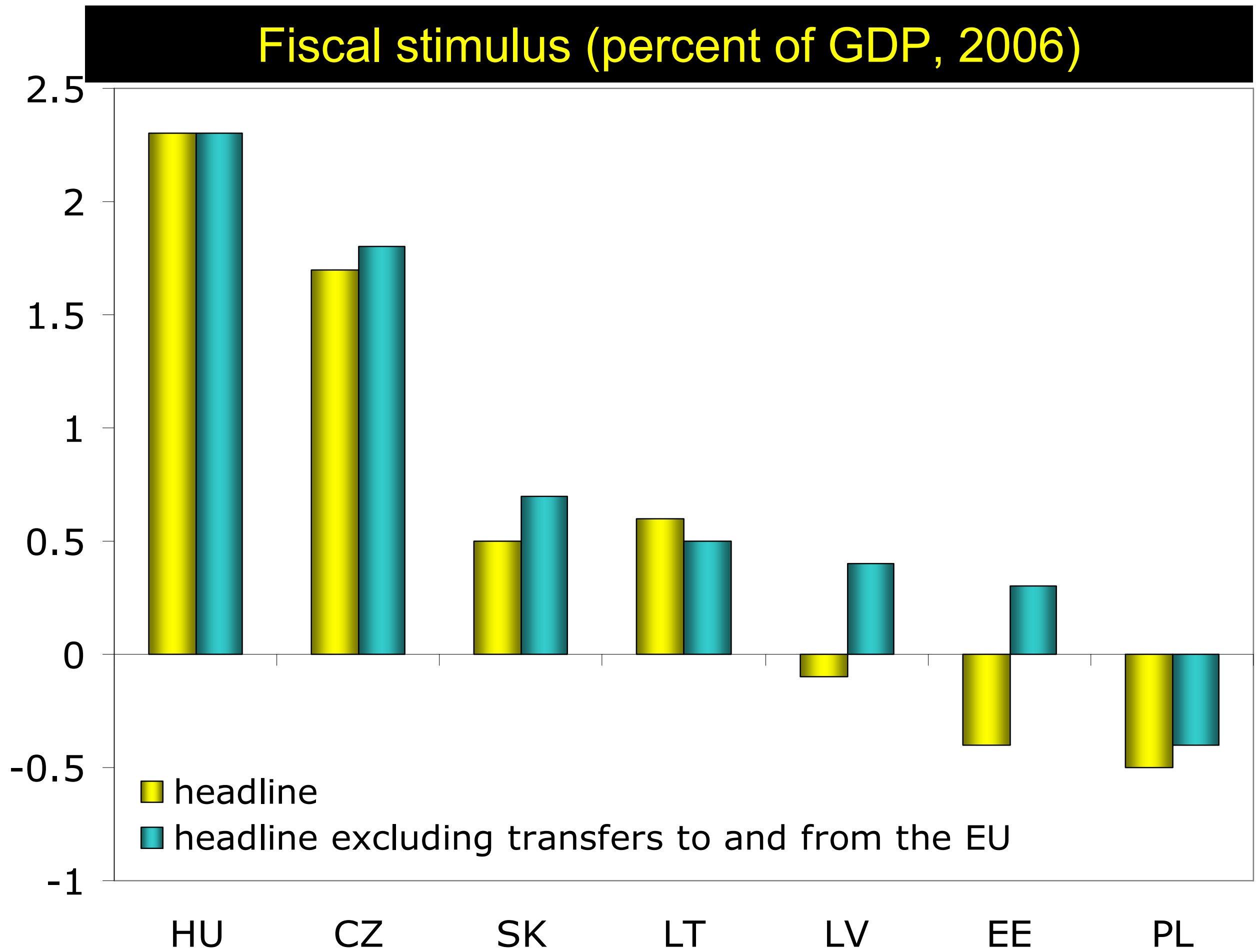
Source: EC, 'Public finance in EMU', 2007; IMF

