

I. INTRODUCTION

This paper examines the continuing role of the IMF's Code of Good Practices on Fiscal Transparency in promoting practices that will help candidates for European Union (EU) accession meet their own and the EU's fiscal management goals.² Fiscal transparency is essential to ensure that national governments are seen by their own citizens to exercise effective control over their fiscal policies, and by the EU to ensure that those policies are in harmony with the overall macroeconomic objectives of the community. Active improvement of fiscal transparency by governments will help to promote sound fiscal policies and effective and efficient delivery of public services. Many such requirements are already explicitly recognized as a legal obligation in the *acquis communautaire*,³ which formally describes all of the regulations and standards with which EU members must comply to help achieve common community goals. Key chapters of the *acquis* define various fiscal management requirements (including transparency) of EU membership.⁴ As will be discussed in more detail below, the aims of the fiscal transparency code and the application of relevant *acquis* standards are substantially complementary, although these two sets of guidelines approach the issues from differing perspectives.

Nearly all of the prospective EU accession countries have participated in an IMF assessment of fiscal transparency—a report on the observance of standards and codes (ROSC).⁵ An analysis of fiscal transparency ROSCs in EU accession countries highlights four areas that are of particular significance for EU accession countries: establishing medium-term budget frameworks; comprehensive coverage of off-budget activities; and effective accounting, reporting, and oversight; and strengthening intergovernmental fiscal relations. These

² The IMF Code of Good Practices on Fiscal Transparency (the fiscal transparency code), adopted in April 1998, aims at promoting good practices of fiscal transparency among all IMF member countries. The code and the *Manual on Fiscal Transparency* (the manual) are available on the IMF website at <http://www.imf.org/external/np/fad/trans/index.htm>.

³ The *acquis* defines all of the obligations of EU member states deriving from the Treaty of Rome, the Treaties of Maastricht and Amsterdam, the Single European Act, community law, and the judgments of the European Court of Justice and is continuously updated and developed. It has been subdivided into 31 chapters for accession negotiations with the EU Commission; a chapter is considered closed when a timetable is agreed for adoption of the required legislative and policy changes. See also Feldman and Watson (2002), Chapter 2.

⁴ EU surveillance of members' stability or convergence programs and rules to dissuade members from noncompliance with EU reference values place a high premium on prompt reporting of fiscal data and rapid adjustment to ensure broad consistency of fiscal and monetary policies within the community. *Stability programs* setting out medium-term budgetary objectives and other relevant information are submitted by euro-area members; *convergence programs*, similar in content, but covering a broader range of objectives including monetary policy, are required from those states not participating in the euro area. The excessive deficit procedure (see Council Regulation (EC) No 1467/97 of July 7, 1997) requires prompt submission of fiscal data twice annually and a clear deadline for effective remedial action.

⁵ Malta and Cyprus have not participated in a fiscal ROSC to date.

measures are also essential for improved analysis of fiscal risks and sustainability. Section II of this paper discusses the significance of these four areas of fiscal transparency in more detail. Section III draws from published ROSC observations in these areas and discusses the progress made by EU accession countries and challenges that lie ahead. The conclusions are summarized in the final section of the paper.

II. THE IMPORTANCE OF FISCAL TRANSPARENCY AND REPORTING STANDARDS

Appendix I shows the correspondence between the *acquis* requirements and good practices identified in the fiscal transparency code. For accession candidates, considerable emphasis has been given in the *acquis* to establishing adequate standards of accountability for use of EU funds, while the fiscal transparency code addresses broader concerns of accountability to the public. In general, there appear to be no points of conflict between the code and the *acquis* regulatory framework, with the latter, perhaps naturally, being more narrowly and legalistically focused, and, of course, covering a range of issues beyond transparency. As Allen (2002) notes, however, most detailed aspects of budgeting are left to member states to decide under the “subsidiarity” principle—*acquis* requirements cover very discrete areas and are nonspecific on procedures.⁶ The fiscal transparency code can play a useful role by helping to align national fiscal management systems with broader EU goals.

The objective of joining the EU and regulatory requirements of accession have very likely been strong motivating forces for candidate countries to participate in fiscal and other ROSCs. As discussed in the following section, leading candidates for EU accession have recorded advances in a number of aspects of the fiscal transparency code—albeit with a continuing need for improvements in important areas. As countries move toward EU membership, it is vital that this progress is continued and deepened.⁷

The need to develop flexible and effective mechanisms for fiscal consolidation and adjustment will be a paramount requirement for productive membership in the EU. Mueller et. al. (2002) have emphasized the importance of reform of fiscal management frameworks in the Baltic countries and examine the role of improved fiscal transparency and adoption of fiscal rules—which eventually would become obligatory under the European Monetary Union. Kopits and Szekely (2002) also make the point that many of the central European accession candidates face a bigger consolidation challenge than do the Baltics. It, and chapter

⁶ Some elements of duality can arise from changes in national systems that respond only to *acquis* requirements rather than to general fiscal management needs: country studies of the ways in which existing members adapted to the *acquis* are provided in SIGMA Paper No. 19 *Effects of European Union Accession—Part I: Budgeting and Financial Control*, OECD, 1998.

⁷ While there are strong imperatives to improve key elements of transparency, progress in many aspects will be achieved only over the long-term, and the pace of reform will depend on country-specific constraints. A critical element of applying the fiscal transparency code is to establish priorities for reform over a realistic time frame, taking into account specific capacity constraints. It can be added that fiscal ROSCs have indicated the need for improvement in some aspects of fiscal transparency even among existing EU members.

7 of Feldman and Watson (2002), strongly advocate the adoption of a medium-term budget framework that clearly identifies general government deficit targets—as well as the costs of structural reforms needed to attain the fiscal targets consistent with consolidation objectives. Development of an open multi-year budget framework is thus a central transparency objective for all EU members.

A second transparency objective that will also play a vital role in facilitating consolidation is that of including all fiscal activities on-budget—or at least including all off-budget activities in fiscal reports and analysis. Extrabudgetary funds, imposition of fiscal tasks on state owned financial and nonfinancial enterprises, and accumulation of contingent liabilities are mechanisms that have been used by most, if not all, countries in the accession group in the past. These devices provide nontransparent vehicles for evasion of fiscal rules that are set in narrow budgetary terms—but, in the long run are counterproductive, since they often give rise to substantial “unexpected” fiscal costs in the future. Analysis of these fiscal risks will be a vital element of effective management in the EU.

