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## ECONOMIC REFORM IN EASTERN EUROPE: A REPORT CARD

### INTRODUCTION

It is over two years since Poland became the first East European nation to adopt decisive free market economic reforms. Since then, all the other formerly communist nations of Eastern and Central Europe have begun taking steps to transform their command economic systems into market-driven economies.<sup>1</sup> Czechoslovakia and Hungary already have had substantial success. In Romania and Albania, progress has come more slowly. Transforming former communist economies into smoothly running market systems is complex and daunting. Yet on its success rests the economic survival not only of Eastern Europe, but also of the states of the former Soviet Union, which anxiously are watching Eastern Europe for clues to their own future. Ultimately the advanced industrial countries, the United States included, have a stake in Eastern Europe's success, since the West's short-term economic recovery and longer-term economic health inevitably will be jeopardized by serious economic distress in the East.

Before Poland's lunge toward a market economy, little was known about the best way to transform centrally planned economies into free market systems, since it never before had been tried. Until 1990, nearly all the transforming had been in the opposite direction, from free markets to communism; and this was accomplished at the point of a gun.

**Profound Effects.** Poland's radical reform program, somewhat ominously called "shock therapy" is nothing quite so dramatic, but its effects have been equally profound. The Polish model, which set the standard for the rest of Central and Eastern Europe and the former Soviet republics, emphasizes rapid transformation. Its basic elements include: freeing prices, eliminating most barriers to trade, making local currency partially convertible to Western currency, slashing government subsidies to state industries, bringing down inflation, and reducing budget deficits.

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1 Czechoslovakia, Hungary and Poland generally are considered part of Central Europe, while the Balkan countries of Albania, Bulgaria, and Romania along with the Baltic states of Estonia, Latvia, and Lithuania constitute Eastern Europe. The Baltic countries will be analyzed separately in a future *Background*.

Other Central and East European countries spent most of 1990 closely watching the fate of reforms in Poland, preparing economic legislation, and fine-tuning their own reform plans based on what they saw.

The objective for Eastern Europe is no less than to replace old, inefficient state-dominated economies with entirely new economies based on market relationships. Partial transformations merely will leave these countries in economic limbo, with the dead weight of the remaining socialist elements a permanent drag on market forces and economic expansion. The measure of their success lies not in such economic indicators as living standards and production, which cannot paint an accurate picture during a period of rapid transformation, but in how well the government is creating the conditions for economic change by freeing markets. Only this leads to growth and prosperity. Ultimately these efforts must be taken as a whole, since success in one area can be jeopardized by a failure to act in another. Example: freeing prices without substantial privatization of state-owned enterprises and deregulation allows state producers to exert temporary monopoly power, thereby hurting consumers and the newly emerging private sector, which relies on the state sector for supplies.

The criteria for judging the economic performance of East European governments include:

- ◆ **Price Liberalization.** Price liberalization, or an end to the communist practice of government-set prices, is a necessary precursor to the establishment of a market economy. A market cannot function without free prices, since price is the basic mechanism for mediating supply and demand. If prices are fixed by the government, there is no incentive to produce efficiently, and no competition—the lifeblood of free markets.
- ◆ **Monetary Policy.** When the money supply is expanded irresponsibly through easy credit, subsidies, borrowing, and printing more money, the inescapable outcome is a rapid rise in inflation. Political pressures in Eastern Europe, for instance, from unions and legions of government workers, can be intense to finance budget deficits and raise state wages by printing and borrowing more money. Unless government officials resist these pressures and show decisive restraint in money supply, Eastern Europe will face the destiny of many Latin American countries, which have struggled with hyperinflation and economic stagnation for years.
- ◆ **Currency Convertibility.** For foreign businesses to invest in Eastern Europe, they first must believe that they can make a profit and take this profit home. This means, eventually, that they will be able to convert, or trade in local East European currencies for hard Western currencies, like the dollar and yen, that are usable on world markets. No East European country had a currency that was even partially convertible before 1990.
- ◆ **Fiscal Policy.** Even in free market economies, governments themselves are major economic players. In the U.S., for example, estimated total government spending for 1992 accounts for approximately 25 percent of total output, or gross domestic product (GDP). All Eastern European countries

inherited huge budget deficits from their communist governments. Fiscal deficits are a direct cause of inflation in Eastern Europe because governments generally pay for these deficits by printing more money. Deficits need to be eliminated, or greatly reduced, through massive cuts in consumer and enterprise subsidies and other spending cuts that reduce the distortionary role of government in the economy.

The wrong way to reduce budget deficits is through tax increases, which merely add to the already enormous tax burden on businesses and individuals, thereby slowing economic growth by discouraging hard work, savings, investment, and the production of goods and services. In fact, tax increases in the long run could lead to declining tax revenues, because slower growth results in fewer businesses and individuals to tax. High taxes in developing economies also drive businesses into the informal, or "gray" economy, where they pay no taxes.

- ◆ **Trade, Debt, and Foreign Investment.** The experience of the Asian Tigers of Hong Kong, Singapore, South Korea, and Taiwan, has shown that the fastest way to growth and prosperity is via an economy open to the world. Free trade allows foreign producers to compete against domestic state monopolies, thereby increasing competition and lowering prices for consumers. Trade too increases the amount of hard currency available to pay off foreign debt. A shortage of domestic savings and capital also makes it important for East European countries to attract substantial amounts of foreign investment in order to modernize inefficient factories and build up decaying roads, airports, communications networks, and other infrastructure.
- ◆ **Privatization and Legal Reforms.** Among the most needed changes in all post-Communist countries is the privatization of state assets and establishment of clear, secure, and fully transferable private property rights. Private property is the foundation of the market system. The more comprehensive and rapid the privatization process in Eastern Europe, the sooner Eastern Europeans can expect economic recovery. Only through private ownership can they increase efficiency and competition, make managers responsive to market rather than political forces, put resources to their most productive uses, and cut the size of government. Other important legal reforms are those that facilitate market activity. Laws on banking, bankruptcy, business, and foreign investment must be adopted, and new commercial codes should be created as soon as possible.

In making the transition to market economies, some of the Central and East European countries have moved more quickly and decisively than others. The countries with the highest grades in this report card are on the cutting edge of economic reform and setting the pace for others to follow.

## Report Card on Economic Reform in Central and Eastern Europe

Country	Grade	Comments
Albania	I	Reforms didn't begin until late summer 1991. Economy and industry is in shambles. On the bright side, new democratic government is committed to radical reform, and agricultural land privatization has been nearly completed.
Bulgaria	C+	Great strides last year. Prices mostly freed, inflation down substantially, trade liberalized, and taxes on business cut dramatically. Privatization, however, is virtually non-existent.
Czechoslovakia	B-	Inflation and budget deficit both very low. Mass privatization program is most ambitious in region. Private enterprise is still hampered by high taxes and heavy regulation.
Hungary	B	Most attractive climate for foreign investment. Inflation has been brought way down, privatization is accelerating, and trade barriers significantly reduced. Taxes are still much too high.
Poland	B-	After a quick start, reforms have slowed. Foreign investors encounter many bureaucratic and political obstacles; trade protection on the rise; and privatization program has suffered many delays. On the bright side, the growth of the private sector has been phenomenal.
Romania	C-	Political instability has hampered reform. Taxes are very progressive and prohibitively high; and property rights still unclear. Privatization plan is ambitious, yet little results so far.
Yugoslavia Croatia Serbia Slovenia	I — — —	Civil war has wreaked havoc on republics. Reforms have progressed the furthest in Slovenia, the richest and most westernized of the former Yugoslav republics.

