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The Problems for Post-Communist Countries in the Context of the European Union

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THE PROBLEMS FOR POST-COMMUNIST COUNTRIES IN THE CONTEXT OF THE EUROPEAN UNION

Contributors include: **Tim Congdon, Victoria Curzon-Price, Raul Eamets, Sebestyén Gorka, Silvana Malle, John H. Moore, Miroslav Prokopijevic Krassen Stanchev, Roger Sandilands, Ljubo Sirc & Jan Winiecki**
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Introduction

POST-COMMUNISM AND EUROPEAN UNION[1]

Andrzej Brzeski

At the outset of post-communist transition, my friend Enrico Colombatto and myself considered the perennial question, "Can Eastern Europe Catch Up?" Taking OECD Europe as the reference - the "West" - and assuming continuation of its historical growth rates, we calculated what it would take to halve, by 2030, the wide gap between the "West" and several post-communist countries. Our hypothetical projections yielded the required *per capita* GDP growth rates (in per cent):

Bulgaria	5.2	(1.3)
Czech Republic	4.3	(2.3)
Hungary	4.9	(3.5)
Poland	5.6	(4.9)
Romania	6.9	(2.0)
Slovakia	4.9	(4.3)

These estimates - or more appropriately, "guesstimates" - have so far proved overly optimistic. The actual growth rates for the 1993-2003 decade (shown in parentheses next to our figures) were considerably lower.[2] Since, however, the Western growth (1993-2003), when compared with our extrapolations from a more buoyant past, has also lagged, the overall conclusions about the post-communist catch-up potential are not critically affected, even though the post-communist tempo has accelerated in the last few years (e.g. in Bulgaria and Romania to 5% in 2000-05).

As we then wrote, "two categories of 'transition economies' are bound to emerge in the next few years. One will follow some kind of fast learning, accelerated convergence process, which will lead them to join the lower cluster of the so-called advanced countries. The other will be trapped in the LDC status, presumably characterised by repeated efforts to launch reforms, each of them doomed to fail, one way or other. Finding out which country belongs to which category is of course an empirical matter . . ."

If growth statistics are an indication, things are pretty much sorting themselves out along these lines. Poland and Slovakia, as well as Hungary are beginning to catch up with OECD Europe. On the other hand, Bulgaria and Romania - still largely unreformed and outside the EU - seem to be falling behind. Yet other post-communist countries, including the leader in liberal restructuring of institutions and policies, Estonia, are doing rather well; 4.4% average growth rate in the 1993-2003 decade. And so is, apparently even better, Latvia (4.7%). In stark contrast, the stalled reforms in the politically afflicted Ukraine, have brought a further setback: a negative rate of change in *per capita* GDP by 2.6% per year for the 1993-2003 decade. The Russian colossus - before the oil boom - has been apparently falling behind too during the same period (0.7%).

To varying degrees, the once communist countries have been ridding themselves of the ballast of the past. Their progress is reflected by the ranking according to the Index of Economic Freedom.[4] This measure - compiled for 2006 from fifty variables pertaining, *inter alia* to government intervention in the economy, property rights, and fiscal burden - compares 161 countries. The ranks are:

Estonia	7
Czech Republic	21
Lithuania	23
Slovak Republic	34
Slovenia	38
Latvia	39
Hungary	40
Poland	41
Bulgaria	64
Ukraine	99
Russia	122
Belarus	151

To put this in perspective, we must keep in mind that the United States ranks 9th, Germany 19th, Italy 42nd and France 44th. Considering the fact that in 1989 politbureau and central planners were still formally in charge of everything, the economic liberalisation in Central and Eastern Europe, while far from complete, has obviously progressed. A juxtaposition with the dismal ranking of Belarus and Russia - countries yet to free themselves of the *ancien regime* - confirms this.

Even the continuing presence of yesterday's *apparatchiks* in government and other positions of power has apparently not stopped the movement away from communism.

True enough, there was no catharsis. The sundry crimes and transgressions of the past have been mostly glossed over; the confiscated property has not been restored to rightful owners, etc. Nevertheless a new page has been turned.

How the EU will affect future developments one can only guess. It would seem that the once communist countries can only gain from more open markets, foreign investment, and, last but not least, the requirements of a pan-European political *savoir vivre* that the membership, and indeed mere proximity, impose. That said, however, the extent of the benefits will be determined by the evolving situation in Brussels and the European Union's major funding countries.

An increasingly liberal, private enterprise and market-based Europe with free trade and factor mobility cannot but benefit the former communist countries. The process of "Europeanisation" - a regional subspecies of globalisation—already afoot, promises rewards to all involved, even those still outside the EU. By contrast, a strengthening of European proclivities toward etatism, regulatory and redistributive excess and the like are bound to limit the advantages. Should such tendencies prevail, they may even set some of the post-communist countries back by encouraging native inclinations in this direction.

It is noteworthy that in all post-communist countries, including those embracing with genuine enthusiasm privatisation and marketisation reforms, the attachment to welfare state institutions persists. This is true even of Estonia which is otherwise closer to a Hayek-Friedman kind of an economy than Western Europe, or for that matter, the United States. Mart Laar himself, reportedly, "likes the health care and social services provided by countries like France."[3] The apparent turn to the right in post-communist Europe, notably but not only Poland, is likely to reinforce similar attitudes even, and perhaps especially, in countries that cannot afford them.

Recent turmoil within Hungary and Poland's government points to the importance of politics in further evolution of post-communism. If I can be forgiven for quoting another paper of mine (on Russia), in which I pointed out the "false, or better to say, misleading dichotomy... of economics and politics. Except on the level of pure abstraction the two are inseparably linked...'good politics,' i.e. consensual and stable government, presupposes 'good economics,' i.e. improving living standards."[5] But although - as pointed out in a recent econometric study - the "economic and democratic reforms are mutually reinforcing"[6], democracy, which is a part and parcel of the liberal order, carries its own perils for the economy.

Monetary issues, in particular that of the euro, require special consideration. Obviously, the putative unification runs afoul of discretionary national policies. Given the political

pressures on the central bankers of the various countries (e.g. Balcerowicz) this is probably good, since as long as the Maastricht rules are in force, the scourge of inflation is more likely to remain under control. But perhaps a commitment to free currency exchange would suffice instead. In any case, with one or two exceptions, the adoption of the euro is not on the immediate agenda in the post-communist countries. And indeed, as the Italian case suggests, its future in the EU is not fully assured.

1 A. Brzeski & E. Colombatto, "Can Eastern Europe Catch Up?", *Post Communist Economies*, Vol. 11, No. 1, 1999.
2 From The Economist, *Pocket World in Figures*. 2006 Edition.
3 J. Thierny, "New Europe's Boomtown," *New York Times*, September 5, 2006.
4 Marc A. Miles et.al, *2006_Index of Economic Freedom*, The Heritage Foundation / *The Wall Street Journal*. 2006.
5 A. Brzeski, "What Prospects for Post-Communism?" Working Paper No. 14195, ICER, Torino: 1995, p. 7.
6 R. Murphy *et al*, "Economic Reforms, Democracy and Growth in Eastern Europe and Eurasia", US Agency for International Development. November 2005.

First Session, Part I

Scope for Further Privatisation in Old Europe with Lessons from New Europe

John Moore: Welcome to everyone. We shall be discussing "The Problems for Post Communist Countries in the Context of the European Union". I look forward to some interesting discussions over the next two days. As everyone knows, Bulgaria and Romania have acceded into the European Union. This means, I believe, that only five states of ex-Yugoslavia remain without. Now the EU claims to be pausing. If this is so, this situation is likely to continue for some time. I think much of the discussion that we have in this conference - and any conference dealing with the EU - is relevant to the non-members as well as to the members, especially in considering their options about the EU. The impact of the regulatory burden on economies, the implications of harmonisation for economic development, the meaning of the EU common policies for sovereignty, for culture and so forth are questions of great importance. We shall be talking mostly about economic issues over the next couple of days: privatisation, finance and banking, labour, competitiveness of some of the individual countries, etc. We shall have an interesting time.

The value of this conference will depend as much on the discussion and comments offered by the participants as on the presentations themselves. The presentations of course are the key, but I urge everyone to join in the discussions freely so we can derive maximum focus. I will now turn the programme over to Natasa Srdoc who is our Moderator. Natasa is well known to many people here. She is perhaps best known as the co-founder and President of the Adriatic Institute for Public Policy in Zagreb, which is one of the leading free-market think-tanks in the region. She is also a businesswoman and an entrepreneur, which I guess fits in with the idea of starting an institute like the Adriatic Institute. With that Natasa, over to you.

Natasa Srdoc: I am honoured to be here today amongst you all. I want to thank Dr. Sirc for inviting me to moderate the session on entrepreneurship. Our first speaker today is Dr. Victoria Curzon-Price, whose presentation will focus on the scope of further privatisation in Old Europe, with lessons for the New Europe.

Victoria Curzon-Price: Thank you very much Natasa, and thank you Ljubo for inviting me. This is my first trip to Slovenia and I am looking forward to getting to know it better. It is another small country getting rich.

The topic of my paper is "Further Steps Along the Road to Freedom". I come from Old

Europe, so I will start there. There are a couple of interesting questions. We recognise that around the beginning of the 1980s, there was a spate of pro-market reforms in the West, starting with Thatcher in the UK, and spreading out. We see this being imitated in New Zealand, the Republic of Ireland and Spain. Free market policies have spread. Why at that time and not another, and what is the process? You also had China putting more liberal ideas into operation at that time. Gorbachev - obviously being pushed in a very rigid environment - is by 1986, proposing *perestroika*, which is amazing. There is something in the air at the beginning of the 1980s. Another question is why has this petered out? Why has this process suddenly gone into the sand? These are the two issues that I shall address.

With regards to the first, 1945 is a good place to start. It is then that the European maximalist welfare state was conceptualised. It was a maximalist welfare state that was universal; it covered the whole population. It had to be monopolistic, as you cannot offer security to the population in an egalitarian mode if you allow individual suppliers onto the market. They will start offering different products, and you do not want that. It was egalitarian, and comprehensive. In other words, it covered as much of the economic territory as it possibly could. You start with the obvious things like health, education and pensions. You then nationalise the railways and make sure the postal service is under your control. You want to nationalise the means of production - this phrase is unfortunately very familiar: you want to cover a maximum. You have learned, thanks to Lord Keynes, that you can compel this and control the economy, have full employment, equality. Why we went for a maximalist welfare state is quite simple and clear - it was a Utopian dream. The debate between Nietsche and Oscar Agger was only ten years old at the time. We did not know that states were bad managers. We had not yet had the experience. We also had the competition of another Utopia, which was being offered by the Soviet Union. Full employment, abundance, and equality. If you have that on offer, you have to come up with an equivalent product. I think that is what our politicians did in 1945. They thought they could offer a Communist dream without entirely getting rid of the market economy, but controlling vast portions of it.

Fast-forwarding, we see for a while it works. But remember the very controlled environment. International trade in Europe was reduced to a pittance, within quotas. There was no foreign exchange, so no means of international payment. You had exchange controls, price controls, wage controls. You had to have all this because the trades unions were forcing labour costs way above productivity. You needed some way to control wages, and then to control prices. It was a controlled economy to all intents and purposes. Then, in 1948, the Marshall Plan arrives and – oh dear – conditionality. The United States generously offered the Marshall Plan but said markets must be opened up. With great trepidation, and no confidence in the outcome of this dreadful policy being imposed upon

us from outside, our timorous leaders enlarged the quotas a little bit, formed the European Payments System and encouraged trade. This was the first crack in the edifice.

I fast-forward again. Let me just say that there is nothing in neo-classical economics which justifies the maximialist welfare state. The most you can get out of neo-classical economics, even if you are of the Left persuasion, is a problem of monopoly – natural monopoly – to market failure. The second is externalities. Again, with public health, people always say externality. I can see that with contagious disease, but if I have appendicitis that is a very private matter. Health is a private matter, with a little bit of externality, possibly. It is the same with education, which is not a public good in any way. All you can get from neo-classical economics is support for the good things such as health and education. As for pensions, you would have to argue for a long time to convince me that normal, conscious adults are incapable of providing for their old age. It really does strike me as being bizarre. You cannot squeeze a justification out of neo-classical economics for the maximalist, egalitarian, welfare state. You have to move to politics, and a desire for equality or, as our social theorists say, equity. I avoid the term equity. There is something deeply unjust about equity. Should everybody be paid the same thing, no matter what they do with their lives? I prefer equality or egalitarianism: everybody should have the same income basically. This is where it all comes from; a passion for equality.

We did not know in 1945 that there was a trade-off between equality and wealth creation. But today we have no excuse. Thatcher appeared on the scene in 1979 and, if you look at the memoirs, it is almost quaint what she had to do. The first thing she was to liberalise policies, to let wages be determined by markets, cut public expenditure and abolish exchange controls. Nobody has gone back to that world, and that is immense progress. Nobody even thinks of returning to wage and price controls. Has the process of liberalisation slowed down? I would say yes, perhaps. But, in a sense, it has to slow down. This is a Hayekian comment: You need a pioneer to go out and do something. Mrs Thatcher was that pioneer. There were a few shoots beforehand; there were the Chicago Boys in Chile, but that is so far away it did not really have an impact on our part of the world. Thatcher had a true impact on the rest of Europe, and then the world. So, the pioneer is there. If you look at history, it was a very close call and could have come unstuck at any time. I would argue it was an historical accident, almost. The reason Mrs. Thatcher was able to pursue her policies was because the British economy was in dire straits. Statism was failing not just in Britain; it was not working anywhere. People were beginning to look for an alternative, and here comes the pioneer, saying, "I have an alternative". Then others start imitating. There is a difference between the initial moment of the pioneer showing a new path, others tentatively following, and then – gradually – the whole thing spreading out through a process of Darwinian natural selection of policies that

actually work. That takes much longer as you need experience. People are not going to be led by ideas but by experience. That is what we are witnessing here.

The other thing I will point out is that, unfortunately, Lady Thatcher was unable to finish the programme. There was a whole lot of the welfare state that remained intact. All she managed to do was to get the private economy back on track; liberalise prices; privatise industries. But the welfare state remained. We still have it, and it is a killer. The easy part was to privatise and sell off the British steel industry, because people were not very attached to the steel industry. Fairly attached, but not very attached. But they are very attached to the National Health Service. The French are very attached to their securité sociale and I am sure the Germans are equally attached to theirs. You are entering an emotional part of the spectrum, and there it is much harder. It will collapse of its own weight – obviously, we are seeing this now – it is just a matter of time. People say there should be a second Mrs. Thatcher, but there will not be. We have to wait for this rather long-term evolutionary process of trial and error and adoption of policies that seem to be working. Think-tanks help by spreading the knowledge of policies that work in other countries. All this takes a lot of time. In 1979-1985, these crucial years, the state was collapsing. People therefore realised that the state was not a good provider of goods and services, but they had no belief in markets. The corresponding belief does not come. You end up believing in nothing at all. The positive belief in markets is, to this day, by a very small minority of people and that is a problem we should discuss. Societies are dragged, most unwillingly, into market modes. They are glad when it works, but they very seldom wish to acknowledge that it has worked because of markets. That is another reason why it takes time.

I will talk now, very briefly, about the next steps on the road to freedom. Obviously they are in the area of the welfare state. Support for agriculture is dying out, and I presume will disappear, but the welfare state remains. You could introduce horizontal competition here quite easily, without changing any laws. First, somebody has to come in and instruct people to outsource everything they possibly can. Outsourcing is extremely profitable for companies, and it should be just as profitable for governments. You could give contracts to foreign firms who could provide all sorts of services. I wish the British National Health Service could outsource hip operations to Thailand. You could outsource an awful lot without changing the nature of the beast, you just introduce competition. Then there is vertical competition; taking slices of the system and giving them over to the market. That is much harder and requires laws. I must say, the comprehensiveness of the Western European welfare state is already under attack, because of the sheer incompetence of the state as a provider of services. You have private schools springing up and they survive, although there is a free alternative. People will bleed themselves to financial death to avoid the free education provided by the state. They will take out private health

insurance. We live in a free society, so this should slowly work itself out too. In the meantime, it seems to me, all you have to do to sell the idea is to abandon universality. Acknowledge that the rich do not need free education – they are rich enough. Why should the rich get family support? Let us means test all the welfare state goodies. If you then support them, you do so with vouchers on the demand side. You select the people who get the vouchers depending on their level of income. I think you could sell that as a political programme. It would cost much less than a universal system. The logic is that, if you select the free goodies available to the poor, then, by implication, you have to let the rich choose their suppliers. You cannot have it both ways. It seems to me that this could be a possible way to undermine the universal welfare state on a perfectly logical, cost-cutting basis. If the voucher system was adopted for health and education, you would very soon get horizontal and vertical competition.

Natasa Srdoc: Thank you very much for these in-depth issues. I would like to open the floor for questions, but let me use my prerogative as moderator to ask a question. It is very interesting how you have suggested a means-tested voucher system. This is being proposed in Croatia and other countries as well. The issue is; how do you test and keep liberty and freedom, and privacy intact. The recent proposition was to have the asset price for all the citizens which would have to show how much every person possesses.

Victoria Curzon-Price: I think, unfortunately, we have given up our right to privacy in most countries when we adopted universal income tax. The state knows exactly what is going on. Your government can look into your bank account most of the time when it wants to. You have no privacy anyway - you have given this up a long time ago - so this is a false debate. I would just use this lack of privacy to better ends. The only country in the world that does respect people's privacy is Switzerland, where the state does not know what your bank account contains, – you are obliged to make a declaration each year of your assets, but they have no way of checking it. That is freedom for you.

Miroslav Prokopijevic: After the Second World War – what was the largest privatisation we knew of? It was British Steel in about 1956; in Germany it was Volkswagen at the beginning of the 1960s. You look at the situation now, and you find it is not just this welfare programme. You find the Italian banking market completely closed, with no foreign banks there and huge state-ownership in the banking sector in Italy, and in Spain. The EU agrees energy should be privatised one day. Some countries do that 100% and France does it, let's say, 20%. In Eastern Europe there are places like Estonia that are interested in privatisation, and then you find welfare states like Hungary and Slovenia that actually smuggled socialism into the EU. Since there is a lot of socialism in the EU, there are different troubles to be faced. Simply, a lot of sectors are not privatised, thus we have huge state expenditure and budget deficits.

Victoria Curzon-Price: I think what you have said just illustrates the fact that this is an ongoing process. It does not surprise me at all that the French should be the last to privatise *Électricité de France* and *Gaz de France*. They have split the two, which is something. But of course they are most reluctant to make any changes. The Italians are hugely nationalistic but they are not the only ones. I deplore it as you do. On the other hand I would equally deplore a state in Brussels that would have the power to force the French to smarten up, I would deplore it enormously. I would rather have this loose system – I wish it were looser in fact – that allows countries to do as they wish. On their own heads be it. If they want to be dumb, so be it. There is no law against committing economic suicide, which is what the Germans, French and Italians are doing. It gives everyone else an opportunity, so that is fine. Then you say Estonia is doing well but Poland and Hungary are in a terrible state. Well, on their own heads be it. It is a free world, and thank goodness Brussels cannot tell you what to do; it is your own responsibility. As for the Growth and Stability Pact, I think it is of no surprise – in fact I will be very interested to know from Tim Congdon whether the euro is going to survive. I do not think these clever leaders can stop it. The cat is out of the bag: markets work. The countries that fail to see it, and whose electorates continue to vote for ex-communists will suffer, but then that is right and proper. That is the only way in Hayekian terms that you get the experience. There is no other way.

