Structural reforms and challenges in the (new) EU member states

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The in-depth country reviews completed in 2017 under the Macroeconomic Imbalance Procedure (MIP), which aims to identify, prevent and address the emergence of potentially harmful macroeconomic imbalances in the EU, found that six EU member states were experiencing imbalances and six were experiencing excessive imbalances.[1] The list of vulnerable countries, nor the latest MIP scoreboard, designed to capture the most relevant internal and external sources of macroeconomic imbalances, show a clear difference between the euro area and non-euro area member states in terms of the identified vulnerabilities or imbalances. At the same time, we can find a certain pattern distinguishing old and new EU countries. The former ones having difficulties meeting thresholds for indicators of internal imbalances (mainly indebtedness) and the latter ones having more difficulties meeting thresholds for indicators of external imbalances (mainly net international investment position). The identified variation in imbalances reflects historical differences, but also uneven approach to structural reforms. Therefore, this article tries to shed more light on the most important structural changes observed in the EU countries within a longer time period. It mainly focuses on the developments in the new EU member states (NMS) and takes into account broader set of indicators assessing also quality of institutions, education or health care.

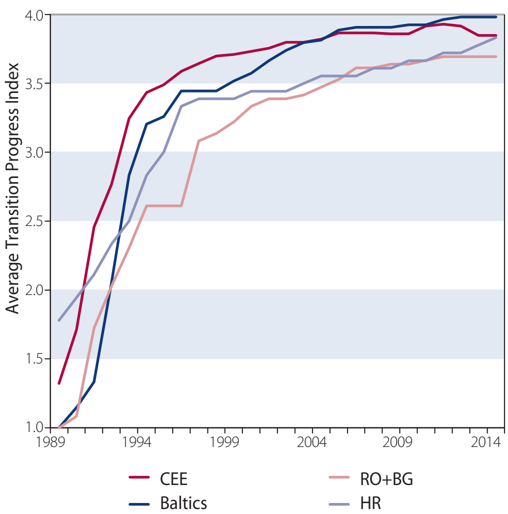
1 *Germany, Ireland, the Netherlands, Slovenia, Spain and Sweden were experiencing imbalances. Bulgaria, Croatia, Cyprus, France, Italy and Portugal were experiencing excessive imbalances. Greece, which is under the stability support programme, was not examined.*

THE SPECIFICITY OF THE NMS

Although, sharing many common values and policies, the European Union consists of countries distinct from one another in terms of political or economic histories. Some of the EU countries represent long-term market economies, but some of them have switched from centrally planned economies relatively recently. The transition period of the new EU member states (NMS) required implementation of many reforms leading to radical changes with economic, democratic and social dimensions.

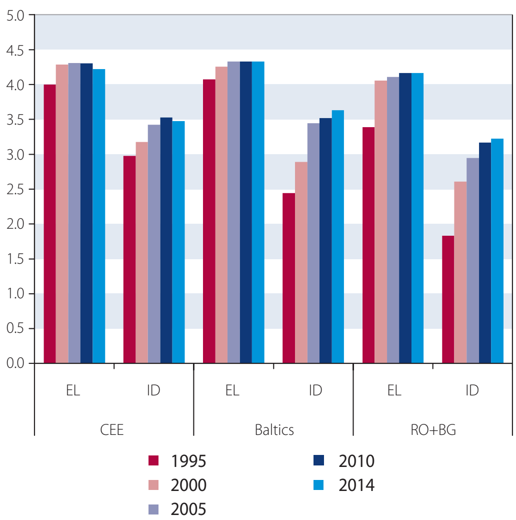
Based on Havrylyshyn et al. (2016) experience of the ex-communist countries indicates that fast and extensive reforms lead to higher growth. They show that early and rapid reformers by far outperformed gradual reformers. Although, in general, institutional development lagged considerably behind economic reforms, rapid reformers ended up with better institutions. And most countries that moved ahead early are still the farthest

Figure 1 Reform progress towards market economy



Source: Own calculation, EBRD.
Note: Following Havrylyshyn et al. (2016), Average Transition Progress Index denotes average value of overall transition indicators (large scale privatisation, small scale privatisation, governance and enterprise restructuring, price liberalisation, trade and foreign exchange system, competition policy).

Figure 2 Economic liberalisation vs. institutional development



Source: Own calculation, EBRD.
Note: Following Havrylyshyn et al. (2016), Economic Liberalisation (EL) denotes average of small scale privatisation, price liberalisation and trade and foreign exchange system. Institutional Development (ID) denotes large scale privatisation, governance and enterprise restructuring and competition policy.