**Note:** A = Excellent; B = Good; C = Average; D = Poor; I = Incomplete.  
**Source:** William D. Eggers, The Heritage Foundation.

# HUNGARY

## Grade: B

Thanks in part to free market Finance Minister Mihaly Kupa, Hungary last year abandoned its gradual approach to economic transformation and now has overtaken Poland as the region's leading reformer.

From 1968 to 1989, the communist Hungarian government enacted a series of cautious market-oriented reforms that did nothing structurally to break the state's stranglehold on the economy. Enterprise decision making was decentralized, tax laws were changed to resemble those in the West, foreign investment laws were somewhat liberalized, and limited private enterprise was legalized.

After Hungary's 1989 revolution, the new Budapest government moved slowly at first, and last year began its ambitious program to move rapidly to a market economy. The government has liberalized prices and trade, tightened monetary policy to reduce inflation, begun privatizing state enterprises, eliminated nearly all enterprise subsidies, and cut the budget deficit.

According to official statistics, real income fell 1.6 percent in Hungary in 1990. Figures for 1991 are expected to show even further declines, although these statistics are misleading because they fail to measure much private sector income and improvements in the quality and quantity of goods available to consumers. This year the economy likely will grow modestly, but could grow between 5 and 7 percent next year.

To be sure, the state sector of the economy in Hungary is in recession. Public sector production decreased by 18 percent last year, as inefficient state industries began to fail. The private sector, by contrast, is booming, benefiting from foreign investment and increases in exports to the West. According to a German study, production in the private sector increased by over 25 percent last year.<sup>2</sup> Over the past year and a half, over 500,000 private companies have been created in Hungary and forty private banks have opened, many with foreign partners.

**Price Liberalization and Monetary Policy.** Much of Hungary's success is due to the end of price controls combined with effective control of the money supply. Price controls have been eliminated on 90 percent of goods, though controls remain on housing, heating oil, and a number of other items considered by the government as too politically sensitive to subject to market forces.

Economic Report Card for Hungary	
Price Liberalization and Monetary Policy	Good
Fiscal Policy	Average
Trade, Debt, Foreign Investment	Good
Privatization and Legal Reforms	Good
Overall Grade	B

<sup>2</sup> "Hungary's Impressive Performance," Deutsche Bank Economics Department, *Focus Eastern Europe*, December 1991.

As price controls have been lifted, the Hungarian government successfully has waged a full-scale battle on the resulting inflation. Prices jumped 39 percent last June due to cuts in subsidies to state enterprises and consumers, and higher energy prices. However, a tight monetary policy and competition from lower-cost imports now are pushing inflation down. Real inflation, in contrast to one-time price hikes resulting from removing state price controls and subsidies, is down to around 1.5 percent a month.<sup>3</sup>

Another side effect of the tight monetary policy is increased savings due to lower inflation and higher interest rates. Savings are four times higher than two years ago, now equaling over 10 percent of earnings.<sup>4</sup> The new savings are creating a pool of capital that will be available to finance new businesses and industries, sparking even higher growth rates.

Full convertibility of the Hungarian currency, called the *forint*, is expected by 1994. To achieve this, monetary policy will have to be further tightened to bring the black market rate, currently hovering around 85 to 90 forints to the dollar, more in line with the official exchange rate of 77 forints to the dollar. In mid-November 1991, the forint was devalued 5.5 percent against the German *mark*.

**Fiscal Policies.** The Hungarian government was not as successful last year with fiscal policy as with monetary policy. The goal is to curb significantly the state's oppressive role in the economy. Currently, 64 percent of Hungarian GDP goes through the state budget; Hungarians want to cut it to 57 percent by 1994.

Due in part to declining tax revenues from state enterprises, the Hungarian government budget deficit is expected to surpass 100 billion forints for fiscal 1992, or about \$1.3 billion at current exchange rates.<sup>5</sup> Nevertheless, the government is trying to rein in spending. Overall, subsidies for state enterprises and consumers were cut from 13.4 percent in 1987 to 4.6 percent of GDP by the end of 1991.<sup>6</sup>

The government is facing rising political pressures to ease its plans for fiscal restraint. Increases in the cost of living have prompted calls from labor unions and members of parliament for state-sector wage increases. If the government gives in to this pressure, however, it will raise the cost of doing business and force firms to cut costs, driving up unemployment. There also are calls for a comprehensive, West European-style social safety net in the form of a massive spending program that further would jeopardize economic reform and increase government's indebtedness.

Hungary has been reforming its tax system since 1987, thus giving it the most West-ern-oriented tax structure in Eastern Europe. The problem is that Hungary has adopted some of the worst aspects of Western systems such as high, progressive income taxes and corporate taxes filled with dozens of loopholes. Until very recently, Hungary's Swiss cheese approach to tax reform offered a host of tax incentives and concessions for preferred industries on top of high standard tax rates. The result was a complicated

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3 Nicholas Denton, "Economic Progress: Ahead of Schedule," *Financial Times*, October 30, 1991.

4 *Ibid.* p. III

5 "Finance Minister Presents 1992 Budget Draft," MTI Radio (Budapest), December 10, 1991.

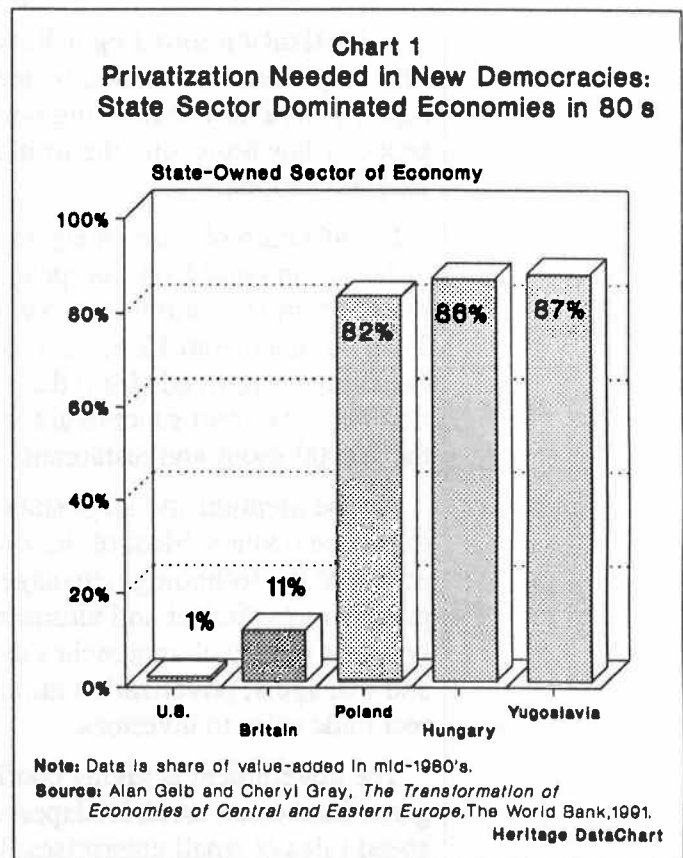
6 "State Subsidy Removal Process to Continue," MTI Radio (Budapest), December 12, 1991.

and seemingly arbitrary tax structure. Until this year, domestic businesses faced steep profits, payroll, and social security taxes, while businesses with foreign capital of at least 5 million forints, or around \$660,000, received a 20 percent tax rate reduction.