Sebestyén Gorka: But that presupposes the understanding of markets as alternatives. This is not the case in our part of the world. In Central Europe it is not "the system is failing and we should look to the other option", because the understanding is that markets are immoral. As a result it is not seen as an alternative, so the natural Darwinian process you described is not occurring, and that is a big problem.

Victoria Curzon-Price: You have raised the fact that the population sees markets as immoral. That is a question about how you introduce the rule of law in a country that has never known it. Indeed, that is a question that worries me. I know that in Western Europe the rule of law was discovered many, many centuries ago, and it is not something you just say, "let us have the rule of law". However, it seems to me that most countries now have laws on their books that protect property. Ljubo Sirc knows something about this. You had laws. What you need are courageous people to take cases to the court and use the court system because it is there, and work their way through. But not just one person, you need hundreds of people to make sure their property rights and human rights are respected. It seems to me that that is the only way you can get around this idea that markets are immoral. Markets are immoral because the system is corrupt. There are laws against this, but nobody takes the cases to the courts. So you need to have, and I think it is one of the things that think-tanks could be involved in, and certainly all these do-gooders

like Bill Gates could possibly offer a bit of money to, to support people with their struggles through the courts. And you need simply hundreds of cases. You need, whenever a corrupt judge hands down an iniquitous ruling, to have further appeals, and to alert public opinion and to fight. Nobody is fighting for the rule of law in your country. It needs money, I agree, and that is why I think one should go to Warren Beatty and Bill Gates and say “don’t give people mosquito nets, help them install the rule of law in their countries.” It takes a long time, but the morality question is that; it is eliminating corruption from the system.

Ljubo Sirc: I wrote a letter to that effect to Bill Gates, but alas did not receive an answer.

Tim Congdon: Victoria said that these societies are collapsing, and the societies with state organised health and education systems. She also mentioned that France, Italy and Germany are committing economic suicide. What seems to have happened since 1945 is that these European states have had public sectors, and really since the 1970s with spending over 40% of GDP, and some 50% of GDP. Life has gone on perfectly well and people are happy with it. We must not kid ourselves that people are unhappy, because they are not. Having said that, I regard these societies to be profoundly inefficient relative to what could happen, and would be much more efficient if, in particular health and education were entirely privately supplied. I think the question I would like to raise is “what is going on here?” The problem is we are mass democracies and one just cannot get around these politicians who are going to promise they are efficient at providing certain services. They will persuade people and they will get votes. I think it would be much better if one was to ask why is it that the State is involved in supplying health, education, welfare state, pensions and so on? And one motive, back in the 1940s, was efficiency.

What many people in the 1940s believed was that communism was efficient. They believed that because of propaganda from Russia, and the Great Depression also dented the reputation of free-market capitalism. So, in the 1940s many people, sitting around tables like this, thought that state supply was efficient. It took 30 or 40 years for that illusion to go. But there is another motive: redistribution. It is part of mass democracies that you are not going to get the state redistribution more than 15-20% GDP – this never happens anywhere for all sorts of good reasons. All that states should be doing is helping the less well off pay for health, education and some accumulation of assets, and leave the rest of us alone. A final point, you say that education and health state systems are universal, but they are not. They are still free societies, and you have a rich minority who can pay education and health privately. In my own country, in Britain, this is very divisive. The top 10% have got private education and health; they have over half the wealth, more than a third of the income – they dominate society in any meaningful sense.

That is profoundly unfair. I think it much better if we have societies where everything was private, and it was straightforward that the state was helping the less well off. It was there just to redistribute.

Victoria Curzon-Price: I said the welfare state is collapsing, not that the societies are collapsing. The welfare state is under attack. Universal undifferentiated welfare – as it was in 1945 - is changing even in France, although it may not look like it. State pension systems are being reduced, encouraging people to save more and work longer. People in France have their private insurance as well as their public insurance for medical purposes. You have no private education system at all in France to speak of, because the state education system is not bad. You are right in that, but it is not the same in Italy; each country is a bit different. But this universal, monopolistic welfare state is disappearing under our very eyes. I think we agree. I did not say the state was collapsing, I said the system of welfare is changing. I will be less extreme and say it is changing, and changing quite fast. These are rich societies, with the rule of law, and they have markets so they are not going to collapse. The economies are not going to collapse, certainly not. In fact, you move around and find that Paris is a nice city to be in, and these are wealthy societies, I quite agree. I think our role is to offer a dream that says you can keep all of your own money to spend as you wish. At the moment, if you are supporting a welfare state – even those on modest salaries have to give over 40% of their income to support the welfare state – and with not much in return for this money. Surely you would prefer to have more freedom to spend it. I think that could be a vision that might work. But I agree with the comments about redistribution in mass democracies. You have got your 51% that want to tax the 49%. It is unfair, divisive and iniquitous.

John Moore: Two quick points about what passes for a welfare state in the US. First, to illustrate the point it dies hard, social security is referred to as the third rail of American politics – a politician cannot touch that without being poisoned. There have been unsuccessful efforts recently to try to revise it. On the other hand we have recently introduced this enormously costly prescription drug programme, for Medicare recipients. That was a year ago and this year already they are introducing a means test, which is rather interesting.

The issue I wish to raise is one you mentioned in passing - why people are opposed to markets. Why do people not like markets, why is it difficult to introduce markets and why markets are always under attack? I offer a few possible reasons. First, people do not like competition. They like to think, erroneously of course, in a non-market economy they will not have to compete. It is not true of course; competition is just channelled in a different way, but still there is that belief. They like security. It has been proved time and again that, unfortunately, people will trade liberty for security. Another reason has to do

with the public choice angle. Politicians do not like markets because they tend to restrict their power. They lose power when markets are introduced because they do not have the allocated authority any more. Unions do not like the markets either, of course. Fortunately our unions have lost strength over the last 40 years, but unions like the National Education Association – the teachers' union – still remains a powerful force against the introduction of private education in the United States.

In democratic societies there many ways for politicians to form interest groups, and get people behind them and win these battles, even though if you took an opinion poll or a vote of the whole populous they might, in spite of these other factors, be in favour. There is an egalitarian ethic that is pervasive and very hard to get rid of as it has very deep roots. It is based in every major religion and it is based in culture. That is another thing that works in favour of redistribution and against the distribution of the market. Sebestyén has mentioned that people do not understand markets, and I agree with that. There is an important educational demand there. The last thing I would mention is current reality against an unknown future. We are in a system with a strong welfare state in many cases, and what is being proposed is very hard for people to imagine improving. I agree with you, Victoria, that examples are very important. Still, if you are sitting there thinking that you get all these things from the state, and are then told that if you agree to a market solution instead everyone will be better off, you will want it explained in convincing terms to give up the *status quo* for an unknown future.

Roger Sandilands: Victoria talked about state provision of health and education, and she also mentioned pensions. I wonder if she would comment on the crises that face many company pension schemes in Britain. I am sure it is not unique to Britain. It does just seem to me that there is a real problem here if the individual worker is not in a position to decide how his or her pension deductions are invested. Nor, I think, are individual companies in a very good position to make these judgements, insofar as they invest in a portfolio of shares and as the stock markets are very volatile institutions with the overall stock markets rising and falling substantially. Many company pension schemes find themselves extremely embarrassed and, in fact, collapsing with the pension contributions being completely wiped out for thousands of workers when reliance is on private pension schemes. I lived in Singapore for a number of years, and the Central Provident Fund required everybody, almost without exception, to provide quite a substantial fraction of his or her income, and the state then handled it. Insofar as pensions are only paid out of current GDP, not out of the state of the stock market, I wonder whether the Singapore-type system – competently and incorruptly managed – might be better.

Victoria Curzon-Price: It seems to me that to leave a pension fund to a company is very risky, and has proved to be so in the UK. I do not pretend to know much about the UK

system, but in principle it seems to me extremely dangerous to allow the company to run its own pension fund. It seems to be far more sensible to let people chose from an array of pension funds available on the marketplace on a competitive basis. These locked-in systems are bound to end in tears, at least in some cases. I think the Singapore system – as you yourself said – works if the state runs it honestly and well, but I do not believe it is a good system. Experience will tell us which is best. When you are pioneering you sometimes do not know what you are doing, and often you have to do things that are politically possible and compromise.

John Moore: Victoria, you should look at the American airline industry, and what has happened to their pension schemes, which have gone totally bust. Now it is likely to happen with General Motors, probably Ford, maybe not Daimler-Chrysler because the Germans may help.

Philip Booth: I agree with Victoria that, in the due course of time, a situation will arise where individuals are making decisions through collective vehicles such as unit trusts and investment funds and so on. With regard to private company schemes it really is a case of the pursuit of the perfect by the government through regulation that has been the enemy of the good. Company systems have worked pretty well over a long period of time. The origin of having a separate trust fund set up from companies' own funds arises as a result of the system of tax relief which was introduced back in 1921. The agreement between the worker and the company was that the company would provide a pension using the assets in that trust fund, administered by the trustees in the best interests of the members. If the fund were insufficient the workers would take some of the risk. The government then comes along and forces the companies to provide enhanced benefits, much higher guarantees and so on, and also absurd regulation whereby pensioners continue to receive all their income if there is insufficient money in the fund. There is a pecking order and if there is insufficient money in the fund, since 1995, those workers who are still working use absolutely everything. Instead of sharing risk throughout the fund, there have been a few thousand workers who have lost everything, when perhaps all members could have had perhaps 90% of their benefits, particularly in old industry where there is a high concentration of retired members in the fund. There is a lot of regulation that has caused what was basically a sound system to collapse.

Tim Congdon: Pension schemes are not collapsing. There are pension fund deficiencies in the UK at the moment but, 20 years ago, there were pension fund surpluses. It is cyclical. Philip is basically right, but they are not collapsing. There are millions of people who have retired and received their pensions and all is well. However, there is a big problem. I did not know that 80,000 have had problems – I did not know that was caused by the interference in the system. They basically worked. We do have a similar

programme to Singapore in the UK; it is called the National Insurance Fund and it is a complete scam. If you ask the question does the National Fund actually exist – nobody knows. You ask what the rate of return on that insurance fund is – nobody knows. The Singapore situation, the central fund gave a very poor return compared with most UK pension funds over the most of the last 30 to 40 years. It is changing now, but most of the time gave a very poor return. Having said all that, the problem of company pension schemes is the effect on personal freedom. The money is locked up in a company fund; it is not yours. This comes through if you want to move – if you move to another job – or in the unfortunate event that you are sacked late in life. The reason that the government under Mrs. Thatcher interfered with the private pension arrangements was to try and deal with this problem – in my view they should not have interfered. Surely in the end there should be personal pensions. Whether or not they should be compulsory or not is for discussion.

Philip Booth: To echo John and Tim's point. It was not just a belief in efficiency that caused the development of the welfare state, although that is probably true of the nationalised industries, but also a belief that security and equality should come above freedom. It is, in my opinion, an immoral belief, because freedom to contract is the only way to distribute wealth within a country by mutual agreement. Anything else involves competition through the political system and coercion. It has become demonstrable that these state-controlled health and education services are much more unequal than they would be if the services were provided through the market, whether through a voucher system or – as Tim suggests – redistribution and people paying for the services themselves. The provision of people's choices with the purchase of food and clothes etc., where people are given money to make their own decisions produces much more equal outcomes than the British education system where the outcome depends on the whether you can afford a house within the catchment area of the school, how articulate you are, how able you are to lobby through the political system and so on. I am much more pessimistic about the ability to change these systems because of public choice economics. There are huge public sector interest groups, only 25% - I think I am right in saying – of the British electorate, are actually employed by the private sector or self-employed. There are over a million people who are employed by the state in education. The only way you can realistically change these systems is by somehow trying to buy these interest groups off, and that is what the Thatcher government did in the early stages of privatisations. The later privatisations tended to be pursued to maximise the value to the taxpayer selling the shares of the water companies and so on. During the early privatisations, a big effort was put into trying to provide free shares to customers and workers in order to buy off the interest groups.

Victoria Curzon-Price: It is not an easy thing, but Jan Winiecki has the answer.

Jan Winiecki: I know what I have the answer for, and have three issues to raise. The first is historical, and is a warning about the determination of this maximalist state – and not only the welfare state you mentioned, I think there are two more. One was the war-planning experience, and the second was after the collapse of the empire, or shall we say self-renunciation of the colonial empire. We know the leftist intellectuals took over in the so-called Third World countries, and they were Marxist to a tee. Whether a soft Fabian variety, or hardcore Soviet or later Chinese style Marxist. Now about the more current relevant issues. I did not find any hint of an answer in your presentation about the question, why reform fatigue, or reform resistance, in our part of the world came earlier than in the West, or – in some respects – later, because you have to remember that it is not only a question of Eastern countries learning from the experience of Western countries. It also works in reverse.

We have been talking of reverse learning: what the West can learn from the East. There are papers on Slovak tax reform, which are very free market orientated. Surprisingly, the present nationalist populist coalition is not tinkering with the triple 19% personal income tax, corporate income and VAT. There is hope. Apart from that there has been some reform of the pension system. This did not go far enough, but compared to the stagnation in this respect in continental European countries mentioned by Victoria, it is a major step forward. There is probably more talk than action, but at least we are talking about some serious health reform systems. It is not a one-way learning process, but a two-way learning process.

Victoria Curzon-Price: I hope I did not give the impression that I though it was a one-way learning process. I think there was the pioneer, and then the idea spread out. The Soviet Union collapses, and I have great hope that the western part of the continent will learn from the Central Europeans, who are much more sensible than we are and have had to go through a harder experience. They have learned much more than we have and, thank Goodness, we will learn. I agree that leftist intellectuals, who were not just in the Third World, but were everywhere, drove the determination of the maximalist welfare state. And they continue; their children are with us and most of our universities are still full of them. How to deal with such interest groups? Of course these interest groups are very powerful. In the end economic reality catches up with them. The institutional competition, not just from Central Europe but I think also from China and shortly, perhaps, from some unknown country in Africa will occur and will spread throughout the world, because we live in a global system now. I think the global system is going to kill those poor old interest groups off one by one. They will be abandoned because they cannot survive if they sit back and refuse to face the modern world.

Sebestyén Gorka: I am afraid I think the Hayek Institute of Slovakia and Mart Laar of Estonia are by far the exception to the rule. Do not expect us to teach you anything. Really, if you look at state capture in a country like Slovenia, which – on the surface looks wonderfully open – and see how many people rely on the state for their income, if you look at Hungary, the tiger of Central Europe for ten years, where 25% of the labour force depends on the state, it is not a rosy picture at all.

Victoria Curzon-Price: Then the competitive force perhaps will not come from Central Europe, but it will surely come. I think the cat is out of the bag.

Natasa Srdoc: It is interesting to speak of Mart Laar. He was initially the pioneer for all the reforms in Eastern Europe with Slovakia following the Estonian example. Mart Laar first introduced the flat-tax in Europe, after Dr. Alvin Rabushka of the Hoover Institution proposed it. They legislated for a balanced budget, so there is no spending than is budgeted for a year. They undertook pension reform and healthcare reform. They actually proclaimed access to the internet to be a basic human right, so everyone has free access to internet. All this led to sustainable economic growth of 10% *per annum* in Estonia.

Matej Steinbacher: We definitely have happy examples when Eastern countries learn from other Eastern countries. You mentioned that Slovenia looks wonderful from outside, but look under the surface and you find that 46% of GDP goes to the State budget. Our income tax has five brackets. The highest bracket is 75% marginal tax rate, of which 50% is income tax and 25% national security.

Victoria Curzon-Price: So you have a flourishing underground economy.

Matej Steinbacher: Actually yes. We have been told, since our independence, how successful our gradual approach to markets is. We are selling ourselves as a success story, but our prospects are limited by the state controlling 40% of our property. The biggest banks and insurance companies are fully state-controlled. In 2004 we had a new government. This government took power because they said, "this is enough, we want to establish a market economy, to reduce the influence of the state in the economy". They were supported by many people. This means the people are debating their responsibility for the economy on their own. The government is now trying to make gradual changes, but they are far too slow. Just recently our government actually debated a proposal to lower the number of tax brackets to three, with the highest income tax bracket at 41%, which is social security and gross salary tax on that.

Victoria Curzon-Price: You cannot do everything all at once, so sequencing obviously occurs. I would not presume to say you should start here or there; surely this has to reflect the political reality of each country. But it is still a bit of a shock to hear that you have banks and insurance companies in the hands of the government. I would start there. It is such an obvious thing to privatise. There is no justification in any way to have national banks and insurance companies.

Matej Steinbacher: How about dealing with the trades unions? They are very influential in Slovenia. For example they have cancelled a debate on flat-tax, even arguing that each person would be poorer.

Victoria Curzon-Price: Yes, but again remember that the Thatcher reform was basically declaring that one could not have a national strike because of a dispute between a trades union and an employer. It had to be a bilateral thing. Also you could not have picketing or sympathy strikes. That was the main reform in the UK, which suddenly put an end to these awful national strikes because it then became illegal to have people striking in sympathy. You still had strikes in the nationalised industries, which is why I would get rid of the state banks and insurance companies as that could bring a country to a halt; they affect everything. It is essential that the trades unions have to be made responsible for their actions, and they cannot just go out on strike in sympathy. I would change the law there. The right to strike still exists, and you can still walk out, but you cannot do so without pretext. There has to be a reason. I think most people would buy that.

Jan Winiecki: I must say I have a problem when debating with my free market friends from this part of the world on the case of Slovenia, because they point to various institutional inadequacies, while at the same time – for a number of years – this country was, according to macroeconomic indicators, doing quite well. It was among the fastest growing countries of East-Central Europe in the second half of the 1990s. It had a balanced budget, balanced foreign trade and so on. However, this has not been an unchangeable thing. In my statistics of the 21st Century, taking 1999 as a starting point and 2005 as an end point (there are no other data for economic growth for 2006 yet) I found that Slovenia, together with Poland, is at the bottom of the table of the eight new European countries. So, something has changed. What? I have my own particular view on the issue.

I think that Slovenia had what may be called historical rent, from the fact that within the communist country that previously existed, it was the one that was ordered to specialise in Western markets. It was the most Western tip of Yugoslavia. Historically they had leaned towards the Habsburg Empire. They had a lot of contacts that let them trade with the West and receive precious foreign currency – that was the term used by communists

all the time because they always had problems with counterfeiting. The western orientation was something that other countries did not have. They knew what the market was, even if they did not have it at home. They knew how to behave in competitive markets, which was a rare thing among foreign trade organisations in other communist countries. This gave them a head start. However, if you look at the foreign trade performance nowadays it is in no way equal to Poland, Hungary, Czech Republic, Slovakia or even the Baltic countries which have a different export structure in terms of the commodities they export. It is doing worse and worse. I think under pressure of reality, something will have to give. This is our hope.

