

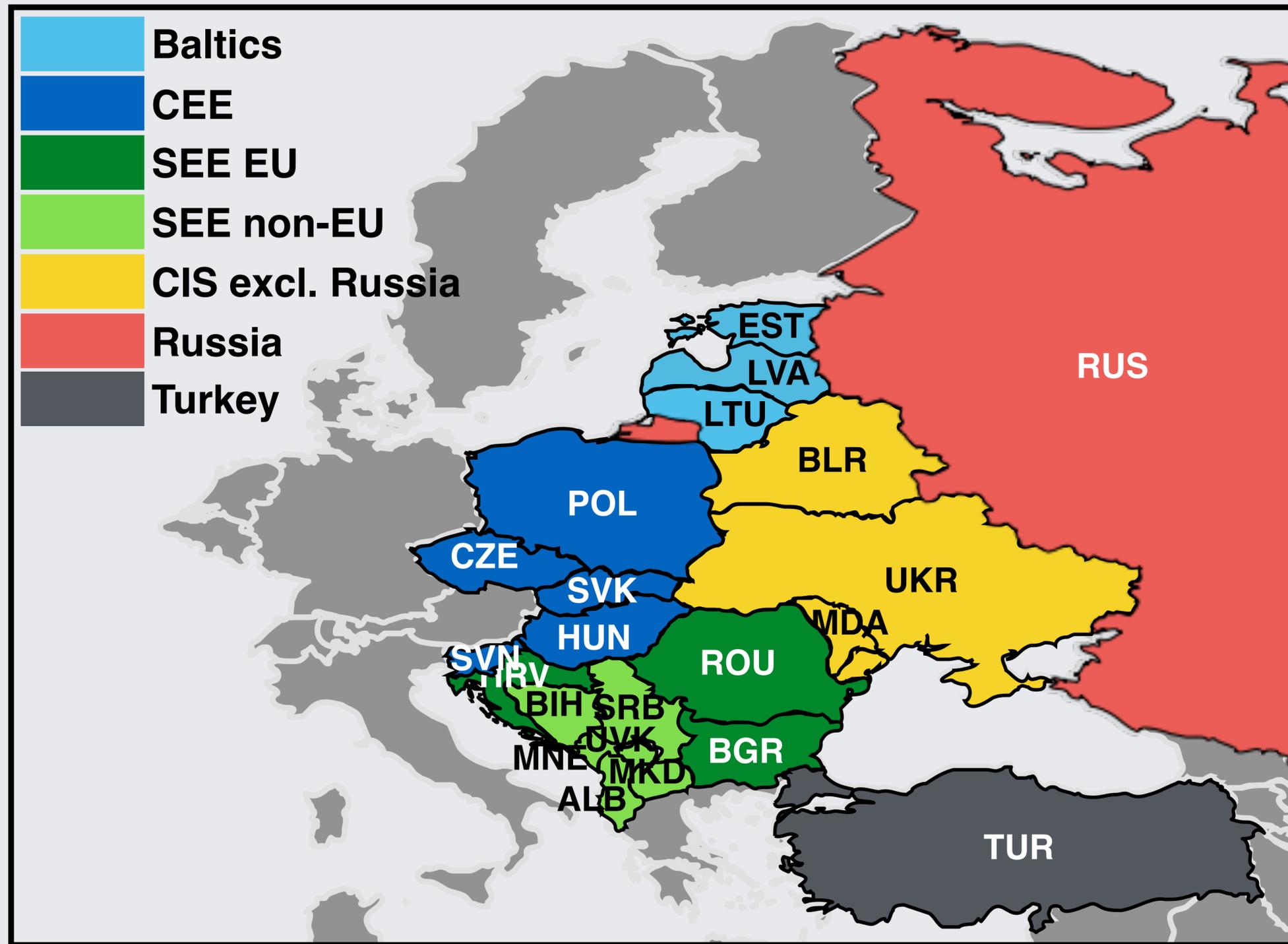
OCTOBER, 2016

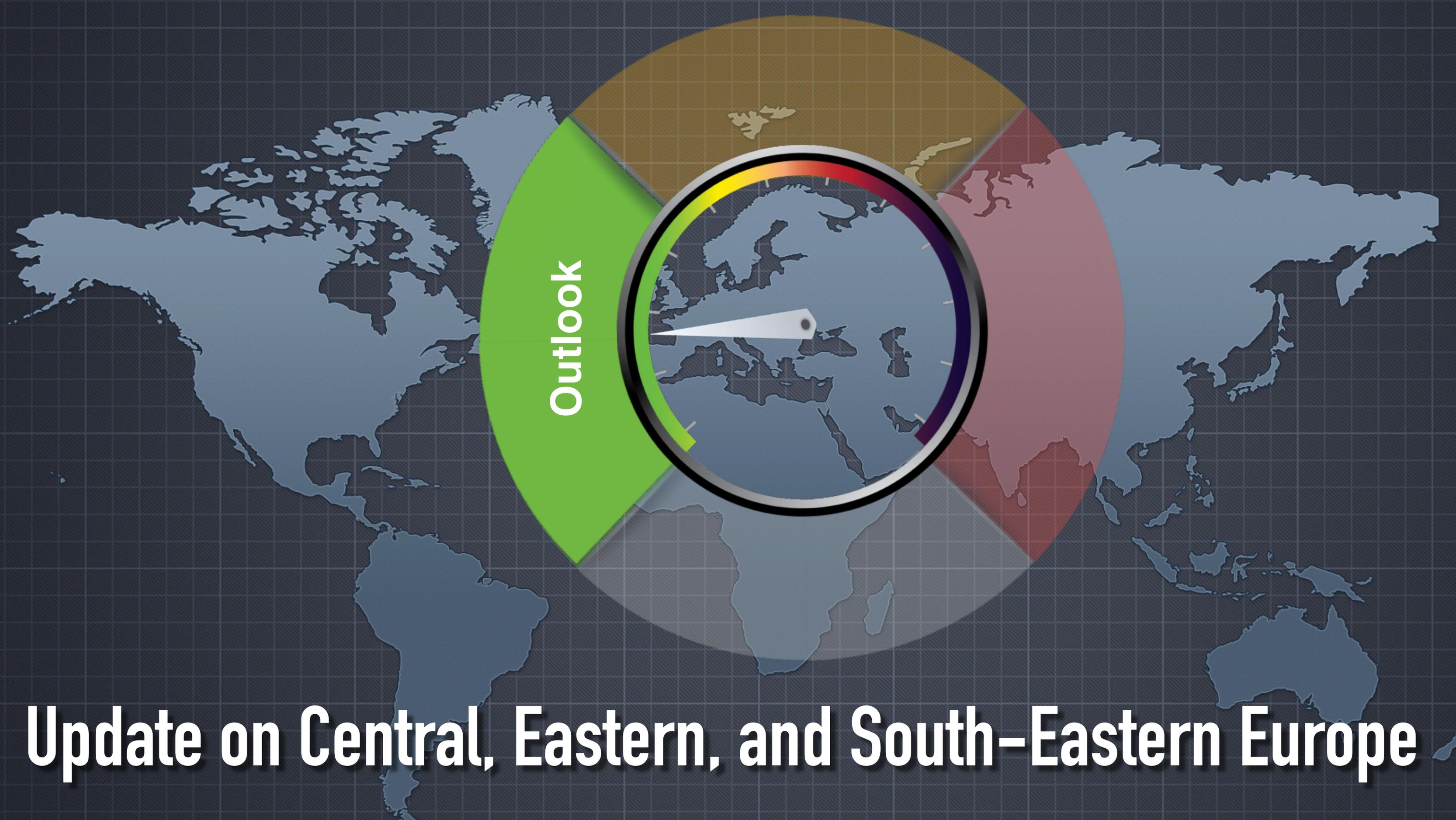
EUROPEAN DEPARTMENT



Update on Central, Eastern, and South-Eastern Europe

Map of Central, Eastern, and South-Eastern Europe



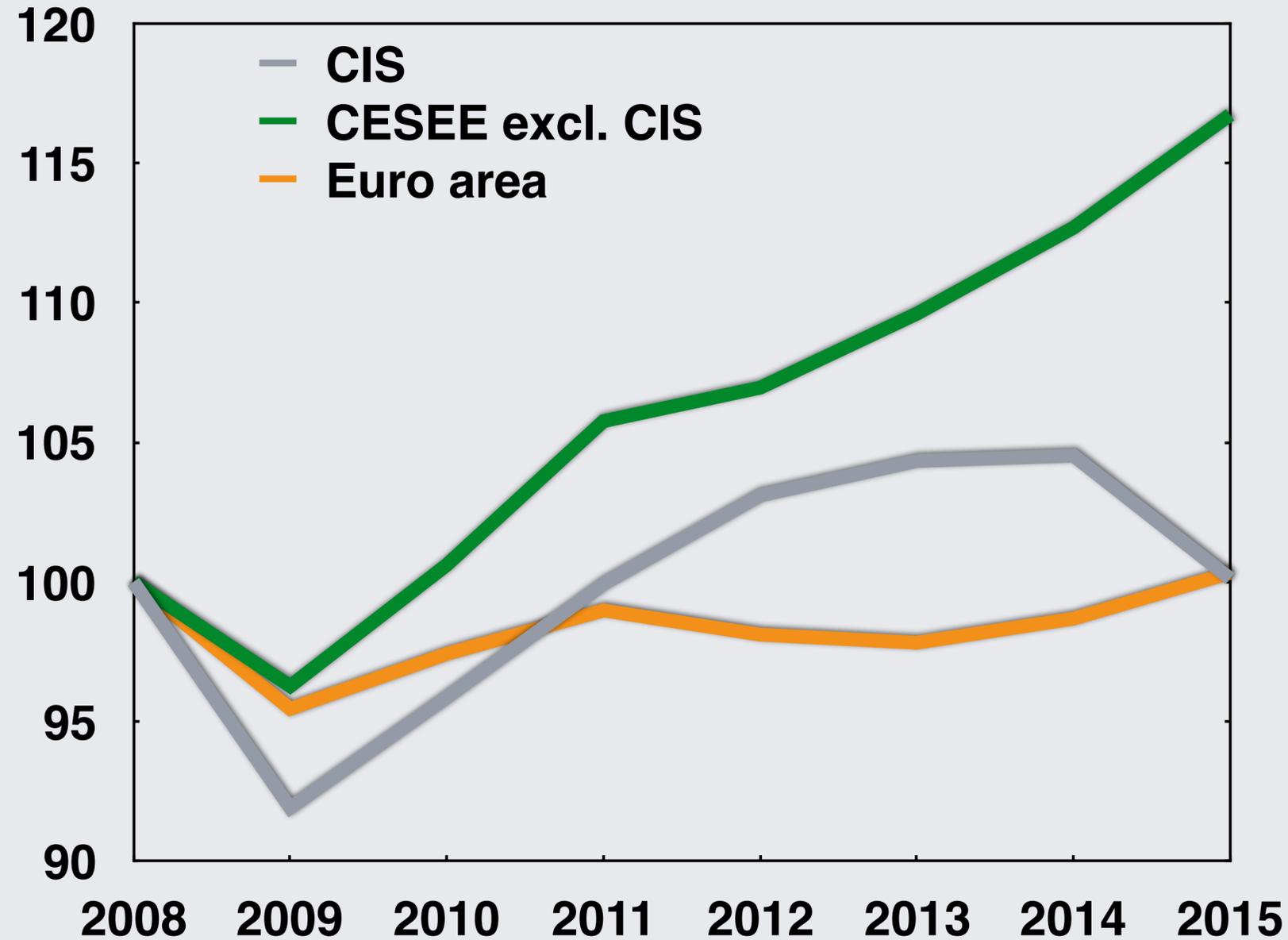


Outlook

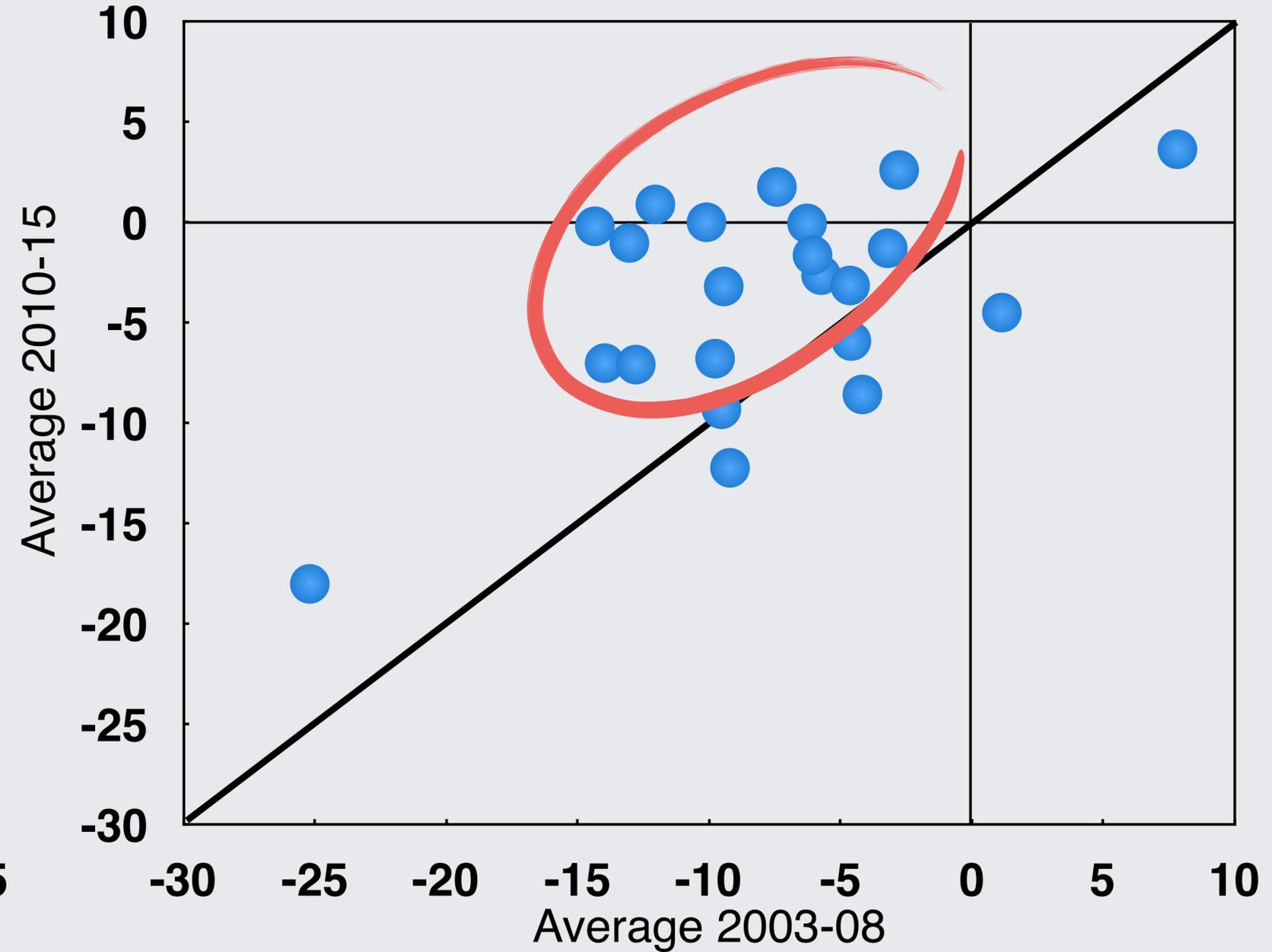
Update on Central, Eastern, and South-Eastern Europe

Many in the region have adjusted faster than euro area after the crisis

CESEE and Euro Area: Real GDP
(index, 2008 = 100)