…and structural fiscal balances do not show strong improvements



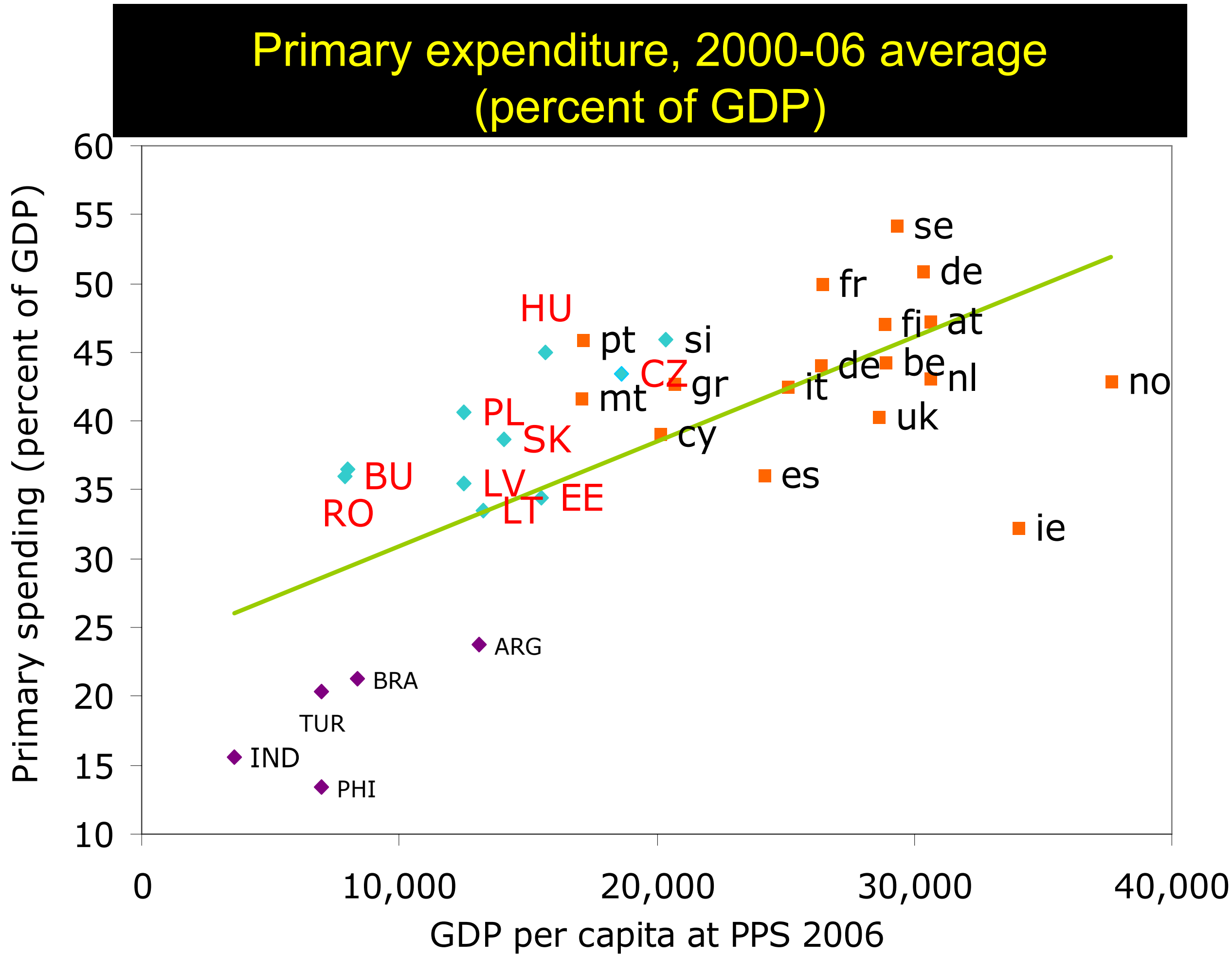
Source: EC Spring Forecast 2007

Fiscal policy is even more pro-cyclical if one accounts for the effect of EU funds



