Beyond the borders

Market-oriented reform outside the EU-25

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Introduction

On a continent that has come to be so dominated politically by the EU, it is easy to forget that there are almost as many countries beyond its borders as there are within. Yet in these oft-overlooked nations, some of the most profound and meaningful reform in Europe is occurring.

From glacial, liberal Iceland to arid, tempestuous Israel, and from alpine, cosseted Switzerland to barren, bellicose Russia, this disparate selection of countries is as diverse politically as they are geographically. Many are attempting to move away from legacies of communist rule and Soviet dominance. Others are seeking to affirm their place among global economic leaders. Some seek membership of the EU, while others reject all the principles for which it stands.

Yet not all is well. The region also contains pugnacious dictators and pseudo-democracies, irredentist and secessionist rebellions. Partitions are being erected as others are brought down. These pose great challenges, but could yield to greater opportunities.

These developments have external significance too. Successful reform in these countries could provide a new role model for others seeking precedents to follow. Countries which lack the financial resources of the big western European nations will need to concoct more ingenious plans to stave off similar crises as demographic change threatens long standing welfare arrangements. War-ravaged states where unemployment grips half the population will need to find new ways to generate investment and work. Nations long governed by dictators and despots will find themselves pressured to democratise, and compelled to find ways to achieve without succumbing to corruption or nationalist dogma. If they thrive, as well as providing the EU and the rest of the world with valuable new trading partners, they may also provide it with new models for how to enact their own reform agendas.

Greater benefits, though, will inevitably be derived by those inside reforming countries, as their personal freedoms and living standards increase. Developments in some of the subject countries have given impetus to this process, particularly with the much-heralded 'coloured revolutions' in Georgia and the Ukraine. While sailing has not always been smooth, especially in the latter instance, the ability of the public to admonish its revolutionary heroes in a democratic manner represents progress in itself. They are advances which leave authoritarian and undemocratic nations shorter of friends, and in an isolation which optimists will look to to spur peaceful transition to reform.

Pessimists, though, would cite acquiescent populations' unwillingness to challenge the most assertive oppressors of freedom, and their reluctance to be weaned away from comparatively generous state support systems, as signs that the public spectacle of reform conceals a demonstrably unchanged mentality.

European Union membership presents a further point of division. Switzerland and Norway have both unambiguously rejected the possibility of acceding in the near future. They are content to maintain their free-trading relationship with the EU, without seeing funds slipping away to Brussels through contributions. Meanwhile, for countries such as Turkey and Croatia, prospective entry dominates the political agenda as they attempt to coalesce with European laws and norms.

Some within these countries, however, express concern about whether EU entry, and the more stringent regulatory system this implies, will mean sacrificing what progress has been made by the reformist movements. After escaping years of economic constriction due to communism, the prospect of volunteering for the same fate from Brussels has caused some disquiet. These concerns may be alleviated by the advantages granted by free access to a much larger trading market, and the potential economic boom this could generate.

What this collection of essays reveals more than anything, is that despite the ostensible differences between the various participating countries, many of the challenges they face are similar. Quandaries of demography, of overwhelming public service costs, of political liberty apply across the board. The ways in which they are addressed, however, is indicative of the great divergence of approaches to be found. A great deal is occurring beyond the borders of the EU. It should not be neglected.

Simon Moore
Editor
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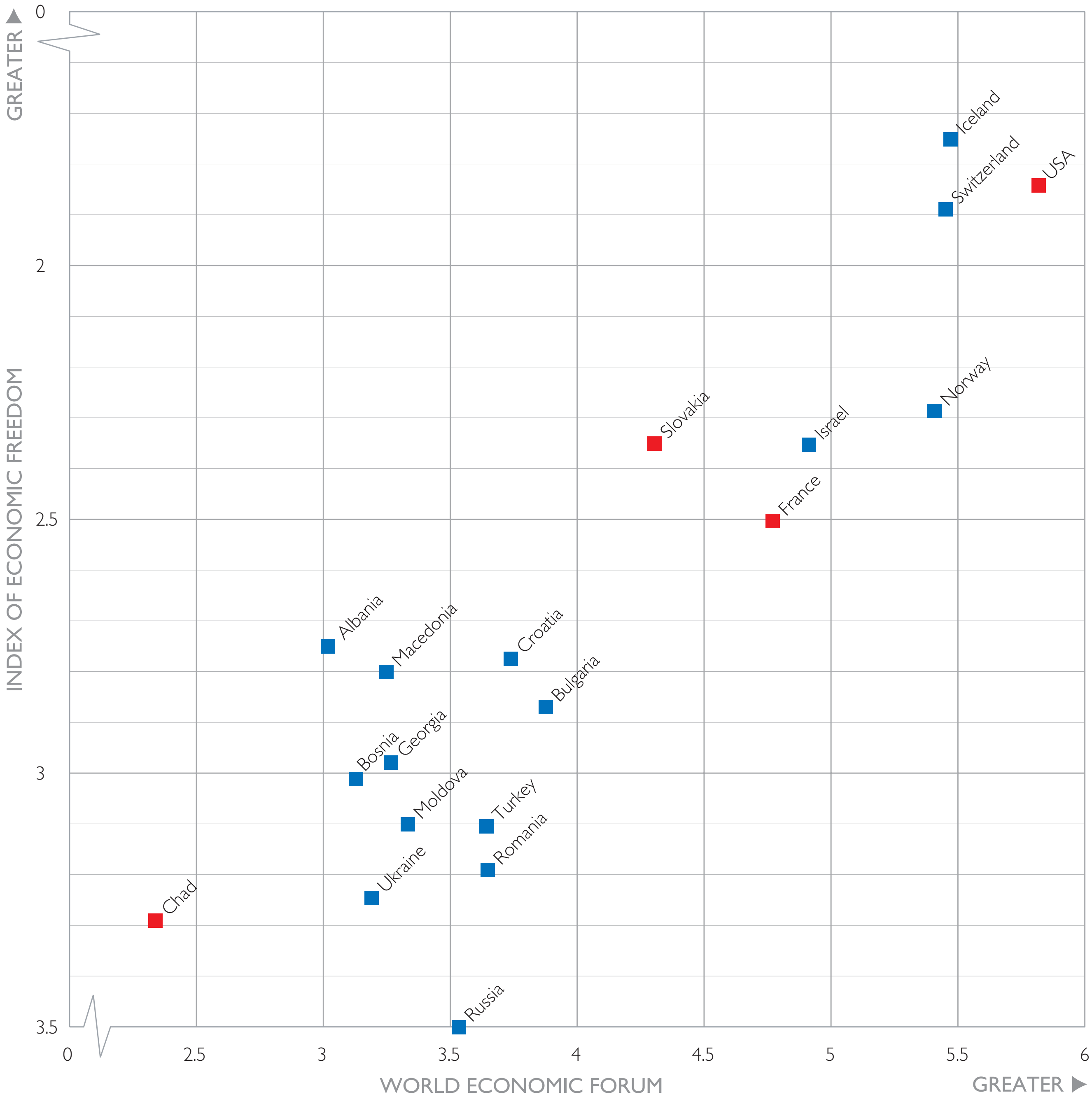
Economic Freedom vs Competitiveness Index Scores

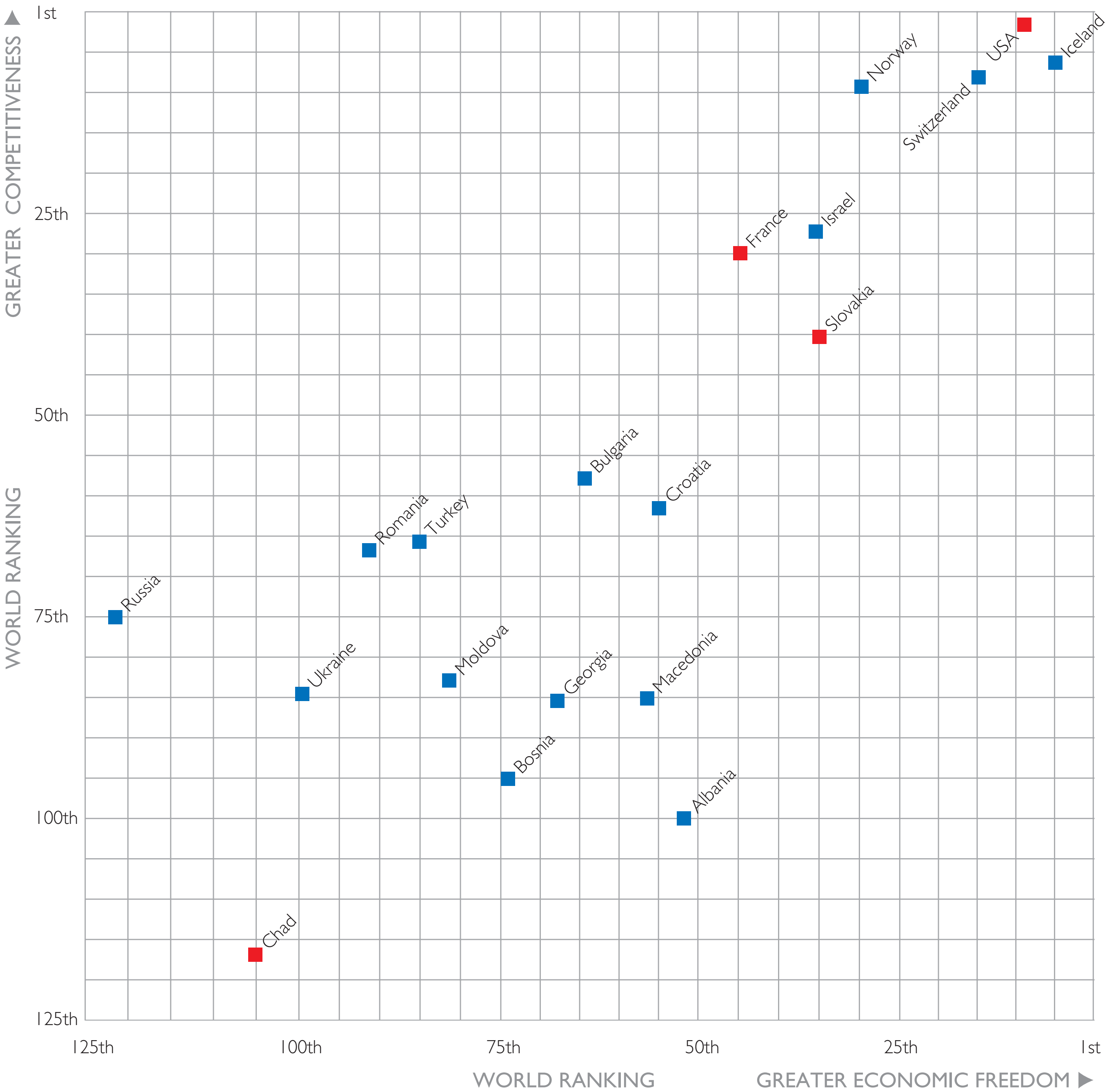
The table below combines data from two annual economic reports, the first assessing economic freedom, and the second assessing competitiveness. Produced by the Heritage Foundation/*Wall Street Journal* and the World Economic Forum respectively, the former study reflects the efficiency of a state's inner workings, while the latter examines its relative performance in global markets. While not being a scientific comparison, it provides a useful at-a-glance view of the progress made by the countries of this report.



Sources
World Heritage Foundation/*Wall Street Journal* Index of Economic Freedom 2006 – http://www.heritage.org/research/features/index
World Economic Forum Comptitiveness Index rankings 2005
http://www.weforum.org

Economic Freedom and Competitiveness: World comparison

The following shows data from the same organisations, but ordered by world ranking rather than absolute score



Belarus not assessed by the World Economic Forum. Index of Economic Freedom score 4.11, ranked 151st
Serbia and Montenegro not assessed by Index of Economic Freedom. World Economic Forum score 3.38, ranked 80th.

Albania

Albania was the last among Eastern and Central European countries to undertake a shift from communism to democracy. It was a transition ultimately precipitated by the perilous economic state of the country, and spillover from the breakdown of other former communist countries.

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During the 1980s, the Albanian economy had fallen into sustained economic crisis, triggering food shortages which subjected the population to malnutrition and fuelled general popular discontent. Because of information coming into the country, particularly from Italian television, Albanians could compare their standard of living with the west. They thus became aware that statements about the supremacy of communism were false. They developed a general cognisance that their system was an economic failure. This discontent manifested in riots that became gradually more frequent and violent, forcing the government to accept change to a pluralistic system with democratic elections. This occurred despite the absence of an Albanian dissident movement. Albania did not possess the internal anticommunist underpinnings that were present in Poland or Hungary, where communism was seen as imposed from abroad. On the contrary, the regime constructed communism in Albania in symbiosis with nationalism, creating a mixed ideology that butressed Albania's lengthy isolation.

Due to the inexperience of opposition parties and the lack of political discontent, the communist party in power (the Party of Labour, which would later become the Socialist Party) won the first democratic elections. In 1991 and 1992, there was economic collapse accompanied by anarchy. Popular discontent reached an apogee. Only an Italian humanitarian mission, 'Operation Pelican' saved the country from famine. This situation forced new elections, held in March 1992. More than 62% of the population, having lost confidence in the old rulers, voted for the Democratic Party headed by Sali Berisha. The Democratic Party created a government comprised mostly of university lecturers, inexperienced in politics, many of whom a short time before had been communists. At that time, only communists and those close to them could access higher education in Albania and obtain such positions.

The intellectuals who had opposed the old regime had disappeared in prisons or in forced labour camps long before. The western world, together with the population's desire for rapid change, influenced the new government to expedite an economic strategy aimed at swift economic growth based on the so-called 'Washington Consensus', which comprises a set of neoliberal policies that have been advised by the Western-based international financial institutions.

In the early stages of post communist transition, inflation in Albania was kept low and GDP increased at one of the highest rates in Eastern Europe. Despite the disadvantageous external pressure that came from the traditionally unstable Southeast European area, Albania remained out of the conflicts during the 90s. Unlike the other countries of the region, Albania has a very ethnically homogenous population, with only 2% in minority groups. From 1996 Albania has been holding irregular elections which created highly contentious governments and gave way to great political polarisation. Such polarisation, combined with the appearance of financial pyramid schemes, caused a popular uprising in March 1997 that soon degenerated into chaos and a public-order vacuum. This situation was resolved only after military intervention by a group of European countries. Although Albania did not suffer ethnic war, she needed the international community to come to her aid (just as in the neighbouring countries), to mediate disputes between Albanians.

The elections organised in the midst of the turbulence of 1997 gave a landslide victory to the Socialist Party, which comprehensively won the local elections as well. The return to power of the socialists begat a return to governing by former communists and the halt of the reforms that were initiated by the Democratic Party. The socialist government created a system of nepotism and clientelism throughout the country. The events of 1997

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decreased the expectations of the Albanian population, which became more concerned about security and safety and less sensitive about economic growth and the progress in the process of democratisation.

International actors became very much concerned about the stability of Albania rather than with the progress of democratisation and economic reforms. The instability of Albania in 1997 was followed by rioting among the Albanian population in Macedonia and the beginning of the armed rebellion of ethnic Albanians in Kosovo. In order to receive international support and legitimacy the socialist government subscribed fully to the approach of the EU and NATO in Kosovo. In the beginning of the Kosovan crisis, Albania discouraged and obstructed fighters from the Kosovo Liberation Army (KLA) but later, when the NATO bombing started, Albania gave full logistical support to both NATO and the KLA. The readiness of the socialist government to do whatever necessary to placate NATO and EU demands, combined with severity of the crisis in the Balkans, granted the socialists a free hand in domestic policies.

Reforms were not only halted, but faced reversal. Most high-ranking officials in the socialist party had stakes in the economy. For instance the former finance minister owned the main oil importer in Albania, and the former minister of agriculture owned the main seed and fertiliser merchant. The administration developed into some sort of *comprador élite* that aligned their interests with those of their foreign trade partners while ignoring the needs and pressures of the country. The socialist politicians had a clear interest in maintaining high rates of imports because they possessed the main importing companies. They therefore discouraged domestic investments and created an economic system dominated by oligopolies.