A third key area of fiscal transparency that will be critical to effective EU membership is the development and maintenance of sound accounting systems that are fully capable of timely reporting on budget execution relative to national and EU fiscal goals. EUROSTAT sets the standards for fiscal statistical reporting in the EU based on the 1995 *European System of Accounts* (ESA 95)—and using modified national budget data. However, the 2001 IMF *Government Finance Statistics Manual*, (GFSM 2001) provides a framework that can help align national decisions more closely with EU fiscal reference values at the outset, as part of national budget formulation and accounting practices.⁸ Some of the EU candidate countries are moving to adopt such a classification in their budgets. As well as systemic improvement of this nature, there is a need in many cases to strengthen internal controls (including procurement) and external audit as well as effective budget review practices to give continuing assurance of the integrity and relevance of reports.

The fourth area of transparency of particular importance to EU members is the establishment of clear and transparent fiscal relations and timely reporting among levels of government. EU fiscal targets are conceived in terms of general government rather than simply the central government and require cooperation among different levels of government in setting fiscal targets. It is thus very important for EU countries that transparency principles are applied to intergovernmental relations and to the reporting practices of subnational governments. Strengthening transparency should enhance cooperation among different levels of government and help to deliver services more effectively to achieve fiscal objectives.

⁸ Bjorgvinsson (2003) describes the 2001 *Government Finance Statistics Manual* (GFSM 2001) reporting requirements and the relationship with ESA 95 reporting. The present paper complements this study by examining developments in accounting systems with respect to fiscal reporting and transparency.

III. PROGRESS AND CHALLENGES IN IMPLEMENTING KEY FISCAL TRANSPARENCY STANDARDS

The performance of the EU accession candidates against these four key aspects of fiscal transparency is summarized in Appendix II.⁹ This summary indicates a reasonable level of practice being attained at the time of the observations, but also the need to take significant action to improve transparency in each of the countries.¹⁰ These recommendations are of direct relevance to improving fiscal management performance in the EU environment. As well as helping establish satisfactory compliance with EU fiscal goals, it is important to emphasize that the major benefits of improving these elements of fiscal transparency will derive from strengthening fiscal decision-making in the countries themselves.

A. Medium-Term Budget Frameworks

All of the EU accession countries have made medium-term projections as part of the requirements for the Pre-accession Economic Programs (PEPs). However, fiscal transparency ROSCs (see summary observations in Appendix II) indicate that few have attained a sufficient standard in all of the elements of medium-term budget frameworks (MTBFs) needed to link domestic budget decision processes effectively with medium-term fiscal policy aims, although a few have made significant progress in several areas.

An MTBF is a complex and highly disciplined process—and, as indicated in Appendix II, covers many elements of the fiscal transparency code. All of the key characteristics identified in Box 1 should function as part of a coordinated process for an MTBF to be fully effective—and it takes time for this to be achieved. Medium-term aggregate projections should be used to inform and constrain annual budget requests. The macroeconomic framework should be used to set an overall expenditure envelope to control unrealistic budget bids—and then guidance should be given to each ministry on policies and program specific parameters and the expenditure ceilings that should be respected.

⁹ These elements are similar to listings by Feldman and Watson (2002)—see Box 7.7; and J. Craig and A. Manoel (2002). See also paragraphs 107-8 of the *Manual on Fiscal Transparency*.

¹⁰ As noted in the Appendix, observations relate to the time of the ROSC mission or update during Fund surveillance missions. Reforms that may have occurred subsequent to these dates but not recorded in formal updates are not shown. The fiscal transparency ROSCs do not attempt to indicate the extent of improvement required to meet EU requirements, but a recent review of fiscal management practices relative to EU requirements found considerable room for improvement in Central and Eastern European countries (see Allen, 2002).

Box 1. Elements of a Medium-Term Budget Framework

An effective MTBF goes well beyond mere rolling 3–5 year budget projections. It is based on (i) *clearly explained macroeconomic assumptions*; (ii) *explicitly costed government policies*; (iii) *estimates owned and maintained by government ministries and agencies*; and (iv) *policy decisions underlying the estimates made openly, and policies clearly explained to the public—including any changes during implementation*. Countries, of course, vary in the precise institutional arrangements for achieving these aims, but the following are common features of such a system:

- Budget estimates based on a medium-term macroeconomic framework, giving a clear statement of policy objectives including the path for the fiscal deficit and consistent tax policies and expenditure targets.
- Top-down translation of expenditure targets into spending ceilings for individual ministries, and maintenance of estimates by ministries on the basis of agreed policies.
- A clear costing of existing commitments and identification and costing of new policies
- A transparent decision-making process for ensuring consistency between top-down and bottom-up estimates
- Integration of investment/development budget and recurrent budget decisions
- Publication of the MTBF framework as part of the annual budget documentation
- Public tracking and accountability mechanisms to trace policy and technical parameter changes from budget year to the next rollover period.

Individual ministries should be responsible for developing more detailed budget estimates for at least two years beyond the budget year to improve the quality of medium-term estimates. These forward estimates should be examined by the Ministry of Finance at the same time that annual budget requests are evaluated, and they should not only be included in the annual budget, but be discussed by the legislature along with the current budget estimates. Deviations from stated policy should then be examined as part of the following year's budget discussions.¹¹

¹¹ The basic elements of such processes in advanced EU member countries were described in presentations by representatives of the Netherlands and the United Kingdom at an EC conference, *EU Accession—Developing Fiscal Policy Frameworks for Sustainable Growth*, held in Brussels, 13-14 May 2002, and organized by the European Commission, the IMF, and the World Bank. See http://europa.eu.int/comm/economy_finance/events/2002/brussel2/summ_en.pdf.

Implementation of such a system, however, needs to be carefully phased in line with underlying capacity and the economic situation. An MTBF is not a readymade kit for resolving fundamental fiscal discipline problems; rather its establishment reflects success in implementing such discipline. A basic fiscal discipline and a realistic annual budget are fundamental requirements before initiating medium-term estimates. Once these measures are firmly in place, medium-term forecasting needs to be strengthened and then credible medium-term budget estimates can be published. Full implementation requires that medium-term estimates are treated as accountable policy statements and reviewed rigorously during each successive budget year. Stronger fiscal responsibility legislation, in some cases embodying fiscal rules, may be considered appropriate to strengthen fiscal policy credibility.

