Trade Access Versus an Economic Model

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Diverse Paths of Postcommunist Transformation

After a decade, the outcomes of postcommunist transformation are varied. In the former Soviet bloc, the Central European and the three Baltic countries have so far been the most successful.[1] All have become full-fledged democracies and market economies, with 70–85 percent of GDP arising in the private sector. All were early and radical reformers.

In contrast are Belarus, Turkmenistan, and Uzbekistan, which have barely undertaken reform. They are still state-trading countries, with the public sector accounting for four-fifths of GDP in Belarus and Turkmenistan, and all are true dictatorships, in which the dictator has done little but dispense with the Communist Party.

Nine of the twelve former Soviet republics, which have become members of the Commonwealth of Independent States (CIS), have become market economies, although it has taken them quite some time.[2] The economies of those countries are still harrowed by excessive state intervention and thus corruption. Some 60–70 percent of their GDP is generated by private enterprise. Freedom House has rated most of them as partially free. Arguably, Romania and Bulgaria belong to this group as well, although they are more like the Central Europeans in some regards. We may call this group of countries late reformers, but reformed they are.

These very different outcomes show that it was never a given that postcommunist transformation would lead to a market economy, private ownership, and democracy. The policy that each country adopted at the start of transformation has usually been adhered to until a profound political and economic crisis occurred. An example of such discontinuity was the Russian financial crash of August 1998; another was the Bulgarian hyperinflation of 1996–97.

The unreformed dictatorships—Belarus, Turkmenistan, and Uzbekistan—have nowhere to go. The question is how long their dictators will possess sufficient economic and military resources to continue suppressing the people.

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Belarus is both politically and economically far too open to persist. It will crumble when Russia finally cuts its still very substantial subsidies, and President Vladimir Putin is obviously intent on doing so. Like Belarus, Uzbekistan is currently experiencing a slow-down in its economic growth, and it might face such an economic squeeze that its leader will feel compelled to undertake economic reforms. Turkmenistan is a full-fledged totalitarian state. Economically, it is totally dependent on its extraction and export of natural gas. Currently, that presents no problem, rendering the survival of the regime a primarily political issue.

The broader question is how East-Central Europe will fare in comparison with the reformed former Soviet republics.[3] Although the latter group is catching up in market economic reforms, the two groups are not converging toward the same economic model. East-Central Europe is adopting a model with high taxes, social transfers, and public expenditures. The reformed CIS countries are opting for much lower taxes, social transfers. and public expenditures, and corruption in those countries remains greater.

In recent years, the ten East Central European countries have been preoccupied with their EU accession. Their economic policy agendas have been determined by West European concern in Brussels rather than by their own economic trepidations. Especially the Central European countries have become, in János Kornai's words, "premature social welfare states."[4] This state is premature because their average GDP per capita is only about 40 percent of the EU level, measured in purchasing power parity, while they have social transfers almost as large and taxes as high as Western Europe's. Their new economic model ensures stability rather than dynamism, and the question is how fast their economic growth will be. Shockingly, these ten countries had an average growth of only 3 percent a year from 1998 to 2001, while the whole West was booming.

The situation of the nine reformed members of the Commonwealth of Independent States (CIS) looks very different. Unlike the Central Europeans, for the last three years they have benefited from average economic growth of no less than 6 percent a year. They have overcome the initial problems of transition, but their corruption remains significantly greater than in East-Central Europe. Their main problem is access to export markets and the attraction of foreign direct investment (FDI).

Some consider these nine countries as two groups. Russia, Ukraine, Kazakhstan, and Azerbaijan are relatively wealthy and have small external debts. Russia's GDP per capita in purchasing power parity exceeds those of Bulgaria, Romania, Latvia, and Lithuania. Kazakhstan and Azerbaijan are being flooded by foreign direct investment because of their oil, and many now believe in the economic success of these four countries.