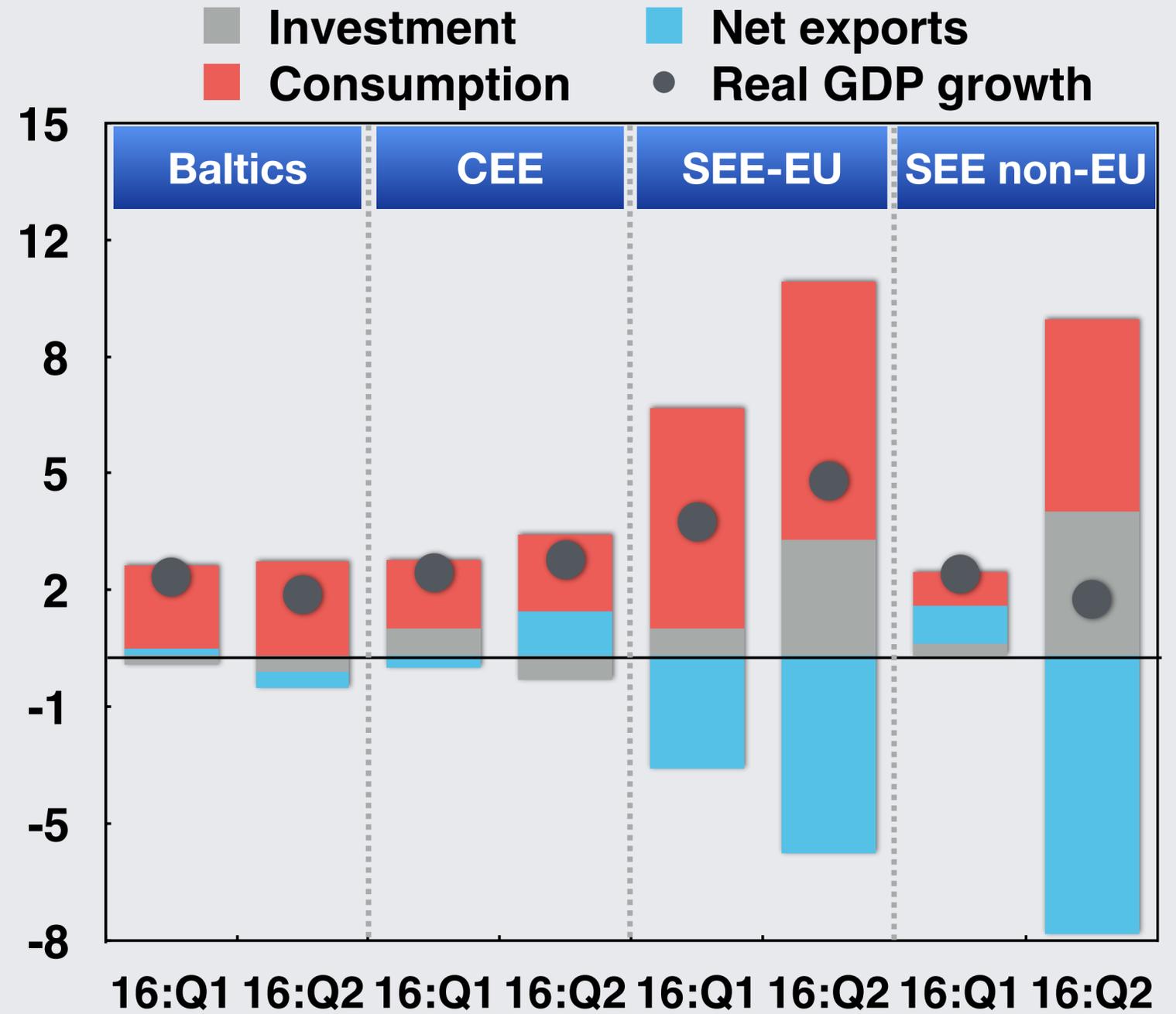
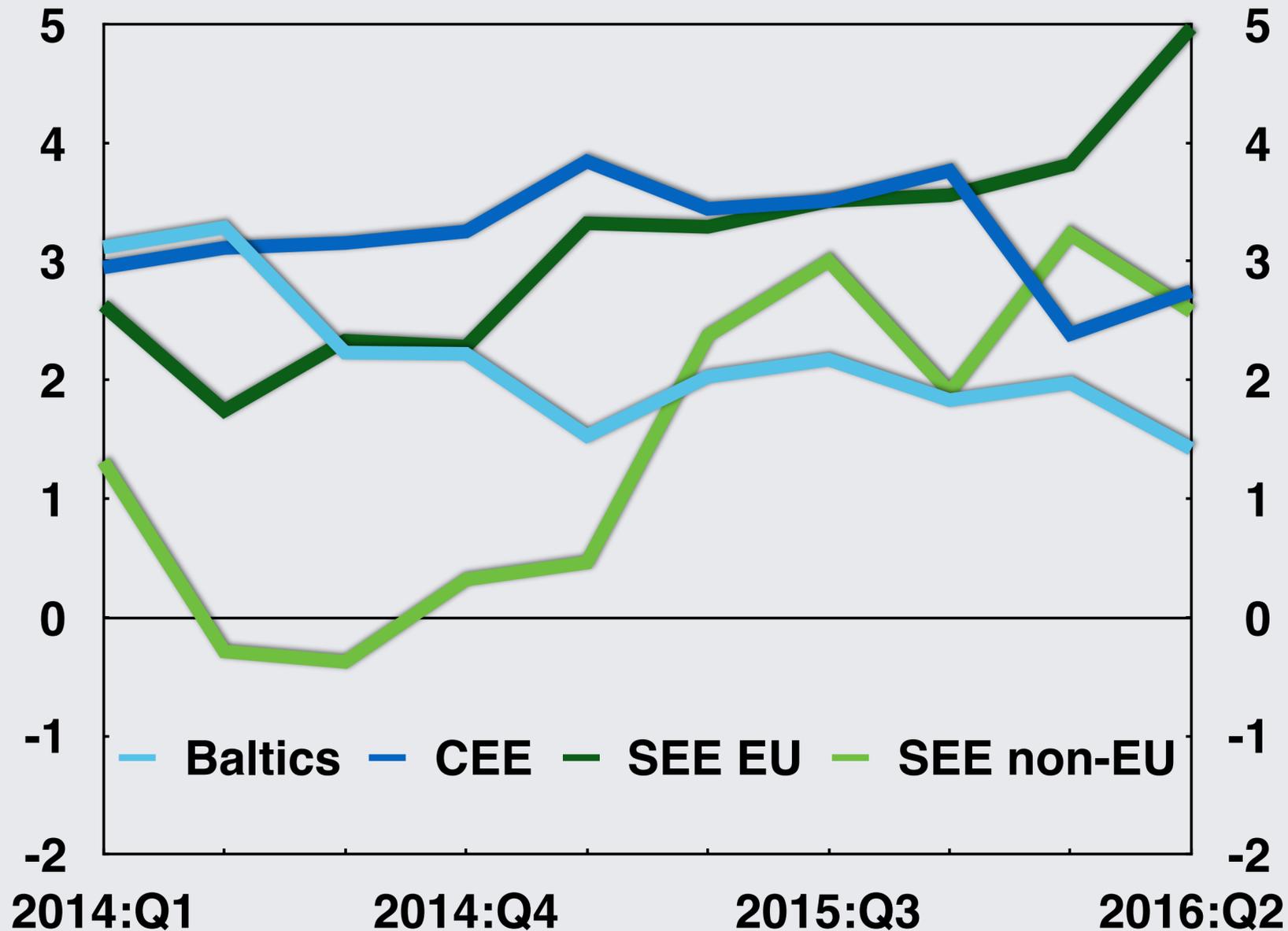


CESEE: Current Account Adjustment
(percent of GDP)



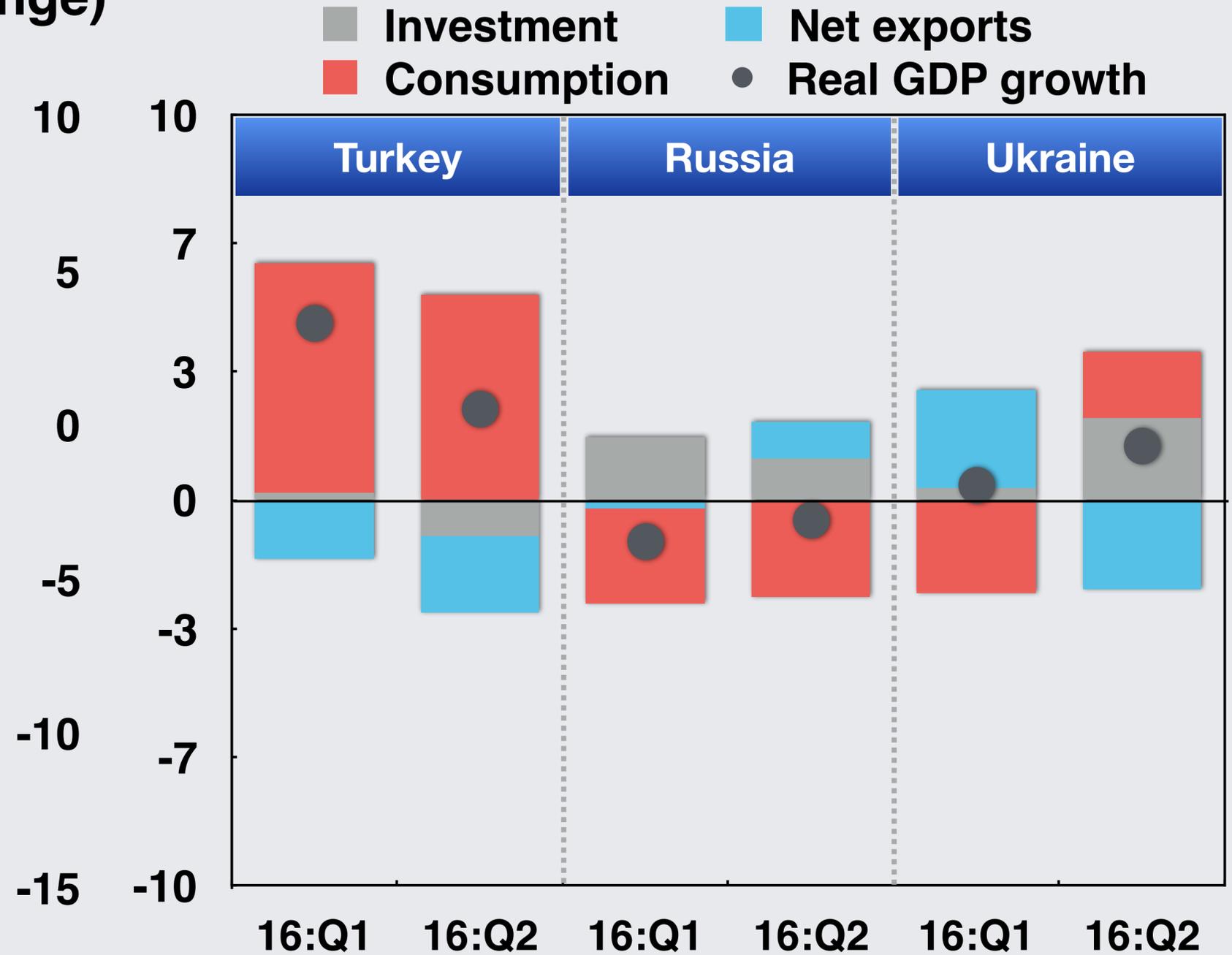
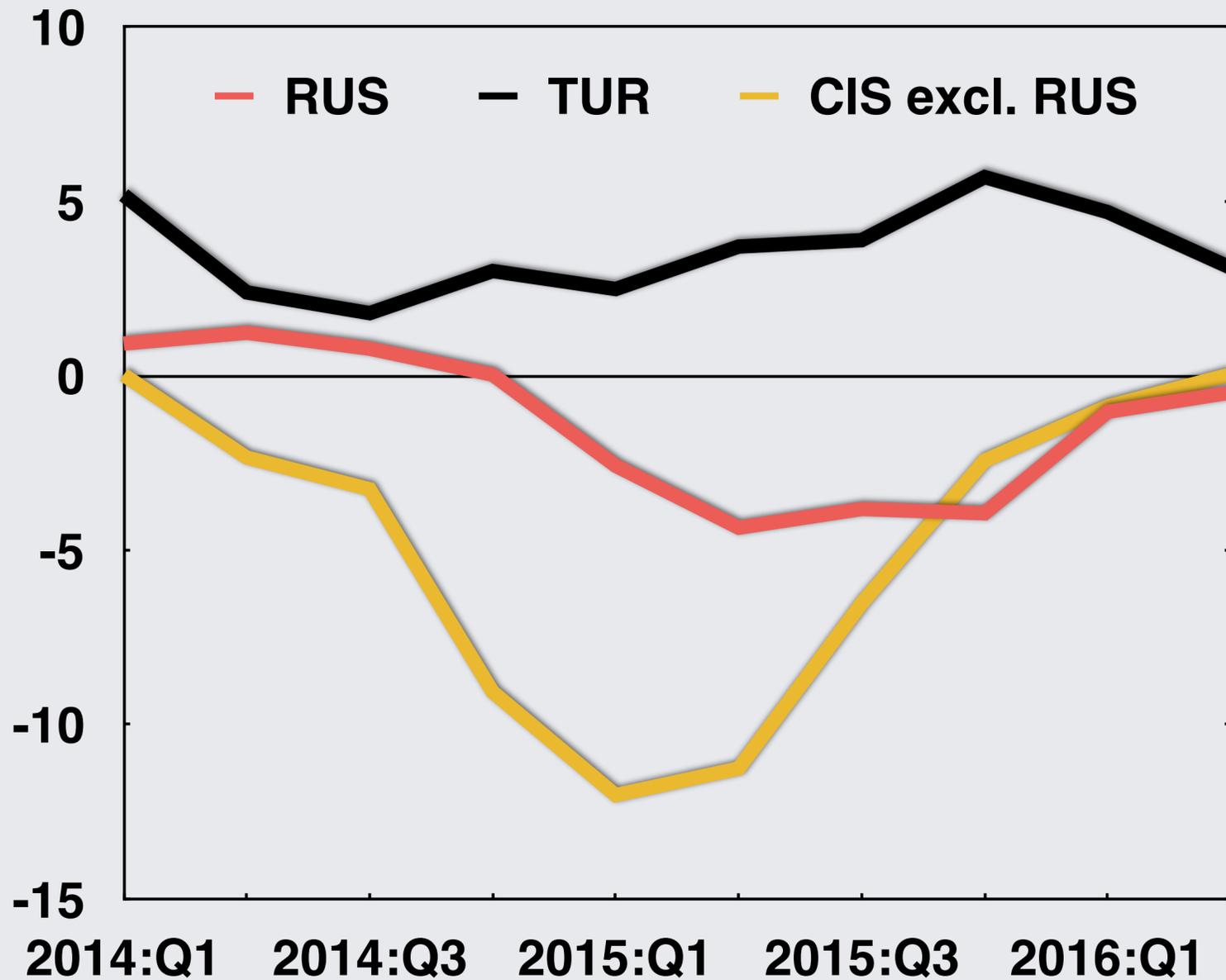
Growth is generally solid outside CIS, on strong consumption

CESEE (excl. CIS and Turkey): Real GDP Growth and Decomposition
(y-o-y percent change)



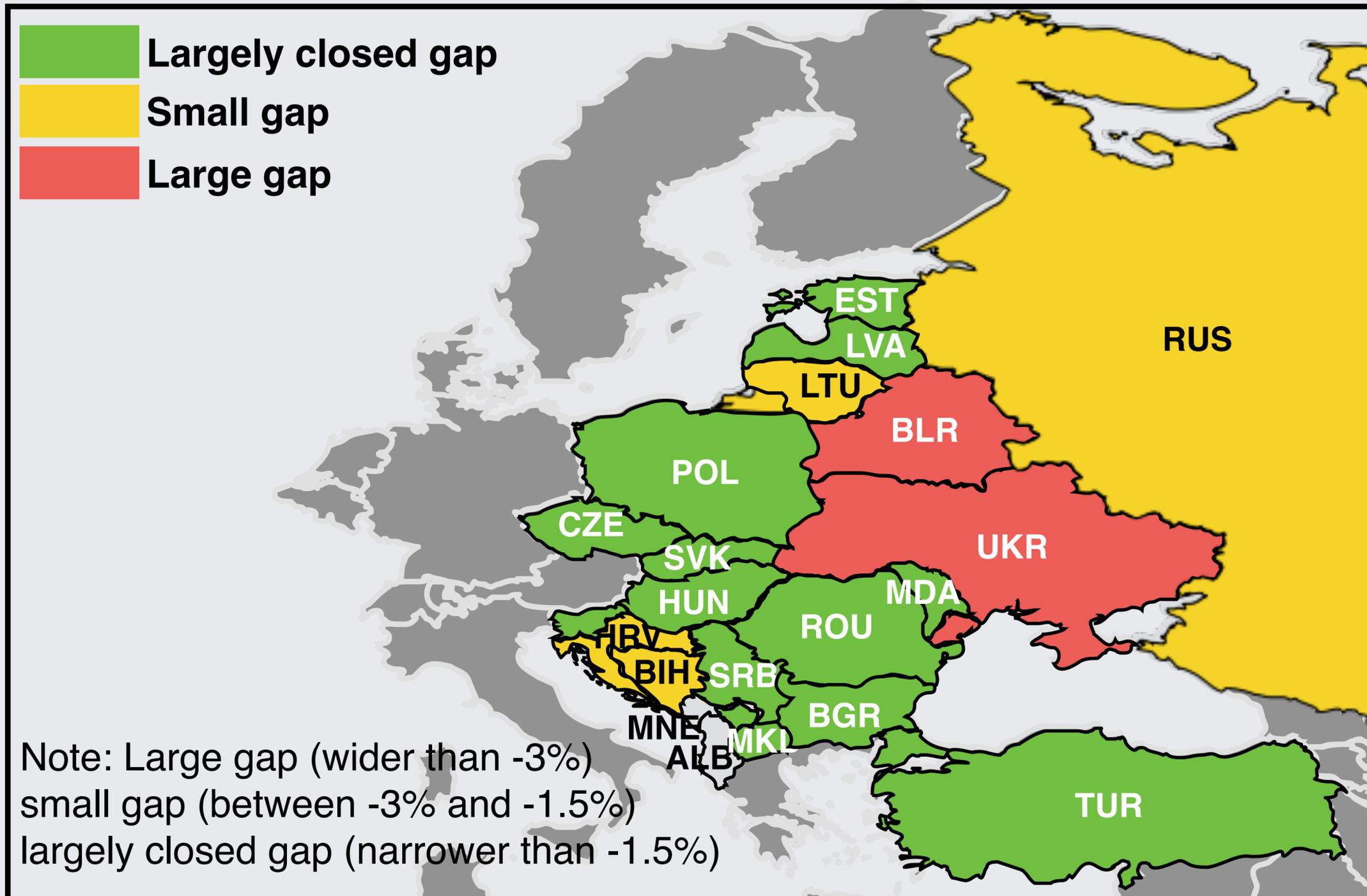
The pace of contraction has declined in CIS

CIS and Turkey: Real GDP Growth and Decomposition (y-o-y percent change)



Output gaps are estimated to be closed, except in CIS

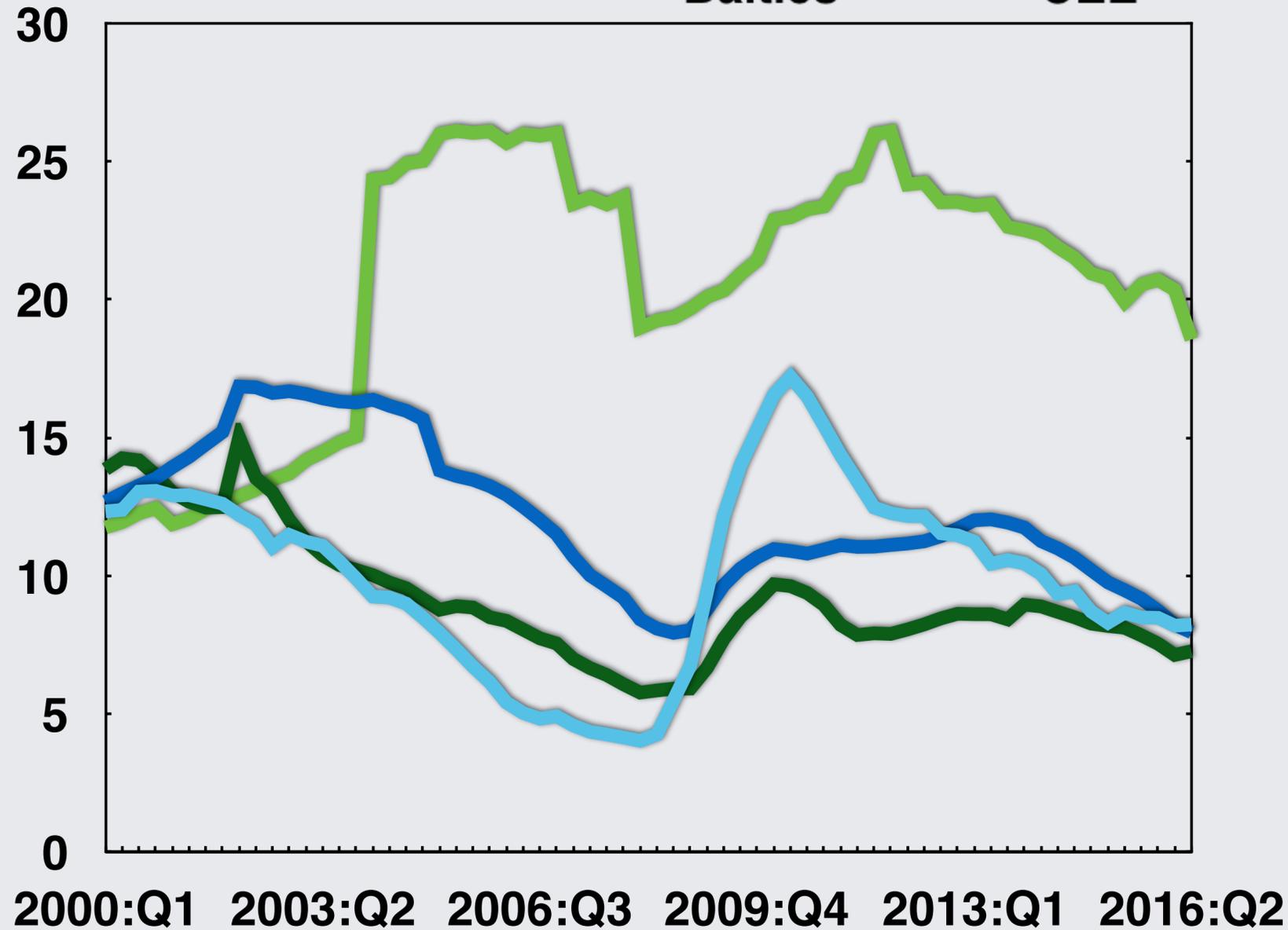
CESEE: Estimated Output Gaps, 2016



Unemployment reaching pre-crisis lows; credit catching up with recovery

CESEE: Unemployment Rate (y-o-y percent change)