Joel Anand-Samy: I would like to take up Victoria's point on the importance of the rule of law. It is something that we in the West have taken for granted within New Europe, or Eastern Europe. But the lack of it has led to chaos in some of the countries undergoing the first wave of privatisation. In countries outside the EU there is concern at the legislation from Brussels is becoming a barrier to further privatisation, and focus on market reforms. There is a recent report commenting on the fact that 80% of new laws in Europe come out of Brussels. For countries beyond the EU, Croatia and the former Yugoslavia for example, we have noticed that when messages from Brussels do not push for privatisation, leaders have used them as an excuse to avoid reforming. This is certainly going to affect the future of these countries as far as economic growth and market reforms are concerned. If there were a group of leaders here from the countries outside the EU, what would you say to them? They are being given incentives to join the EU, with better jobs for themselves as the political elite.

Victoria Curzon-Price: I would say join the European Free Trade Agreement, then you will remain reasonably free to do as you please. Join Switzerland! Come on, do not join the EU if you can avoid it. But I have been telling all my Eastern and Central European friends this for years now, and whenever I produce this as a solution they say, "We can't, we have to join the EU. The population wants it". Well there is no law against committing suicide. It is not real suicide, I am just exaggerating. It could be worse. But it could be so much better. It is such a heavy, awkward, invasive form of integration. It could be so much lighter and more agreeable, but no. So I would say join EFTA.

Jan Winiecki: If you were geographically located as Switzerland is, that would be enough. But for our countries, like Poland, we do not need to look only at the lightness of regulation, but we also need to think where we are located, and that is very important. I do not believe Western European countries would come to the rescue, just as they did not in 1939.

First Session, Part II

The EU and Applicant States: A View from Bulgaria

Natasa Srdoc: Our next speaker is Dr. Krassen Stanchev. Since 1993, he has been the executive director of Sofia's Institute for Market Economics. He is a former Member of Parliament, recipient of the best individual country analyst award for 1996, nominee for Bulgaria's *Mr. Economika*, 1995 and initiator of the Balkan Network and the European Emerging Economies Network.

Krassen Stanchev: The story of the privatisation was reform. We learned that there were a couple of peculiarities. First, the Bulgarian communists learned from the Yugoslav communists' negative experience, and they never attempted to nationalise the land. Instead, they nationalised the users rights, collectivising them and transferring them to the Ministry of Agriculture. Therefore, the restitution of arable land was difficult as it was nominally still private, but the opportunity to use the land was held collectively. Most of the inputs were still government owned and the agricultural enterprises and farmers retained no access to the capital endowments to use the land. In the early 1990s, they ended up as nominal owners of the land without the right to use it as a capital endowment. Secondly, the 1991 law that provided for the restitution of full rights of land ownership was altered following changes of government in 1993 and 1995. Although the Constitutional Court overruled most of the amendments in 1995, as a violation of private property laws, there was a demonstrable hesitation to restitute arable land. The result was that it took virtually seven years to restitute arable land, with the process ending in 1998.

There was, as you probably remember, another restitution. In 1984-1985 Bulgarian Turks had been given official Christian names, and it took them some time to organise themselves and reverse the process. When they did so in 1989, they were expelled from the country thus forfeiting their property rights. 10,000 families left the country during a period of about five weeks in mid-1989. When their names were restored in 1990 – one of the messages from the emerging democracy in Bulgaria – most families returned and a special process ensued, restoring their rights. Out of 10,000, only 283 families had their properties returned as they had been promptly resold and it proved impossible to restore them. They were given compensation bonds, which were used in the privatisation. These bonds became a tool used in the restitution process.

Physical assets, such as factories and shops were either returned or privatised; those remaining in government ownership were privatised. The privatisation was relatively

insignificant between 1992-1997, with only 15% achieved in that period. The bulk was completed between the second half of 1997 and the end of 1999.

As I highlight, there were different types of privatisation. The most interesting type was, perhaps, the Czech type of voucher privatisation. The laws were prepared over five years for voucher privatisation, which was applied to only 13% of the assets that remained in state-ownership. Another peculiarity was that the vouchers being used for privatisation were not to be traded on the stock market until the second wave of mass privatisation, but there was no deadline. Between 1996 and 1998, people transferred their vouchers to privatisation funds and were effectively selling futures. Finally, this scheme was considered ineffective. Meanwhile, the socialist government of 1994-1995 had amended the privatisation law to allow for management buy-outs. This scheme was very simple; you paid ten per cent, you got 20%, then the remaining 90% after 20 years. However, there were insiders creating privatisation units and buying an enterprise, putting outsiders who were cash buyers at a disadvantage.

The next important thing was the procedure. There were two major sellers, various ministries and for small assets, and the Privatisation Agency for bigger assets. Sales methods included public auctions, public tenders, negotiations with strategic buyers and sales to insiders. If we look at small privatisations, almost 50% were sold to insiders, 22% after negotiations with buyers. Auctions were rarely employed with seven per cent of sales and the so-called tenders – not very public – accounting for 22%. The large privatisations followed the same process, although negotiations and public tenders accounted for virtually all privatisation. Public auction accounted for six per cent, and there was one offering on the stock exchange. These figures are for the period up to 2000.

For large enterprises, which were under the jurisdiction of the Privatisation Agency, the average time taken for a sale was 17 days. These enterprises had a value of at least five million euros, at today's rates. On average, smaller enterprises were sold in five or fewer working days. Very often intermediaries, regulated by law, sold these smaller enterprises. Many enterprises were grouped for sale, so these intermediaries bought both profitable and unprofitable companies, as part of a package. Because of these loss-making enterprises, the intermediaries requested that their fees were not based on the success of the sales. These fees were paid by the World Bank and with European Union grants.

I will mention a couple of unintended consequences. One result was the emergence of vigilante groups enforcing contracts with arable land restitution. 86% of the urban population received rights to restitution of their land ownership but they did not have the resources to manage the property and very often the land would be taken over by someone else. But, following the hyperinflation of 1996-1997, many of these people left the cities

for the countryside and began taking care of their properties. They started voluntary groups to defend the properties. Professional security groups also saw an enormous demand for their services as well. These groups competed by demonstrating the strength of their security guards. You may know that Bulgaria is famous for its wrestlers. One of my doctoral students is about to publish his doctoral thesis, and the following data are from him. In 1988, the police force was 65,000 strong and 63,000 of these were wrestlers. When the subsidies disappeared in 1989, there was an oversupply of wrestlers, and these men left to enforce contracts. Today, we have a police force of 80,000, and private security firms employing 130,000 men. This constellation raises questions about the force of the rule of law in Bulgaria, especially whether Bulgaria is able to enforce property and contract law. We have parallel systems: a private police force that is successful at doing its job and the state police that is not. Of course this causes problems with entering the EU. However, judging by the macroeconomics – Bulgaria has the highest growing personal income in Europe, with wages following productivity. She has the fastest growing real estate market and foreign investment is cancelling out the current account deficit – Bulgaria is a country able to spend some money. I do not think that in terms of the rule of law and corporate governance entry to the EU will make any difference.

Natasa Srdoc: When you quoted Friedman, saying “privatise, privatise, privatise”, I wanted to remind you that he later concluded he was wrong. He revised this to say that before you privatise, you must have the rule of law. What is the point of owning property if you cannot use it in the way you want?

Jan Winiecki: I found two more general issues in your presentation, which may be worth considering. One applies to privatisation of the banking sector. My analysis is that if you do not privatise this sector, and do so with Western money, you may have a perpetuation of the old *nomenklatura* ties. It was inevitable that in the early transition you would have a lot of illicit or licit takeovers. But this is the initial distribution of property rights. If the game is played by the clean and open rules of the financial markets this, sooner or later, is going to change. Some communists are going out because they will be bankrupted - others go out to get money to survive - through their old colleagues in state owned banks. If these banks privatise just by being owned by various state enterprises, they are not really privatised. You need take-overs by Western banks. It is then that they will lose the power to obtain the kind of loans that the normal banks would never extend. I am sorry to say that this is one of the reasons Poland has succeeded further than Bulgaria. At one point, we were able to privatise, wholesale, up to 80% of the assets of the whole banking sector. This is probably less contestable than the influence in other areas of free-market economics.

I believe excessive attention is given to the importance of macroeconic stability. I think that this is wrong, although I accept that it is necessary to construct a conducive framework for a new private sector. It is important that new entrepreneurs know that the money they earn will be worth something, otherwise they will be new Russian-style entrepreneurs, doing only short-term, often illicit, trade deals. If stability is imposed, it is positive. There are no free goods and stability is a good; you must pay for it. Then, if you do that, the opportunity for the private sector to survive and extend its horizons becomes a benefit to the economy, and creates a private sector that is resistant to the idiocies of politicians, which I can vouch for when I look at Poland. The Polish sector is almost autonomous from the politicians.

Krassen Stanchev: I agree. All the negative effects of state-ownerships of banks are very well recorded in Bulgaria. The assessment of the process was that Bulgaria had the highest rate of private banks financing government enterprises, and that the central bank was compensating private banks. It was a rather complicated system, which was removed two years ago. 90% of Bulgaria's banking system is foreign owned. The remaining ten per cent are under negotiations for sale, and one small bank will soon be sold to an Icelandic institution. The remaining shares of Bulgarian banks will be about four per cent of the whole system. This is one bank, financed by EU money. It is insignificant, and does not have a penny at the moment, but it does have the highest remuneration rate for its members.

Jan Winiecki: I realise that Bulgaria may be a nice place for Icelandic banks. I also note that Icelandic banks have been considered to be particularly incautious in their external expansions.

Victoria Curzon-Price: What kinds of reforms have occurred in the social security system in Bulgaria?

Krassen Stanchev: The reforms for the entire region have three pillars including pay-as-you-go systems and compulsory private involvement. The peculiarity in Bulgaria is that for every worker, we have 1.1 pensioners. This compares with a ratio of 2:5 in France. The system is rather risky, and the government is hesitant to make reforms. The history of the last few years has seen contributions being reduced from 49% to 43% of income, and there is a deficit expected. There is no immediate risk to the system, but the risk is systemic.

Bob Reilly: How do you have a 1:1 ratio? That has to be worse than anywhere else in Europe.

Krassen Stanchev: The population is aging. Life expectancy is 72 years for men, and 73 for women. The retirement age is 63.5 for men, and 59.5 for women. Hungary is only slightly better. People in employment in Bulgaria is 54%, in Hungary it is 57.8%.

Ljubo Sirc: I would like to add to your description of the situation in Bulgaria, by drawing comparisons with Slovenia. Slovenia is a separate case, but not for the reasons you have mentioned. It is different because it was a part of Yugoslavia which switched from central planning to self-management. Self-management was not good, but it was much better than central planning. I do not know how you would assess the national income per head, in comparison with the pre-war GDP. As far as I know, Slovenia is the only country in Eastern Europe, where the GDP per head and the wages are about the same as they were before the war. Everywhere else these are lower, with the Czech Republic being a particularly marked example. The switch from central planning to self-management was one of the reasons for Slovenia's better performance. The whole of Yugoslavia, after the quarrel with Stalin, was receiving enormous subsidies from 1952 to 1970. Slovenia received four billion dollars, at present value, each year. Yugoslavia also continued borrowing for another ten years.

It is interesting what happened in 1980. Suddenly, the Swiss banks tired of lending Arab money to Eastern Europe and never getting it back, and were no longer prepared to lend money to Eastern Europe. In Yugoslavia, the wages fell back from the level of 1980 to the level of 1965. They lost about one third of their value, which was about the pre-war level of wages. The 1980s were particularly bad. Privatisation in Bulgaria ended up in the form of take-overs by managers. The enterprises did not start working well after that, as the banks were still in state hands. The banks were still extending loans to the enterprises and, perhaps up to the end of the 1990s, the enterprises taken together were operating at a loss. Now it is a little better because things have changed. Nevertheless, these subsidies via the banks allowed much bad management to remain. You rightly pointed out that now Slovenia is falling back. This is because things are stricter than before. Slovenia is a strange example; Milan Kučan, who was Secretary General of the Communist Youth Party, and after 1990 President of the country, has started an organisation called Forum 21. This organisation consists of the former managers, now owners, of a large proportion of the enterprises. Here, money plays a political role, as this Forum 21 wants to teach the parties how to behave. The Forum members say the party leaders are young, and do not know how things work, so they can assist with their considerable experience. It is a strange situation as we now have a democratic government, but the economy is to a large extent controlled by former managers.

Krassen Stanchev: The level of GDP reached pre-1989 levels in 2005. Currently it is around €9,000 *per capita*, which is around one third of EU-25 average. The situation of

Bulgaria in 2006, is comparable to the Republic of Ireland in 1957/1958. I do not believe this is a problem *per se*, taking price differences into account.

Ljubo Sirc: Before the war, wages in Slovenia were catching up with Austria, and now they are around one third of Austrian levels.

Natasa Srdoc: It is interesting to compare productivity of the work forces.

Ljubo Sirc: Productivity must be reflected in some way by wages. One of the characteristics, even of Slovenia, which in some ways is similar to other communist countries, is enormous investment. Sometimes 40% of GDP was invested. But Greece and Portugal, which were at the Yugoslav level, achieved the same results with about half the investment. But there is no doubt that Yugoslavia was in a much better position than the rest of Eastern Europe. Slovenia is currently catching up with Portugal and Greece.

Second Session

Banking in Transition

Silvana Malle: Let me introduce Professor Congdon. Most of us who have been in Great Britain know Tim Congdon, as he is a well-known commentator on economic and financial events and developments. He has been a member of the treasury panel that advises the Chancellor of the Exchequer on economic policy, and he founded Lombard Street Research in 1989, and is currently its chief economist. Among our conference readings were excerpts from his numerous works. We know that in several Eastern European countries and Russia state banking is still present. I do not know if you are going to touch on the issue of property in banking.

Tim Congdon: I will start by saying I am not going to be talking about the euro particularly, although that may come in. I am not really an expert on East European economies, so apologise for being somewhat of an impostor here, although it is very nice to be invited. I would like to apply some of the lessons I have picked up in studying Latin American economies in the 1980s, when some of the processes that have been underway since 1990 were anticipated. I think there are some interesting parallels, particularly between what happened in Chile in the 1970s and 1980s, and some of the things that have happened in Eastern Europe in the last 15 years.

Copies of a paper were distributed on the "Rise and Fall of the Chilean Miracle"[1]. Plainly, the heart of the process of moving from a communist economy to a market economy is a change in the pattern of ownership: from state to private. What does this really mean? Communism was clearly about the ownership of the means of production, but, even in the most communist societies, people could own bank deposits, and certainly they could own notes and coins; they could also own consumer durables. In some communist societies they could even own houses. In China, despite collectivising agriculture, the state never tried to take the peasant's homes. Indeed, certainly in Yugoslavia before 1989/1990, people owned their own houses, small businesses, and I assume such things as hairdressing and plumbing were never nationalised. There was private ownership in communist societies. I think Marx had a final vision of communism with no money or financial system, but in practice there were banks and deposits, and even insurance companies, albeit in a slightly different form. The difference compared with the market economies is that the banking system would be one institution:

[1] **The Rise and Fall of the Chilean Economic Miracle** by Tim Congdon, Latin America and the World Recession, RIIA 1985

monobanking. There may be a separate bank for foreign trade as that has slightly special things to do, but there was no distinction between the central banks and commercial banks. The monobank was, essentially, an instrument of state planning. As far as I am aware, even in communist societies, the state never stole bank deposits, although I am open to correction if anyone knows otherwise. The only way in which they did appropriate the resource behind them was through inflation, which was very common. They did respect money in the sense they never stole money in an outright way.

Ljubo Sirc: Savings were stolen in Russia. People had savings that became worthless and there was nothing to spend them on.

Tim Congdon: You had monobanking, central planning and state-ownership of the means of production, and the government itself would hold deposit with the monobank, as would the state owned industries, which would also borrow from it. There were very few loans to individuals, but they were made to state owned companies as part of the planning process. That is one pattern, and there were variations on these patterns in South America in the 1970s and 1980s, and they are seen in many developing nations today, often in milder forms.

You could have, in some of these mixed economies, large parts of the capital stock being privately owned, and the central bank being separate from the commercial banks, but the commercial banks could be of two kinds: state owned or privately owned. Quite often, in South American countries, there would be just one big state owned bank – I know this to be true of Chile. So, there are some echoes of the central planning of communist economies. The state owned bank would, in these developing Latin American economies, in many ways resemble a large industrial conglomerate. In the market economy of the West it is unusual for commercial banks to have equity claims on the private sector. Instead, there are loans on which a nominal sum must be repaid at a future date. In Latin American economies, it was often the case that the big state owned commercial bank had a big hodgepodge of claims on the commercial sector – loans and equity claims – and this was associated with planning taking place in a large part of the economy. One finds that today in China, where there is a private commercial banking sector as well as a state owned banking sector, that the state owned sector makes loans to state industries, resulting in high levels of inefficiency and many bad loans. Obviously, this sort of structure - not quite like the communist monobanking sector, but with the state owned bank - is very open to politicisation, to some extent deliberately, and is often very corrupt. The political class and the financial class are allied. There are many variations on the political system, whether military dictatorships or temporary democracies. The whole system is very inefficient. The inefficiencies are often disguised by arguing that the state owned bank

has a duty to be socially responsible. So, for example, if there is a problem that an industry is obsolete and needs to shed workers, the government leans on the bank to make loans to sustain employment. The result is gross resource misallocation in the long run.

I want to examine how economies move from these systems to a more Western, market economy structure, and I am not going to try and define the process categorically. I will first make a rather scathing comment about traditional economics, then evaluate Chile, and finally draw conclusions that I hope will lead to a wider discussion.

My comment is that traditional economic theory, neo-classical economics, is frankly useless in prescribing what the right structure of the financial system is relative to the economy as a whole. That may seem a very strong statement, but let me illustrate it. I may say things that offend people here, which will encourage debate. Hayek gives the one prescription of the idea structure of the banking system. In his view, money should be denationalised, legal tender laws scrapped and then there would be a system of competing monies by private banks. A superior brand will be established, and the economy carries on as before. So, you end central banks and legal tender laws and privatise the whole thing. I put it to you that this is a crazy idea, and is from someone who believes in spontaneous orders rather than imposed orders, evolution – the selection of the right system and so on. Then we have this idea, which is radically different to what has evolved spontaneously over centuries. Impose something which we have no idea how it would really work. Why would you take a piece of paper from me if I tell you it is worth $100? The only reason you would take it is if I have something behind it that is worth something. You may be prepared to take it from me because you get something back. It is not clear in Hayek’s system what backs the issue of paper money by private banks. We then have Friedman who, at various points in his career, has advocated 100% reserve banking. The essence of banking in a market economy is to make a profit. If you are forced by the state to adopt 100% reserve banking, all of your assets must be non-interest bearing. You cannot make a profit. It is true that such a bank would be completely safe, but the essence of banking is that banks must economise on their non-interest bearing assets – cash – and raise the amount of interest bearing capital. That is what banking is all about. These people want a market economy, with specific exceptions. Fischer supported prohibition; Friedman wants effectively to abolish banking. Both denationalised banking and 100% reserve banks are imposed orders, and this fact demonstrates they are not the desire of the people in market economies.

