

Chapter 3

FISCAL ASPECTS OF ACCESSION: CAN WE ENTER THE EUROPEAN UNION WITH A BUDGETARY DEFICIT?

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ABSTRACT

Although there is no common fiscal policy at the European Union (EU) level in Croatia, accession will entail important changes in budgetary revenue and expenditure. On the one hand, accession brings transfers from the EU budget, but also means the loss of customs revenue as well as the need to adjust the structure of tax revenue. On the other hand, in conjunction with significant expenditure for adjustment in areas such as transportation and the environment, as well as expenditu-

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res for the EU budget, there will be a change in the structure of expenditure, in order to be able to check on transfers from the Structural Funds. The objective of this paper is to evaluate the intensity and direction of fiscal effects that accession will lead to, as well as the changes in their structure and the possibility of meeting the convergence criteria.

Key words:

fiscal policy of Croatia, structural funds of the European Union, harmonisation of tax legislation, convergence criteria

INTRODUCTION

When considering the fiscal effects of enlargement we come upon a kind of absurdity. This concerns matters that are regularly dominant in negotiations about EU accession, although they are actually negligible in relation to the total costs and benefits of joining. We shall nevertheless direct our analysis precisely to the fiscal aspects of accession, because for a number of reasons we consider them exceptionally important. First of all, irrespective of the principle according to which new members should not have to make a net contribution to the EU budget, it seems that accession will regularly increase fiscal pressure in new members, even to the extent that there will have to be discussion of a possible fiscal crisis occasioned by the enlargement. Secondly, new members will have to run their fiscal policy in line with the principles of the Stability and Growth Pact (SGP), which can also have certain negative consequences.

In line with this focus, in the first chapter we shall consider the sum effects of joining on the revenue and expenditure of the Croatian budget. This kind of harmonisation of the Croatian tax system with EU guidelines could result in new revenue from excises on mineral oils, while a reduction of revenue is expected because of payment of some of the customs duty into the EU budget and also due to the harmonisation of the customs system. The most important new revenue item will consist of various transfers from the EU budget, since some of these transfers, due to the substitution effect, will reduce the expenditures of the Croatian budget. Nevertheless, some of the transfers, because of the need to pre-finance and joint finance projects, will increase the expenditure side of the budget. A considerable increase in expenditure will primarily be the consequence of payments into the EU budget, as well

as of essential investment in the infrastructure and environment areas. Because of the harmonisation of the system of state aid with the EU rules, considerable fiscal savings can be looked for, although it is impossible to predict when this could be expected.

In the next chapter the effects of joining on the handling of fiscal policy will be considered, particularly the implementation of the SGP. First of all, most of the future members still have to reduce their budgetary deficit considerably so as to harmonise with the fiscal rules of the EU. After that, since these rules are tailored to the situation of the current members, from whom the new members will differ in several factors important for the shaping of macro-economic policy, the new members will have to adapt a somewhat different approach to the management of fiscal policy so as not to violate the common rules. Finally, we consider what effects the management of fiscal policy will have on the dynamics of the public debt in the future members.

We conclude the work with recommendations that, according to our analysis, might improve the preparation for the handling of fiscal policy within the context of the EU.

FISCAL EFFECTS OF ACCESSION

Effects on the national budget revenue

We shall start our analysis of the fiscal effects with an analysis of revenue that on entry into the EU will inevitably be subject to certain changes. On the one hand, some of the budgetary revenue, from VAT and customs duty, will be channelled off by the standard mechanisms into the EU budget, while on the other hand there will potentially be a wide open space for the increase of certain kinds of revenue (like excises) as a result of the harmonisation of the tax system. As counterbalance to this net drain of resources, there will also be transfers from the EU budget into our own national budget. However, as we have already pointed out, it is a question whether all these trends will ultimately have a neutral, positive or negative effect on public finances. From this point of view, the analysis below will focus on the quantification of given effects, to the extent that this is possible.

Value added tax

We start with an analysis of VAT, a part of which through the indirect keyⁱ will drain into the EU budget. The task is to evaluate the revenue from VAT in 2007, and this figure will then, later on in the paper, be used to estimate the amount of the drain into the EU budget.

In order to estimate the amount of revenue from VAT in 2007 we shall use the knowledge that there is a significant link between VAT revenue and nominal GDP (EIZG, 2003), according to which for each 1% rise in nominal GDP, VAT revenue rises by 1.2%. From this point of view, the key is to estimate the growth of GDP in the period up to 2007. Without entering into details about considerations of which GDP growth rate to use, it seems most correct to use estimates of potential rates of growth (Mihaljek, 2002) as guidelines, which from 1994 to mid-2002 came to almost 5%, and to reduce this by one percentage point, in order to get as realistic, or conservative, as possible a projection of GDP growth. Thus, the assumption is that in the next three to five year period the Croatian economy might rise on average at a real rate of 4%, that is at a nominal rate of 7.1%, considering the assumed average annual rate of inflation of 3%.ⁱⁱ Considering the assumption stated concerning the growth of nominal GDP, and the standard *ceteris paribus* assumption that the VAT system will not change, revenue from VAT in 2007 can be estimated at 38.4 billion kuna or 15.4% of the GDP of that time.

Taxes on international trade (customs)

There is a dual loss of revenue from customs. First, there is direct loss according to the key by which 75% of the revenue from customs duties is automatically channelled into the EU budget. There is also an indirect loss, arising because of harmonisation with the EU customs tariff structure.

In order to estimate the direct loss, we shall assume that the value of imports will come to 55% of GDP in 2007,ⁱⁱⁱ and that 80% of this^{iv} import will come from countries with which we have free trade treaties. From this point of view, of the 137 billion kuna value of imports in 2007, no more than 27.4 billion kuna will be subject to customs duties. Since on accession Croatia will have to take on board the current EU customs tariff, according to which the average customs rate is

2.6%, the total revenue of customs duty can most simply be estimated on the assumption that the current average EU customs rate will not change.^v In this case, it can be estimated that in 2007 a revenue of 712 million might be collected, which means a direct drain of 534 million kuna (75%) or 0.2% of the then GDP into the EU budget.