The general elections of 2001 coincided again with ethnic turmoil in the region. After witnessing how embarrassed the EU has been in the past by failures in Balkan regional stability, it is perhaps understandable that it should now dominate their policy concerns. Hence, Albanian influences in former Yugoslavia have shaped the relationship between the Republic of Albania and international actors. The EU has consistently supported Albanian political actors that have discouraged the rise of Albanian nationalism in the neighbouring countries regardless of the domestic support that these actors have within Albania. In fact, the main interest of the EU in Albania has not been the development of democracy in this country but the maintenance of an anti-nationalist approach towards their regional compatriots. As a consequence of this policy the EU has offered open support for different 'reliable' political parties at different times, trying to finagle Albanian public support for

these parties. Even more concerningly, the EU has recognised fraudulent elections as long as they granted power to political parties that had acquiesced to EU instruction regarding 'the Albanian question'. Such actions have seriously contributed to the slowdown and reversal of the process of democratisation in the country and have increased mistrust amongst Albanian citizens on the liberal democratic system. Because of the civil war in Macedonia, the loyalty of the Albanian government towards Western policies once more became very important. As a result, the results of the general elections of 2001 were officially internationally recognised, even though they were highly fraudulent.

Consequently the socialist received a second mandate, and carried on with the anti-free market approach. Besides damaging the freedom of the economy the socialist government developed a highly corrupted system of governance, through the eight years of their governance Albania plunged more than twenty places in the Transparency International ranking of corruption in the world. Law enforcement statistics under socialist rule were almost 50% worse than in the last year of the Democratic Party. Albania became a haven for the trafficking of drugs, weapons, and people, and a prominent international money laundry.

These were the circumstances Albania found itself in prior to the 2005 general elections. The Albanian Democratic Party identified the high level of corruption and the damage done to the free market, and made their correction the two main priorities of the campaign and of the electoral platform that this party put forward. The campaigns for the parliamentary elections of 2005 were particularly imbalanced, as on one side there were the Socialist Party candidates who spent a great amount of money (it is estimated that about €60 million were spent in campaigning), had access to the media and could commandeer state owned facilities and logistics. On the other side was the Democratic Party with little funding and limited access to the media.

Nevertheless, the Democratic Party won the elections and built a coalition government with other right wing parties. The new government of Sali Berisha was formed in accordance with the classical liberal principles that were campaigned before the elections. The new government reduced the number of ministries from 18 to 14, looking to create a smaller government. Continuing this approach, the new government undertook a restructuring of the public administration and cut 30% of the size of the administration as well as 25% of governmental operative expenditures. Two weeks after it came to power, the new government reduced taxes for small and medium sized businesses by 50% and disclosed the plans to minimise income and corporate taxes within a year. Moreover, the new government undertook an aggressive devolution process to simplify and reduce the administrative procedures concerning opening and running businesses. From a minimum of 40 days that were required to be spent in the labyrinths of state bureaucracy, a business can now be registered in a maximum of 8 days under a 'one stop shop' format. Another priority of the democratic government has been the formalisation of the economy and creating a legal legitimacy for the scores of 'informal' buildings that have been constructed in Albania during the last decade. Furthermore, Berisha's government started a policy of zero tolerance against crimes and monopolies, and has been resolute in dismantling the consolidated networks of crime and economic monopolies. It is because of the progress achieved within such a short time, that Albania joined the EU in a Stabilisation and Association Agreement in February 2006.

Belarus

Belarus is the last surviving dictatorship in Europe, a basket-case of a country with its dictator crushing what little is left of personal liberty beneath his iron fist. Private enterprise is virtually non-existent, and government interference is commonplace. As a result, foreign investors have little interest in the country.

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The aforementioned dictator, the 'democratically elected' President Alexander Lukashenko came to power in the wake of the break up of the USSR. Having been elected in 1994 with a sizable majority, he pushed through referenda that could be quaintly described as 'rigged' to consolidate almost all power with the presidency. The referendum that passed in 2004 to remove the two-term limit on his power, described by international observers as "vastly fraudulent," accompanied a parliamentary election where Lukashenko's party won every seat. His 're-election' in March 2006 was met with what is becoming standard international criticism, but any prospect of a repetition of the 'coloured revolutions' seen in Georgia and the Ukraine seemed little more than unrealistic optimism on behalf on the west. In the aftermath of the vote, sanctions, including travel bans and asset freezing, were raised by the EU and the USA against members of the Belarusian government. Nevertheless, most independent observers also conceded that had the election been free, Lukashenko would probably still have carried the popular vote. How much of this can be put down to the tight governmental controls on media and opposition activity in open to much dispute.

What little output Belarus produces is mostly bought by Russia, the only nation with which Belarus enjoys a friendly relationship.

In 1995, Lukashenko launched a programme of so-called 'market socialism'. The purpose of the 'market' part of this term has yet to become clear; indeed, at various points over the last 10 years, the KGB has been used to 'impose order on the market'. This is about as far from *laissez faire* as it gets. The state controls over 80% of the economy, and accounts for more than 95% of industrial output. Furthermore, government has acquired control over pricing and management of 'private' enterprise. Business regulations change swiftly, with little coherent pattern to the alternations, and new laws are often applied retroactively so that businessmen can be (and frequently are) arrested for breaking laws that did not exist at the time. Indeed businessmen and factory owners are generally perceived as disruptive, threatening to the state and the President, and often end up behind bars.

A similar fate awaits most of those politicians who speak out against the president. In December 2004, politician Mikhail Marinich became the latest in a long string of arrested opponents, ostensibly for 'stealing office equipment'. At the 2005 referenda and elections, scores of exit-pollsters were locked up in a move decried by opposition campaigners. All of Belarus' judges are appointed by the President. Latterly, another law was passed hardening penalties for those found guilty of 'inciting demonstration' or distributing information deemed harmful to national interests or defamatory to the president. This arrived in anticipation of the 2006 election.

What little output Belarus produces is mostly bought by Russia, the only nation with which Belarus enjoys a friendly relationship. Lukashenko is highly loyal towards Russia, and in recent times is being increasingly rewarded for this stance, as other former Russian allies such as the Ukraine and Georgia turn their attention westward. Russia purchases goods from Belarus despite their uncompetitive prices, and rewards it with discounts on imported goods, particularly energy (during the gas crisis of January 2006 Belarus was the only nation exempt from Russia raising energy prices by 25% or more). Indeed, in December 1999 the two countries agreed to form a two-state union aiding greater political and economic integration, although as yet little practical implementation has come of it. However, this may provide clues as to the final resting place of Belarus, as reuniting with Russia would make both political and economic sense. However, Lukashenko's predictably fierce patriotism leads him to believe they can combine in a 'union of equals' – something Moscow would never countenance.

Other problems bedevil the nation, but all are derived from the poverty and repression instilled by its rulers. In 1997, President Lukashenko announced the revival of the Soviet tradition of '*subbotniks*,' weekend unpaid mandatory labour. Since 1998 food has been rationed, a catastrophic development in a peacetime Europe.

International agencies have taken an assortment of steps against the country. In November of 2004, the United States imposed sanctions on Belarus, condemning the electoral malpractice. The Act, passed unanimously by Congress, forbids US federal agencies from sending money into Minsk and calls for assistance of non-governmental organisations dedicated to the peaceful overthrow of the present regime. The EU and its members have at various times withdrawn officials in protest at an array of Belarusian actions, including the expulsion of inspectors from the OSCE (Organisation for Security and Cooperation in Europe). The EU has also maintained for a number of years a comprehensive travel ban on senior government figures.

Belarus has demonstrated reasonable growth numbers over the past couple of years registering 6.4 and 7.8% in 2004 and '05, sustained principally by Russia importing machinery from Belarus at prices well above the market rate. However, mammoth inflation rates (between 1995 and 2004 the average rate was 27%) and cataclysmic trade deficits negate any possibility of positive economic development. The grand redistributive intent of the state has left the country with possibly the most equally distributed wealth in the world – rendering everybody equally impoverished.

Freedom House assigned Belarus its lowest rating ('not free') in its most recent assessment. It was particularly critical of the levels of press freedom within Belarus, in addition to the other problems already outlined. The state has persistently harangued independent media outlets, and ultimately closed most of them down. In the meantime it uses state-run newspapers and television channels to broadcast pro-government propaganda, especially, although by no means exclusively, during 'election' and referendum campaigns.

Worse still, the Heritage Foundation ranks Belarus 151st of 157 countries assessed giving it the ranking of 'repressed', placing it marginally

above such luminaries as North Korea, Iran, Burma, Zimbabwe, Libya and Venezuela.

Belarus also features on two more prestigious lists. It is one of the 'Committee to Protect Journalists' "10 worst places to be a journalist". President Lukashenka, meanwhile, appears on the 'Reporters Without Borders' organisation's list of "predators of press freedom", and stands accused of carrying out a "systematic crackdown" on private press in the country.

One of the more worrying facets of the whole situation is the remarkable degree of public support for the Marxist goals of the president. Rural communities in particular are keen to see the continuation of state-sponsored collective farming and other similar initiatives. Although buttressed by the constant media propaganda, government foreign policy finds much favour among a highly anti-Western population.

Prospects for the future look bleak. The President's tight grip on power and the willingness with which he exercises force to subdue any dissent make the prospects of any kind of popular revolution, as seen in regional neighbours like the Ukraine and Georgia a remote possibility. His health is sound and he is still relatively young (he was born in 1954) so the likelihood of his withdrawal from power, voluntary or otherwise is also slight. The more plausible future scenario is one where Belarus is absorbed back into the mass of Mother Russia. As the two tightened their relations, the value of Belarusian independence diminishes. Whether Lukashenko will sacrifice his premiership to Moscow, or his people to national bankruptcy may well become the final issue.

Bosnia and Herzegovina

Bosnia and Herzegovina emerged in 1995 from half a decade of conflict almost obliterated, but also independent. The cataclysmic breakup of Yugoslavia probably hit Bosnia worst of all. Its territory was bitterly fought over by all the parties involved in that war. The Dayton Peace Agreement, finalised in 1995, divided Bosnia-Herzegovina into two executive power wielding entities, the Muslim-Croat Federation and the Serbian Republika Srpska. Now a federal republic, Bosnia is ruled by a tripartite Presidency of Ivo Miro Jovic (Croat), Borislav Paravac (Serb), and Sulejman Tihic (Bosniak).

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There is now growing international consensus that an ethnically unified single government must be built up in order to preserve Bosnia's future. Former High Representative Lord Ashdown, and his successor Christian Schwarz-Schilling, have slowly but surely guided a process of limiting the powers of the two existing governments, in hope of turning Bosnia into a fully fledged liberal democracy. However, some domestic observers recognise certain inherent advantages of the present federal system, particularly as competition between the federal units has maintained pressure for lower taxation and better business incentives.

Furthermore, the Serbian district has proven itself willing to embrace reformist agendas. The regional leader threw out nationalist members of the executive with a vote of no confidence, and is now attempting to pass as much reformist legislation as possible before the next election in the winter of 2006, particularly intended to combat corruption, drugs trade, official misconduct, and excessively complex business procedures. That this is occurring at the state, not national, level is indicative of the reasons the federal advocates hedge their support for a more unified national system of governance.

Post-war Bosnia is enjoying a period of economic recovery. However, it remains at the transition stage, and is only beginning to institute market-oriented reforms. Since the war, attempts have been made to remodel the country's infrastructure, and many refugees have returned home. However, unemployment remains obstinately high, approaching the 50% mark, with a far worse situation in some rural areas. In Sarajevo, it often seems as though every employed local is working for foreign non-profit organisations, or in restaurants and hotels that cater to visiting westerners. The situation in some border regions shows modest signs of recovery, principally due to cross-border investment from the 'parent' countries. And other issues also persist — GDP is lower than it was before the war, and the private sector lacks vigour.

However, some key reforms have been enacted. Peter Nicholl, Governor of the Central Bank of Bosnia-Herzegovina (CBBH) from 1997-2004, helped guide Bosnia away from crippling debt problems, which approached US$2 billion in 2004. He also led efforts to reform the CBBH. The introduction in 1998 of the convertible Marka as the new currency to replace the BiH Dinar was one of the elements enacted to stabilise Bosnia-Herzegovina's currency. Its shadowing of the Deutschmark, and later the Euro also helped to maintain a low rate of inflation. This reform was an early priority, having proven successful in several other transition economies. Citizens have trusted the foreign base currency more than their own existing institutions and currencies, and the Euro has strengthened trade and economic links to Bosnia. Under Nicholl, Bosnia also helped consolidate its banking sector, with the number of banks halving from 76 banks to 33. Indeed 8 banks hold 80% of the deposits in a country of 4 million people. The bank has come to be seen as a beacon of stability in a country still recovering from conflict.

That said, those deposit values do not amount to much and the banks do not offer the products one might expect. Chequeing accounts are unheard of, so transaction must be conducted in cash, or with very expensive electronic transfers. Even the international institutions such as the EU and NATO have been known to pay their employees 'under the table', allowing those employees to decide for themselves whether they want to declare that income for taxation, as going through the official procedures are too costly to be efficient.

The Thessalonica summit meeting of the European Council in 2003 resolved to integrate the Western Balkan states into the EU. It has been concluded that Bosnia-Herzegovina is "considered likely to join the EU between 2010 and 2015" depending on its fulfilment of the admission criteria. First and foremost, Bosnia-Herzegovina must enact the entire contents of their Stabilisation and Association Agreement before officially applying for EU status. Similarly, Bosnian constitutional reform, which is running at a very slow pace, due to the unwillingness of the various ethnic groups and political parties to reach tough compromises, is critical. The three-member presidency will be reduced to one single executive power, thereby relieving ethnic factionalisation, but as anticipated there are strong disagreements over how this position should be elected. At the moment, a two stage process seems likely, with one nominated president and two vice-presidents representing the three states, but with the roles alternating on a rotating basis. In an effort to create greater governmental efficiency, the central government will be strengthened, placing the rights of ethnic entities to vote on national legislation in question. However, a stronger central government is in Bosnia-Herzegovina's best interest, if for no other reason than that it will make EU accession more feasible and facilitate communication and negotiations between Bosnia and the outside world.

Despite the long journey Bosnia-Herzegovina must travel to reach EU accession, its achievements up to now cannot be overlooked.

A regional free trade agreement (FTA) is being developed among Bosnia-Herzegovina and other Western Balkan countries at the instigation of the European Union. This should serve to boost Bosnia-Herzegovina's intra-regional trade by integrating the existing networks of bilateral FTAs in the Balkans into a single regional FTA by mid-2006. Suspicions have been raised, though, that these free-trade agreements may be used in the future as an excuse for the EU not to accept the Western Balkan states for membership, The EU must make it clear that membership into the Union is ultimately inevitable (even if only in the very long term) if they expect Bosnia to trust the European Commission's mooted reforms. To assist this process, financial contributions are expected to come from the European Union. After all, it is, in the EU's best interest to stabilise and develop Bosnia-Herzegovina.

Employment discrimination remains rife in the Bosnian work force. In the aftermath of the war, allegations were made against the Aluminij Aluminium Factory in Mostar for hiring only Croats. Another example comes from the Ljubija iron-ore mines near Prijedor where non-Serb workers were fired from their jobs without explanation and have still not been able to get their jobs back. Displaced minority members have a very difficult time finding employment, and therefore are often receiving social care. This discrimination in employment points to the deeply engrained sense of factionalism that still exists in Bosnian society. However, this problem pales into insignificance compared with the numbers who simply cannot find work, or who have nowhere else to turn but the state pension (equivalent to US$200 per month) and cleaning westerners' houses to raise some extra cash.

Although Bosnia-Herzegovina has come a long way since Dayton, reform is still a necessity for the country's economy to approach European Union standards. It is critical that the reform process continues at a faster rate than hitherto. Privatisation, freeing trade and removing barriers to foreign investment are three of the main prerequisites for further economic development. Retroactive measures, designed to redress some of the excesses of the privatisation programme to date have caused quite a stir, though. Practices which, while ostensibly dubious, were also commonplace and apparently legal during the first round of privatisation, have come under considerable criticism since, and there has been an inclination on the part of the current rulers to try to 'punish' them. Therefore, the European Commission will continue to help expand the region's economy, making it more competitive, improving its administrative capabilities, and helping it to conform to the Union's *acquis communautaire* (the body of common EU law).

The Commission has also identified high unemployment rates and the remnants of factionalisation as major problems in need of resolution. The Commission has acknowledged progress in the area of justice, freedom, and security, as many actions to combat organised crime have been implemented or at least agreed. The EU's presence in peacekeeping missions and conflict prevention gives it a greater ability to observe conditions within Bosnia than it may have in other prospective applicants.

Despite the long journey Bosnia-Herzegovina must travel to reach EU accession, its achievements up to now cannot be overlooked. In an attempt to encourage Bosnia and other countries aspiring to EU status to persist in their reform, the EU should try to match each positive step with a positive response.