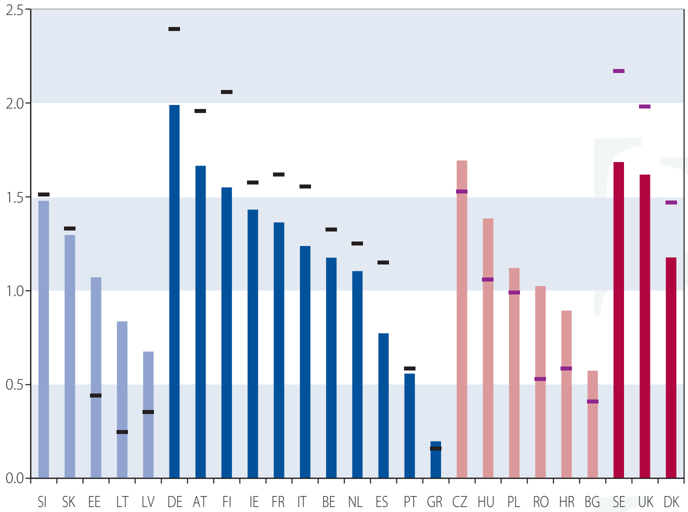
ahead. As shown in Figure 1, Central and Eastern European countries (CEE) led the reforming process, shortly followed by Baltics and later followed by Romania and Bulgaria. Figure 2 indicates that in spite of the clear improvement over the last two decades, the gap between economic conditions and institutional development in NMS remains.

Radical political and economic reforms followed by integration ambitions shaped the current state of the new EU member states more than the successful euro adoption (completed by part of the country group). In this vein, a simple distinction between euro and non-euro area countries is not sufficient. The analysis of structural reforms and related challenges therefore cannot omit significant differences between the new and old (former) EU member states.[2]

Strong economic growth fuelled by EU accession and the benefits of the Single market and EU pre-accession and structural funds resulted in a rapid economic convergence of the new member states to the old member states. The average new member states' GDP per capita in PPS increased from 39% EU-15 in 2000 to 54% EU-15 in 2008. However, the post crisis development is significantly less optimistic, especially in the context of convergence towards the most advanced EU countries.[3] Most of the NMS failed to return to the pre-crisis growth path.

The longer-term evolution of the EU member states indicates that the economic and political changes in the NMS translated into a significant increase in relative competitiveness. As illustrated in Figure 3, NMS have on average gained competitiveness, while old EU member states (notwithstanding the single currency) lost part of their competitiveness in the last 15 years. As a result, two non-euro area and two euro area NMS record

Figure 3 Competitiveness of the EU member states (Economic Complexity Index)



Source: The Atlas of Economic Complexity.
Note: Columns represent value in 2016, points represent values in 2000. New EU member states in lighter colour and old member states in darker colours. Data on Cyprus, Luxemburg and Malta are not available.

higher competiveness levels than the majority of old member states.

The new member states' achievements in terms of income and competitiveness convergence to a large extent reflected significant improvements in the quality of business environments in the NMS. As indicated in Table 1 changes implemented in the NMS in the EU pre-accession period were so intense that in several cases the reforming NMS were recognised as "top reformers" by the World Bank. They most frequently eased starting busi-

2 To account for these differences, in this chapter we consider four relatively homogenous groups of EU countries: new euro area, new non-euro area, old euro area and old non-euro area member states.

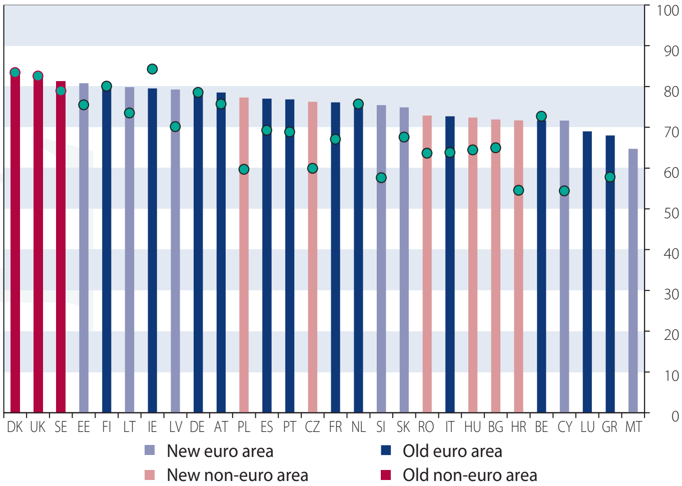
3 In the next seven years relative GDP per capita in PPS in NMS increased by only 8 p.p. to 62% EU-15 and the ratio between GDP per capita in PPS in NMS and GDP per capita in PPS in Germany remained almost constant (with increase from 52% in 2009 to 54% in 2015).

