



POLAND

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2004 was supposed to be a time of longstanding promises kept and expectations fulfilled in Poland. At both a national and European level, however, it has been a year of hope and disappointment in equal measure.

Market-oriented reform is continuing to open up the economy – the OECD recorded 4.5% economic growth in 2004 and predicted the same in 2005 – but in the six months following accession to the European Union, little progress has been made. Tellingly, Poles have since surmised that not only has EU membership failed to deliver all the promised benefits but that most of the reasons for this shortcoming lie at home, and are bound up in red tape.

It was long hoped that accession would strengthen the rule of law and liberalise the markets in Poland. Both hopes have been disappointed. At the core of this shortcoming, was the weight of the expectation itself, and a concurrent failure to recognise that nothing changes automatically. Polish citizens are only now beginning to realise that energy and political will are needed to bring about change, and that the main obstacle to market-oriented reform is the government.

INTERNAL WEAKNESS

In a country uncertain about EU membership following centuries of foreign domination, government agencies have spent a preponderance of their time in recent years distributing pro-EU propaganda. This, in conjunction with a judiciary too weak to adopt new laws, has led Polish citizens to regard the state not as their servant but as the enemy. Corruption is rife amongst the civil service, and violations of individual property rights are widespread and indiscriminate. By and large, these abuses go unpunished domestically. As a result, Poland has more cases in arbitration in the European Courts than any other country. Public concern about state encroachment and civil servant abuses is growing, and is not assuaged by the frequent but minor law changes that the government has used to persecute private business. Recent legal amendments to the business code have made book-keeping very difficult, and the resulting transgressions have been used as a pretext by the government to bankrupt several

well-run businesses. It is thought that the additional fees that bureaucrats earn for such acts of 'regulation' may have been a factor:

The burden of taxation is also a huge problem in Poland. The government has raised taxes on numerous occasions in recent years in order to curb the deficit, and the EU's budgetary rules have always been invoked as the excuse. However, a number of investigations by journalists uncovered evidence that in each instance, the tax rises were inspired by domestic policy decisions. Moreover, such journalism has made many Poles aware that the EU actually gives domestic legislators more, not less, scope in making laws and reining in the deficit. Yet recent tax hikes have raised the cost on a diverse range of products and services including baby carriages, internet services and the construction industry.

Compounding both these issues is reflexive distrust of capitalism within Poland's political class. The legacy of communism means many are much more comfortable with the familiarity of socialism. The recent affair surrounding the Polish oil monopoly PKN Orlen – reportedly, a prominent businessman with links to the top of the Polish political scene met with a Russian spy to arrange the sale of PKN's smaller domestic rival, Grupa Lotos, to a Russian firm – demonstrate the

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extent to which politicians and businessmen regulate the markets together. That politics, and not the market, makes people rich in Poland is evidenced by the recent passage of a bill raising the tax rate in the highest income bracket. Fortunately, the bill was opposed by the main opposition party, the



centre-right Platforma Obywatelska (Civic Platform). This tacit recognition of the importance of fostering entrepreneurship offers a ray of hope in next year's competitive general election.

Indeed, the memory of the vast economic transformation of the 1990s is still fresh. Poles remember that they were the principal force behind the opening up of the economy following the end of communism. This produced a period of economic growth that eclipsed Ireland's. However, the bureaucracy has slowly retrenched itself, and the rule of law, fundamental to encouraging domestic entrepreneurs and foreign investors, is being eroded. Overseas observers are increasingly unsure how the Polish economy will fare in such an unpredictable environment.

RAYS OF LIGHT

There has however been some good news for business this year: The government passed the Economic Liberty Act, simplifying regulations to facilitate business and commerce. A number of independent experts, some from think tanks, were brought in to shape the reform, and progress was made in reforming public finances as budgetary spending and taxes were cut. The huge public debate surrounding this legislation, and the evident successes of such policies in neighbouring member states, forced the government to introduce a flat corporate tax rate of 19%. Entrepreneurs are hoping that this is not the last of the tax cuts in Poland.

Another important issue is the trial of businessman Roman Kluska, who was recently cleared of major charges of systematic tax evasion. In the 1990s, Mr Kluska was an innovative investor and owner of the biggest Polish IT company, Optimus. He was charged by the state with fictionally exporting computers that were then 'reimported' into Poland through the Ministry of Education avoiding import taxes but profiting from a 22% sales tax. Unusually in Poland, Mr Kluska decided to fight the case through the courts, and was vindicated in early 2004. He recently launched a case for compensation to recover the significant legal costs of the affair. The case has taken on a wider significance, becoming a symbol for justice. There is hope that this victory will herald an end to the government clerks' 'mafia', and the public are beginning to feel that, for the first time in living memory, the law is there to serve them, not the omnipotent bureaucracy.

The change in Polish society in recent times is palpable. After more than ten years of silence, almost every newspaper now regularly expresses its support for market-oriented reform. Journalists are developing a much sounder knowledge of economics, and citizens are becoming aware that the monopoly provision of many goods and services is forcing them to pay higher prices. More and more Catholics are also coming to understand that the free market provides better for families than the state – a crucial realisation in a country with chronically high unemployment.

There are many reasons to be optimistic about the future. A climate for change is developing and the public now seem willing to accept the radical reform of the healthcare system, and a dramatic reduction in social spending. One crucial area that needs reform is the burden of unemployment provision. Indeed, a recent attempt to increase the social security tax met with widespread protest. The socialist mentality, so long the prevailing trend in Poland, may finally be on the wane.

Only one issue threatens the increasing consensus for reform, and that is the European Union. The parliamentary vote on the joining the EU saw the Social-Democrats, the broader centre-right and the liberals vote 'yes'. The opposing voices of the Nationalists, Conservatives and Libertarians were voted down, and largely drowned out of public discourse. While the proponents of integration promised the social paradise of the welfare state, their opponents decried Brussels' 'political satanism'. However, there is consensus that now that Poland is in the EU, it should play a pro-active role. Poland's history means that it is instinctively wary of the French and German leadership of the EU. Recent attempts to preclude free competition and impose tax harmonisation met with derision in Warsaw, and other Central and Eastern European capitals. 'New' Europe wants competition, not regulation, and if that means rejecting the constitutional treaty, it will probably happen. Poland is, after all, still waking up from the bad dream of socialism.