Finally, one should bear in mind the additional loss of revenue from customs duty because of the adoption of the customs tariff structure of the EU. Considering the current difference between the average customs rate in the EU and Croatia (2.6% as against 6.3%), the loss that might come about on this basis in 2007 would be about one billion kuna, or 0.4% of GDP.^{vi} It is useful to emphasise once again that this is money that is simply lost because of the transition to a new customs tariff (part of the harmonisation process), and that this amount has to be included into the amount of the total loss of revenue from customs duty, which with this climbs to 0.6% of GDP.

Excises

Unlike VAT and customs duties, excise or special taxes are the only item on the revenue side that might, as a result of the harmonisation of some of the rates in line with EU guidelines, increase budget revenue. However, it is worth pointing out that there are EU members that have not totally harmonised their structure of excises,^{vii} which leads to the conclusion that Croatia then does not at once, on entry into the EU, have to harmonise the whole structure of its excise duties.^{viii} Harmonisation will have to be carried out in an agreed transition period. From this point of view, one should thus talk about the potential of larger budgetary revenues in 2007.

At the very outset it would be useful to point out that the EU aims at the harmonisation of three kinds of excise – mineral oils, tobacco products and alcohol, and that these three kinds of excise in Croatia – in terms of both coverage and amount – are already fairly well adjusted with those existing in the EU. In essence, harmonisation of the amount of the excise on alcohol is not at all necessary (Arbutina, Kuliš and Pitarević, 2002), so that on this basis alone no additional revenue can be anticipated. As for the excise on tobacco products, only a minor adjustment is required – the raising of the excise on cigarettes expressed as a percentage of the retail price from the existing 49.1% to 57% (for the Standard Group). Because of the specific nature of the product

and the market, as well as of the workings of the black market, we think that such an increase, if it actually happens, will not entail considerable additional revenue for the Croatian budget. Thus all that is left is the excise on mineral oils, which are also the most important from the point of view of their share in the overall revenue from excise (60%). In Croatia the excise on unleaded petrol is 12% lower than the EU minimum, and that on diesel fuel 22%. On the other hand, excise on heating oil is already harmonised and here no additional revenue can be expected.^{ix} The newly created additional revenue – in the event of the application of minimum excises for unleaded and for diesel, and on condition that the existing excise on heating oil is not changed – would come to 1 billion kuna in 2007, or 0.4% of the GDP at the time. This would be the total additional revenue from the harmonisation of excises.

There is also potential additional space for revenue from excise connected to mineral oil fuel, since in the EU there are also excises on fuels such as kerosene, natural gas and LPG. From this point of view we can expect the introduction of new excises on additional products, and then the restructuring of the amount of excise depending on the purpose the fuel is used for (for engines, for engines in commercial use, for heating). Depending on the categories, the same kind of fuel will have various excise rates, all for the purpose of meeting the broader tasks of transportation policy, environment protection policy, agricultural policy, and finally, employment policy. It seems very reasonable, however, to assume that the application of such comprehensive policies will require time, and also to take into consideration only the 1 billion kuna of additional revenue in 2007 stated above, which is also in a sense potential, in that it assumes the harmonisation of excises on unleaded petrol and diesel fuel.

New kinds of revenue for the national budget

Apart from the effect that joining will have on the existing national budget revenue (customs duty, VAT, excise), there will be new categories of revenue that will arise as the consequence of transfers from the EU budget and as a result of participation in the common policies of the EU. Although these revenues are one of the things that attract new members most, including Croatia, it is necessary to accentuate two aspects that diminish the attractiveness of obtaining transfers, particularly from the standpoint of public finance.

- Some transfers will not affect the budget, which will serve as a medium for the transfer of these resources to the end users.
- Not all transfers will be exclusively revenue for the budget; some, because of the principle of joint-financing and pre-financing, will have an effect on the expenditure side of the budget.

The positive side of obtaining transfers from the EU budget can be seen in the reduction of expenditure for the financing of existing aid systems. This is called the substitution effect, since resources from the EU budget will substitute national financing.

The estimate of the amount of transfers is made more difficult since their aggregate amount, in the case of Croatia, is determined by a new financial perspective that will work from 2007 to 2013, the creation of which will be addressed at the earliest in 2005. In addition, the amount of transfers will directly depend on the outcome of the actual accession negotiations and on the direction of reforms in regional and agricultural policy within the EU. An additional unknown variable relates to the capacity of Croatia to build up an institutional infrastructure for the administration of EU funds. It is estimated that new members, that have had more time to set up effective transfer mechanisms than Croatia will have, will not manage to use all the resources that are available to them in the first years of membership. In Croatia, such institutions are still in their infancy.^x

Within the framework of these constraints, it would seem opportune to make use of data for Slovakia and Lithuania from the documents of the European Commission in which net budgetary items for the new member states are worked out (see Annex 1). The figures for Slovakia will be used for the calculation of transfers from the Structural Funds, since those to the greatest extent depend on the size of the population (Slovak population is 5.4 million, Croatian 4.3) and GDP (Slovakia has a GDP of 23.7 billion dollars, and Croatia 22.4). In the case of transfers from agricultural funds, we shall make use of the data for Lithuania, because they depend to a great extent on the total population (which in Lithuania is 3.5 million), the share of agriculture in GDP (7.2% in Lithuania and 9.7% in Croatia (World Bank, 2003)), and on the structure of the farm sector (in both countries there are a large number of small, unconsolidated farms, because of which they have the same structural problems). Although the results obtained in this manner cannot be completely accurate, they will nevertheless make possible a review of the order of magnitude and the direction of effects of joining on the Croatian budget.

Transfers from the EU budget can be divided into (1) those that are not related to projects and hence their sums automatically become budget revenue and (2) those that depend on projects, while the inflow depends on the power of Croatia to absorb it, i.e., to what extent projects at state and local level will be co-financed from the budget. Direct income supports, market intervention in agriculture and internal politics transfers fall into the first group. The second group includes transfers from the Structural Funds, the cohesion fund and resources for rural development. There is also a third group of revenues that include the remains of the pre-accession assistance, special arrangements and budgetary compensations. As can be seen from Annexe 1, in the first year of membership transfers will be at a fairly low level because of the inability of new members to absorb all the resources, on account of their own economic, administrative and institutional underdevelopment.