Recently the government reversed course on its tax policy toward foreign investors. In December the parliament passed legislation that would phase out tax incentives for foreigners. Between its complicated and inconsistent tax code, and shifting tax ground rules, Hungary has made it difficult for business to plan for the future, thus discouraging business development and investment. Instead, Hungary should tax all individuals and businesses at low, uniform, flat rates.

**Trade, Debt, and Foreign Investment.** Trade and foreign investment are two particularly bright spots in the Hungarian economy. An attractive foreign investment law that grants tax preferences to foreign investors and allows companies to take profits out of the country without government authorization, combined with a privatization program open to foreigners, makes Hungary the most popular East European country for foreign investors. Two-thirds of all foreign investment in Central and Eastern Europe, or over \$2 billion, has flowed to Hungary.<sup>7</sup> This foreign investment, together with a substantial increase in Western trade and tourism, earned \$11 billion to \$12 billion of hard currency for the first three quarters of 1991.

As in the rest of Eastern Europe, the Hungarian economy was jolted severely by external economic shocks: the collapse of the Soviet economy, the breakdown of the COMECON East bloc trading group, and Gulf war oil price rises. Economists estimate that these shocks wiped out nearly 30 percent of Hungary's hard currency reserves, while the Gulf crisis accounted for \$700 million in higher energy bills. Despite these shocks, Hungary's 1991 external trade performance was strong. Reason: trade with the West grew by 40 percent the past two years, most of it driven by newly created small and medium-sized private Hungarian companies, even as trade with the East dropped by 60 percent.<sup>8</sup> As a result of the shift to Western



<sup>7</sup> "Survey: Hungary," *Financial Times*, October 30, 1991, p. 1.

markets, Hungary posted a trade account surplus in the \$300 million to \$500 million range in 1991.<sup>9</sup> Trade with the West was aided by a cut in the average tariff rate from 16 percent to 13 percent; 99 percent of applications for permission to import restricted Western consumer goods were granted in the first half of 1991, and licenses now are required for only 10 percent of imports. Certain industries, however, continue to be protected from foreign competition by quantitative restrictions on imports.

Hungary's foreign debt is the highest per capita debt in Eastern Europe. Annual payments on the \$19.7 billion principal will vary between \$2 billion and \$3 billion from 1991 to 1996.<sup>10</sup> However, strong growth in hard currency exports has increased substantially Hungary's capacity to service its debt from foreign currency earnings.<sup>11</sup> To date, the government has refused to reschedule this debt and so has retained the confidence of private investors. Hungary spent \$2.6 billion on debt payments last year.

**Privatization and Legal Reforms.** Laws important to the functioning of a market economy have been passed by the parliament. These include a Western-style bankruptcy law, a new accounting law in line with European standards, and an intellectual property law protecting the form and structure of semiconductor designs and lower-level inventions.

Privatization of state enterprises and other assets is moving somewhat faster in Hungary than in other East European countries. It still, however, must accelerate to realize the government's ambitious goal of privatizing 50 percent of the economy by 1995. Thus far, only from 12 percent to 15 percent of state holdings have been privatized. Government proceeds from the sales total a little over half a billion dollars. Privatization has been most successful for small and medium-sized businesses. About 8,000 of the 10,000 shops and restaurants up for privatization last year were sold.

Of the medium and large state enterprises, 330 out of 2,200 eligible have been sold to private owners. Most of these were sold in whole or part to foreign investors with access to the technology, managerial expertise, and foreign capital to make the enterprises more efficient and ultimately profitable. The State Property Agency (SPA) relies on a variety of approaches to speed privatization, including buyouts by employees and managers, privatization initiated by investors, stock offerings to the public, and direct trade sales to investors.

The government is giving conflicting signals over the future of privatization in Hungary. On the one hand, Budapest announced in October a new privatization method to speed sales of small enterprises. Termed "self-privatization," enterprises can find investors themselves and then need only apply for approval to one of eighty state-approved privatization consultants, rather than through a centralized, bureaucratic agency. The process, in effect, excludes the SPA from the negotiation process, its only function being the approval or rejection of individual privatization proposals. The first

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8 "Kadar Predicts Turning Point in Foreign Economy," MTI Radio (Budapest), December 18, 1991.

9 "Hungary's Impressive Performance—A New Partner in the International Economy," Deutsche Bank Economics Department, *Focus Eastern Europe*, December 1991.

10 "Fluctuations Noted in Repayable Foreign Debt," *Nepszabadsag* (Budapest), December 11, 1991, p. 1.

11 "Hungary's Impressive Performance," Deutsche Bank Economics Department, *Focus Eastern Europe*, December 1991.



phase of self-initiated privatization started in 1991; and out of 404 enterprises included in the initial program, 266 have been approved by the SPA; and 39 already are in private hands. The second phase of Hungary's self-initiated privatization program, scheduled for this spring, will include 300 companies, valued at approximately \$950 million.

However, a discouraging development is that Karoly Szabo, deputy director of SPA and a strong proponent of fast privatization, resigned in late December over policy differences with the government. According to Szabo, Prime Minister Joseph Antall's government favors keeping profitable state enterprises in state hands as a means of earning revenue.

## POLAND

### Grade: B-

Poland, the country that introduced economic "shock therapy" to the world in 1990, slowed its rapid pace of reform last year under tremendous pressure from such political interest groups as farmers, trade unions, and state enterprises. Foreign investors are frustrated by myriad obstacles and the once promising privatization program has been stalled for months. Nevertheless, Poland has made great strides in the last two years, especially in the development of the private sector.

In January 1990, Polish Finance Minister Leszek Balcerowicz initiated a sweeping economic reform program. This included price and trade liberalization, monetary stabilization, drastic cuts in subsidies to state enterprises, a balanced budget, partial currency convertibility, and a one-time massive devaluation of the Polish *zloty* from 700 zlotys to the dollar to 9,500 to the dollar.

This shock therapy brought immediate results. A \$4.5 billion trade surplus was registered with Western Europe in 1990. Inflation was brought under control, the budget was slashed, goods of all kinds were in the shops and streets of Polish cities, and the private sector has boomed.