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PORTUGAL

The political turmoil of the latter half of 2004 meant that the progress made in some key policy areas earlier in the year could not be consolidated upon in Portugal. In May, José Manuel Durão Barroso's decided to resign the post of Portuguese Prime Minister in order to become the new European Commission President.

After an interlude during which most of the opposition called for early elections, Portuguese President Jorge Sampaio invited Pedro Santana Lopes (Mr Barroso's successor as leader of the Social Democratic Party) to form a new government. On June 17th, Mr Lopes took office at the head of the same centre-right coalition as his predecessor.

However, the new government proved to be very short-lived. President Sampaio chose to dissolve parliament on November 30th and call early elections. A confluence of factors – unpopular reform measures, declining support among business leaders and the larger public, accusations of improper media interference, and the resignation of a minister four days after taking office – created, in Mr Sampaio's judgement, a crisis of credibility and instability that necessitated the dissolution of parliament. Naturally, this ruling was opposed by Mr Lopes and the parties in the centre-right ruling coalition.

Once again, 2004 has seen the overall relative size of the public sector remain fairly constant, with public expenditure expected to continue accounting for roughly 48% of GDP. However, the budget deficit, which is on the borderline of the 3% of GDP limit imposed by the Stability and Growth Pact (SGP), has maintained the pressure on the government. In 2001, the Portuguese budget deficit had breached the SGP limit of 3% of GDP (by a substantial margin). In response to a budget deficit estimated at over 4%, the European Commission initiated the excessive deficit procedure in October 2002.

Two years ago, the government implemented a policy of freezing public sector wages in excess of €1000 per month. However, public sector expenditure has continued to grow as this provision has been circumvented by a system of

automatic promotion and other embedded civil service entitlements. In order not to repeat the previous breach of the SGP, the government made containing the deficit one of its key priorities. Consequently, they have had to resort to extraordinary measures, such as the sale of publicly-owned property, in order to finance the debt. While this may be an acceptable short-term strategy, it is clearly unsustainable in the long run. The excessive deficit procedure was lifted by the European Commission in April 2004 but the deeper structural reforms

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required to curb public expenditure in the long term are yet to be implemented, and recent announcements regarding salary and pension rate increases do not seem to offer promise of a commitment to fiscal discipline.

One of the main structural barriers to the competitiveness of the Portuguese economy continues to be the inflexibility of the labour market. Some progress was made with new labour legislation enacted in 2003 and early 2004, as measures were introduced to reform the rigid rules governing collective bargaining and develop a system of individual contracts in the public sector. However, much remains to be done, particularly in the area of hiring and firing employees. Despite their declining influence, labour unions continue to offer significant resistance to the structural reform of the Portuguese labour market. Recent attempts



at reform met with intense labour union protests, as union leaders called for the revocation of the new legislation claiming that it spelled the death of collective bargaining. Unfortunately, this latest round of reform failed to address many of the issues central to improving labour market efficiency in Portugal, and as a consequence, must be considered as a missed opportunity.

LESS PROGRESS STILL

In the crucial areas of health and education, the Portuguese government remains the dominant player. The former sector has seen some tentative market-oriented reforms in recent years, but the state-run National Health Service (*Serviço Nacional de Saúde*) remains inefficient and largely unreconstructed. Despite several recent plans to eliminate them, extended waiting lists for consultations and medical procedures remain a persistent problem. Poor conditions and organisational shortcomings are also a feature of the public health system. More broadly, significant barriers to entry still prevent many prospective (and much needed) doctors and nurses from entering the medical profession. The licensing process for new medical schools continues to be very problematic and places at the existing public universities remain extremely limited (despite a relatively significant, but small in absolute terms, increase over the last few years). One of the most emblematic reforms in recent times has been the introduction of some forms of private management in state hospitals. It remains to be seen, however, whether these efforts are the beginning

of structural market-oriented reform, or merely cosmetic changes that will actually postpone the needed adjustments.

In education, no meaningful efforts towards allowing for more parental choice and competition have been undertaken in the last year. The entrenched, and extremely influential, bureaucracy at the Ministry of Education, combined with powerful teacher unions, have been successful until now in maintaining a largely monopolistic public education system and blocking any reformist proposals. Even something as basic as the publication of rankings of the results achieved at national exams by different schools (one of the few positive measures in terms of accountability of the public system that has been implemented in the last years) met widespread opposition. At the university level, tuition fees paid at the heavily subsidised state-owned universities are substantially lower than those charged at private universities. These institutions are financed largely through student tuition fees, and, in general, private schools continue to suffer from competition on unequal terms with the public education system.

The business and financial sectors have seen a significant slowing of the major privatisations of the late 1980s and 1990s. The momentum created by this liberalising movement has been lost, despite producing significant economic gains. One of the largest banks, *Caixa Geral de Depósitos*, has remained under state control, and significant regulatory barriers exist to mergers and

acquisitions that involve foreign capital. This, however, is unfortunately a feature common to many other member states. In telecommunications, the state continues to hold a 'golden share' (giving them veto powers at the board-level without holding a controlling stake) in Portugal Telecom, the dominant market player. Charges of abusive monopolistic behaviour have been frequently levied against this industry giant by smaller competitors. The state also continues to have a significant influence in the media sector, both directly and indirectly. Proposals for privatising one of the two state channels were quickly abandoned in the face of opposition. Indeed, local radio stations and press outlets are in many cases largely dependent on public funds. This does not create much industry impetus for independence.

In the last twelve months, progress in Portugal has been generally mild, and limited to certain areas of the economy. In many important sectors, such as the crumbling state-run pension and welfare programmes, or the cumbersome justice system, no significant steps towards reform have been taken. While no major setbacks have occurred, the significant reformist impetus that many had hoped could be achieved when the new centre right government took office in 2002 has, for the most part, failed to materialise. In addition to insufficient progress in terms of structural market-oriented reform, it remains to be seen if the electoral cycle now beginning, will not actually result in the enactment of populist spending measures and the retrenchment of the state in public life.