Transfers unrelated to individual projects

The first group of transfers unrelated to individual projects comprises direct income support to farmers and market interventions. Both kinds of transfer come from the agricultural fund, or more accurately, from its guarantee-related part.

In the most recent accession negotiations it was agreed that in the first year of membership income support would be paid only in the amount of 25% of total support that is obtained by EU members, with the proviso that this amount would gradually rise until in 2013 it reached 100%.^{xi} If we assume that in the next round of enlargement the same principle will hold, in 2007 Croatia too will get 25% of the aid. The very nature of financing income support also tends to the detriment of new members. That is, income support payments arrive about three months late, which always shifts the payment into the following fiscal year, so that the amounts earmarked for 2007 will in fact only be paid in 2008 (the liquidity gap or the so-called Green Hole effect).^{xii} Since this paper is concentrated only on fiscal effects, in 2007 we can conclude that revenue from the EU budget will be zero, but that a very considerable amount will be shown on the expenditure side. Taking the data for Lithuania, the total liquidity gap in 2007 might come to 590 million kuna. This expenditure will be reduced in the very next year, but there will not be any positive effects on the budget since the support is meant for the end beneficiaries - the farmers - and the budget will be

used only as a transfer instrument. Still, there will be positive effects on the budget, and as early as 2007. That is, already in the budget for 2003 the Agriculture Ministry has earmarked 350 million kuna for income support, and since this instrument was introduced only this year, it can be expected that the sum will have risen by 2007. Because of the substitution effect, the Croatian budget will save this small amount.^{xiii}

Transfers on the basis of market support also come late, and about 205 million kuna of expenditure could be expected in the 2007 budget for pre-financing. Still, the budget will once again have savings because of the substitution effect in the amount of these 205 million kuna, since EU resources will cover the support part of the budget and free these resources for other purposes. Also, since with entry into the EU Croatia will have to accept the principles of the CAP, other aid meant for market intervention will have to be abolished.

Transfers on the basis of internal politics, which are mainly used for the financing of existing policies, institutional upgrading and the establishment of quality border controls with third countries constitute the second group of transfers. Since most transfers are calculated according to the share in the total population and GDP of the EU, for the approximate calculation of the amount that Croatia will receive on this basis we shall use the example of Slovakia again. These transfers will be exclusively the revenue of the national budget, since they will either replace or complement national financing, and they might amount to about 354 million kuna.

Transfers related to individual projects

Project-related transfers require joint financing. For this reason, in the past there have been cases of member states even refusing this kind of aid since they were not able to bear the burden. Transfers from the Structural Funds, the Cohesion Fund and resources for rural development come into this group.

The national budget bears from 25 to 50% of the costs of financing projects from the Structural Funds, the typical percentage being 25%. Resources from the Structural Funds represent additional financing, as it is called, which means that the resources of the funds may not be a substitute for financing from national sources. Countries have to keep financing at least at the level they used to in the period before they obtained these resources. Hence, the use of these resources, de-

depends on the power of absorption of each member state, and the resources that are allocated to the new members may not exceed 4% of their GDP.^{xiv} Because of the requirement for joint financing, the real inflow of resources in the first year of membership is lower by about 25%.

On the basis of the Slovak data, Croatian regions (units of local government and self-government) might in 2007 get 779 million kuna, and the budget would have to find another 253 million. Some of these resources will be distributed to institutions outside general government (e.g. to privately owned firms), which means that in these cases, these institutions will have to bear the costs of joint financing. Since it is at present impossible to predict which part of the structure funds will finance projects in the private sector, for the sake of simplicity of calculation we shall assume that all these resources will enter the budget of general government.

Resources from the Cohesion Fund are meant for the financing of infrastructure and environment in member states whose GDP is less than 90% of the EU average. According to data for Slovakia, in 2007 Croatia can expect 31 million kuna of direct revenue for the budget. Since taking part in projects financed by the Cohesion Fund comes to between 80 and 85% of total costs, the burden of joint financing would be only 5.4 million kuna.

The third source of revenue and costs for the national budget will be resources for rural development. The level of joint financing amounts to 20%, so that Croatia, again on the basis of data from Lithuania, could get 438 million in 2007, and the budget would have to add another 110 million. Although these funds are meant for the ultimate beneficiaries, farmers, there will still be positive effects for the budget, since transfers from the budget will replace national financing of rural development. Since we have data only for 2003 (60 million kuna is earmarked for rural development) we can predict that, due to the substitution effect, savings will come to a minimum of 60 million kuna.

Other revenue

Other revenue includes pre-accession assistance, which will continue to flow into the budget because of its nature even after joining the EU, special cash-flow facilities and interim budgetary compensations. These transfers will be the direct revenue of the national budget and will not require co-financing.

Although it can be expected that Croatia, when it becomes a full candidate, will obtain pre-accession assistance from the programme in which other candidates take part, for now it is hard to guess how much these resources will amount to, since comparison with any other country is impossible without in-depth analysis. For this reason, we will keep to the conservative approach and assume that Croatia will keep on getting only the resources from CARDS, with the same dynamics as to date, about 450 million kuna p.a.

Special cash flow facilities are meant to neutralise the negative effects of joining during the first years of membership. The key according to which these resources are allocated is not universal, and the existing distribution was the result more of good or bad negotiating positions in Copenhagen than of real factors. For Croatia, we have taken the example of Slovakia, which means that the inflow into the budget could be 558 million kuna.

Temporary budgetary compensations relate entirely to members that would be net contributors to the budget of the EU. It would be politically unacceptable to put new members, whose GDP is much below the EU average, into the position of financing the budget of the EU. In order to avoid this kind of situation, additional resources were allocated to Cyprus, Czech Republic, Slovenia and Malta. Since we can assume that Croatia will not get into the situation of being a net contributor we shall consider this potential revenue to be zero.