There is a lot of uncertainty in economy theory about how financial systems should be structured. One of the issues that was generated by the Great Depression in America was the relationship between commercial banking - essentially the making of loans and receiving of deposits – and investment banking – the trading and underwriting of

securities. In their wisdom, the American authorities decided these functions should be split, and they were right. That has been changed in the last few years. When, with the end of communism in 1991, the societies of Eastern Europe had to move from their existing institutions towards what we had in the West, there was no very clear theoretical blueprint. There were many things that central banks in the West could teach those in the East as they developed, but the theory was lacking.

I now want to talk a little bit about Chile, where they had somewhat similar issues rather earlier than 1990. You will remember that Chile had been a very open market economy at the end of the nineteenth century, but in the twentieth century it became a mixed economy with a large state sector. It suffered from inflation and politicisation of the economy. In 1970, a communist president was elected constitutionally, although he did not have a majority of the votes, and he moved further in the leftward direction, with more nationalisation and price-controls. Then in September 1973, there was a military coup in circumstances of extreme political turmoil. The pattern of economic policy changed rapidly, as Pinochet gave his blessing to the economic reform policies of the Chicago Boys. I went there in 1978, 1981 and 1984, and studied and became very interested in what was happening. In 1973 there was, of course, a central bank, but there were a number of small commercial banks with a trivial share of the economy. There was a huge state owned bank, and the financial system as a whole was tiny. They had a state owned pension system which had, due to inflation, broken all of its promises. The theme was to go from state-ownership to private ownership, but what were they to do? The first thing was to control inflation. I said earlier that there was no very clear theoretical blueprint for what policy makers should do in these circumstances, but perhaps that was an exaggeration. I think the inspiration for what the Chicago boys came partly from Friedman, but much more from McKinnon, who had argued that economic development saw an increase in the ratio of money to GDP. This required the banking system to become market-orientated, with the interest rate freed to market forces – involving high real interest rates for a period and that inflation be controlled. The Chicago Boys, over the 1970s, eliminated the budget deficit, reduced inflation from a very high level, and this period was associated with trying to encourage commercial banks to become better capitalised so that, in due course, they could take some of the credit business away from the big state owned bank. Well, this process was quite successful.

By 1978, it was decided to deal with the inflation problem by fixing the exchange rate against the dollar after an announced devaluation. Inflation was coming down. What happened over the five years from 1977 – 1982, was that the stock of bank credit to the private sector rose five times - in real terms, not in money terms. That all took place in the private banks that had been nurtured to take on this task in the mid 1970s. The big state owned bank was gradually being stripped of its assets. The system was being

privatised and there was a move towards a private, profit-maximising system; all fine. Alongside this was privatisation of means of production and the introduction of a very successful private pension system started in 1980. They wanted to privatise pension provision to grow the private banking system. What happened? I should say looking back over 20 years that it has been a great success in many ways, and I admired what the Chicago Boys were doing.

However, I am afraid that this process turned out catastrophically in the short-term. When one moves from a system where the means of production are state owned to one where they are privately owned, there are major problems of valuation. These arise partly because of the insecurity of the property rights. You see an extreme example in Russia where, if you were in the Gulag in the 1930s you were killed. So, if you became rich in Russia in the early 1990s, you did not know when the regime would change. Because of that, and I suspect this is true across much of Eastern Europe to differing degrees, assets were initially significantly undervalued. Gradually the situation stabilises, assets rise not just because of the returns they are making, but also because the situation is becoming more stable, so for a period you have very high rates of asset-price inflation. We have seen property prices in Eastern Europe grow very rapidly in recent years. This happened in Chile. So how do you keep inflation down, how do you restrain bank credit? Part of the answer is to have very high real interest rates, but there are accountancy problems with inflation accounting, etc. Some people - businessmen, entrepreneurs – take lots of risks. In this situation they are not worried about the politics, so they borrow and buy assets and they see their assets sore in value. That is how the Russian billionaires became so rich. This was going on in Chile with the banks often lending in pesos against dollar loans. It was a miracle the way they had transformed the economy from 1973 to 1981.

The system seems solid – the exchange rate cannot change. The banking system borrowed heavily in dollars to lend in pesos in Chile, often to property developers, who had no dollar source of income whatsoever. In 1982, as part of the weakness of the world economy at the time, the price of copper collapsed. The Chilean government did not have enough foreign reserves to maintain the exchange rate, so the rate was devalued. The result was that property developers and others who had borrowed in pesos, could not replay the loans, and the banks could not repay the dollars internationally. The banking system, that had been carefully nurtured, went bust. Then who was around to pick up the tab? The central bank made lump-sum loans to the banks to help them get over the problems and – bless me – the same large state commercial bank, although much smaller. I think when one thinks about this a number of lessons can be learned. To some extent, and this may sound shocking, I think you should move very slowly when liberalising financial systems. You must be very careful to make sure that banks can be profitable and can survive if the asset prices fall. If the banking system needs to be recapitalised, it is at

huge cost to the state and, usually, through a period when the banking system returns to state-ownership.

I have described the structures one sees in a typical market economy. I would like to make one or two remarks about it. If you are moving from the situation in Eastern Europe in 1990, you would not necessarily have thought this was where you were heading. One of the most important things is that the central bank should be very small relative to the commercial banking sector. One of the problems found in developing countries is that the state should support development, and that the central bank should be making loans to promising industries. In the ideal system the central bank is very small and has only two customers; the government and the commercial banks. The government has no deposits with commercial banks, and there is no problem with politicisation. The banks maintain their cash reserves at the central bank, which exist only to support the purpose of clearing. It is very important that the central bank does not impose high reserve requirements on the commercial banks. When this happens it has either been to finance government deficit but, sometimes, supposedly as part of industrial policy. It is important to track the capitalisation of commercial banks, and there must be a number of them so they compete.

Silvana Malle: I will now open the floor for discussion. We have heard a lot about banking structure, particularly in Chile, and we have many topics to discuss.

Roger Sandilands: I spent some time in Chile in the 1970s. What seems to be to be missing from your article is the impact of globalisation after 1973 on the housing finance system. It was not a system of the banks as such, but a system of non-bank financial intermediaries, who were handling genuine savings that were diverted from the existing money supply. By liberalising financial markets and trying to get a grip on inflation and adjusting interest rates, there was a major adverse impact on long-term lending, in particular mortgage finance. The validity of long-term financial contracts to survive in the free market with the freeing up of interest rates was uncertain. When I was there in 1975, the financial sector was in complete paralysis; it just could not compete against the short-term commercial and consumer credit. They were much better placed to capture a much higher proportion of the nation’s savings than before. To my mind, that was one of the biggest mistakes the Chicago Boys made after 1973, and it was several years before the construction industry recovered.

I do agree with you that the dual role of the Latin American banks is dangerous; controlling the nation’s money supply on the one hand, and being a development bank on the other. These should be kept quite separate, and have not been. I do disagree with you on your hostility to 100% money. The problem with banking throughout the world is that the commercial banks perform the functions of administering the nation’s money supply

as well as administering the nation's savings. There is a real danger that the money supply will become endogenous to credit, potentially causing inflationary problems. I think 100% reserve requirements can achieve that end. You can overcome the problem of making a profit, by charging people for transactions.

Tim Congdon: I want to pursue this debate about 100% reserve banking because this is very important. If somebody sets up a bank, and says he will repay you with something that is worth what you deposit with him, and organises his affairs so that he is able to have a balance sheet that includes loans, he is able to have reserves of 80%, not 100%. But suppose that this bank is competing with a 100% reserve bank, and this was the real world as it was in the fifteenth century. Which bank would give you a better return for your money, or charge less for its transaction services? The 80% reserve bank. The process of competition will ensure that those banks able to reduce the reserve ration will out-compete the banks with higher ratios. We will have to pay more for our banking if you decide to treat banks like gambling or alcohol and ban them because of risk. If you believe in a free-market economy, you cannot have 100% reserve banking; it is just a complete misunderstanding. One should not, in this sort of forum, have this discussion. I know that Friedman and a lot of these people still talk about this, and it is wrong. My talk is to knock this on the head, and explain that it is wrong. It is tragic. One should be able to tell Eastern European economies what they should do, and 100% reserve banking is not the answer.

In the 1970s, the chiban banking system had very high reserve requirements so the governments could take the people's savings cheaply, and cheat them by inflation. The commercial banking system is handicapped by the high reserve requirements. But there were still many lending opportunities out there. Quasi-bank financial institutions develop, taking in deposits but not offering clearing services and taking away business artificially from the banks. You should have free competition. There should be no inequality between banks and non-bank financial institutions. Reserve requirements are an artificial imposition from outside.

Roger Sandilands: You begin by condemning Hayek, and complete privatisation of money, but then the argument that you can allow banks to compete on the size of their reserve requirements is only true if you have no regulation common to all. Of course, if you have one bank offering 100% reserves and another 80% reserves, the latter is going to prevail. But, in the process, it is going to be creating money, very much related to the loaning process. I think there should be a distinction between what is money and what is not money. Money is the means of settling a debt, a means of payment, as opposed to a savings account, which gains interest and is not in itself money – but has to be converted

to money. There should be a universal reserve requirement, which allows you to get a much better grip on inflation.

Tim Congdon: Money to me is about a means of payment, but is better understood as all the assets given a nominal value. The problem with excluding saving deposits is that it is not very expensive to convert saving deposits into transaction deposits. For large financial institutions today, they are interest bearing, but are basically available for transaction at a moment's notice. I agree that the banking system must be regulated to some extent, and I accept this is a very difficult topic.

Krassen Stanchev: I should like to comment briefly on Hayek. I believe Hayek's ideas to be completely enforceable in crises. I recall three examples; the first two are from the history of Bulgarian money supply over the last 70 years, and the third from Lenin's monetary reform in the early 1920s.

Bulgaria sided with Germany and Italy in the First World War, was defeated on all fronts and had to make reparations. In response, in 1921, the Bulgarian Central Bank, was privatised by auction. A French management company then privately ran it between 1921 and 1934. The reparations were by then almost paid and debt was reduced to around 50% of GDP. The Government then opted to buy back the Central Bank, and introduced two monopolies to finance this. The Bank was operated reasonably well; inflation was stable and Bulgaria did not suffer much from the crisis at the beginning of the 1930s.

The second example from Bulgaria is the hyperinflation of the mid-1990s. On 6th December 1996, the President's Council of Economic Policy suggested three possible ways in which to deal with the crisis. The first was to have the Central Bank operating as if it were a currency board, and not printing money. The second was to make everything legal tender; full currency substitution. This would include the Ministry of Finance accepting tax payments in all currencies. The third option was introduction of a currency board. For months, from January, we prepared projections and attempts to identify different impacts on the situation. The politicians liked the idea of the introducing a currency board, and thus maintain their influence. The consensus of the group was that the best option was to allow everything to be legal tender. With 1000% inflation per month, everything was real tender; that was a fact of life.

The third example is Lenin's monetary reform. A move to have a money-free economy did not work, so they introduced the gold standard. The problem with the system was not the gold standard *per se*, it was that Lenin did not have any competition, so there was no other currency with which to compete. The temptation was that central government –

Lenin – reintroduced government capture. The point that Lenin's policy proves is that competition is the key.

Tim Congdon: I am not quite sure what the French management company was doing. When the Bank of England was set up in 1694, the idea of central banking did not exist. The idea only caught on in the late nineteenth century. It was a private institution, but it had an important obligation; to be able to redeem all of its paper liabilities in bullion. For example, take the Gaza Strip. What they have done is to accept foreign currency as legal tender, and give a foreign management company the job of providing banking services to the banks. That is not a privatised banking system in any meaningful sense. It is only like that because the nation is so badly run that it has foreign legal tender as its national legal tender. You get back to the question of what the paper money is convertible into. If gold is the answer, you have gone from a paper money system where you economise on the use of commodities, back to a commodity-based system that requires more resources. If you move to a 100% reserve system, you make banking much less efficient, and much more expensive to the general public and companies. It is bizarre to go back to this system.

The Chileans thought they had a currency board as their monetary base was fully backed by dollars. But as long as the banks can convert pesos to dollars, this is not the case. When confidence collapsed and mass conversions of pesos to dollars occurred, the dollars disappeared and there was no backing of the dollars that they had to devalue. The same problem was seen in Argentina. It is the broader money that is important.

The right to issue legal tender by a specialised central bank, should not be held by a bank that is making loans to the private sector. In an advanced system, the issue of legal tender does not get involved with lending to the private sector. The management of the amount of money you issue and the business of banking was behind the 1844 Bank Charter Act. They split up the Bank of England into two parts: the issue department that issues the notes to be backed by gold, and the banking department which was to be a private bank. The bank would have deposits and could make loans. What happened was that the gold, notes and deposits were all interconvertible. So when, between 1844 and 1847, the Bank of England got involved in railway mania and made huge increases in its balance sheets, the deposits rose dramatically and then the problem of crisis developed: the banks and non-banks started to convert their deposits into notes and then the issue department did not have the coverage. So you cannot split these two things. You must try and make sure the central bank is very small and that commercial banking should lend to the private sector. When you consider where the East European countries were in 1990, the monobank had all the loans in the country. Moving from there is a tremendous change.

Krassen Stanchev: Monobanking in Eastern Europe was dismantled fairly early, and the first attempt was in Hungary in the mid-1980s. In 1987 it was adopted as a common policy throughout the region. You described two pillars of the system – international payments and local trade – divided into two different sectors. But there was another player, the government which was borrowing expensively from the Paris Club and the London Club. So the system was already rather decentralised by 1989.

Philip Booth: I am surprised by your comment that you think it right to stop deposit banks from getting involved in the securities business. That would seems to be a restraint on the natural evolution of the market. It seems the market can naturally sort out these problems. There are advantages of having combined, conglomerate institutions in that the information-gathering and transaction costs are significantly lowered. On the other hand there are benefits of having the institutions separate as there are fewer conflicts of interest and so on. The academic evidence suggests that securities houses, which were independent from banks were able to charge higher prices for their research and higher premiums as they were regarded as independent. The excuse for separating the functions by legislation was wholly bogus, as the cause of the depression in the late 1920s was wholly monetary and not related to the behaviour of private banks, as you have yourself written.

Tim Congdon: This is a very interesting topic. I should say I have spent 30 years working in the financial sector and, on the whole, the people who work in the City of London are honest and straightforward. But you really do not know how wicked people can be. Let me illustrate this by what happened in America in 1929-1931, and also what happened in Chile in the late 1970s and the early 1980s. In America things were pretty much *laissez faire*, although there were reserve requirements. You had commercial and investment banking under the same roof. The executives would know and control what the loan book would do. The commercial bank lends to the executive directors of the bank to buy some shares. The bank is also involved in marketing and transacting in those shares. Oh - prices going down! Instruct them to buy some shares! Bail me out. Do you see what I mean? This happened on a massive scale.

In Chile, you had people who were, again, executives of the bank and would know when the investment operation would be involved with certain types of development, and would lend to the directors to buy land before it took place. I was working for an American investment bank and was told I was an important employee and was invited to put some of my own savings into a special fund. I was told the brightest people in the bank would work to make sure this fund got the brightest ideas and best investments.

It is absolutely right to split up commercial and investment banks. This fraud goes on today, imagine what it was like in the 1990s. Normally the law does sort these things out.

Either you get self-regulation – the British tradition – which was pretty good before the Americans came in. The American way is that if it is legal, it is acceptable. I am disappointed the American legal system has not sorted out investment banks. The fines make no real difference to what they do.

Jan Winiecki: There has indeed been a Latin American *nomenklatura*, when they started to talk about privatising the economies in the 1980s. A Latin American economist recommended that before Poland privatised the public sector, she should privatise the private sector because there had been an incestuous relationship between the state-owned banks, the state bureaucracy and the private firms. That much similarity exists between the continents, but it ends there.

In our part of the world, banks were not banks. They were simply accounting offices controlling whether the money allocated by the central planning commission was spent as it should be, according to the rules. For this reason, the next problem was how to find those who could train people in basic banking. You had to find and interest people. There was the idea of persuading Western banks into buying a small share in Eastern banks, and sending a team of people to train people in basic skills. Before this happened there was just the lending of inflationary money from nobody's bank to nobody's enterprise. How to invite Western banks? The bankers needed to see that there was some stability in the economy. This was tremendously difficult.

Victoria Curzon-Price: The fractional reserve banking system surely makes bankers merchants in time. It allows them to convert short-term deposits into longer lending. It makes them merchants and converters, and that seems a useful function, which is why we tolerate this dangerous banking system. I tell my students that money is nothing but debt and can be blown away quickly. It seems to me it has become more dangerous, as everybody knows the central banks are there to bail out an imprudent bank, so there is a moral hazard problem. It seems to me as a cure the 100% reserve system is worse than the disease. There you do not have this efficient merchandising of time any more. You have to use people's real savings to invest, and this deprives the economy of an extra source of renewal.

One should think of alternatives that do not involve such heavy regulation. It seems to me we all know the story of the goldsmith who takes in gold and hands out credit. This is spontaneous. Before we start regulating this system because we cannot control the money supply, we should think of alternatives that are more compatible with human behaviour.

Tim Congdon: It is possible to combine a free banking system – current reserve requirements are not very meaningful now in most European economies including the UK – with macroeconomic stability, as that is what we have done in the last 15 years.

To pick up on what Victoria said, the way that banking evolves is by economising on their cash reserves, enabling them to compete more effectively for the deposits as they can pay more for them, and then the banking system gets overextended, so the banks decide they need to have a specialised reserve bank. This reserve bank will be particularly good in a gold system at managing the gold stock, or in a system where we have dispensed with gold at issuing legal tender. So, the reserve bank will be the bank which has the right to issue legal tender. But it would be wrong if that bank can compete aggressively in the market for private loans.

Andrzej Brzeski: It occurs to me that as there were no banks in the communist systems, there were no firms either. There were firms, so, therefore, there also had to be banks. If there are to be banks, in the context of the European Union one would assume banking would be free – and it is not. The best case I know is in Poland, where the government has prohibited purchase of a bank by a foreign bank. In the EU, one thing that has to be open is the banking market.

Jan Winiecki: Although we did not have decent enterprises where there were good management skills, at least they had good technical skills. The banks did not even have these.

Raul Eamets: If I do not like my Estonian bank, I can switch my funds to a Finnish bank, or a Swedish bank. These days, how often do you visit your bank? So the competition is increasing inside the eurozone where you do not have a transaction cost. If my bank starts to charge, I will shift.