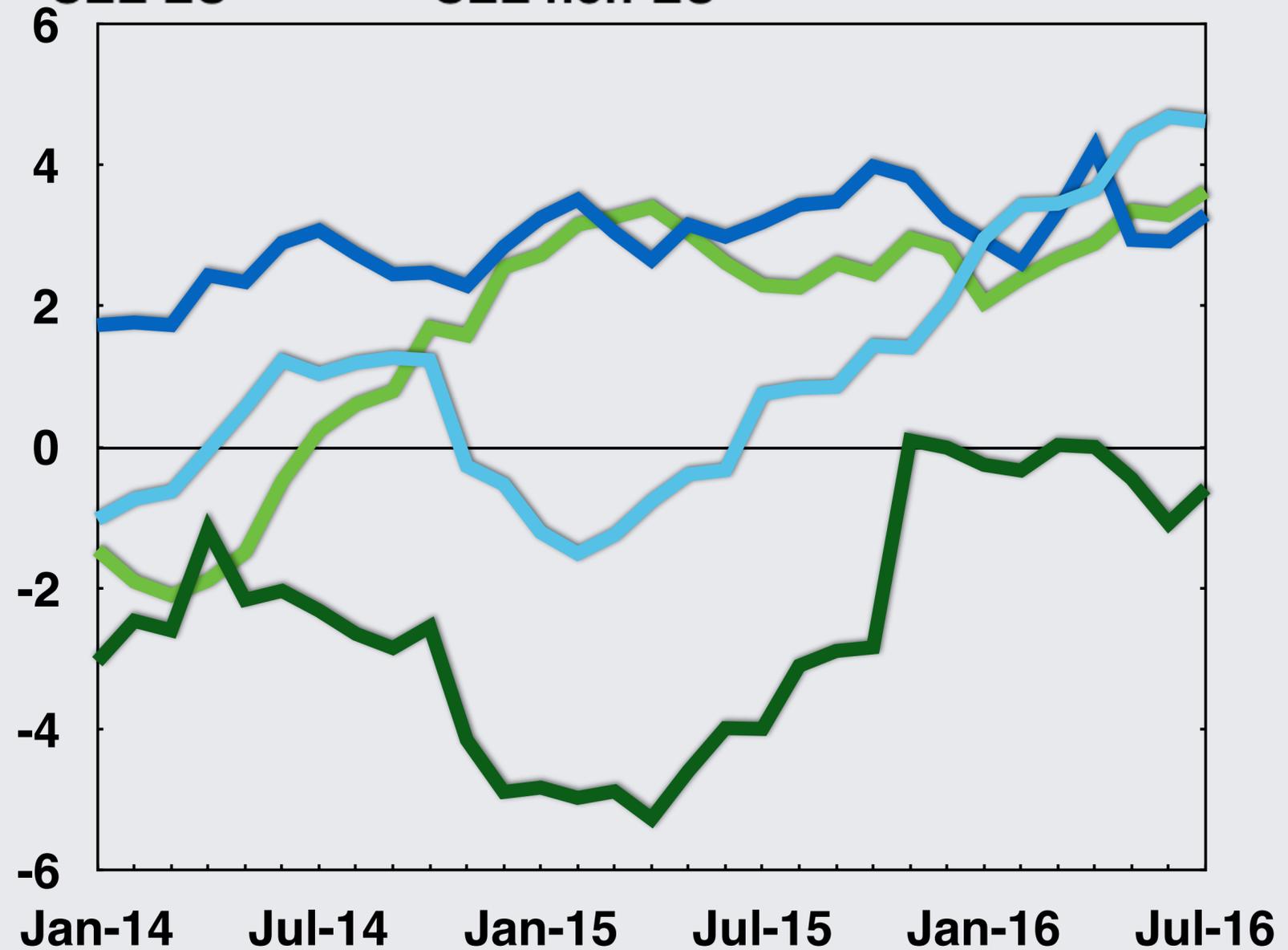
— Baltics — CEE



CESEE: Nominal Credit Growth (y-o-y percent change; net of FX valuation effects)

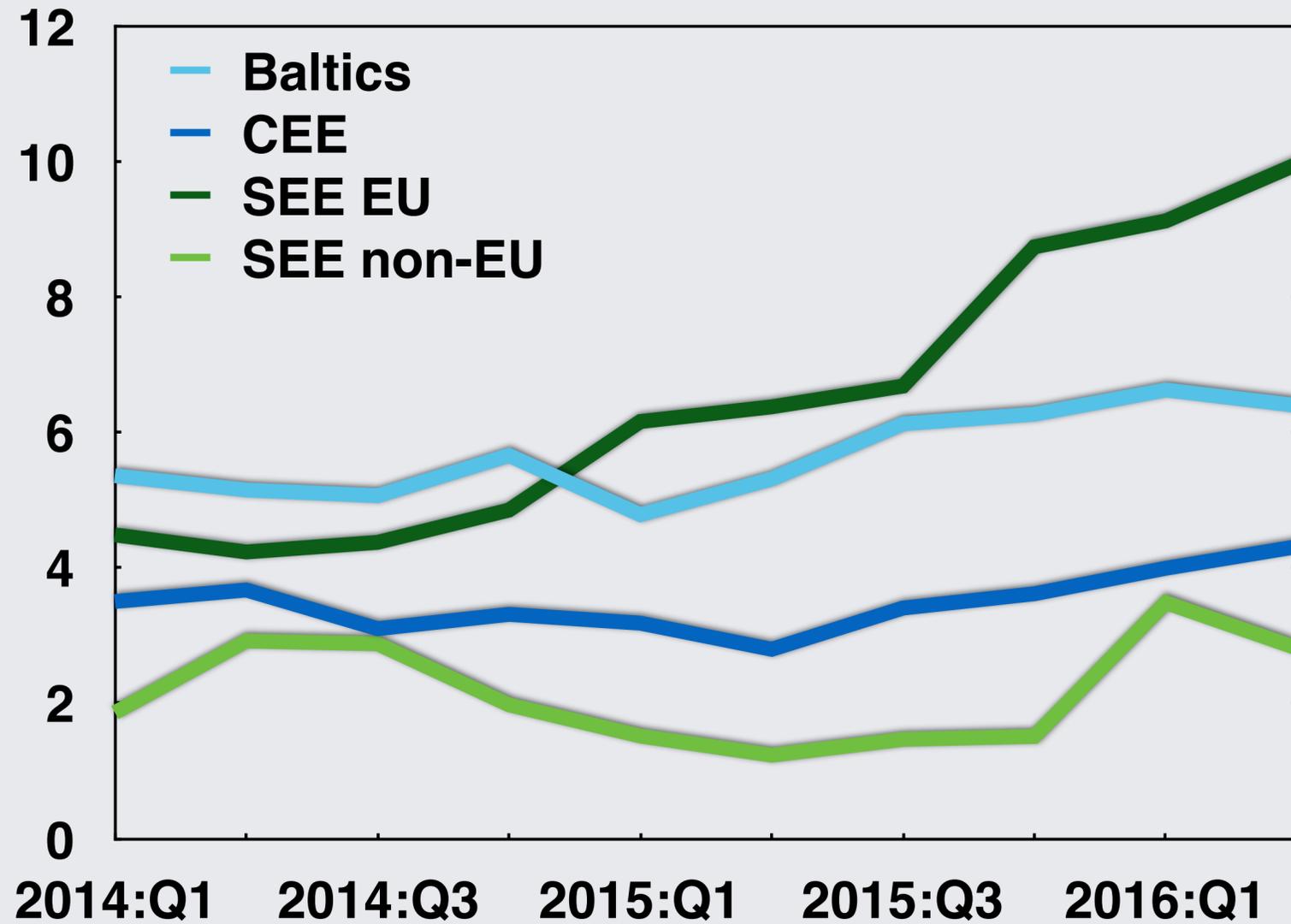
(y-o-y percent change; net of FX valuation effects)

— SEE EU — SEE non-EU

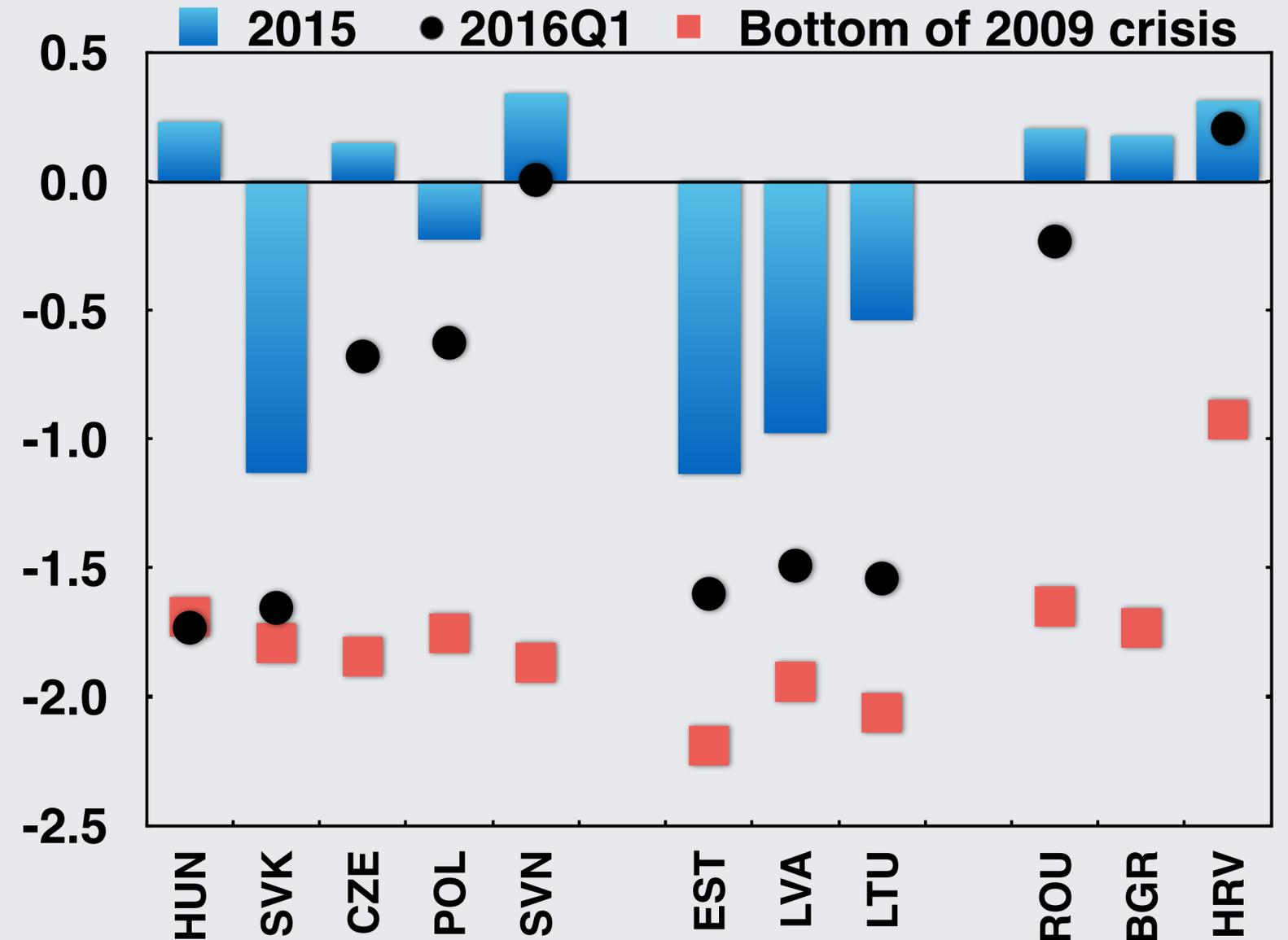


Wages are growing strongly and profit margins are under pressure

CESEE: Wage Growth (y-o-y percent change)



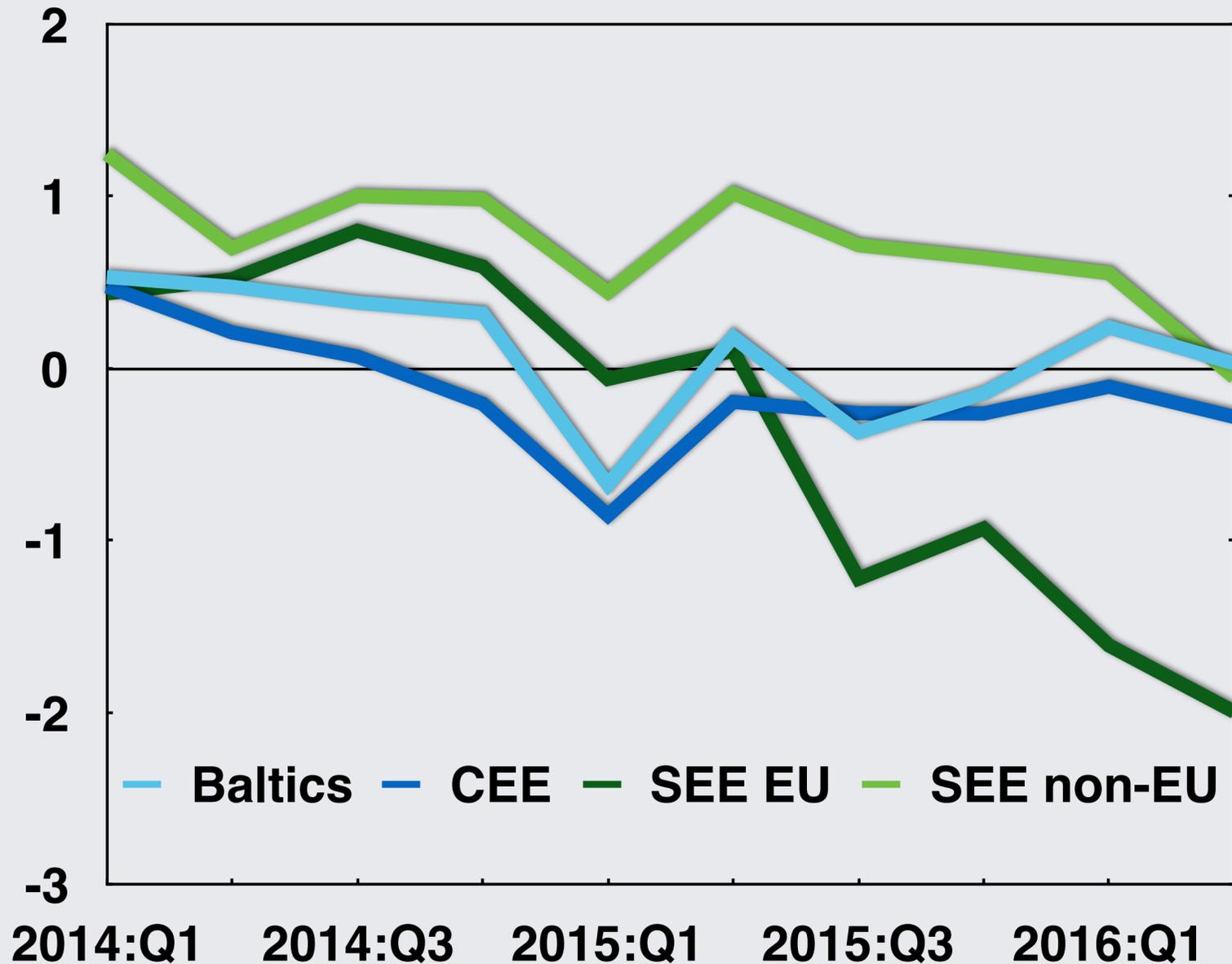
CESEE EU: Gap in Corporate Profit Margins (difference from long-term average^{1/}, percentage points)



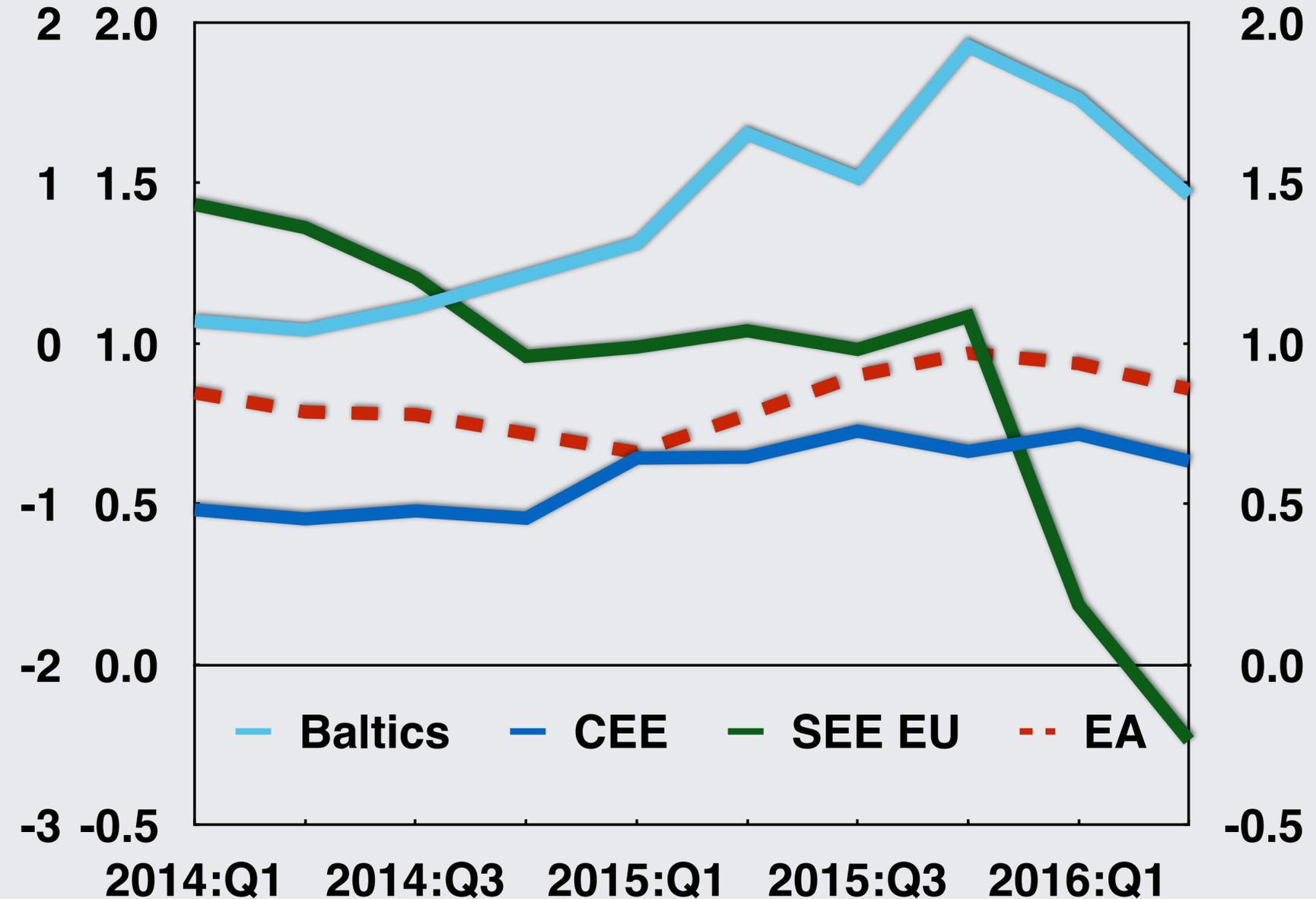
^{1/} Long-term average calculated over 2002-2016H1.