Despite these successes, however, political pressures threaten to derail Poland's economic transformation. Reform largely came to a halt following the October 28, 1991, general election in Poland, when the two parties dominated by ex-communists, the Democratic Left Alliance and the Peasants' Party, picked up 21 percent of the Polish vote. The right-of-center coalition of parties now running the government, led by Prime Minister Jan Oleszewski, put forward an economic reform plan this February that reverses free market reform in some areas by easing the fight against inflation, assisting ailing state industrial enterprises with subsidies and providing price and credit

<b>Economic Report Card for Poland</b>	
<b>Price Liberalization and Monetary Policy</b>	Good
<b>Fiscal Policy</b>	Average
<b>Trade, Debt, Foreign Investment</b>	Average
<b>Privatization and Legal Reforms</b>	Average to Good
<b>Overall Grade</b>	<b>B-</b>

subsidies to farmers. The plan was criticized heavily for opposite reasons by free market liberals in the Liberal Democratic Congress Party and the former communists in the Democratic Left Alliance. It was rejected by the Polish parliament, the *Sejm*, in March. The government's wavering political commitment to economic reform, coupled with a wave of xenophobia, already is slowing the flow of critically needed foreign investment into the country.

Not surprisingly, the state sector is declining rapidly in Poland. Production in the state sector dropped 25 percent in 1990 and was down another 15 percent last year.<sup>12</sup> Still, as in Hungary, official statistics exaggerate the real drop in production. Also as in Hungary, the drop in state output is made up to a large degree by a dramatic upsurge of private business. Over 1.15 million new private small businesses and 30,000 private companies have been created in Poland since market reforms were introduced. In the first nine months of 1991, the number of small and medium-sized private businesses increased by almost 250,000, amounting to a 20 percent increase, and 110 private banks now are operating.<sup>13</sup>

As in the U.S., many of these new start-up businesses and companies failed in 1990 and 1991, but some have succeeded.<sup>14</sup> Excluding agriculture, the total output of the private sector was 26 percent higher in 1990 than 1989.<sup>15</sup> Private sector retail sales soared by 4.5 times in 1990, while private sector industrial output increased 8 percent.<sup>16</sup> By the end of 1991, the private sector accounted for 20 percent of total industrial sales and 45 percent of all employment.<sup>17</sup>

Officially, unemployment now stands at 2 million, or about 11 percent of the work force, but according to Polish economists only about half of the registered unemployed actually have lost their jobs. The rest are private entrepreneurs trying to augment their incomes, or housewives supplementing family income with unemployment benefits. Demand for skilled labor remains strong, leading to almost zero unemployment in many of the largest cities.<sup>18</sup>

**Price Liberalization and Monetary Policy.** Nearly all prices, including energy prices, now have been completely freed. Inflation, which reached 600 percent in early 1990, was brought down to 60 percent last year by sharply slowing money supply growth. The new center-right coalition government puts much of the blame for Poland's lingering recession, however, on the tight money policy, and repeatedly has pledged to ease money supply growth. Such a policy would risk renewed inflation and therefore slow the growth of private enterprise and savings.

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12 "Poland: Facing a Dual Economy as Elections Approach," Deutsche Bank Economics Department, *Focus Eastern Europe*, October 7, 1991.

13 "Planning Office Reports Private Sector Growth," *Gazeta Wyborcza*, December 12, 1991, p. 3.

14 *Poland: International Economic Report 1990/1991*, World Economic Research Institute, Warsaw School of Economics, 1991, p. 64.

15 Most of the increase came in trade, not production. Production output of the private sector grew 8 percent in 1990.

16 Paul Hare and Irene Grosfield, "Privatization in Hungary, Poland and Czechoslovakia," Centre for Economic Policy Research, *Discussion Paper Series*, No. 544, April 1991, p. 12.

17 "Poland: Facing a Dual Economy as Elections Approach," Deutsche Bank Economics Department, *Focus Eastern Europe*, October 7, 1991, p. 1.

18 *Ibid.*

**Fiscal Policy.** A growing budget deficit has emerged as one of the major economic issues in Poland and a source of conflict with the International Monetary Fund (IMF), jeopardizing the IMF loans that Poland relies on heavily to support its economic program. In the first quarter of this year, the deficit was \$1.6 billion, or 2 percent of GDP. This would translate to an 8 percent year-end deficit. This is unacceptable to the IMF, which is threatening to halt loan payments. In an attempt to appease the IMF and keep the deficit to 5 percent of GDP, the Polish government announced in late March that it would increase taxes. If the government follows through with this plan, it will further slow economic recovery by decreasing savings and investment.

Taxes in Poland already are very high. The social security tax was raised 2 percentage points in 1991, to 45 percent, and the Polish parliament is considering raising the top personal income tax rate to 50 percent. Private businesses must pay a 40 percent tax on profits, 20 percent tax on wages paid, and a "turnover tax," which is like a sales tax except it is levied at different rates depending on the product, ranging from 10 percent to 20 percent.<sup>19</sup>

**Trade, Debt, and Foreign Investment.** In 1990, Poland eliminated import quotas, lowered duties to between zero and five percent, and eliminated tariffs on 58 percent of all imports. This made it one of the economies in the world most open to imports. Poland's trade liberalization increased competition in the state-dominated Polish economy and brought prices down for Polish consumers and exporters. Partly as a result of the lower trade barriers, which enabled Polish companies to buy cheap imported components and thus reduce costs, Polish businesses increased exports by 50 percent in 1990.

In April 1991, however, Poland reversed course and began enacting protectionist trade measures. The average tariff on agricultural goods was raised from 9.8 percent to 19.3 percent and duties on finished tobacco products from 30 percent to 60 percent.<sup>20</sup> New customs barriers went into effect this January 1, including a 35 percent tariff on cars and a 90 percent levy on cigarettes. Quantitative restrictions, or import quotas, will apply to dairy products, and imports of hard liquor will be prevented altogether. Computers, video recorders, televisions, and cameras are now shielded with duties of 20 percent to 35 percent.<sup>21</sup>

Polish state officials also have restricted foreign investment by preventing foreign investors from buying profitable state companies. Last year, the Polish government held up a deal with Volvo for a truck factory until the company agreed also to take on a notoriously bankrupt truck factory in Starachowice. Foreign purchases of land must be approved by the Interior Ministry, and it virtually is impossible to buy a company without approval from the undermanned Ministry, for Ownership Transformation. Another bar to foreign investment is Poland's failure to reach agreement on debt with the

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19 William D. Eggers, "A Pro-Growth Tax Reform Agenda for Eastern Europe," Heritage Foundation *Backgrounders* No. 830, May 23, 1991.

20 William D. Eggers, "A Five-Plank Program for Trade and Investment with Eastern Europe and the Former Soviet Republics," Heritage Foundation *Backgrounders* No. 862, October 23, 1991.

21 "New Customs Tariffs Become Effective Early in 1992," TVP Television (Warsaw), December 13, 1991.

so-called London Club creditors — international banks which hold \$10 billion in Polish debts.

The Polish government has had considerable success in convincing the West to forgive or postpone payment on its large foreign debt. In February of this year, for instance, Germany forgave half of the \$5.5 billion debt Poland owed the German government.