Tim Congdon: One last comment on the Eurozone. They have a single currency; very impressive to combine monetary union without proper political union, I am very surprised that they have done that. But, if they really want to take advantage of having set up this system, surely they should centralise clearing. You cannot write a Spanish bank cheque to a French customer – the banking systems are still separate. As far as I know, the European Commission has tried to force down the cost of cross-boarder payments. The reason there is this cost is because there is no common clearing system. I would guess this is tied to the problem of nationalism in banking, but also due to differing regulations. Now we come back to politics, I am sure in many companies the banking elite and political elite are interrelated. I am sure this nationalism in banking is really about protecting the banking elite.

Silvana Malle: Thank you for leading a very interesting discussion.

Third Session
New and Old Europe

Part 1
Balancing Labour Market Flexibility and Social Security

Raul Eamets: European labour markets face great challenges: on the one hand, there are high expectations concerning competitiveness of the European economy, which also means more flexible labour markets as employers demand wider deregulation in order to compete internationally. On the other hand the European social model stresses the importance of high labour security and social cohesion, as workers seek more employment security in a time of rapid structural change and job reallocation. Beside the impacts of globalisation, Europe must also meet the combined challenges of low population growth and ageing. Faced with these challenges, Europe and its member states need to improve labour productivity, employ more people and guarantee long-term growth and social cohesion. The key issue of the Lisbon strategy is the urgent need to increase competitiveness of the European economy. The strategy ranges from information society to enterprise policy, single market, innovations, education, social environments, research, globalisation policies, etc. The renewed strategy 2005 stresses the importance of increasing economic growth, productivity, competitiveness and creation of jobs. The Renewed Lisbon Strategy focuses on efforts around two principal tasks: delivering steady and persistent growth and creating more and better jobs. One potential way to achieve this is increased labour market flexibility, which should be combined with workers' social protection. The balance between labour market flexibility and social security is labelled, flexicurity. In this paper, we give an overview of the discussions concerning both the concepts of labour market flexibility and flexicurity, and emphasize the ongoing issues also in the context of new member states, particularly in the Baltic States.

1. Labour Market Flexibility.

Despite the growing importance of the issue of labour market flexibility in policies and academic research, this concept is still not clearly defined. This concept is neither uniform nor homogenous. The extensive literature on the subject introduces several typologies for exploring different aspects of flexibility, emphasizing their functions, areas of influence, levels, connections to social protection, etc. At the same time, the degree of labour market flexibility is particularly difficult to assess or quantify. There are still neither clear definitions nor a unique system of indicators for the assessment of flexibility that would

allow us to say whether labour markets are sufficiently flexible for adjustment with asymmetric shocks in the economy.

The term 'labour market flexibility' has been given so many definitions as to arouse the suspicion that there is lack of any theoretical rigour behind this concept. However, this is not entirely true. From the point of view of the general equilibrium theory (that means economics point of view), perfect flexibility may be thought of as a situation where all resources in a given market are allocated in a Pareto efficient way**.** But it could be also argued that we use this term as characterizing state or process. Our opinion is that it is even more appropriate to describe a process with the term of flexibility. For instance, a market is more flexible than others if it moves faster towards Pareto efficient resource allocation. In principle it means that we use the framework of the neoclassical equilibrium model, and any kind of intervention to the labour market will slow down the adjustment speed.

So, we can say that labour market flexibility shows the speed of adjustment to external shocks or, in other words, how quickly a labour market reacts to the changing macroeconomic conditions. This definition, which is provided also by Pissarides (1997), is very broad and measuring such effects as the adjustment speed is empirically difficult; it also depends on the definition of labour market adjustment. Thus, various issues should be considered in order to define this concept clearly e.g. which indicators to take into consideration, what time span we measure etc.

The following four different aspects of labour market flexibility are usually viewed in the OECD studies (OECD, 1999):

- External numerical flexibility is the employers' ability to adjust the number of employees to the current needs of production. In other words, it is the ease of hiring and firing workers, which manifests itself in the mobility of workers between employers (external job turnover).
- Internal numerical flexibility is the employers' ability to modify the number and distribution of working hours with no change in the number of employees. It is often labelled as working time flexibility.
- Functional flexibility is the employers' ability to move their employees from one task or department to another, or to change the content of their work. It reflects the mobility of employees within enterprises (internal labour turnover).
- Wage flexibility enables employers to alter wages in response to the changing labour market and competitive conditions.

Nickell (1997) points out three aspects of labour market flexibility: employment protection, labour standards and labour policy. The employment protection index drawn up by the OECD is based on the strength of the legal framework that governs hiring and firing. The labour standards index refers to the strength of the legislation governing a number of aspects of the labour markets. This index ranges from 0 to 10 of the five dimensions: working time, fixed-term contracts, employment protection, minimum wages and employees' representation rights (on works councils, company boards, etc). Labour policy is divided into active and passive labour policy. The main means of a passive labour policy are several schemes of unemployment benefits. These benefit schemes are mainly characterised by the replacement rate, which shows what share of income is replaced by the unemployment benefits, and the duration of these benefits. The active labour market policies refer to expenditures on activities that are geared to help unemployed people back into work. These policy means include labour market training, assistance with job search, subsidised employment and special measures for the disabled. Later Nickell *et al*. (2005) also added some other institutional aspects like wage setting institutions, trades unions and different tax wedges to the system characterising labour market flexibility.

Considering the tightness of countries' employment protection legislation as a proxy for labour market flexibility and relying also on the analysis of previous theoretical considerations and empirical studies (see also Bertola, 1990; Grubb and Wells, 1993), we can conclude that the Western European labour markets (mainly EU-15) have so far been relatively inflexible which was also reflected in the harmonisation process of labour institutions during the preparation of the EU's eastward enlargement and accession of the new member states.

2. Macro- and Micro-levels of Labour Market Flexibility

Below we present a principal model of the concept of labour market flexibility, which outlines two distinct levels of flexibility: the macro- and micro-level (Figure 1). In reality these different aspects of labour market flexibility are interrelated, presumably in a hierarchical way.

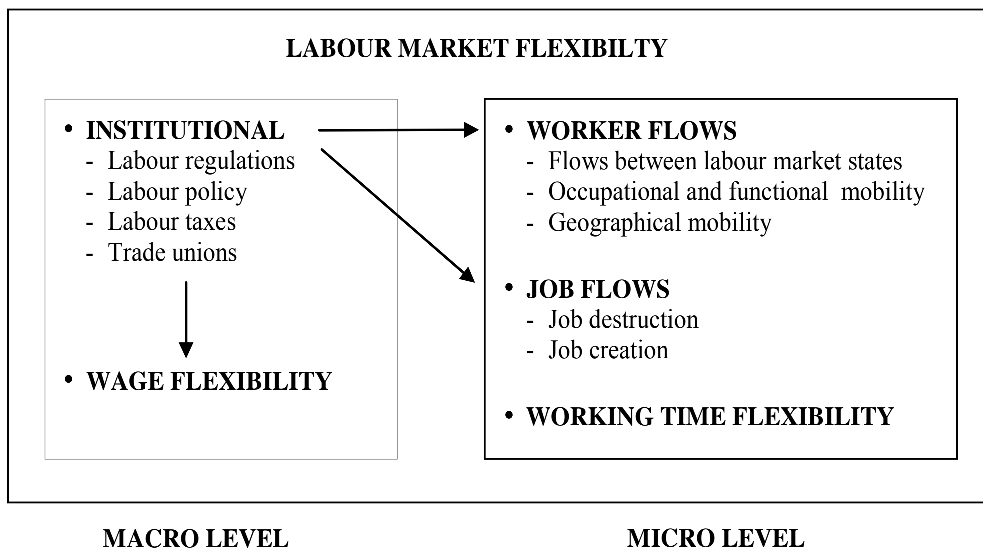

Figure 1. The concept of labour market flexibility
Source: Initial idea Eamets, 2002.

Macro-flexibility can be further divided into institutional and wage flexibility. The institutional flexibility of a labour market shows to which extent state institutions and trades unions are involved in regulation of the labour market. As previously mentioned institutional flexibility covers labour market regulations, labour policy, trades union activities and labour taxes. Wage flexibility shows how responsive wages are to market fluctuations.

Micro-level flexibility relates three types of labour market mobility. One is worker flows, indicating labour flows between different labour market states (unemployment, employment and inactivity). Another is the geographical mobility of labour and occupational mobility. Geographical mobility could mean domestic or internal mobility and international mobility. A separate type of mobility is domestic or cross-border commuting between home and work place. Occupational mobility shows how much people move between different occupations. It can be a flow inside the firm, in which case it is treated as functional mobility, or a flow between firms and occupations. Job mobility could be characterised by job creation and job destruction, e.g. how many jobs are closed or opened during a certain time period (usually a year). Working time flexibility reflects the possibilities for overtime, part-time and shift work.

These different flexibility categories characterise both the macro- and micro-levels of labour market flexibility in their interrelation. If trades unions are weak, wages are probably more flexible. It is easy to adjust wages if agreements are concluded at the individual level. Branch-level agreements make it difficult to adjust wages at a firm level if the economic environment changes.

We assume that macro-level flexibility can partly be measured via the indicators of micro-level flexibility. While it is generally difficult to quantify institutional involvement, it is much easier to measure worker flows, job creation and job destruction. High occupational mobility shows high level of human capital and/or well-developed training and life-long learning opportunities, so it is not difficult to change occupations. But it can also show rapid structural changes in the economy caused by external shocks such as the transition shock in Eastern European countries. People were simply forced to change their employment because their old jobs disappeared.

Why did we reject the more traditional approach to flexibility? First of all we believe that flexibility aspects reflected on micro level are determined by the institutional (macro) framework. For instance, if workers are well protected by employment protection laws then worker flows between jobs, and job creation and job destruction should be low, or if trades unions are very strong then wage flexibility at the firm level is low etc. Therefore we need to study all different aspects of flexibility together.

In the case of the Baltic States we found an interesting phenomenon, that even though the employment protection index in the Baltic States is relatively high (see appendix 1) then job destruction and job creation is very high as well (see for details appendix 2, figure 3). We face a strange situation: by law it is difficult to lay off people but firms still do that. Research demonstrates that laws exist, but law enforcement is low in the Baltic States (Eamets, Masso, 2005). This is connected with low administrative capacity of state institutions (labour inspectorates) but trades unions are also rather weak in these countries.

A unique system of indicators to assess flexibility of labour markets is still lacking. Therefore, there are plenty of studies discussing the problems of labour market flexibility assessment. In the next sub-section, we give a brief overview of these discussions emphasising the lessons of analysing labour market flexibility issues in the new member states.

3 The Concepts of Social Security and Social Protection

Social security is an important component of flexicurity as a policy option which combines social protection with the flexibility of labour market. According to the Encyclopaedia Britannica (2004), social security denotes any of the measures established by legislation to maintain individual or family income or to provide income when some or all sources of income are disrupted or terminated, or when exceptionally heavy expenditures have to be incurred. This concept is closely related to the concept of social protection – protection against socially recognized conditions, including poverty, old age, disability, unemployment, families with children and others.[2] In fact, these two concepts are interrelated; some publications even use them interchangeably.

The term "social security" can be used to refer to social insurance, where people receive benefits or services in recognition of contributions to an insurance scheme. These services typically include provision for 1) income maintenance – mainly the distribution of cash in the event of interruption of employment, including retirement, disability and unemployment; 2) services provided by administrations responsible for social security. In different countries this may include medical care, aspects of social work and even industrial relations. More rarely, the term "social security" is also used to refer to basic security, a term roughly equivalent to access to basic necessities – things such as food, clothing, shelter, education and medical care.

A concept related to social security is social protection. Being part of a broader concept of the European social model, it is a rather new and evolving concept in Europe. The European social model tries to incorporate the social protection of workers with interest co-ordinations (industrial relations), effective regulation of economic competition and social cohesion. According to the narrow definition, social protection incorporates public measures meant to provide income security to individuals (Holzmann and Jørgensen, 2000). There is general agreement that the overall goals of social protection are to improve welfare and reduce poverty. In the past decades, however, there has not always been consensus about what welfare improvement is when taking into account all the indirect effects of several policies. Therefore the exact measures used to target the goal have been wide-ranging.

The World Bank's Social Protection Sector defines social protection (World Bank Social Protection Sector, 2004) as "a collection of measures to improve or protect human capital. Social Protection interventions assist individuals, households, and communities to better

[2] For more about social protection and the European social protection models see Part 5.

manage the income risks that leave people vulnerable”. Thus one argument in favour of social protection is that it may increase welfare through avoiding human capital loss e.g. during unemployment. Another economic argument could be that in the event of decreasing marginal utility, individuals’ welfare is increased by smoothing income across different time periods, thus making more preferable patterns of consumption feasible over time. However, individuals themselves might not be able to smooth their income and consumption, for example, due to borrowing constraints or not being able to insure against the risk of unemployment.

The definition of social protection was reviewed during the preparation of the Social Protection Sector’s new strategy by the World Bank (Social Protection Sector, 2000) which was aimed firstly at assisting individuals and communities to manage risk better and secondly to provide support to the critically poor. The idea was that it should provide a safety net to the poor but also help them out of poverty. Therefore, the system can be viewed not as expenditure on social transfers but primarily as investment in human capital. The goal is to make social protection systems focus on the causes of poverty rather than the symptoms.

Generally, social protection measures are thought to belong to four large areas: social insurance, direct transfers, social funds, and labour market institutions. The goals of a social protection system can be divided into two groups: there are measures which are directed at helping people to escape poverty, and measures for providing a certain minimum income to those in poverty. Both are directed towards avoiding the social exclusion of people and thereby supporting directly or indirectly the preservation or even raising the value of the human capital. Social insurance (like health insurance, unemployment insurance, pension insurance, etc.) as well as most of the direct transfers should provide people with a minimum income. Some labour market regulations, such as minimum wage and trades unions’ activities have the same goal – to provide people with a certain income above the minimum level or a level considered to be fair. There are also other measures, such as active labour market measures and several other social funds directed at providing people with the possibility of escaping poverty by, for example, improving their qualifications.

In the context of labour market flexibility and flexicurity, emphasis is on the concept of social security taking into account four aspects of security: job security, employment security, income security and combined security (Wilthagen, Tros and van Lieshout, 2004). A short introduction to the content of these security aspects is as follows:

1. Job security – the certainty of retaining a specific job with a specific employer. It is guaranteed by the protection of employees against dismissal and against sig-

nificant changes in working conditions. This is the principle objective of employment protection legislation.

2. Employment security – certainty of remaining at work (not necessarily with the same employer). It means the availability of jobs for the dismissed and unemployed corresponding to their qualifications and previous working conditions. The employability of job seekers can be improved by life-long professional training which can be offered both by employers and in training programmes within active labour market policies.
3. Income security – income protection when paid work ceases. Standing (1999) considers it more generally as protection of income through minimum wage, wage indexation, comprehensive social security, including progressive taxation, provisions for old age etc.
4. Combined security – certainty of being able to combine paid work with other social responsibilities and obligations. This form of security cannot be traced back to the other forms of security. Tros (2004) explains it as a work-life balance, work-family balance, early flexible part-time retirement, flexible working hours, and leave facilities.

Tangian (2005), who has worked with flexicurity measurement issues, proposes five different estimates of benefits as components of social security to calculate flexicurity indexes: unemployment insurance, paid holidays, paid maternity leave, public pension scheme, paid leave. In considering the flexicurity issues, we focus mainly on two aspects of social security – employment protection and income protection.

4 The Concept of Flexicurity

Flexicurity is a comparatively new paradigm for reforming national employment and social systems in Europe in order to find a balance between flexibility and security and between the interests of employers and employees. Debates continue about the concept of flexicurity and its policy instruments. Wilthagen and Tros (2004) ascribe the initial concept of flexicurity to the Dutch professor H. Adriaansens who started to use this term in 1995. He defined flexicurity as a shift from job security towards employment security and suggested compensating the decrease of job security due to fewer permanent jobs and easier dismissals by improving employment opportunities and social security. Based on these initial considerations, Wilthagen and Rogowski (2002) defined flexicurity as "a policy strategy that attempts, synchronically and in deliberate way, to enhance the flexibility of labour market and to enhance security – employment security and social security – notably for weaker groups in and outside the labour market on the other hand". This definition is sometimes also called the Dutch approach of flexicurity (see Klammer, 2004). In Denmark flexicurity is associated with a low level of dismissal protection and

high unemployment benefits (see also Madsen, 2003). Denmark and the Netherlands are often pointed out as examples of good practice in the field of flexicurity.

Although some authors still consider flexicurity as a specific Dutch/Danish phenomenon (Gorter, 2000), the idea has spread throughout Europe within a few years. At the Lisbon summit of 2001 the EU already referred to this concept (Vielle and Walthery, 2003). In the European Union's Employment Guidelines for 2003 the balance between security and flexibility was explained as follows: "providing the right balance between flexibility and security will help support the competitiveness of firms, increase quality and productivity at work and facilitate the adaptation of firms and workers to economic change" (Council of the European Union, 2003, paragraph 12).

Several authors have defined flexicurity in a much more general way. For instance Keller and Seifert (2004) view flexicurity as social protection for a flexible workforce, understood as an alternative to pure flexibility, or to deregulation-only policy according to Klammer (2004). As correctly mentioned by Tangian (2005), the definitions describing flexicurity concepts are more like strategies which are difficult to describe quantitatively. Therefore he suggests to arrow the definition so that we could measure the flexicurity numerically. According to Tangian, flexicurity is the employment and social security of atypically employed people, thus people who ordinarily do not have permanent full time jobs. Based on this relatively narrow definition he constructs the flexicurity index which is based on qualitative juridical data and several other indicators. From the protection side the eligibility of public pensions, unemployment benefits, paid sick leave, paid maternity leave and paid holidays as the indicators for social security are used for describing employment protection.

In our interpretation flexicurity means increasing labour market mobility (job flows, worker flows, functional and occupational mobility, geographical mobility, flexible working time arrangements) with providing opportunities for getting a new job and not losing substantially in income levels. The last two mean that unemployed people should get sufficient training and active labour market policy support in order to get a new job quickly. The unemployment benefit should be sufficient to cover major income losses while people are looking for new jobs. The duration paying unemployment benefit should be relatively short, so that people will not lose the motivation to seek new jobs. Thus, despite the existence of different definitions, the balance between social security and labour market flexibility remains the core issue of the flexicurity concept. We would like to stress that the concept should include all types of employment, not only atypical

workers. If we concentrate only on atypical workers, a large share of the labour force with permanent full time job contracts will be deprived of social protection.

Policy options and institutional tools in the framework of flexicurity can be viewed from two sides; flexibility and security. One possibility for considering these aspects of flexicurity is to present a matrix which links policy instruments, labour flexibility and security (see Table 1).

Table 1. Policy intruments in the framework of flexicurity

Policy instrument	Flexibility	Security
Labour protection legislation	Shortening the notice time and lowering the severance payments	Better guarantees for temporary work agency workers
Trades unions	Less restrictive migration policy (between member states). Needs change in attitudes	Collectively agreed guarantees for more vulnerable employee groups: temporary workers, part-time workers, youths etc
Social policy	Reduction of early retirement schemes/variable retirement schemes	State support to inactive people without income or long-term unemployed people should cover at least the minimum subsistence level
Labour policy	Period of receiving unemployment benefit should be shortened	More stress on active labour market programmes, like training. Governmental support schemes to SMEs in order to introduce intra-firm training

Source: Author's compilation.