Bulgaria

It is sixteen years since the beginning of the transition from communism to markets and freedom, yet Bulgaria remains poorer than almost all other European countries. The good news is that the economy is developing, growing much faster than most EU member states. Eventually, Bulgaria should become a wealthy nation. Nevertheless, the challenge is substantial: depending on the pace and depth of reforms, this change could take as few as ten years or as many as sixty. This disparity is too large to be left unexamined.

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The transition began at the end of 1989 and early reform focussed upon the political process and its institutions. The former communist party remained in power for most of the following seven years and these reforms were implemented very slowly. State-owned enterprises and banks dominated the economy, inflation was high, and taxes and regulations were punitive. The state companies sustained ever greater losses, yet because of the generous support of the government and its banks, not one of them went bankrupt. There was a huge fear of real change, so reform was prevented by any means. As a result, the economy contracted; real economic growth averaged -5% per year.

These attempts to maintain the structure of the economy and to 'save' loss-making state companies incurred a high cost. The government assumed the non-performing debt of state enterprises, which led only to larger non-performing debts. Eventually most, if not all, state companies were technically bankrupt, as were most of the state banks. The government was running a huge budget deficit (more than 10% of GDP), which they funded by printing yet more money. By 1996 most state banks were closed, inflation reached 1000% and the economy was in a deep crisis. The government debt had reached 120% of GDP.

One of the boldest reforms enacted in recent years is the dramatic reduction of direct taxation.

The desire of the government to slow down reform in order to make it more 'socially bearable' inevitably produced the opposite result - the public suffered a much higher burden of hardship than necessary. At this point it was evident that sweeping reforms were needed and, finally, they began. The crisis provoked huge anti-government rallies and protests which resulted in the government being ousted in early 1997. After elections a new government took its place with a substantial majority and a clear mandate for reform.

In subsequent years progress occurred more swiftly. The old monetary policy was abolished and a currency board system was introduced. Most prices were liberalised; foreign trade was facilitated by decreasing customs duties. About half of the state-owned enterprises were sold, including all banks, the state telecommunication company, and many steelworks. The share of the private sector in the economy increased to 79%. Critically, within several years the public sector share of total employment decreased from 70% to 30%.

Considerable advances were also achieved in other spheres. In 2000 pension reform began, wherein a small portion of the social security tax was directed toward individual pension accounts in private pension funds. This proportion has increased over the years and, despite some delays in the stipulated timing, it reached 3% of the salary in 2005. The reform could have occurred much faster and been more substantial – other countries in the region are a testament to this. Nevertheless, it represents a substantial step in the direction of creating a fully-funded private pension system. It is also important that the new centre-left government has continued that policy by increasing the portion directed into private pension funds to 4% from 2006.

One of the boldest reforms enacted in recent years is the dramatic reduction of direct taxation. In 1997 the corporate tax rate in Bulgaria was 40.2%. After 8 years of reform, this rate is now 15%, almost three times lower. The top rate of the personal income tax was 40% in 1997; it is 24% now. Thus by 2005-

2006 Bulgaria had some of the lowest profit and income tax rates in Europe.

However, at the same time the social security tax has remained among the highest in Europe, accounting for more than 42% of salaries. Here, it has been difficult to achieve any progress over the last 6-7 years. However, following a two-year campaign by various think tanks to introduce a 10% flat rate for all direct taxes - corporate tax, personal income tax and social security tax - some success has been achieved in this area. The new centre-left government recently cut social security tax by 6% in its 2006 budget.

Government debt has decreased substantially as a share of GDP since these farther-reaching reforms were enacted. From a level of more than 120% of GDP in the mid 1990s it has now dropped to about 30% of GDP. This is a result of increasing GDP while the debt was maintained at the same nominal level, and later repaying a portion of it with proceeds from privatisation and budget surpluses.

The result of these reforms was stark and instantaneous. Economic growth increased by 9-10% per year – from an average of -5% before 1997 up to roughly 5% post-1997. Unemployment increased initially, and then decreased as a result of economic development and subsequent job creation. It is clear that reform has yielded beneficial results.

However, it seems that recently the momentum for reform has started to disappear. Budget surpluses, positive economic growth and improved economic indicators have slowed the pressure for change. Government complacency has increased and the spur for such rapid reform - the economic crisis of 1996 - is now fading into the past. As a result, some necessary improvements remain politically sidelined.

Despite positive developments in the area of direct taxation, the overall tax burden in Bulgaria remains relatively high, both compared with the new EU member states and comparable countries that are experiencing higher economic growth. Effort must be concentrated in that direction to change things further. Yet a willingness to promote further reform in that area, sadly, seems lacking in the new coalition government. In the past few years the fiscal budget is constantly in surplus, reaching almost 5% of GDP in 2005. Yet still, the overall tax burden has not decreased visibly, though this is principally due to the insistence of the International Monetary Fund that Bulgaria should continue running budget surpluses.

In the long term education and healthcare are the sectors most in need of improvement, so that the increase in economic growth can be sustained, while government expenditure decreases concurrently. The Ministry of Finance recently released a paper on public education spending which called for the introduction of a 'voucher system' - whereby spending is determined by the student according to his or her priorities, rather than by the school - and the decentralisation of decision making in order to increase incentives within the system. Although, this was supported by most political parties, strong opposition emerged from schoolteachers' unions. The Ministry of Education joined that opposition and has now effectively precluded any reform in the foreseeable future. A new Education Minister has thus continued the existing policy, pouring ever more money into the already bloated sector.

The healthcare system is also notorious for high spending without commensurate improvements in the provision of services. Medicines are being procured at prices above market levels, corruption is perceived to be widespread and hospitals run deficits every year while asking for additional subsidies from the government. Despite these obvious failings, little is being done in this field either. Although there is much talk of the privatisation of hospitals nothing has been achieved until now. There is some move toward partial implementation of the 'payment for activities principle', which will change the present situation whereby hospitals receive most of the healthcare funding irrespective of the actual amount of service they provide. The previous government promised to allow private alternatives to the state monopoly health fund, but failed to deliver on that promise.

Similar problems can be seen in the areas of administrative and regulatory reform. Each new government starts by cutting its administrative staff by 10%, but balancing this out in subsequent years by increasing total staff numbers by 15-20%. Deregulation is also a favourite topic for politicians even though they admit that, to paraphrase the Finance Minister, for every regulation removed two new ones are usually introduced.

Reform in other areas has been delayed and as a result Bulgaria is still lagging behind the leading reformers of Europe. For example, military service is still compulsory despite defence expenditures being amongst the highest in Europe, which serves only to remove manpower from the labour market. The loss-making state railways are subsidised because no one has the will to implement a programme for reform, prepared years ago by former government and World Bank experts.

Overall, the outlook is mixed. Significant reform has been enacted yet much more is still needed. The pace of these reforms will determine how many years will be needed before Bulgaria can claim to enjoy the wealth of nations.

Croatia

The bloody and destructive war in the early 1990s gained Croatia its independence, but at a heavy cost. Much of the nation's infrastructure was destroyed. Populations shifted from place to place as they sought refuge from the conflict. The medieval port of Dubrovnik just about survived bombardment from the Yugoslav military, but other industrial cities, such as Vukovar, were not so fortunate. To this day, the war torn areas in the eastern part of the country remain an economic wasteland with unemployment rates above 50%.

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The nation's first post-communist election ushered in President Franjo Tudjman and the nationalist Croatian Democratic Party (HDZ). As with many transitional countries in Eastern Europe, President Tudjman's ruling government (1991-1999) catered to cronyism and corruption that further hampered the fledgling nation's efforts to establish the rule of law. Rather than transitioning to a free market economy, the fragile rule of law gave way to criminal capitalism which created a privileged group of instantly wealthy selected individuals, as former senior government officials were installed in key management positions in large state owned companies (SOEs).

After Tudjman's death, the Socialist Democratic Party (SDP) came to power in 2000, but continued the HDZ's failed policies of central planning, leading to the government bailing out a number of troubled SOEs. The weak coalition of SDP was punished by the electorate when the Croatian Democratic Party, led by Dr. Ivo Sanader, won the elections in November 2003, promising market reforms before they took office a month later.

Croatia's economic growth has slipped along with a significant slowdown in foreign direct investment.

Two years later, the government has failed to implement a single major initiative in favour of free market reforms. An absence of economic policies and pro-growth solutions has led to economic stagnation. Citizens, taxpayers and entrepreneurs were hoping for market reforms that would lead to economic growth, increased employment and prosperity.

In the economic arena, the government has peddled half-baked changes such as establishing a 'one stop shop' for registering a new business that still takes longer and costs more in comparison to the US, UK and other EU nations. A growing number of local entrepreneurs and business leaders from abroad have come to call it a 'one shop…and then stop', having observed the difficulties of starting, growing and sustaining private enterprises.

Worryingly, the myth that Croatian entry into the European Union will automatically boost economic growth, increase employment and bring about a higher standard of living seems to be gaining ground. A quick glance at Greece or Portugal provides ample evidence that EU entrance is not an automatic guarantor of economic vitalisation and prosperity

Croatia's economic growth has slipped along with a significant slowdown in foreign direct investment. The nation's only saving grace has been its flourishing tourist industry that brings several million tourists to the Adriatic coast during the brief summer period and provides an infusion of foreign currency into a cash-strapped economy.

The 2006 Index of Economic Freedom published by The Heritage Foundation and *The Wall Street Journal*, ranks Croatia 55th of 155 assessed countries, yet this leaves it behind Albania and the majority of Eastern European's transitional nations. Croatia is categorised as 'mostly free'. The report rates the areas of property rights and regulation with a score of 4 out of 5 and informal market 3.5 (five being the worst). The areas of foreign investment and fiscal burden receive a score of 3.

In October 2005, Transparency International unveiled the annual Corruption Perception Index (CPI) and Croatia's ranking slipped from 67 in 2004 to 70 in 2005 (The survey covered 158 countries). The CPI score for Croatia decreased from 3.5 in 2004 to 3.4 out of 10 in 2005 (ten being 'cleanest'). It is important to note that the CPI report reveals that poor performance in long-term EU states including

Greece and Italy, as well as the new members Czech Republic and Poland show little or no sign of improvement. The Report further states, "This weakens the credibility of the EU in promoting anti-corruption in its new member states and exporting anti-corruption to countries proposed for accession in 2007."

According to the World Bank's annual report 'Ease of Doing Business – 2005', Croatia once again performed poorly. Croatia was ranked 118th out 155. Croatia's leaders were surprised to hear that neighbouring Serbia was considered one of the top economic performers in the world. The World Bank's report again ranked Albania ahead of Croatia.

During 2005, Croatia's current government stalled the vital process of privatisation and eventually pushed through a seriously flawed privatisation deal in the summer. This incident led to an investigation which resulted in the firing of the president and vice-president of the Croatian Privatisation Fund (CPF) over concerns about corruption. The CPF has shares and stock in 1035 companies and its portfolio includes agricultural based companies, shipyards, aluminium and steel plants and hotels that are heavily subsidised. These poorly managed and loss-making state entities have significant debt.

According to *The Wall Street Journal* and The Heritage Foundation's 2006 Index of Economic Freedom, 'Red tape presents difficulties to foreign and domestic investors alike… Lack of transparency in government decision-making often leads to allegations of conflict of interest or bad decisions… Some local governments have occasionally been openly hostile to foreign investment.' Moreover, unrealistic preconditions set by the CPF, including requirements to retain unnecessarily high staffing levels or predetermining the level of future investments impede sales. A fair, transparent and ethical process of privatisation has yet to be realised.

The Economist online reported on February 16, 2006, "In Croatia, a widely admired justice minister, Vesna Skare-Ozbolt, was sacked last week. She had pushed both judicial reforms (such as appointing independent senior judges) and an aggressively timetabled anti-corruption programme. These delighted the outside world, but annoyed Croatia's old guard, who prefer the old system of cronies and favours." The lack of bold leadership in combating corruption dampens Croatia's economic vitality. Much of the corruption is connected with the tremendous influence of government involvement in the economy. Skare-Ozbolt advanced anti-corruption strategies and presented a comprehensive package that would have dealt a serious blow to corruption.

According to the 2006 Index of Economic Freedom, "Huge case backlogs mean that business disputes can go unresolved for years;

some investors have chosen to insist that contract arbitration take place outside of Croatia. The Government of Croatia has made a commitment to reinvigorate its efforts to reform the judiciary, but much remains to be done."

It is important to note that a backlog of 1.4 million unresolved cases burdens Croatia, a nation with a population of just 4 million people. Property restitution remains a major roadblock as local governments impede restitution stating that they are protecting the 'local government's interest'. A majority of the cases dealing with property have been tied up in the court systems for more than a decade.

Croatia's huge bureaucracy, restrictive labour laws and high taxation all create obstacles for those working in the private sector. Prime Minister Sanader's government originally pledged to reduce taxation during its political campaign. Croatia's government expenditure, as a percentage of GDP, is over 52%, the highest in Eastern Europe and above the EU average. Lack of fiscal discipline is worrisome as Croatia's debts increase amidst economic stagnation and lack of FDI. Its high debt remains a ticking time bomb.

The Organisation for Security and Cooperation (OSCE) Mission to Croatia reports, "The general climate for public debate in Croatia continues to improve. Croatian print media has become more critical and has progressively begun reporting on sensitive issues such as war crimes committed by members of the Croatian Army and the return of refugees." The report stated that, "HTV has generally freed itself of political bias but retained a strong bias in terms of topics covered." However, as progress is made in strengthening free media, journalists and media communications entities in Croatia have experienced a number of setbacks including a plethora of lawsuits and journalists facing prison sentences. Over the course of 2005 reporters and editors have felt pressure from Croatia's government leaders and several investigations have been abandoned for fear of the state's response.

The grassroots reform movement has just begun in Croatia with a spirited debate on flat tax rates, labour and pension reforms, rapid privatisation, and education and health care reforms. Prime Minister Sanader has publicly commented that he stands for reforms in Croatia. The minority HDZ government has an opportunity to clearly articulate pro-growth solutions and advance practical economic reform initiatives that will lead to economic growth.

Croatian taxpayers have noticed that neighbouring countries are prospering, drawing foreign capital and creating jobs. Parliamentary elections are expected in 2007 and the electorate showed in 2003 that they will vote with their wallets in mind. The ruling government should take heed and work on creating a pro-reform economic team that will begin the reform process in Croatia by fully implementing the 'anti-corruption strategies', tax reform, labour law flexibility and addressing the privatisation process.

In 1998, former UK Prime Minister Lady Thatcher, known for her bold leadership in advancing free market reforms, visited Zagreb. Croatia's leaders will do well by heeding to Lady Thatcher's profound message, that "the system of freedom and free enterprise is, above all, based on the rule of law — law which must be fair, clear, and honestly administered, and to which government, and all those associated with it, are also subject like everyone else. Such is the political and economic system for which we should aim. Wherever it is tried it is successful."

These words, delivered nearly a decade ago in Croatia, are still highly pertinent to today's leaders and taxpayers. They outline a goal well worth pursuing.

Georgia

In the aftermath of Georgia's 'Rose Revolution' of late 2003, it did not take long for the incoming government to realise that, without swift and radical economic reform, the collapse of the state would have been inevitable. Based on their reform record to date, it is safe to say that the government believes liberal values and economic freedoms are the best routes to success and profit.

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Georgia's two main aspirations at present are economic liberalisation and EU accession. However, there seems to be a misconception of the benefits that EU membership will bring. While on the one hand, the boon in terms of free trade and movement of labour and capital will be enormously beneficial, the additional imposition of much more overbearing regulation and bureaucracy could be equally damaging.

The government was so committed to the reforms it even went so far as creating a cabinet-level position – State Minister for Reform Coordination – to manage the project. Sadly though, the vast scope and structural irregularity of the existing systems has meant some vital components in need of reform have eluded his grasp, and he has also found progress thwarted on some occasions by institutional enemies of beneficial reform plans.

The first step to reform, taken directly following the revolution, was a sweeping privatisation plan. The government sold off pretty much everything ("except its conscience", said Reform Minister Kakha Bendukidze). The government, seeking the most lucrative short term revenue haul, sold all its 'strategic assets' such as ports, railways, and oil and gas pipelines. Yet in spite of this, privatisation is moving slowly. Political instability and uncertain property rights have made foreign investors wary, resulting in revenues of just 330,000 GEL (US$183,300) from privatisation in 2005.