**Privatization and Legal Reforms.** Municipal privatization of shops, stores, and restaurants has been carried out at a brisk pace. Around 80,000 formerly state-owned small businesses have been privatized. The government hopes to sell the remaining shops this year. Over 50 percent of the distribution network has been privatized and over 300,000 new stores have been opened.<sup>22</sup>

Although Poland has privatized nearly all of its retail trade, the state sector still counts for more than three-fourths of industrial production. Only 10 percent of Poland's state-run industrial companies have been sold. Last year, only 200 of over 3,000 state enterprises with between 100 and 800 employees were turned over to the private sector, and only nine very large enterprises have been completely privatized.<sup>23</sup> State enterprises are being privatized by a variety of approaches. These include direct sales to investors, buyouts of enterprises by management and employees, stock offerings to the public, and a much-publicized mass privatization program.

In the planned mass privatization program, Poland will try an innovative approach to privatizing state companies. Poland will privatize 200 enterprises — comprising one-fourth of Polish production — through a complex privatization scheme that would make 27 million Poles immediate shareholders. Controlling interests, in the form of shares, are to be transferred to between 15 and 20 privatization funds that would resemble U.S. mutual funds. Each Pole born before 1974 then would be given or sold at a significant discount a share in each mutual fund. The mutual funds, managed by Western investment firms, then would set about the task of restructuring and liquidating enterprises. After one year, shares in the mutual funds would be freely tradeable. The problem with Poland's mass privatization program is that too few companies are included and the government has played too great a role in the formation of the investment funds. The danger is that the investment funds simply could come to resemble state holding companies that the government would have to bail out at each sign of trouble.

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22 "The Progress of Privatization," Radio Free Europe/Radio Free Liberty Institute, *Soviet/East European Report*, Vol. VIII, No. 42, September 1, 1991, p. 4.

23 "Poland's Elections Put Economic Reforms to the Test," Deutsche Bank Economics Department, *Focus Eastern Europe*, November 1991.

## CZECH AND SLOVAK FEDERAL REPUBLIC

### Grade: B

Czechoslovakia inherited from the communist era one of the strongest economies of the former East Bloc. The Czech communists left behind little inflation and a low foreign debt, but they also passed on little experience with markets and almost no legal base for a market economy. Since the 1989 "velvet revolution," prices and trade have been liberalized, subsidies slashed, and the legal groundwork laid down for privatization. More needs to be done, however, to decrease the role of the state and encourage private enterprise, such as tax cuts, large-scale privatization, and deregulation. This month, Czechoslovakia plans a mass privatization campaign. If successful, it could catapult Czechoslovakia to the top of its class in Eastern Europe.

Czechoslovakia waited until last year to embark fully on an ambitious economic reform program. To be sure, the government of President Václav Havel, under the eco-

nomic direction of Finance Minister Václav Klaus, enacted a few reforms in 1990. Most food subsidies were eliminated, land prices and commercial property prices were liberalized, credit and fiscal policy were tightened; and critical laws on joint ventures, small business, and privatization were passed. Nevertheless, compared to Poland's shock therapy, Czechoslovakia's initial approach was timid.

### Economic Report Card for the Czech and Slovak Federal Republic

<b>Price Liberalization and Monetary Policy</b>	Good to Excellent
<b>Fiscal Policy</b>	Average to Good
<b>Trade Debt, Foreign Investment</b>	Average
<b>Privatization and Legal Reforms</b>	Average to Good
<b>Overall Grade</b>	<b>B</b>

One reason for Czechoslovakia's slow start was that the country enjoyed one of the highest living standards among the former East Bloc countries and a very low rate of inflation. This left little incentive to move as quickly, for example, as did Poland, which was experiencing hyperinflation. Further, the government was split about the desired pace and extent of the transition to a market economy. The social democratic wing of the ruling Civic Forum government still talks about a "third way" between socialism and capitalism, even as Klaus and his free market supporters argue for "capitalism with no adjectives."

Klaus gained and still holds the upper hand, however, and in January 1991 Czechoslovakia introduced a radical economic reform package. Prices were liberalized, most non-tariff barriers such as quotas and licensing restrictions were eliminated,<sup>24</sup> the Czech currency, the crown, was made convertible into hard currencies for purposes of foreign trade, and a sell-off of small, state-owned businesses began.

As in the rest of Eastern Europe, state industrial output dropped in 1991 by over 20 percent.<sup>25</sup> Unemployment, however, remains low in the Czech lands, hovering at

24 Although a protectionist 20 percent surcharge was imposed on imports.

about 4 percent even in official statistics. This contrasts with 11 percent official unemployment in Slovakia as of this January. The disparity is a source of political tension between the two republics. As in other former East Bloc countries, rapid growth of the private sector is essential so jobs are available for displaced workers from faltering state factories. This appears to be happening, as Czechoslovakia's unemployment in February registered 5.9 percent lower than in January.

**Price Liberalization and Monetary Policy.** Here Czechoslovakia gets its highest grades. Prices on 85 percent of goods were freed January 1, 1991, and in November prices were liberalized on another 5 percent including bread, milk, and meat. Since July 1991, inflation has been near zero due to the government's restrictive monetary policies. Interest rates still are high, at 22 percent, but down from last year's 24 percent rate.

A less wise government policy was to devalue the crown three times in 1990: by 18.6 percent in January, 55 percent in October, and 16 percent in December. To stabilize the exchange rate, the crown now is fixed relative to a weighted average of a number of Western currencies.

**Fiscal Policy.** The Czechoslovak budget was in surplus by 15.3 billion crowns in the first quarter of 1991, and by October 31 the nation still had an 8 billion crown surplus.<sup>26</sup> No budget deficit is foreseen for this year, but there is little room for maneuvering and problems could arise if demands are met to spend more on social programs.<sup>27</sup> While state subsidies to enterprises have been cut, the government has given in to political pressures and granted tax relief, debt write-offs, and additional credits to agricultural and industrial enterprises, thus simply delaying restructuring.

Very high taxes on private enterprise are slowing private sector development in Czechoslovakia. Taxes are so high that companies risk going out of business unless they find ways to avoid them. Entrepreneurs must pay a 55 percent tax on profits as well as payroll, social security, and turnover taxes. As in the other East European countries, business taxes need to be cut drastically to give new entrepreneurs a chance to flourish. In December, taxes on incomes over 10,000 crowns a month were raised from 27 percent to 33 percent. The only bright spot in tax reform in 1991 was a modest rate reduction in the turnover tax.

**Trade, Debt, and Foreign Investment.** Czechoslovakia liberalized its trade in 1991, although a temporary 20 percent import surcharge imposed in January 1991 greatly retarded import growth.

After initially trailing Hungary and Poland by a large margin, foreign investment is beginning to accelerate in Czechoslovakia. Foreign investment in the country last year totaled around \$600 million. Foreign capital flow into Czechoslovakia is sure to accelerate greatly this year as the privatization program moves into full swing. Laws and

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25 "Czechoslovakia's Big Bang Strategy—Looking Back on 1991," Deutsche Bank Economics Department, *Focus Eastern Europe*, December 1991, p 2.

