Anders Åslund replies:

Scrutinizing the European Union

Christoph Stefes's points coincide with conventional wisdom over Central Europe versus the countries in the Commonwealth of Independent States (CIS), but that conventional wisdom is in disrepair.

European elites have entered a state of EUphoria. I sympathize with that as a reflection of a new pan-European nationalism, but economic policy must be subject to critical analysis. It should be an uncontroversial statement that the European Union (EU) is economically a double-edged sword. After all, in the last decade Europe's strongest economy, Germany, has barely grown by 1.5 percent a year, virtual stagnation in per capita terms. Slovakia's minister of finance Ivan Miklos puts it bluntly: "Europe is hindered by labor market inflexibility, heavy tax burdens, bloated public sectors, and other competitive constraints, and the gap between the United States and Europe continues to widen rather than shrink."[1]

As early as 1992, Janos Kornai called the Central European countries "premature welfare states."[2] Jeffrey Sachs and Andrew Warner calculated that the Central European countries would not achieve a high growth rate if they did not reduce their taxes and social transfers.[3] Unfortunately, their predictions have come true. Postcommunist Central Europe never experienced any "period of double-digit growth," which Dr. Stefes incorrectly alleges. The peak was 1995–97, when Poland and Slovakia grew by slightly more than 6 percent a year. The EU may have many sympathetic features, but economic dynamism is not one of them.

The liberal Russian economists Vladimir Mau and V. Novikov have analyzed what *acquis communautaire* would mean for Russia, classifying its chapters as desirable, disadvantageous, useful but not essential, or irrelevant.[4] Their list of advantages is short, the four freedoms (of goods trade, movement of people, service trade, and movement of capital), the Customs Union, and company legislation. They consider equally many chapters of *acquis communautaire* as disadvantageous: the Common Agricultural Policy, the fishery policy, taxation, social and employment policy, environmental regulation, and consumer protection. They classify eleven chapters as irrelevant and six as beneficial but nonessential. Competition policy and state aids are considered partly harmful and partly desirable.

The advantages of the EU for market access to the accession countries are obvious. The share of their exports directed to the EU has increased from half to two-thirds in a decade, while the CIS countries are stuck with only one-third of their exports going to the EU, primarily because of severe EU protectionism against the goods the CIS countries produce. For long, this EU protectionism contributed to depressed foreign direct investment in the CIS countries. Surprisingly, the nine reformist CIS countries (excluding Belarus, Turkmenistan, and Uzbekistan) have started catching up. In 2001, net foreign direct investment inflows in the CIS 9 was on average 3.7 percent of GDP, almost as much as the 4.5 percent of GDP in the ten postcommunist EU accession countries.[5]

Unfortunately, other benefits of the EU on economic growth are less obvious. New institutional economics teaches us the importance of economic systems and

their incentives. The Common Agricultural Policy and EU fishery policy are obviously harmful. Other important institutions are public redistribution of GDP, tax system, labor market regulation, environmental regulations, technical regulations, and corruption.

The difference in public expenditures as a share of GDP is striking: 45 percent in the four Central European countries—Poland, the Czech Republic, Slovakia and Hungary—to compare with 25 percent in the nine reformist CIS countries in 2001. The additional public expenditures in Central Europe go essentially to social transfers, weakening the incentives to work correspondingly.

The Baltic countries pioneered radical tax reform, but several CIS countries have caught up, although the Central Europeans have done little. (Slovakia is making a brave attempt to change things before it enters the EU.) The differences are greatest in personal income tax and payroll tax, while corporate profit tax and value-added tax are similar. Russia has a flat income tax of only 13 percent, while Poland still has a progressive income tax peaking at 40 percent. Central Europe has payroll taxes around 50 percent, while Kazakhstan has a payroll tax of only 21 percent and Russia has a regressive payroll tax with an average of 30 percent. Plainly, Russia and Kazakhstan offer better tax incentives to work and hire people.

As expected, the combination of high taxes, high social transfers, and substantial social regulation has led to high unemployment in Central Europe, notably 19 percent in Poland and Slovakia, while Russia has about half that—unemployment of 8–9 percent notwithstanding restructuring. The EU directives on social and employment policies, the European trade unions, and the examples of nonreforming Germany, France, and Italy will hardly help Poland to liberalize its labor market.

Alan Mayhew has boldly estimated the cost to Poland of introducing the 320 EU environment directives and arrived at the staggering sum of 4–8 percent of current GDP for the next twenty years.[6] Mayhew has also calculated that the cost for Poland to comply with EU directives on standards and safety rules in transportation would be somewhat less.[7] Nobody seems to think that the cost to Poland of EU entry will be less than 4 percent of GDP a year in direct budgetary costs. Most argue that the Central European countries need to raise their standards, but the question is how fast. It appears doubtful that it would be advantageous for them to accept those high costs at this stage of their economic development. The EU regulatory system may put the new EU accession countries a poverty trap. In spite of huge West German spending on infrastructure in East Germany, not to mention social benefits, East German growth remains disappointing.[8] The territory appears stuck in a social welfare trap. To date, it is the only postcommunist country that has become a member of the EU.