Table 1 "Top reformers" among NMS based on Doing Business

Year	Country	Starting a business	Dealing with construction permits	Getting electricity	Registering property	Getting credit	Protecting minority investors	Paying taxes	Trading across borders	Enforcing contracts	Resolving insolvency	Hiring and firing*	Closing a business	Dealing with licenses
2003	Slovakia	x				x				x		x		
	Lithuania	x								x			x	
	Poland	x										x	x	
2004	Slovakia	x			x	x						x		
	Romania	x				x		x		x				
	Latvia	x			x			x		x				
2005/06	Romania					x	x		x			x	x	x
	Croatia	x			x					x				
2006/07	Croatia	x			x	x							x	
	Bulgaria							x		x				x
2009/10	Hungary		x		x			x					x	
2010/11	Latvia	x		x	x						x			
2011/12	Poland				x			x		x	x			
2014/15	Cyprus			x		x		x		x	x			

Source: Doing business Reports 2005-2017.
*Note: *Including Employing workers, the last three categories ceased to be reported.*

Figure 4 Doing Business ranking in the euro area and non-euro area in 2008 and 2017 (in DTF)



Source: World Bank.
Note: Dark red colour represents old non-euro area countries, bright red new non-euro area countries, dark blue represents old euro area countries, bright blue new euro area countries. Dots represent values from Doing Business 2008 and bars represent values from Doing Business 2018.

ness procedures or improved processes related to enforcing contracts. The table also shows that the pace of reforms slowed down and no EU country was recognised as a top reformer in 2007 or 2008. Some of the countries improved their business environment in the following years in the response to the worsened economic developments during the Great Recession and the Euro Area Debt crisis.

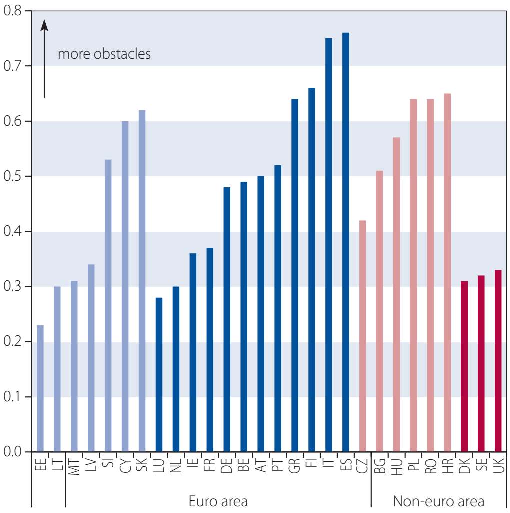
The longer-term evolution of the Doing Business ranking shows (both beta and sigma) convergence in terms of business environment quality within the EU and confirms that several pre-crisis top reformers lagged behind during the crisis and countries facing deeper structural weaknesses, as exposed by the Great Recession and the Euro Area Debt crisis, were forced to reform more.[4] However, based on the Doing Business in 2018 the EU still records large cross country differences. In particularly, all three old non-euro area countries (DK, UK, SE) stand out. But as indicated in Figure 4, new euro area countries like Estonia or Lithuania (together with Finland) now lead the euro area group and may also serve as examples of good practices.[5]

Table 2 World Bank Governance Indicators (2016)