26 "Aggregate Budgets Show Surplus at End of October," *Hospodarske Noviny*, December 6, 1991, p.1.

27 Tomas Jezek, "Privatization in Czechoslovakia Twenty Months After," paper presented at the Mont Pelerin Society Meeting, Prague, November 5, 1991.

regulations on foreign ownership are more liberal than in Poland, yet not quite as favorable as in Hungary. Foreigners can purchase real estate through foreign-owned joint stock companies and limited liability corporations; however, government approval is necessary for 100 percent foreign ownership. The 40 percent corporate tax rate on foreign companies is a barrier to investment and looks good only in comparison to the astronomical 55 percent tax rate on domestic companies.

Foreign debt, which was not a problem for Czechoslovakia two years ago, could reach up to \$10 billion in the next year because of heavy borrowing from international financial institutions.

**Privatization and Legal Reforms.** Around 600,000 private businesses have been created since January 1990. Although flourishing, Czechoslovakia's new private sector has not made the gains of Hungary and Poland. One reason: unnecessary barriers to private business, including difficulty in obtaining credit from state banks, high taxes, and cumbersome government regulations.

For instance, credit to private businessmen in 1990 amounted to only one-quarter of one percent of total credit in the Czechoslovak economy; in Poland, by contrast, credits to the private sector were up to 10 percent of total credit in 1990.

Privatization of the economy is beginning to accelerate after a slow start. Small-scale privatization of shops, retail trade, and restaurants began in January 1991. These state entities are sold by auction to domestic and foreign bidders. In the first four months, an average of 80 percent of small businesses up for sale were sold at each auction for about two times the asking price. All proceeds from the auctions are frozen for two years as an anti-inflationary measure. Close to 18,000 small businesses worth over 11 billion crowns, or around \$366 million, have been auctioned off.<sup>28</sup> Over 500 small and medium-sized industrial enterprises have been turned over to the private sector.

Privatization of large enterprises has been decentralized by requiring each firm to draft its own proposals for privatization and to submit these to the Czech or Slovak privatization ministries.<sup>29</sup> Some enterprises will be privatized through management-employee buyout, others will be sold in whole or part to foreign investors, while initially around 500 state firms valued at 300 billion crowns, or \$10 billion, will be privatized through a voucher scheme. Vouchers, sold to citizens at very low prices, will allow Czechs and Slovaks to purchase shares in state enterprises directly or to purchase shares in investment funds that then would use the coupons to buy shares in state firms. Over 80 percent of the adult population in Czechoslovakia has purchased privatization coupon booklets for \$33 each. Over 450 private investment funds aiming at taking part in the voucher privatization program already have sprung up. The voucher privatizations likely will take place in three rounds of auctions, the first of which is to begin this month.

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<sup>28</sup> *Ibid.*

<sup>29</sup> The privatization ministries are then charged with accepting the enterprise's plan for privatization or choosing an alternative approach.

A recent survey by the Czech Statistical Office finds that the current managers of most state enterprises would prefer privatization via sale to a foreign investor, instead of by voucher. Fully three-quarters of all industrial state firms in the Czech republic are searching for a foreign partner.<sup>30</sup> The Czech Privatization Ministry expects foreigners to purchase 22 billion crowns, or \$733 million, worth of state property in 1992.

Some 830,000 people have applied for compensation for land, housing, and private enterprises confiscated from them by the communists. Only a few claims have been settled thus far. The claimants will receive special vouchers that can be used to buy land, state-owned apartments, or businesses. The maximum amount of compensation is 5 million crowns, or \$166,000. Most claimants are expected to receive between 100,000 and 500,000 crowns, or \$3,330 to \$16,660.

## BULGARIA

### Grade: C+

The speed and extent of Bulgaria's economic reforms in 1991 was one of the year's best kept secrets in Europe. Bulgaria, alone among its Balkan neighbors, has had a peaceful and steady transition to democracy, with two free elections since the fall of communism. Bulgaria's main failure has been to adopt a radical privatization program to transfer state assets rapidly to the private sector.

Bulgaria too often is lumped in with Romania and Albania as the basket cases of the former East Bloc. This may have been true in 1990, when a political stalemate between the ruling socialist party and the opposition Union of Democratic Forces (UDF) delayed real economic reform. However, since the December 1990 formation of a coalition government with the UDF in charge of economic policy, Bulgaria has moved rapidly with far-reaching economic reforms.

The economic situation inherited by the UDF-led coalition was bleak. Non-agricultural output fell 20 percent in 1990 and the collapse of the Soviet market and the dismantling of the Soviet-led COMECON trade bloc hit Bulgaria especially hard, due to its high reliance on COMECON trade. Another shock to the Bulgarian economy was the Persian Gulf crisis, which led to energy shortages and, in some places, 24-hour lines for fuel.

Economic Report Card for Bulgaria	
Price Liberalization and Monetary Policy	Average
Fiscal Policy	Good
Trade Debt, Foreign Investment	Average to Poor
Privatization and Legal Reforms	Poor
<b>Overall Grade</b>	<b>C+</b>

<sup>30</sup> "Czech companies say they want foreign investment," *PlanEcon, PlanEcon Business Report*, June 26, 1991.



Against this backdrop, the government initiated a Polish-style reform program at the beginning of 1991. Prices were freed on almost all goods on February 1. Shops soon filled with goods and lines disappeared in front of stores.<sup>31</sup> This did not happen without some hardship. Prices rose 123 percent in February, another 45 percent in March, and 3.5 percent in April before finally stabilizing in May. Cutting state subsidies in June spurred another temporary surge in prices, but inflation was kept below 5 percent per month for the rest of 1991 due to restrictive credit and fiscal policies. Bulgaria also significantly liberalized trade barriers, resulting in increases in imports. This, too, also helped temper price increases.

State output was down 19.5 percent in 1991, mainly because of shortages of raw and primary materials and decreased demand, but the private sector is growing. As of August 5, 1991, around 174,000 private businesses were registered in Bulgaria, of which 68 percent were sole proprietorships.

**Price Liberalization Monetary Policy.** Since January 1991, the Bulgarian government has maintained a strict monetary policy. Interest rates were raised from 4.5 percent to 45 percent and then hiked up to 52 percent in June, therefore further impeding money growth. Beginning this January, Bulgarian citizens were allowed to exchange up to 10,000 *lev*, or about \$417 each year into hard currencies. The *lev* has stabilized at a rate around 24 *lev* to the dollar.

**Fiscal Policy.** Budget expenditures were cut by 35 percent in 1991. One way Bulgaria cut expenditures was by eliminating subsidies for oil and gas in June, causing a 50 percent to 70 percent increase in energy prices. In 1991, the share of Bulgaria's GNP accounted for by government subsidies declined from 16.1 percent to 3.2 percent.<sup>32</sup>

Bulgaria has moved the furthest of any East European country in easing the tax burden on private business. In June 1991, the government exempted all companies with 50 or less people from taxes on profits for two years, and offered these firms state-owned lots for constructing buildings and credits at preferential rates to cover 50 percent of electricity, water, and telecommunications costs.<sup>33</sup> In February 1992, the exemption on profits taxes was extended to three years and applied to all private businesses and joint-ventures. State-owned enterprises do not enjoy the same tax breaks.