SLOVAKIA

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Joining the process of globalisation, and the market mechanisms which that engenders, lie at the heart of the success of Slovakia's economic reform. According to Robert Wright, author of *Nonzero: The Logic of Human Destiny*, there were roughly 600,000 isolated political units in 1500 B.C. Currently, there are about 200, and a robust body of scientific evidence already illustrates how foreign trade and investment have increasingly unified the world economy.

Globalisation has created greater opportunities for specialisation, and reduced zero-sum thinking. Natural advantages such as an advantageous geographical location have thus been superseded by technological connectivity, and this interlinking has been a great source of growth for many nations in recent centuries.

Historically, these individual units were governed by very different economic rules which precluded full interaction and cooperation between them, and thus the full exploitation of the benefits of globalisation. For example, centrally-planned and market economies (like totalitarian and democratic regimes) have always cooperated poorly. The enhancement of cooperation between a large number of individuals and their groups requires a universal system of enforceable rules. The market mechanism, based on private ownership and the limited and controlled redistribution of benefits, is such a system. Previously, within families and small, isolated societies, the question of who would get the best land would have been resolved by discussion or force (both forms of social intervention). Within larger societal structures, it must necessarily be determined by a market mechanism (i.e. an auction) and the legal protections of private ownership that prevent social redistribution.

A low level of redistribution and an elevated role of private property have been the common denominator in the programme of reforms that Slovakia has undertaken in recent years. GDP growth averaged 4% over the last decade. However, unemployment remains at 17.5%, and while the government is shifting the deficit towards a target of 3% of GDP, inflation remains between 7-8%.

PLANNING FOR THE FUTURE

The reform of the pension system, which was begun in 2003 and is due to be completed later this year, is the most comprehensive example of this programme. At the core of the reform is the introduction of a second, or fully-funded pillar based on personal savings. Prior to the reform, 28% of an individual's gross wages were dedicated to the first pillar (pay-as-you-go or PAYG) system – an extremely high level of redistribution. But since January 1st, individuals have been able to channel 9% of their gross wages into the new second pillar, and 9% into the existing first pillar. The future returns from both pillars are calculated solely on contributions, and there is no distribution between contributors. An additional 10.75% of gross wages have retained the characteristics of taxed incomes, as they are collected to fund disability insurance (6%) and a reserve fund (4.75%). However, while total contributions increased only marginally, from 28% to 28.75% within the compulsory system, over two-thirds of new income to the pensions system is retained by the individual.

Another shortcoming of the old system that has now been remedied is the inefficient nature of the redistributive system. Previously, the level of an individual's pension depended primarily on the salary they had earned during the best five years out of the last ten years of their working life. Under this system, an individual who had earned the minimum wage for forty years and the average wage for just five would receive a higher pension than an individual who had earned slightly less than average for forty five years. The system thus did not support the poor (and sick) at the expense of the wealthy, as is generally expected of social programmes. Rather, it transferred money from those who speculated more to those who speculated less.



Under the old system, an individual who earned the average wage for forty years would receive an annual pension of 7296 Slovak Korunas, the same amount as someone who earned three times the average throughout their working life. By the end of the reform transition period in 2007, those individuals would be guaranteed pensions of 7982 and 23,946 Slovak Korunas respectively. (For a full reference guide to pension variations before and after the reform, see Appendix 2 on page 59).

As a consequence, this pension reform has also significantly restricted future politicians' room for political manoeuvring. While the formula for calculating pension contributions to the first pillar is much improved following the reform, it could plausibly be re-altered in the future. Therefore, the introduction of the second pillar was crucial to preventing the raising of contribution rates, or the distribution ratios, over time. Indeed, a number of international firms have been given access to the Slovak pension market. In the past, the limited economic understanding of the politicians charged with the system's administration had led to great volatility. However, such firms as Aegon (Dutch), Credit Suisse Life and Pensions (Swiss), ING (Dutch), CSOB (Belgian/Czech) and Sympatia – Pohoda (Israeli/Slovak) are now invested in the long-term sustainability of the pensions system.

Another significant piece of legislation that holds to the maxims of lower distribution and the limitation of government discretionary power in the future was the reform of tax system, valid from January 1st 2004. The increased labour mobility that recent economic growth has allowed had greatly complicated the collection of direct taxes, whose high marginal rates were already harming the country's competitiveness. The Finance Minister Ivan Mikloš shifted the burden from direct to indirect taxation, and pursued the elimination of all forms of double taxation, such as the dividend tax. To introduce an element of fairness into the system, the government agreed to tax all income at the same flat rate, and after

fixing on 19% as the optimal rate, applied it to personal income, corporate and value-added taxation. And while fiscal constraints necessitated a commensurate rise in indirect taxation, the tax revenues for 2004 actually exceeded expectations, paving the way for further tax cuts.

The consolidation of the two previous (14% and 20%) VAT rates into a single 19% flat rate was controversial because it significantly raised the price of (previously lower rate) goods, such as basic food stuffs,

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medication and electricity. However, this has prevented economic speculation of goods between the two tax rates, and the rise in the tax-free allowance has compensated for this price rise. The previous income system had been strongly progressive (encompassing five bands between 10-38%), while the new system not only flattened the rate, but expanded the base-rate exemption from 38,760 to 80,832 Slovak Korunas. Under the new system, people who earn less than half the average now pay no tax at all, and because of this exemption, the system has retained a progressive bias. In the short term, those on higher incomes have benefited most from the flat rate, while lower income earners have gained from the elimination of around 80% of the higher-rate tax exemptions.

These reforms – especially the reduction of the corporate and the elimination of the dividend tax – have greatly increased Slovakia's competitiveness among Central and Eastern European countries. However, other countries in the region have already reacted – Austria had planned to reduce its corporate tax rate from 34% to 31%, but chose instead to drop it to 25%, and

Hungary similarly reduced its rate from 18% to 16%. The increase in investment that these cuts have precipitated has helped the Slovak government fend off criticisms, from opposition parties and trade unions, about the short-term 'injustices' of this weakened progressivism. However, the government ensured the adoption of their bill through careful timing, adequate compensation for lower income earners, and strong support from the business sector.