		Voice and Accountability	Political Stability No Violence	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption	Total
Euro area	Estonia	85.22	66.19	83.17	92.79	86.54	87.02	83.49
	Malta	85.71	87.62	75.96	84.62	84.13	79.33	82.90
	Lithuania	75.86	69.05	85.58	87.98	81.25	70.19	78.32
	Cyprus	79.80	61.43	81.25	80.77	81.73	80.29	77.54
	Slovenia	74.38	77.62	77.40	72.60	80.29	76.44	76.46
	Latvia	72.91	60.00	84.13	81.73	75.96	68.27	73.83
	Slovak Republic	75.37	80.00	75.00	75.48	69.71	62.02	72.93
	Finland	97.04	87.14	96.63	98.08	100.0	99.52	96.40
	Luxembourg	96.55	97.62	93.27	93.75	96.15	96.63	95.66
	Netherlands	98.03	78.57	97.12	96.15	97.12	94.71	93.62
	Austria	94.58	90.48	90.38	91.35	95.67	90.38	92.14
	Ireland	92.61	78.10	91.35	97.60	93.27	91.83	90.79
	Germany	95.57	70.00	94.23	93.27	92.79	93.27	89.85
	Belgium	94.09	65.24	88.94	87.50	88.94	90.87	85.93
	France	86.21	56.67	89.42	83.65	88.46	87.98	82.07
	Portugal	83.74	75.24	86.06	79.33	83.65	79.81	81.30
	Spain	78.82	57.14	85.10	75.00	78.37	69.23	73.94
	Italy	77.34	58.10	69.23	73.56	64.42	57.21	66.64
	Greece	68.47	36.67	63.94	65.87	63.94	53.85	58.79
Non-euro area	Czech Republic	78.33	80.95	81.73	81.25	82.69	67.31	78.71
	Poland	80.30	75.71	74.52	80.29	76.44	70.67	76.32
	Hungary	66.01	70.48	71.15	74.04	66.83	61.06	68.26
	Croatia	64.53	63.33	71.63	64.90	62.50	63.46	65.06
	Romania	61.58	54.76	51.92	72.12	61.06	57.69	59.85
	Bulgaria	61.08	49.52	62.02	71.15	52.88	48.56	57.54
	Sweden	99.51	81.43	96.15	97.12	99.52	98.56	95.38
	Denmark	97.54	76.19	97.60	94.71	99.04	98.08	93.86
	United Kingdom	92.12	62.38	93.75	98.56	93.75	94.23	89.13

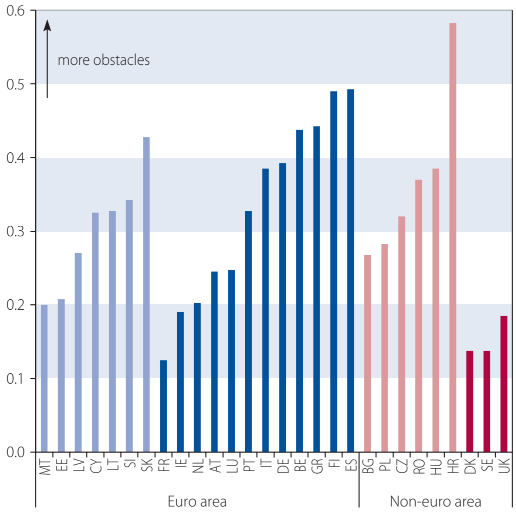
Source: World Bank.
Note: The presented values represent percentile ranks among all countries. Dark red cells represent the worst (lowest) rank and dark green cells represent the best (highest) rank. Total represents simple average of the six components.

Figure 5 Quality of the public administration (% of firms observing obstacles)



Source: EC.
Note: Flash Eurobarometer 417, Questions 1.2, share of respondents dissatisfied with getting reliable information from public authorities.

Figure 6 Quality of the tax administration (% of firms observing obstacles)



Source: EC.
Note: Flash Eurobarometer 417, Questions 8.1, 8.2, 8.3 and 8.4, average share of respondents finding filing and paying taxes (corporate tax, VAT, property tax and social security contributions) difficult.

4 For example, Croatia or Slovenia reduced their gaps to frontier by more than 18 points between 2008 and 2017. For more details on the developments in the quality of the business environment in NMS see NBS (2016) or NBS (2017).

5 For example, enforcing contracts takes slightly more than a year in Estonia or Denmark and it takes more than four years in Greece.

6 See Lopez-Garcia et al. (2015) for more details.

Institutional challenges

As briefly indicated by the evolution of the EBRD indicators in NMS (Figure 2), institutional reforms lost their track and the former transition EU countries still largely lag behind former EU countries. Table 2 confirms a clear divide between the most advanced EU countries and NMS with the EU periphery in terms of institutional quality. A certain difference can be also spotted between (on average) slightly more advanced euro area NMS and non-euro area NMS.

At the same time, relatively homogenous results across the individual governance indicators except the indicators of political stability (presented in Table 2) give a certain warning sign for reform implementation. Relatively widespread low political stability may represent a decisive barrier for deep structural reforms in the EU.

In addition, as suggested by the results of the Commission's survey (EC 2015a), room for improvement in the area of institutions persists across the entire EU and is not limited only to the new member states or the EU periphery. Even countries like Germany, Belgium or France lag behind in some of the important business environment issues.