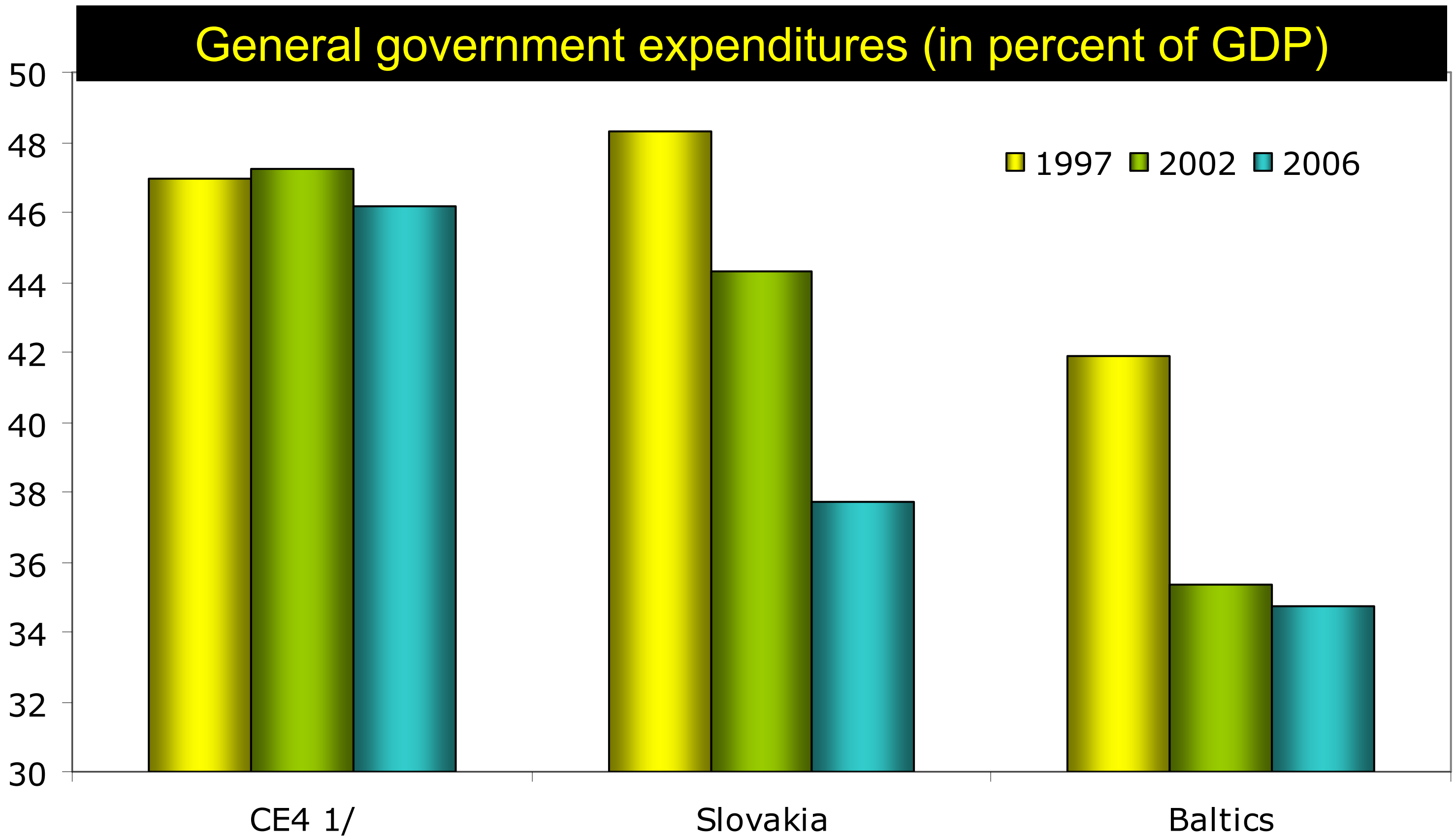
Source: Christoph B. Rosenberg and Robert Sierhej, Interpreting EU Funds Data for Macro Analysis in the New Member States, IMF Working Paper 07/77.

Primary spending in CEE is relatively high suggesting that fiscal adjustments should start at expenditure side