**Trade, Foreign Investment, and Debt.** Bulgaria was more heavily dependent on East European trade than any other former East Bloc country. Exports to countries in Eastern and Central Europe fell 70 percent in the first half of 1991. In part the gap is being taken up by exports to the European Community, which increased by \$62 million, or 10 percent, in 1990. The introduction of market forces also is changing the composition of Bulgarian trade. Exports of machines and heavy equipment, which Bulgaria does not produce efficiently, fell from 60 percent of total trade in the first half of 1990 to 31 percent for the same period in 1991. Meanwhile, exports of raw ma-

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31 However, unexpectedly in late July and early August prices on some foodstuffs such as bread, milk, and wheat increased sharply.

32 "Bulgaria: A New Constitution and Free Elections," RFE/RL Research Report 1991, January 3, 1992, p. 79.

33 "New deal for small business," PlanEcon, *PlanEcon Business Report*, June 26, 1991, p. 6.

terials and processed food products, in which Bulgaria has a competitive advantage, increased from 14 percent to 28 percent of total exports.<sup>34</sup>

The Sofia government also has taken measures to liberalize trade. Two hundred products were exempted from import taxes, and the list of goods banned from export was slashed. While a positive step, these reforms do not go nearly far enough. Many goods still are banned from export, and the government has put price controls on exports of meat, dairy products, and timber.<sup>35</sup>

A foreign investment law passed in November guarantees foreign investors equal rights with Bulgarians. It also allows 100 percent foreign ownership of new or existing companies. Late this January, the foreign investment law was further liberalized. The previous limit of \$50,000 on foreign investment has been removed and joint-venture companies now are allowed to change their profits into hard currency and export them.

**Privatization and Legal Reform.** The parliament has passed laws on commerce, banking, companies, and accounting, all designed to establish a legal framework for a market economy. Small-scale privatization began in June 1991 with the auctioning of state-owned shops and restaurants to individual citizens. In mid-December 1991, shop owners deprived of their stores in the former communist government's final round of nationalization, in 1975, were able to reclaim their premises after refunding the money they received for the stores in 1975.<sup>36</sup> Around 100,000 Bulgarians are eligible to reclaim stores through this program.

The weakest aspect of Bulgaria's reform program is privatization of large enterprises. The privatization law is still being debated in the parliament and no enterprises have been turned over to the private sector.

Agriculture is the most important and most regulated sector of the Bulgarian economy. Privatization of this sector, which accounts for 40 percent of total economic output, should be the government's highest priority. Instead, agricultural reform has lagged. Bulgaria, once a net exporter of agricultural goods, now is a net importer. Bulgarian agriculture is in a tailspin: milk output was 289 million liters less in 1991 than 1990; egg production was also way down.

Government policies and the slow pace of agricultural privatization largely are to blame for the current agricultural crisis. Prices on such staples as grain continue to be held down artificially by the government, while prices for fertilizers and seeds have increased steeply. The result: production is stifled and cooperatives hoard stocks and often pay salaries to workers in grain rather than in cash.

Bulgaria passed land reform laws in early 1991 that in principle provide for the breakup of collective farms and the return of land to those who owned it before 1945. Over 400,000 former owners already have applied to the government to get their land back. In practice, implementation of the law has been slow. The government some-

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34 "Bulgarian Exports: More Foods and Raw Materials, Fewer Machines," *168 Hours*, BBN, (Sofia), Vol.1, No.5, September 16-22, 1991, p. 8.

35 "Ambitious Reform Programme, Great Difficulties," *168 Hours*, BBN, (Sofia), Vol. 1, No.18, December 16-22, 1991.

36 "Restitution of Nationalized Property May Begin," BTA Radio (Sofia), December 12, 1991.

what unrealistically hopes to return 70 percent of the land to its former owners by the fall of this year. Stalling the process are legal provisions preventing owners from selling the land for three years and requiring the land to be used only for farming. Such restrictions, if not eliminated, will hamper the development of private farming because, among other reasons, many former owners now are very old or live in cities and are unable to farm the land.<sup>37</sup> All restrictions on selling or trading land should be removed once it is returned to its rightful owners.

If privatization begins soon and other reforms are continued, the long-term prospects for the Bulgarian economy are good. The government has shown a steely commitment to economic reform and the population is fairly optimistic. According to a recent poll, 61 percent of Bulgarians believe that economic conditions will improve within five years and 65 percent say they can manage on their own without help from the state. Also encouraging is that 62 percent prefer high prices and well-stocked shops to the way things were before market reforms.

Though it is not likely to develop as quickly as the wealthier countries of Central Europe, if it continues resolutely to pursue market liberalization, Bulgaria should experience steady growth in coming years.

## ROMANIA

### Grade: C-

The economic outlook for Romania is among the bleakest in Eastern Europe. Former Romanian dictator Nicolae Ceaucescu's policies of harsh austerity and forced industrialization left the country utterly impoverished; Romania's per capita income is one of the lowest in Eastern Europe. Ongoing political instability has stalled many needed reforms.

Last July, the government of former Prime Minister Petre Roman announced its first serious economic reforms, including cuts in taxes and customs duties, and a phase-out of all price controls by January 1992, except those on heating, electricity, and housing. Some of these reforms, however, have sputtered in the face of opposition from labor unions and ex-communists. Each month it seems the government is confronted with a major industrial disruption or strike.<sup>38</sup> Nevertheless, the government's apparent determination to push ahead with pervasive economic reform is encouraging.

Industrial output in Romania fell around 20 percent in 1990 and 22 percent in 1991. GDP was estimated to have declined by 12 percent to 14 percent. Because of the initially slow pace of reforms, the private sector is not yet growing quickly enough to offset the collapse of the state sector. Romania's biggest problem is inflation, driven by wage increases of an average 100 percent over the past six months.

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37 "Problems Noted in Implementing Land Restitution," BTA Radio (Sofia), December 25, 1991.

38 "Romania's Torturous Road to Reform," RFE/RL Research Report: 1991, p. 96.

Wage ceilings imposed this January should temporarily delay the exorbitant increases. However, proposals to index wages to inflation, if adopted, will set off yet another inflationary wage-price spiral. This would ruin any chance the economic reform program has to succeed and further deter foreign investment. Understanding this, Prime Minister Teodor Stolojan warned this January about the disastrous inflationary consequences of repeated wage indexation, and said he would not compromise on economic reform.

Approximately 230,880 private entrepreneurs have registered in Romania. There are about 75,000 commercial companies, of which 9,089 are at least partially financed with foreign capital. Unemployment still is a relatively low 3.4 percent.

