

**PROSPECTS FOR ECONOMIC FREEDOM IN EUROPE
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INTRODUCTION

On May 1, 2004 there will be a process of 10 new countries entering the European Union completed. Despite the fact that this historical moment is quickly approaching many fundamental questions still remain unanswered. What will be the costs and benefits to Central and Eastern European countries of joining the EU? Will accession to the EU increase economic freedom in the CEE countries? What effect will accession countries have on the EU itself?

Both current as well as new EU member countries are facing their own sets of problems and challenges. These are not caused by the process of 10 new countries becoming the members of the European Union. However, as a result of this process they are more visible and there is more urgent need to find efficient solutions to them.

The first section of the paper will explore some of the most serious problems and challenges that are currently faced by the current EU member countries. The second section will be devoted to the identification of the most important problems and challenges with which the CEE countries are confronted. The final section will briefly review two basic alternatives of the EU future.

I. THE PROBLEMS AND CHALLENGES FOR THE EU

At the time of accession of 10 new member countries the EU finds itself in a difficult position. The EU is losing competitiveness, both population and politicians ignore the major reason of current economic and social difficulties – non-sustainability of the so called European social model, especially the largest EU countries are unable to implement necessary reforms of

their public sectors, politicians are adopting “quasireforms”, and there is growing tendency to ignore previously respected rules and principles.

1.1. Growing gap between promises and reality

European leaders gathered four years ago in Lisbon at the summit where they announced an ambitious goal for Europe – to become the most competitive area on the globe by the end of the decade. Nowadays, it is clear that this promise given to citizens of European countries will not be kept. Europe is lagging behind its global competitors, during the last decade the EU is outperformed especially by the U.S. as it is measured by major economic indicators, including GDP per capita, GDP growth rates, employment rates, unemployment rates, etc.

This fact is already publicly recognized by top representatives of the European Commission, including Romano Prodi. However, this recognition is not enough. The most of the European leaders fail to acknowledge deeper roots of this growing gap between their promises and reality. While they are still talking about importance of technical issues like innovations, information technology diffusion, productivity growth, they keep silent on the issue of ultimate importance – on the role of the state, the government interference in the economy.

1.2. European social model – a “sacred cow” of European ideological identity

Unwillingness (or inability) to identify statist policies as a real reason of the growing gap between Europe and e.g. the U.S. can be explained by the fact that the so called European social model is a major source of European interventionist policies.

They result into extensive public sector, tax-financed goods and services, high rate of redistribution, high taxes and public expenditures, labor market inflexibility significantly worsened by a tripartite mechanism, overregulation of private sector. These parameters represent the most important barriers to increased competitiveness of the EU countries. At the same time, all efforts to reform them are perceived as evil intentions to give up a core part of European ideological identity.

The fact that EU members stubbornly hold on to the so called European Social Model that consequently leads to the above mentioned regulations plays an important role in global economic competition. The (non)competitiveness of a social system is of great importance. Without making major changes to the social model, reducing the level of regulation, and increasing flexibility, Europe will be doomed to fall further behind the USA. This can have a significant negative impact on the new EU member countries as well.

1.3. Population demanding paternalistic policies, politicians unable to deliver necessary reforms

Unlike in the CEE countries population in Western Europe was not confronted with an open economic and social crisis of the system. Welfare state mentality of the population was not undermined by any open financial collapse of the welfare state itself. Services are still provided, even though their quality is deteriorating. There is no sense of urgency in efforts to introduce any changes in tax system, pension system, labor market legislation, etc.

As a result of policies from the second half of the 20th century a public sector employment represents a significant share of total employment. Public sector employees are one of the most powerful interest groups benefiting from maintaining of the current status quo.

Under such circumstances politicians fail to explain a necessity of public sector reforms. Mass protests organized against proposals of changes of the status quo further discourage politicians from implementing far-reaching reforms.

1.4. Quasireforms

In addition, what is in a political debate or public discussions usually referred to as “reforms” are not reforms at all. “Tax reforms” are at best just fine-tuning of a bad system of progressive income taxation rather than a radical redesign of the whole tax system, “pension reforms” are just moderate efforts to reduce some of significant advantages given in the past to public sector employees.

Politicians in the EU do understand the problem and risks of not implementing of necessary reforms. However, they know that those reforms, if implemented thoroughly, would bring many painful adjustments that could eventually endanger their positions. Their courage to take unpopular steps is very limited. That is why they prefer a short term approach – just pretending true reform efforts.

A vicious circle of a lost competitiveness – inability to identify real reasons – unwillingness to give up the current European social model as an important part of prevailing European ideological identity – welfare mentality – quasireforms is completed.