Basic Budget Discipline

In the face of high rates of inflation and poor control over budget expenditures, it will be virtually impossible to establish credible medium-term fiscal targets. Priority must be given first to imposing firm control over the annual estimates, and inflation rates must be brought to a relatively low and stable level. Progress in this area appears to have been established in many of the countries. The observations with regard to budget realism (4.1.1 of the code) in Appendix II indicate that many of the EU accession countries are establishing a good record in terms of budget outcomes corresponding fairly closely to the original estimates. However, institutional factors in some countries (such as use of supplementary appropriations in Hungary, a disconnect between macroeconomic constraints and budget estimates in Turkey, off-budget measures in Poland,¹² and government payment arrears elsewhere) appear to have contributed to substantial slippage from original plans—and these issues have to be addressed to establish a solid foundation for MTBF implementation.

Establishing Forecasting and Forward Estimates

A number of the EU accession countries have effectively established relative macroeconomic stability and are moving on to strengthen their medium-term policy frameworks. However, medium-term projections associated with the accession process do not yet appear to be firmly integrated with annual budget formulation in most candidate countries. Even in Estonia where budget submissions include the budget year plus 3-year forward estimates, it was observed that the PEP projections do not have a formal role in guiding these forward estimates. At the time the ROSCs were completed, some countries (Latvia, the Czech Republic, and Turkey) did not provide any medium-term projections with the annual budget estimates. In addition, the fiscal ROSCs indicate that medium-term fiscal projections are not adequately linked to macroeconomic analysis in several countries (Turkey, Bulgaria, Latvia, and Romania).

¹² The June 2003 ROSC update notes some improvement in this regard, but notes continuing work underway to eliminate extrabudgetary funds, agencies and special funds and lack of transparency with regard to recapitalization of state-owned companies

Most of the accession countries are likely to face challenges in forecasting and setting appropriate medium-term fiscal goals consistent with efficient observance of eventual Stability and Growth Pact (SGP) reference values taking cyclical factors into account.¹³ Historically, variation in the output gap has been higher in these countries than the current EU average—mainly due to the initial transitional output shock. Setting targets and achieving balance over the cycle may be more difficult in the accession countries and may require discretionary policy, as well as structural reform, to support the automatic stabilizers.¹⁴ In any case, the countries themselves must take action to ensure that they can converge to the fiscal reference values and respond adequately to whatever rules are determined by the EU. It is essential that each accession country establish credible fiscal transparency and accountability practices to address these issues.

Establishing Accountability and Credibility of Medium-Term Policies

The accountability features of MTBFs described in Box 1 should play a central role in establishing credible medium-term targets.¹⁵ Rigorous monitoring of expenditure and revenue plans should help establish policy credibility as well as to minimize political maneuvering around fiscal targets set simply in terms of aggregate balances. As yet, none of the countries have yet established clear reporting mechanisms to account for changes from the previous year's forward estimates. The forward estimates thus cannot be taken to constitute a firm policy commitment by the governments. Moreover, in most cases, ownership of the forward estimates has not been passed on to the ministries and agencies.

An important initial step to establish an accountable MTBF is to establish careful costing of ongoing expenditures and to draw a clear distinction between these and new expenditure policies. Four ROSCs (the Czech Republic, Estonia, Hungary, and Slovenia) record that such steps are being taken. Integration of decisions on recurrent and capital spending over the medium-term, however, appears to be a continuing problem in some of the countries (Poland, Latvia, and Lithuania). In the Baltics, a level of credibility has been established by consistent application of conservative fiscal policies, perhaps particularly in the case of Estonia. Accountable MTBFs offer a vehicle for formalizing such policies, and their wider implementation could help establish fiscal policy credibility more widely—as well as helping

¹³ See discussion in Mueller et al (2002), pp. 12–14 with reference to the Baltics.

¹⁴ There is need in this context for some resolution of the issues relating to the future interpretation of SGP rules and the question of whether the special difficulties faced by some accession countries require adjustment to the way in which the rules are applied and measured. See discussion in final section of Kopits and Szekely (2002).

¹⁵ In some advanced countries, explanations of changes are given for differences between budgets and the forward estimates for that budget year previously published. This form of accountability is a strong feature of the Australian budget estimates presentation.

to counter fiscal policy deviations that arise from change of governments and the effects of the political cycle.¹⁶

Fiscal Responsibility Legislation

Consideration could be given to implementing a fiscal responsibility law. Developing such supporting frameworks by each of the EU accession countries could strengthen the institutional foundation not only for an MTBF, but also for the other aspects of transparency discussed below. A number of countries have taken steps to strengthen the national legal framework for budgeting precisely to establish a clear discipline for fiscal policy and its implementation that is protected from the political cycle to the greatest extent possible.¹⁷ New Zealand has led the way in establishing such an approach through its 1994 Fiscal Responsibility Act, and a number of countries have now adopted similar legislation, including Australia, the United Kingdom, and, more recently, Brazil and India. While it can be argued that the supranational framework provided by the EU provides some comparable level of support, such a discipline seems likely to be much stronger if it is supported by consistent national legislation. In this context, the question of whether national fiscal rules will further help to establish accountability could also be considered.¹⁸

B. Off-Budget Activities and Fiscal Risks

The term off-budget is used as a broad term to designate activities that have at least a potential fiscal impact (often over the longer term), but are not effectively captured in the official budget presentation. Such activities include government activities carried out by extrabudgetary funds or autonomous agencies financed by budget transfers or earmarked revenues but not adequately included in budget processes and fiscal policy analysis. Two other prominent types of off-budget activities are contingent liabilities (government guaranteed loans and other potential liabilities) and quasi-fiscal activities (QFAs) (involving below-market pricing or noncommercial services provided by public financial institutions or nonfinancial public enterprises). In addition, while tax expenditures¹⁹ are in a sense “on

¹⁶ Hemming and Kell (2000), discussing expenditure rules applied in several OECD countries argue that “they tackle deficit bias at its source...by forcing participants in the budget process to internalize budget constraints... governments are made accountable for what they control most directly...(and) there is now a large body of evidence suggesting that expenditure-based fiscal adjustments tend to be more successful than tax-based adjustments.” (p.417). Similar arguments can be applied to MTBFs, the question of whether these need to be supported by a formal rule is largely a question of credibility.

¹⁷ See paragraphs 91-2 of the *Manual on Fiscal Transparency*.