The government has also commenced a severe clampdown on tax avoidance. This generally involves sending financial police into firms for 'auditing', closing them down for weeks at a time, resulting in profit losses, without any compensation. Most of this occurs outside of the court system, with injunctions being set by the Office of Public Prosecutions and cabinet officials, at a massive cost to the taxpayers. While it is likely that tax compliance was low during previous regimes, this kind of aggressive intrusion carried out by unaccountable bureaucrats only serves to scare away the investment needed to reconstruct the country.

The next step on the road to reform was liberalisation of the tax system. A new tax code was adopted in January 2005 that reduced the overall tax burden, but, because of additional administrative costs to handle the more complex codes, may have made life more complicated for businesses. The number of taxes has reduced, from 23 to just 7, as has the size of the tax burden. Income tax has reduced, from a progressive system to a flat tax which, at 12%, is among the lowest in Europe. VAT has gone from 20% to 18%, and social security taxes have dropped from 33% to 20%. However, corporate taxes still stand at a relatively high 20%, and a tax on reinvestment dampens enthusiasm for business development.

Tax collectors have unlimited powers to take arrears, including the forcible mortgaging of property, without recourse to the courts. Indeed, with only the authority of the head of the tax department, property can be seized and sold. Money may be removed from bank accounts and from cash stockpiles. These kinds of actions prevent entrepreneurial activity and are hazardous to the safety of the whole society.

The radical liberals, whose ideological background is based on the idea that in a free market, monopoly positions must not be permitted, changed anti-monopoly legislation and created a new free trade and competition law. Under the new regulations, only the government can create monopolies, or give permits for particular firms in 'natural monopolies'. With these few exceptions, any state activity which hinders competition is prohibited. State bodies may not impose any tax cuts, or other initiative, which may favour one firm over another, pose any kind of impediment to entrepreneurial activity, grant special powers which deter competition, or influence decisions to grant monopoly positions.

One result of this law was the so-called 'third-party access' provision. This states that owners of specific types of property (e.g. pipelines, or railway lines) are obliged to offer other economic agents free access to their grids under non-discriminative conditions. They may only refuse if the other party does not fulfil predefined technical requirements. Equipment for the transmission of non-tradable goods created by private investments is free from this obligation. The shortcoming of this law is that it delimits property-owners' rights, although it does serve to open up markets, which in other countries are severely hindered by access agreements (for example, Georgia's open pipelines give it among the most competitive energy sectors in Europe).

In order to oversee the implementation of these objectives, the Free Trade and Competition Agency was established. However, the precedents of government corruption make it hard to be too optimistic about how effectively this will operate.

The reform of the licensing and permit system was also radical. The number of licenses and permits was reduced from 909 to 159. Additionally, the system was vastly simplified. A 'one-stop shop' system was created to enable ease of acquisition. The 'silence equals consent' principle was introduced, whereby a wait of longer than a certain length of time (usually 30 days) equates to the automatic receipt of the license. Finally, the 'one umbrella' principle allows owners of generic permits to not need to acquire subordinate specific ones. The regulatory burden was reduced thanks to this law, and the removal of many layers of bureaucracy also removed much of the opportunity for corruption. However, its laxity may also permit activity previously considered 'criminal'. Perhaps a more effective way to solve problems in this area would be the adoption of an 'insurance-like' system, but government is unwilling to completely privatise in this area.

The next direction reform went was the privatisation of land ownership. All government owned land on which rent was collected, and that was not within 5km of an international border, has been or will be sold off. Unfortunately omitted from this, though, are pastures, forests, and some special historical areas, meaning nobody in particular owns or is able to take care of them. Only Georgian citizens, or institutions legally registered within the country could buy the land.

This reform will aid agricultural development, and allow market mechanisms to set land prices. However, more detailed property rights

are less easily determined. For example, there is a distinct absence of clarity as to whether resources found on private property belongs to the land owner or not. At the moment, the government claims all such resources as the nation's, and the land owner only has the right to compete with other parties to produce resources found. This rule reduces the market value of land, and may go some way to explaining the apparent scarcity of resources in Georgia.

Reform in the banking sector is ongoing, but so far change has been modest.

Reform in the banking sector is ongoing, but so far change has been modest. Selling procedures were tweaked to simplify collateral mechanisms. The minimum capital required to set up a bank was raised to 12 million Georgian Lari (about €5 million). This has not helped make the sector more accessible for foreign banks, though, and government continues to meddle in this sector with an overly visible hand.

Customs also stands in need of reform, as high tariff and quota restrictions engender corruption among customs officials. Customs tariffs need immediate revocation to support economic growth by raising import levels and reducing prices, and increasing domestic competitiveness by exposing firms to new rivals.

Georgia needs rapid privatisation of its social security and healthcare systems. Now is the perfect time, as Georgia's government is unable to take great responsibility in this area because of funding shortfalls. Georgia's state pension burden is so insignificant (€12 per citizen per month), that for the government to allow private assistance would seem appropriate. Georgia has no unemployment benefit, or any decent state healthcare system, but at the moment private alternatives exist outside the law. Legalising them would foster beneficial competition and reap better outcomes for the society.

It may be time for Georgia to look further afield for inspiration. The EU model may be too state-heavy for such a small and underdeveloped country. Other examples, such as new EU members like Estonia, or free-market trendsetters like New Zealand may hold better exemplars of the reforms Georgia should be pursuing, alongside a more thoroughly developed rule of law which creates a safe harbour for individual activity. Hopefully, the Georgian government understands that, and a free-market rose may bloom in the flowerbed of the former USSR.

Iceland

Today, Iceland is one of the wealthiest and most prosperous countries in the world. However until the late 1980s, Icelandic society was deeply socialistic – there were many state-owned enterprises, high tax rates and excessive government interference in day-to-day business operations. However since the early 1990s, Iceland has been on a steady track toward sustained economic growth, achieved through market-orientated reforms and liberalisation.

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Prior to this recent period of reform, true capitalism was widely considered an extreme economic model, and any step taken towards liberalising the economy was seen as a grave political risk. However, a new generation of politicians took over the leadership of the conservative Independence Party (IP) in the beginning of the 1990s and brought with them a new way of thinking. The IP began to put its ideas into practice; liberating the economy, introducing privatisation, lowering taxes and, as a direct consequence, limiting the powers of politicians. Today libertarianism and economic reform directed toward a more liberalised economy are considered to be mainstream political ideology in Iceland. The two individuals most responsible for this development are Professor Hannes H. Gissurarson, the ideologist of the movement, and Davíð Oddsson, who has been principally responsible for putting these ideas into practice.

Oddsson became Prime Minister of Iceland in 1991 following his election as chairman of the IP. His first government was a coalition with the Social Democratic Party (today a part of the Social Democratic Alliance), but since 1995 the Independence Party has governed with the centrist Progressive Party (the IP is the only centre-right political party in Iceland, and won around 40% of the vote). Oddsson served as Prime Minister for more than 13 years, from May 1991 to September 2004, when the Chairman of the Progressive Party took over as Prime Minister and Oddsson became Foreign Minister, in accordance with a pact the two parties made after the general elections in 2003.

On September 27th 2005 Oddsson left politics in accordance with this earlier decision and stepped down as Foreign Minister and as an MP and took over as president of the Icelandic Central Bank. The main reason for this decision was the length of time he had spent on the front line of Icelandic politics (an unbroken succession of prominent positions since 1974). Geir H. Haarde took over as Foreign Minister in Oddsson's place, having previousy served as Finance Minister since 1998. Haarde was then elected chairman of the IP at its biannual national congress in October. He has announced he will continue the same economic policies.

From a cultural point of view Icelanders are extremely open to all innovations, new ways of thinking, of doing things and particularly new technology.

The fact that the Independence Party has been the ruling partner in government since 1991 has led to a great political and economic stability and ensured steady progress in the right direction. Iceland has sustained an impressive GDP growth ever since 1995 with the sole exception of 2002. In 2004 the growth was 8.2% and it is forecast to have been around 5.5% in 2005. Purchasing power has grown every year and unemployment is very low (1.6%). As a result Iceland has in recent years scored very highly in international reports on countries' socio-economic success.

Taxes have been lowered significantly in Iceland since 1995. Corporate tax rates have been cut over that period from 33% to 18%, though this has actually raised government tax revenues. Income taxes collected by the state have also been lowered since 1995 from 33.15% down to 24.75% and are scheduled to be reduced again to 21.75% in 2007. Property taxes paid by individuals and companies will be abolished this year (2006) and the same goes for a special tax on high income earners. The value added tax is also up for review and a number of other smaller tax reforms have been scheduled.

Serious discussions about the benefits of flat taxes have emerged in Iceland at the initiation of the Icelandic Chamber of Commerce. In February 2005 a special report from the ICC on the issue recommended a 15% flat tax for the income of individuals and companies and on consumption (taxes in Iceland are actually already rather flat due to the absence of thresholds). The fruits of these discussions are already beginning to show - the IP has accepted into its tax policy a recommendation that immediate work will start on collecting information about flat taxes and estimating what impact the introduction of such a tax would have on the state's finances.

A special committee was thus appointed on October 20, just after the party's national congress, by the Minister of Finance, Árni M. Mathiesen, for the purpose of reviewing the Icelandic tax system in light of the possible introduction of a system of flat taxation. The committee is mainly supposed to shed light on what makes the Icelandic economy competitive and efficient, and also to look into development in tax reform and structures in other countries. They will be looking for inspiration not only from countries which Iceland traditionally compares itself to, but also countries which are not stuck in the western way of thinking on the issue of taxation.

Halldór Ásgrímsson, the Icelandic Prime Minister, also announced at the beginning of October the government's intention to launch a special campaign of deregulation in Iceland. He said the Icelandic administration was the third most efficient in the world. Nevertheless there were many things that could be better. The campaign is called 'Simpler Iceland' and is aimed at simplifying the legislation, decreasing bureaucracy and encouraging greater efficiency.

In Iceland there are few obstacles to reform towards economic freedom. From a cultural point of view Icelanders are extremely open to all innovations, new ways of thinking, of doing things and particularly new technology. One of the reasons for this is the small size of the country – new, and better, ideas are able spread quickly. However, when it comes to the healthcare and educational systems and (especially) agriculture, many people are very sceptical about any mooted liberalisation.

One of the main reasons for this is the fact a center-left majority has governed the city of Reykjavík since 1994 and it has been very hostile towards trusting the private sector for projects within the city related to education and health services (about a third of the Icelandic population lives in the capital). Nevertheless, public trust in the private sector's ability to behave responsibly in health and education is slowly growing. This shift in opinion may be acted upon if the IP are able to form a majority following municipality elections this spring.

Agricultural reform, however, remains stuck in the mud. The level of producer support in Iceland remains among the highest in the OECD. According to the OECD, state subsidies account for 69% of the income of farmers in Iceland. Scepticism about reform exists both within the Independence Party and among the other parties, not the least its coalition partner, the Progressive Party, which has strong ties with the countryside – it was formerly the Agrarian Party. Yet there are strong voices in Iceland calling for the reform of agriculture, including possible international steps towards lowering tariffs, and liberating the international trade with agricultural products.

The National Telephone Company (Landssíminn) was privatised in the summer of 2005 and was sold for 67 billions Icelandic krónur (€954m). About half was paid in foreign currencies, euros and dollars, which was used exclusively to pay off the foreign debts of the Icelandic state. The results of this is that since the beginning of 2006, the state has effectively no foreign debt. What remains of the windfall is intended to be used for several projects, but not until 2007-2012, and then only if the economic conditions in the country remain suitable. Until then the money will be kept, accruing interest, in the Icelandic Central Bank.

Many other state-owned companies have been privatised since 1991. This includes three banks; the National Bank of Iceland (Landsbanki Íslands), Búnaðarbanki Íslands (now part of Kaupthing Bank) and FBA (now part of Glitnir).

The liberalisation of the economy in Iceland has provided a strong foundation for the 'break-out' of Icelandic companies to other countries in recent years, especially to Denmark and the United Kingdom. This has taken many people outside Iceland by surprise, but there are several reasons for this. Economic reform has made it much easier for Icelandic companies to grow and become stronger. Equally, the Icelandic market is small and many Icelandic companies quickly reach the limit of their growth in Iceland and have therefore increasingly taken to looking abroad for investment opportunities. Finally, Icelandic companies are, in general, very well run.

The Icelandic economy has recently come under some criticism from abroad, with some economic analysts warning that the economy is overheating and that recession lies ahead. Given the recent high exchange rate of the Icelandic króna, a correction had been anticipated and prepared for. It is not, however, expected that this will lead to a depression, and GDP growth in Iceland is forecast to remain high in forthcoming years.

The single most important thing for Iceland to continue on the road towards increasing economic liberalisation is to retain its center-right government. The left-wing of Icelandic politics has fought hard against the government's policies and therefore it is quite certain that if a center-left government were to take power in Iceland that it would mean dramatic changes in policies – in all the wrong directions.

Israel

In 2005, the Israeli economy started to show the first signs of a long-awaited economic recovery. The overall economic growth rate exceeded 5%, and more significantly, the business sector grew at an even more impressive rate of 6.4%.

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The recent spurt of growth can be explained by a number of factors. One is the relative improvement in the security situation, which resulted in an immediate increase in the number of tourist arrivals and a recovery in the tourism sector, which accounts for 4% of GDP. However, Israeli experience demonstrates that a calm security situation does not ensure economic growth; sound economic policies and fiscal discipline are much more essential ingredients. Benjamin Netanyahu, the former Prime Minister and Finance Minister, clearly understood this and pushed for a more reasonable fiscal policy consistent with deficit targets. A more favourable environment for private businesses was created through his economic policies. The privatisation of several public companies and the cancellation of bank monopolies helped create more competitive markets and lowered prices. The move towards a new welfare system influenced by US welfare-to-work reform also led to necessary changes in the labour market.

The recent recovery of the Israeli economy is, however, still fragile and strongly dependent on economic policies that will be implemented after the elections in March 2006. The Israeli economy continues to suffer from the vestiges of a heavily centralised economy. The public sector in Israel currently controls 51.5% of the economy, compared to an average of 41.6 % among OECD countries, and 34% in the United States. Note that large military expenditures do not fully account for this discrepancy. The government debt to GDP ratio in Israel is also expected to reach 101.5% in 2005. Netanyahu's push to liberalise the economy and reduce the weight of the public sector promises to help sustain and further accelerate economic growth. On the other hand, the fragility of the recent growth will be quickly demonstrated if the statist programs presented by all other candidates in the election prevail.

Breaking with a long tradition of interventionist economic policies and a continuously growing public sector, Finance Minister Benjamin Netanyahu launched a series of reforms that helped contain public expenditures and spur economic growth. After much social unrest and loud demonstrations, the bankrupt welfare system was finally reformed along the lines of the welfare-to-work reforms adopted nationally in the United States in 1996. Before the new reforms, average welfare payments in Israel exceeded the average wage that most welfare recipients would have received in the labour market, leaving them with very little incentive to look for work. The Israeli welfare-to-work plan was first implemented in the beginning of 2005, and the immediate effect was a reduction of transfer payments from 7.3% of GDP in 2004 to 7% in 2005. At the same time, unemployment decreased from 10.4% to 9.1 % in the first and second quarters of 2005, accompanied by an increase in the number of transitions from part time to full time employment.

In addition, the long awaited privatisation of public companies was launched in full force in 2005. Workers employed in public-sector monopolies were earning five times the average Israeli salary and were enjoying exceedingly advantageous retirement plans. Thus, it is not at all surprising that the privatisation plan was met with fierce opposition by public sector labour unions. But in March 2005, after two months of strikes that literally shut down the country, the Israeli taxpayer won a small victory against privileged public sector employees. In a first step towards privatising Israel's seaports, the government signed an agreement with the Histadrut (General Federation of Labour) resulting in the breaking up of the port authority. Each port will be transformed into a different public company that will have to compete in the market. These public companies will then be privatised in the future. The oil refineries are also planned to be split into two competing public companies that will be privatised in a second stage. A similar initiative was partially introduced for Israel Military Industries Ltd.

In 2005, Netanyahu also succeeded in slightly lowering individual income tax rates and the VAT without significantly increasing the budget deficit as a percentage of GDP. Tax brackets were widened at all wage levels and the highest marginal tax rate was lowered to 49% from 60% in 2003. The VAT was lowered by .5% from 17.5% to 17%. These fiscal changes increased the disposable income of Israelis and domestic demand, creating growth in the commerce and service industries. In July 2005, the Knesset approved a tax reform bill that will gradually reduce the corporate income tax rate from 34% in 2006 to 25% in 2010. On a less upbeat note, capital gains taxes for individuals will grow from 15% to 20% in 2006.