It is also worth mentioning that Slovakia has profoundly reformed its labour market. Hiring and firing workers has become much more flexible – mandated compensation or notice is now 2, rather than 5 months – and compensation levels have been roughly halved. Similarly, employers now have much greater freedom over the terms of contracts and working hours, both of which were previously subject to Union and National Labour Office approval.

CONSENSUAL ECONOMICS

A recent survey of academic, economic and business opinion has revealed that the two most influential factors in Slovakia's reformist success were 'the results of the 2002 parliamentary elections' (when pro-reform politicians increased their share in the parliament), and 'the political inclinations of a small but influential group of senior political/economic figures'.* Over 60% of respondents pointed to these two factors, revealing the importance of a legislative majority elected on, and unified around, a pro-reform platform. However, certain reforms, such as that of the healthcare and education systems, remain incomplete. The government needs to continue its efforts, because globalisation will not only increase competition between products, services and people, but among social rules and expectations too.

* 'Survey of Causes of Reform in Slovakia' by INEKO (Nov 2004) – www.ineko.sk/english/survey_on_reforms.pdf



SLOVENIA

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Self-flattery has been in abundance in Slovenia in recent years. Having successfully navigated the unsteady seas of transition – vastly facilitated by the maintenance of domestic stability following the fall of Communism – Slovenia achieved, in decreasing order of magnitude, a respectable degree of social, political and economic achievement. The shift to a parliamentary democracy and multi-party coalitions with almost weekly referenda has ensured the further development of an already functioning economy, and facilitated membership of the EU and NATO. Unfortunately, no other former Yugoslav republic has achieved either feat yet.

Slovenia's achievements are evident in its high purchasing power parity (\$19,200), relatively high standard of living and steady (but slow) growth. The mood of public discourse, has taken a downturn of late. After twelve years of rule, the government dominated by liberal democrats was replaced by one dominated by Slovenian democrats. It has become apparent that after fifteen years of transition, much work remains to be done, and doubts are growing about whether the gradualist approach to reform will ever lead to a free market economy.

In truth, much of the success achieved was built upon the economic and social circumstances prior to independence in 1991. Slovenia has long been the most Western of the former Communist nations. It had developed a semi-market economy because of the Yugoslav system of self-management in which decision-making was decentralised to the workers of the State-owned enterprises (SEs), and had long benefited from its geographical and historical proximity to Italy and Austria. A Serbian embargo on Slovenian products in the late 1980s consolidated the on-going shift towards trade with the West, and a number of well-run enterprises were able to compete in the global markets. Indeed, Slovenia's macroeconomic circumstances were such that independence, and the avoidance of either full-blown conflict or recession, has actually lowered the Yugoslav-era hyperinflation. Slovenia thus seceded peacefully (and almost unanimously) in 1991 and embarked on the path to democracy. However, a slower path has been taken towards economic freedom, and this has ensured that while Slovenia has achieved stability, it has not yet fulfilled its promise.

Estonia and Slovakia, two successful transition economies, have recently demonstrated that a full-scale reorientation from central planning to economic liberalism is best accomplished when 'big-bang' policies are adopted. These policies often have high social costs (unemployment, reduced wages, lower production in many cases due to malpractice) in the short-term, exacerbated by the legacy of Communist provision and transitional social and legal chaos. However, a gradualist approach presents other dangers. For example, it prolongs and slows the pace of necessary reforms, incurring greater cost at every stage. It is equally more likely to shelter and encourage rent-seeking interest groups, and corrupt practices, by shielding certain industries and SEs from exposure to market forces. A full examination of the virtues of the two approaches is beyond the scope of this essay, but it is sufficient to say here that Slovenia is now suffering the consequences of its gradualist approach.

WEEDS IN THE GARDEN

Reform has slowed significantly in the last four years. A former Social Affairs Minister likened the reformist dilemma to the difference between clearing a forest and trimming hedges. Naturally, most of Slovenia's politicians, loathe to court unpopularity, opted for the latter course: horticultural reform. Structural reform has not been undertaken, and business and politics remained unhealthily intertwined, except, of course, for those involved. For a long time, the government sought to ensure its legislative majority rather than oppose the entrenched interest groups. Consequently, many SEs still flourish (in relative terms) in the shelter offered to them by government subsidy, and in some of Slovenia's poorer regions, the economic structures remained



unchanged from the late 1980s. The textile and industrial SEs in these areas are non-innovative and uncompetitive. Yet they survive through government funding diverted from investment in newer technologies and emerging sectors. Much of the outgoing workforce was pensioned-off early, wages remained high (and growing) in the public sector, and as a consequence, taxes have risen progressively to an average of almost 40% of personal income. This inverted economic landscape, and the bureaucratic impediments to market entry, has deterred many potential foreign investors. The private sector also suffers from a lack of access to capital because of an underdeveloped domestic financial sector, still dominated by state-owned banks.

The recent elections in October 2004 have inspired hopes for greater reform

Throughout the transition period, the two state banks (and other collaborating parties) have ensured the setting of mutually favourable interest rates. SEs such as Telekom Slovenije, Zavarovalnica Triglav, and Vzajemna dominate the mobile telecoms, domestic insurance and health insurance markets respectively. The latter also regulates the market in which it has an 80% share. It is unsurprising, therefore, that the most successful Slovenian enterprises today are the companies as prior to independence. Equally, the few success stories have had their growth limited, and their international competitiveness curtailed, by the prevalence of SEs in the Slovenian economy. A good example is the significantly lower proportion of Slovenia's high technology exports (4.8%) to total exports relative to such nations as Ireland (40.8%) and Finland (21.1%), the EU average (19.8%), and even such transition countries as Estonia (11.6%) and Romania (5%).

Silent agreement, geographical segmentation, and powerful associations with obligatory or

limited membership, such as the Forestry chamber or the Chamber of Commerce and Industry, must all be navigated within the Slovenian economy. Moreover, the State has neither withdrawn its support from such enterprises nor pursued an active antitrust policy. Little progress has been made in the crucial sectors of primary, secondary and tertiary education – links between universities and industry are weak and weakly encouraged – and healthcare, where the state remains the dominant player. The state has enmeshed itself within civil society, and a profusion of agencies, the 'maids of the state' (e.g. agency for minority rights, agency for equal opportunities, governmental agency for corruption prevention which in many cases targets only the weaker links of the establishment) have inhibited the development of a domestic NGO sector. Commensurately, government attempts to ensure social peace by adopting this gradualist approach has entrenched rent-seeking interest groups within the Slovenian political system.