This matrix could serve as an example of how it is possible to implement policy instruments in order to achieve flexicurity. Despite common problems and similar solutions in all member states, we still believe that policy options in the framework of flexicurity should principally be country-specific. Thus, flexicurity approach is a comprehensive political strategy of co-ordinated measures promoting modernisation of work organisation and labour relations as well as job security and social protection of all types of employees, who need support in order to improve their competitiveness in the labour market. How realistic is the implementation of flexicurity approach and what are the different scenarios for member states?

5 Future developments

In new member states opening up national economies to global competition has made domestic enterprises adjust their inputs, including labour, to market demand. Within the structural adjustment package, introducing employment flexibility and lowering social protection was in most cases offered as the sole alternative for transforming labour markets in the new market conditions. As a result, the low administrative capacity of labour market institutions and weakness of trades unions combined with poor law enforcement have contributed to high labour market flexibility and job insecurity felt by workers. In EU 15 we can see relatively regulated labour markets, relatively high density and coverage rates different forms of workers representation etc. However the best way to differentiate countries is according to their type of social model. Well-known typology groups countries into four different models: Anglo-Saxon, Continental, Nordic and Mediterranean. We can say always that new member states fall into one or other group. In real life these groups are relatively mixed.

The European Foundation launched a survey of flexicurity in EU countries. We can use these results to illustrate future developments in EU member states towards flexicurity. The results show that the flexicurity concept is implemented in different ways for different country groups. We believe that countries are strategically in different positions (see Figure 2):

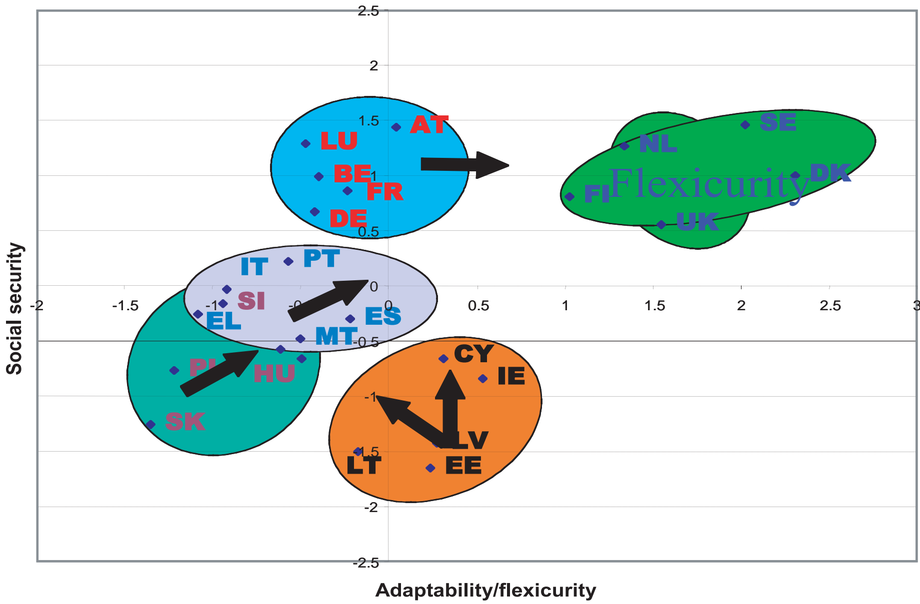

Figure 2. Flecixurity and social security by different country groups

Source: Philips K. Eamets, R. Benchmarking industrial relations against Lisbon Strategy, European Foundation, 2007

Some old member states are, to a large extent, characterised by high social security and a relatively rigid labour market (continental group). The biggest task for these countries is to make labour markets more flexible. The second group consists of the Anglo-Saxon model and the Baltic States with their very liberal economic policy. The Baltic States are a special case in terms of flexicurity. It sounds paradoxical, but in order to achieve more flexicurity, the Baltic labour markets should become more rigid, providing sufficient protection to the labour force and then possibly more flexible labour market arrangements will be implemented again. Cyprus and the Republic of Ireland should deal mostly with social protection issues. Mediterranean countries and the new member states of Central Europe belong to the same group. Our analysis indicates that both security and flexibility should be developed further if these countries want to implement the flexicurity model. The Nordic countries, Netherlands and the United Kingdom are actually very close to the model that the EU commission has labelled as flexicurity.

It is important to understand that in order to converge with western economies some new member states, particularly the Baltic States, should maintain a relatively liberal economic policy, which means a flexible labour market with a strict monetary and fiscal policy. In general, for new member states, there are two unavoidable issues: time and active labour policies from government. Time means that a certain time period should be considered while nominal and real convergence of the new EU economies takes place. Active labour policies help to achieve the faster adjustment of the labour force to external shocks mainly via training activities. Mutual trust is also an important issue stressed in flexicurity strategies. Both employers and employees should trust each other and realise that it is possible to implement effective measures which may increase flexicurity as in Denmark and the Netherlands.

In the old member states with the continental model, the main stress should be increasing the flexibility of labour markets. The demographic situation is very bad, employment is not increasing and unemployment is very high. Old Europe needs reforms in order to maintain global competitiveness. There are not many options. Innovation and increase in productivity is one: how to compensate declining employment, reduction of labour costs, introduction of flexible work-forms, flexible labour contracts. Such decisions are not easy to implement because politically it is hard to explain to the public that workers will lose some of their job security. Social protection should also be increased in the United Kingdom and the Republic of Ireland. South European countries and Visegard countries will experience the most serious problems, as both social security and labour market flexibility need to be increased. In the long run both parties will shift towards a modernised European social model (see Figure 4 in Appendix 3¤) which tries to find a balance between social security and flexibility. New member states will lose some of their current labour market flexibility and old member states will probably lose some job security.

Conclusion

The European economy is losing its position in world market. One important way to improve economic competition is to make labour markets more flexible. This means that the speed of adjustment to the changing macroeconomic conditions, and thus to external shocks, should be increased. The Western European labour markets have been relatively inflexible so far and that has also been reflected in the harmonisation of labour institutions in the new member states. It should also be taken into consideration that the necessity to increase labour market flexibility may reduce labour protection and security. In order to create a new balance between labour market flexibility and security and to provide an alternative to the deregulation policy, a new policy option called flexicurity has to be implemented in Europe.

In conclusion, the achievement of the correct balance between flexibility and security takes time and requires resources to implement proper policy measures (labour, social educational policy) by the Baltic States' governments. A specific period of time should be considered for introducing flexicurity. This would be connected to the time necessary for the nominal and real convergence of the Baltic economies. It is evident that flexicurity and the new models of social protection and partnership cannot be developed overnight: In Western countries it took a long while to become established. We should take into consideration that there is no single optimal institutional setting for any specific country. Each country must consider a wide choice of policy options for creating labour markets which offer flexicurity. To what extent social partners are involved in the implementation of the renewed Lisbon strategy depends on level of trust and co-operation between them.

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APPENDIX 1

Table 2. Different types of employment status and EPL, 2001 (%)

	Self-employed and other	Regular contracts (unlimited duration)	Fixed term contracts	Temporary agency contracts	Part-time work	EPL strictness, standard employment (and adjusted*)	EPL strictness, temporary employment
Latvia	13.7	55.4	20.1	5.7	10.0	2.3 (1.3)	2.1
Lithuania	19.7	62.9	13.8	0.4	11.0	3.0 (1.9)	1.4
Estonia	10.1	75.6	10.7	1.2	8.0	3.1 (2.3)	1.4
Baltic States	14.5	64.6	14.9	2.4	9.0	2.8 (1.8)	1.6
Bulgaria	17.4	56.4	20.7	1.4	10.0	2.8 (1.6)	2.7
Czech Republic	15.9	72.1	9.5	0.9	8.0	2.8 (2.0)	0.5
Hungary	17.4	73.4	8.4	0.0	6.0	2.1 (1.5)	0.6
Poland	33.5	54.8	7.8	2.5	6.0	2.2 (1.2)	1.0
Slovakia	12.7	75.0	10.6	0.8	7.0	2.6 (2.0)	1.4
Slovenia	21.9	66.7	10.1	0.0	9.0	3.4 (2.3)	2.4
CEE average	18.0	65.8	12.4	1.4	8.2	2.7 (1.8)	1.5
EU-15	16.6	68.1	8.3	1.8	18.0	2.6 (1.8)	2.3

* The adjusted EPL strictness indicator for standard employment is the EPL indicator (calculated according to OECD, 1999) multiplied by the frequency of regular employment contracts.

Source: Eamets and Masso 2005

APPENDIX 2

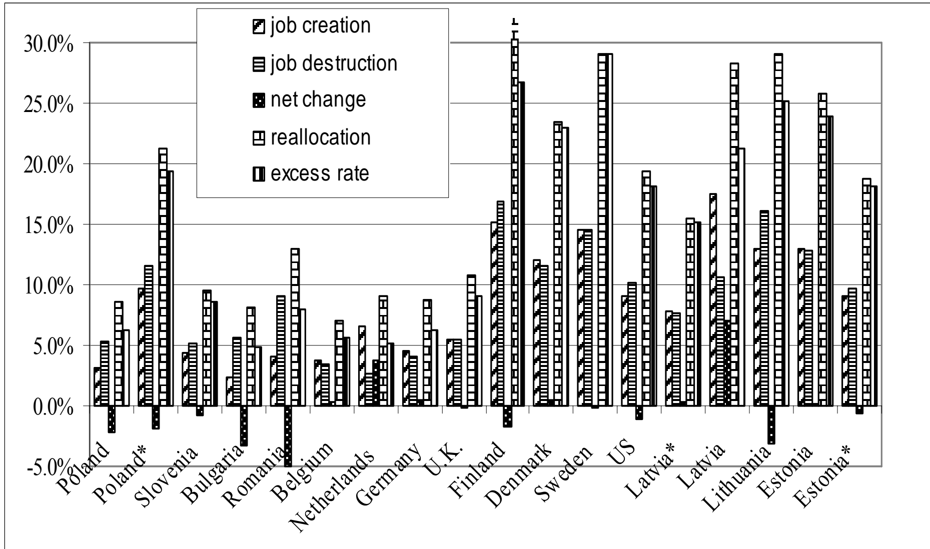

Figure 3. Indicators of job flows in the Baltic States in international comparison (% of employment).
Source: Eamets and Masso 2005

Definitions:
Gross job creation (*pos*) is defined as the sum of all employment gains in all expanding firms, while gross job destruction (*neg*) is the sum of all employment losses in all contracting firms in an economy, sector or region. Usually these gross job flows are expressed as rates by dividing them by the total amount of jobs available in an economy, sector or region.
The sum of the gross job creation rate and the gross job destruction rate is the gross job reallocation rate (*gross*, $JR_t = JC_t + JD_t$), while the difference is the net aggregate employment growth rate (*net*, $NET_t = JC_t - JD_t$) that can be observed in aggregate statistics. A measure of reallocation of jobs, which is over and above the amount of job reallocation necessary to accommodate a given net aggregate employment growth rate is the excess job reallocation rate and is defined as the gross job reallocation rate minus the absolute value of the net aggregate employment growth rate (*excess*, $EJR_t = JR_t - |NET_t|$).

APPENDIX 3

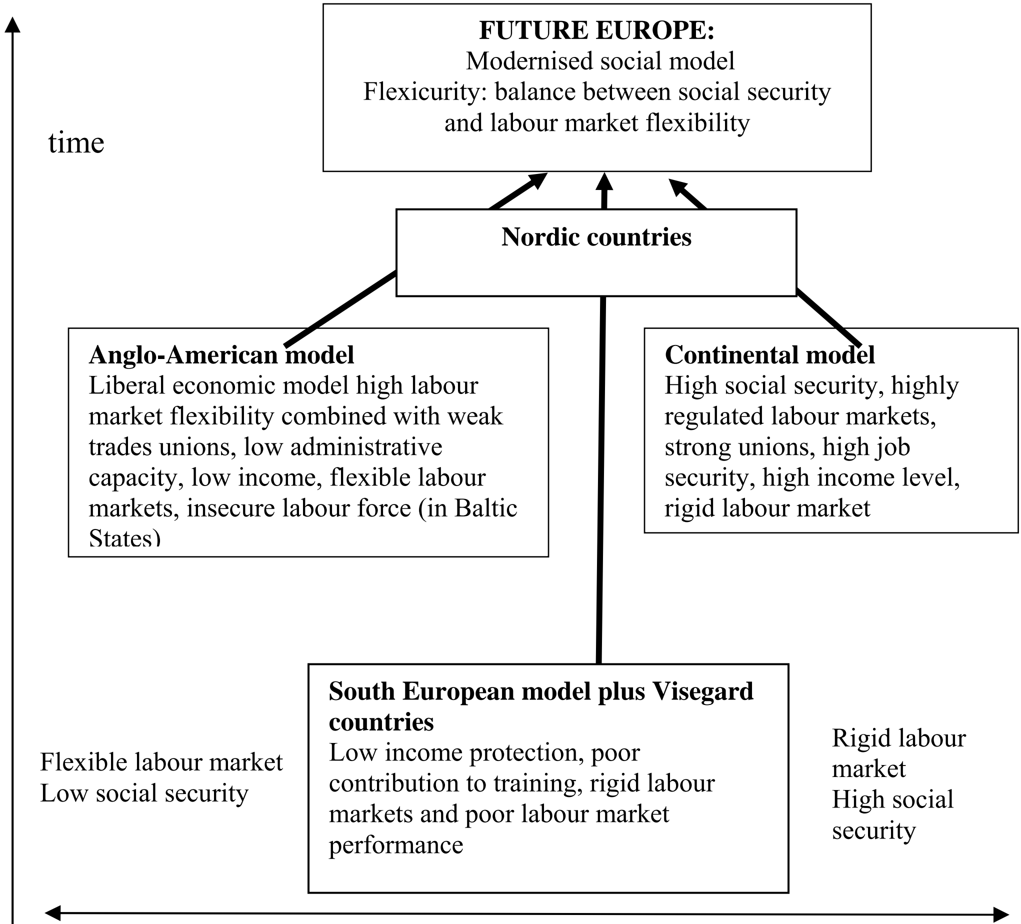

Figure 4. Convergence of "Old" and "New" Europe in flexicurity framework

Source: Philips K. Eamets, R. Benchmarking industrial relations against Lisbon Strategy, European Foundation, 2007

Third Session, Part II

Progress Reports from Transition Countries

Hungary

Sebestyén Gorka: It is wonderful to be here – thank you very much Lisl and Ljubo. When you are sitting in Hungary or other countries of the region, fighting the good fight, you often feel alone and dejected, but when you come to Bled you can recharge your batteries and realise that everybody else is fighting the same fight in the region. Thank you for this opportunity.

My wife thought of the title: The Hungarian Tiger, and it is the title of a project we are starting on; a book examining how the economic success of Hungary has rapidly been turned into a failure by the former communists, and also by the conservatives when they were in power.

The detailed paper by Katie Gorka[3] gives you a real snapshot of what the current situation is with regard to the scandal and the crisis around the government of Ferenc Gyurcsany. Because, similarly to Churchill's description of Russia, Central Europe is not understood – or cannot be understood – unless one is very familiar and comfortable with contradictions, complexities and paradoxes, I would like to do a 101 on Hungary since the transition, what happened between 1990 and 2006 and why we were the Tiger of Central Europe economically for the first ten years, and why we are the foot of the ladder now.

To understand Hungary, and this is true for most countries of the region, you have to throw all Anglo-Saxon concepts out of the window. Words such as conservative, socialist and liberal have very little traction in the way we understand or use them in Western political science. What are the groups that we need to understand in Hungary? The most important one is the elite of the former communist dictatorship, now renamed socialists, who are now in government. They are very much unreconstituted and consist of many factions: old hardliners, more modern reform-minded types and many of the former communists who are now billionaires. There are very many wings, but the important thing is that the socialists are the former communists. Where it gets a little more complicated is the question of the original competition to the regime. The opposition as a mass can be identified or sub-divided into three groups. The oldest generation at the

[3] This paper available from IDTIS and CRCE

change of regime in 1990, those over 50, made up the MDF – the Hungarian Democratic Forum – and formed the first Hungarian government. These were conservatives in the traditional Christian Democrat vein. The plight of the Hungarian minority stuck outside Hungary in neighbouring countries since the Paris peace treaty of 1920 was very important to them. They are now pretty defunct, with about two per cent of the vote. Lower down in age - and I am talking about 1990 with reference to these ages - you had 30-something dissidents. These are the hardcore anti-communists who eventually became the SDF or Liberal Party. Liberal, in the way it is understood by them, is very much pro-market – at least in their rhetoric. The last group was formed by the 20-something individuals; hardcore student radicals, who were very much anti-communist, but not at all conservative to begin with. This generation of dissidents became the Young Democrats, or Fidesz Party. It is important to have these groups in mind when discussing Hungarian politics.

What has happened since the collapse of communism in Hungary? What kinds of governments have we had? Well, until the last election, this year, I have seen a classic pattern redolent of the trends in the region which have been pendulum swings; from communism to conservatism; from conservatism to reformed communists. In the first government, 1990 – 1995, the first generation of conservative dissidents was in power; academics, historians and professors made up the cabinet. The biggest problem with this government was that they were unprepared to exercise any kind of shock therapy on the nation. Hungary had the highest *per capita* debt in the region in 1990, and they did very little to deal with this situation. The second problem that they are responsible for, which has resulted in great repercussions since 1990, is that we also have the weakest lustration system in the region, perhaps bar Romania, Albania and Serbia. What does Hungary's lustration policy look like? The first free government left the lustration issue until the very last moment. Not until after the Prime Minister died in 1993 of leukaemia and was replaced by his interior minister did they finally present a lustration bill to Parliament.

Lustration in Hungary functions in the following way: A so-called independent court of judges was created inside Parliament. These judges had access to the remaining files of one of the directorates of the secret services. It was restricted to one specific directorate, the "three by three", which contains the records of the secret police who spied on their fellow citizens. They were responsible for the defence of the Communist regime. If you were found to have been an agent or an officer of the three by three, or if you were in such a position in the party to regularly receive reports by the three by three, you were challenged *in camera* by the judges with the evidence, and told "you are compromised, here is the evidence, you have 30 days to remove yourself discreetly from public office. The pool of lustration was made up of all Members of Parliaments, all members of the Cabinet and State Secretaries, all the chief editors of large newspapers, TV and radio, and

finally Bishops of the major churches. If you refused to resign quietly, after the 30 days expired, the court had the power to publish that you were compromised in the Hungarian equivalent of Hansard, which of course nobody ever reads. So, what was the result? People such as the former Prime Minister under the reformed Communists Gyula Horn gave a "ná es" response, which means "so what? I am democratically elected, who cares?" And the "ná es" defence has been used repeatedly by former Communists since then. We have no power to remove them from office, or fire them as in Poland or elsewhere.