1.5. Double standards in complying with fundamental principles and rules

As a part of pre-accession exercise 10 candidate countries were forced to accept many principles and rules of the EU club whether they liked them or not. The most recent events in the EU bring more and more evidence that even “club members” are having more and more troubles with a sticking to their own rules.

One striking example that is illustrating this trend is a story of a Growth and Stability Pact. All of the new member countries in their Accession Agreements committed themselves to introduction of Euro. In order to comply with Maastricht criteria, especially with maximum debt (60 % of the GDP) and maximum budget deficit (3 % of the GDP) rule, they already started with necessary adjustments.

As is well-known, recently Germany and France are running large budget deficits and having problems with complying with 3 % maximum budget deficit rule. Instead of making spending cuts the discussion has started about a stupidity of the rule.

This makes an impression that there are rules they are good for a purpose of disciplining others. However, when suddenly and unexpectedly they should be applied to those who invented them, all possible arguments are put on the table in favor of breaking those rules.

Needless to say that this “pragmatic” approach has potentially devastating impact on new member countries doing their best in order to comply with Maastricht criteria as soon as possible. A very worrying signal about “double standard” approach within the EU has been sent.

II. THE PROBLEMS AND CHALLENGES FOR THE CEE COUNTRIES

2.1. Poor economies, advanced public sector reforms

Economies of the CEE countries compared to the current EU member countries are still relatively poor. Major indicators of their economic performance are still well below EU levels. GDP per capita, wage levels, price levels, and many other indicators, range from about 25 % to 75 % of the EU levels. The impact of their communist heritage is still very visible.

On the other side, the CEE countries have made a huge progress in changing of old structures of their economies. Especially privatization process, despite its political sensitivity, and time consuming disputes over the most appropriate privatization methods, went even further than in the EU. Today, a private sector represents in some cases more than 90 % of the economy. It is an excellent result for the countries that started less than 15 years ago their transition with almost completely nationalized economies.

An undisputable level of progress has been reached in widening of the four fundamental economical liberties: freedom of movement of goods, services, capital, and labor force. This was the result of liberalization of external economic relations.

However, it is not only a success of microeconomic restructuring that is an important feature of the transition economies. In addition, ambitious programs for reforms of public sector were launched by many governments as well.

Tax reforms, pension reforms, reforms of educational systems, reforms of health care sector, public administration reforms, and all other reforms have one common denominator. It was an understanding that public sectors inherited from communist times were too extensive, too

inefficient, too costly, and without significant reforms it would create difficult conditions for a growth of a private sector by being a serious threat for its performance.

The only way how to change the current system is to replace at least a part of tax-financed goods and services by private provision of these goods and services, or to introduce co-payments of these goods services that are still provided by public sector. The reforms of this type are the pension reforms introducing funded pillars for private pension savings, school reforms introducing tuition fees, co-payments of patients for prescriptions, for hospital care, for medical treatment.

These reforms taking more cash out of pockets of population can not be successful without other reforms taking less money from them for redistribution. That is why radical reforms based on the idea of flat income tax are quickly spreading especially among the CEE countries.

All in all, what we can witness in the CEE countries is the beginning of the end of a welfare state in Europe as it was known in the second half of the 20th century. A long list of tax-financed goods and services provided directly by the public sector is the past, systems based on successful transition from welfare state mentality towards individual responsibility is the future.

The CEE countries today play a role of leader in this movement. The more progress the CEE countries achieved in efforts to reform their public sectors, the better for them. In fact, it represents the most valuable asset of these countries entering the European Union. Thus, the CEE countries are relatively poor today, but they laid down solid foundations for accelerated growth rates in future in order to catch-up with the more advanced economies.

2.2. Reform “fatigue”

Of all reforms conducted so far by the CEE countries the public sector reforms are the most difficult ones. A scope of adjustments that is required from population is enormous. It is natural that people do not welcome these changes and they tend to prefer existing status quo. Many political populists benefit from this situation. They feed generally wide-spread illusion that the current state of affairs are not that bad and that reforms are neither necessary nor needed. Under the circumstances of growing discontent of population on one side, and growing populist opposition on the other side, even reform oriented politicians tend to fall into a reform ”fatigue”. Their commitment to adopt necessary reform measures is weakening quickly.

It is of crucial importance, especially in the context of the EU accession process, to overcome this reform “fatigue” as soon as possible and to regain a momentum for the reforms.

2.3. Costs of the EU accession already levied, full benefits still questionable

After May 1, 2004 the new member countries agreed to give up important parts of their independence in their policymaking processes. In some areas like trade policy, or tax policy (indirect taxation) it will have negative impact on their economies.