Five small and very poor countries, Moldova, Georgia, Armenia, Kyrgyzstan, and Tajikistan, are in a more precarious position. All but Kyrgyzstan have suffered badly from war or civil war. They are deeply indebted, mainly to the international financial institutions and Russia, and they need debt relief. All suffer badly from limited trade access. Yet, their economic systems are about as reformed as those of the richer CIS countries, and the European Bank for Recon-

struction and Development (EBRD) reckons that Georgia and Kyrgyzstan are the two most reformed CIS countries. They have generated high growth rates in recent years. Therefore, it makes sense to treat these nine CIS countries as one group.

The Central European and Baltic states appear to have succeeded in the first decade of postcommunist transition, whereas countries such as Russia and Ukraine are perceived as having failed. However, that might not be the case a decade from now. It depends on how well these countries are able to tackle their current problems. Their approaches vary greatly, with the East-Central Europeans dominated by their EU accession and the reformed CIS countries seeking other sources of inspiration.

The EU Agenda

The European Union is not only a customs union but a highly intrusive political and economic union, requiring all of its potential members to adopt 80,000 pages of legislation, the *acquis communautaire*. The *acquis* includes all the treaties, regulations and directives passed by the European institutions as well as judgments laid down by the Court of Justice. Candidate countries must adopt, implement and enforce all the acquis to be allowed to join the EU. As well as changing national laws, this often means they must set up or change the necessary administrative or judicial bodies that oversee the legislation.

Half of the *acquis* consists of the common agricultural policy (CAP), which is a suffocating system of agricultural regulation and protectionism. Although several EU member countries want to reform the CAP, the Union is compelling all accession countries to adopt it. As a result, all the accession countries have to regress substantially from market reforms they have already undertaken, reintroducing large agricultural subsidies paid by the EU. This will stifle their agriculture for the foreseeable future. Unfortunately, the candidate members are complaining that they will not be entitled to subsidies as large as other poor agricultural producers in the EU.

Another feature of the *acquis communautaire* is the Social Charter, which reinforces social rights and transfers. Some EU member countries, notably Poland and Hungary, already have extensive social transfer systems. The disincentives to work that the social transfers cause are widely perceived as major obstacles to higher economic growth. The Baltic states, by contrast, have successfully trimmed their social transfers to a reasonable level. Now those states are enticed to adopt a system less conducive to the growth they need so badly.

One major problem in Central Europe is unemployment, caused by excessive regulation of labor markets. Average unemployment in the EU accession countries is 13 percent, with Poland and Bulgaria having the highest unemployment of more than 18 percent of the labor force. Labor market regulations vary within the EU, but strong European trade unions are pressing accession countries not to liberalize but to further regulate their labor markets and wages, whereas they need the opposite to raise their growth and employment.

Tax systems differ somewhat within the EU, but the variations are not great. The

accession countries, which already have high taxes, are being persuaded not to cut them, although the general tendency within the EU countries is to reduce excessively high taxes. In particular, EU accession countries have very high payroll taxes of about 50 percent, which are a major cause of their high unemployment.

Part of the problem lies in concrete demands of the *acquis*, but a more profound problem is that the *acquis* and the EU more broadly contain a social democratic ideology of a social welfare state with extensive state regulation, high taxes, large social transfers, and substantial public expenditures. The main aim of this system is stability, but the candidate members need economic growth.

The addition of twelve new members would enlarge the EU to twenty-seven members, and any discussion about changing the existing system will become even more complicated. The question is whether the EU will be able to undertake necessary regulatory reforms within a reasonable time. Otherwise, the new members are likely to suffer more than the current members from the status quo.

Obviously, the accession countries have also benefited from the EU. First, they have enjoyed advantageous trade access to the large EU market. As a result, their exports have skyrocketed and the share of their total exports going to the EU has expanded from one-half in 1989 to two-thirds in 2000. This trade expansion has been a major growth engine. Second, the accession countries have attracted ever larger foreign direct investment, which rose to 6 percent of GDP by 2000. A major cause was the trade access to the EU market

Ireland, Spain, and Portugal, which are relatively poor, have greatly benefited from their entry into the EU, through both liberalization and substantial transfers from the richer member countries. However, Greece and East Germany have performed very poorly after having become EU members, as they were more focused on subsidies than on reforms.