Effects on expenditure of the national budget

When Croatia enters the EU, the national budget will experience a number of serious shocks. The first will be the joint financing and pre-financing of transfers from the EU budget, and the second, the bigger shock, will relate to payments into the EU budget. If one can judge from the last wave of enlargement that takes place in the countries of Eastern Europe and the Baltic, Croatia will have to pay into the budget of the EU from the moment it becomes a member.

Payments into the European Union budget

The distinguishing feature of the EU as international organisation is that it has a budget that is financed from what is called its own

revenue. This includes revenue from customs duties and sugar imports, revenue deriving from VAT and revenue from the GNI.^{xv}

Since customs duties and the revenue that on the basis of customs duties will be channelled into the EU budget were treated in the previous chapter, this chapter will concentrate on payments deriving from VAT and GNI.

Payments deriving from VAT are calculated as a certain percentage of the base of VAT (which cannot exceed 50% of GDP). Since the Croatian VAT system is almost totally harmonised with European standards, on the basis of the estimate of the base for VAT for 2007, we can estimate that Croatia will have to pay in an amount of 338 million kuna.

Payments deriving from GNI will be the biggest burden for the national budget. The total revenue of the EU budget on the basis of GNI is calculated as the difference between total EU budgetary expenditure and revenue collected on other bases. In other words, this revenue patches holes in the budget and every member state pays in its own part on the basis of the size of GNI. On the basis of the estimate of GNI (GDP) for 2007, the total amount that Croatia would have to pay comes to 1.9 billion kuna.

An additional expense to the budget will be the UK rebate. After joining the EU the UK became the biggest contributor to the budget, mostly thanks to the low level of transfers from the CAP due to its relatively small agricultural sector. For this reason, in Fontainebleau in 1984 Margaret Thatcher won the right for the UK to get refunded part of its payment into the budget in the amount of 0.66% of its net position. The loss of this revenue is made up together by the other member states, with the proviso that Germany, Holland, Austria and Sweden (the largest net contributors) bear only one quarter share. The drain into the budget of the EU on the basis of this could be 177 million kuna.

Other payments

Although payments into the budget of the EU are by far the biggest payments that the Croatian budget will have to bear, it is also necessary to mention contributions to EU institutions in which Croatia will have to participate from the very beginning of its membership. This relates to the ECB and to the EIB – European Central and Investment Banks.

Since in 2007 Croatia will not enter the EMU – it will need at least two or two and a half years more – the obligation to pay for

membership in the ECB will come to only 5% of its capital share, which amounts to 5 billion euro. The calculation is based on the share of Croatia in the total population and of the total GDP in the EU. During this calculation, data for Romania and Bulgaria have been used, since the next enlargement, in our model, includes those countries too. The total costs of membership could come to 10.5 million kuna. It has to be pointed out that this payment will be one-off, and that the cost of subscribing to the capital of the ECB will be borne by the CNB, which means that it will not have immediate effects on the budget.

Payment of membership in the EIB consists of two parts. The first relates to that part of the paid up capital that the countries have to pay in, while the other is based on the obligation to cover EIB reserves. New members subscribe only 5% of their share, in eight equal annual instalments. Since the amounts are based on GDP and population, on the basis of the Slovak case we can assume that the membership fee for the EIB should be about 75 million kuna.

Finally, on the expenditure side of the budget, costs could vault over 3 billion, or 1.2% of GDP, only as a result of payments into the EU budget and the EIB.

Table 1 Payments into the European Union budget for 2007

	In million kuna	% of GDP
EU Budget		
Customs duties	534	0.21
VAT	338	0.14
GNI	1,900	0.76
UK rebate	177	0.07
EIB	75	0.03
TOTAL	3,024	1.21

Source: Calculation of the authors

State aid

Croatia will also have to harmonise its state aid system with the current system in the EU. The obligation to harmonise began at the start of 2002, when the Interim part of the SAA came into force. According to EU definition, state aid is aid that distorts or threatens to distort com-

petition by giving advantages to certain producers or products and in this way affects international trade between the member countries. The harmonisation of state aid systems actually means a gradual abolition of discriminatory or sectoral aids and reliance on horizontal aid that favours no product or producer in particular and the gradual introduction of the principle of transparency into the system of allocating aid.

According to estimates of the Institute for Public Finance (Kensner-Škreb, Pleše and Mikić, 2003), state aid in Croatia comes to 5.25% of GDP, while in the EU it comes to only 1% of GDP. Although according to these data it can be hypothesized that the final harmonisation with the EU will bring savings to the Croatian budget to the tune of 4% of GDP, it is hard to estimate the effect in the budget for 2007 itself. The harmonisation process is long in the making and expenditure for it will be diminished gradually. According to the SAA, until the beginning of 2006 Croatia will have to draw up a comprehensive list of aid programmes and then harmonise these with European criteria, which means that a large part will have to be harmonised by 2006. It is also possible that Croatia will manage to negotiate a transition period for the lifting of state aid and so shift the effects to some later years. Since without a more detailed analysis exceeding the constraints of this paper it is not possible to arrive at more exact figures during the calculation of the effects of Croatia's joining the EU on the budget, we shall not take them into consideration.

Expenditure for adjustments related to infrastructure and the environment

In this sphere, adjustment to EU standards will constitute a considerable burden on the budget, an expenditure that will be drawn out over a considerable number of years. The best guide for an estimate of the expenditures for adjustments in the sphere of infrastructure and the environment in 2007 will be the experience of new members. But this experience does not yet exist; hence, the only thing left for us to do is to rely on existing studies and expert papers that comment on the area.

There is no real knowledge about how much the existing infrastructure in the accession countries, or in Croatia, is adequate (from the point of view of quality and quantity). In addition, this matter is rendered more complex because all the costs of the adjustment will not be financed by the government, i.e., by the budget. Instead, a certain amo-

unt of costs can be financed from private sources. This can come out particularly in two large and essential infrastructure sections – energy and transport (see World Bank, 2003). Still, there are some indications that speak in favour of candidate countries (see EBRD, 2002). In addition, there is a well-grounded idea that candidate countries as a group do not have the problem of underinvestment in the infrastructure (Backe, 2002) and that the key to adjustment does not lie in increasing capital expenditure as compared with GDP, but rather in increasing the effectiveness of existing funds (Funck, 2002). If we attempt to include Croatia into this picture, then measured by capital expenditure, Croatia is right at the top as compared with other candidate countries.^{xvi} From this point of view, it is realistic to suppose that actual entry into the EU will not exact additional expenditures on the infrastructure, but will certainly require its restructuring at the expense of more profitable investment in the infrastructure.