The recent recovery of the Israeli economy is, however, still fragile and strongly dependent on economic policies that will be implemented after the elections in March 2006.

The above reforms were also accompanied by a much needed overhaul of the banking system in which more competition was introduced. Israel's banking system has been historically dominated by two banks, Bank Hapoalim and Bank Leumi. These two banks control almost half of all tradable assets. This duopoly received almost all national savings and enjoyed exclusive powers in the lending market because only banks can offer credit in Israel. There are no other lending institutions. One of the results of this corrupted system was that 70% of all credit went to 1% of borrowers (insiders). Unfortunately, the vast majority of 'outsiders', other businesses and entrepreneurs, struggled to raise capital. Profit opportunities were stymied because of lack of competition in the lending market. This damaged economic growth.

The 2005 economic reforms have already borne fruit. The high-tech industry had its best year in 2005 since the dotcom bust of 2000. The high-tech sector generates 40% of all Israeli exports, amounting to $13 billion a year. Israel's high-tech sector includes within its ranks Intel, the world's largest chip maker. Intel already has six production and design plants across Israel and is opening a new plant in the southern town of Kiryat Gat. This new plant will add another 2000 jobs to Intel's large Israeli workforce of 6000 men and women.

The Intel success story is accompanied by the notable number of Israeli companies listed on NASDAQ (New York's technology stock market). Israel has more listed companies on NASDAQ than any other country outside of the United States. Israel's highly skilled and well educated workforce bestows on the country a competitive advantage that is attractive to high-tech businesses. A more competitive lending market will further foster the growth and creation of new high tech firms.

Overall, 2005 was the start of a new vision for the Israeli economy, but last year's economic recovery is still very fragile and, at this time, it is not at all clear that the policies of fiscal discipline, privatisation and deregulation will continue in the future. The unions will undoubtedly fight every move towards modernisation that encourages economic growth, in a country that already loses more workdays to union-led strikes than any other industrialized nation. In fact, the national labour union leader, Amir Peretz, has recently taken over the leadership of the Labour Party and is running for Prime Minister in 2006. Note that Peretz has earned the nickname of Stalin, not just because of his physical appearance, but because of his lifelong economic philosophy. If elected Prime Minister, Peretz has already pledged to cancel proposed cuts in education, health, and welfare and at the same time raise the minimum wage by 30%. Economists have assessed the costs of Peretz's proposal to be over $2 billion.

The business community is correct in voicing serious concerns over the potential impact of Peretz's proposals. The Israel Manufacturers Association already warned that raising the minimum wage will lead to the firing of thousands of workers, the shut down of factories and the transfer abroad of production facilities. If Peretz's plan was to be put into action, Israeli private businesses will once again suffer from high taxes, excessive government oversight, new tariffs, and endless bureaucracy. Further signs of uncertainty have been introduced following the appointment of Ehud Olmert as Finance Minister, following Benjamin Netanyahu's resignation over Sharon's disengagement and expulsion of settlers from Gaza. Olmert, like Peretz, is also known to believe in old-style economic interventionism and statism that has proven to cripple economic growth in the past. Only hours after Peretz was elected as head of the Labour Party, Olmert announced a new plan to combat poverty through public spending.

The Israeli economy has enormous potential. The possibility of a Hebrew Tiger is within reach. However, the overwhelming majority of Israeli politicians remains short-sighted and unfortunately eschew policies consistent with economic freedom and economic growth. 2006 will certainly be a critical year for the future of the Israeli economy.

Macedonia

The economic transition of the Republic of Macedonia was unique. It combined a struggle for independence, a transition towards political democracy and free market economics, regional instability, UN sanctions being imposed on its most important traditional foreign market – Serbia – and a bizarre transport embargo from its southern neighbour. If we add in a paucity of political will for swift and deep reform, it is clear why the economy suffered greatly.

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Macedonia opted for a model of privatisation where managerial buy-outs were key. 'The idea was that by encouraging management to acquire their companies, it would be in their interest to run them well. In practice, for the most part they opted to run the companies badly, decreasing the price they would have to pay out. Prior to their privatisation, companies suffered from investment shortfalls as the prospective new owners had little interest in modernising equipment. In the process, many companies were driven to bankruptcy. In 1990 the private sector share of GDP in Macedonia was 15%, the same as the average in the transition economies that recently acceded to the EU, but by 1994 private sector share of GDP in Macedonia was 35% whilst in the EU applicants it had risen to 54%. That is a significant indicator of the speed of reforms towards the free market economy.

Slow reforms and an inappropriate policy mix resulted in a long transition period.

Allied to this, the banking sector operated a policy of extremely high interest rates which caused many further bankruptcies. Macedonia, in the beginning of its independence, had inherited high interest rates, corresponding to high inflation. Its programme for monetary stabilisation immediately after the dissolution of the former Yugoslavia brought inflation to a single digit annual level, and the new currency, the Denar, was stable, being pegged to the Deutschmark. However, monthly interest rates remained obstinately in double digits. For companies that had loans, this was disastrous. The best example is Gazela, a shoe producer and one of Macedonia's largest exporters in the late 1980s, with more than 3,000 employees. Gazela was one of the largest shareholders of Makedonska Bank and took a small loan to pay for labels for shoe boxes. With such high interest rates, Gazela lost all its shares, went into bankruptcy, and Makedonska Bank became the owner of the company.

Slow reforms and an inappropriate policy mix resulted in a long transition period. Real GDP declined from 1989 to 1995, finishing at a level of less than 70% of its 1989 mark. Real wages in the first four years dropped sharply. In 1992 they were a little above 40% of their value in 1989. Employment also declined, until 1997, when it was at only three quarters of its 1989 level. After six years of recession, for the first time, Macedonia in 1996 recorded its first GDP growth (a modest 1.2%). For the next four years Macedonia experienced growth which achieved healthy rates in 1999 and 2000 of 4.3% and 4.5% respectively, in spite of the huge crisis in 1999 when it received over 360,000 refugees from neighbouring Kosovo (equivalent to 18% of the population). During this period the Macedonian government had a young finance minister, Nikola Gruevski, who was a genuine reformist. During his term of office he conducted rigorous policy reforms, including amongst other things, introducing VAT, transferring the payment system from the government owned Social Accounting Agency to the banking system, and a denationalisation act. Unfortunately, this growth was interrupted in 2001 by ethnic conflict, which was contained and resolved by political means with the Ohrid Framework Agreement.

The government, aware that Macedonia was a small market in the second half of the 1990s, began to negotiate bilateral trade agreements. Today, Macedonia is a leader in regional trade cooperation and has concluded free trade agreements with all of the countries in the region. Through the Stabilisation and Association Agreement it conducts free trade with the EU trading bloc. The Republic of

Macedonia has also concluded free trade agreements with member countries of EFTA, Turkey and Ukraine. Furthermore, Macedonia recently acceded to CEFTA. This ensured preferential access in the markets of 38 countries with 647.5 million consumers. The aim was to provide markets for products originating in Macedonia and to attract foreign investors. The openness of the Macedonian economy is confirmed by comparative studies prepared by several international institutions and institutes. Namely, the Report on International Openness for 2003 from the Italian Academy of Inter-Disciplinary Studies ranked Macedonia on the 40th position out of 141 countries. Only Slovenia, (ranked 19th), and Bulgaria (ranked 27th), are placed ahead of it among its neighbours. The policy was the right option but it was not followed up with measures for enhancing Macedonian exports and attracting foreign investors, and as a result the trade deficit is very high (20.6% of the GDP in 2003), unemployment remains over 39%, and a low inflow of FDI persists. The high political risk level of the region and some surprising legislative decisions made foreign investors wary, despite positive statements from governmental officials.

The major hindrance to economic development in Macedonia is a lack of vision. Macedonia has traditionally faced two major problems – high unemployment and a trade deficit. Therefore policies that promote economic growth, enhance exports and create jobs are needed. The IT sector is seen to be one of the answers to this problem.

During his term of office, President Boris Trajkovski, who was elected in the autumn of 1999, made it one of his top priorities to educate both citizens and the government on the need to become more IT savvy. Under his patronage, he created the 'E-Macedonia For All' committee, which brought together the country's top IT specialists to forge a policy for the government to pursue. This committee created an environment for the development of an IT society, helping to raise awareness among government officials and the general public. The committee also drafted a 'Declaration on IT' which was subsequently adopted by the Macedonian Parliament. This declaration laid out a strategy, still being pursued today, to encourage both the government and the private sector to aggressively pursue ways of using IT to better people's lives.

Another top priority of President Trajkovski was to bring computers and IT education into the nation's schools. To accomplish this, he turned to experts on his 'E-Macedonia For All' committee who helped lay out a strategy to provide schools with computers and internet access. With this strategy, President Trajkovski requested, and received, from the People's

Republic of China, 2,000 computers in 2003 for all of Macedonia's 100 high schools. Under a project sponsored by the U.S. Agency for International Development, these schools were then linked via high-speed wireless technology to each other and the world. Shortly after his untimely death in a plane crash over Bosnia-Herzegovina, Trajkovski's second request to the Chinese government was granted, resulting in an additional 3,000 computers for the country's primary schools. These schools will also be linked.

This resulted in another USAID project which ambitiously aims to make Macedonia the first wireless country in the world, providing wireless access to 95% of the territory. Through Trajkovski's foresight, the citizens of Macedonia now have the opportunity to interact more closely and effectively with the world.

The successful establishment and maintenance of macroeconomic stability, the significant progress in reforms achieved over the last decade, and EU candidacy status should have a positive impact on enhancing economic growth. The government needs, in the coming years, to develop an integrated economic policy that will improve the competitiveness of the national economy in domestic and international markets. Transparency and predictability for concluding business activities should be ensured. It is therefore necessary to improve the institutional and regulatory framework, especially in the judicial sector, which is inefficient and one of the main obstacles for a better business climate. Forming a flexible labour market and decreasing employment expenses (contributions and taxes) are an important element for the creation of a more viable economy. The restructuring of private companies, the strengthening of their technical capacity, and the enhancing of the quality of management as well as improving their access to financial products that are available to their competitors are important elements for improving competitiveness. Attracting export-oriented labour-intensive foreign direct investment is also key to strengthening the economy and growth of export and job creation. Further liberalisation of the telecommunications market and further development of SMEs in the IT sector are also essential for innovation and economic expansion. The educational system should be reformed in order to create a new and well-educated generation that will be able to work in the knowledge economy. Human capital should be the most important element for economic development. The next few years will be critical for Macedonia to engage in reforms in order to transform the country into a functional market economy.

Moldova

During Soviet times Moldova was something of a testing-ground for new agricultural technologies, and most of its industry was oriented towards food production. More recently, Moldova has become a laboratory for a different kind of experimentation, as economists and politicians attempt to develop a flourishing economy in this former Soviet backwater.

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Moldovan efforts to build an efficient market economy have been commended by the Index of Economic Freedom

After gaining independence in 1991, Moldova experienced an economic shock from which it did not recover from until 2000. GDP plummeted and poverty prevailed – an inauspicious start for the transition from a centrally planned to a market economy.

Unfortunately, the inherent problems of transition have been exacerbated by the efforts of separatists to gain independence for a substantial swathe of Moldova's territory. Transdniester, the eastern part of Moldova which accounts for 10% of territory and around 15% of population, declared itself independent in 1990, but has not been recognised internationally. The separatist regime was supported – morally, at a minimum – by the Russian troops which remained there following the break-up of the Soviet Union, but were now re-classified as 'peacekeepers'. It is difficult for Chisinau, the Moldovan capital, to exert much in the way of political influence there, and crime is rampant. Transdniester's self-declared government is also one of the last bastions of Soviet-style rhetoric, and its international isolation massively restricts its economy's potential – an economy which contains much of territorial Moldova's industrial infrastructure.

Moldova began to build a market economy, based on the advice of international organisations, by first privatising most public property, including land holdings. However, privatisation based on property bonds, distributed proportionately to the population according to their length of service to the state, was not as efficient as expected. At the same time several investment funds emerged. They exchanged their shares for privatisation bonds which they used than to purchase enterprises. Unfortunately, gaps in the regulatory framework allowed speculation and fraud became rife. Having been reduced to cash cows for fund managers, many enterprises either went bankrupt or came perilously close to it. As a result, the general population saw no benefits from privatisation. As the process calmed down, the funds became weaker and the problem came up more obvious. Ultimately, the authorities decided to liquidate the funds through the regulated repurchase of shares from the population.

The land privatisation programme had its own drawbacks. Moldova had more than one million landlords (around 30% of all population), but the average size of the land plots barely exceeded 1.5 hectares of land. Obviously, this means land use is incredibly inefficient, though a consolidation process is emerging, with land being bought by those who have the capacity to utilise it best.

Reforms in 1999 led to the development of a new Social Insurance Fund, separated from the state budget. The system is pay-as-you-go, whereby the Fund collects social contributions and distributes them as social insurance benefits. The Democratic party-led government has also started to increase the pension age, from 55 to 60 for women and from 60 to 65 for men. Such reforms were undertaken in order to improve the financial sustainability of the Social Insurance system.

By 2000, the social assistance system was based mostly on privileges given to certain categories of the population, depending on their needs. Yet while few benefits took the form of cash payments, more than 30% of the population benefited from the system. The same year, energy subsidy privileges were replaced by nominal cash compensations and the administration of child benefits changed. This reduced the number of beneficiaries to around 10% of the population.

Financial constraints since independence quickly led the healthcare sector to the brink of bankruptcy. Despite a charitable response from foreign aid donations, the overall capacity in the system was reduced, with particular problems being found in hospital capacity. This gap has not been filled by a strong primary care system or emergency provisions and thus the quantity and quality of healthcare has worsened. Since 1998 the issue of health insurance has been a popular cause for reformists, the government moved towards the introduction of the reform only in 2004 due to the high transitional costs. Since 2000, the government has also specifically focussed on primary healthcare, but so far overall improvements have been minor.

In 2001 the Moldovan people elected the Communist Party into government, awarding it 71 out of the 101 seats in Parliament. Some expressed surprise that after a number of pro-democracy governments, the Communists were able to gain such an enormous majority. However, the inefficient governance and corruption of the Democrat regime resulted in deep poverty and uncertainty - thus spurring the electorate to vote for radical change.

Until 2003, the policy of the country under the Communist government focussed more concertedly on relations with the Commonwealth of Independent States (CIS), and Moldova remained economically and politically dependent on Russia. Moreover, relations with aid donors were neglected which led to a considerable reduction of international aid to Moldova, and to a period of technical default. For around two years, Moldova did not receive any new funding from multilateral donors and some previously agreed deals were held back.

Increased government awareness of its own inability to tackle these ever-growing problems led to the rediscovery of the interim Poverty Reduction Strategy which had been developed in 2000-2001. Since 2002, the government has started to show more interest in its relationships with aid providers, and, since 2004, in its relationship with the EU. Under pressure from external donors, the final Economic Growth and Poverty Reduction Strategy development process was conducted more transparently, and as national development priorities were openly agreed, this enabled the development of medium term financing instruments. The Moldovan Parliament approved the Strategy in 2004, and suddenly, tiring of interference from Moscow, the Communists cooled their relationship with Russia and prioritised the EU. It was a dangerous move considering their economic and political dependence on Russia, although this has decreased of late. Following the Russian crisis of 1998, Moldova diversified its export market and so Russia's share of exports dropped from 58% in 1997 down to 36% in 2004. At the same time EU countries accounted for increasing share rising from just 13% up to 30%. Moldova has enjoyed a Partnership and Cooperation Agreement with the EU since 1994, and in 2005 it signed a new EU-Moldova Action Plan. The issue of EU integration was actively used by the Communists during 2005 Parliamentary

elections. This helped them to keep the majority in the Parliament, although their share was trimmed by 15 seats compared with the 2001 elections.

Labour emigration has greatly increased since independence, reinforcing the degradation of labour supply and the spread of poverty throughout the country. Despite assorted official declarations acknowledging this problem, the situation has not been improved. According to official sources around 15% of the population of working age is permanently abroad. Other sources provide even higher figures. Remittances represent more than 25% of GDP and are now one of the cornerstones of economic growth. They feed the import sector, driving its value up to double that of the export sector. Obviously, sustaining economic development depends on the efficient use of those remittances and creating a favourable business environment for their investment.

As part of the efforts made to secure aid and FDI, the Moldovan administration declared a new wave of reforms of the regulatory framework to ensure the sustainable economic growth. Additionally, following increased GDP growth and improved tax collection, the government undertook some questionable and costly reforms in the social sphere. It increased pension provisions for some sections of the population, froze the pension age, and introduced a new health insurance scheme.