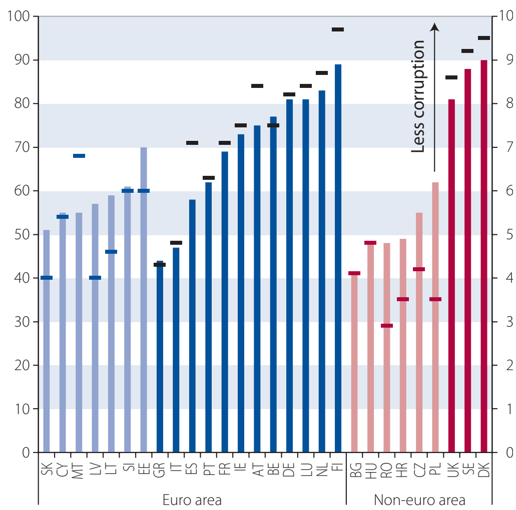
Figure 7 plots Transparency International's Corruption Perception Index in 2004 and 2016. Although, the scores are not fully comparable across time, from the ranking of the individual countries we can recognize a significant improvement in most of the CEE and Baltic countries since their EU entry. As a result, most of the new member states outperformed EU periphery countries. However, with exception of the periphery the gap between new and old member states is still clearly visible.

Corruption and clientelism continue to suppress economic progress in the NMS. Gamberoni et al. (2016) confirm negative impact of corruption on the efficiency of within sector production factor allocation and total factor productivity in the CEE NMS applying a new micro-based database information.[6]

Deeper structural threats and opportunities

The improvement of the institutional competitiveness and quality of public services in NMS is not important only to attract investors and support business activities, but it may also reduce incentives for emigration and brain drain, the challenges valid for most of the NMS. As indicated

Figure 7 Corruption Perception Index in 2004 (points, rhs) and 2016 (columns, lhs)



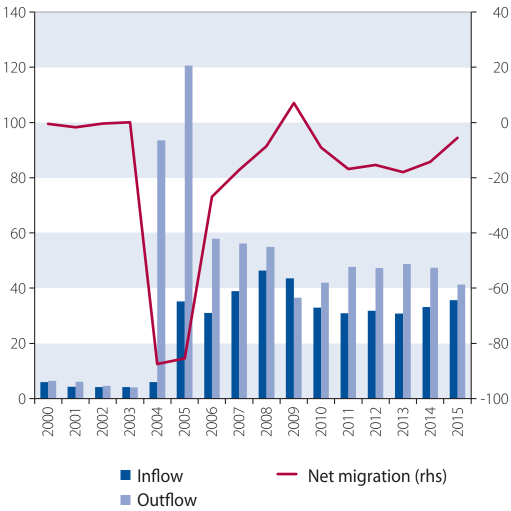
Source: Transparency International.
Note: Columns represent values in 2016, points represent values in 2004. New EU member states in lighter colours and old member states in darker colours.

in Figures 8 and 9 describing Slovak experience, the EU enlargement created opportunity for young people from NMS to seek higher quality of life abroad. Halus et al. (2017) also show that it is mostly young and educated people, who leave the country. Although, the overall outflow is not entirely permanent, and many people return, the migration balance remains negative.

The persisting negative migration balance increases the demographic risks related to ageing, that puts increasing pressure on labour markets and pension systems of the NMS. Pensions, representing the largest single individual government expenditure in the developed world, became naturally one of the major reform interests in NMS during their transition. And almost all NMS have introduced some kind of a multi-pillar pension system (with dominant public pillar). According to Carone et al. (2016), not only NMS, but almost all EU member states have undertaken some pension reforms in the last decades, primarily in response to the changing demography. However, in majority of NMS the multi-pillar systems were significantly supressed or even abolished during the crisis due to short-term fiscal gains.

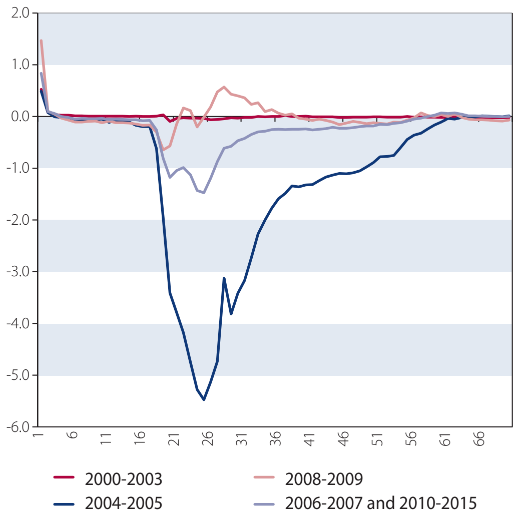
According to the latest Ageing report (EC 2015b), the ratio between the inactive elderly (65+) and total employment of 20-64 years persons (effective economic old age dependency ratio) is projected to rise significantly from 41.5% in 2013 to 66.5% in 2060 in the EU. The NMS recording lower average dependency ratio will experience the largest