¹⁸ Again, this is largely a question of credibility. For further discussion of these issues see Mueller et al (*loc cit*, particularly Box 4), Kopits and Symansky (1998), and Hemming and Kell (2002).

¹⁹ Tax expenditures are defined as concessions from a “normal” tax base that involve loss of revenue rather than an expenditure to achieve a particular policy objective.

budget,” they are most often not regularly reported after an initial exemption is introduced and thus not scrutinized as carefully on a regular basis as policies pursued through public spending.²⁰

As Appendix II indicates, most EU accession countries do not have complete coverage of the general government sector in their budget presentation. Moreover, most do not have a mechanism for assessing and monitoring contingent liabilities, tax expenditures or QFAs. The monitoring of off-budget activities is critical for a complete analysis of fiscal risks and sustainability. Ideally, the actual or potential costs of these activities should be included in the budget documentation to give a comprehensive picture of the government’s fiscal policy—both to improve internal consistency of decisions and to inform the public and the EU community. Together with the development of MTBFs, estimates of the future costs of these policies will play an essential role in building capacity to handle fiscal adjustment in response to economic change.

A number of underlying institutional issues will need to be addressed. In several EU accession countries, ROSCs have indicated that government activities are not clearly defined—although significant reforms are underway in the context of EU accession, aided by the fiscal transparency dialogue with the IMF. Extrabudgetary funds have been prevalent in many of the candidate countries. Autonomous agencies that carry out noncommercial activities were also very often observed in fiscal ROSCs as being excluded from the budget or reporting even though a majority of their financing is from earmarked revenues (including from privatization), government transfers, or funds raised on behalf of governments in international capital markets (the Czech Republic, Hungary, Poland, Bulgaria, the Slovak Republic, Latvia, Estonia, Lithuania, Slovenia, and Turkey).²¹ This situation has often contributed to difficulties in reconciling data among the central bank, statistics office and ministry of finance, which may all use different criteria to define government transactions. Furthermore, reporting by extrabudgetary funds and autonomous agencies has in many cases not been timely or complete²² making it difficult to provide comprehensive reports on the activities of general government.

²⁰ Extrabudgetary funds are discussed in Paragraphs 40–44 of the manual, in the context of the legal framework, and in Paragraph 59, in the context of comprehensive reporting. Contingent liabilities, tax expenditures, and QFAs are discussed extensively in Paragraphs 62–77 of the manual.

²¹ Handling of privatization receipts presents a particular issue in a number of countries, including the need to ensure the accountable use of privatization proceeds (Estonia), the need to clarify and rationalize the government’s involvement in the private sector (Bulgaria), and the need to report on public enterprise activities (or report on the entire public sector) and government equity (Slovenia, and the Slovak Republic) in the final accounts. In Estonia and Poland it was noted that *all* proceeds from the sale of enterprises should accrue to the budget first, and then be allocated as desired; and a clear rule specified in the event receipts are above or below the budget forecast.

²² Only transfers from the central government to the autonomous institutions are recorded rather than their full activities on a gross basis as recommended.

Requiring complete and timely reports on these extrabudgetary operations is an important first step for producing a consolidated presentation of general government activities on a regular basis. In a limited number of cases (such as social security funds), setting up funds outside the general fund is justified, but reporting on all general government activities should be consistent and fully coordinated. In most cases, the better solution is to bring most such activities fully into the central government budget. This step not only improves reporting, but would strengthen coordination and rationalization of spending and clarify fiscal policy presentation. Most EU accession countries are taking steps in this direction, and some have made considerable progress in reducing extrabudgetary operations (Bulgaria, Estonia, Lithuania, Romania, and Turkey). In the Czech Republic, however, the August 2002 ROSC update noted an increase in the activities of extrabudgetary funds.

Granting of government guarantees were cited as particularly problematic in the Czech Republic and Turkey. However, after the initial fiscal ROSC, the Czech Republic introduced strict limits on government guaranteed debt, as has the Slovak Republic. Some ROSCs have also highlighted the need to report on other government obligations (Slovak Republic, Estonia, and Lithuania) such as unfunded pension liabilities and liabilities of public enterprises.²³ A comprehensive analysis of fiscal risks similar to that prepared for the pre-accession economic program should be done regularly with the annual budget. Ideally, this analysis should cover general government and include all contingent liabilities as well as disclosure of the potential fiscal impact of other obligations.

Particular attention needs to be placed on QFAs. Fiscal transparency ROSCs, as well as monetary and financial ROSCs, generally carried out in the context of a Financial Sector Stability Assessment (FSSA), place emphasis on the implications of fiscal activities carried out by the financial sector. The fiscal ROSC looks at fiscal implications, while the FSSA is more directly concerned with immediate financial stability concerns. Box 2 illustrates the possible interactions between sectors, and the potential value of a more comprehensive analysis of broad economic vulnerabilities that may emerge through intersectoral interactions.

Most EU accession countries have greatly reduced the opportunities to conduct QFAs through public enterprises or public financial institutions through extensive privatization. However, some QFAs continue, including the use of below-market pricing for credit or services, and other forms of indirect support for certain activities. In the Slovak Republic, for instance, the ROSC suggested that government financial relations with state-owned enterprises could be clarified by establishing an *ex ante* dividend or rate of return policy, and/or by transforming some subsidized institutions into joint-stock companies. In Lithuania,

²³ But the issue of *disclosure* of these obligations for fiscal planning and in accounting statements should be clearly distinguished from their *recognition* as liabilities in financial statements and statistical reports. The latter topic is subject to continuing debate in terms of international accounting standards, but irrespective of the outcome of this debate, it is important that information on such obligations be available and used for fiscal policy.

the ROSC noted continuing prevalence of administered prices, particularly for municipal enterprises and extrabudgetary funds, and these QFAs could be eliminated by permitting market prices and/or including explicit subsidies in the budget to replace implicit ones. In the case of Hungary, the April 2003 ROSC update notes that activities of the Hungarian Privatization and State Holding Company and the Hungarian Development Bank are now consolidated as part of general government reports consistent with ESA 95 requirements, however, significant activities, particularly of the former company, remained outside the scope of the budget.