It is generally accepted that the economic growth since 2000 has been fuelled mainly by the swelling stream of remittances, and the recently launched regulatory reform is considered to be an important tool to redirect remittance money away from pure consumption and savings towards productive investment. More broadly, regulatory reform is now at the forefront of the reform agenda. It began in 2003, but its efficacy improved dramatically in 2005 when the 'guillotine' approach was introduced to abandon inappropriate bureaucratic regulations. The 'guillotine' system consisted of several stages during which central public authorities submitted lists of their business-affecting activities for review and revision. Around half of all regulatory acts have been severed by this 'guillotine'.

Moldovan efforts to build an efficient market economy have been commended by the Index of Economic Freedom, reflected by its slight improvement in the 2005 Index. Moreover it has out-performed its neighbours for several years. When rated on an 'ease of doing business' scale, Moldova ranks just below Romania and Russia, and is far ahead of the Ukraine.

It is important for Moldova to retain momentum as its economy is highly sensitive. During Soviet times laws carried little power or utility. They were very general, and the arbitrary orders of ministries and other public authorities usually took precedence. This may have been deemed an appropriate system of command when public property dominated. However, this system should not have been permitted to continue for as long as it did. After the declaration of independence, Moldovan authorities continued to issue very general laws which delegated much power to the ministries. Although the system remains highly bureaucratic, lacks transparency, is corrupt, and is regularly flaunted, reforms to promote and implement principles of market economics struggle through.

Further introduction of well thought-out and viable market-oriented reforms which can both contribute to the growth of the economy and to the social sphere are directly linked to the effective enforcement of the rule of law. Obvious progress has been made, but questions about its sustainability are liable to linger.

Montenegro

In April 2006, the Republic of Montenegro plans to conduct a referendum allowing its citizens to vote on complete independence. Alongside representing the end of the process of break up of Former Yugoslavia, this process might also symbolise the ending of the era of politics' domination over the economy, at least in the smallest ex-Yugoslav republic. More importantly, this would be unique chance for Montenegro to strengthen the on-going creation of a free market and open society.

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After a decade of destruction due to the wars in the surrounding countries, waves of refugees (that at one point reached 20% of the overall population), a brain drain triggered by hyperinflation in 1993, political tensions under the Milosevic regime and NATO air strikes in 1999. Montenegro ended up in a unique union, imposed by the EU, consisting of two republics - one ten times larger than the other and with completely different economic systems. However, Montenegro is gradually moving to the next stage of its development.

Under the Belgrade Agreement (signed by Serbia, Montenegro and EU representatives) Montenegro retained the right to proceed with economic reforms through its own Parliament with the Euro as the only currency, while Serbia retained its Dinar. Over the last five years, the success of the economic reforms has been confirmed by the following improved macroeconomic indicators: the inflation rate reduced from 28.0% in 2001 to 4.3% in 2004 while estimated inflation for 2005 is 2%.

This country of 620,000 inhabitants increased its GDP from €1 billion in 2000 to 1.53 billion in 2004. GDP per capita is €2,500 (2004). Real GDP growth was 3.7% in 2004 and 4.7% in 2005. In terms of the conditions for business registration, Montenegro has been recognised by OECD as a champion with just €1 required as starting capital for a limited liability company and just 4 days of requested time to confirm the registration in the Commercial Court. Montenegro has been ranked for the first time by the Fraser Institute in their indices of economic freedom. It is placed 86th out of 127 nations with a score of 6 out of 10 (with 1 being the most economically repressed). Standard and Poor's awarded Montenegro a BB in 2004 and an improved BB+ in 2005.

The government has developed a more corporatist approach to business relations, with the private sector considered a valuable partner in drafting legislation. As a matter of fact, Montenegrin private sector, represented by the private chamber of commerce (the Montenegro Business Alliance) managed to convince the government to reduce corporate tax and contributions for wages. The corporate tax rate is now the lowest in Europe - 9%, while wage contributions were reduced by 10%. Still, taxation of personal income is moderately progressive with the rates of 15% and 23%. Introduction of a flat tax rate remains a possible challenge for 2006.

Unsurprisingly, both the World Bank and the International Monetary Fund opposed the tax changes. Their main concerns were to protect budget revenues and to insure macro-economic stability. However, stability can be achieved at different levels: a level that causes stagnation or a level that fosters economic growth and development. The best proof that free marketeers were right in demanding tax cuts was the increase of budget revenues that occurred in Montenegro after the reduction of tax rates. Revenues from corporate tax and from personal income tax were higher in 2005 than a year before, and total budget revenues increased from €379.3 million euros in 2004 to €432.1 million in 2005.

Value added tax (VAT) is set at 17%, and the average customs tariff is 6%, which is still higher than in most of the EU and is nearly three times higher than in the US. Only 68.2% of imports in 2004 and 67.7% in 2005 were covered by exports. Foreign investments rose and fell, but reached a peak in 2005, accounting for over €300 million or 18% of GDP, mainly through the privatisation of state enterprises. A semi-independent agency for investment promotion was set up. Privatisation is approaching its end with fewer than 20 enterprises still state-owned. Telecommunications, the banking sector and the capital market (including two stock exchanges, ten brokerages and six investment funds) are now 100% privately owned. By adopting the euro as its currency Montenegro contributed to a valuable saving on transaction costs, especially for European investors and import/export firms.

A recent Montenegro Country Memorandum issued by the World Bank highlighted some negative aspects of Montenegro's development. However, The Institute for Strategic Studies and Prognoses identified over 30 errors in this report and deduced that the World Bank experts had selected out-of-date information to discredit progress made by the economic reforms, and only used new data when it aided their case. Thus, the value of such an inaccurate report is questionable.

Although many positive changes have occurred at the state level that are improving overall environment for business development, three processes pose a significant threat to progress: (i) public expenditure still accounts for a large proportion of GDP; (ii) municipal bureaucracies are growing in power and influence (iii) the number of regulatory agencies is expanding.

Budget expenditures (government spending, excluding state pension and health overheads) account for 25% and total public expenditures account for 45% of GDP. Budget expenditures have increased from €259.3 mill in 2001 to €400.6 mill in 2004. While the main portion of budget expenditures are the fixed costs of employees' salaries (constituting almost 40%), this boost is mainly due to the commitments toward the union with Serbia.

Numerous taxes and levies were created at the municipal level, making them the largest single barrier to private sector development. The growth of such barriers developed under the cover of two processes: decentralisation and democratisation, both imposed by foreign donor support programmes. While such processes make sense in large countries, it is hard to believe that they can really support the development of democracy in a country of 620,000, with 21 municipalities, where over one third of the total population lives in the capital city Podgorica. In fact, those processes created monopolies at the municipal level, demonstrating that there is no single solution for all countries. Simply copying successful processes from other countries to Montenegro has proven unhelpful due to Montenegro's circumstances.

Additional danger comes from the regulatory agencies. Such agencies already raise business costs. When regulators' solutions fail initially they will persist in their attempts to restrict business practice, and problems are always blamed on the market. Therefore, the regulatory costs for a particular business are not limited to those relating to equipment and employees, but also incorporate the additional legal and accounting work needed to comply with the rules, and these costs must be passed to consumers through higher prices. These regulatory costs have cut jobs and investments and there exists scant evidence of any benefit.

This will nurture a population which thrives on free thinking, free dissemination of ideas, and pure freedom.

So were does Montenegro go? Today, Montenegro represents a melting pot of various ethnic groups (Montenegrins, Serbs, Muslims, Albanians, Croats, Roma and Bosnians), religious beliefs (Orthodox, Catholic, Islam), as well as of other types of differences (for instance, between urban and rural population, or among the various regions). It managed to avoid the ethnic conflicts and extreme polarisation between religions, cultures and other identities of individuals and groups which so plagued its neighbours. This creates an opportunity in Montenegro to develop a coherent Montenegrin identity that goes beyond the religious or ethnic distinctions.

Still, some are raising the question of how much of a hindrance underdeveloped human capabilities will become in Montenegro's future development? It is vital that the successes of those institutions operating outside of the formal state education system be allowed to continue to expand Montenegro's human capital. This will nurture a population which thrives on free thinking, free dissemination of ideas, and pure freedom.

There is no doubt that Montenegro is being transformed into a pluralist type of democracy and that with every day that goes by it is becoming an increasingly open society. The reforms of the past five years have been successful. So long as Montenegro is allowed to adopt the policies most suited to its development it has the potential to become the most successful economy to emerge from the Yugoslav ruins.

Norway

According to the UN's Human Development Reports, Norway, the North European beacon of big government, is the best country in the world to live. Needless to say, this does not make for the most conducive environment in which to advocate market-oriented reforms.

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Last year Norway celebrated its 100 years of independence from Sweden. However independent, Norway has both adopted and developed further the welfare state ideology of the Swedes. Since the early 1970s, thanks to enormous revenues from oil and gas, the country has steered clear of crisis which, in other countries with a more 'normal' economy would automatically trigger a debate on the costliness of the welfare state.

Petroleum revenues have made a significant contribution to the Norwegian economy during the past few decades. Still, onshore production constitutes about 80 per cent of total value added in Norway, a share that will gradually increase as a consequence of the foreseen decline of petroleum extraction. Ensuring mainland Norway's capacity for growth is thus vital. It helps to be the most productive European country measured by GDP per capita (US$ 40,784 in 2005)

> It was socialists and protectionist farmers who voted 'no' to an EU which for them was a symbol of international capitalism and, astoundingly, lower subsidies

To sustain today's public services and meet future pension obligations, the public sector must deal with a gradually increasing financing gap. Compared to 2003, the gap is estimated to increase to around 8 per cent of Norway's mainland GDP in 2060.)

The Labour party dominated Norwegian politics from the end of the Second World War until the mid 1960s, after which came a period with alternating governments before a return to Labour party dominance through much of the 1970s as well. The 1970s saw the birth of a new right-wing protest party – the Progressive party – which today is the strongest non-socialist opposition party in parliament.

The renaissance for market oriented ideas reached Norway in the late 1970s and early 1980s. The Conservative party won the parliamentary election in 1981, with promises of deregulation and tax cuts. The hegemony of the Labour party was broken and a coalition of non-socialist parties commenced a series of long overdue reforms. Financial service markets were deregulated, the state monopoly on broadcasting ended, and restrictions on the buying and selling of private homes were lifted. Private healthcare was no longer forbidden and the first privately owned hospitals were established.

When a more 'moderate' and pragmatic Labour party came back to power in the early 1990s they did not reverse the reforms of the 80s. Together with the Conservative party, their primary goal was to convince the population of the need for EU membership. In the referendum in 1994, a majority (52 percent) voted 'no'. This was not an objection to big government; on the contrary, it was socialists and protectionist farmers who voted 'no' to an EU which for them was a symbol of international capitalism and, astoundingly, lower subsidies. Since then the question of EU-membership has remained politically taboo.

After the parliamentary election in 2001, the Conservative party formed a coalition government with the Christian Democrats and the smaller Liberal party, with support in parliament from the Progressive party. Market oriented reforms were supported on a municipal level. Outsourcing, more competition, and the use of vouchers became central in the modernisation of the public sector.

The tax burden was reduced, both on businesses and on personal income, although not as much as was initially promised. Norway continues to have a relatively low formal tax rate on corporate income, but a comparatively broad tax base implies that the effective tax rate on company profits is in the middle range internationally. The highest marginal tax rate on labour income has increased during the last decade and is now relatively high (64.7 per cent, including employers' social security contributions). Due to Norway's dual income system, with a flat 28 percent tax rate on capital income and a progressive taxation of labour income, there is a need to bridge the gap between the taxation of individuals and that of companies.

As every economic indicator was signalling success, Norway's voters decided that it was time for a political experiment. The Labour party, together with the Socialist party and the agrarian and strongly protectionist Centre party, formed a majority coalition government after the election in September 2005. The Conservatives experienced their worst ever election result. The challenging socialists succeeded in painting a rather grim picture of the state of public social services. The centre-right government was accused of dismantling the welfare state and giving tax cuts to the wealthy, rhetoric which though largely unfounded, was never credibly answered. The election also saw a more radical Labour party teaming up with labour unions and, for the very first time the Socialist party as well, in an effective campaign against market oriented reforms.

The leading Norwegian labour union (LO) has always played an important role for the Labour party. The labour union has traditionally represented the interests of Norwegian industrial workers in the private sector. With a growing public sector and decreasing industrial sector their focus has shifted. The labour union has now become the leading force against market oriented reform in the public sector. They play a far more active role today and have gained stronger influence within the Labour party. The Labour union financed the parties election campaign, and are now seeking a return on that investment.

The private sector is losing ground and public expenditure is rising. One out of three Norwegian workers is employed in the public sector. With a population getting older and an increasing demand for better services, it is quite obvious that market oriented reforms should have been high on the agenda. But, on the contrary, this government came to power by promising "less market and more government".

A few months after the parliamentary election it is quite clear for everyone that the majority government, which promised stability, is on unsteady ground, mainly due to a series of blunders from the ministers from the once-popular Socialist party. The question is how

long the Socialist Party can afford to be a part of government.

So what are the hopes for market oriented reforms today? The answer is probably that a non-socialist coalition which includes the Progressive party will form in the election in 2009. Meanwhile, in Oslo and in other cities run by centre-right politicians, reforms initiated by the former government will to some extent continue.

Building a non-socialist coalition is crucial. The Progressive party has gained popularity and for the first time they represent a serious threat to the Conservative party's historical hegemony on the right side of politics. The Progressive party is now by far the biggest non-socialist party and no future coalition is possible without their participation. That is quite remarkable, considering the Progressive party's history of inconsistent politics; a peculiar mix of free market economics and support of increased government spending and state ownership, combined with scepticism towards immigration.

However, the Progressive party and the Conservatives agree on the need for market oriented reforms. The challenge is to build an alliance for change in 2009 and to work on different levels and in many arenas to create a better understanding for the need for reform that includes the private sector and which reduces government spending.

Romania

Romania wasted the first 15 years of its independence. Following 1989 revolution, a vague, haphazard, and middle-of-the-road 'gradualist' reform programme was chosen as the safest way to economic prosperity. In practice this only ever amounted to a continuous series of ineffectual responses to ever-expanding crises.

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No progress had been made by 1996 when the former Communist party was finally ousted from power and replaced by a centrist government. Bedevilled by infighting however, the new government achieved little more than its forebears. By 1999, having failed to achieve either economic liberalisation or macroeconomic stability, growth was recorded at close to 0%. Thankfully, this marked the end of the decline. In the period from 2000-2005, the economy entered a recovery phase, marked by accelerating growth. By 2004, the privatisation programme was largely complete following some major sales. Just as crucially, a long-discussed property rights regime finally became a reality. Furthermore, administrative decentralisation and other institutional improvements began to produce promised efficiencies.

These small changes set the stage for a second wave of reforms, which were put into motion following the election of a centre-right government at the end of 2004, the 'Orange Alliance' between the National Liberal Party and the Democratic Party, and by the formation of a governing coalition around this reconstituted political force.

The most significant feature of this second wave was the creation of a system of flat taxation. Assuming a proposal previously made by a group of NGOs in 2003, the Alliance set a 16% flat tax as the policy cornerstone of its electoral platform. The proposed measure was based upon a fairly detailed and sound macroeconomic projection of the flat tax's impact on the economy. The main argument was simple: previously, the nominal taxation level was 25% on corporate profits and ranged through five bands between 23% and 40% for personal income tax. However, due to the massive problem of tax evasion – estimated to account for as much as 40% of GDP - the effective taxation rate was eventually set at just 16 percent. Subsequently, the report concluded that it was necessary to lower the nominal tax rates to match the real one), thus enlarging the taxation base in seeking to achieve the Laffer optimum (the point at which taxation income is at its highest without disincentivising production). The new government was sworn in before the Parliament on December 28, 2004, and the law implementing the flat tax was finalised the same evening and passed before January Ist, so that it could enter into force starting in the 2006 fiscal year.

In addition to the corporate and income tax rates, various other taxes were also set at the uniform level of 16%. Some fiscal modifications such as the increases of the tax on stock market gains (from 1 to 16%) and of the special tax for micro enterprises (raised from 1.5% to 3%) were postponed until 2007. Beyond the actual tax levels, tax collection was greatly simplified by abandoning highly complicated global income forms in favour of a direct 16% income tax, applied at source, for all persons having a single source of income (amounting to about 80% of taxpayers). The simplified system has lower maintenance costs and ensures a whole array of advantages, including more uniform tax collection and a reduced probability of personal accounting mistakes.