Figure 8 Migration balance in Slovakia (thousands of persons)



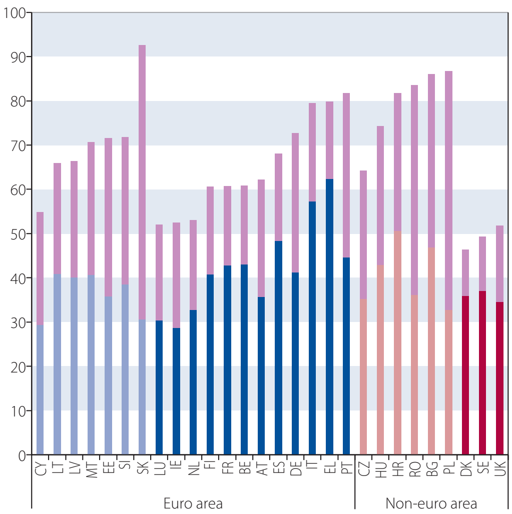
Source: Halus et al. (2017).
Note: Time on the horizontal axis. Migration flows on the left vertical axis. Net migration balance on the right vertical axis.

Figure 9 Age profile of the migration balance in Slovakia (thousands of persons)



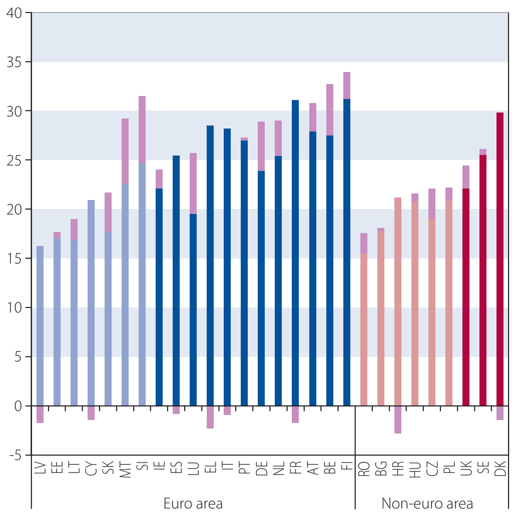
Source: Halus et al. (2017).
Note: Age cohort on the horizontal axis. Migration balance on the vertical axis.

Figure 10 Changes in economic old age dependency ratio, 2013-2060 (in %)



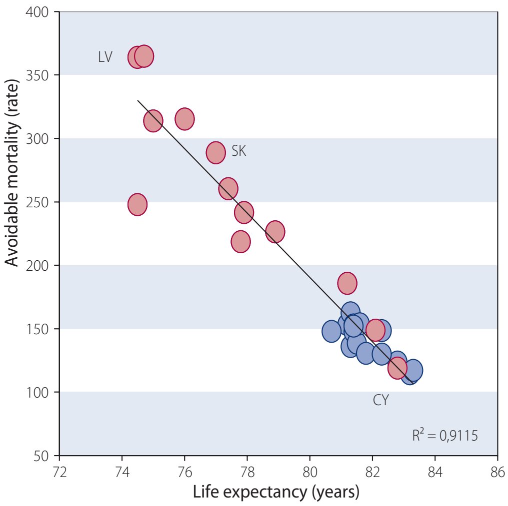
Source: EC (2015b).

Figure 11 Changes in total age related expenditures, 2013-2060 (in % GDP)



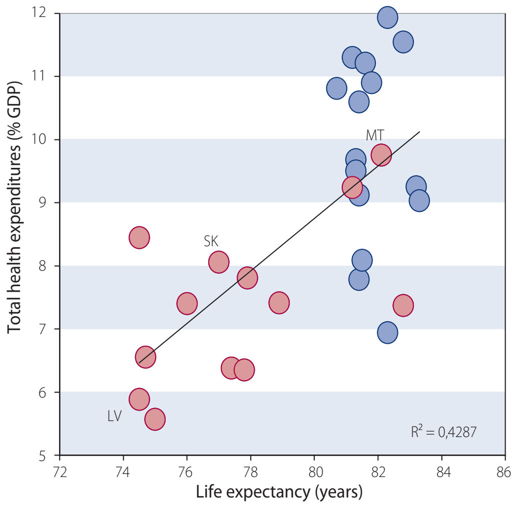
Source: EC (2015b).