A LONG AND WINDING ROAD

In retrospect, the gradualist approach was clearly the least painful political decision. Slovenia was relatively developed, and enjoyed a favourable geographical location. National aspiration was wholly (and romantically) inclined towards the ideals of the Nordic welfare state: security, stability, wealth and solidarity. Yet paradoxically the economic measures that would have, in the longer term, have increased national wealth were ignored in favour of short-term comforts and political quietude. On current economic indicators, Slovenia is years from affording such social provisions and indeed the communitarian approach to government is imposing an ever greater cost upon society.

The recent elections in October 2004 have inspired hopes for greater reform, privatisation and the introduction of sufficient economic inducements to encourage entrepreneurialism and innovation. The continuation of the state-directed redistribution of funds within the economy, and its inevitable market distortions will

foreclose the possibility of foreign direct investment (FDI) and stifle the long-term international competitiveness of Slovenian enterprise. It should not be forgotten that Slovenia could conceivably return to the economic model from whence it came – self-managed socialism propped up by protectionism and state interventionism.

There are however many reservations about real changes being made. The current government has decided to go ahead with the tax reform put together by the previous government. In sum, this will mean lower taxes for more than half of the population, but with a great deal of paper acrobatics to master and for a small change, while property, savings and stock will be taxed more highly. As a good side-effect, people who have always kept to the idea of a generous state and leftist economics are becoming aware of the taxes they are paying and of a state headed by a government that may not have been of their choice.

Furthermore, what looked like a pleasant surprise may be turning into a farce. The renowned classical liberal Mićo Mrkaić received a mandate from the Prime Minister to form a supra-ministry for strategic economic affairs with many prominent economists and businessmen. However, the council's first suggestion to suspend tax reform was ignored. Instead the new tax system reform will be reformed later on in the year. This may mean that we will see another return to political horticulturalism in the near future.

Events on the international stage may mean that the impetus for reform may be lost in the near future. Slovenia holds the chairmanship of the Organisation for Security and Co-operation in Europe (OSCE) in 2005. In 2007 it plans to adopt the Euro, and it will hold the EU presidency in the first six months of 2008. Such foreign engagements will probably deter difficult domestic decisions.

Optimism remains that when the current Prime Minister, Janez Janša, concludes the current mandate in 2008, he will not repeat President Janez Drnovsek's 2000 proclamation, already echoed by the outgoing Prime Minister, Anton Rop, in 2004, that the transition was now over. However, one also hopes that the Slovenian economist's joke about transition being a permanent revolution will soon be regarded as a frivolous relic of a time long since past.



SPAIN

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Modern government is a Spanish invention. It developed around 500 years ago, a few decades before it financed Christopher Columbus' famous voyage aboard the Santa Maria. Since the formation of its government, Spain has possessed an extremely efficient state apparatus. However, throughout history, most of its energy has been spent on preserving its dominance over its citizens.

Spaniards long ago became accustomed to the state making most of their decisions, providing security but dulling personal initiative. It is only relatively recently that Spain has enjoyed greater freedoms, yet nostalgia for the embrace of the state lingers. As Eastern Europeans may recall, it is comforting to be able to absolve oneself of one's responsibilities, especially when the state constitutes such an amenable scapegoat. However, such a system dulls acceptance of risk and impedes their entrepreneurial spirit. More fundamentally, it runs contrary to the idea of liberty – a defining trait of mankind. For our purposes, it will suffice to say that the efficiency of the government leads to severe inefficiencies in the behaviour of economic agents.

The advent of democracy in Spain almost 30 years ago did little to change public feeling about the virtues of big government, and indeed, it may have exacerbated them. However, the transition focused mainly on political reform, and ignored the much needed introduction of liberalising economic policies. This shortcoming was only rectified by the Pactos de la Moncloa (Moncloa Pacts) during the economic crisis in 1977. Economic and political attitudes henceforth began to change, gathering momentum as Spain transformed into a nation unrecognisable to its former self. Even if the results of the remarkable change were not apparent to all until the mid-1990s, the watershed was undoubtedly Spanish accession to the EEC in 1986.

Unlike the experiences of many newer members of the European Union, meeting the EEC membership criteria necessitated the introduction of many free market practices, economic freedoms, and a concurrent reduction in the Spanish government's bureaucracy and interference. This institutional and regulatory shake-up has brought Spain much prosperity in the

ensuing period but this economic success must not mask the amount of work that remains to be done.

THE IDES OF MARCH

The period 1991-93 marked the worst economic recession experienced by Spain since 1959. Much of the blame for this crisis lies with the contemporary Prime Minister Felipe Gonzalez and his Economic Minister, Carlos Solchaga. When the Conservative Popular Party (PP) came to power in 1995, Mr Aznar and his economic team (lead by Economics Minister, Mr Rodrigo Rato) were able to encourage growth, and succeeding in guiding Spain successfully into the Euro, thus fulfilling Maastricht obligations that had once seemed in jeopardy. The success is all the more laudable because it was built upon the shaky foundations laid by the last Socialist Economic Minister, Pedro Solbes.

The advent of democracy almost 30 years ago did little to change public feeling about the virtues of big government

During his two terms of office, Mr Aznar reduced public expenditure from 60% of GDP to roughly 40%, and reduced the budget deficit from 7% in 1995 to a small surplus in 2003. Nearly five million net new jobs were created during the same period, reducing unemployment from over 20% to around 11%. Inflation was also brought under control, and the latest Eurostat statistics demonstrates that (contrary to conventional wisdom), productivity actually rose by an average of 1.3% over the last eight years. These successes mean that



Mr Aznar's terms of office were the most successful yet of any Spanish democratic leader, even if structural reforms in such sectors as the energy, pensions and labour markets remain incomplete. His legacy will be the introduction of such economically sound concepts as freer markets, lower taxation and public spending, and balanced budgets (which were once considered political heresy) into Spanish political discourse. Throughout the 2004 electoral cycle, political parties could virtually guarantee themselves media coverage by promoting these liberal market ideas.