With respect to expenditures on the environment, there are certain calculations (World Bank, 2003) for Croatia that estimate the total necessary capital expenditure on the environment (for the sake of harmonisation). According to these calculations, the necessary capital expenditures range between 6.1 and 11.8 billion euro.^{xvii} It is important to stress that these expenditures imply total, i.e., both private and public, investments. Assuming that these costs or investments will be realised according to the dynamics and the profile of the parameters of Poland,^{xviii} then in the first year public expenditure (budget expenditure) will come to 76 million euros (in the rapid implementation of reforms scenario) or 233 million euros (in the slow implementation of reforms scenario). This study of the World Bank says that in 1999 in the Croatian budget some 35 million euro was spent on the environment (last available information). Assuming that the same amount continues to be spent, this means that in 2007 it will be necessary to increase the expenditure of the budget by at least 40 million euros (or 0.1% of the GDP of that time).^{xix}

Aggregate effects of Croatian membership in the European Union

The expected net costs of Croatia's accession to the EU might in 2007, perhaps the first year of membership, come to more than 2.5 billion kuna, or about 1% of GDP in 2007.

Table 2 Effects of European Union membership on the general government budget in 2007

	In million kuna	% of GDP
REVENUE SIDE OF THE BUDGET		
1. Transfers unrelated to projects		
1.1. Income supports		
Liquidity gap	-590	-0.24
Substitution effect	371	0.15
1.2. Market supports		
Liquidity gap	-205	-0.08
Substitution effect	205	0.08
1.3. Internal politics		
Revenues	354	0.14
2. Transfers related to projects		
2.1. Structural funds		
Revenues	779	0.31
Joint financing	-261	-0.10
2.2. Cohesion Fund		
Revenues	31	0.01
Joint financing	-5.4	-0.002
2.3. Rural development		
Substitution effect	71	0.03
Joint financing	-110	-0.04
3. Other transfers		
3.1. Pre-accession assistance	478	0.19
3.2. Special arrangements	558	0.22
3.3. Budgetary compensation	0	
TOTAL REVENUE	1,676	0.67
EXPENDITURE SIDE OF THE BUDGET		
1. Payments into the EU budget and EIB		
1.1. Payments into EU budget		
Customs	-534	-0.21
VAT	-338	-0.14
GNI	-1,900	-0.76
UK rebate	-177	-0.07
1.2. EIB	-75	-0.03
TOTAL PAYMENTS	-3,024	-1.21
2. Harmonisation expenditure		
2.1. Customs tariff harmonisation	-996	0.40
2.2. Environment	-300	-0.12
Total harmonisation expenditure	-1,296	-0.52
TOTAL EXPENDITURE	-4,320	-1.74
NET LOSS TO THE BUDGET	-2,644	-1.06

Source: Authors' calculations

BUSINESS CYCLES, FISCAL RULES AND PUBLIC DEBT

In conjunction with the effects on the revenues and expenditures of the budget, joining the EU will also lead to changes in the way in which fiscal policy is handled. The EU and the EMU are commonly seen as creations in which monetary policy is centralised or subject to hard rules, while fiscal policy is the opposite, that is, an instrument of autonomous national economic policy. However, although the EU budget is negligible as compared with the budgets of member states, fiscal policy has actually turned into an instrument of economic policy at the level of the whole Union. In practice, member countries come up against very tight constraints in the formulation of fiscal policies, so that a very high degree of coordination among them has already been attained.

Variables such as average level of inflation or the value of the euro in terms of other currencies have become a common asset in the EMU, hence every national policy that affects these variables can lead to an ECB reaction, and consequently, to changes in the environment for all the member states. Also, rules with respect to running fiscal policy have been introduced because of the dangers of a spill-over of effects of risk growth from one of the EU members as a result of irresponsible fiscal policy. Finally, although it is explicitly banned for the ECB to directly buy bonds of any of the member countries, there is always a danger that a panic reaction on the financial markets will lead to monetary instability in the whole EMU area.

Fiscal rules in the European Union

Getting the balance of the budget of general consolidated government close to equilibrium or into a small surplus is the main aim of each member country. Balancing the budget relates to its structural balance, while the cyclical component of the budget can be adjusted depending on the state of the economic cycle, which makes possible the working of automatic stabilisers.^{xx} In addition to balancing the structural budget, the largest deficit of the budget of general consolidated government is limited to 3% of GDP. In emergency situations, which are defined as a reduction of GDP by more than 2 percentage points, the resort to sanctions laid down by the SGP is automatically suspended.

The SGP imposed constraints are stated in such a way that they allow for the working of automatic stabilisers in the case of the normal cyclical fluctuations. In the definition of the restrictions, attention was paid to the potential rate of growth of the economies, fluctuations in growth and sensitivity of the budgetary balance to cyclical movements.

The potential rate of growth in member countries is about 2.5%, while in the case of a reduction of the growth rate by 1% below the potential on average there is a cyclical budgetary deficit of 0.6% of GDP. Since the average largest output gap recorded in the member countries during the period from 1960 to 1997 was 4%, which corresponded to a 1.5% reduction of GDP, appeals to extraordinary circumstances in the context of the SGP should be a rarity (European Commission, 1999). Of course, fluctuations in GDP are not the same in all the countries, and the automatic stabilisers do not react equally strongly because of differences in the structure of revenue and expenditure. For this reason those countries that are exposed to greater shocks and that have more powerful automatic stabilisers, or that wish to back them up with active counter-cyclical fiscal policy, must aim at higher budgetary surpluses.