Figure 12 Avoidable mortality vs. life expectancy



Source: Own calculation, Eurostat.
Note: Avoidable mortality equals average of amenable and preventable mortality. Red dots represent EU NMS and blue dots represent the remaining EU countries.

Figure 13 Health expenditures vs. life expectancy



Source: World Bank, Eurostat.
Note: Red dots represent EU NMS and blue dots represent the remaining EU countries.

changes. The EU public pension expenditures expressed as a share of GDP are expected to increase in the medium-term and return to the current level in the long-run. The changes will reflect primarily the diversity in the individual systems and implemented reforms.[7] However, total age related spending in the EU will increase by 1.6 percentage points.[8] The increase will be mostly driven by health care and long-term care spending. The old euro area countries will continue to bear the highest costs, but new euro area member states will face the highest increases.

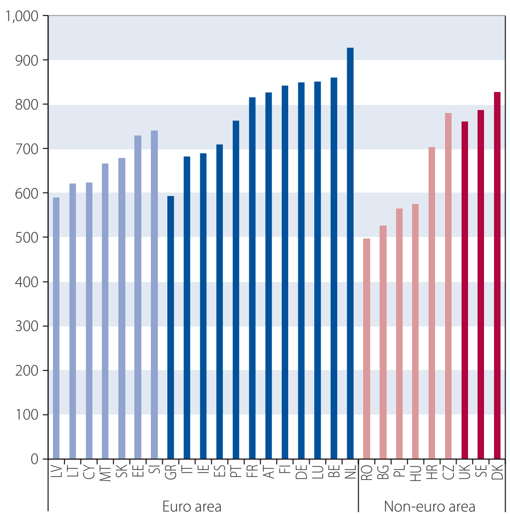
The current state of the EU countries health care system outcomes can be illustrated by the life expectancy and avoidable mortality. Citizens of the old EU economies benefit from low avoidable mortality and live longer than the citizen in most of the new EU member states (with the exemption of Malta, Cyprus and Slovenia). As indicated in Figure 13, health results are correlated with allocated expenditures. However, the EU countries differ also in terms of the cost efficiency, with several old but also few new member states recording inefficiencies (worse than the EU average cost/benefit ratio). To a large extend the current state of the healthcare systems in the NMS reflects partial or incomplete reforms.

The recent annual EU healthcare review (HCP 2017) based on a number of detailed indicators states that the European healthcare is steadily improving, but too many countries stick to inefficient ways to fund and deliver health care services and significant gaps between countries persist.[9] In Figure 14, we can see relatively clear differences between old and new EU countries (with few exemptions, Czech Republic on the positive side and EU periphery on the negative side). The review concludes that copying the most successful health systems would save lives and money.

Similarly to the Ease of Doing Business review, many good practices exist, they only need to be implemented.

Another area with less satisfactory results and more subdued funding in NMS is education. Although, the new euro area member states (on average) outperform the former euro area countries in terms of tertiary education attainment, the relative quality of education in the new euro area countries is not so excellent (with the exception of Estonia and Slovenia), based on the latest PISA results. And as indicated in Figure 16, higher financial support of education tends to bring better results. At the same time the experience of Cyprus

Figure 14 Euro Health Consumer Index – total scores (2016)



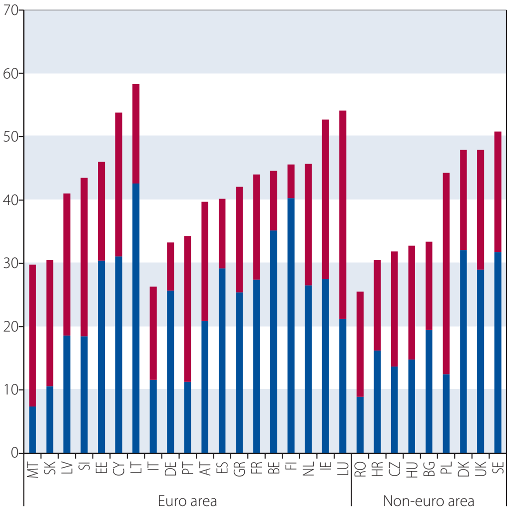
Source: EHCI 2016.
Note: New EU member states in bright colour and old member states in dark colour.