The strong argument that many, including Stefes, raise against the CIS countries is their corruption. Obviously corruption is bad, but our interest, as social scientists, is what they do about it. The World Bank and the European Bank for Reconstruction and Development (EBRD) carried out large business surveys in most postcommunist countries in 1999 and 2002. They measured the bribe tax as a share of sales. In 1999, it was much smaller in East-Central Europe at 1.2 per-

cent, but it stayed the same in 2002. In the nine reformist CIS countries, the bribe tax was on average 3.0 percent in 1999, but it was fell substantially to 2.3 percent in 2002.[9]

Unfortunately, no statistical series over corruption exist, but this is possibly one of the fastest declines in corruption the world has ever seen. The EBRD emphasizes the great improvement in their transition indicators by the CIS countries. By contrast, it is unclear whether the EU has influenced corruption. After all, Transparency International considers long-time EU members Italy and Greece to be more corrupt than EU candidates Slovenia and Estonia.[10] Nontransparent bureaucracies, such as the EU, are not known to mitigate corruption.

In the early postcommunist transition, Poland and Estonia were the leading radical reformers, but that was long ago. Today, Kazakhstan is one of the brightest lights. It has a good liberal tax code with the lowest payroll tax in the region. Public expenditures have been reduced to 22 percent of GDP. Like Estonia, it has undertaken a radical civil service reform. Alone in the region, it has carried out a radical Chilean pension reform based on private savings. Like Estonia and Latvia, it has deregulated its labor market, promulgating a labor code inspired by New Zealand. Privatization of large enterprises has proceeded further than in Poland. Kazakhstan's banking system is the best in the CIS, and it is the only CIS country with an investment rating. For the last three years, it has enjoyed an average growth of 11 percent a year, and it is likely to stay close to that level for the foreseeable future, considering its planned oil production increases and its liberal economic system. That growth is neither accidental nor temporary, although it is also true that Kazakhstan is subject to corrupt and authoritarian rule.

Stefes argues that some CIS reforms "represented a surrender in the face of widespread bribery and tax evasion, not the victory of a liberal agenda," liberal thinking develops and wins in such situations. The great liberal revolutions of the 1840s were reactions to the corrupt feudal system. The classical liberal philosophers took the evil of the state for granted, as CIS reformers wisely do. Therefore, liberalism won ground in the mid-nineteenth century as it now does in the CIS. Economic thinking in Moscow is far more liberal than in Warsaw, where many believe that the postcommunist state may be good, which is the social democratic and indeed West European creed.

In economics, it is, in the end, growth that counts. From 1998 to 2002, the ten EU accession countries had an average GDP growth of 3.4 percent a year, while the nine CIS reformers had an average growth of 5.7 percent a year. Neither number is sufficient, but the latter appears more likely to rise than the former.

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NOTES

1. Ivan Miklos, "A European Flat Tax," *Wall Street Journal*, 8 May 2003.
2. Janos Kornai, "The Postsocialist Transition and the State: Reflections in Light of

Hungarian Fiscal Problems," *American Economic Review* 82, no. 2 (1992): 1–21.

3. Jeffrey D. Sachs and Andrew Warner, "Achieving Rapid Growth in the Transition Economies of Central Europe," Harvard Institute for International Development, Cambridge, MA, Development Discussion Paper no. 544, 1996.

4. Vladimir Mau and V. Novikov, "Otnoshenia Rossii i ES: prostranstvo vybora ili vybor prostranstva?" *Voprosy ekonomiki*, no. 6 (2002): 133–43.

5. If not otherwise mentioned, all statistics are from European Bank for Reconstruction and Development, *Transition Report 2002*, (London: EBRD, 2002).

6. Alan Mayhew, "Financial and Budgetary Implications of the Accession of Central and East European Countries to the European Union," Working Paper 33, Brighton: Sussex European Institute, cited in, *Measuring the Costs of Protection in Europe*, by Patrick A. Messerlin (Washington, DC: Institute for International Economics, 2001).

7. Alan Mayhew and W. Orlowski, "The Impact of EU Accession on Enterprise Adaptation and Institutional Development in the EU-Associated Countries in Central and Eastern Europe," London: European Bank for Reconstruction and Development, 1998, cited in Messerlin, *Measuring the Costs.*

8. World Bank, *Transition: The First Ten Years* (Washington, DC: World Bank, 2002).

9. European Bank for Reconstruction and Development, *Transition Report 2002*, 28.

10. <www.transparency.org>.