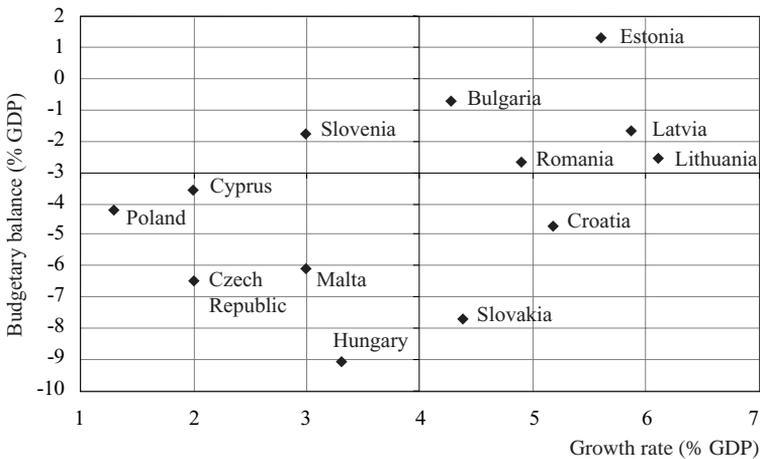
Fiscal constraints from the SGP also enable the stabilisation of the level of public debt. Thus an average budgetary deficit at the level of 3% of GDP, with an expected 5% growth rate of nominal GDP,^{xxi} is in line with the maintenance of public debt at a level of 60% of GDP. This level of public debt is also prescribed by the SGP as the highest permissible level of public debt that all members with a higher public debt should aim at. Since the SGP nevertheless prescribes the balancing of public finances, in the event of achievement of it, in the mid-term reduced levels of public indebtedness should be expected (Mathieu and Sterdyniak, 2003).

Effects of fiscal rules on future members

Immediately on joining the EU new members assume all obligations laid down by the SGP. For this reason, accession countries and candidates usually take part in a pre-accession fiscal surveillance procedure in order to prepare as well as possible for the obligations that membership will entail with regard to running macroeconomic policy, within the context of which they do not have any formal obligations except to inform the EU of their economic policy and establish communication channels. Of course, after entry into the EU, before joining the

EMU, which is actually obligatory for new members after they have met the Maastricht criteria,^{xxii} provisions regarding sanctions for not fulfilling the SGP do not apply to new members. Although they will not be exposed to financial penalties, they will be under very strong pressure to start running their fiscal policy in line with common rules.

Figure 1 Rate of GDP growth and budget balance in the accession countries, candidates and Croatia (2002)



Source: European Commission (2003), CBS and Ministry of Finance

If the degree of fiscal adjustment in Croatia is compared with that in the accession and candidate countries, it can be concluded that the situation is not all that bad.^{xxiii} Only Estonia had a budgetary surplus, and a total of half of the twelve countries met the 3% deficit limit, although in 2002 GDP did not fall in a single country. In Croatia the deficit was 0.9% worse than the average, but the growth rate was 1.4% higher than the average, which came to 3.8%, and this should also be taken into account when assessing the differences in the structural deficit. In addition, all the countries with worse indicators with respect to budgetary deficit also had lower rates of growth than Croatia. According to these indicators, we can conclude that Croatia, like most of the transition countries, is only coming up to the process of fiscal consolidation. Hence, considering the rate of growth that can be expected in the mid-term, probably a little lower than the current rate, in Croatia the

budgetary deficit should be reduced by about 6% of GDP, so as to ensure a structurally balanced budget.

We have already mentioned that the effects of the SGP on the fiscal policy of each member depend essentially on its characteristics. Future members, like Croatia, differ in several important features from the current members. Firstly, these countries are much poorer than the current members and they possess a considerable potential for real convergence. In this paper we have assumed the potential rate of real growth for Croatia to be 4%. Secondly, because of the level of prices that is about half the EU average, nominal convergence brought about by the Balassa-Samuleson effect and a growth of the level of administrative prices can be expected. This will make the differences in rates of nominal growth, which is essential for the dynamics of public debt, still greater than the difference in the rates of real growth. Also, the levels of public revenue and expenditure in the future members, including Croatia, irrespective of the lower level of development attained, are not essentially below the revenues and expenditures of the current members. This means that the automatic stabilisers should not be any weaker than in the present members. However, the future members have a relatively unfavourable structure of expenditure, with a high proportion of fixed expenditures, like pensions and healthcare expenses, which do not change depending on the state of the business cycle (Richter and Römisch, 2003). Although it would seem that because of the weaker automatic stabilisers the new members will not be confronted with the appearance of impermissible deficits, they will actually have to depend even more on an active fiscal policy in order to stabilise the economy. This has proved dangerous to date in their case because after the end of the recession the cyclical deficits gradually turned into structural deficits (Kopits and Székely, 2003). Finally, future members, including Croatia, are on the whole smaller and more open than the present members. This means that fluctuations of production will be greater in their case, as will the need for the concomitant stabilisation, which can bring about greater cyclical deficits during some periods than those common with the old members.

All these features could well have a negative effect on the efficiency of fiscal policy in Croatia and in some other transition countries within the framework of the SGP. For example, for Croatia, because of its relatively high potential rate of growth, the sanctions provided for in the SGP would be suspended only in the case of a reduced rate of growth of GDP by 6 percentage points below the potential, while for

member countries this reduction comes on the average only to 4.5 percentage points. For this reason, Croatia will have to make a stronger effort toward fiscal adjustment if it wants to retain flexibility of fiscal policy. Furthermore, automatic stabilisers constitute a special problem. In Croatia at the moment we have no understanding of the structural balance of the budget or of the working of automatic stabilisers, because of which we are unable to say whether they will suffice to stabilise the economy, or in what way the budget balance will react to a change in the rate of growth. If it is concluded that automatic stabilisers are too weak to bring the economy into balance, of which there are already indications, it would be good to think about ways of preparing an active fiscal policy to respond fast and effectively to the state of the economy, that is, how the budget deficit could be simply increased or reduced in the current year.