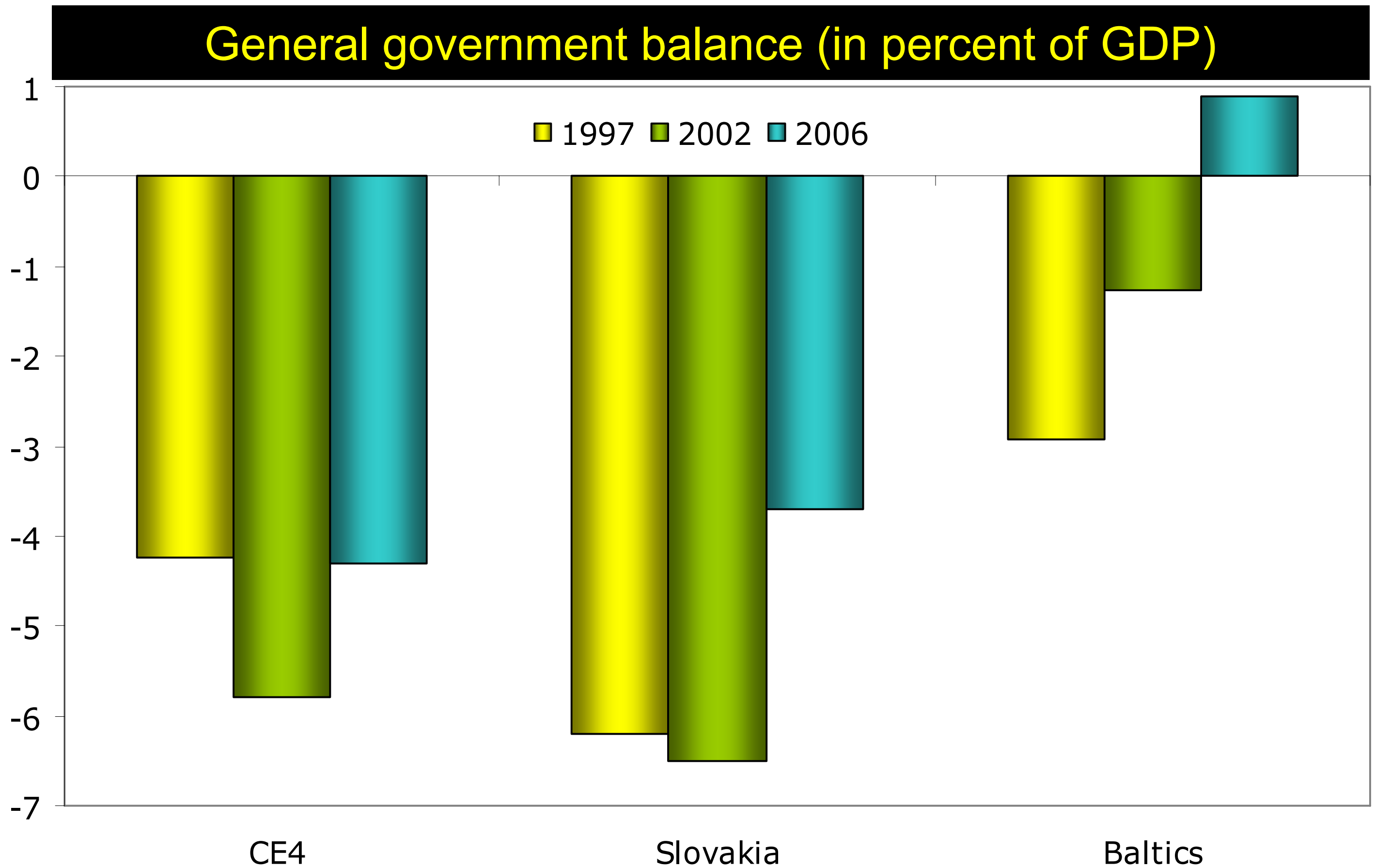
Source: AMECO.
Data for RO & BU for 2005.