...though inflationary pressures are still subdued

CESEE: Headline Inflation (y-o-y percent change)

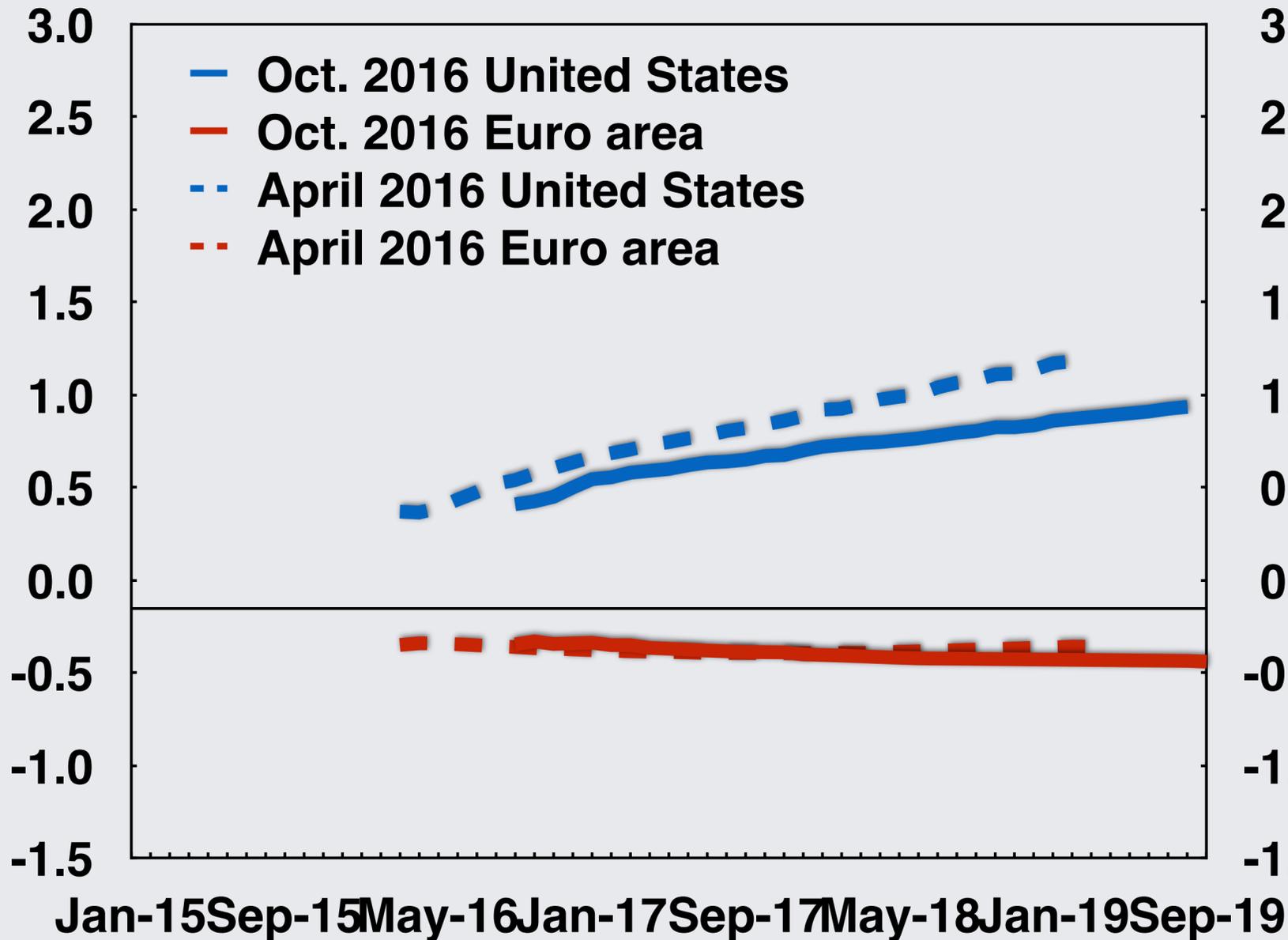


CESEE: Core Inflation (y-o-y percent change)

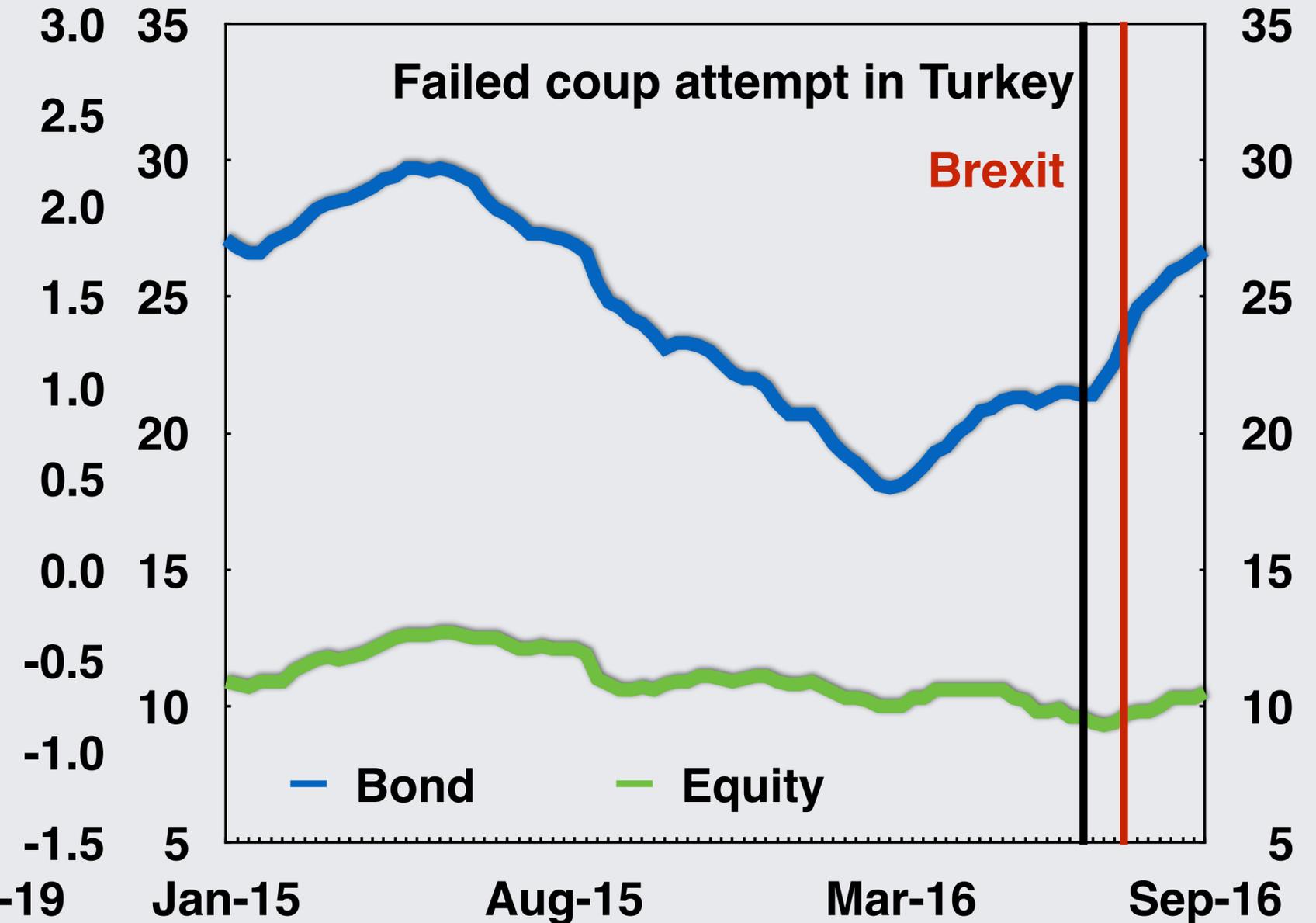


Monetary and financial conditions remain supportive

Policy Rate Expectations (percent)

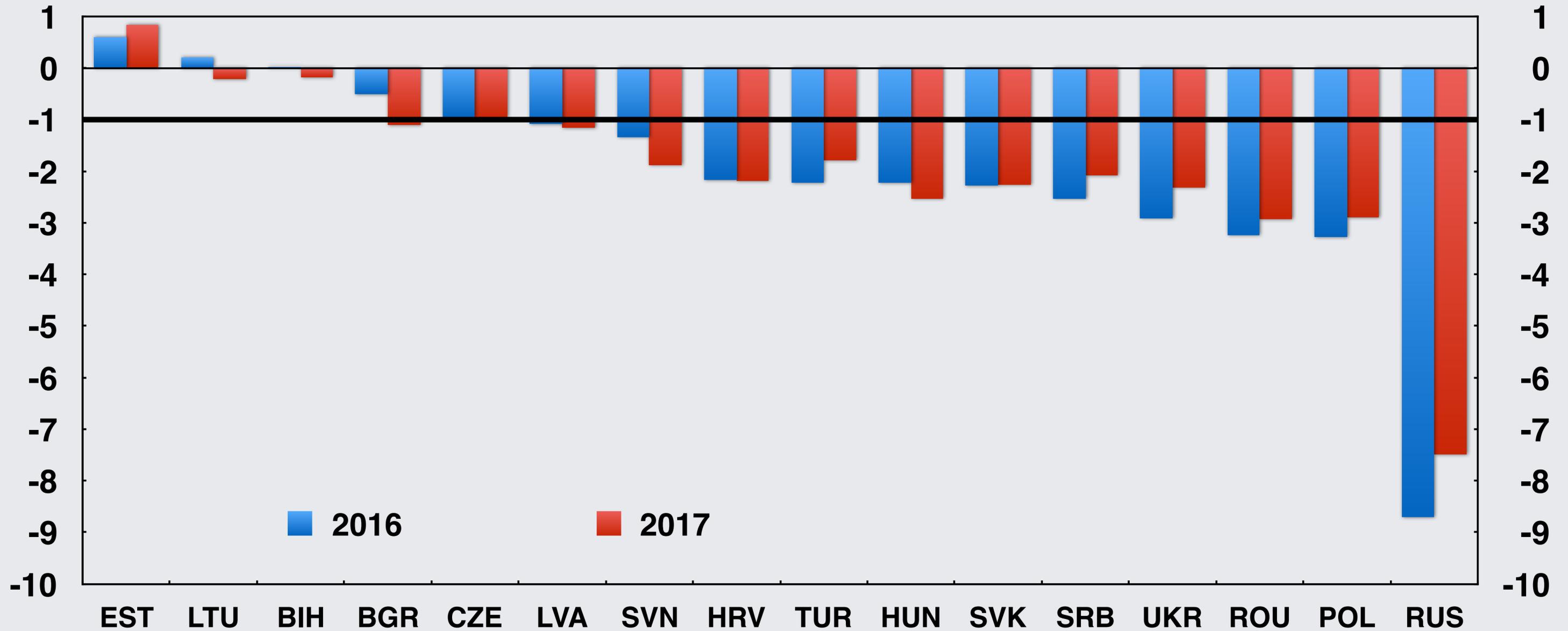


CESEE: Cumulative EPFR Portofolio Flows (billions of US Dollars)



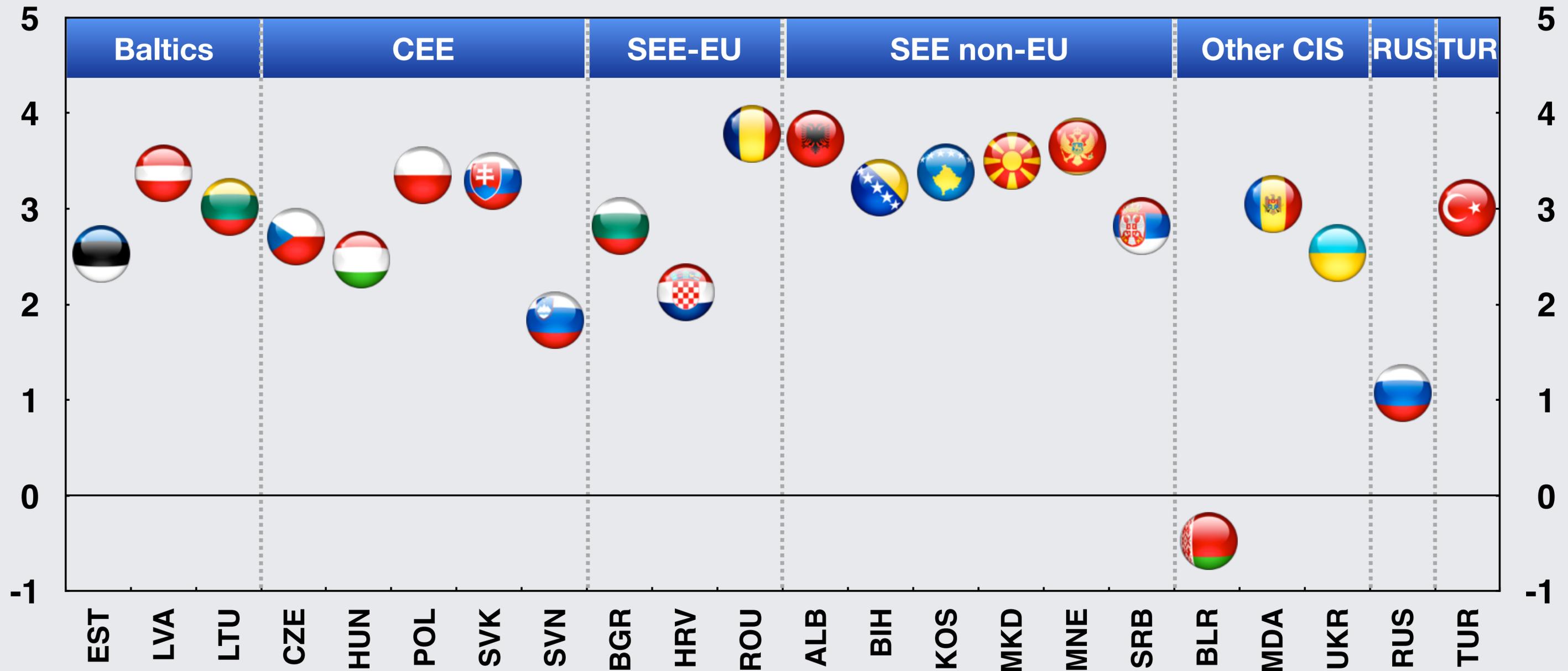
Fiscal policy is mostly neutral or expansionary

CESEE: Structural Fiscal Balance
(percent of GDP)



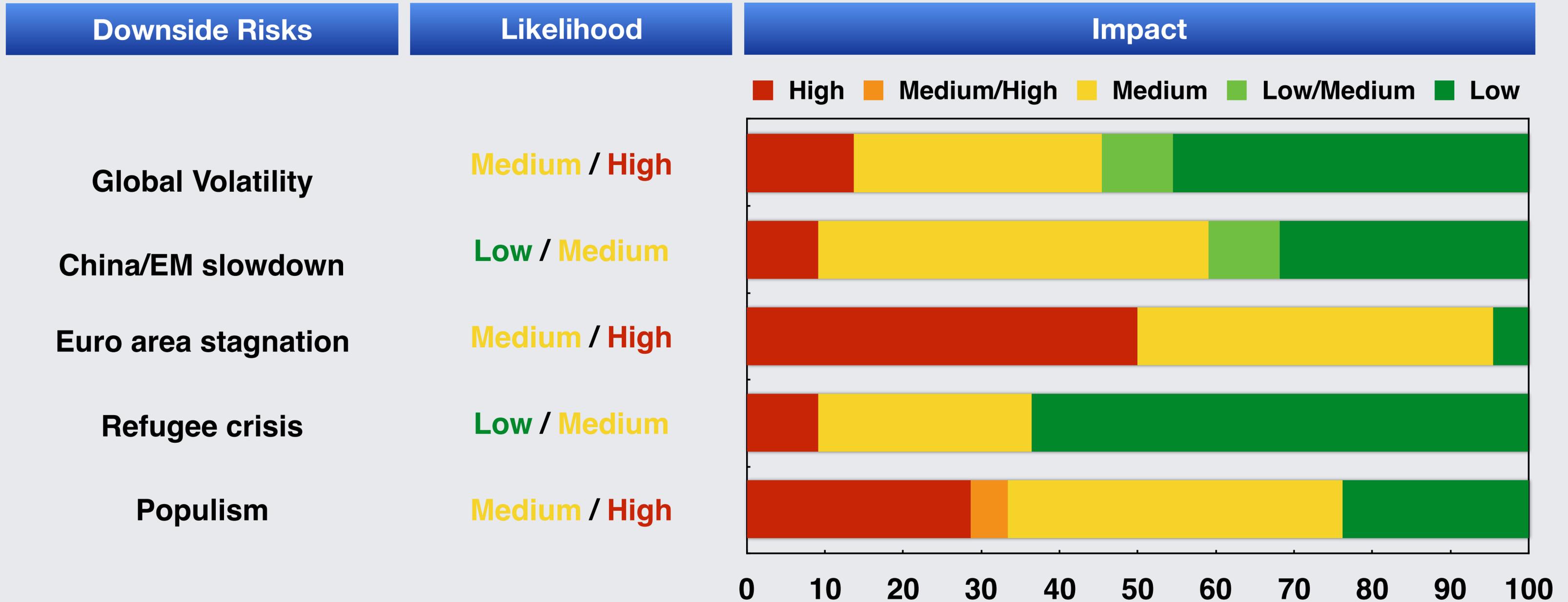
In the near-term, solid growth is expected to continue. Can it be sustained?