The balance is likely to be different for various accession countries. Romania has the least liberalized economy, and its population is most positive on joining the EU. The Estonians, by contrast, are the least enthusiastic. The Estonian economy had the most free transition economy, but had to abandon its free foreign trade and regulate its free agriculture; social transfers are likely to be raised; its low taxes are under attack; and its free labor market can hardly survive the pressure from the European trade unions. It would be surprising if this reversal of Estonia's good economic policy did not reduce its solid economic growth.

Thus, several East Central European countries appear likely to suffer from an aggravation of their economic system as a result of their EU accession, while they have so far benefited greatly from their advantageous trade access. However, as their trade with the EU countries already exceeds their trade with one another, most of the trade potential may already be exhausted. Early gains resulting from initial structural reforms have already been exploited.

The CIS Agenda of Far-Reaching Economic Reforms

Policy making looks remarkably different in the reformed CIS countries. For the last few years, the dominant influence on them has been the Russian financial crash of August 1998 which, although concentrated in Russia, affected the whole

region. First, international finance dried up. Then the Russian export market plummeted, and with it their exports. The Russian devaluation forced most CIS countries to devalue their currencies by about half. Another important influence was the hyperinflation that grasped all these countries in 1992–93; in its aftermath public revenues dwindled, while corruption remained high.

The IMF has probably had the strongest influence on economic policy in CIS countries, followed by the World Bank and USAID, which has given substantial technical assistance. Thus, the United States has had a larger impact on CIS economic policy than has the EU. Russian economic policymaking and debate have also remained influential as Russian publications and media are widely watched. The role of the EU has been surprisingly marginal. It has given little technical assistance and has been too preoccupied with its own enlargement to look farther to the East.

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Because of their initial failures with macroeconomic stabilization, the CIS countries have become all the more focused on financial stability. Consequently, after the Russian crash of 1998, budget policies have been very firm and are bound to remain so. Initially, the countries lacked sources of financing, and so had to cut their budget deficits. But soon they made a virtue out of the necessity, realizing that their economies were actually doing much better without significant public deficits.

When the CIS countries became serious about minimizing their budget deficits, they realized that they could not realistically raise state revenues and so were compelled to undertake expenditure cuts. Rightly, their focus became enterprise subsidies, which had ballooned particularly in Russia and Ukraine. As these subsidies were not socially justified, going primarily to corrupt managers, little social resistance arose and public expenditures could be cut much more than had been possible in East Central Europe. Although the CIS countries had higher public expenditures than East Central Europe as a share of GDP in 1993, the ratios were 28 and 41 percent of GDP by 2000, and expenditure cuts have proceeded in the CIS countries.

Much of the enterprise subsidies had been extracted through tax rebates in nontransparent barter deals with the state. Those countries that had extensive barter, primarily Russia and Ukraine, cleaned out the barter by demanding that the state and major state enterprises be paid in real money. Because of the drastic cut in enterprise subsidies and a sharp reduction of barter, the playing field became more level, which was one factor prompting higher economic growth.

The reform agenda has gone much further. The tax system has been transformed. Progressive income taxes have been replaced with ever lower flat taxes. Estonia pioneered with a flat personal income tax of 26 percent in 1994. Latvia

followed with a flat tax of 25 percent, and Georgia of 20 percent. In 2000, Russia introduced a flat income tax of 13 percent, which substantially boosted income tax revenues. Russia has set a standard, and flat taxes of 10 percent are being discussed in several countries.

Corporate profit taxes have also been reduced to very low levels. Estonia took the ultimate step by abolishing them in 2000, and corporate profit taxes have been scaled down to 20 percent in Georgia and Kyrgyzstan, and 24 percent in Russia, and are set to fall farther. Payroll taxes have been reduced to 33 percent in several countries; Kazakhstan has cut them to 21 percent, which is a world of difference from the 50 percent payroll tax levels in East Central Europe. Value-added taxes, however, usually remain at 20 percent, although Kazakhstan has cut its tax to 16 percent.