Terrorist bombs murdered 192 people three days before the election, and Spanish society was stunned by the atrocity. The age-old instinct of blaming the government again took hold, and the PP were removed from power. Never having expected to win the election, a hastily arrayed coalition of nationalists (who variously seek regional independence) and left-wing parties (including the Communists) were handed a legislative majority. Equally, the natural inclinations of governments to expand their powers once again resurfaced. It is not unusual for a people, during periods of violence and uncertainty, to seek protection under the state's wing. However the government has abused this political situation by extending its remit into hitherto private areas. Combined with the inclination of the Left to recentralise economic controls, the prospects in 2005 for much needed structural reform do not look promising.

One indicator that running to the state will not actually provide more security is the proposed level of defence spending. In its original budget, the government proposed an increase of 4.5%, which amounts to 1% in real terms. Spain's military has long been undermanned and under-equipped, and only became a fully professional service in 2002. However, Mr Zapatero is now pushing an amendment that would reduce this funding even further: (Ironically, for such an outspoken opponent of US foreign policy, these further cuts will make Spain even more reliant on Washington for its security).

DOMESTIC SCIENCE

Another area of new state interference is the adoption of mandated shop opening hours. Previously, under Mr Aznar, Spaniards were forbidden to shop on up to 40 of each year's 52 Sundays every year. But new legislation has allowed regional governments to extend that prohibition to 44 Sundays, and to choose the days on which they will waive the prohibition. Seemingly keen to discourage commerce, most regions have allowed shops to remain open on Sundays in January and February – hardly the height of shopping season, even in touristy Catalonia, and this has killed many small retailers and modern retailing projects. The autonomous region of Madrid, which has one of the more liberal opening hours regimes (shops may open 21 Sundays a year), has a thriving retailing sector, and fortunately, 'tourist municipalities' have been excluded from these provisions.

But this should not detract from the fact that they have pushed many small enterprises out of business.

The attitude of Mr Zapatero's government is not encouraging either. Not unnaturally for a government supported by a loose coalition of leftist and regional parties with conflicting interests, the government's recipe for any reform has only two constituent parts: dialogue and agreement or, more bluntly, political appeasement. Will, determination, and farsightedness are not among its ingredients. Such a recipe is almost a guarantee that nothing, or very little in the way of reforms, will be achieved in those areas, such as the labour market, where the need for reform is widely accepted.

Indeed, certain areas of the economy, including the healthcare and pensions sectors, remain resolutely beyond the reach of reformers because of entrenched interests and the public denial of the need for a shift towards the market. As in many European countries, Spain's pay-as-you-go pension system is in desperate need of reform. Increased life expectancy and rapidly declining fertility rates mean that, while Spain has a longer grace period due to its relatively recent development, when the demographic crunch comes, it will be at least as severe as anywhere else in Europe. Wide-reaching reform of the pension system is imperative, yet the prospects look bleak.

Spain is a sunny nation, but the sun is unlikely to shine upon reforms anytime soon. However, it must not be forgotten that Spain is one of the three oldest nations in Europe, and that if it retains its sovereignty, the sun will one day shine again.



SWEDEN

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Sweden is sometimes regarded as the model welfare state. After all, Sweden did go first and farthest in the direction of big government dedicated to providing welfare services and social security. Tax pressure as a share of GDP rose from 20% in 1950 to 50% in 1980, and today it lies at around 53%. Around 40% of total public expenditure consists of income transfers within the social security system, and another 30% funds welfare services.

This model of society contributed in large part to a long period of weak economic growth. Between 1970 and 2000, Sweden fell from 4th to 14th place in the OECD's economic prosperity league table. This created a momentum for reform, and in the last 15 years, Sweden has periodically assumed a leading role in market-oriented

In the public services, steps were taken in the traditionally politically-sensitive areas of pensions, education & healthcare

economic reforms. For example, both the City and County of Stockholm have been willing to experiment by removing services from the purview of public monopolies.

There are several reasons why these reforms took the form that they did. The global renaissance of market liberalism in the 1980s naturally had an influence, as did the subsequent growth of free trade within the European Union and the increasingly globalised nature of society. However, the everyday reality of inefficient, centralised, highly regulated systems was also powerful. Yet confronted with these two phenomena, most of the market-oriented reform which lifted Sweden from 41st in the Economic Freedom of the World Index in 1985 to 22nd in 2004 only took place following the last minute acquiescence of the traditionalist factions of the major parties.

Significant reforms were undertaken in a number of crucial sectors. Substantial deregulation has occurred in the markets for financial services, electricity, media and

telecoms, and Sweden is now pushing for commensurate deregulation in other EU member states. Subsequent governments also capped total spending and reiterated their intention to maintain a balanced budget. This has meant that, despite periodic attempts by certain governments to overspend, a prevailing ethos of fiscal discipline (and an independent Central Bank committed to price stability) has vastly improved the state of the public finances.

In the public services, steps were taken in the traditionally politically-sensitive areas of pensions, education and healthcare. After ten years of negotiations, all the political parties except the Greens and the ex-Communists agreed to put an end to the pay-as-you-go pension system. Public pension levels were reduced substantially and now the system is funded partially through personal accounts. In education, a voucher system was introduced in the early 1990s which made it possible to take the cash equivalent of the cost of educating your child in the public sector and use it to enrol them in any school. This system of free choice is largely still in place. Healthcare also saw significant reforms, as private enterprises were offered tenders in public sector health and elderly care. As a consequence, around 10% of both sectors are now run by private companies, and although healthcare remains publicly financed, around 290 healthcare companies are now operating in Stockholm alone.

A SLOWING OF THE PACE

This period of rapid reforms seems, however, to have ended. Over the last 5-10 years, successive administrations have only scratched the surface of the remaining apparatus of big government. Mirroring the experiences of many other liberalising nations, once the initial reforms of the late 1980s and early 1990s brought about a period of much stronger growth, popular

pressure for further reaching reforms faded quickly.