Box 2. Fiscal and Financial Sector Vulnerability: The Experience of the Czech Republic

The importance of quasi-fiscal activities (QFAs) by public financial institutions is recognized by the fiscal transparency code through a requirement to disclose QFAs and their estimated fiscal effects regularly and fully; and the soundness of the financial system is directly assessed through the Financial System Stability Assessments (FSSAs). Experience in the Czech Republic illustrates the two-way interactions between fiscal vulnerability and financial sector vulnerability, and the feedback effects that can occur.

The fiscal ROSC for a number of countries have identified problems with recording and controlling government guarantees. The problem of “hidden liabilities” is well-illustrated in the Czech Republic where in 1998 they were estimated to amount to 13 percent of GDP (and to be rising). These were quasi-fiscal costs arising in the process of economic transformation—specifically from government guarantees of development projects, and bad assets in public financial institutions from directed credits and purchases of low quality assets from banks. The fiscal ROSC for the Czech Republic (published in July 2000, but prepared in August 1999) indicated that there was a need to break a “culture of guarantees,” to put in place processes to better manage guarantees, and to fully report QFAs of public financial institutions and nonfinancial public enterprises so as to prevent the further accumulation of hidden liabilities. ROSCs generally also recommend developing a comprehensive fiscal risk statement to illustrate the impact of fiscal risks under alternative scenarios.

An FSSA for the Czech Republic was completed in July 2001. It concluded that: “The key vulnerability facing the Czech Republic stems from the unsustainability of fiscal policy.” (Paragraph 87). This was due in part to the potential impact on the financial system of an increase in interest rates driven by concern about fiscal sustainability. The increase in fiscal vulnerability had itself been largely driven by the deterioration in the fiscal deficit due to the impact of the cost of meeting the previously accumulated hidden liabilities.

This illustrates the need to take account of interaction between banking crises and fiscal linkages to the banking system. Fiscal ROSCs tend to focus on the fiscal impact arising from QFAs and the implicit liabilities from a weak banking system. However the Czech Republic FSSA illustrates there can be a serious second round macroeconomic vulnerability arising from the realized fiscal stress following bank restructuring. This can lead, via increases in interest rates, to further stress on the soundness of the recently strengthened banking system. Further coordinated follow up to examine whether there are continuing significant QFAs that may represent a further potential source of financial and fiscal sector vulnerabilities may be appropriate.

Further integration of state aid reporting into domestic budget processes could help to focus sustained attention on the various off-budget activities. Although the EU accession process requires the documentation of various forms of state aid, including through tax relief, this is

not integrated with the budget process in most of the EU accession countries. The EU accession countries could expand on the information they have to prepare on state aid to include all the various types of tax expenditures and QFAs including through concessions, license agreements, price controls and import restrictions. This quantitative information should be used in the budget preparation process and be included in the budget documentation. Hungary, which reports exemptions under the personal and corporate income tax laws in the final report on budget execution, and the Slovak Republic, which has a website with information on state aid, have made some progress in this area. Most ROSCs for the EU accession countries do not comment on the extent of tax expenditures. However, a number indicate that tax expenditures could be relatively large²⁴ but that efforts are underway to reduce them.

Ideally, the potential impact of all of these factors affecting short-term fiscal risks (see paragraph 22 above) and long-term sustainability should be analyzed and presented as an element of the budget documentation each year alongside the estimates for appropriation purposes. Long-term sustainability issues have not yet figured prominently in budget presentations to national legislatures. Most EU accession countries have completed analyses on specific long-term fiscal issues on an ad hoc basis, but none have developed a systematic process for reporting on long-term fiscal sustainability. In the future, regular reports analyzing short-, medium-, and long-term risks and fiscal sustainability should be produced. In particular with regard to the long term, the potential costs of unfunded pension liabilities and the future costs associated with EU accession need to be reported and examined.

C. Fiscal Monitoring, Reporting, and Control

All EU countries are required to comply with ESA 95 standards of fiscal reporting. The quality of fiscal data in these reports is dependent on the underlying quality of the accounting system, as well as the budget and accounts classification and coverage and the methodology of compiling fiscal reports from accounts data. A number of issues have been highlighted with regard to the first two of these aspects in fiscal ROSCs.

Accounting and Reporting

The quality of accounting systems was generally reported as sound in most EU accession countries, and effective accounts reconciliation was highlighted in a number of cases (Estonia, Czech Republic, and Latvia), but weaknesses were also noted in some areas. Some

²⁴ The Latvia ROSC mentions that tax laws are being streamlined to reduce tax exemptions and the ROSC for Poland recommended continuing efforts to simplify the tax system and restrict tax preferences (the June 2003 update for Poland, however, notes a number of steps being taken to eliminate tax exemptions, but a continuing need to report on remaining tax expenditures). ROSCs for Romania and Turkey also note the complexity of the tax system.

are moving toward adoption of accrual-basis accounting (Estonia and the Czech Republic).²⁵ Moves toward accrual basis accounting among EU accession countries are very welcome and availability of data in this format should greatly facilitate compilation of fiscal reports for EU purposes. *GFSM 2001* provides an appropriate basis on which to model government charts of accounts to achieve this purpose—but technical assistance may be needed to ensure that these concepts are fully integrated with domestic reporting and budget review functions. Application of *GFSM 2001* at this level should facilitate statistical reporting to EUROSTAT and serve as a link between emerging international accounting standards for the public sector and EU fiscal reporting requirements. It should in no way interfere with the acknowledged role of EUROSTAT to determine technical criteria for fiscal reporting to the EU.

It is important to stress that adoption of accrual basis reporting standards does not imply immediate adoption of accrual basis accounting. Development of accrual accounting and reporting systems has to be done in a phased way in line with institutional capacity and the pace of reform of fiscal management practices. Cash-basis measures of fiscal balance remain very relevant to macroeconomic analysis and are still a key focus for most advanced countries. The approach advocated in implementing *GFSM 2001*-based fiscal reporting is first to build on cash-basis measures (such as net or gross financing requirement²⁶) for short-term macroeconomic policy analysis. From this basis, capacity should be progressively added to report on broader balance sheet developments and full accrual basis accounting and reporting. These accrual data will give a more complete picture of fiscal sustainability by including the impact of changes in valuation and other economic flows that do not result from government transactions—but cash data will continue to be important.

The fiscal transparency ROSCs indicate a number of areas where improvements in underlying accounting systems are needed:

- Weak centralized accounting and information systems (Poland, Slovenia, Bulgaria, Lithuania, and Turkey²⁷).
- Inadequate accounting and reporting practices by both extrabudgetary institutions and local governments (most ROSCs), exclusion of externally financed projects (Poland).