The practical implementation of the flat tax needed to address a core problem: the time lag between the sudden decrease in budgetary revenues, resulting from the tax cut, and their subsequent increase, as a result of a larger base and Laffer optimisation. Among the measures employed to address this, an 'amnesty' was offered to taxpayers for previous fiscal frauds; the bureaucracy was made more accessible by extending tax office opening hours and improving staff training; and a retaliatory policy of tightened fiscal monitoring and sanctions was put in place. The government has also subsequently operated on a much tighter budget, refusing to increase public sector employment levels and not expanding resources for government departments.

The whole plan provoked heavy criticism from the IMF and other international actors who predicted that increasing the budget deficit would accelerate inflation. When revenues started to increase, this dissent swiftly dissipated. This pressure did bring about an array of contradictory announcements from government officials in the spring of 2005. Some promised tax increases, while other pledged to maintain the *status quo*. These declarations created confusion and jeopardised the economy's ability to adjust to the new measures. Deficient communications were also evident in the separate announcement of some increases to collateral taxes, which, though of little significance, led to a public belief that the tax burden was likely to rise.

While it is far too early to make a final conclusion regarding the effects of the flat tax, the initial indicators are encouraging. Six months after implementation, budgetary revenues increased by about 4.7% compared with the same period of the previous year. A cumulative 16% increase is estimated for 2005. 100,000 new jobs were added to the economy in the first five months, and 140,000 in the first eight (although some critics suggested that they would have been created regardless of the flat tax). Important economies of scale are being derived from the reduction in bureaucratic waste, as tax offices become easier to manage and tax forms are simpler to fill out. However, despite these achievements, criticism of the implementation of the flat tax system become more vociferous

Another major achievement for the new government, one which had been a prominent feature of their electoral campaign, was their first attempt at reforming the retirement system. The recalculation of all pensions began with a review of all retirement portfolios, which started in January. Over the years, inflation, the government's persistent squandering of the retirement fund, and the fight for preferential treatment amongst and within occupational categories, caused unfair inequalities between different groups of retirees. This unfairness was exacerbated as the ratio between contributors and retired persons decreased. However, the measure is of minor significance, and the system is still a pay-as-you-go nightmare in which current generations' contributions pay for the older generation pensions. With dependency rate estimations ranging between 0.7 and 1.1 contributors per beneficiary, this recalculation of all pensions must only be a necessary preliminary step with more daring and drastic reform to follow.

Progress is also being made in reforming the justice system, which needs to counter widespread corruption both within the system and society at large. Whilst low-level corruption is largely containable through the improvement of incentives that will render it

economically inefficient (such as, for example, lower taxes), combating high level corruption requires vesting stronger investigative and punitive powers in the justice system.

The appointment of Monica Macovei (a former leader of a corruption-fighting NGO) as Minister of Justice was regarded as a means of building confidence and ensuring such reforms gets off the ground. Initially, a set of legislative measures focussed on the justice system and property rights were codified, as the previous lack of legal clarity in the area was a bounteous source of corruption. However while this provoked a political crisis in the spring of 2005, and in spite of various blockages, the continuation of the process and the replacement of several high level justice officials constitute positive, if preliminary developments. The progress Macovei's campaign has made was evidenced by recent clashes between the Ministry of Justice and the Parliament, which rejected two decisions in the anti-corruption investigations. During this spell of prominence, public support sided more strongly with Macovei's team than the parliamentarians.

But much wider-reaching reform is still needed. Reforming the health system is an urgent priority - following appalling backlogs and shortages in 2005, the Health Minister was forced to resign. The system is, in its current state, financially unsustainable. Education reform has also lagged behind schedule, though the recent resignation of Education Minister Mircea Miclea, coupled with continued teachers' protests, will hopefully help push reforms forward.

The civil service is also in poor shape. Under the auspices of 'depoliticising' the administration, public officers have been granted immunity from being fired, making them rather difficult to motivate. The selection of such public officers also suffers heavily from corruption: preferential treatment is given to friends and contacts.

Consequently incompetent staff, and lack of general administrative capacity (as recognised in all EU Commission Reports on Romania's progress towards integration), are state-wide phenomena. The quality of administrative output (for example, laws and regulations, but also reaction capability and general efficiency) has decreased steadily. Some progress has been made, though the results are currently unclear.

The public have also demanded the creation of a more proportionally representative electoral system

One reform that commands widespread public support – roughly 80% in opinion polls - but which is yet to be addressed is that of the electoral system. More than 60% of those asked favoured abandoning closed party lists and replacing them with nominated candidates. The public have also demanded the creation of a more proportionally representative electoral system, combined with a reduction in the number of MPs. However, obtaining the necessary consensus of all the political parties will not be easy.

In Romania, as in so much of Eastern Europe, the picture is mixed. Fiscal and judicial reforms are encouraging, but without commensurate improvements in education and healthcare, they are of little value and liable to be short-lived. That said, the pace of reform has picked up through 2004-2005, and the public's appetite for it is not diminishing. The progress of this year should be taken as evidence that further improvements are possible.

Russia

Much like its forefather *perestroika*, reform in Russia has always occurred in a rather spasmodic fashion. Sweeping changes are hinted at from time to time, but their application scarcely runs as advertised. And, all too often, a period of reform is followed by a reassertion of the oppressive tendencies that the country so desperately needs to shed. In the short period of time since communism's fall, this has never been more apparent than under the premiership of President Vladimir Putin.

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Between the economic collapse of 1998, when the Russian currency's value was slashed by 75%, and 2001, a period of vital growth (two of the three years, growth was in excess of 15%) generated a rare optimism about the economy. In a 2001 assessment, even the OECD was complimentary of Russia's economic reform record and optimistic about its potential. Indeed, at that time the state had practically withdrawn from direct involvement in the economy, and with more than 90% of GNP produced in the private sector, Russia was (by that measure) the most capitalist country in Europe. Yet under Putin's increasingly visible hand, the economy has lurched back toward old practices, frightening away investors and harming prospects for the future.

In June 2005, the OECD's follow-up report was much more critical, pointing to the increased concentration of power in the hands of the government, and an apparent inability to refrain from interfering in business operations and economic activity. Growth predictions were down to 5.8% for 2005, signifying the downturn in reforming activity over that period.

Russia was the only country this time around to regress toward lower levels of freedom

Moreover, it could easily be argued that, since 2001, there has been a regression in terms of freedom. For example, government now exerts enormous influence over the media. Reporters Without Borders has expressed concern at "mounting press freedom violations" in Vladimir Putin's Russia, including "the absence of pluralism in news and information, an intensifying crackdown against journalists... and the drastic state of press freedom in Chechnya." Even when the state makes no overt interference, self-censorship occurs to such an extent that reporting, particularly on controversial subjects such as Chechnya, or presidential elections, becomes wholly subservient to the Kremlin.

Political freedom barely exists. Freedom House assigned Russia their lowest possible rating, 'not free', in their 2004 report (even the USSR was rated 'partially free' in its final assessment in 1990). Russia was the only country this time around to regress toward lower levels of freedom. The crackdown on official and unofficial opposition alike has been dramatic. Supporters and key members of opposition parties face harassment and persecution from the state, as political power has become more and more concentrated in the presidency. In 2005, a new bill was drafted requiring foreign NGOs to apply for permits to operate in Russia. This seems to be partly in response to the revolutions in neighbouring Georgia and the Ukraine in recent years, in which foreign NGOs were seen as leading the democratic charge. Fearing 'regime change' advocacy in Russia, the new laws grant the government the ability to decide who may stay and operate and who can be forced out. And even when permits are granted, NGOs will be compelled to have a 'council of trustees' composed of Russian nationals or permanent foreign residents. Mercifully, this law has not yet been passed and remains open to amendment, but it would come as little surprise if Putin pushes this through.

Business freedom is also heavily encroached upon by the state. The World Bank's latest *Doing Business* report places Russia 79th of 155 countries assessed, while the Heritage Foundation's Index of Economic Freedom ranks Russia 124th of 155, in the 'mostly unfree' category. The latter report decried in particular the Russian government's doubling of income from property and industrial enterprises, and massive restrictions of foreign involvement in the aerospace, natural gas, insurance, electric power, defence, natural resources, and large-scale construction sectors. Property rights are feebly protected, with bribery a common resort in the face of weak and incomprehensibly inconsistent judicial rulings. Inflation, however, is gradually being brought under control, trending downwards from around the 20% mark in 2000 to around 11% projected for 2005.

Following abysmally poor levels of tax contribution during the 1990s, a period when enforcement was negligible, and tax rates were high, (and in some cases also hopelessly unfair: a 'turnover tax' meant loss-making companies were still taxed), a system of flat taxation was introduced under Putin. Personal income is taxed at 13%, while corporate taxes sit at 30% (with a +5% option available for municipal governments to add to this). Alongside this, and arguably more significant than the flat part of the new tax law, a much more effective payment enforcement regime was instituted, alongside other reforms including the abolition of most deductions and exemptions, and the creation of a new, regressive social security payments scheme where contributions vary between 39.5% at the low-earnings end to just 5% in the top band. The turnover taxes were repealed completely. The outcome of this swathe of reform was an increase in tax income, but a slowing of growth rates (from an average of 10.6% over the six quarters before the law's introduction to 4.6% for the same period afterwards), although both the revenue increase and the growth slowdown are attributable to other factors acting in combination with the tax reforms.

The new enforcement regime has come under severe criticism from business leaders because of its more stringent application against political enemies of President Putin. The case of Mikhail Khodorkovsky, one of Russia's wealthiest oligarchs and a key contributor to Russia's opposition parties, has received the most publicity – many have correlated his conviction and 9-year sentence for tax fraud with his erstwhile burgeoning political aspirations. Other major business leaders have become wary of using their vast wealth and influence in the political arena, lest they suffer the same fate.

This antipathy represents one of the more startling policy changes between Putin's government and his predecessor Boris Yeltsin. Yeltsin was highly supportive of the oligarchs, facilitating their accumulation of extraordinary fortunes from privatising key state industries, while keeping them close to government as key advisors. This inevitably drew charges of cronyism, which Putin, himself a onetime stooge to the oligarch power circle, has taken drastic steps to remedy.

Privatisation programmes in energy industries in the early capitalist days were among the most radical and lucrative embarked upon ever. Yet the scheme ultimately failed to produce any kind of meaningful competition in the sector, instead granting vast wealth and influence to a small cabal of energy magnates while failing to address the needs of the industry or the nation. Russia has failed to take advantage of the increase in oil prices, seeing little change in government revenues or corporate investment. Meanwhile, what cash does flow in is rather disproportionately distributed between Moscow, the Siberian oil and gas-producing regions, and the bank accounts of the major companies. Most of the remainder of the Federation has developed little or not at all since the fall of the Soviet Union nearly 15 years ago. Infrastructural concerns outside Moscow, St. Petersburg, and the oilfields makes what is left of the country a poor destination for investment, while minimum wage concerns put labour costs above some competing 'developing' economies, including many former allies in Eastern Europe.

Another hindrance to Russia's development is its continued state of quasi-war with separatist rebels in the Caucasus province of Chechnya. Under Yeltsin, the conflict consumed vast amounts of government resources, and yielded little in the way of clear successes. Under Putin, though military engagements have been scaled back, the conflict has not been resolved. Hopes were high when a 2003 referendum was passed granting greater autonomy to Grozny while cementing Chechnya's position as part of the Federation. Since then, however, terrorist attacks have not abated, and Russian retaliatory attacks have been scaled up, including the assassination of the separatist government President Aslan Maskhadov. Concerns abound, too, about other areas of the Federation. Russia's territorial integrity may be wholly in question, with up to eight regions exhibiting various degrees of secessionist yearnings.

More successful revolution attempts in other neighbouring states have also prompted ire in Moscow. The 'Rose' Revolution in Georgia and the 'Orange' Revolution in the Ukraine both replaced Moscow-aligned regimes with more westward looking, pro-EU governments. This has harmed Russia's regional influence, and may also eventually harm Russia's trade status, as many of its neighbours in the former Soviet Union presently rely on Russia for large portions of their imports. Friendlier relations with the EU for these countries could see the bulk of that import market transferred to EU members.

What the future holds is always difficult to predict, but Russia's case is more difficult than most. Its history has been dogged with underachievement and the squandering of major advantages by political mismanagement and communist doctrine. Its sheer size (with the natural resource benefits this provides) and traditional scientific expertise ought to constitute a sound basis upon which to develop productive niches in the global economy. However, if these opportunities are wasted through corruption, government interference and underinvestment in infrastructure and development, Russia's economy may remain buried beneath a Siberian winter for many years to come.

Serbia

After 35 years of Tito's rule, and a further 12 years under Slobodan Milosevic, 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.

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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 cooperation 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.

Another example of this so-called reform is the anti-monopoly regulation passed in September 2005, allegedly modelled 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 sale 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 inviable.

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 easily enter the country 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 belongs 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

> Another example of this so-called reform is the anti-monopoly regulation passed in September 2005

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 EU25. 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 to completely 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.

Switzerland

Switzerland is often regarded as a model economy. It ranks amongst the world's top ten nations in terms of its competitiveness, global integration and economic freedom. Referenda ensure that the public can influence tax increases or reductions. Recent studies show the Swiss as being among the happiest people on Earth, with cities such as Zürich and Geneva leading international safety and quality of life standards. Beneath this glossy surface, however, the country faces similar challenges to the rest of Europe - government spending has increased by 65% in the last 15 years, and free-market reforms have stalled in many sectors.

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Despite Switzerland's apparent history of slow economic growth since the mid 1970s, it still manages to produce a remarkably high GDP per capita; a fact that explains economists' allusions to 'the Swiss paradox'. The Swiss economy divides itself into two very distinct sectors: a high-growth, high-value-added sector of global corporations and innovative, export-oriented smaller firms, generating revenue from investments abroad; and a stagnant, overregulated internal sector, including an enlarged government sector.

Much criticism has recently been levied against the decentralised structure of Swiss politics, whereby most laws are modified and approved at the *canton*, or 'state' level. This lack of centralisation is seen as one of the main causes of the gridlock in internal reforms. In 2004, attempts to introduce a federal package of tax cuts – a potentially groundbreaking and advantageous reform – was defeated by a left-wing minority accounting for just 25% of the parliamentary vote that, when joined with a coalition of *cantons*, was sufficient to defeat the motion.

However, Switzerland's decentralised political system and the Swiss citizens' bottom-up veto power have also prevented many costly political mistakes. The evidence suggests that it is not so much the country's institutional framework, but rather its climate of opinion, that constitutes the main obstacle to reform (in other, more centralised countries with no referenda, street protests just as often mean the withdrawal of mooted reforms). Perhaps equally important is the creeping bureaucratisation that has entangled every level of government and which makes liberalisation a painstaking process. The agricultural sector is a good example of this shortcoming. Swiss farmers derive roughly 80% of their income from protectionist measures – a system which makes the Soviet *kolkhoz* seem a liberal concept in comparison. At WTO negotiations, the Swiss government, along with Japan and others, exclusively defend farmers' interests with no consideration for consumers. Swiss agriculture, a remnant of World War II, still enjoys extraordinary popular sympathy, which is aided by taxpayer-funded marketing campaigns and manicured fields featuring the world's most coquetted and expensive cows. This is all the more sordid since Switzerland applies lower tariffs than the EU on industrial goods, and is otherwise a self-interested champion of free trade.

An equally pressing challenge is the demography-related increase in welfare payments. Mandated redistributive transfers, including healthcare, now make up 29.9% of GDP, up from 19.7% in 1990, and 17.9% in 1980. Just a little over half of those transfers are funded on a pay-as-you-go basis; the rest are based on private insurance accounts and capitalisation. The looming pension crisis is therefore less acute than in most countries, and Switzerland also benefits from the freest labour market and the highest ratio of working people in old age in Europe. A modest attempt to merely equalise men's and women's retirement age at 65 failed in 2004, and the government's future steps are likely to be even more restrained. At the same time voters rejected a huge tax increase to finance future pension liabilities, though ironically on the same day as they also rejected tax cuts. Either the country will soon find itself at a fiscal dead-end, or the Swiss government will need to revise its confused strategy without being able to resort to its well-worn motto: 'We need to wait'.