Tax reforms in most of the reforming former Soviet republics have gone in a liberal direction, with Ukraine being the exception. Ukraine has not yet undertaken any fundamental tax reform, although such reorms are being prepared. Although taxes are still much higher than in East Asia, changes that have been made point in that direction, and a liberal paradigm has taken hold in the whole region.

The radical tax cuts have also been accompanied by simplification in tax administration and a reduction of the problem of corruption in the tax services. There is hardly any tendency in this direction in Central Europe. The Baltic states have pioneered tax reforms, but the level of their taxation remains much higher than in the reformed CIS states.

In parallel with tax reforms, attempts are being undertaken at regulatory reform of registration, licensing, certification, and other bureaucratic routines to diminish red tape and causes of corruption. The initial attempts are usually unsuccessful, but countries such as Ukraine and Kyrgyzstan have gone a long way to boost small enterprises with extensive economic freedom.

Labor market reforms are of vital importance, as is obvious from the large unemployment in East Central Europe. Although Soviet labor legislation widely remains in place or, worse, has been incorporated in new labor laws, Estonia, Latvia, and Kazakhstan have deregulated their labor markets according to the radical New Zealånd model with short severance pay and predominantly individual labor contracts. Probably, this is the road toward the future.

Social transfers have been brought under control. In contrast to Central Europe, they were not very large to begin with. Many focused on welfare for the old elite, rendering it desirable to cut them. Other social benefits were simply inefficient.

Pension reforms remain spurious. Kazakhstan undertook a radical Chilean pension reform with private cumulative accounts as early as 1997, but no other country in the region has adopted such a reform. The financial crash of 1998 put the stability of private investment accounts into serious question. Most countries in the region are considering or undertaking a more moderate, mixed pension reform, with a guaranteed state minimum pension, a compulsory private pension, and private pension accounts.

In all these regards, the reforming CIS countries appear to be opting for a stable and simple liberal economic system, which seems to move toward an East

Asian system rather than the EU system. With the beneficial effects on economic growth of low and predictable taxes, low social transfers, deregulation, and flexible labor markets, there is reason to believe that the CIS countries will prove more dynamic than most expect at present.

However, the CIS reformers face important obstacles as well. Although judicial reforms are part of the reform agenda, surveys indicate that the system of justice appears to function much worse in the CIS than in East Central Europe. Presumably, the *acquis* contains many institutional advantages that are difficult to pinpoint.

Whereas the big advantage of the EU accession countries has been their access to export markets in Europe, the opposite has been true of the CIS countries. As a result, the share of their exports to the EU has not risen from 1989 to 2000 but stayed at the level of one-third. While their exports to all other nontransition countries tripled from 1992 to 2000, their exports to the EU have only doubled. Typically, trade barriers are being raised against especially successful exports, such as steel, agricultural goods, clothes, and chemicals.

Initially, the limited CIS exports to the EU market could be explained by lack of domestic reforms in the CIS, but exports have not increased as domestic reforms have proceeded, suggesting that the cause is rather EU protectionism. Another trade problem is what the CIS countries are doing to one another. The CIS is supposed to be a free trade area, and six countries have even concluded a purported customs union, but the CIS has no functioning trade organization because it has no mechanism for the resolution of trade conflicts. The effective legal framework and arbitration court for international trade are provided by the World Trade Organization (WTO).

Alas, to date, only four small CIS countries—Moldova, Georgia, Armenia, and Kyrgyzstan—are members of the WTO, and they have not yet developed much skill in using the organization. Therefore, the WTO plays very little role in the region. Undoubtedly, this will change when Russia becomes a member, probably within the next two years. Kazakhstan and Ukraine are likely to follow suit, which may improve the CIS countries' trade opportunities both with the outside world and among themselves.

When export opportunities are so limited, FDI is naturally limited, to about 1.5 percent of GDP, or one-quarter of the current level in East Central Europe. It has not increased over the years or with reforms, suggesting that the limited trade access is becoming an increasingly important bottleneck. Naturally, FDI tends to focus on domestic markets or oil extraction.