²⁵ At the Joint Vienna Institute seminar, representatives from some other countries (notably Bulgaria and Malta) indicated their authorities' commitment to introduction of accrual basis accounting.

²⁶ The nearest equivalent balance in *GFSM 2001* is *net lending/borrowing* from the Statement of Government Operations.

²⁷ The June 2003 update notes that steps have been initiated in Poland to move toward accrual accounting for the entire general government. The original ROSC for Bulgaria recommended a more comprehensive accounting system; the update on Bulgaria notes treasury improvements including new Chart of Accounts that is consistent with ESA95 and new *GFSM*; and more comprehensive accounting. In Turkey the presence of a large number of budgetary and nonbudgetary organizations collecting and spending public resources while following various accounting and reporting requirements hindered the transparency of fiscal operations.

- Insufficiently detailed information or comprehensive data on general government debt (Lithuania) or deficit financing (Romania).

Addressing these underlying accounting and reporting weaknesses will be fundamental for timely, comprehensive and reliable fiscal reporting for domestic fiscal policy as well as for reporting to the EU. More comprehensive reporting on government debt is particularly important for the analysis of fiscal sustainability and the determination of the correct fiscal policy stance. Publication of both projected timing of debt issuance and a medium-term debt (and asset) management strategy would better guide market expectations. To meet the broader aims of fiscal reporting, the EU accession countries should also begin to focus on systematic reporting of central government assets and liabilities, leading toward publication of a central government balance sheet. Initially, this balance sheet statement may be limited to financial assets and liabilities, but should gradually move toward comprehensive coverage—and progress will depend on both capacity and resource constraints.

Fiscal reports could also be improved by including analysis of data relative to budget estimates or policy intentions. Regular quarterly reporting and analysis on budget outturn would promote communication with the public and guide market participants and other users of fiscal information.²⁸

Budget Control and Audit Functions

Capacity to achieve fiscal targets is also dependent on effectiveness of budget controls. ROSCs have raised some issues in this respect in the context of reviewing the openness of control and monitoring systems. In principle, all spending should be authorized by the legislature, and spending in excess of the budget appropriation should be subject to review by parliament through requests for supplementary appropriations. However, some EU accession countries have permitted significant scope to the executive to reallocate spending or raise spending above appropriated amounts (the Czech Republic,²⁹ Hungary, Estonia, Turkey, and the Slovak Republic). For example, in Hungary executive resolution has been used to spend from higher than forecast revenues. In some cases, spending of privatization proceeds has not been on-budget and not always subject to prior parliamentary approval (Hungary,³⁰ Estonia, Latvia). In Turkey, some investment projects could be financed by the treasury's borrowing or guarantees without explicit parliamentary approval. In the Slovak Republic, supplementary budgets and the carryover of appropriations from one fiscal year to the next

²⁸ Some ROSCs also recommend publication of budget and accounting summary information in a major European language or English to better inform markets.

²⁹ From 2001, parliament must approve all increases in budget spending, but these rules do not apply to extrabudgetary funds.

³⁰ Practices in Hungary have been amended, as noted in ROSC updates, to ensure full parliamentary scrutiny of use of privatization receipts.

have been carried out without seeking new parliamentary authority. Strengthening of legislation should be considered to avoid such gaps in public accountability.

The continuing issue of budgetary payments arrears in some candidate countries is evidence of underlying transparency and control problems. ROSCs for Lithuania, Turkey, and Romania point to the need for measures, such as commitment controls on large expenditure items, and improvements in the expenditure control framework more generally, to avoid budgetary arrears. By and large, such issues need to be addressed by a range of measures to make budgets more realistic and strengthen internal and external audit.

It is also important that information from the accounting system is applied effectively in a budget review process to inform the public and provide a strong incentive to examine policies and maintain the quality of data. In the Slovak Republic, the legislature undertakes quarterly reviews of state budget performance. However, none of the other countries are recorded as conducting quarterly or mid-year reviews by parliament, and a number of the ROSCs have advocated adoption of such a process.

A number of fiscal ROSCs mention the need to further strengthen and modernize both internal and external audit capacity. (Latvia, Estonia, Bulgaria (internal),³¹Romania, and Turkey). Nearly all countries were perceived as needing to develop mechanisms to ensure adequate follow-up on the recommendations of internal and external audit reports.³² To this end, it would be desirable that regular follow-up reports on the actions taken to address previous audit recommendations be published.

EU accession countries also need to move at an appropriate pace in the direction of developing performance audits. Reform on these lines however, depends on building more results-oriented budget systems, including the provision of a more detailed statement of policy objectives with the annual budget law (e.g., Poland) to facilitate ex post evaluation. Reporting systems also need to be developed to include data on program outputs and outcomes in fiscal reports.³³ Parallel with these reforms, the external audit agencies need to develop performance audits and systematically review performance of all spending agencies in terms of results as well as financial regularity.

³¹ However, the Bulgaria update notes improvements that permit it to be first EU accession country to manage the Special Accession Program for Agriculture and Rural Development (SAPARD) funds under EU member country guidelines for management of state aid; six other accession countries now also have SAPARD accreditation.

³² In some cases, it has been recommended that a public accounts committee be established to review external audit reports and follow-up on its recommendations. In Turkey, the ROSC advocated expanding the scope of the external audit to cover extrabudgetary funds, provincial administration and social security institutions.

³³ Some steps are being taken in this direction in several countries (for instance, in Lithuania since 2000, the government has been working on establishing program-based medium-term budgeting to link the strategic plan with budget plans of government agencies). However, development of results-oriented budgeting, reporting, and audit is necessarily a long-term program, even in the most advanced countries.

D. Subnational Governments

Since the EU focuses on general rather than central government, the aim of improving transparency applies with equal force to subnational government. Given that subnational governments have a high degree of autonomy, there is an evident need to promote cooperation and coordination in setting and monitoring central and local government deficit targets. If the relative split of the general government deficit between the central and local governments is not agreed by all players, the central government may find itself in a position where it must reduce its own deficit in order to compensate for a higher-than-expected deficit at the subnational level of government.³⁴

A number of EU accession countries have put in place restrictions on local government debt, debt service or size of the fiscal deficit. Estonia, Hungary, Lithuania, and Romania all have established legal limits on local government borrowing and similar limits are planned in the Slovak Republic.³⁵ Some countries have recently implemented “no bailout” laws and policies—though the effectiveness of such laws need more time to be fully tested.³⁶ In Latvia, local governments cannot borrow without approval from the central government and the annual budget law sets overall limits on local government borrowing, but it is difficult to enforce these limits for individual local authorities with access to credit.