Some CEEs implemented deep spending cuts in the last decade…



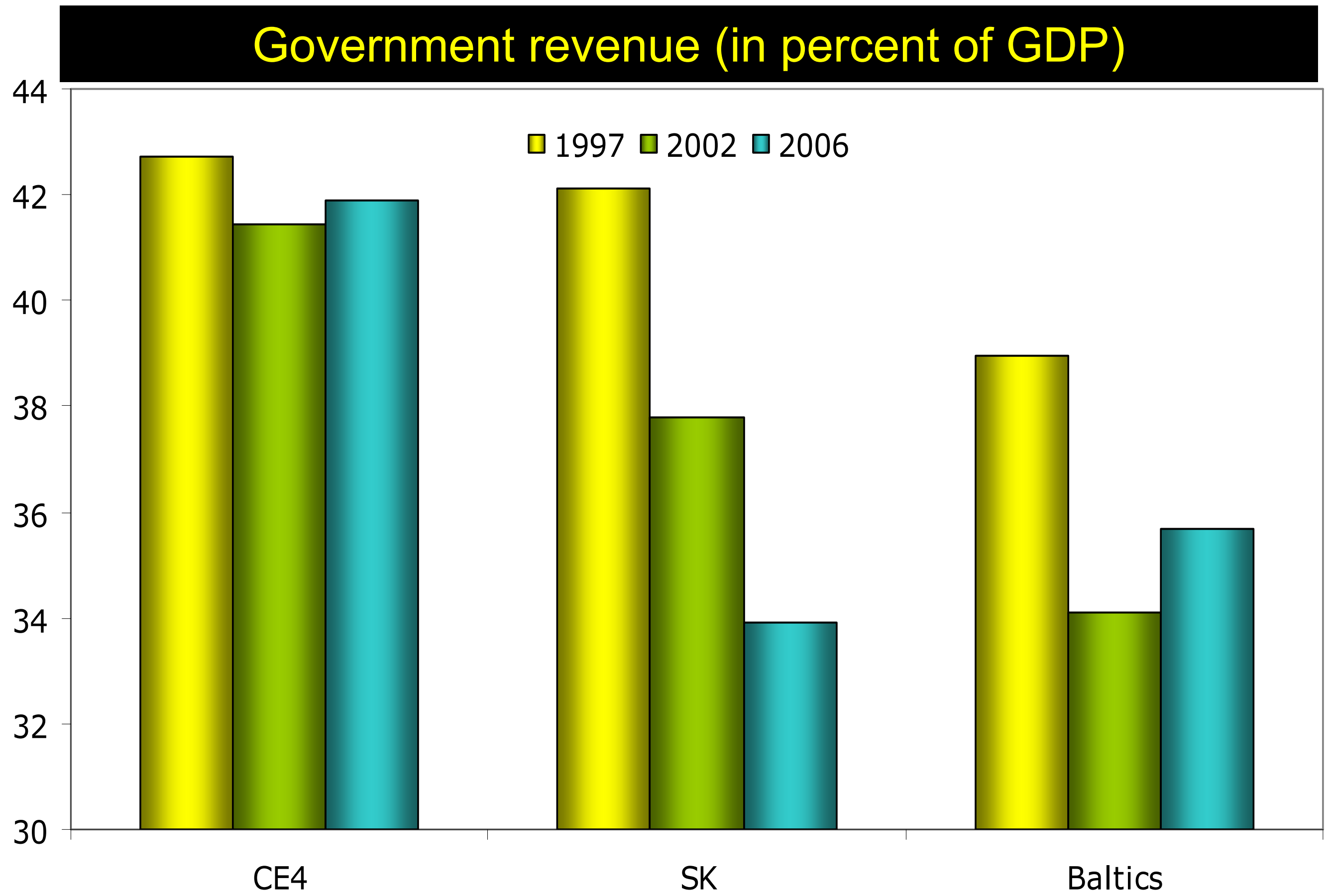
1/ Czech Republic, Hungary, Poland, and Slovenia.
Source: Eurostat