For example, the trade policies of some of the CEE countries were more free trade oriented and they will need to be replaced by more protectionist trade policy of the EU. Restrictions and requirements imposed on their tax policies will increase their indirect tax rates and bring them at the EU levels with serious consequences for their competitiveness. In future they agreed to adopt Euro and give up their independent monetary policy.

Progress in liberalization of certain areas (e.g. in external relations) of the CEE economies in the past was in many cases diminished by increased regulation in other areas. Many of the new regulations introduced resulted from the aim of the CEE countries to become the EU members.¹

Taking in 30 chapters of EU law (Acquis Communautaire) within the last several years not only caused technical problems, it also meant taking on the attitudes of western Europe, which in many cases, resulted in overregulation or interference with contractual relations between two or more businesses. Under the guise of environmental regulation, anti-trust regulation, safety and health protection, customer protection, strict technical standards for various goods and certain environmental laws were introduced into a legal system of the CEE countries. For businesses, these standards will be a serious additional financial burden, and will also narrow their operational efficiency.

While costs of the EU accession are already levied upon the new member countries, benefits are still questionable. The new EU member countries expected to enjoy full benefits of an internal European market immediately after their accession. However, since some important

¹ In this regard, the gradual increase in regulation of Slovakia's internal business conditions can be mentioned as an illustration. Legislation that used to govern business conditions after November 1989 (i.e. the Commercial Code and Trade Act passed in 1991) were much more liberal and simple than their current versions, which have undergone multiple amendments.

The registration process became more complex, unjustified barriers in the form of special licensing regimes grew, conditions for operating even the simplest business grew more strict, etc. The state was not the only actor that contributed to this situation by passing more and more complex legislation. Professional associations which took over competencies from the state in order to guide direct competition through such actions as a licensing process also played a significant role. This lack of liberal approach has increased through so-called "fundism", or the aim to solve the existing problems by establishing re-distribution funds (Guarantee Fund, Recycling Fund), and making businesses financially contribute to these funds. This was more or less indirectly increasing financial burden within the business environment.

aspects of four fundamental economic freedoms of economic integration are compromised, obviously it will not be the case.

There were many distortions adopted during the pre-accession process based on the requirements of some member-states. The required 7-year transition period for a free movement of labor force is a prime example. There were two countries, Germany and Austria, declaring that they will not open their labor markets fully during the period specified by the Accession Agreements. As May 1, 2004 is quickly approaching, a list of the member countries adopting restrictions on labor force movement from the new member states is getting longer. It is rather a strange way of saying welcome to the new members of the European Union...

2.4. A dark side of Euro funds euphoria

While in eyes of many people from the candidate countries the EU funds are one of the highlights of EU enlargement, they are in fact one of its most unfortunate aspects. A lack of “absorption capacities” of the candidate countries was frequently criticized by Brussels bureaucrats. However, it is not a lack of “absorption capacities”; it is rather the EU funds themselves and their negative consequences that are a real problem that needs to be faced by the new EU member countries. The most serious of them are following ones:

- a) Serious distortions of market incentives
- b) Serious distortions of government spending of the new EU member countries
- c) Growing bureaucratization of decision-making processes
- d) Corruption

e) “GDR phenomenon”

- a) *Serious distortions of market incentives:* EU funds together with overregulation are the most important distortions of fundamental principles of a market economy. They undermine traditional market incentives for income generation via providing goods and services that people are willing to buy. With EU funds available the best brains start to consider also this opportunity how to generate income, this time via applying for funds in Brussels. From a long-term point of view this can have extremely devastating consequences for performance of economies entering the EU.
- b) *Serious distortions of government spending of new EU member countries:* the same affect will materialize in the area of public finances. A co-financing opportunity from the EU funds represents an irresistible temptation for finance ministers of the new member countries. As a result of this, these countries will spend money on purposes they originally did not want to. A spending side of their public finances will be seriously distorted, with Brussels spending priorities taking upper hand.
- c) *Growing bureaucratization of decision-making processes:* another price paid for a huge EU money injection is a creation of a whole jungle of various decision-making, implementing, and monitoring bodies inspired by the EU with hundreds of so called “Euro officials”. Growing bureaucratization of decision-making processes with all negative consequences is inevitable.
- d) *Corruption:* taking into account a weak tradition of the CEE countries in transparent practices of public sector institutions it will be of no surprise when the EU funds will become the most important source of corruption in these countries in following years.

e) “*GDR phenomenon*”: there is well-known result of enormous redistribution of funds between Western and Eastern (GDR - German Democratic Republic) parts of Germany that is disappointing for both sides. The similar results can be expected also in a case of EU funds. The current member countries – net contributors will be frustrated because they will think they pay too much. The new member countries – net recipients will be frustrated since they will think they get too little compared to countries joining the EU previously. These concerns are reflected in the most recent discussions on a potential reduction of the EU budget to a maximum of 1 % of GDP of the EU.