Also relatively unfavourable are the consequences that EU fiscal rules will have on the level of public debt of new members in the event of the strict application of the SGP. Because of the essentially higher potential rate of growth of nominal GDP, bringing the structural budget into balance will rapidly reduce their public debt. While for EU countries with a structural deficit of the budget at the level of 3% one can expect an equilibrium level of public debt at 60% of GDP, for transition countries, assuming a nominal rate of growth of 7% and an identical start level for public debt, their convergence on 43% of GDP can be expected. In addition, in the case of a structural imbalance of the budget, in the new members it is possible to expect a much more rapid reduction of the ratio of public debt and GDP. In case of the initial assumptions concerning growth and level of indebtedness, new members could halve this ratio in some ten years. This means that new members, which because of the high expected rates of growth have a greater capacity to take on debt and a larger need for infrastructure investments, will in fact be forced into a more rapid reduction of public debt.

CONCLUSIONS AND RECOMMENDATIONS

The Government has made fiscal projections up to 2007, by which time we assume that with a bit of luck Croatia might enter the EU. According to Government's projects, the deficit of the budget of general consolidated government might by that year be reduced to 2% of GDP.^{xxiv} However, the actual fact that Croatia will have greater net

transfers from the EU budget than payments into the budget does not necessarily mean that joining will not entail additional costs for the Croatian budget. Our estimates say that in 2007 we might expect negative fiscal effects of accession in a total amount of about 1% of the anticipated BDP. Of course, the reserve of potential savings through the reduction of state aid should also be kept in mind, which might be considerable, although its dynamics would be hard to predict in that year.

Additional difficulties derive from the framework of the SGP for running fiscal policy. The possibility of running an anti-cyclical fiscal policy in line with these rules will not be retained with a structural deficit of the budget of 2% of GDP, as the Government's projections look for, or even 3% of GDP, if we count on the potential fiscal effects of joining. In connection with this, certain recommendations as to how to prepare fiscal policy for the challenges of EU membership might be drawn from the paper:

- As soon as possible it is necessary to realistically assess the structural balance of the budget, and also the effect of the automatic stabilisers on the budgetary balance.
- If the automatic stabilisers are judged to be inadequate to stabilise the economy, which is likely because of the structure of budgetary revenues and expenditure, it will be necessary to develop a fiscal activism policy capable of rapidly and flexibly increasing and decreasing the budgetary deficit in line with the movements of the business cycle.
- According to an assessment of the structural balance of the budget and the strength of the automatic stabilisers, or the expected degree of fiscal activism, it is necessary to draw up a projection of fiscal adjustment to facilitate the running of an anti-cyclical fiscal policy that does not involve infringements of the SGP. Because of a rate of potential growth higher than that of current members, Croatia would very likely have to create a structural surplus so that the automatic stabilisers could act without exposing Croatia to possible sanctions in the case of a deeper recession.

It is important to realise that all these recommendations lend force to the already routine steps that the European Commission takes when estimating the harmonisation of each country with the SGP. In addition, they are a necessary part of the consideration of each of the candidates of the EU as it prepares to join the EU. On its way to membership in the EU Croatia will certainly meet the necessity of carrying

out all these steps. However, we think that these steps should be taken as soon as possible because of the long period in which fiscal adjustment is usually made, and the shortness of the time span in which Croatia plans to become an EU member. Finally, we are of the opinion that current plans for fiscal adjustment do not lead to a completely efficient policy within the context of the EU.

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- i* There is an intermediate key according to which a certain percentage of revenue from VAT is paid into the EU budget.
 - ii* Inflation of 3% is not essentially greater than the indirectly targeted inflation of the EU, and yet also allows space for adjustment of relative prices in the remaining protected sectors, and the working of the Balassa-Samuelson effect (which comes out particularly in the transition countries with an intensive growth of productivity). We recall that the Balassa-Samuelson effect arises when growth of productivity within a sector of internationally marketable goods rises faster than the rate of production within the sector of international non-marketable goods, which in turn assuming mobility of labour brings about a wage cost rise, and then of prices in the internationally non-marketable goods sector.
 - iii* This is a negligibly greater value than the average value if the 2000-2002 period is taken into consideration. Actually, for a considerable number of years, the value of imports has come to between 50 and 60% of GDP.
 - iv* The value of the proportion of imports in GDP from countries with which Croatia has made free trade agreements has remained unchanged (about 80%) irrespective of the making of these treaties. For this reason, it can be assumed that these shares will not change in the new future either, i.e., there will not be any significant effect of changes in trading.
 - v* There are good reasons for expecting a reduction of the rate in the next four years (the EU is negotiating with several countries about free trade) but since we can only guess how much this might come to in the end, it seems most appropriate to work with the current rate, 2.6%.
 - vi* The loss might be even greater, depending on the deepening of the difference between the average customs rate in the EU and here (see note 5 above).
 - vii* Interesting here is Kischel's (2003) finding, which recalls that the harmonisation of excises on mineral oils, tobacco and alcohol in the EU started as long ago as 1972, and is still not complete.
 - viii* Here it is perhaps more correct to speak of the amount of individual excises rather than of structure, because different countries can have different excises; yet what is essential is that the amount of the excises for agreed-on kinds (mineral oils and fuels, tobacco and alcohol) is harmonised among the member countries.
 - ix* European Parliament Fact Sheets, ch. 3.4.7 The Taxation of Energy.
 - x* It is expected that the administration of the EU funds will be done by the newly-founded Fund for Regional Development (at the current time this has only 7 employees) and the Fund for the Development of Employment (4 staff members) and specialised agencies whose organisation is earmarked for the future.
 - xi* This principle has been the subject of great debates since it directly disrupts competition in the farm sector. The reasons for the introduction of such a discriminatory regime for new member states lies in the great expense of farm policy (the budget would be faced with great expenditures if new member states that have a much