WEO Growth Forecasts, 2017 (y-o-y percent change)



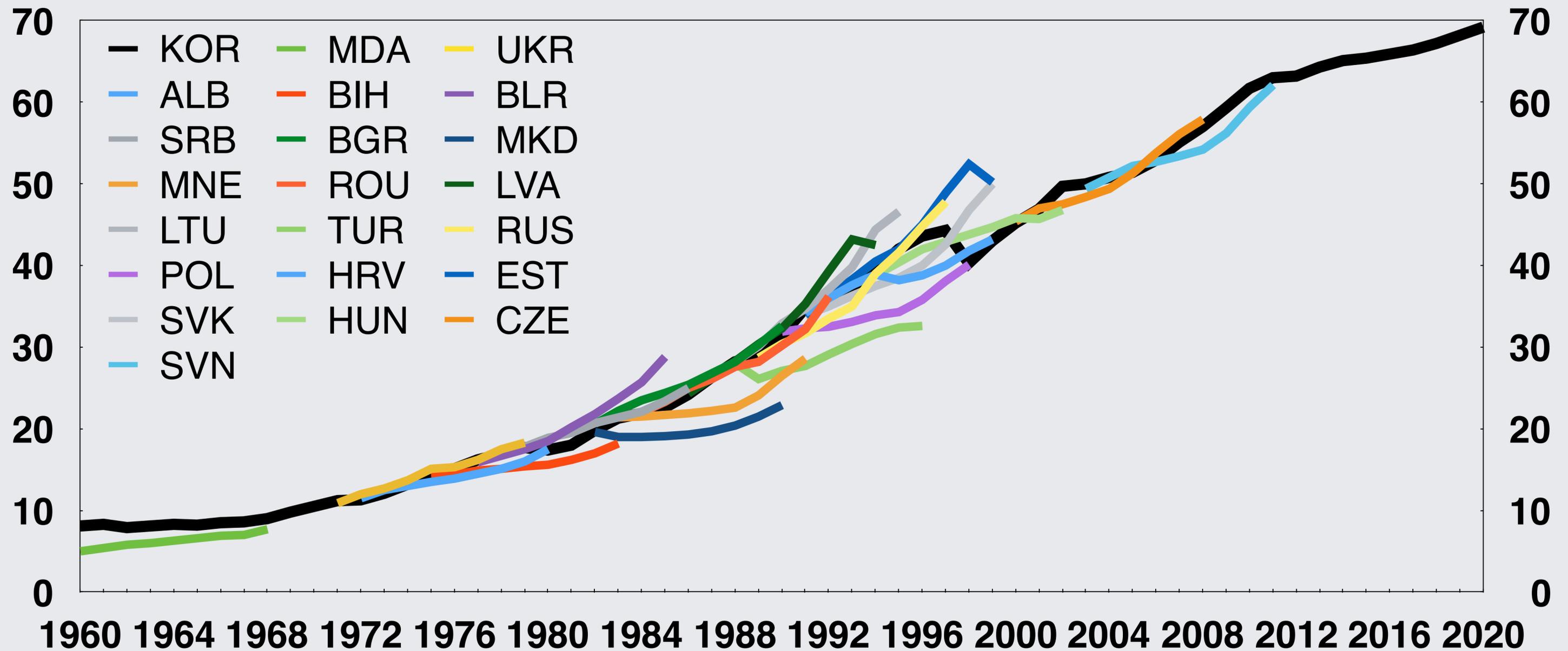
Risks diminished relative to April, but remain to the downside

CESEE: Desk Assessments of Risks to Outlook (percent of total responses)



Fast pace of convergence before crisis...

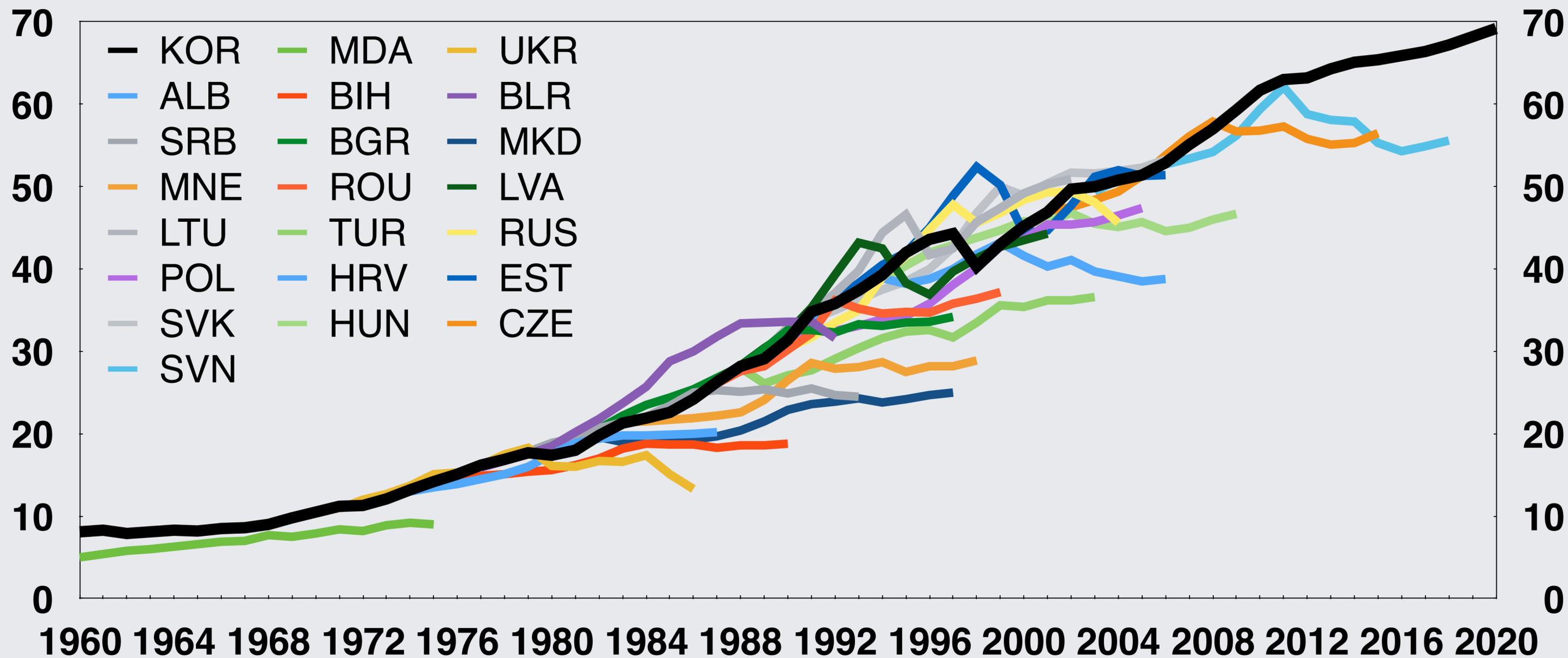
CESEE and Korea: GDP per Capita
(percent of per capita GDP of the U.S. at PPP)



Note: Data for CESEE countries are for 2000-2008 and are shifted back in time to comparable level of development of Korea.

...leveled off since 2009

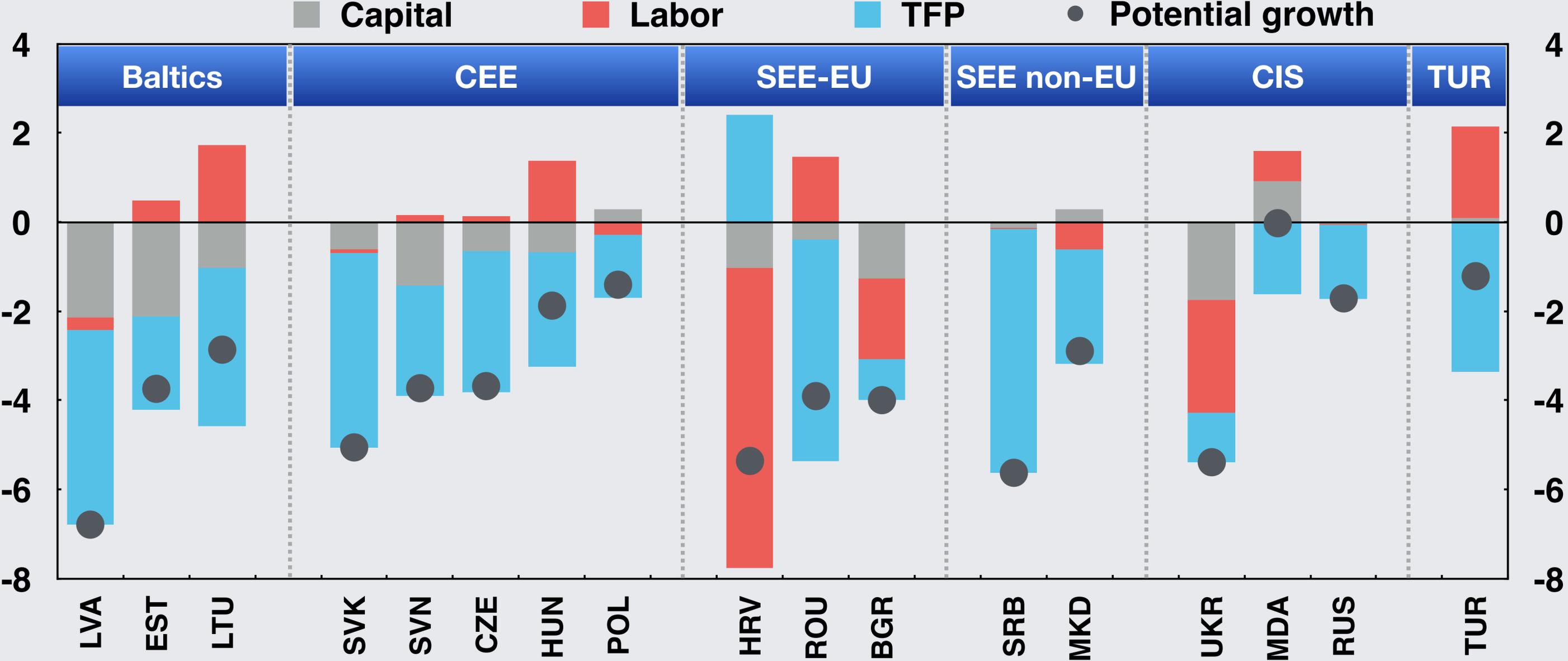
CESEE and Korea: GDP per Capita (percent of per capita GDP of the U.S. at PPP)



Note: Data for CESEE countries are for 2000-2015 and are shifted back in time to comparable level of development of Korea.

Potential growth is lower due to productivity and investment slowdown

**Difference Between Average Potential Growth Before and After Crisis:
Factor Contributions (*percentage points*)**



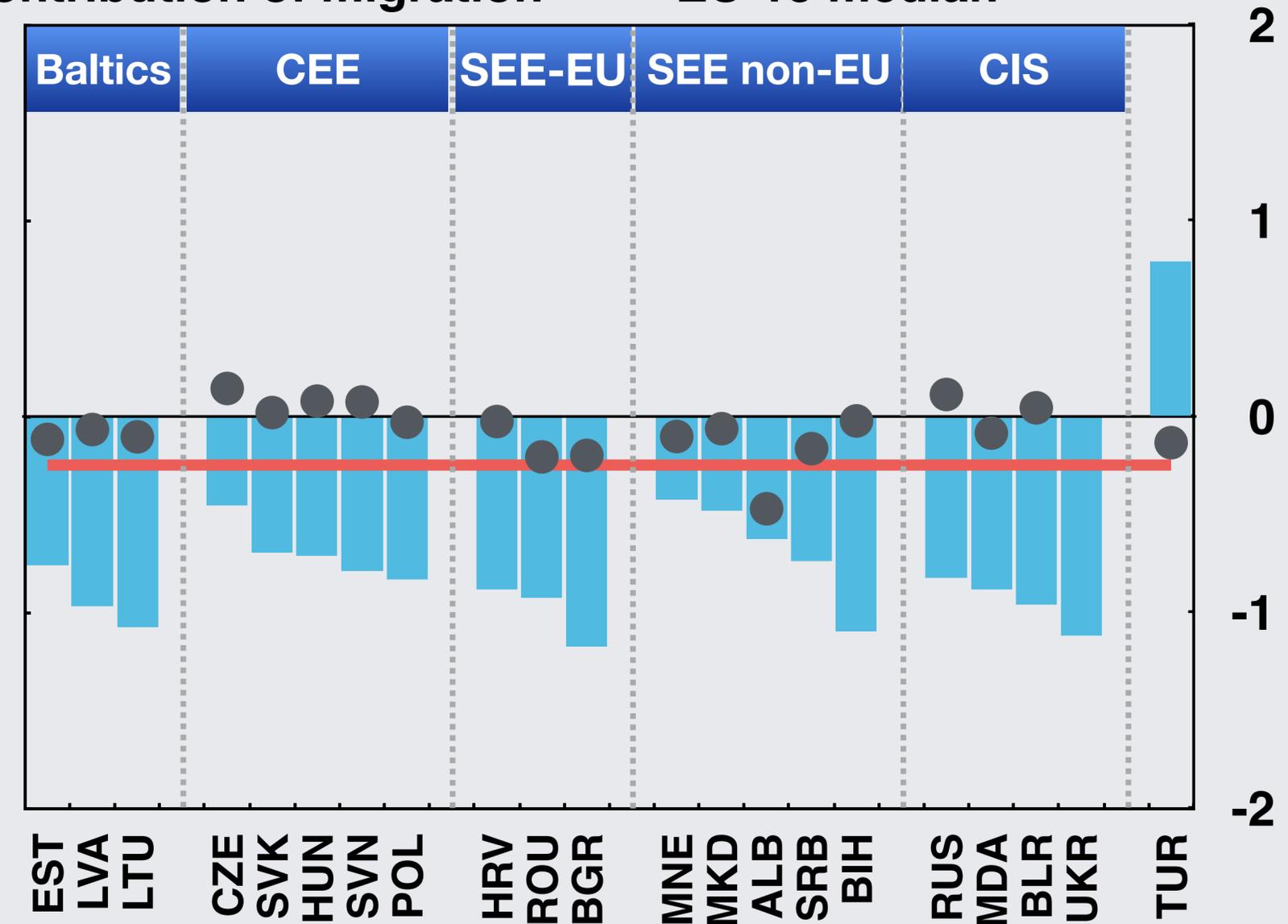
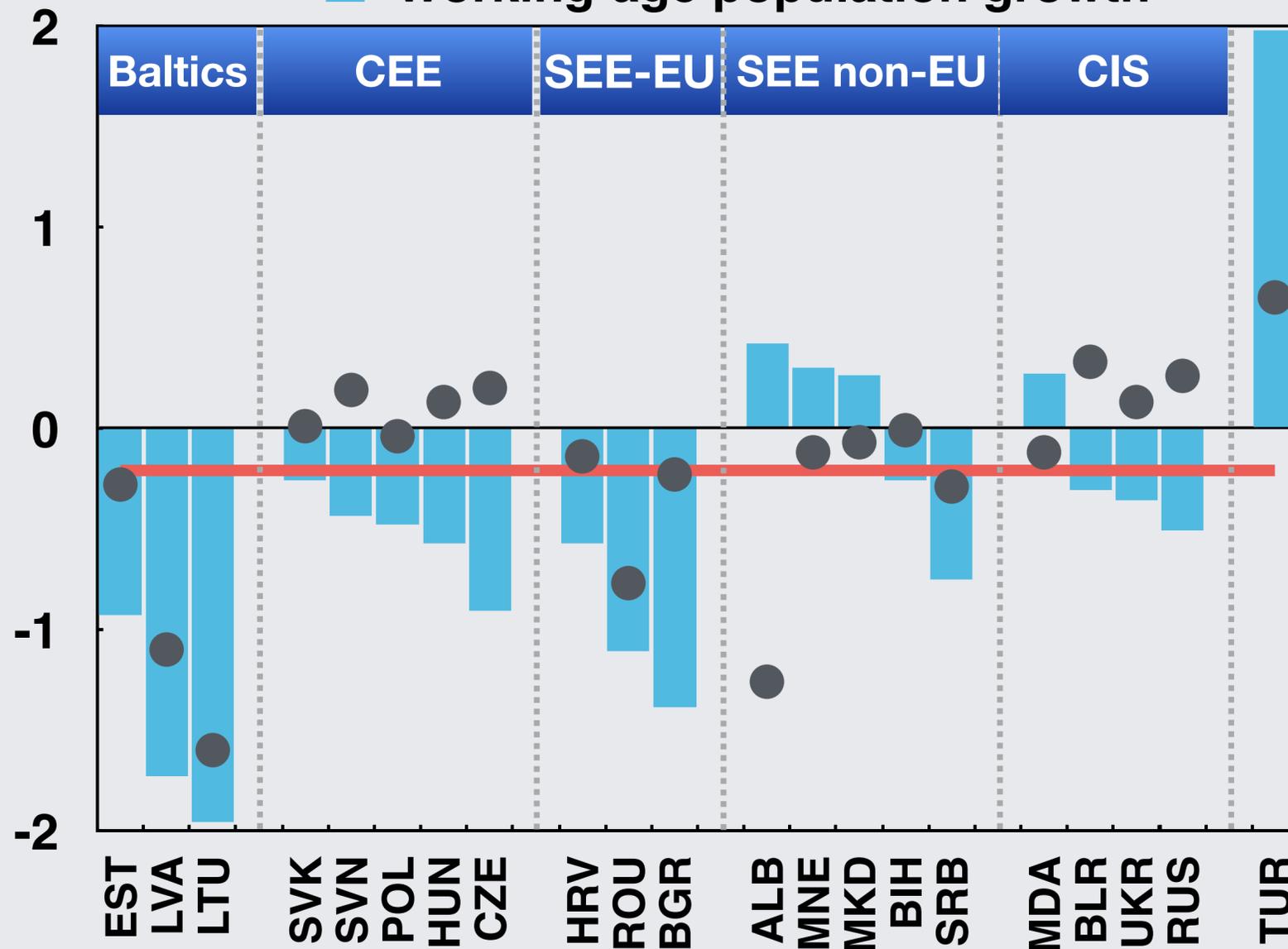
Note: TFP is the difference between potential growth and the contributions of capital and labor.