…achieving fiscal consolidation…



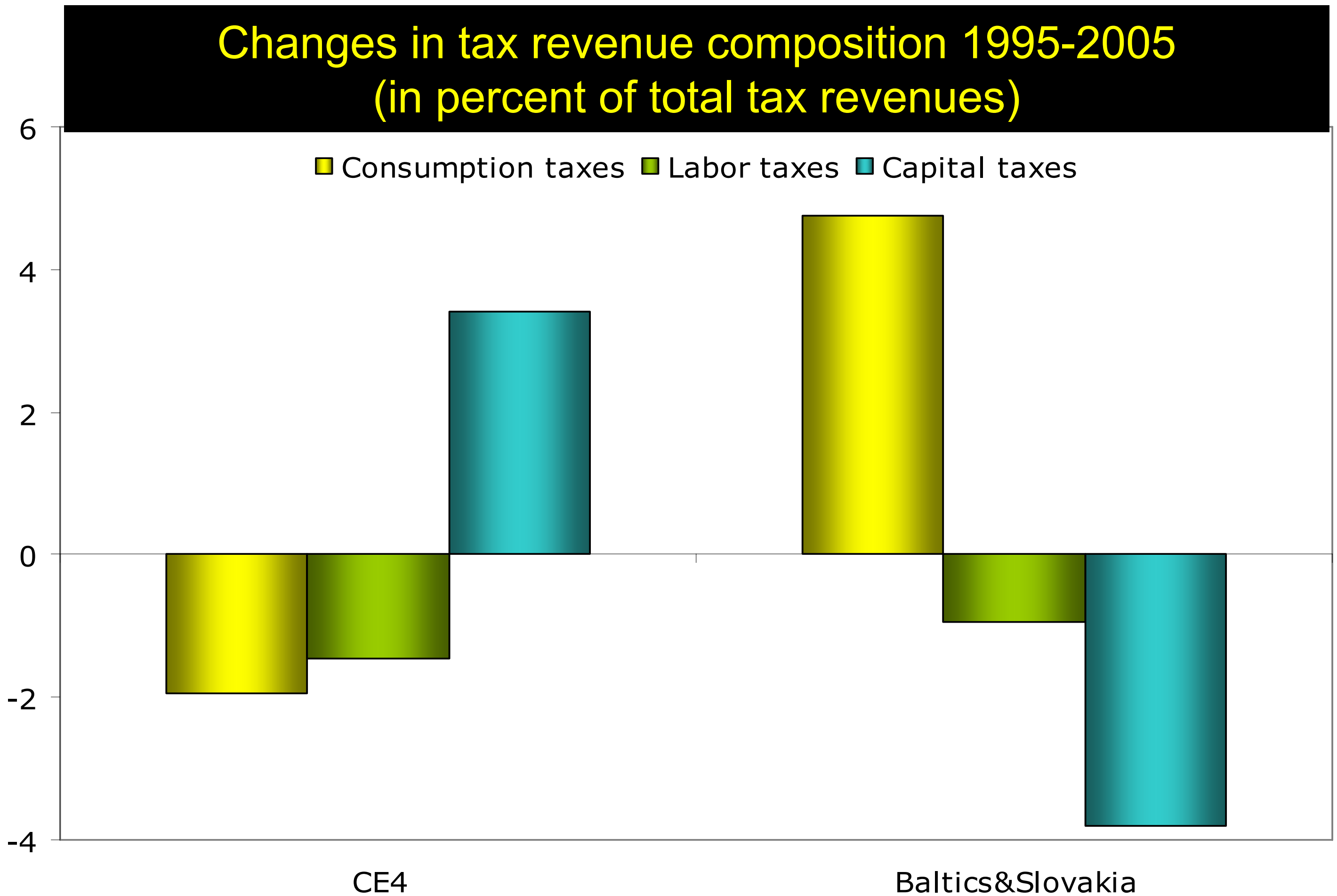
Source: Eurostat

…while at the same time lowering the fiscal burden