Having undertaken very substantial domestic reforms in the last few years, the reformed CIS countries now need to focus more on their interaction with one another and the outside world, notably the EU. Trade policy is becoming most important.

"The First Will Be the Last"

The conclusions of this reasoning run counter to current perceptions. At present, there is a huge difference between the economic policies of the EU accession countries and those of the reforming CIS countries.

Most East Central European countries carried out heroic, early, radical reforms, but now the social democratic EU accession agenda has replaced the previous growth-oriented policy. If you pay less attention to economic growth, you are also likely to get less. The EU debate has given rise to several kinds of dangerous populism. Some argue that the EU will always bail out the accession countries, as happened with Greece and East Germany, making responsible behavior appear irrational. Others insist that the EU should pay new members subsidies by the same principles as the old members receive them, suggesting huge subsidies. An ordinary form of populism is social democratic/social welfare thinking. The worst populism, however, might come from the opponents of EU membership, who appeal to more-or-less obscure national values. It becomes increasingly difficult to face up to remaining problems of transition.

At present, Poland appears the best example. In terms of economic growth, it was the unchallenged leader during the first decade of economic transformation, but now it seems unable to grapple with any of the remaining problems. Its unemployment has risen over 18 percent, but there has been neither deregulation of the labor market nor a reduction of the payroll tax of 48 percent. Attempts at introducing a flat income tax of 21 percent have been jeopardized for good, and the highest marginal income tax lingers at around 40 percent. The budget deficit has expanded to 5.5 percent of GDP under the onslaught of populism, and the independence of the central bank is under serious threat from the government. Social reforms have been undertaken, but they have caused a strong populist reaction. Although Poland's early radical reforms were generally successful, its privatization of large enterprises was not. Thousands of them remain in state hands, including the coal industry and most of the steel industry, which seem impossible to restructure without privatization, which now appears politically impossible. Restructuring of agriculture is impeded by many factors, including special social transfers for small peasants. The EU accession does little to solve these problems, and it is difficult to fathom that Poland will come near the 6 percent growth a year it enjoyed for many years in the 1990s.

By contrast, the CIS reformers know that nobody will save them but themselves, and they can obtain economic growth only through their own hard work. Therefore, economic policy must support economic growth. Years of disaster have bred sound economic thinking, and leave little room for complacency. Reforms are proceeding, and competition has evolved among the major CIS countries—Russia, Ukraine, and Kazakhstan. For the last two years, Kazakhstan has taken the lead with its radical but select economic reforms and oil wealth, leading to a growth rate of 11.5 percent a year. Ukraine comes second with a very decentralized reform model, as the central government is no longer able to sabotage economic development through outrageous rent seeking. Russia comes third in this group, and economic debate is colored by concern over low economic growth, although few believe that it can be less than 4 percent in 2002, and it has been an average of 6.5 percent for the last three years. This resembles the virtuous competition that characterized the East Asian tigers in the 1980s and 1990s.

The drawbacks of the CIS countries have been delayed reforms, more corrup-

tion, less trade access, and less FDI. They are now catching up with regard to reforms, which should mitigate corruption, although that tends to take time. Their restricted trade access is the big remaining handicap, but it is likely to rise on the international policy agenda, because the CIS countries are joining the WTO, and EU enlargement is freeing scarce policymaking capacity in the EU for handling issues involving the CIS countries. Therefore, there are good reasons to believe that the CIS countries will continue the swift catching-up that they started in 1999. On the other hand, it is difficult to see any reasons for faster growth in the EU accession countries, and the pitfalls in the enlargement process are plentiful.

NOTES

1. With Central Europe, I connote Poland, the Czech Republic, Slovakia, Hungary, and Slovenia.
2. Russia, Ukraine, Moldova, Georgia, Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan, and Tajikistan.
3. By East-Central Europe, I mean the ten EU accession countries: Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Romania, Bulgaria, Estonia, Latvia, and Lithuania.
4. Janos Kornai, "The Postsocialist Transition and the State: Reflections in Light of Hungarian Fiscal Problems," *American Economic Review*, 82, no. 2 (1992): 1–21.