And working age population is expected to decline further

Working Age Population Growth, 2010-14
(y-o-y percent change, average)

Working Age Population Growth, 2015-30
(y-o-y percent change, average)

■ Working-age population growth ● Contribution of migration — EU-15 median



Policy Priorities

Supportive monetary policy and growth-friendly fiscal consolidation remain an appropriate policy mix for many CESEE economies

Where growth has been high and output gaps appear closed, there needs to be more fiscal adjustment

Economies that are still under pressure need to facilitate the recovery by avoiding excessive fiscal tightening

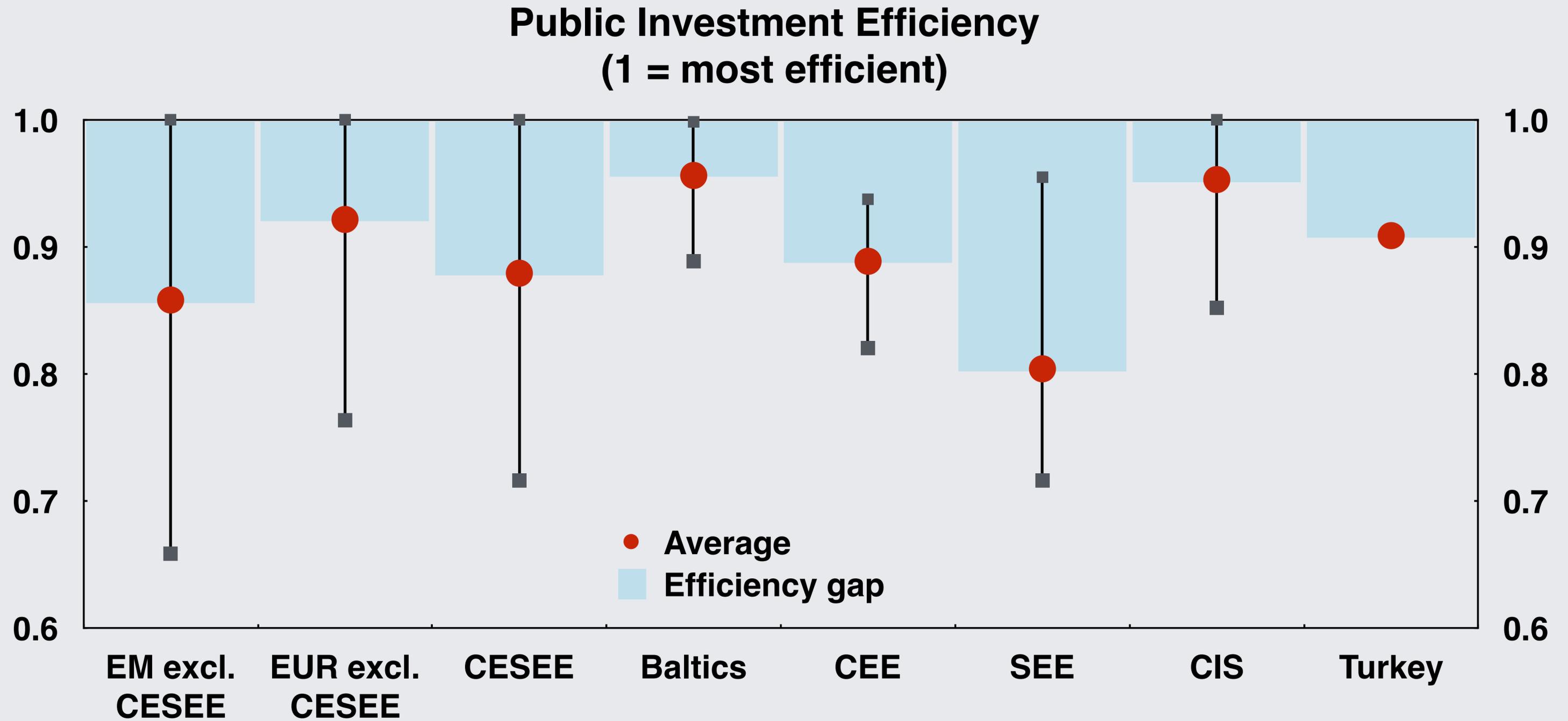
Reforms to boost productivity and investment to reinvigorate convergence of the region are critical



Public Investment

Effective Government for Stronger Growth

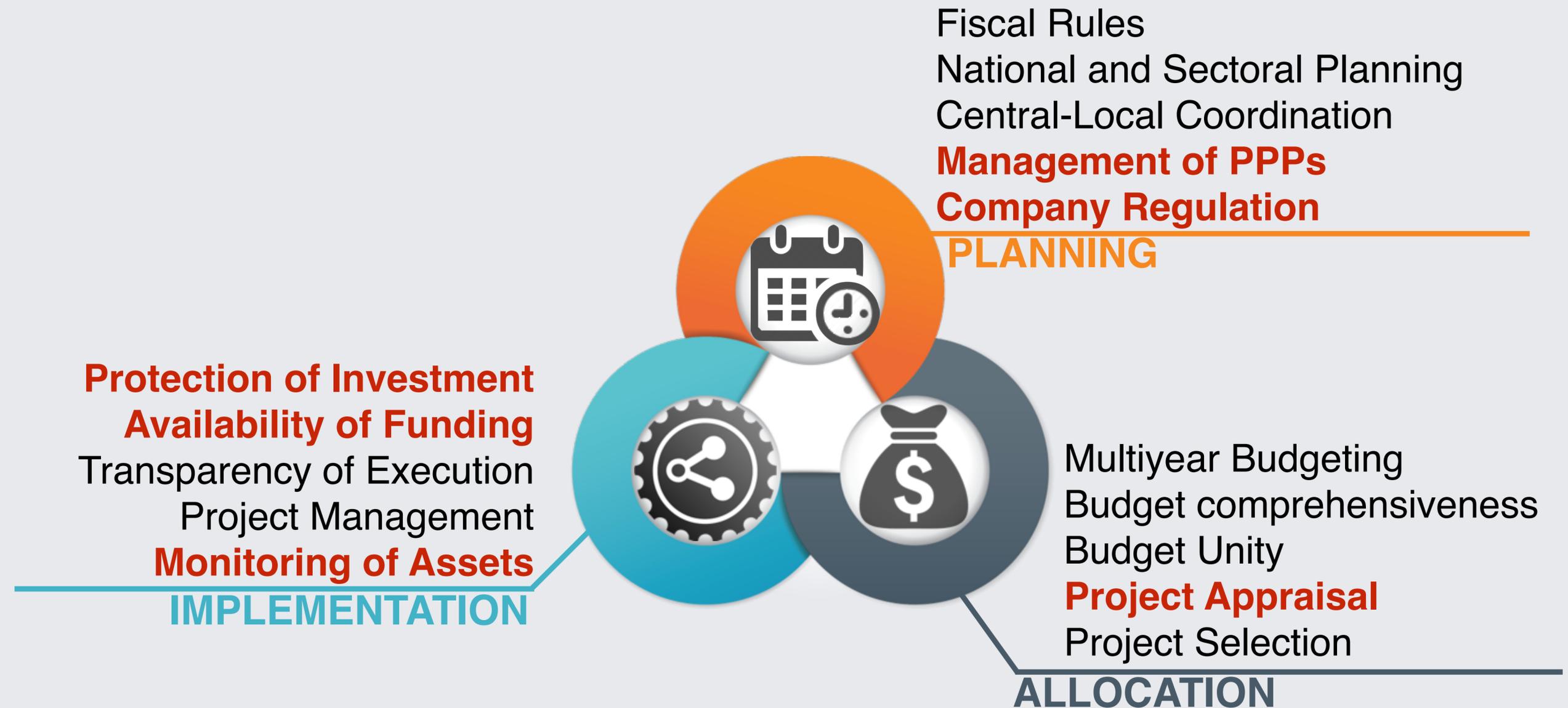
Public investment efficiency in CESEE is somewhat lower than in advanced Europe



Note: The efficiency frontier is given by countries achieving the highest quality and access to infrastructure for a given level of public capital stock and income. Efficiency gap is measured relative to frontier.

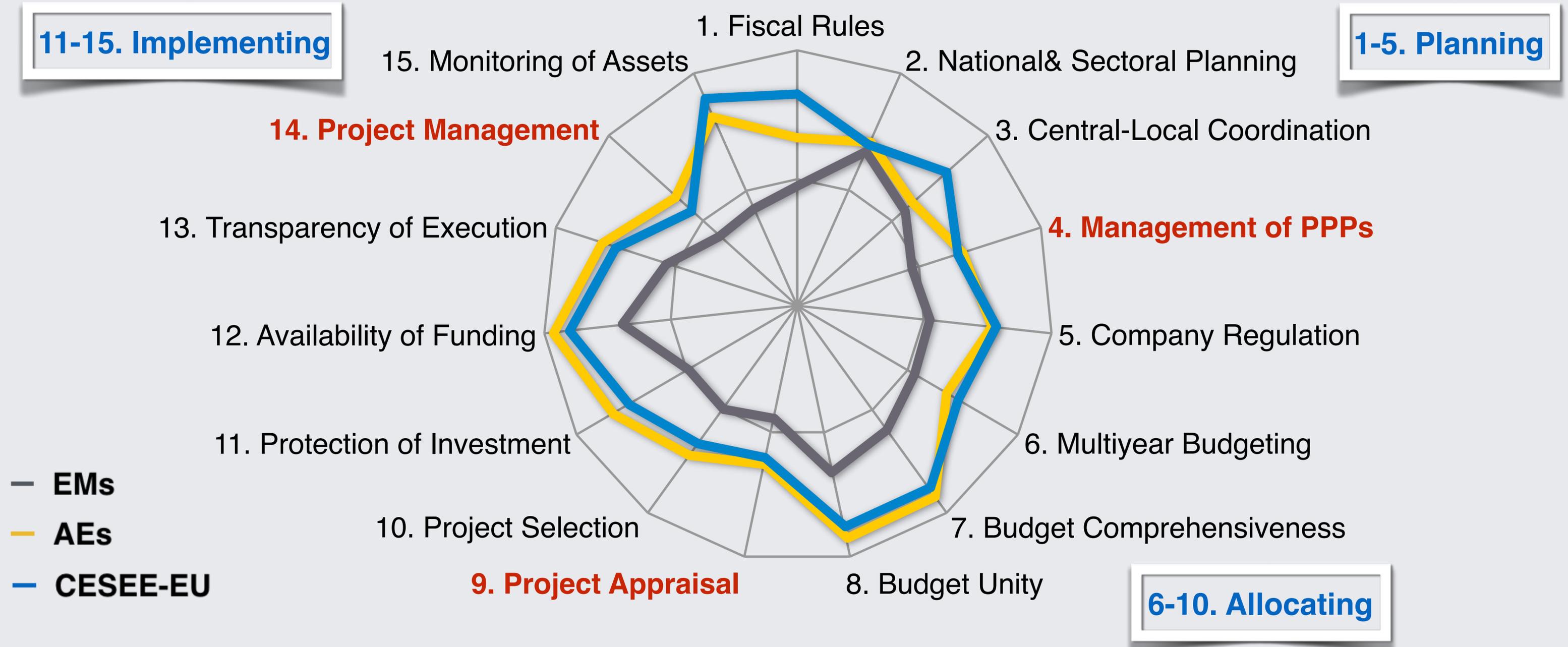
Is efficiency of public investment linked to quality of institutions?

The IMF's Public Investment Management Assessment (PIMA) Framework

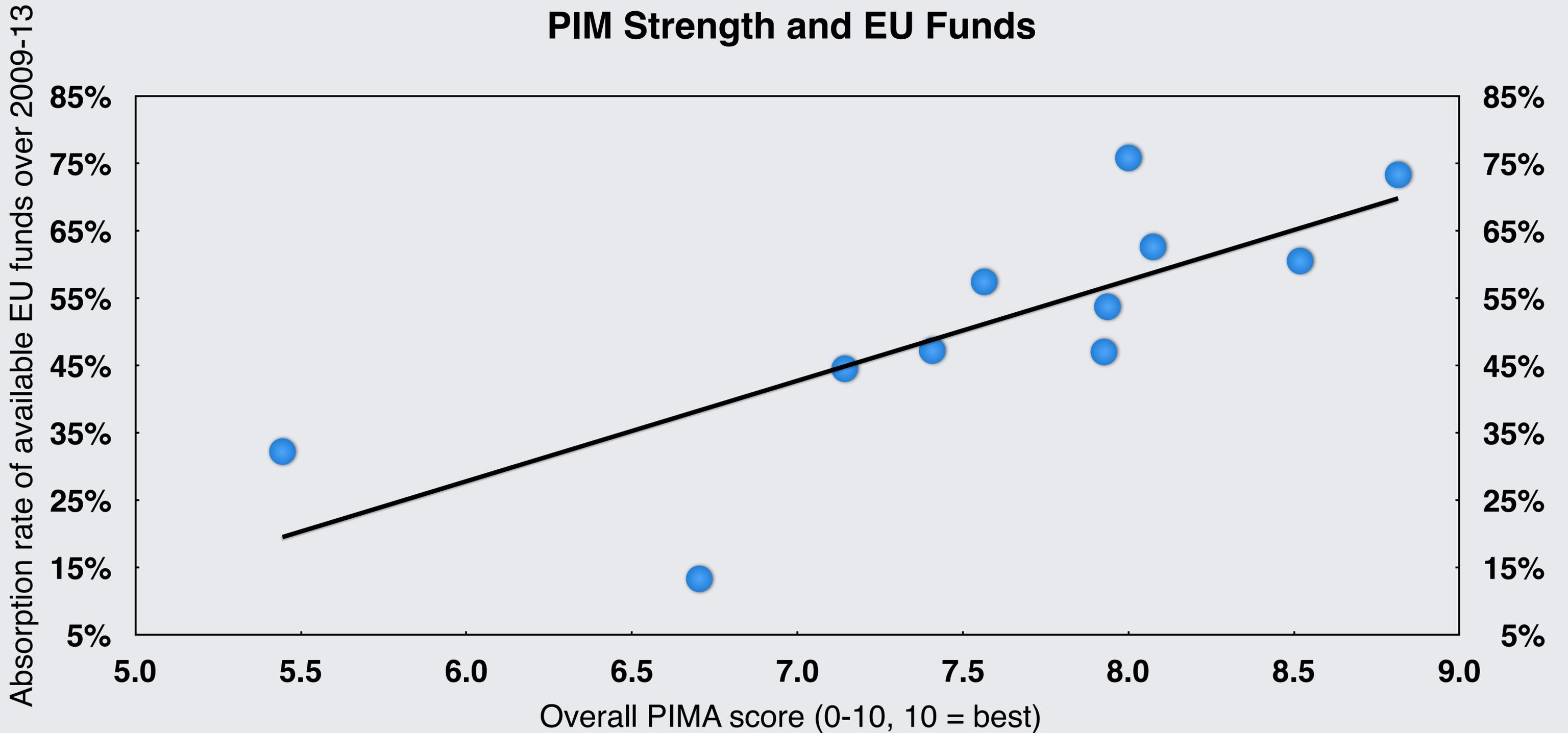


CESEE-EU could improve project appraisal and management

Strength of Public Investment Management (PIM) Institutions

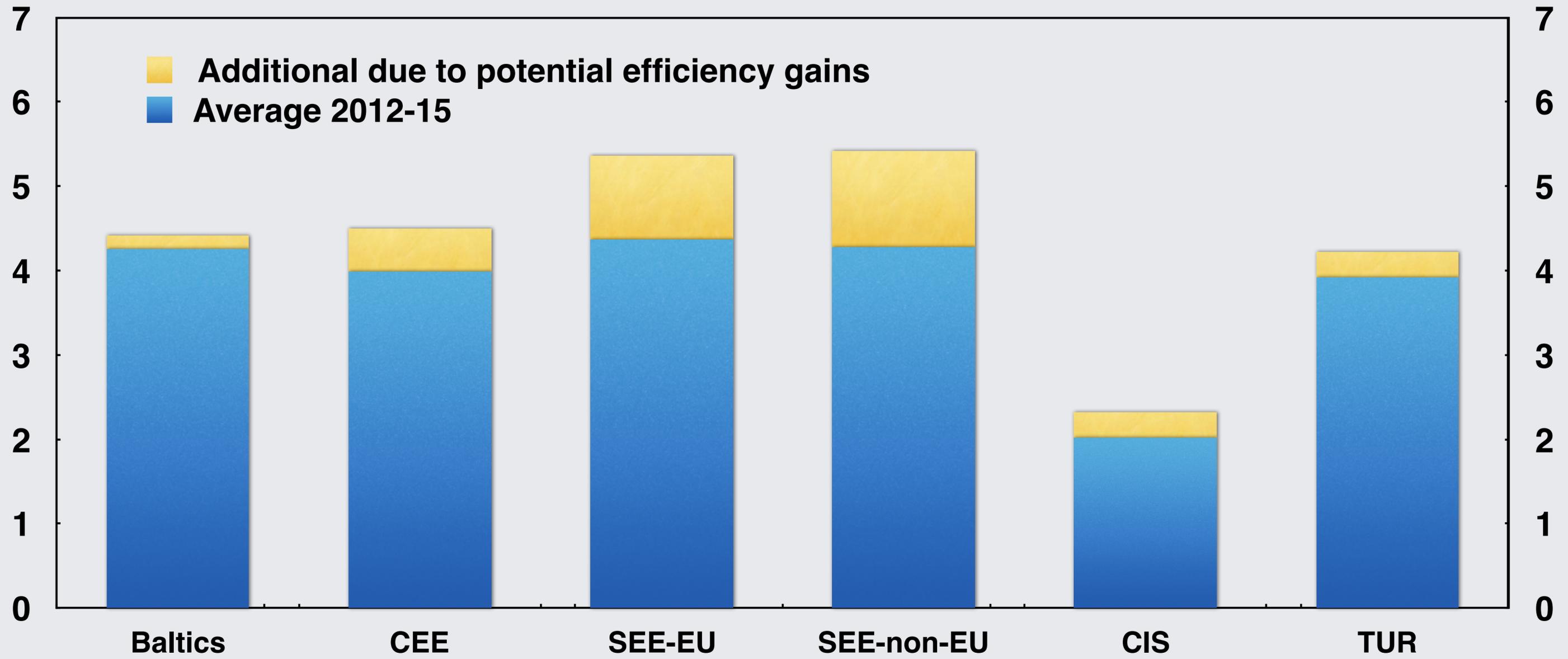


EU funds' absorption is higher in countries with better PIM



Public investment can be boosted by improving PIM institutions

**CESEE: Public Investment-to-GDP Ratio
(percent, 2012-15)**



Note: Efficiency gains refer to gains from moving to efficiency frontier for given income level.