In healthcare, the Swiss model of 'managed competition' is slowly reaching its limits. Insurance premiums have increased at ten times the rate of inflation over the last ten years. Compulsory basic insurance is driving up costs because of consumption incentives and overcapacities in subsidised hospital facilities, and the supposed competition between insurance funds works far better on paper than in practice due to excessive regulation. Although there are no complaints about the quality and accessibility of services, the cost spiral is increasing people's dependency on government subsidies to pay for their premiums. It has also provoked a vicious circle of ever increasing regulation that threatens to put Switzerland completely on the path of socialised medicine. A free-market initiative drawn up by the Swiss People's Party, the largest party, is likely to be submitted to voters within the next couple of years, as is a left-wing initiative which will seek to remove the last vestiges of competition in the system. In the meantime, a hesitant parliament has failed to advance planned market-oriented reform.

In the field of tax policy, the main reform in progress seeks to reduce the double taxation of dividend income, currently taxed at both corporate and investor levels. Unfortunately, the government plans fall short of expectations – so much so that the measure will probably not have any future impact on economic growth. Parliament is likely to strengthen it, but this runs the risk of rejection by the *cantons*. At state level, a number of competing *cantons* have announced, and many are already implementing, significant reductions in their corporate tax rates; slashing them in some cases by up to two thirds of existing levels and adopting regressive tax rates for higher incomes. Tax rates of holding companies, headquarters and administrative firms are also likely to remain attractively low, and criticism from abroad largely ignored. Furthermore, after having accepted in 2005 the introduction of an anonymous withholding tax system on savings income for EU residents, Switzerland will adamantly refuse to further relax its financial privacy laws for tax matters.

Despite the rejection of EEA entry in 1992, Switzerland has recently been able to deepen its already strong ties with the EU. In addition to the extensive 1972 free-trade agreement, both parties now benefit from additional bilateral agreements in several fields, including the free movement of people, which has induced a large number of people from Germany and France to immigrate into Switzerland. In 2005, voters approved with a comfortable majority the extension of that freedom to the citizens of the ten new EU member states. However, there is no chance of Switzerland joining the EU, as the Swiss financial and business community is explicitly against full membership. In 2001, 76.8% of voters turned down a proposal to open entry negotiations, and the government in 2005 downgraded membership from a frozen 'strategic goal' to a 'long-term option'. In truth, the advantages of staying out by far outweigh the perceived costs, and the political bias is clearly in favour of independence. But in

economic terms, too, Switzerland's autonomous monetary, economic and tax policies avoid some of the pitfalls of the 'one-size-fits-all', overregulated EU approach.

> The revitalisation of government following the general election in 2003 has reinforced its free-market outlook

The revitalisation of government following the general election in 2003 has reinforced its free-market outlook, in particular with the inclusion of two renowned business personalities, the industrialist Christoph Blocher and the renowned manager Hans-Rudolf Merz, in the seven-member cabinet. But despite their credentials, Switzerland's tradition of consensus politics, culture of civil society consultation prior to decision-making and popular veto rights through referenda give them little leverage to effectively implement the necessary reforms. For free-market alternatives to succeed, it is necessary to reverse previous governments' mistakes, be they in pensions, healthcare, tax policy or agriculture. However, history shows that in uncertain times voters are more likely to play it safe and support existing policies. This is politically hazardous terrain. If most government members are unable to persuade popular majorities to implement the policy changes or, worse, are not fully convinced themselves of the urgent need for such changes, Switzerland, like so many of its neighbours, will slowly drift from its present flawed model to an even less palatable future.

Turkey

In 2004, Ali Babacan –Finance Minister, and, since 2005, Chief EU Negotiator – described the extensive market reform Turkey had undergone as a miracle rather than a mirage. Change was here to stay. Successive economic crises had made change expedient. Moreover, it has been recognised that large-scale restructuring represents Turkey's ticket into the EU. Membership is the single overriding national objective as it will represent both the crowning glory of Turkey's Atatürkist modernisation drive and a vindication for national pride after a saga that began in 1959. So, market reform is at the forefront of government policy.

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Turkish politicians and diplomats, as well as Western supporters of the country's EU bid, defend Turkey's membership in economic terms. Turkey possesses a large, young labour force that can sustain Europe's aging population; although that presupposes a degree of free movement for Turkish workers which many EU members are unhappy with. Turkey has long had stable economic relations with the EU, incorporating a customs union and established trade routes that could become wider and busier following accession. Moreover, Turkey offers a large and growing market for European goods with better access channels to the Middle East, immense growth potential as well as scope for industrial development. Productivity is high and optimism is soaring. The question is, is the optimism well-founded?

Turkey's growth record has been extremely volatile in the past twenty years. In 1990 the growth rate of real GDP was nearing 10%. In 1991 it was 1%. This roller-coaster – with real and painful day-to-day side effects for Turkey's citizens – plummeted to almost -8% in 2001. At the end of December 2000, interest rates were almost four times higher than at the beginning of November. The intense financial crisis, in the middle of an IMF-supported stabilisation programme, soon translated into a political crisis as the exchange rate system collapsed and urgent assistance was needed. The remedy entailed a departure from patchwork solutions and the adoption of a strict, IMF-endorsed economic programme for the restructuring of the Turkish economy.

The aftermath of the 2000-2001 crisis put an end to the populist manipulation of economics for short-term political gain by effectively removing economics from the control of governments. While, since the 1980s, the economy was the core arena of public activity and debate, following the limitations on political deliberations imposed by the 1980 coup leaders, after 2001 the situation was reversed. Economic policy was no longer a matter of choice for Turkish governments; the path was carved and the goals were set by a team of experts. One of them, Kemal Dervifl, noted that the primary goal for Turkish economic restructuring in the new millennium was first health, then wealth. Financial health – a healthy market, sustainable growth and economic stability – should be, for Dervifl, the criterion to determine Turkey's EU entry. This realisation enhanced the commitment of both politicians and the public to the post-2001 economic diet. It is important to note that, also in 2001, the National Programme for the Adoption of the *Acquis*' was adopted by parliament, making the pursuit of EU accession the top priority for Turkish politics and thus lending economic restructuring even more urgency.

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The combination of the two means that the past five years have witnessed a concerted, well-orchestrated and conscientious effort to stabilise growth, increase productivity, minimise corruption, streamline taxation and standardise financial regulation. On paper, Turkey is doing well. In practice, institutions, directives and guidelines are gradually taking root while the government is also learning to be responsible, responsive and transparent in its financial dealings. Turkey has a long way to go. However, certain phenomena, such as the growth of the so-called Anatolian Tigers, give Turkey's supporters cause for satisfaction.

It is generally believed that Islam, with its opposition to usury, interest and certain kinds of profit, is an obstacle to the growth of capitalism. As a result, it had been suggested that Turkey's pious Anatolian population was going to hinder its economic development, industrialisation and modernisation. And yet, according to the 2005 European Stability Initiative Report, it is that very population - pious, socially conservative and yet entrepreneurial - that now represents the most rapidly growing segment of the Turkish economy. Manufacturing is flourishing in Anatolia and religion, rather than standing in the way of economic growth, is actually helping it benefit the community as Islamic charity, practiced widely by the Anatolian Tigers, translates into schools, universities and hospitals that further enhance modernisation.

However this image is not complete. Such Tigers do not exist in every corner of Anatolia. Their appearance depends on myriad factors, such as capital availability (often linked to the degree of mechanisation of agriculture in the region) a large and specialised skill-base (as in the case of the Kayseri furniture-makers) that can be utilised and expanded and, of course, luck. Moreover, the Tigers, their entrepreneurial skills and instincts notwithstanding, embrace modernity selectively. Markets are good, as is capitalism. But allowing their wives and daughters to join in is a different matter.

The Anatolian Tigers are not alone here. A 2005 opinion poll indicated that 12.8% of Turkey's population believe that women should definitely not work outside the home while a further 11.5% maintained women should only work in all-female offices. Such attitudes are a severe obstacle to growth as they effectively incapacitate almost half of the country's labour force. ESI observers express hope that such traditional attitudes will dissipate in the face of pressing demands for extra workers if Turkey is to maintain its international trade share and remain competitive in both manufacturing and services provision. Time will tell.

In the meantime, however, women are the chief 'victims' of one further problem of Turkish economic practices, namely the informal economy. A combination of traditional male-dominated and family-centred attitudes combined with decades' worth of lax financial regulation and control, paternalism and the relative success of clientelistic networks in delivering solutions to individual problems, mean that Turkey now possesses a huge and thriving informal economy. This is not quite the underground economy that many former Soviet-bloc states labour under. Yet it remains unregulated and largely untaxed. Moreover, informal economy workers are uninsured and receive no formal remuneration and no pension upon retirement, while their workspace, usually a family-run shop,

workshop, or farm, rarely meets health and safety standards. Turkey's informal economy (which chiefly but not solely affects women) represents an obstacle to EU accession at all levels of regulation and compliance. Successive 'Commission Communications' have drawn the government's attention to the pressing problem of regulating the informal economy and bringing its activities and workers into the mainstream. It is not certain, however, whether the state can do much about this.

Turkey's republican experience has always been state-centred. The *devlet-baba* (father-state) wields considerable power and legislates on everything from industrial policy to lifestyle choices, although its ability to protect, control and provide for its people is circumscribed as a result of EU human rights concerns and international regulation capping state economic activities. The state can and has introduced sweeping reforms in the economic sphere. Starting with Özal's post-coup economic restructuring in the 1980s, through to the AKP's fiscal policy, the Turkish state has used its powers to affect sweeping economic change – always with an eye to Europe.

Dismantling the informal economy, however, may be beyond the abilities of the state. In order to ensure that seamstresses working from their kitchen meet health and safety regulations; that wives working in their husbands' shops are properly insured and will, eventually, receive a pension and that cousins helping with the harvest are not effectively evading tax, large-scale social change would be necessary. For Turkey to fully harmonise its practices with EU regulations, social relations would need to evolve in a manner that seems unrealistic given the time frame in which it has to be achieved. And it must be remembered that for many the change would also be undesirable. Even though family assistance in farming and small-scale businesses may fall between the cracks of the tax system, it constitutes a tightly-knit nexus of kinship and mutual assistance that, for many, engenders a stronger and healthier society. Although the line between family-based exploitation of female or teenage labour and 'mutual assistance' is blurred, there might be some merit in this claim. What is certain, however, is that if Turkey is to maximise its international market share and reach its full growth potential, traditionalist attitudes that block women's access to the market will have to be radically revised so that the large numbers of marginally employed, unemployed or underemployed women can gradually enter the workforce and allow Turkey to live up to its promise of bringing Europe a large, young and vibrant labour force.

Ukraine

Ukraine has a long history of invasion and occupation by foreign forces. The Mongols, the Grand Duchy of Lithuania and the Polish-Lithuanian Commonwealth have all had the privilege. The last country to exercise its powers over Ukraine was its big neighbour to the East, the USSR. Final independence for Ukraine was achieved in 1991 with the collapse of the Soviet Union, although the Kremlin continues to play an influential role in Ukrainian politics.

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The latest example of this took place in 2004 when Russia's President Putin came out in strong support of Ukraine's rigged presidential election, which saw the re-election of the Moscow-friendly and corrupt Viktor Yanukovych. The move, however, backfired as thousands of people took to the streets in protest. Supported by foreign governments, the international media and a variety of international organisations, Ukrainians forced their tainted regime to submit to a second round of elections, which resulted in the election of a government led by the popular Viktor Yushchenko. His government promised a more transparent, prosperous and westward- leaning Ukraine. Yet the following 15 months have yielded few tangible results.

The Soviet Union left a legacy of endemic corruption, poverty and state control. According to the International Monetary Fund (IMF), Ukraine has posted perhaps the most disappointing economic performance among Eastern European transition countries emerging from planned economics. With its fertile soil, diverse raw materials and heavy industry Ukraine used to be the most important 'republic' in the Soviet Union. Although a post-Soviet Union economic recession was expected, the degree of Ukraine's poor economic performance after independence is still surprising.

One explanation for Ukraine's poor economy following its independence has been the inability of the country's leadership to build the institutions necessary to secure the rule of law, well-functioning markets and property rights. This again was due to a lack of consensus among the ruling elite, for whom the links to the former Soviet Union were still important and whose main concern was to secure privileges for themselves and their supporters. Many hoped that Yushchenko's new government would eradicate the culture of government corruption and privileges once and for all, but it has proven to be more difficult than anticipated. The new government has in fact had to struggle with its own corruption scandals, leading president Yushchenko to fire his entire government in September 2005. Unfortunately, corruption is not confined to the political sphere, but rather a characteristic of Ukrainian society as a whole. A poll developed by the Ukrainian Institute for Social Research and the Social Monitoring Centre in conjunction with the United Nations Development Program, revealed that about 44 percent of respondents had paid bribes or made gifts in one form or another at least once in the last year.

Another legacy of the Soviet Union is a universal yet poorly funded and ill-equipped welfare state. In principle, every Ukrainian has the right to free health care. In reality, due to a chronic lack of resources, these services are both underdeveloped and inefficient. During the Soviet era the healthcare system in Ukraine was under the strict control of the central government and the Ministry of Health in Moscow. Control was exerted through centrally determined five-year plans, which took no account of local trends or needs. The state was the direct employer of health care workers; it paid staff salaries and was responsible for equipping health care facilities, research institutes and educational institutions.

After independence in 1991 the Ukrainian state continued to supervise the country's formal health care system. Nevertheless, an increasing amount of health care services are now delivered in facilities owned and managed at regional or district levels. Although the market has been opened up to private health care providers, these facilities continue to be poorly developed. This is largely due to the history of state-run health care and therefore the dominant position of state providers in the market. Most importantly, the demand for private health care is low because most Ukrainians cannot afford it.

Privatisation in other areas has also accelerated over the last 10-15 years. A process of transforming the country from a centrally planned economy to a market economy was initiated right after independence in 1992 and is still going on. The aim of this transformation has been to increase the private sector share of industry and to find strategic investors to speed up the development of industries and companies. Although the process started modestly, it has recently gained pace and 80% of the country's industry is now privatised. The remaining privatisation consists of the largest state enterprises, mainly in electricity distribution, telecommunications and metallurgy. The question of privatisation of welfare is still highly controversial, as in the rest of Europe.

Due to Ukraine's history, most of its foreign trade has been conducted with Russia and other neighbouring countries. The country has also had an important role linking Europe and Asia. In 2003 the country joined Russia, Belarus and Kazakhstan in creating a single economic area (SEA) designed to coordinate the countries' trade regulations and reduce tariffs. But the fact that it constitutes a preferential trade agreement may complicate Ukraine's ambitions to join the World Trade Organisation (WTO). After Yushchenko came into power in 2004 however, the government has made a conscious effort to become more independent of Russia and create closer links with the European Union. Adding to the Partnership Agreement originally set up between Ukraine and the EU in 1998, President Yushchenko travelled to Brussels in February 2005 to negotiate an EU-Ukraine Action Plan. While EU membership is not yet a viable proposition, the aim of the Action Plan is to set out the main areas of reform Ukraine needs to implement in order to meet EU standards.

Despite Ukraine's enduring economic recession the country seems finally to be moving in the right direction

By diversifying its economic partners and seeking alliances outside the former Soviet Union, Ukraine is aiming to become less vulnerable to the politics of the Kremlin or indeed other external factors. The country still has a long way to go, as the gas crisis of January 2006 made evident. Russia, resorting to natural commercial interests, decided to quadruple the prices of gas in the middle of the coldest month of the year and left Ukraine, which is dependant on Russian imports for the bulk of its gas consumption, literally in the cold for days.

Interestingly, Ukraine's vulnerability to external factors has not solely been a negative factor for the country's economy. The high growth rates the country experienced in 2000 after years of post-independence stagnation were in fact mainly due to favourable external shocks including booming trade and metal prices. In 2004 real growth in Ukraine reached the remarkable, (yet unsustainable) rate of 12%. It is however, important to keep in mind that this ascent began from a very low base. In 2005 the growth had returned to a robust 4%. Although this is a huge decrease from 12%, it is still more than double the growth rate of the EU, which in 2005 was 1.7%.

Despite Ukraine's enduring economic recession, the country seems finally to be moving in the right direction, albeit at a modest pace. However, disillusionment with the manner President Yushchenko has handled his Orange coalition led to his former ally and former Prime Minister Yulia Tymoshenko taking the largest portion of votes in parliamentary elections in March 2006. While not a direct revocation of the principles of the Orange movement, it does represent growing disappointment with Yushchenko's inability to dislodge endemic corruption or generate the economic growth he promised. It is doubtful, at this point, whether the parliamentary shake-up will have any long-term effect on Ukraine's ability to advance further. If a rapid turnaround cannot be achieved, the momentum that the revolution gave to market advocates may ebb away. Presently, it is hard to see a bright future, or indeed, an Orange one.

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