As a result of the MDF's lack of ability to create Switzerland within four years out of the ruins of the Kádár regime, we saw what happened elsewhere in the region and the former Communists were reinstated in 1994. If you look at the dates, there is one important thing; you will notice that, unlike any other country in the region, in Hungary, every single government has completed its full four-year mandate. This is not because we are an exceptionally stable country. Instead of a new constitution, the Communist constitution of 1949 was amended in 1990 and we are still functioning pretty much under the old Communist constitution with various amendments, we took a passage from the Scandinavian and German models that only allow a constructive vote of no confidence against the Government. In short, you can vote yourselves out of power if you have the majority of Parliamentary seats, but the vote of no confidence can only be effective if concurrently the next prime minister is designated. This never happens. You never get 50 plus one to agree on the next prime minister, and that is why every government has filled its full four year term.

In 1994 it was the turn of the former Communists again, now called the Socialists, which is confusing. They are about as socialist as Margaret Thatcher was. They sold everything that was not bolted to the floor. Under the former Communist Government of 1994, privatisation went ahead at 100 miles per hour and, in 1996 the Government did execute severe shock therapy on the nation. Wages were frozen, student fees were introduced for the first time for every university student, and so forth. Perhaps in response to the shock therapy, but perhaps more because of some large scandals that erupted in the second half of the Government's term, which related to public funds being diverted into party coffers. The former Communists lost power in 1998, and it was the turn of the former radical students; young men who had never ever had a job in their life. They went from students to members of parliament in opposition for eight years, and then suddenly were swept into power and they had to govern a country. The interesting thing about the period in which they took power is that a year before they had decided to change their name and to change their avowed anti-communist philosophy, which also included being anti-church and anti-traditional conservative values, to being the new conservative power. They became the new Hungarian Civic party, Fidesz. How did they do this? As Churchill says, "He who is

not a liberal when young has no heart. He who is not a conservative when old has no brain". They went through the same transformation. They married, had children and became conservatives. Or maybe they did not. Maybe they saw that since the MDF – the old guard conservatives – had imploded; fallen apart through internal schisms and lack of popularity; they saw a vacuum on the political landscape. Someone had to pick up the conservative banner and they decided it would be Fidesz. Fidesz came in on a banner of conservative traditional values. They promoted large families and the Church, and their basic economic policy was Gaullist. It was statist and interventionalist. They saw the role of the state as being important in the economy and large. They gave Government subsidised loans to couples with children who wanted to build houses and they scrapped university fees.

In 2002 the pendulum swung again. It was very close; only a ten-seat majority win to the former Communists and their allies, the Free Liberals. Why? It is hard to tell. Many thought this was due to a bad campaign and people not identifying with Oban, the Fidesz leader, finding him unsympathetic. At a previous Bled conference I spoke about the scandal that had just erupted, when the former Communists retook power in 2002. Two and a half weeks after the election it was leaked by the only surviving conservative daily that the new Prime Minister had been an acting officer – not an informant but an officer – in the secret police in the late 1970s and 1980s. I had the honour to be on the committee investigating the Prime Minister. We could not get him out. Out of the several hundred pages of documents that should have been in the Interior Ministry files, which he would have filed during his tenure as an officer in the secret police, only 18 pages were left available to us by the time of the investigative commission. It made it very difficult to find the smoking gun indicating what he had actually done against his fellow Hungarians. Nevertheless, he was eventually deemed to be a liability to the Government, and a year later he threatened to resign and his fellow former communists accepted his resignation. As a result somebody who had never been elected to public office in Hungary became Prime Minister, the then Sports Minister Ferenc Gyurcsany, and he is currently in office. He is one of the richest individuals in the nation, and is a former Vice-President of the Hungarian Communist Youth League. Then the elections came in 2006, and this is where we broke the trend in Hungary. In 2006, for the first time an incumbent government won the elections. This time by almost 30 seats, an even larger majority, and Ferenc Gyurcsany was reinstated as Prime Minister.

Today, we have a crisis in Hungary. For the last three weeks we have had demonstrators outside Parliament every day as a result of a leaked digital recording of the Prime Minister addressing his fellow members at a closed meeting of the Socialist Party, where he admitted they had lied for a year and a half to win the elections, and had not done anything worthwhile in the last four years whilst in power. In this recording he used

obscene language to describe his own nation. As a result of the speech being released, many people went out on the streets. On the first day there were 50,000, and a very small group of demonstrators – I was there myself and I witnessed it for the first few day – went to the television station. A group of about 50 football hooligans decided once the TV station had refused to read the petition on air, to attack the TV station. As a result you have all seen the pictures: cars were set alight; one building attacked. That is why Hungary has been in the headlines. Of course violence is not the solution, but if it had not occurred there would not have been eight different satellite trucks and media companies, including CNN, the BBC and the Independent, outside the Parliament in Budapest. Unfortunately, the demonstrators are led by a group of very well meaning amateurs who do not really know what they need to do and how to do it. They say they will stay there until the Prime Minister resigns. Unfortunately, we cannot remove the Government because of the constitution. The strange thing is that Fidesz, until yesterday, has played no role in these demonstrations. In fact, their speakers and members have been banned from going to the demonstrations and addressing the crowds. I see two reasons why this could be. One of them is fear of being identified as being allied with any radical right-wing group which is why they do not want to take the stage. For ten years they have been accused of being under the table radicals, and they may not want to give ammunition to the former Communists. The second possibility, based on a conversation I had with a former Economics Minister, is that they do not want to govern. An opposition that does not want to govern? It is a bit like Monty Python and the Dead Parrot sketch. They know that Hungary is in a mess with the largest deficit since the fall of communism. It is not just because of the former Communists. I think, personally, it is a lot to do with the spendthrift way Fidesz ran its economic policy. I think they would prefer to see this Government carry the can for the next three years, then take control down the road. A third reason, substantiated by the international media, is that they do not have a clue what to do economically. Even if they were able to push the Government out, or call a new election and win it, because they are statist, they do not want a small state and are not prepared to take the austerity measures that have to be taken. As I mentioned yesterday, not only do we have the biggest deficit, we also have huge state capture in Hungary. 25 per cent of the active labour force depends upon the state. The current Government has been advertising its new austerity package. Three days ago we found out the Prime Minister spends 1.2 million forints (six thousand dollars) per month on having himself photographed. That is how austere the Government is now. In the last eight months they have spent 20 million forints on office furniture. The austerity package is being executed on the people, not the Government. That is the problem.

I will stop there. I am not an economist, I am a political scientist, so please do not ask me for numbers or percentages. All I can tell you is that we are in trouble.

Croatia

Joel Anand Samy: The Adriatic Institute was primarily funded, as far as the launch and seed money, by an individual foundation. One message this clearly articulates is that it is about sacrifice. It is about philanthropy. Our funding is mainly from the Croatian-American community, which has benefited from the free-market economy of the United States and wishes to give something back to their parents' homeland. This is a very open venture, and we do not receive or seek any government money. Now, a note on the Government of Croatia: at present it is a centre-right government with a strong tendency to promote the European Social Model; it is very socialistic. The ruling party actually belonged to President Tudjman in the 1990s and promoted criminal capitalism for nearly ten years. We have a group of people in power today; not very different from those Sebestyén Gorka is experiencing in Hungary. These people are just a little bit more discreet in what they are doing. Natasa Srdoc recently stopped the privatisation deal last summer, 2005, which involved 100 million dollars, with the strong possibility of the Government receiving a kickback. This action has underlined the Institute's credibility, probably not directly because this is an American entity, but Natasa Srdoc, the Institute's president was born and bred in Croatia. We have to work hard to be strategic and consistent all time. This is one of the reasons we are based in Rijeka rather than Zagreb, where there is a great deal of corruption, even though we spend much of our time there to stay in contact with people in the capital and, of course, it is the media centre as well.

Natasa Srdoc: The differing perceptions of think-tanks were shown in a recent article by *The Economist*. In Germany, it was shown that a think-tank would only be considered truly independent if the government funded it. In the US, to be independent a think-tank must be funded privately by companies or individuals. It becomes day and night. That is how it is in Croatia. Those think-tanks funded by the Government are sheltered. We are commonly asked who is funding us.

I would like to present a SWOT analysis, which is a business tool in assessing Strengths, Weaknesses, Opportunities and Threats of a particular concept: a SWOT analysis of Croatia joining the EU

STRENGTHS (Croatia's strengths in joining the EU)

- Potential opportunities in investing in Croatia (pending structural reforms)
- Access to a new market (for foreign investors)
- Attractive real estate investments

WEAKNESSES

- Presently, lack of competent and honest public administration – loss for taxpayers
- Constructive and open public debate about the benefits and drawbacks of joining the EU is not encouraged in Croatia
- Non existent cost-benefit analysis of Croatia's joining the EU
- Lack of transparent approach to the taxpayers about the current state of affairs in Croatia (recent example of the EU Progress report not being translated in Croatia, and spun as very favourable – this approach questions the validity of political will in dealing with reforms, since the first step in solving a problem is acknowledging that you have one)
- No publicly known strategy for negotiation – is there anything to negotiate?

OPPORTUNITIES

- Croatia could be pressured into establishing the rule of law, protection of property rights and the combating of rampant corruption
- The Government could be pressured to uphold the freedom of speech and independent media – prerequisites for a democratic society.
- Economic criteria should be fulfilled by Croatia: reducing and eventually eliminating subsidies to government owned companies, further privatisation, and easing the Government out of the economy will make the economy more efficient, less corrupt and increase economic growth
- Access to the wider EU market for Croatia's companies – increased competition will spur more innovation, bring specialisation, lower prices and bring higher quality products and services to citizens
- Eliminating tariffs and other non-tariff barriers to free trade with the EU, which increases the well-being of Croatia's citizens
- The only way to catch-up with the standard of living of western countries is to grow much faster than them – higher sustainable economic growth will only be possible if Croatia has a more competitive business environment (low taxes,

flexible labour market, reduced cost of labour through pension and health care reform, and other reforms) and attract new FDI.

THREATS

- Overly regulated EU market which stifles competition
- One of the EU's recent attempts at regulation is REACH - registration, evaluation, and authorisation of chemicals. REACH has been rightfully criticised for being expensive and bureaucratic
- Common Agricultural Policy (CAP) consumes 50% of the EU budget – for example impeding Croatia to plant more new vines and olive trees – which is ridiculous in a global market – Croatia should not limit its potential by looking only at the EU market
- Brussels bureaucracy increasingly regulating new areas
- Sovereignty transferred from the national to the European level – requirements for Croatia to keep its territorial waters open – Italy not allowing Croatia to proclaim an economic zone by threatening to stall further EU negotiations
- Imposed harmonisation in the European Social Chapter – thus maintaining a heavily regulated labour market (high unemployment)
- Attempts to harmonise the taxes starting with harmonisation of the tax base
- Voting system within the EU jeopardizes citizens' democratic rights – Switzerland's cost-benefit analysis of EU membership showed that the Swiss would have fewer than 20 seats in the European Parliament out of 732 seats, or a voting weight of less than 2.7%.

EU Enlargement

RISKS OF EU WIDENING for the EU as a political union

- If the EU does not insist on rule of law (independent judiciary), protection of property rights and combating corruption as major criteria for accession, the EU community becomes dysfunctional – we see that in the UK the rules are upheld, whereas other countries ignore them
- Is it possible to apply and enforce the rules that are valid for all? - (even Germany & France surpassing the budget deficit limits without being penalised)
- When a new country joins the EU, the leverage for reforms is lost - A number of international journalists revealed challenges in receiving information for the sake of transparency and accountability from Romania and Bulgaria, once they were confirmed as future EU members

- Taking the independent judiciary for granted in an EU country – European Court of Human Rights in Strasbourg takes independent judiciary, rule of law and protection of property rights for granted in Slovenia (since it is an EU country) and does not question the decision of Constitutional court of Slovenia – I should like to quote Janez Jansa, Prime Minister of Slovenia, in *Demokracija*

> Those who have ruled Slovenia almost without interruption for the last 60 years, succeeded in establishing during this time a special one-party judicial system controlled by their own power…They dominated everything – from professorships at the universities to prison guards…This network has never been fully dismantled. The judiciary reform of 1994 even attempted to re-build it in some way.
>
> Perhaps measures such as the European Union has recently demanded from Bulgaria could help…

- Reversal of reforms in former communist countries - Recent case of Poland's twin brothers – the Prime Minister and the President - reversing the reforms, for example: public administration back to be based again on political criteria (rather than professional)

All these risks mentioned above for the EU as a political union, clearly articulate the argument for a Europe as a European Economic Community.

I believe that in the near future Europe should become an area of the countries engaged in free trade with no political integration. Economically, this would bring more flexibility and innovation, lower cost and allow Europe successfully to compete with other countries, especially China and India. Europe should introduce flexible immigration (keep in mind Europe's low population growth and impending pension crisis), and free market reforms that will certainly lead to higher employment and higher economic growth; that is higher living standards for its citizens and taxpayers.

The European Journal published an article co-authored by Roger Helmer, a British Member of the European Parliament, and Joel Anand Samy, where they stated "The United Kingdom has a unique opportunity to advance reforms within the EU and encourage nations beyond the EU's borders to press ahead with free market reforms based on the rule of law and protection of property rights. For Croatia's hopeful citizens, reforms for the EU should be replaced by "free market reforms for its own future".

This should be the goal of Croatia's government: advancing economic freedom by upholding the rule of law, establishing an independent judiciary, combating corruption and implementing free market reforms. By striving for growth and prosperity through reform, both Croatia and Europe would benefit.

Roger Sandilands: We have learned a lot, and thank you very much indeed Natasa and Joel.

We now move onto Matej Kovac who is a long time associate of the CRCE.

Slovenia

Matej Kovac: We have seen the Hungarian Tiger groaning. Slovenia has never been a tiger, but perhaps can be compared to a fat cat purring by the fire. Possibly Slovenia is concerned that the fuel is running low, but hopes moving closer to the fire will suffice. Of course, there are some changes that could be called reforms. The first major change happened two years ago, when after 12 years a centre-right government was elected, although with a slender majority. We have, by law, a system of proportional representation that elects seven or eight parties to Parliament, so a coalition has to be built. Due to this narrow majority, the centre-right parties were joined by other small, but not insubstantial, parties. Why did this change take place after 12 years with a centre-left party in government? My explanation is that voters felt that the Left betrayed the very egalitarianism they championed. The change did not come about due to a crisis or because people felt economically deprived, but because the previous elite became so self-confident that they started displaying their wealth. The former president Milan Kucan established the so-called Forum 21 where all the winners from privatisation got together and preached the ethical values of the new society and so on to their countrymen, and that was a little bit too much for Slovenians.

In a way, no radical reforms were promised by the then Opposition and now Government. The only radical promise was from one of the smaller parties, which declared that, in eight years, it would bring public spending down from 46% to 35%. Of course, this party won only nine per cent in the election, and now in the public eye they are ashamed of promising this. Some politicians have indicated they may explore the possibility of flat tax, but that was the boldest proposition of today's Government. When this Government was elected two years ago, it had no comprehensive economic programme, so from the beginning the Prime Minister started flirting with a group of academic economists. This flirtation ended a year after Mart Laar visited Slovenia. I think to begin with the co-

operation was quite sincere, but the Prime Minister and the political elite were still aware that Slovenia was a fat cat with a pile of logs by the fireplace and no sense of urgency. The academic economists do not take into account the importance for politicians to be re-elected, and will not risk their positions for ideals.

Slovenia still has very good macroeconomic aggregates. This year GDP grew by around five per cent. Not much less is expected next year, and last year it was just below. Inflation is below three per cent and Slovenia will adopt the euro next year. The currency has now been successfully pegged to the euro for two years. I think the euro will not cause too many problems as we are a small economy. We have such a shallow money base that it will in fact be a saving, as maintaining our own currency is somewhat expensive. The budget deficit is around 1.2 per cent, and unemployment is below six per cent and falling. So, the cat has reason to purr.

On the other hand, there are some negative indicators describing counter-competitiveness. A recent World Bank survey of ease in doing business shows there are only ten countries where it takes longer than in Slovenia to enforce a commercial contract in the courts. Another indicator is that the share of the total exports in Slovenia is half that of Hungary. So there are signals that something may go wrong, but in general there is no sense of urgency. Even though the Government has stopped flirting with more aggressive market reforms, there is not a single new party or initiative at the local level that would try to bypass the existing coalition with a more pro-market agenda. In three weeks time we have local elections. All new ideas on the local level come from the philosophy one can label "tax and spend".

The Government has taken some positive steps. I think the boldest one was deciding to abolish income tax gradually, which will eventually reduce the labour cost by 25% each year. In most areas the tax reform has been more or less cosmetic, but personal income tax has been lowered, and the number of bands reduced from five to three. This added an additional 100 million Euros additional deficit to the public income, and caused unrest in certain groups, including trades unions, who were concerned where this additional money would come from. The second was to start dealing with some cartels, for instance the automobile cartels. Compulsory membership of the Chamber of Commerce and Industry has been abolished, and privatisation in the telecommunications industry initiated, although we will not see this until next month. The most negative things in the past two years include the complete failure to tackle public spending. In the beginning they had to keep their pre-election promise to make a small amendment to the pension system. This cost about 10 million Euros a year, not much in itself. The fact is that we had had pension reform in the year 2000, when it was declared that pensions should not totally follow the salaries. There was a small trick in the legislation, not understood at that time by

pensioners, which was that in real terms the pensions were falling. The pensioners protested, and so this legislation was abolished, costing an additional 10 million euro yearly expenditure. Over the longer term it is not a very good sign. Another issue that may be seen as problematic is how the Government tackles companies and the economy. The ownership structure of Slovenian companies is similar to that seen in Austria and France 20 years ago: Semi-private companies with a large share of government ownership. In the past, the government concealed its influence with a lot of talk of independent managers, but usually they fell in line with the Government when necessary. Of course, this present Government did not have this luxury. If they wanted a share of the spoils, they would have revealed the real nature of the system, so they replaced those managers in the bigger corporations influenced by the Government. If the Government continues with the privatisation, this may not be a bad thing. If not, they will gradually start behaving like their predecessors.

I will conclude with the opportunities and threats for the Government. If they manage to press forward with the privatisations, they may find some manoeuvring space to tackle public spending. The threat is that, in past years, governments have shown a preference for social engineering. This was so in the approach to flat tax: with the indication that "we can engineer the society to get more welfare out of this reform". Recently the Government proposed some big political projects. These range from new clinical centres to building a new island off the Slovene coast. It is not clear whether these are empty political promises as the time line is somewhat far in the future, but it is not a very promising sign as it shows how the old industrial policy may revive. The second threat is that even these cosmetic reforms towards markets may bring about a backlash in elections.

Roger Sandilands: Any questions about the country we are in?

Jan Winiecki: I would question your use of the term, "Centre-Left". It is the former Communist Youth and Communist Party.

Sebestyén Gorka: What is the level of discussion of these economic issues in the public arena, outside the elites? How well are things such as state capture, and their relevance, understood?