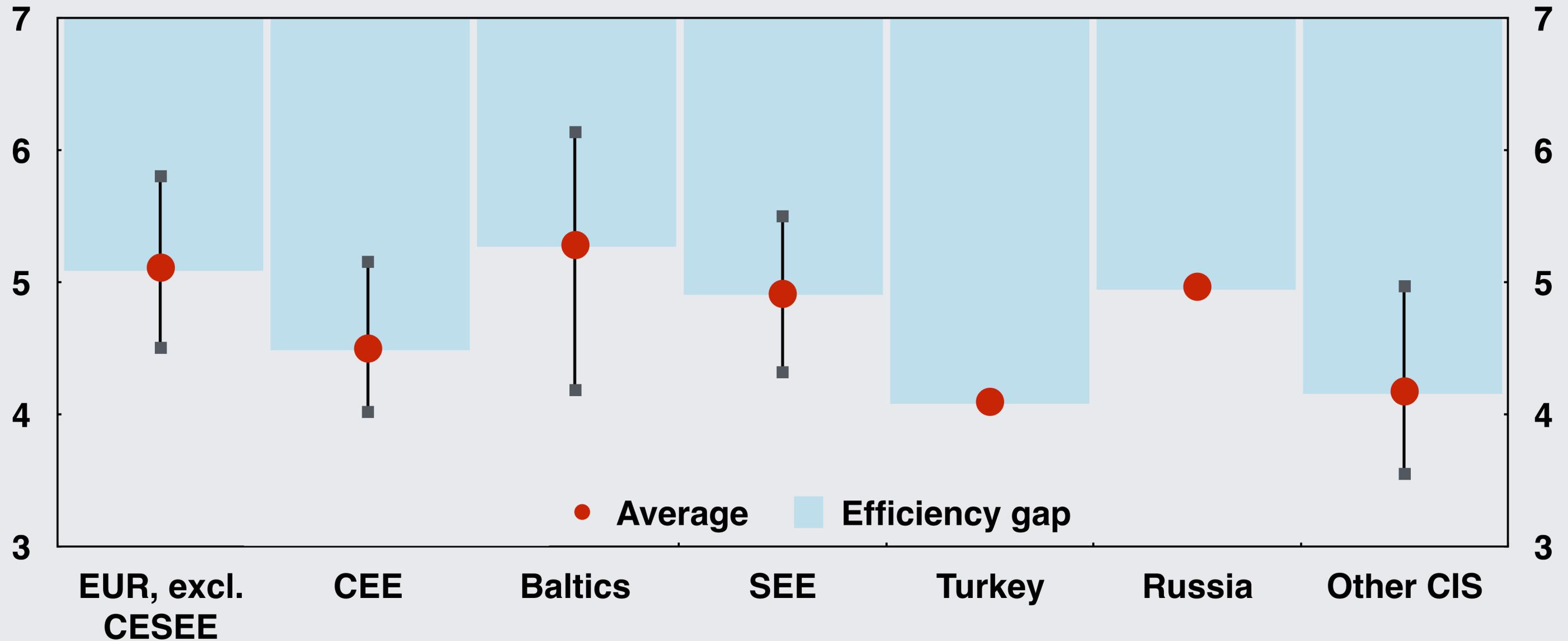


Tax Administration

Effective Government for Stronger Growth

Tax efficiency gaps in CESEE still sizable, especially in CIS & Turkey

Tax Efficiency (VAT, PIT, CIT)
(10 = most efficient)

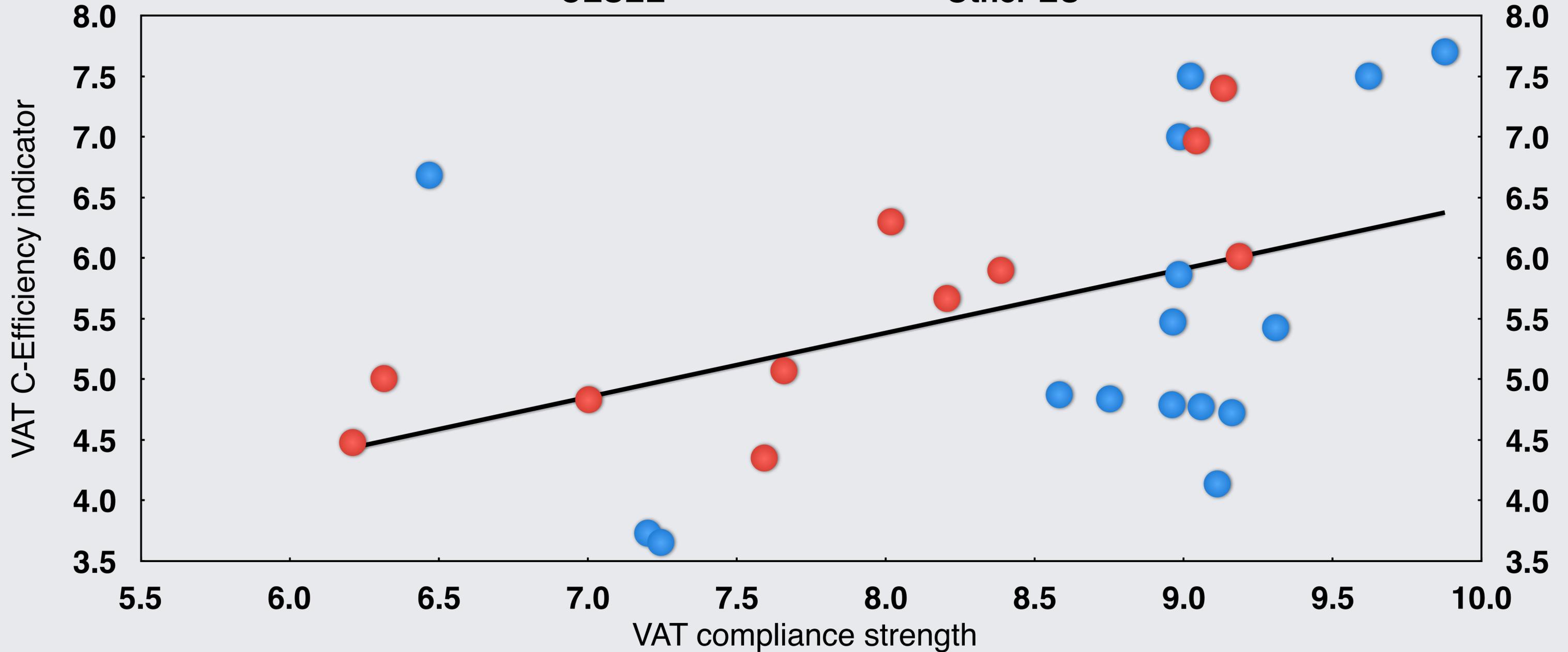


Note: Tax collection efficiency compares the revenue actually raised (for each tax) with that which could be raised if it were perfectly enforced and levied at a uniform rate on the full tax base.

...largely reflecting compliance gaps

VAT Efficiency and Compliance

● CESEE ● Other EU



How to assess the strength of tax administration?

1  **Institutional Arrangements**
Unified Body
Autonomy

4  **Human Resources**
Staff Formation
Staff Retention
Verification and Debt Collection Function

2  **Organizational Structure**
Functional Structure
Large Taxpayers Unit

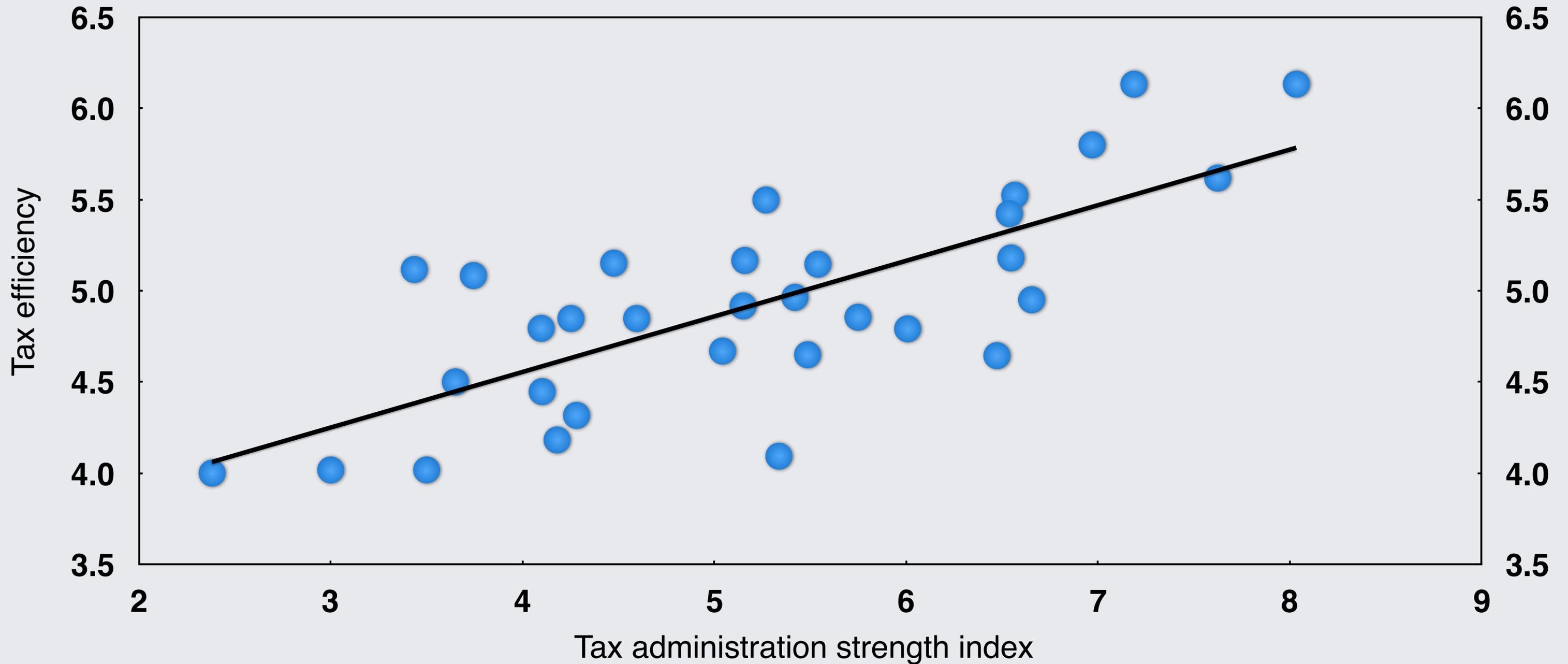
5  **Operational Performance**
VAT Refunds
Value of Completed Actions
Low Tax Debt

3  **Strategic Management**
Risk Management Approach
Identified Compliance Risk Areas

6  **IT/Online Services**
E-Filing (VAT, PIT, CIT)

Tax efficiency is linked to the strength of tax administration

Tax Administration Strength and Tax Efficiency



Large scope for improvement in HR, IT & strategic management

Tax Administration Core Areas (10 = most efficient)

Institutional Arrangements

10

8

6

4

2

0

IT/Online Services

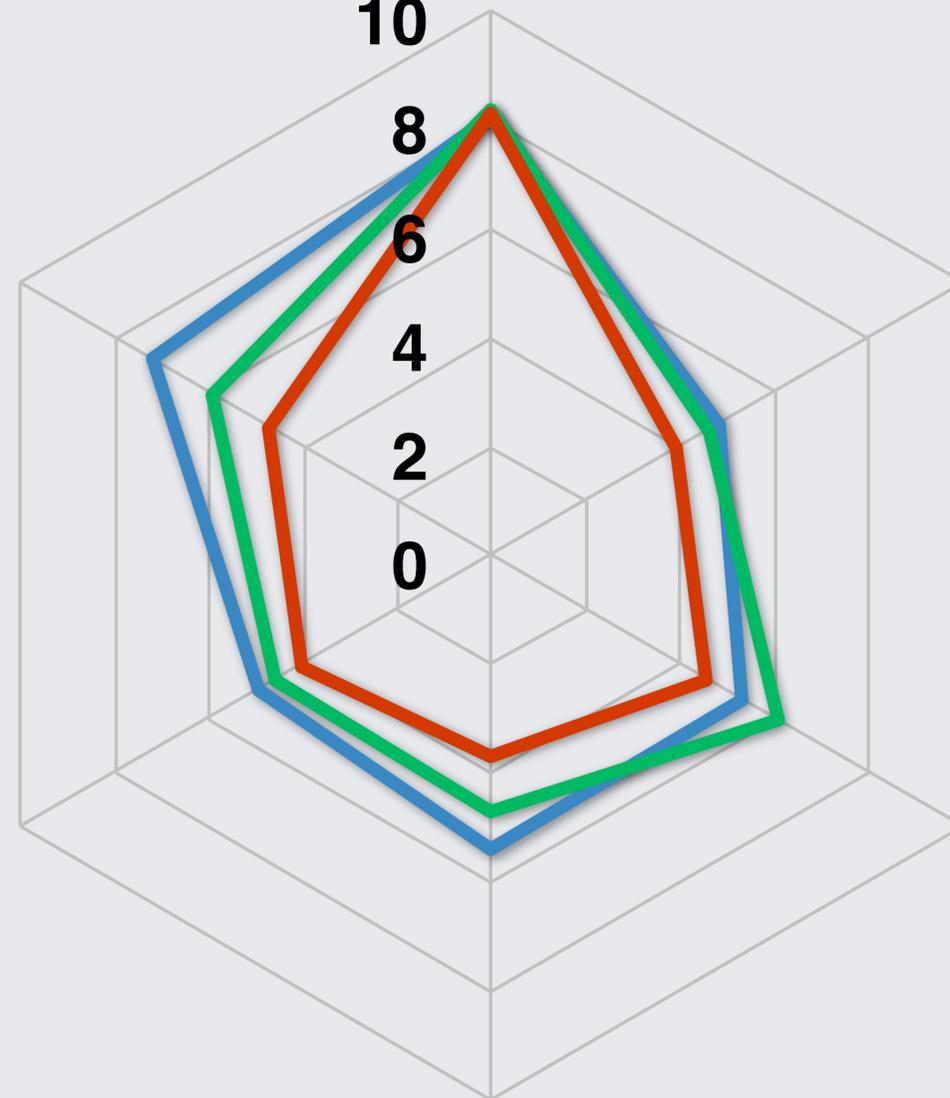
Organizational Structure

- EU excl. CESEE
- EU-CESEE
- Non-EU-CESEE

Operational Performance

Strategic Management

Human Resources



Case of Estonia: Overall strong performance

Tax Administration Core Areas (10 = most efficient)