- greater farm sector were to be paid the same support as old members without reform of their agricultural policy), and in claims that new members are incapable of making use of greater transfers.
- xii Income support is paid from the national budget in October, while resources from the EU budget arrive only in January.
- xiii If we assume that Croatia will not make use of the possibility of cofinancing income support in the first years of membership.
- xiv Estimate of absorption power made on the basis of data for existing member states (Mayhew, 2003).
- xv GNI includes all the income of residents, irrespective of whether it is made inside the country or abroad. Since Croatian GNI from 1997 to 2002 on average differs from GDP only by 0.2%, we can use the already calculated projection of GDP for 2007 for the same period.
- xvi In 2002 6.3% of GDP was earmarked from the budget for capital expenditures. This is well above the value for other countries (candidates), which earmark from 2.3 to 5%. Here, however, it would be important to point out that any relevant analysis should take into account a longer number of years, and in our case exclude capital expenditure for reconstruction, which is a distinctive feature of the Croatian case.
- xvii The span of the estimate is broad, because of the uncertainty with respect to unit costs and of the uncertainty of the effectiveness of investment strategies.
- xviii About 40% of total expenditure will be done in the first 6 years, and of this 30% will be financed by the government, 60% by the private sector and 10% by external resources.
- xix Total expenditure (private and public) will have to be increased by at least 200 million euro (about 0.6% of GDP).
- xx The work of automatic stabilisers implies the automatic increase or reduction of revenue and expenditure of the budget depending on the phase of the economic cycle (and not on changes in tax regulations and/or discretionary changes in expenditure).
- xxi Expected rate of growth of nominal GDP is more or less the same as the sum of the potential rate of real growth and the rate of inflation. The ECB has adopted a rate, as unofficial rate of inflation, that is lower than 2%, but it is close to this level, so that the rate of nominal growth in the EU will probably be a little lower than 5%, though not much.
- xxii Like Denmark and the UK, which have the right of derogation, so far Sweden has not introduced the euro, which does not have this right, because it joined in the last round of enlargement, but so far it has avoided the introduction of the euro by refusing to join in the ERM-2 exchange mechanism. This means that those transition countries that really want to, will probably be able to put off joining in the EMU, as well as the implementation of the SGP in its entirety.
- xxiii Turkey is excepted from the comparison because of the recent financial crisis and the uncertain future vis-à-vis European integration.
- xxiv Session of the Government of the Republic of Croatia, September 1, 2003.

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Annex 1 Net budgetary position after N-10 enlargement

1999 prices, million euros EU accession May 1, 2004 Copenhagen	deflator: own sources + other expenditure deflator: farm and other funds:										2003		2004		
	Cyprus	Czech	Estonia	Hungary	Poland	Slovenia	Lithuania	Latvia	Slovakia	Malta	Total	1.0866	1.0824	1.1073	1.10408
2003															
Pre-accession assistance	16	170	55	197	844	45	115	84	123	11					1,661
2004															
Pre-accession assistance	11	181	67	235	970	51	127	99	120	7					1,869
Agricultural	12	100	29	125	426	43	73	42	57	3					911
Structural assistance	6	169	39	209	859	27	94	66	118	7					1,594
Internal politics	5	44	5	42	154	12	11	10	19	2					305
Additional expenditure	0	7	25	58	131	38	84	28	21	0					392
Special cash-flow arrangement	28	175	16	155	443	65	35	19	63	12					1,011
Temporary budgetary compensation	69	125	0	0	0	30	0	0	0	38					262
Total allocated expenditure	131	801	181	824	2,983	267	423	264	398	70					6,343
Traditional own revenue	-27	-66	-8	-97	-123	-18	-22	-7	-33	-14					-415
Revenue from VAT	-10	-74	-6	-61	-194	-22	-14	-8	-26	-4					-420
Revenue from GNI	-60	-426	-37	-349	-1,114	-129	-78	-48	-148	-23					-2,412
UK rebate	-8	-56	-5	-46	-148	-17	-10	-6	-20	-3					-320
Total own revenue	-105	-623	-56	-554	-1,579	-187	-124	-70	-225	-43					-3,566
Net position	27	178	125	270	1,404	80	299	195	173	26					2,777
2005															
Pre-accession assistance	6	153	57	199	823	43	110	86	102	2					1,581
Agriculture	37	392	82	544	1,512	125	228	116	205	8					3,248
Structural assistance	14	355	88	438	1,776	59	203	151	244	13					3,343
Internal politics	9	76	9	72	266	21	18	17	33	4					524
Additional expenditure	1	9	26	61	141	38	109	29	52	0					466

Special cash-flow arrangement	5	92	3	28	550	18	6	3	11	27	744
Temporary budgetary compensation	119	178	0	0	0	66	0	0	0	66	429
Total allocated expenditure	191	1,255	266	1,342	5,068	370	674	402	647	119	10,334
Traditional own revenue	-40	-105	-12	-150	-213	-29	-33	-11	-54	-21	-667
Own revenue from VAT	-16	-116	-10	-95	-304	-35	-21	-13	-40	-6	-657
Revenue from GNI	-91	-653	-57	-535	-1,707	-198	-120	-74	-226	-35	-3,697
UK rebate	-12	-88	-8	-72	-230	-27	-16	-10	-30	-5	-497
Total own revenue	-160	-963	-86	-853	-2,454	-288	-191	-107	-350	-66	-5,518
Net position	31	293	179	490	2,614	82	483	295	297	53	4,816
2006											
Pre-accession assistance	1	98	35	124	509	27	66	52	64	0	976
Agriculture	46	483	102	653	1,934	158	294	156	260	10	4,095
Structural assistance	18	427	110	524	2,107	73	248	189	289	15	3,998
Internal politics	12	102	12	97	359	28	25	22	45	5	708
Additional expenditure	1	9	26	61	140	38	127	28	52	0	481
Special cash-flow arrangement	5	92	3	28	450	18	6	3	11	27	644
Temporary budgetary compensation	112	85	0	0	0	36	0	0	0	63	296
Total allocated expenditure	194	1,294	288	1,487	5,498	378	766	451	720	121	11,198
Traditional own revenues	-40	-105	-12	-150	-213	-29	-33	-11	-54	-21	-667
Revenue from VAT	-17	-119	-10	-97	-310	-36	-22	-13	-41	-6	-671
Revenue from GNI	-94	-670	-58	-549	-1,752	-203	-123	-76	-232	-36	-3,793
UK rebate	-13	-93	-8	-77	-244	-28	-17	-11	-32	-5	-529
Total own revenue	-163	-988	-89	-873	-2,519	-296	-196	-110	-359	-68	-5,660
Net position	31	307	200	614	2,979	82	570	341	361	53	5,538

NB: In the event of political agreement on Cyprus an additional 127 million euro if expenditure will have to be anticipated for the 2004-2006 period