Matej Kovac: They are widely discussed, but this is not helpful. Trades unions invested a lot in labelling governments as responsible for increasing inequalities. Public debate was quite lively in a way that forced government to backtrack. I think, in Slovenia, the present government cannot control debates as their predecessors did. They have much less power. One of the reasons the Prime Minister took pensioners into the Government was to have this vehicle of constructive no-confidence vote, but in Slovenia it was

successful when the Left wanted to do it, or allowed it to happen. So we have had two successful votes of no confidence. Both were engineered by the Left, with one success for those on the Right. This time the Prime Minister wanted to cover his back with a greater majority. Of course this was at the expense of the public purse.

Victoria Curzon-Price: You say the budget is in balance, basically. What proportion of that is financed by the EU handouts?

Matej Kovac: So far, nothing. We have received minor funding. We have 80% of the EU-25 (purchasing power). One of the threats of these newly available funds is that the Government is motivated to propose fancy projects, as we have to spend these funds. It becomes embarrassing if they are not spent, so to draw 80 million Euros of European funds we will spend an additional 250 million of the budget, and expect to receive, say, 150 million Euros of private money – I do not know from where, except for borrowing with state guarantees. I do not live in Slovenia during the week, so I really cannot say whether these projects are just empty promises for the electorate. It is dangerous anyway, as – sooner or later – you become hostage to your past promises.

Roger Sandilands: To what extent, if at all, has the Common Agricultural Policy extended to subsidies for Slovene farmers.

Matej Kovac: In Slovenia – I may be wrong by a per cent or two – agricultural contribution to GDP is small, around 6%. But we draw well. The agency that implements these subsidies was, relative to Hungary and Poland and so on, better prepared, so farmers still complain, but we used to be part of Austro-Hungarian bureaucracy and we are relatively efficient at filling-out this paperwork!

Victoria Curzon-Price: I think that is a fantastic advantage in Europe.

Roger Sandilands: Certainly that is a lower proportion of GDP than many other EU countries.

Matej Kovac: I think we share that figure with the Czech Republic. All the others have bigger agricultural contributions to GDP. With regard to handling the farmers, Slovenia is the only accession country that may top up the agricultural subsidies received from Brussels. We phase in to the EU subsidies reaching the level of the old members, over ten years. In Slovenia, we have said this period is not enough; our farmers will be exposed to the European market too early, and we need the right to top up these subsidies. This is a significant proportion of the budget, and yet we still have a very small budget deficit.

Roger Sandilands: Thank you very much indeed. The next paper is from Miroslav Prokopijevic, from Serbia.

Serbia[4]

Miroslav Prokopijevic: After 35 years of Tito's rule, and a further 12 years under Slobodan Miloševic, Serbia became a democracy in October 2000. Many expected a clean break from the past, and hoped for a series of swift and wide-reaching reforms. They were to be disappointed – all of Serbia's subsequent leaders have been largely preoccupied with corrupt self-enrichment, and have merely paid lip-service to Western demands for reform.

The West's guilt about their belated military intervention during the break-up of Yugoslavia resulted in considerable foreign aid donations and soft loans in exchange for Belgrade's co-operation on reform. Yet this influx of cash has only served to prop up the existing economic structure, further reducing the authorities' appetite for reform. Why risk costly changes? After all, Western aid has allowed them to sustain the illusion that improvements in living standards are possible without reform.

Noting this reluctance to reform, the attitude of Western countries and institutions began to change in 2003. Aid is still provided, but must now correspond to reforms mandated by the World Bank, International Monetary Fund (IMF), and the European Bank for Reconstruction and Development (EBRD). As a result, the Serbian authorities have passed specific legislation at the behest of the international institutions, but significantly, the actual reforms have failed to wrest the economy free from the heavy hand of the state and special interests.

For example, the 'Action Law' regulates companies in which the government has a minority 2-50% stake following privatisation so that explicit government authorisation is required to act in any one of nine different capital areas of business policy. This requirement fundamentally undermines private property rights and is an open invitation for corruption, as governmental approval simply comes in exchange for 'monetary compensation'. Similarly, a new labour law was passed in June 2004 that replaced a previous, more liberal law enacted earlier the same year. It reintroduced compulsory collective bargaining, made the procedure for dismissing employees enormously complicated and raised the minimum wage well above the market equilibrium.

[4] Reproduced with the kind permission of the Stockholm Network. First published in *Beyond the Borders* by Simon Moore (ed.), Stockholm Network, 2006

Another example of this so-called reform is the anti-monopoly regulation passed in September 2005, allegedly modeled on the EU system. It does not, in fact, regulate state aid and actually exempts firms the government deems to be of 'special public interest' from the application of the law. The government has the prerogative to declare any firm a 'special public interest', a practice which has been common in Serbia for decades, and which renders the entire law to be little more than an illusion.

The current draft of a new law on trade requires all retailers with more than 5000m^2 of sales space to obtain special permits, another unnecessary interference in market forces. Similarly, another draft law on foreign trade, which is currently circulating, restricts foreign trade even when trade and current account balances are jeopardised, another decision left to the discretion of the government. Draft bills on investment, pension and other funds effectively prohibit shared investment, wherein state bonds (approved, naturally, by the Serbian Central Bank) are the only available investment option. And even if the Central Bank were to allow trade in foreign securities by reclassifying them as 'safe', another banking law currently prohibits their sale, rendering them utterly financially unviable.

The position of the individual investor is even less favourable because hard currency can only be transferred outside the country for a restricted number of health and educational services. Regulation in this area is a holdover from Tito's rule, allowing money to enter the country easily but only able to leave it in 'extraordinary circumstances'. All the other ex-Yugoslav states have liberalised current and capital transactions. Serbia remains the exception.

Following a pattern that runs contrary to both internal and international demands for reform, and to the recommendations of the EU's Feasibility Study in April 2005, the Serbian authorities continue to use any and every opportunity to strengthen the role of the state, control voluntary exchange, suppress market forces and extend opportunities for corruption opportunities and the discretionary involvement of the state in individuals' affairs. For that reason Serbia is at the very bottom of the list of European transition countries in terms of personal and economic freedom.

Serbia has never been ranked by the Fraser Institute in their indices of economic freedom, and it has not been ranked for two years by the Heritage Foundation & *Wall Street Journal* because of a shortage of investor interest. The last time it was ranked, in 2003, it was placed 149th place among 160 nations of the world with a score of 4.25 out of 5 (with 5 being the most economically repressed). In contrast to private investors and independent researchers, who either do not rank Serbia at all or rank it at the bottom of their respective lists, the IMF, World Bank, EBRD and other non-market funds fluctuate between two

extremes when evaluating the Serbia's performance. On some occasions, Serbia is heralded as a champion of reform; sometimes it is admonished for struggling to implement any international recommendations. Often, one institution will issue a very positive statement just as another provides a very negative one. For example, the IMF threatened to withdraw its support if the Serbian government did not conduct minimal reforms - consisting of the selection of a privatisation adviser for sale of two oil refineries, a reduction of state pensions and making initial moves for the liquidation of some bankrupt firms. At the same time, the World Bank ranks Serbia a relatively high 92nd among 155 nations in the world in its *Doing Business 2006* report, and declares Serbia as one of the twelve leading reformist nations in the world. This report also ranks Croatia the 118th best nation in the world to start a business. This is several places behind Serbia, and all the other remaining research suggests that this is wrong. (The list also ranks Belarus 106th and Iraq 116th - mistakes that might be amusing if they were not so misleading to potential investors).

So what are the basic facts about Serbia? A country of some 7.5 million inhabitants, it produces an annual GDP of approximately €15bn - just 10% of Greece's GDP or 0.0015% of the EU-25. Its average growth rate between 2000 and 2005 hovered around the 3.5% mark, though GDP growth stagnated in 2005. Inflation in 2003 and 2004 was 11% and 13.7% respectively. It is currently around 17% per annum and is still on the rise despite already being the highest in Europe. The Serbian state is the most overbearing in Europe. State expenditure accounts for 55% of GDP, ahead of Sweden's 52% and Belgium's 50%. However, the Serbian paradox is that while state expenditure is proportionately the highest in Europe, many important tax rates are relatively low. Personal income is taxed at a flat rate of 10%, and corporate income tax at just 10%.Yet these two taxes do not contribute significantly to government revenues. Instead, numerous smaller taxes counter this shortfall. There are around 200 different tax schemes, and some of them are prohibitive. In order to pay an employee €100 of net salary, employers have to pay an additional €73 in payroll tax. Sales tax is set at 18%, and the average customs tariff is close to 10%, three times higher than in the EU and nearly five times higher than in the US. Imports outweighed exports by 31% in 2004, and by 42% in 2005. Under these circumstances, investment amounts to 14% of GDP, with just a half of that received by more successful transition countries. FDI in 2004 was around €700 million, just a third of Bulgaria's FDI in the same year. Both figures reflect a low level of economic freedom and the weakness of the rule of law. So what will become of Serbia? The honeymoon period that followed the October 2000 elections – principally financed by Western donations, soft loans and privatisation revenues – is over. During the next two years, Serbia must reach final settlements with Kosovo and Montenegro on issues of territorial and sovereignty. Both are likely to gain greater autonomy, or even independence.

To compensate for the loss of Kosovo, the EU will launch negotiations on the 'Stabilisation and Association Agreement', in order to boost pro-European sentiment and to suppress nationalistic forces. Unlike transition champions, such as the Baltic States or Slovakia, which adapted to the conditions of EU membership relatively smoothly, it seems that Serbia may be less able to adapt. Democratic institutions, economic freedom and the rule of law in Serbia are all far weaker than in the EU. The only way to implement tough reform is with the encouragement of the EU. But in order for Serbia to take this route, it needs completely to reverse its current economic policies. Instead of clinging on to the ways of the old regime, it needs to break from them. Instead of serving the old interest groups, the government needs to serve the public interest. Instead of closing the country off, they must lower barriers with the rest of the world. Instead of a heavy-handed state, economic reform is needed to free market forces. Instead of cultivating corruption opportunities, the government policy should be to fight corruption. Only the passage of time will show whether such fundamental changes are possible and what the cost will be.

Dragan Lakicevic: This national investment plan is a peculiar Serbian issue. They have quite successful privatisation, at least in terms of finding private foreign owners for major banks, and they have collected now around 1.5 billion euros. A hobby of mine is writing down on how this national investment plan will be spent. I am well above 2 billion now, and maybe I miss some. The fact is that there will be elections within six months.

Roger Sandilands: How is Serbia living with 17% inflation?

Miroslav Prokopijevic: That is something that we are proud of. In 2000 it was 150%, in 2001 it was 40, and it fell to 11.7 in 2003, then 2004 and 2005 it was 13.7 and 17.7 respectively. Currently it is at an annual average level of 12.8. The principal rogues are the State and the Ministry of Finance. They support state ownership which is unable to pass the market test.

Roger Sandilands: What are the implications for interest rates and the exchange rate.

Miroslav Prokopijevic: Concerning the interest rates, they are pretty low. So, they are actually negative compared to inflation. The exchange rate, exports are less and less competitive, and even the euro lost 15% on the Serbian currency last year. Probably one of the largest devaluations of Europe. The State Statistics Office researches the data – there is no independent institution. In negotiations with the IMF, we said that GDP was 39 billion euros. I checked with my students, and the last figure I got was the GDP in 2003 was 13.5 billion euros. The IMF accepted this. This year it must be around

23 billion. There is no proper investigation. When ranking by heritage, Serbia should be around 100 billion euros. But with this level of economic freedom, we cannot sustain such a level of growth.

Roger Sandilands: How peaceful is it compared to the past, and what is the level of military spending?

Miroslav Prokopijevic: Military spending is now reduced, but it is still well above the level recommended by the European Union. NATO recommends spending of two per cent, and Serbia has recently reduced spending from four per cent to 3.4 per cent.

Victoria Curzon-Price: I would like to ask a question on accession to the EU. Your government is anxious to join. Do you see a timeframe over which this might occur?

Miroslav Prokopijevic: The government has a strategy that involves acceding to the EU. There is a lot in the document outlining this strategy, but the year of accession is notable by its absence. When you consider the issue from the existing members' points of view you see that Serbia cannot join yet, as it does not meet the economic criteria. The earliest date could be 2014. I have spoken informally with friends on the Commission, who consider 2020 to be more realistic.

Jan Winiecki: If there is still a European Union!

Roger Sandilands: That sums up a depressing session so far. It is now up to Petr Mach to – hopefully – end the conference on a high note.

Czech Republic

Petr Mach: I am privileged to be the last speaker, and promise to be brief. I am Executive Director of the Centre for Economics and Politics; a think tank established in 1999 by Vaclav Klaus, then Speaker for Parliament, and now President of the Czech Republic.

In 2005, the growth of GDP was six per cent, which is relatively high, especially from a Western European point of view. Inflation is relatively low. However, we do not have flat tax. We have relatively high value added tax and very high social security contributions. Employers must pay 35 per cent of gross wages in social security contributions. So, the fact that the growth is six per cent is not particularly admirable. It is not difficult to have higher rates of growth than the old EU Fifteen as their average

growth is on a downward trend. The Czech Republic is not performing impressively in comparison with Estonia.

A basic characteristic of the Czech economy is currency appreciation. In 2001, it took more than 40 crowns to buy 1USD. Now it is 21 crowns. A similar trend has been seen with the euro. Everything is becoming cheaper for us. This development is due to low inflation, relatively high growth and inflow of foreign private capital.

Taxes and social security contributions are now slightly above 36 per cent of GDP. The proportion of GDP paid to the government had been decreasing until 1997, during Klaus' tenure. Since 1998 the Social Democrats have been in power, and the tax quota has been rising again. Moreover, government expenditure has been rising faster than tax increases. The government is able to balance the budget using money from the privatisation of national companies, but this is not sustainable. Income from privatisation is drying up, so the deficit is increasing, and will continue to rise.

We had very low debt as a proportion of GDP in 1997, when it was about 10 per cent. Now the deficit is about four per cent of GDP, and the debt is increasing. One factor affecting the budget deficit is our membership of the EU. In 2004, the Czech Republic was a net contributor to the EU. In our first year in the European Union, the beneficiaries of EU funds were the Irish, Greeks, Portuguese and Spaniards. The acceding countries did not end up any better off. In 2005, the Czech Republic paid approximately one billion euros to the EU, and received about the same. But every country, as you know, must finance EU projects, and so cost the taxpayer more. Moreover, we have to pay many new bureaucrats connected with administering EU funds. So, membership probably increased our deficit by one per cent; a significant amount. I see over-regulation as a big problem for the Czech Republic. In 2004, there were more than 20,000 pages of legislation; much of it from Europe.

We had elections in June this year. The Civic Democrats – the party established by Vaclav Klaus after the Velvet Revolution – won the election. However, they did not have enough seats, together with their would-be coalition partners, to form a government. The coalition gained 100 seats out of 200. The other 100 were held by a coalition of communists and social democrats. We then discovered the problem with having an even number of seats!

The bad news is that we cannot introduce a flat tax. The good news is that, since June, not one single page of legislation has been passed. So the situation is not very good, but is not that bad.

Silvana Malle: You mention capital inflow. What types of investment do you observe?

Petr Mach: There is a huge inflow of foreign direct investment as a result of the government programme of incentives. There are many big companies – especially in the automotive industry – that receive such incentives. My institute criticises the concept of incentives. We suggest that it would be better to have a lower level of tax for all companies than to have the disparity of a 24 per cent tax for the vast majority, and a zero per cent tax for perhaps fewer than 100 companies. We believe a 15 per cent tax for all would be just.

Miroslav Prokopijevic: How has this appreciation affected your competitiveness and export opportunities? Everything is cheaper for you, but everything is more expensive for others.

Petr Mach: Of course it is more difficult for exporters to sell their goods. The exchange rate is always just the result of market forces, so we must not consider a particular exchange rate to be any better or worse than any other; we must allow the market to decide the best price. One interesting aspect is that this process of appreciation is one channel into which this inflow of capital translates. If we fix our exchange rate in order to adopt the euro, this inflow of capital will probably translate into higher inflation. This was the situation until 1996, when we had a fixed exchange rate. Our inflation, of about ten per cent, was due to capital inflow. This inflation was only due to the intervention of the Central Bank in the exchange rate, as we had no budget deficits. I am afraid that if we fix the exchange rate, we could face inflation of ten per cent again. At present it is about two per cent.

Krassen Stanchev: How does your constitution deal with a situation such as the current hung parliament?

Petr Mach: The President chooses the Prime Minister, who has to ask the House for a vote of confidence. If he fails to win this vote, the President must make another attempt. He can choose the same person again, or another. If this second attempt fails, then there is a third, this time made by the Speaker of the House. The problem is that the current Parliament could not elect a Speaker.

The difficulty is that the constitution is not very clear. Because this is a new situation, we expect that the constitution will evolve. The Parliament can, eventually, pass a constitutional amendment, which requires a two-thirds majority. Through this tool, they can initiate new elections. At the moment elections are unlikely to be in the interest of the

Social Democrats, and without them there can be no constitutional amendment. We are in for an interesting time.

Victoria Curzon-Price: Surely, if the third attempt fails, the President can dissolve Parliament?

Petr Mach: Yes, but we will have to wait until the third attempt has failed. The problem is that the third attempt is dependent on the Speaker. Although technically we do have a Speaker, he has made a public promise to resign if the situation continues until a third attempt. The parties were not able to elect the Speaker, so they agreed to elect a known person who agreed to resign if the first two attempts failed.

Krassen Stanchev: The Mongolian constitution specifies that the interim Speaker is the oldest Member of Parliament.

Petr Mach: So that would make it important for all parties to have at least one old member!

Jan Winiecki: How long could this situation last?

Petr Mach: The communal elections and senate elections are later this month[5]. The President has said he will not announce his second choice until after these elections, in order not to unduly influence the public. Probably, the President will say who will be his second candidate by the end of October, and that candidate then has one month to ask for a vote of confidence.

John Moore: How does Government operate without a budget?

Petr Mach: Technically they do have a budget, as the constitution allows the monthly spending of one twelfth the previous year's budget.

Miroslav Prokopijevic: Has the stock exchange shown any reaction to the political situation?

Petr Mach: No. The crown continues to appreciate. It is, obviously, good news not to have a government!

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[5] In the 2006 election, the Civic Democratic Party (Občanská demokratická strana, ODS) won the narrowest majority in the Senate, with 41 seats of 81. They also became the largest party in the Chamber of Deputies, with 81 of 200 seats.

Roger Sandilands: That sounds like a very appropriate note on which to end. Thank you very much Petr. Before we adjourn, John Moore would like to say a few words.

John Moore: I think this has been an unusually interesting conference in many aspects, particularly the opportunity to hear reports on the state of affairs in various countries. I want to thank Lisl and Ian on everyone's behalf for the work they have done in organising the conference, and thank you all for your contributions. I think this is an excellent series of conferences, and I am sure one and all would agree that they are stimulating, useful and informative. They keep us Americans on our toes about what is going on in this part of the world!