Institutional Arrangements

10

8

6

4

2

0

IT/Online Services

Organizational Structure

— EU excl. CESEE

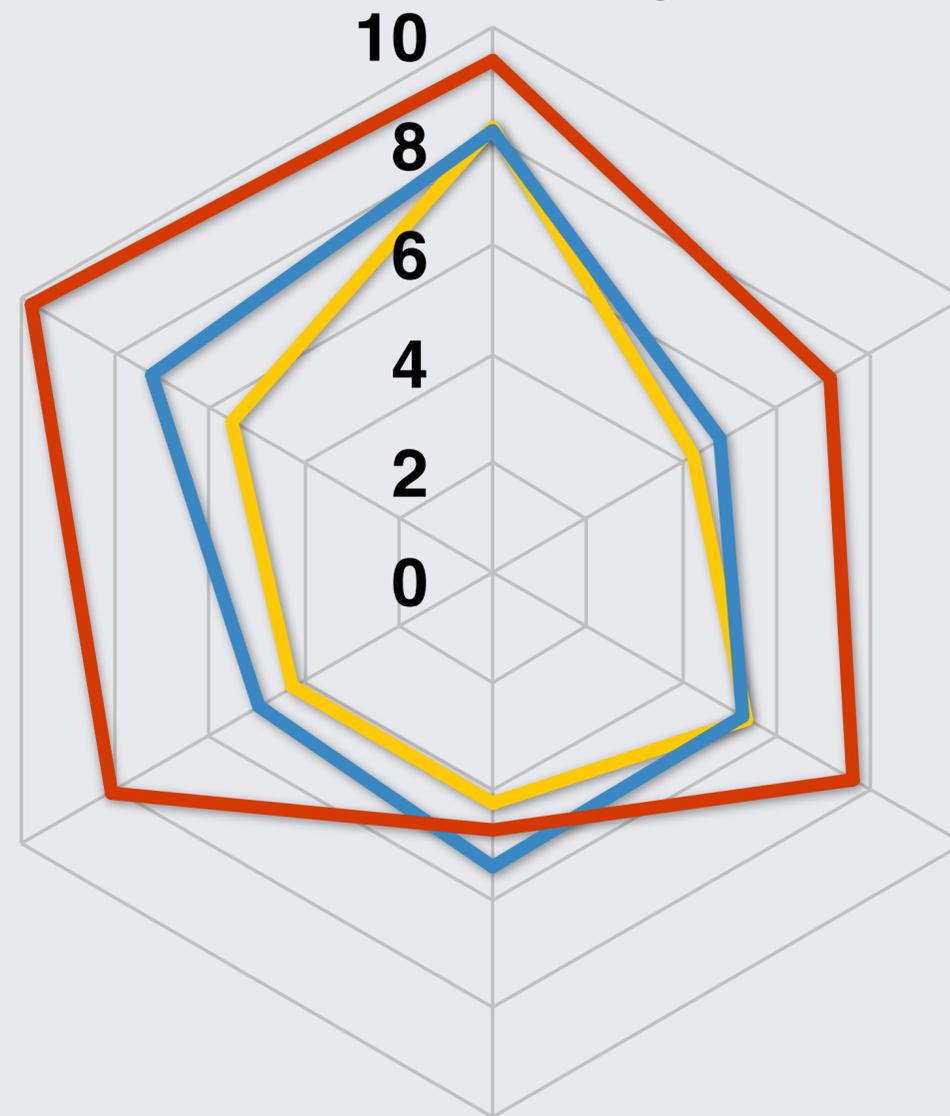
— CESEE

— Estonia

Operational Performance

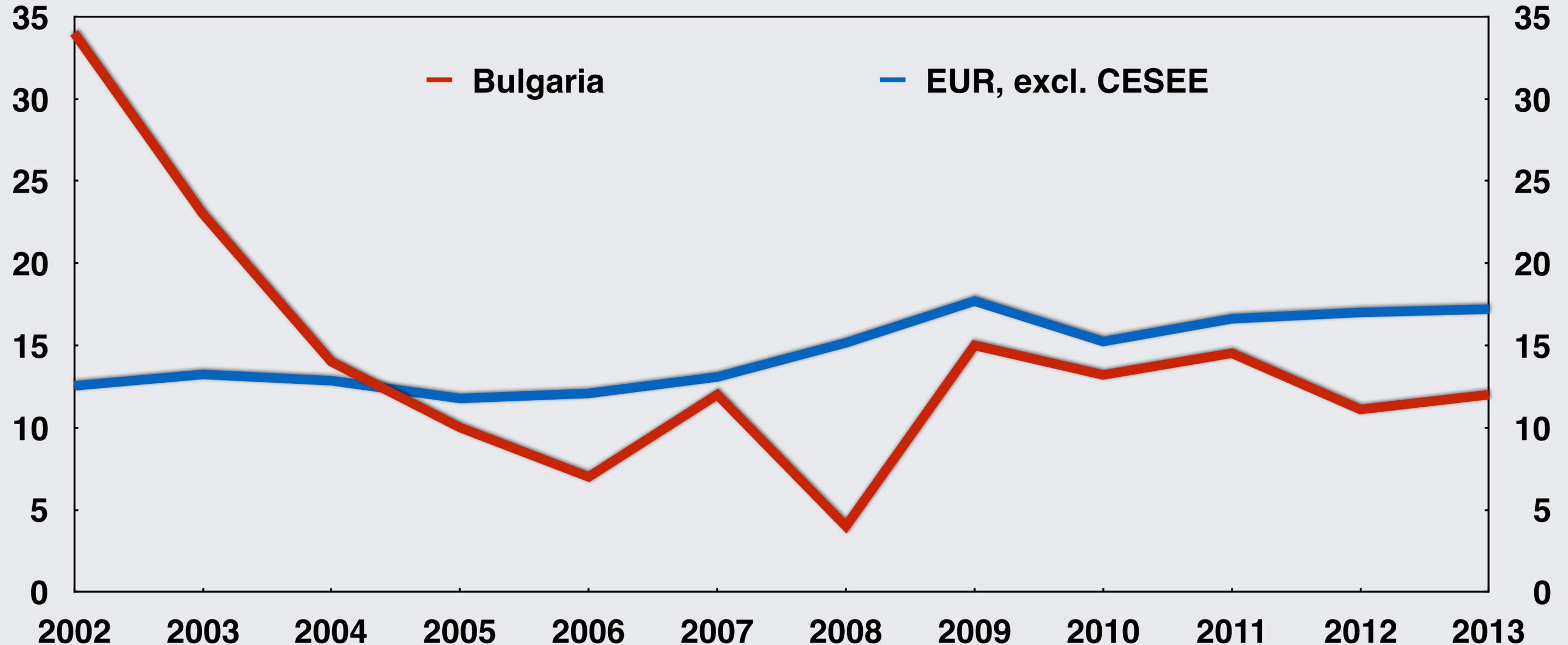
Strategic Management

Human Resources



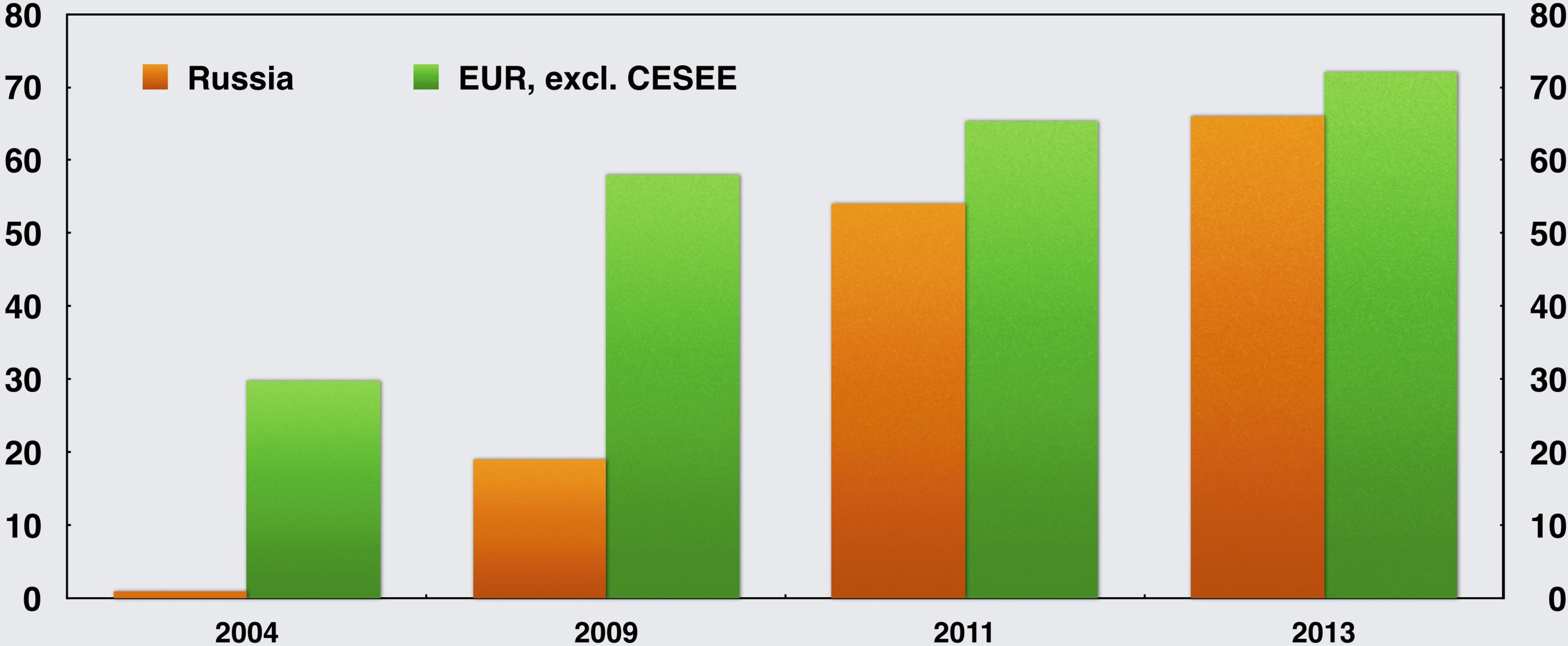
Case of Bulgaria: Improvement in VAT compliance

**VAT Compliance GAP
(percent of VAT collection)**



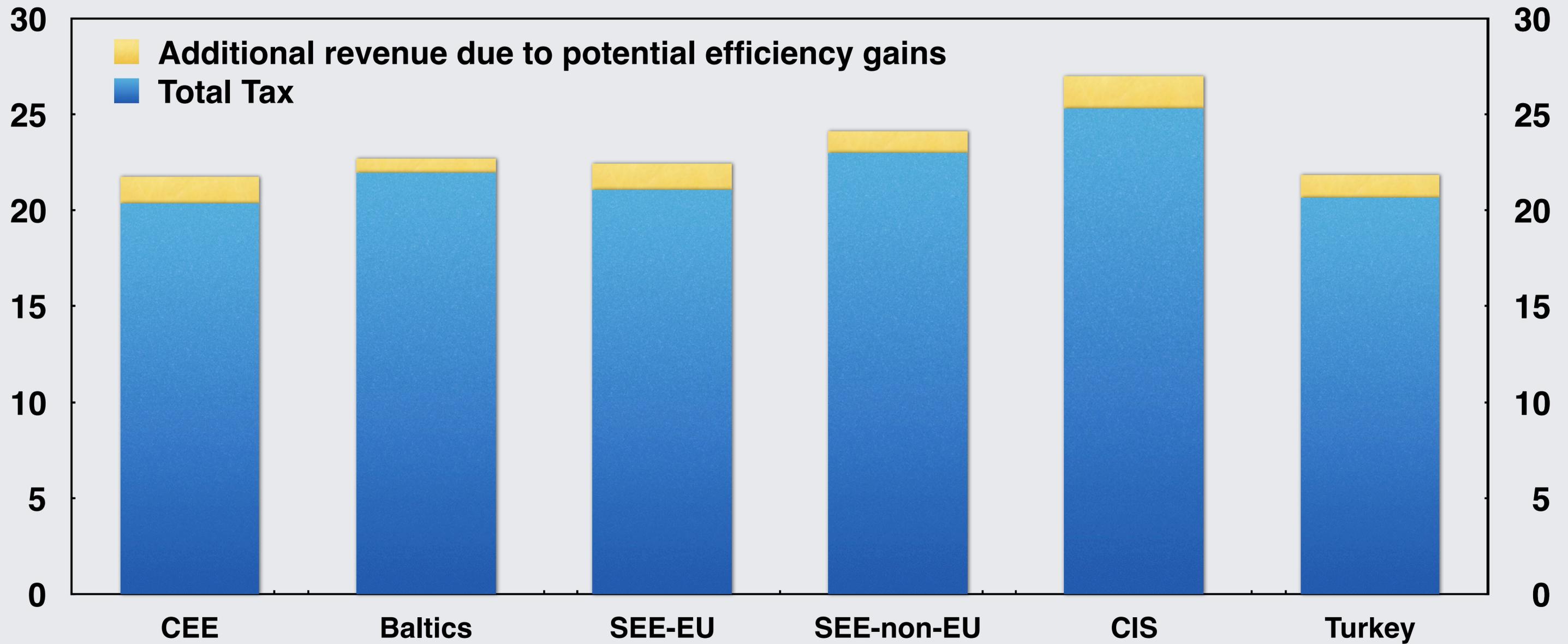
Case of Russia: Improvement in organization & IT

**E-Filing
(percent of total)**



Improving tax collection efficiency could generate sizable additional revenue

Potential Revenue Gain from Efficiency Improvement (VAT, CIT and PIT efficiency gains; percent of GDP)



Note: The benchmark for estimating efficiency gain is the average tax collection efficiency for each type of tax at different income levels.



Political Economy

Effective Government for Stronger Growth

Prevailing political institutions may constrain improvements in government effectiveness

The characteristics of political system influence incentives and ability of those in power to extract rents from the rest of the society

📌 Prevalence of patronage and favoritism in politics

📌 Quality of Bureaucracy

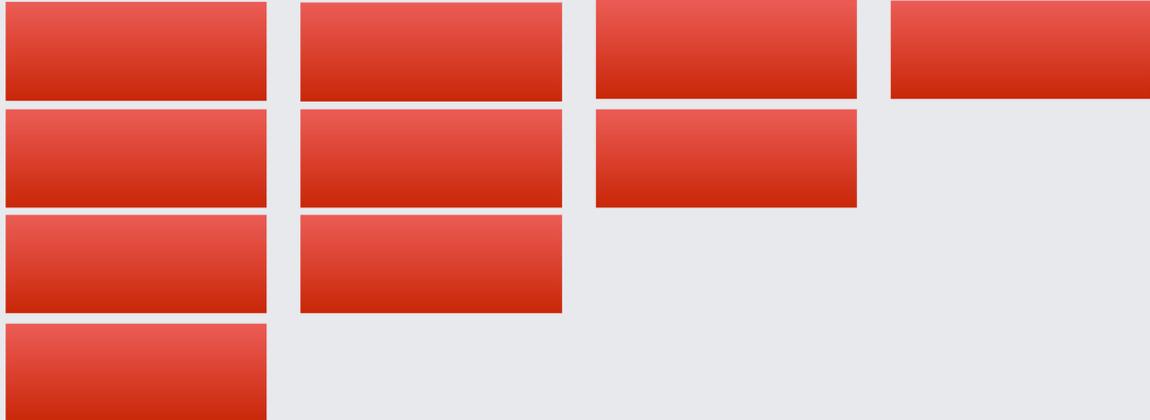
📌 Accountability

Political institutions and government effectiveness are correlated

Control of corruption in politics Quality of bureaucracy Accountability Constraints on executive

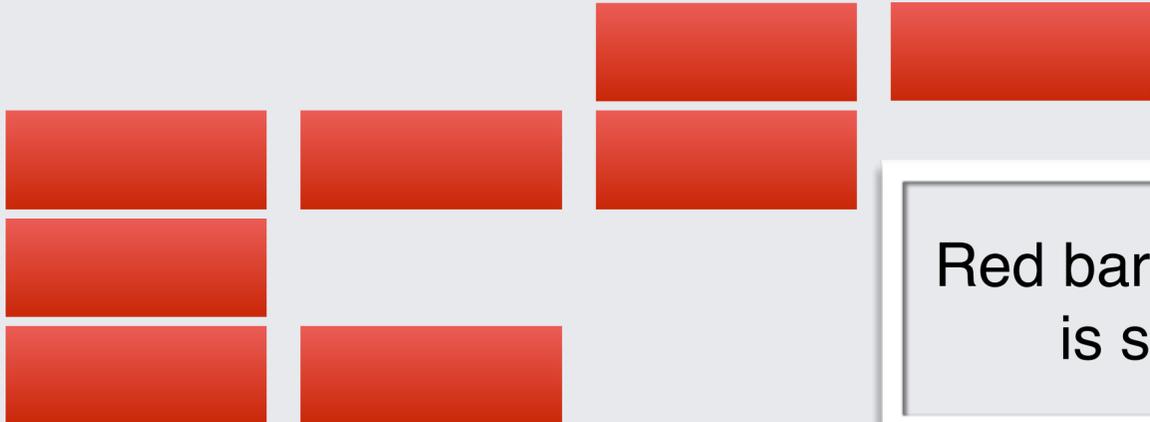
Public Investment Efficiency

PIMA overall score
Implementation
Allocation
Planning



Tax Administration Efficiency

Institutional Arrangements
Operational Performance
Strategic Management
IT/Online Services

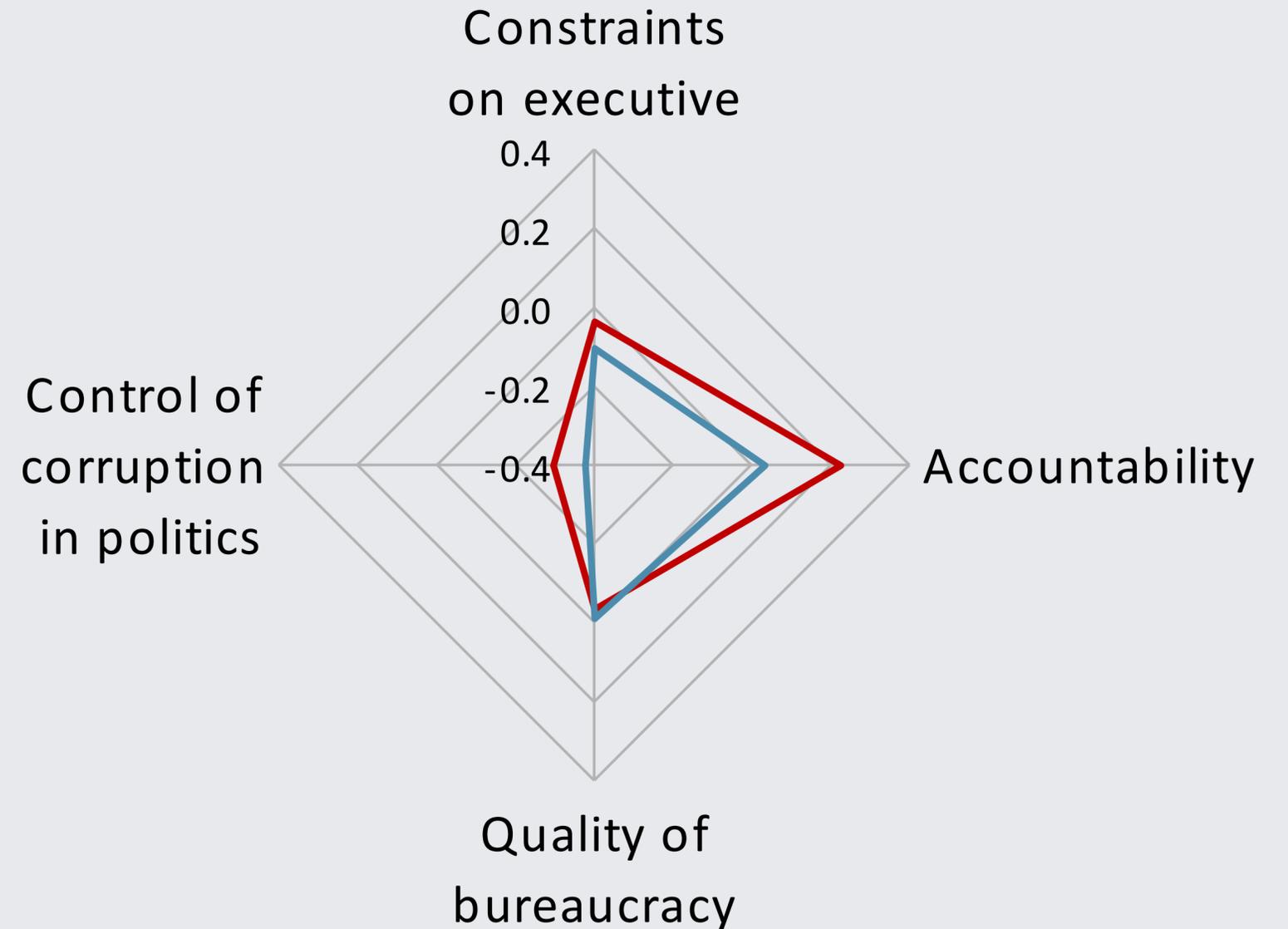
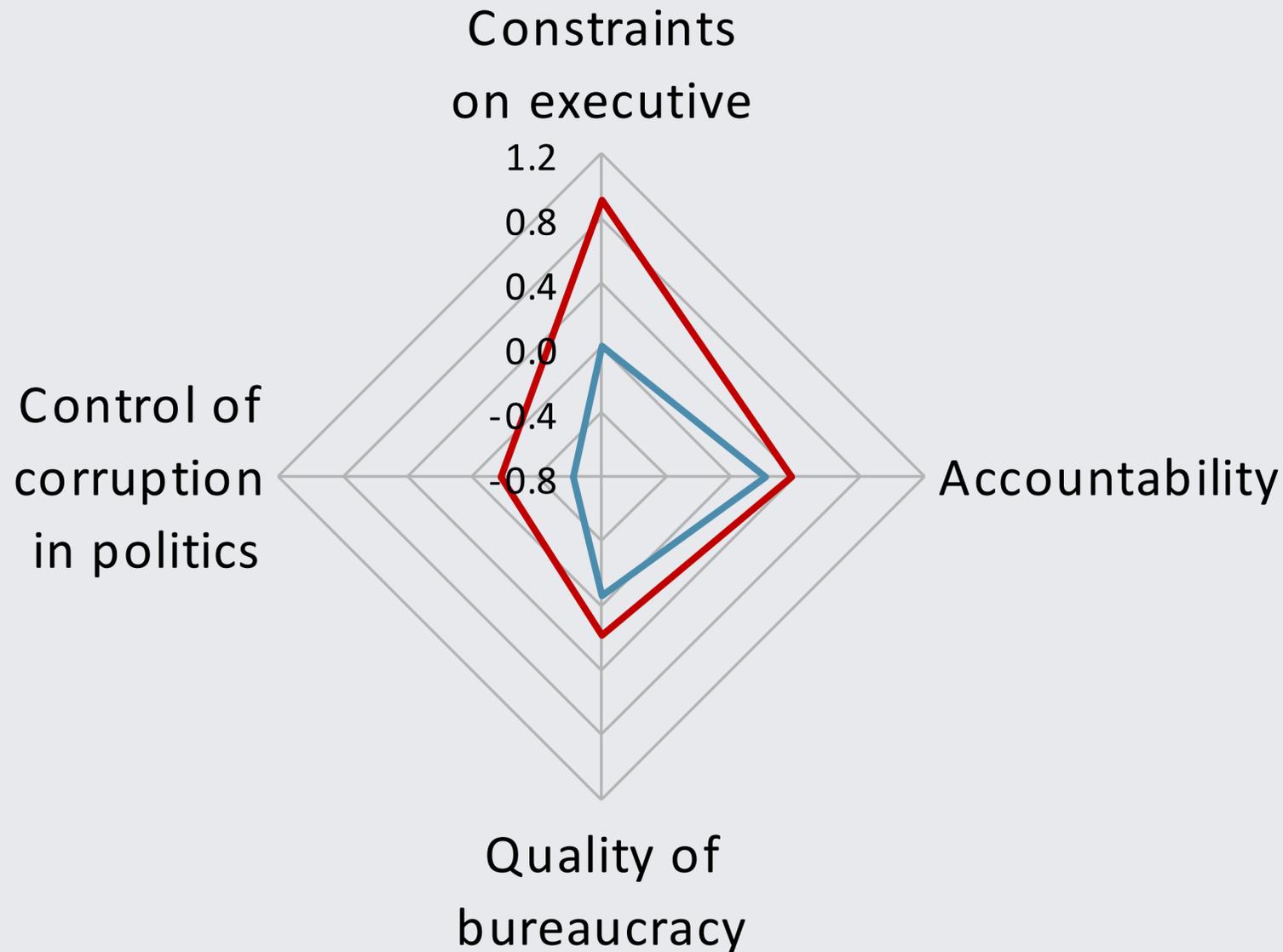


Red bars indicate that correlation is statistically significant

Reforms may face political economy constraints

CESEE and other EMs: Average Change in Political Economy Indicators (2000-15)

- Countries where tax administration improved
- Countries where public investment efficiency improved
- Countries where tax administration deteriorated
- Countries where public investment efficiency deteriorated



Conclusions and Policy Considerations

Closing efficiency gaps in public investment and tax collection (relative to benchmarks for given income level) could bring sizable benefits for CESEE countries:

- Between 2-4 percent of GDP in fiscal space annually over the medium-term
- ...which, if allocated to public investment, could eventually translate into 2-4 percent higher GDP

Further public investment management upgrades should focus on improving allocation and implementation frameworks and procedures

Further reforms of tax administration should focus on improving the organization structure, upgrading IT systems and strengthening strategic management

Improvements in quality of bureaucracy, control of corruption in politics, or accountability could ease political economy constraints to reforms