Source: Eurostat

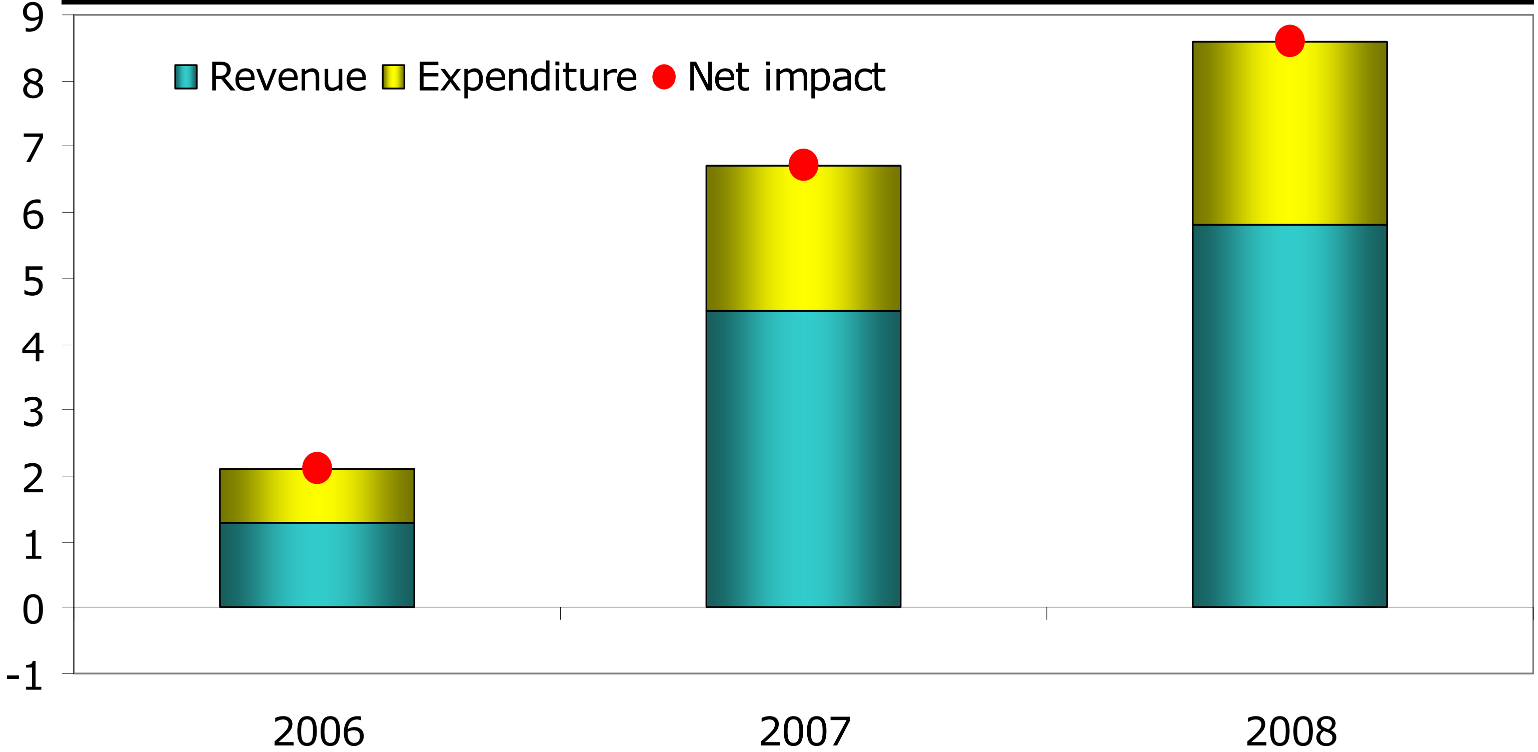
Tax structure has moved towards consumption in ‘reform’ countries