7 *Majority of the EU countries will record at least some decrease in the long-run. But few old EU members (LU, BE, DE) and new EU members (SI, MT, SK) will face significant increases (exceeding 2 p.p.).*

8 *Unemployment benefits will reduce the increase in strictly age related spending projected to 2 p. p.*

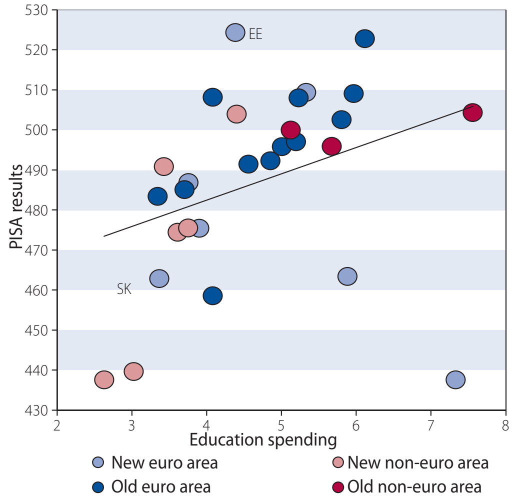
9 *The Euro Health Consumer Index (EHCI) published by the Health Consumer Powerhouse (HCP) analyses national healthcare using 48 indicators in 6 key areas (Patient Rights and Information, Access to Care, Treatment Outcomes, Range and Reach of Services, Prevention and use of Pharmaceuticals).*

Figure 15 Tertiary education attainment in 2000 and 2016 (in % population)



Source: Eurostat.
Note: Tertiary education (levels 5-8), population from 30 to 34 years.

Figure 16 PISA results vs. public education expenditures (mean score, % GDP)



Source: OECD, EC (2015b).
Note: Average PISA 2015 score for Science, Reading and Mathematics, Total education spending in 2013.

(or Malta) show that financial stimulus is not always a sufficient condition for better education.

In the environment with constantly changing technologies, the long- term growth sustainability will increasingly rely on the R&D and innovation potential. These areas mostly beyond the direct influence of national public authorities, represent again bigger challenges for the NMS than the former EU member states (notwithstanding the euro). Although, the gross domestic expenditure on R&D as a percentage of GDP is below the target for 2020 in all EU member states except Sweden, Denmark and Austria, in Figure 17 we can see a clear gap between the NMS and former EU countries.

Conclusion

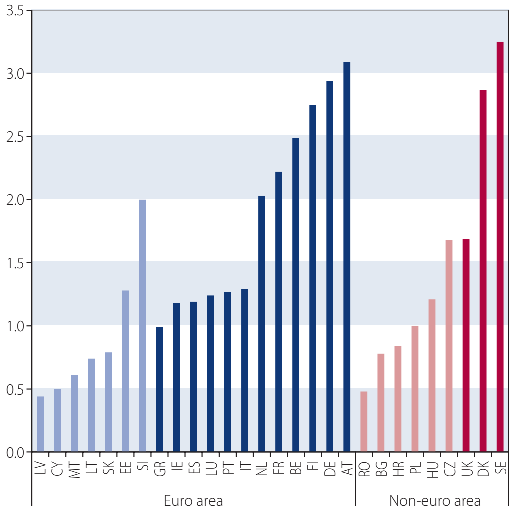
As indicated by the results of the standard Macroeconomic Imbalance Procedure and further confirmed by several cross country comparisons, despite significant convergence recorded in the last two decades, we can still see larger differences between old and new EU member states, than between the euro and non-euro area countries in terms of structural challenges.

The new member states, that experienced complex transition to the market economies, represent an important historical example of fast and radical reforms with limited impact on household income inequalities and positive impact on external competitiveness. However, the pace of reforms in these countries has dramatically decreased after their successful EU accessions. Substantial progress on country specific recommendations was recently recognised by the European Commission only in case of three partial issues in two countries. New member states recorded mostly some or limited progress.

The list of uncompleted structural reforms in the policy areas of national competence includes mainly a wide range of institutional competitiveness issues like regulatory quality, rule of law or control of corruption, challenges directly applicable also to the euro area periphery. More importantly, majority of the NMS significantly lags behind in the financially demanding areas affecting long-term growth potential like healthcare, education or R&D.

At the same time, we observe large cross country differences in the structural reforms and challenges in the EU and individual new member states (such as Estonia) represent important examples of good practices (comparable with the old non-euro area countries) for the euro area countries, not only in terms of business environment, but also education outcomes or other structural policies.

Figure 17 Gross domestic expenditure on R&D (% GDP, 2016)



Source: Eurostat.

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