Some countries (Latvia and Romania) have central government councils that monitor and approve borrowing (mainly for external loans). However, the central government does not always monitor local government debt effectively.³⁷ Since local governments in the EU accession countries often depend to a large extent on transfers from the central government, this leverage can be used to deter such ‘misbehavior’ by local governments. For example, as recently legislated in Estonia, transfers can be withheld if borrowing limits are exceeded or if local governments fail to provide sufficient information on their liabilities.

³⁴ See, for instance, footnote 12 of the June 2001 ROSC for Estonia.

³⁵ In Estonia, for example, the ROSC records that borrowing by local governments in excess of one year requires that the funds be devoted to approved investment projects, that the stock of their debt not exceed 60 percent of projected revenues (the June 2002 ROSC update notes that this limit was tightened from the former 75 percent), and that debt service payments cannot exceed 20 percent of projected revenue in any one year. In Hungary local government debt is limited to 70 percent of adjusted own revenues, and regional authorities have to submit to an external audit before borrowing.

³⁶ In Hungary, local government bankruptcies are governed by the *Law on Bankruptcy of Local Governments*. In 2002, the Czech Republic removed existing limits on borrowing and the extension of guarantees for subnational governments. However, the new law explicitly states that the central government is not liable for the debt of municipalities and regions.

³⁷ In Estonia, for example, 10 municipalities exceeded borrowing limits and in 2 cases the central government had to bailout the local governments.

In order to monitor the general government effectively, improvements are needed in accounting and classification so that local governments can provide timely data that meets ESA95 requirements. Several ROSCs note inadequacies in the coverage and timeliness of subnational government data (Turkey, the Czech Republic, and the Slovak Republic).³⁸ Absence of uniform accounting and reporting standards has also complicated consolidation of general government accounts. In some cases, the central governments have established requirements to standardize accounting and reporting by all government entities.³⁹ However, implementing these standards may well require significant efforts to strengthen the accounting and reporting capacity of local governments. In Slovenia, the treasury accounting system under development will cover all of general government including local governments—and this approach should ensure timely and comprehensive reporting on general government activity.⁴⁰

Finally, it will be essential to ensure adequate information on all “off-budget” general government fiscal activity. All of the types of off-budget activities discussed above are also available to local governments. Therefore, controls on subnational borrowing are not sufficient to protect the central government from all possible future liabilities. Occasions may arise where the central government will be forced to adjust its fiscal position in order to compensate for liabilities that result from local off-budget activities. ROSCs have identified a few countries where local governments do engage in such activities.⁴¹ Even those countries with “no bailout” policies could find that it is necessary to take action to discourage such local activities to improve the chances of establishing credible fiscal independence at the local level.

IV. CONCLUSIONS

The preceding sections have demonstrated the high degree of complementarity between the requirements of EU membership and implementation of key principles of the IMF’s fiscal transparency code. The code, however, helps identify features of fiscal management that go well beyond the formal minimums necessary to meet *acquis* requirements. In this sense,

³⁸ The Czech Republic and Estonia reportedly intend to publish quarterly general government accounts according to ESA95 standards in 2003.

³⁹ Steps have been taken in this direction by the Czech Republic, Slovenia, and Estonia; such steps are not recorded in other ROSCs or updates.

⁴⁰ It can be noted that similar problems occur in many advanced countries (for instance Italy and the United States). Australia provides a good example of the application of uniform statistical standards for presenting fiscal data at federal (commonwealth) and state levels as well as a mechanism for agreeing on general government borrowing levels. Germany provides another good example of consistent classification and planning systems.

⁴¹ ROSCs note that local governments have expanded extrabudgetary activities (Poland), engaged in QFAs (Lithuania), increased the size and number of local government enterprises (Turkey), and run payment arrears (Lithuania).

monitoring of progress in implementing the fiscal transparency code through fiscal transparency ROSCs and regular updates can play a highly significant role in ensuring that the fiscal management objectives of EU membership are met not only in a formal sense but also in keeping with their true spirit. Consistent with the voluntary nature of ROSCs, such an approach needs to be motivated by a concern for domestic fiscal management reform and driven by the authorities of the countries concerned.

Significant progress has been recorded in all four of the areas of fiscal transparency discussed above. It is essential, however, that the remaining issues be addressed for an adequate fiscal management capacity to be put into place. Naturally, these improvements cannot be put in place simultaneously or in a short period. Reforms must be carefully phased, and priorities will vary according to individual country circumstances. The arguments advanced in this paper suggest a core set of four areas of fiscal management reform to be pursued by all EU candidate countries:

- Implementation of an effective MTBF as a mechanism for both managing domestic fiscal policy and planning within the EU. A fully accountable MTBF should play a central role in establishing fiscal policy credibility. This can best be achieved by integrating medium-term estimates into the annual budget process.
- Strengthening and modernizing government accounting and reporting systems are equally critical and complementary elements of reform. In some countries, weaknesses of cash accounting need to be addressed. From this point onward, countries should move progressively toward a *GFSM 2001*-compatible chart of accounts and accrual basis reporting. A major advantage of *GFSM 2001* is that it is consistent with ESA 95 standards and a budget and accounts structure based on these principles can facilitate planning and accounting relative to EU fiscal reference values.
- High priority should also be given to establishing a regular comprehensive analysis of fiscal risks that can arise from off-budget activities, including those of subnational governments, or external macroeconomic shocks; and this analysis should be included as an integral part of the budget process.
- Efforts to strengthen central government fiscal management and reporting must be supported by programs to develop uniform reporting standards for general government and to improve the management capacity of subnational governments.

Implementation of these reforms should be closely monitored and experience shared among the candidate countries—as well as existing EU members. As this paper has illustrated, the fiscal transparency ROSCs provide an instrument that helps governments to focus on key elements of reform, and regular ROSC updates can therefore be used as a monitoring tool to assess progress and communicate experience in the region.