The gridlock of the current parliament, led by a minority Social Democrat government unable to legislate without significant support from the Green and the post-Communist parties, offers little hope for market-oriented reform in the near future. This barrier to reform now also exists at the municipal levels after the Social Democrats' victory in Stockholm in 2002.

It even appears that at a national level, steps may be taken to reverse some of the earlier liberal measures. The government has proposed a 'stop-law', which would prevent private healthcare companies from entering the public market in the future, and could be used to force the closure of three large private hospitals. Indeed, the government is proposing to create a new post of a Minister of Social Planning – hardly a step in the direction of market reform.

The opposing, non-socialist alliance of four parties is united on an agenda of quite limited change to the status quo. The extent of their lack of ambition is evident in their spending proposals for 2007, where total spending is set at only 2.5% less than the current government's. However, some of their proposals to reduce government contributions and encouraging employment have some merit; currently, only 3m out of a total of 9m Swedes are gainfully employed. The use and abuse of sick-leave has exploded, and the work ethic has eroded. Over 60% of the adult population is dependent on the public sector to support themselves.

In these circumstances, very little reform of any consequence is likely to occur before the next general election in September 2006, but there is light at the end of the tunnel. Two important committees have been created by the government, both of which, provided they obtain sufficient political backing, may table bold proposals for reform and open up the debate about changes for the future.

The Committee on Public Responsibility has been given a very wide mandate: to propose a new structure, through research,



discussions and evaluations, for the entire public sector. It has, at least initially, received broad cross-party support. At the core of its mission lies the issue of what the extent of public responsibilities should be, and at what level relevant decisions should be taken.

Similarly, Prime Minister Göran Persson personally oversaw the formation of a Committee on Social Security. Inspired by the earlier round of pension reform, the Prime Minister has stated that while pension systems were to remain partially funded by the state in the future, the level of funding is likely to be vastly lower than today's punitive rates – up to 80% of an individual's salary. Proposals likely to be mooted include private negotiations between employees and employers over pension contributions and the promotion of personal savings accounts. But tellingly, this Committee is not scheduled to present its conclusions and recommendations until one month after the next election.

The vast majority of Swedish political parties are fearful of losing voters to populist and traditionalist candidates, and are consequently unwilling to alter the prevailing tone of protectionist and statist political rhetoric. However, some reforms are likely after the election because most mainstream politicians – from the left to the right – recognise the need for change: very high taxes cannot be maintained in a globalised world. The majority of the population cannot live off the work of a

few. Citizens are becoming increasingly demanding of public services, and more consumerist in their relationship with the state. Only a more independent means of financing the public services will provide sufficiently for this changing relationship. Despite this realisation, Sweden's risk-averse politicians are likely to wait until the situation gets worse before they enact significant reform.



UNITED KINGDOM

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Under the premiership of Margaret Thatcher (1979-90), the United Kingdom pioneered reforms to a sclerotic public sector. The received wisdom was that reforms such as privatisation were the unrealistic fantasy of a few swivel-eyed ideologues. But her government's determination to change the rules of politics, and to embed reform as the sine qua non of good governance, meant that what were once seen as wildly controversial measures have now become commonplace, and not merely in the Western world. So greatly did she transform British politics that today both main parties in Britain seek to be judged on their reformist credentials.

Indeed, the real mark of her success was the transformation in Labour thinking. When Labour won power again in 1997 it did so precisely because it was no longer Old Labour but New Labour. The slogan meant something specific: that it accepted the bulk of the Thatcherite reforms. Baroness Thatcher's political legacy lies in shifting the political centre ground from the so-called Butskellite approach of the 1950s onwards, with its ratchet to the left, to a new consensus which accepts the market and competition as the default position of political and economic life. (Indeed, in 1995, Labour's internal constitution was changed, from a commitment to nationalisation to an embrace of the market, to reflect this shift).

In July 2004, the Labour government published the findings of a review committee chaired by Sir Peter Gershon, "Releasing Resources for the Frontline: Independent Review of Public Sector Efficiency". The Gershon Report was emblematic of how British politics had changed forever. A Labour government had set up a committee to examine "further efficiencies... within the public sector's back office, procurement, transaction service and policy-making functions" – an act unthinkable just a few years before. Recommending a reduction of over 80,000 civil service posts, and the relocation of 20,000 posts out of London and the South East – which was welcomed in its entirety by the Chancellor, Gordon Brown – Sir Peter claimed that efficiency programmes would deliver savings of over £20 billion a year by 2007-08. The 2004 Budget announced that the government was aiming to achieve an overall efficiency target of 2.5% a year for the whole of the public sector for the 2004 Spending Review period, a figure derived from the Gershon review of public sector efficiency.

But Sir Peter was not alone. The Conservatives had also set up a similar committee under the city businessman, David James, and while the former report was mainly concerned with wringing extra efficiencies from governmental activity, the James Committee had a wider remit, recommending a series of cuts in that activity itself, and proposing what it calculated as a £35 billion saving in "wasteful" public spending. Whatever the accuracy of the James Committee's figures – and they were greeted with much scepticism from impartial experts – the real point was that both parties were engaged in a competitive bidding process to demonstrate to the electorate that they were best charged with the task of reducing the size of the public sector and civil service. Truly, British politics now plays to very different rules.

Not that there was ever any doubt. Since New Labour took power in 1997, it has been, in some senses, a classic tax-and-spend social democrat government; indeed, it has taxed and spent at record levels. But it has also adopted a series of unprecedented reforms in public service delivery; unprecedented, that is, not merely for Labour but even for the Conservatives.

Take the NHS, which exemplifies Labour's approach to reform. On the one hand, the government's policy has been to spend as much as is physically possible on healthcare. Labour's basic premise is simple: there is nothing fundamentally wrong with the NHS idea – a comprehensive, universal, state funded system. The problems are a result of under investment, inefficiency and hopeless management structures. The answer is therefore relatively simple: to spend as much money as possible and reform the delivery mechanisms. Thus in January 2000,



Tony Blair promised to increase health spending in the UK from 6.7% of GDP to around 9% (the then EU average). He has been as good as his word: by 2007-08, Labour is due to spend 9.4% of GDP on the NHS – £105.6 billion (a real terms doubling since Labour took office). Indeed, this spending bonanza means that the NHS will soon be responsible for 0.35% of the entire world's measurable GDP.