Source: EC, ‘Taxation trends in the EU’, 2007

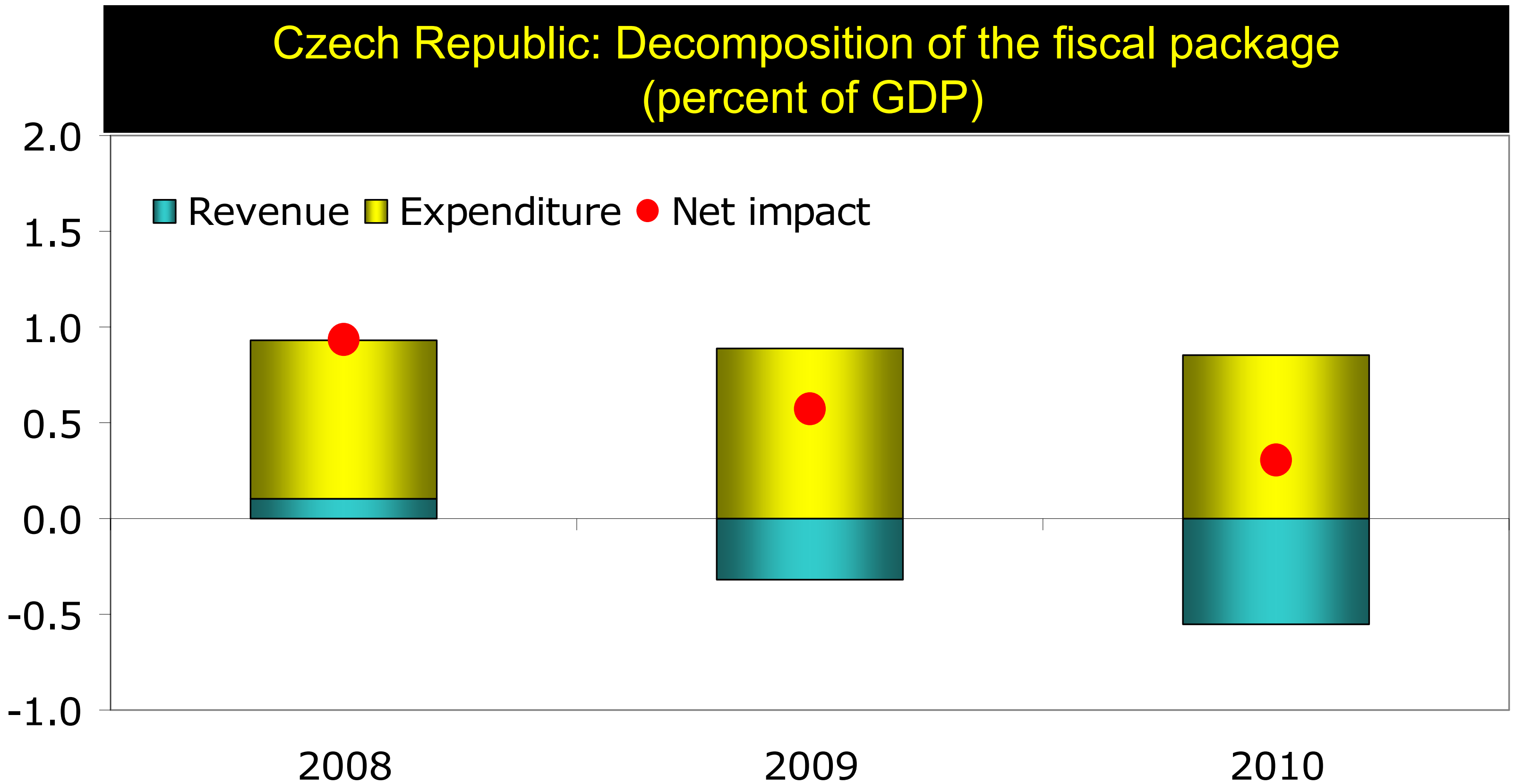
The Hungarian reform effort is sizeable, but mainly based on revenue increases…

Hungary: Decomposition of the fiscal package (in percent of GDP)



Source: National authorities, Barclays, IMF

… while the recent fiscal package in the Czech Republic has only a modest fiscal impact



Flat taxes are becoming increasingly popular in the region

Country	Year of reform	PIT rate	
		Before reform	After reform
Estonia	**1994**	**16-33**	**26**
Lithuania	**1994**	**18-33**	**25**
Latvia	**1997**	**10;25**	**25**
Russia	**2001**	**12-30**	**13**
Ukraine	**2004**	**10-40**	**13**
Slovakia	**2004**	**10-38**	**19**
Georgia	**2005**	**12-20**	**12**
Romania	**2005**	**18-40**	**16**
Czech Republic	**2008**	**12-32**	**15**

Note: The "flat PIT" rates are moving closer to the lowest pre-reform tax rate.

Revenue effects of reforms have been mixed (change in revenues in year t+1)

Country	PIT	CIT	Indirect	Total
Estonia	↓	↓	↑	↑
Lithuania	↑	↓	↑	↑
Latvia	↑	↑	↓	↑
Russia	↑	↑	↑	↑
Ukraine	↓	↓	↓	↓
Slovakia	↓	↓	↑	↓
Georgia	↓	↑	↑	↑
Romania	↓	↓	↑	↓

Source: 'The "Flat Tax(es)": Principles and Evidence', M. Keen, Y. Kim, R. Varsano, IMF, 2006

Some experiences with flat taxes:

- Micro-level evidence in support of flat taxes is weak:
  - Laffer curve effects seem absent
  - Improved compliance is not automatic
  - Impact on work incentives is unclear
  - Flatness is certainly a simplification, but does not necessarily guarantee simplicity

- Generally, flat taxes appear to work best as a part of broader fiscal reforms

Key messages

- The macroeconomic environment is better than ever, but:
  - ➢ vulnerabilities are growing
- There is 'reform fatigue' and:
  - ➢ an opportunity to reduce structural deficits and make budgets more flexible maybe missed
- Fiscal adjustment should start on the expenditure side but:
  - ➢ recent fiscal reforms in CEEs do not follow this pattern
- Flat taxes are not an universal cure to fiscal problems:
  - ➢ they should be a part of broader reform efforts