Monitoring also helps governments focus on areas where capacity development may be needed and technical assistance could be helpful. Assisting with implementation of *GFSM* 2001-compatible charts of accounts is one area where Fund expertise will be particularly relevant. The EU, the Fund, and other agencies could help in advising on implementation of MTBFs and techniques of fiscal risk and sustainability analysis and reporting. Reforms along the above lines also need to be supported by efforts to close loopholes in existing budget legislation and to strengthen the mechanisms of internal control, budget review, and external audit in most of the accession countries. Capacity development in these areas is of vital importance and is being supported by EU programs for accession countries.

Appendixes

I. The Fiscal Transparency Code and EU Accession Requirements

Fiscal Transparency Code		EU Accession Requirements	
Code		Ch	Summary
1.1.3	Clear mechanisms for the coordination and management of budgetary and extra budgetary activities should be established.	21	The candidate countries clearly have to define the tasks and responsibilities of all the bodies and institutions involved in the preparation and implementation of Structural Funds and the Cohesion Fund and to ensure an effective inter-ministerial co-ordination.
1.1.4	Relations between the government and nongovernment public sector agencies (i.e., the central bank, public financial institutions, and nonfinancial public enterprises) should be based on clear arrangements.	11	This chapter requires prohibition of direct financing of the public sector by the Central Bank, prohibition of privileged access of the public sector to financial institutions, and independence of the Central Bank.
1.2.1	Any commitment or expenditure of public funds should be governed by comprehensive budget laws and openly available administrative rules.	21	The Structural Funds are currently covered by a framework regulation laying down general provisions on the Structural Funds (Council Regulation (EC) 1260/1999).
1.2.2	Taxes, duties, fees, and charges should have an explicit legal basis. Tax laws and regulations should be easily accessible and understandable, and clear criteria should guide any administrative discretion in their application.	10	Adopting this acquis requires that members comply with the value-added tax (VAT) directives. A proportion of the VAT revenue calculated on a unified basis to finance the Community budget. The sixth VAT directive (77/388/EEC) ensures that tax is applied to the same transactions in all Member States. A strong and well-equipped administration is required for the application and enforcement of the taxation acquis. The countries have some control over their excise taxes and direct corporation taxes but they have to adhere to a code of conduct which ensures that cross-border activities within EU are not hindered, and that the tax measures are not potentially harmful in the meaning of the code.
2.2.1	The publication of fiscal information should be a legal obligation of government.	12	Sound statistical bases are needed for conduct of policies in many areas. Countries need to be able to produce accurate and harmonized fiscal and national accounts data as part of stability or convergence programs.
3.1.1	A statement of fiscal policy objectives and an assessment of fiscal sustainability should provide the framework for the annual budget.	21	Countries need to design a development plan, as required in the Council Regulation 1260/1999 and have the appropriate procedures for multi-annual programming of budgetary expenditure in place.

3.1.3	The annual budget should be prepared and presented within a comprehensive and consistent quantitative macroeconomic framework, and the main assumptions underlying the budget should be provided.	21, 28	The candidate countries need to comply with the specific control provisions applicable to the Structural Funds and Cohesion Fund. In the field of PIFC (Public Internal Financial Control) the main criteria for the assessment are the presence of the legislative framework (primary and implementing legislation), the development of the internal audit function and ex-ante control mechanism throughout all the income and spending centers, as well as ensuring the functional independence of the internal auditors.
3.2.2	A statement of objectives to be achieved by major budget programs (e.g., improvement in relevant social indicators) should be provided.		
3.3.3	Budget execution should be internally audited, and audit procedures should be open to review.		
3.4.3	Results achieved relative to the objectives of major budget programs should be presented to the legislature annually.	21	Members need to comply with the specific monitoring and evaluation requirements, in particular as regards to the ex-ante evaluation of the development program.
4.2.1	A national audit body or equivalent organization, which is independent of the executive, should provide timely reports for the legislature and public on the financial integrity of government accounts.	28	External Audit comprises the ability of the candidate countries to confirm the independence of their external control body in terms of deciding on the questions of audit approach and choice of inquiry, as well as reporting without restriction or interference by the government or other bodies. It is also of crucial importance that the candidate country ensures an independent audit of the financial accountability of all public funds, irrespective of their origin. The presence of the formal mechanism for the Parliament for a proper reaction to the audit findings is of particular importance.

II. Observations on Fiscal Transparency

Medium-term Budgeting and Analysis							
Country	Realistic annual budget	Budget documents include forward year estimates	Medium-term macroeconomic framework guides annual budget process 5/	Budget documents include medium-term objectives	New and ongoing policy costs are distinguished in the budget	Medium-term estimates guide annual budget submissions 5/	Analysis of fiscal sustainability/ long term risks
Code element	4.1.1	2.1.2	3.1.3	3.1.1	3.1.4	3.1.3	3.1.1/5
Bulgaria	*	Yes—3 years	No	Yes 3/	*	No	6/
Czech Republic	Yes	No 1/	Yes	Yes	Yes	No	4/
Estonia	Yes	Yes—3 years	Yes	Yes	Yes	No	4/
Hungary	Yes	Yes—3 years	Yes	Yes	Yes	Yes	1/
Latvia	Yes	No 1/	No	No 1/	No	No	6/
Lithuania	Yes	Yes—3 years 2/	Yes	No	No	No 1/	4/
Poland	No	Yes—2 years 2/	No	Yes 3/	No	No	4/
Romania	No	Yes—3 years	Yes	Yes	No	Yes	1/
Slovak Republic	Yes	Yes—2 years 2/	*	Yes	No	Yes	4/
Slovenia	Yes	Yes—2 years	Yes	Yes	No 1/	Yes 1/	4/
Turkey	No 1/	No	No	No	No	No	6/

Source: Fiscal ROSC for the respective countries and IMF staff. All observations are derived from published fiscal transparency ROSCs or updates published on the IMF website. In several cases, particularly when no recent updates have been published, significant reforms may have occurred. Any such reforms should be embodied in future ROSC updates.

* No observation made in the ROSC

1/ Improvements are in progress.

2/ Aggregate projections only (Lithuania and Slovak Republic aggregate projections are not in the budget document but are sent to parliament with the draft budget)

3/ Objectives are stated in general terms only

4/ Analysis of long-term risks is done on an ad hoc basis. In the case of Poland, some improvement was recorded in the June 2003 update.

5/ No in these columns is usually implied by the early stage of development of medium-term planning; Yes means the medium term framework or strategy (rather than agency estimates) is used to guide annual budget submissions

6/ ROSC mentions inadequate consideration of fiscal risks in general.