But there is, as Labour now sees, a flaw in the plan. Since 1997, spending on the NHS has already risen by 40% in real terms. Yet activity has increased by a paltry 6% – a pretty awful return on any investment. Between 1999 and 2000 alone, spending rose by 9.2%, but the number of cases dealt with increased by only 1%.

All patients, in other words, are to be given a choice as to where they are treated

The Scottish experience is even worse. Despite NHS spending levels that have long been 20% higher per person than in England, with over 30% more specialists, nurses, GPs and acute beds (relative to the two populations), waiting lists in Scotland are far longer than in England, waiting times are getting worse, and death rates for heart disease, cancer and strokes are amongst the worst in the Western world. Money alone, it has been comprehensively revealed, is not the answer.

The NHS reforms show that this is what one might call a 'Market Leninist' government. On the one hand its answer is to give the state even more power, in the form of ever increasing spending, and to channel that power through an 'NHS Plan', as the document charting this course is called.

But since, on the other hand, Labour's analysis of the problem of healthcare was that too little money was being inefficiently spent, that meant that as well as increasing

spending it needed also to introduce a market mechanism and competition within the system. Thus, having arrived at power in part because of attacks on the Conservatives' internal market, it then went further, introducing, for instance, foundation hospitals – intended as self-governing quasi-independent bodies within the NHS.

Yet foundation hospitals are emblematic of Labour's approach more generally: great ideas, terrible delivery. In theory, foundation hospitals were a wonderful idea; in practice, the need to win support from the more antediluvian elements amongst the party's MPs were meant that the original idea was so watered down as to be almost entirely symbolic.

Foremost amongst those oppositional elements – and certainly the greatest obstacle to reform – was the Chancellor of the Exchequer, Gordon Brown. A former Health Secretary, Alan Milburn, identified a chasm in the government between 'transformers' – those (such as he and the Prime Minister) who wanted to introduce bold market based reforms – and 'consolidators' – those (such as Gordon Brown) who wanted, in effect, to spend more money and then leave alone. The story of public sector reform has been one of transformers making the running, only to be frustrated by the Chancellor. This has been Labour's fundamental problem.

There are, though, positive signs. In health, once more, the government has introduced a voucher system (albeit under another name). As Mr Milburn put it, when introducing the idea: "From December 2005, by when extra capacity will have come onstream, choice will be extended from those patients waiting longest for hospital treatment to all patients. They will be offered choice at the point the GP refers them to hospital. Patients needing elective surgery will be able to select from at least 4 or 5 different hospitals, again including both NHS and private sector providers".

All patients, in other words, are to be given a choice as to where they are treated, and

by whom – including private hospitals. The cost of their treatment will be quantified and made available to competing healthcare providers: tariffs are to be set for procedures, and anyone who so wishes will be able to compete for that business. And the patient will be given the choice as to where to go.

That is the essence of the voucher, first enunciated by Milton Friedman in 1955, that was announced by Mr Milburn to zero fanfare. It was almost as if he was ashamed of it. If the rhetoric is backed up by action, it is revolutionary stuff indeed. The NHS has been the archetypal system of socialised healthcare, with patients directed where to go and when, within a state funded, state administered, state governed system, by doctors who are in turn directed by bureaucrats as to where and when they can have their patients treated. These NHS reforms exemplify all the other aspects of the government's reforms. Education reforms, too, are intended to bring about more choice through expansion (this time via the introduction of specialist schools, City Technology Colleges and other new types of school).

The main criticism of Labour's reform programme must be that it does not go far enough. Yet given the party's historic role, and the mindset of many of its members, this might perhaps best be considered an accolade rather than a criticism.

APPENDICES

APPENDIX I

Industry shares owned by the Irish State (Source – www.irlgov.ie/organisations/)

Company	State-Owned Assets (Million €, 2003)	Comments
Electricity Supply Board (ESB)	5,514	Monopoly provider of electricity. ESB came under criticism for restrictive practices in granting access to the grid.
Coillte	1,156	Forestry holding with a role in rural employment. Environmentalists and unions resist privatisation. The sector is being primed as a state-controlled outlet for CAP reforms.
CIE	1,124	A near-monopoly in public transportation facing limited competition on bus routes and light rail operations.
Voluntary Health Insurance (VHI)	994	
Irish Gas Board	937	Monopoly in gas distribution. Perceived to be a strategic asset.
Aer Lingus	595	In summer 2004 pressured by the unions, the government rejected any possibility of the airline privatisation.
Aer Rianta	586	Airports management monopoly that was broken up in 2004 into 3 regional monopolies. Since 1999 the government is considering a privately financed independent terminal in Dublin Airport, resisted by Aer Rianta despite severe constraints on air traffic capacity.
An Post	241	Over the last three years the postal service sustained losses despite frequent large-scale price increases.
BNM	203	A monopoly peat producer.
Shannon Development	184	A regional development body that serves as an avenue for subsidisation of the western regions.
RTE	76	State-owned television and radio provider with 50% market share.
Sea Ports (8 in total)	73	Despite the UK success with privatisation of ports, there is little hope for privatisations in the Republic.
Irish Aviation Authority (IAA)	61	Air traffic control monopoly operating under favourable conditions of increased air-traffic revenues.
Aramara Teo	>20	A seaweed producing monopoly, 82% state-owned, operating in the subsidy-reliant areas of the West.
National Stud	13	State involvement in the horse breeding industry is linked to the political interests in the industry.

APPENDIX 2

Slovakian Pension Benefits (p.a.) prior to and following the 2004 pension reform. All figures in Slovak Korunas (SKK).

Ratio of Wage to Average wage	Pre-Reform (2003)		Post-Reform (2007)	
	36 years Employment	42 years Employment	36 years Employment	42 years Employment
0.6	6375	6870	4310	5029
1.0	6928	7480	7184	8381
1.5	6928	7480	10776	12572
2.0	6928	7480	14368	16762
2.5	6928	7480	17960	20953
3.0	6928	7480	21552	25143