2.5. An uneasy transition from policy-taking to policy-making

During pre-accession period were candidate countries subjects of EU regulations coming from Brussels. Since May 1, 2004 also the new candidate countries will be the Brussels. What will be their impact within the EU? It will depend on their success in going through a difficult transition process from “policy-taking to policy-making”.

There are two broad strategies the CEE can use in order to try to maximize their impact on policy-making process: 1. directly, via voting mechanisms and procedures, 2. indirectly, via a so called “demonstration effect” of their reforms.

The first channel is rather limited in terms of its potential impact on policy-making process in the EU. Despite the fact that representatives of the CEE countries will be sitting in all crucial EU decision-making bodies like European Commission, European Parliament, European Economic and Social Committee, their capacity to influence outcomes of voting will be limited

by number of their votes. In other words, if the current EU member countries will not agree, the new members will not be able to push through anything.

Paradoxically, indirect influence might prove more efficient in next several years. Its mechanism has been well described in one old movie called “Just let him to be scared”. In this movie a music composer finds himself in a crisis. He is not able to compose new music any more, breaking all his deadlines and contractual obligations. One day his friends notice that after he went through a situation horrifying him very much he started to compose again. Since that day they were intentionally putting him into situations scaring him to his death, just making sure that he will be producing again.

The similar mechanism can be recently witnessed in a region of Central Europe. Slovakia is a pioneering country introducing as the first country of this region a radical tax reform based on a flat income tax of 19 %.

In neighboring Austria, an EU member country, a discussion about a necessity of a tax reform is going on for many years. Internal opponents of any reform were not listening to any rational arguments supporting reform ideas. Arguments in favor of the reform raised abroad, e.g. by Slovakia, would be listened even with a greater ignorance.

Slovakia was not wasting time and energy to try to persuade others about the necessity of the reform. It introduced its own radical reform. And it scared governments of all neighboring countries and forced them to take immediate action. In Austria a consensus on a plan cutting corporate income taxes to 25 % was reached within a short period of several weeks. All other countries started to send verbal signals that they will move in the same direction like Slovakia as soon as possible. The herd was moved on and hopefully this movement will “scare” other

countries of Europe as well! So, this is the most efficient way how to persuade reform outsiders: let them to be scared and finally they will act!

III. FUTURE OF THE EU

3.1. The EU on the crossroad - two possible alternatives

Division line within the EU after May 1, 2004 will not be drawn between “Old Europe” on one side and “New Europe” on the other side as it was coined by Donald Rumsfeld. Despite many signals from last several weeks it will not be drawn between large European countries and small European countries either.

The major conflict in the EU in a following decade will be between “frontrunners” implementing economic and social reforms and “reform outsiders” that will be for many different reasons unable to adopt them. Once again, it will not be about tensions between the current EU member countries and the new members, it will not be about the conflict between old and new Europe, it will be about abilities and capabilities of countries in the EU to carry out necessary reforms.

In the first camp there will be countries like Estonia, Slovakia, Ireland, and Great Britain that will be able to advance these reforms, especially to reduce significantly a heavy burden of extensive welfare state and give up underlying ideological assumptions of the so called European social model. In the second camp, countries like Germany and France will not be able to join these efforts and therefore will be opposing them.

Good news for smaller countries is that a size of the country will matter in this conflict only into the lesser extent. Non-reformers can use all available voting mechanisms to eliminate reformers via EU legislation. By doing this they will try to export their domestic problems to the EU level.

Reformers must be quick enough to implement domestic reform policies as soon as possible in order to maximize their “demonstration effect”. This can put non-reformers under a pressure, it can force them to take defensive stance and accept more reforms just because of this external pressure.

A final result of this conflict of two camps of countries is far from being certain today. However, one thing is certain already today: the EU is on the crossroad.

There are two basic alternatives: either reformers will win at the end of the day and solid foundations for long term sustainable prosperity in Europe will be laid down, or reformers will loose and it will bring Europe into a long period of stagnation or even recession.

The first stage of the above-mentioned conflict is already going on in the context of a process of 10 new countries joining the European Union. As a result of this process we will witness in a following years that either 1. a reform lethargy of the current EU members will be imposed on new member countries or 2. a reform euphoria of the new member countries will be imposed on the current EU member countries.

A historical fight for freedom that was started by the CEE countries 15 years ago is not over yet. After May 1, 2004 it is rather getting into a new stage and will be fought in new circumstances. Its final outcome will depend very much on whether they will stay on a reform

path or not. To fight this fight successfully will remain the greatest challenge for next 10 years not only for the CEE countries, but for the whole Europe.