**Price Liberalization and Monetary Policy.** Beginning mid-1991, controls on prices and wages were liberalized in four steps: in November 1990 and then in April, in July, and in November 1991. Now price controls remain on only fourteen goods and services deemed by Bucharest to be basic necessities, including bread, milk, sugar, and butter. Consumer prices, which for many goods now have cleared market levels, are up 260 percent since October 1990. The government hopes to bring real, underlying inflation, as opposed to an initial temporary price surge due to the removal of price controls and subsidies, down to an annual rate of around 15 percent by further tightening money supply. The Romanian currency, the *lei*, was devalued three times and on November 11 most currency exchange controls were eliminated, thus making the lei partially convertible to hard currencies. In January 1992, however, the Romanian National Bank limited the amount of money that could be exchanged for hard currency by its citizens to 50,000 lei or about \$250.

**Fiscal Policy.** Romania's government deficit is 65.5 billion lei or \$330 million. A number of major tax changes were introduced in early 1992. Previously business taxes were steeply progressive, rising all the way to 77 percent, thereby punishing success and encouraging tax evasion. Businesses now are taxed a flat 30 percent rate on profits lower than a million lei and 45 percent on profits above one million. The tax rate on businesses should be unified and lowered significantly. The government also should consider repealing two taxes passed this year: a 10 percent dividend tax and a tax on company earnings from the sale of assets. Both taxes will eat away at business profits, thus resulting in lower wages for employees, higher unemployment, and fewer goods and services produced.

**Trade, Debt, and Foreign Investment.** Bucharest has somewhat liberalized its trade laws, but still imposes high barriers. Tariff rates have been limited to between 10 and 30 percent.<sup>39</sup> Romania registered a \$1.4 billion deficit in foreign trade in 1991.

Economic Report Card for Romania	
Price Liberalization and Monetary Policy	Average
Fiscal Policy	Average to Poor
Trade Debt, Foreign Investment	Poor
Privatization and Legal Reforms	Poor
Overall Grade	C-

39 "Economic Slide Continues," COSMOS, Inc., *Romania Economic Newsletter*, July-September 1991, Vol. 1, No. 2, p. 7.

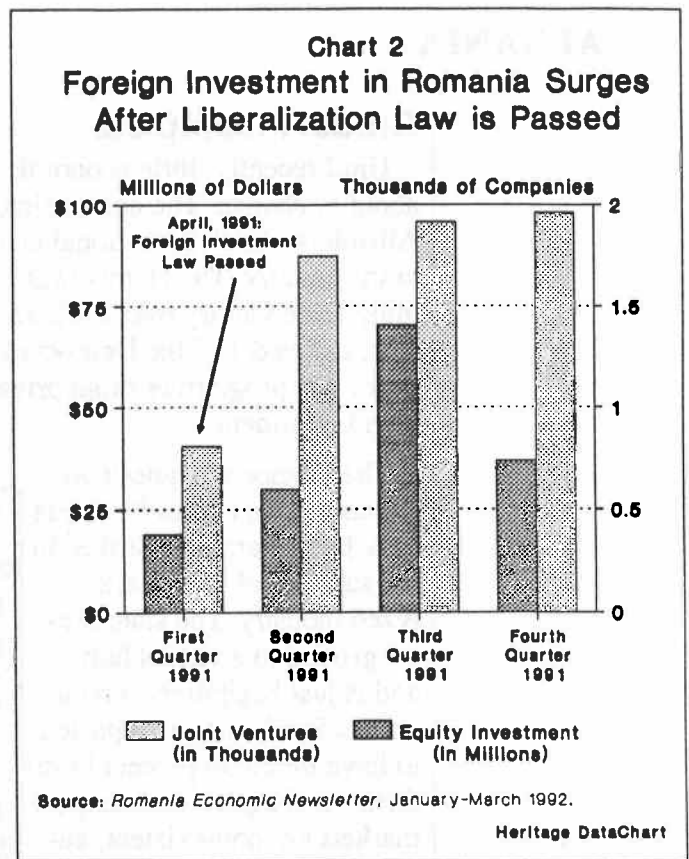
Reason: trade from East European countries and the Soviet Union dropped 75.3 percent in 1991. On the bright side, exports to the West increased by over 100 percent in 1991 compared to 1990. Romania does not have a substantial foreign debt to worry about.

Because of a fourth quarter surge, 1991 exports reached 1990 levels and the trade deficit was reduced. Exports amounted to \$3.5 billion in 1991. The government hopes continued success in trade with the West will stimulate the falling economy. Recently, Romania's uncertain political climate and the poor state of its economy has kept foreign investment in Romania low. Between January and June last year, however, 2,128 foreign joint ventures were

formed, totaling \$51 million in investment capital.<sup>40</sup> An April 3 law grants foreign investors such guarantees as the ability to transfer profit out of Romania in a convertible currency, and an assurance that foreign capital will not be nationalized or expropriated, and offers investment incentives like tax holidays and exemptions.

**Privatization and Legal Reforms.** The government has been slow to enact reforms to promote private enterprise, such as deregulation, lower taxes, and easier business licensing. There has also been little progress in establishing, defining, and protecting property rights. A new constitution was adopted last November 21. It includes articles on private property protection, but these apply only to agricultural land.

The Romanian parliament approved a privatization bill in July 1991. The bill calls for setting up five Private Ownership Funds, which will take control of 30 percent of the capital of state companies. The fund will issue certificates of ownership to citizens valued at 5000 lei, or about \$25 each. Vouchers are to be given to all Romanian citizens eighteen years of age and older. Vouchers then could be converted into shares in individual state enterprises and into shares in mutual funds.<sup>41</sup> A list of 240 companies slated for privatization has been released.



<sup>40</sup> *Ibid.*, p. 7.

<sup>41</sup> "Enterprise Reform as Privatization: The Givaway Scheme," COSMOS, Inc., *Romania Economic Newsletter*, April-June 1991, Vol. 1, No. 1, p. 7.

## ALBANIA

### Grade: Incomplete

Until recently, little economic reform has taken place in Albania. All this may be about to change. The convincing victory of the anti-communist Democratic Party in Albania's March 21 national elections will mean greatly accelerated economic reform in the country. The Democratic Party, with 62 percent of the vote, scored a surprisingly large victory over the Socialist Party, which received only 25 percent. Sali Berisha, the leader of the Democrats and the likely future Albanian president, backs an economic program of rapid privatization and elimination of most restrictions on foreign investment.

The Democrats inherit an economy that makes Romania look like a paradise. Strikes in the summer of 1991 paralyzed industry. The state sector ground to a virtual halt and is just beginning to recuperate. Production is reported to have fallen 50 percent in industry and agriculture. Export markets are non-existent, energy prices have skyrocketed, and one estimate puts industrial production for 1991 at

only 15 percent of that in 1990. Albania's major economic concern in 1991 was simply securing food aid. As a result, the country now is almost wholly dependent on foreign food supplies. In the face of this bleak economic situation, the Albanian parliament approved in the fall of 1991 a series of far-reaching economic reforms, including privatization, restitution of land, and price liberalization.

**Price Liberalization and Monetary Policy.** Prices were freed in January on all but twelve basic necessities.

**Trade, Debt, and Foreign Investment.** Albania is beginning to open up its long isolated economy to foreign investment. According to government sources, foreign investors will be allowed to purchase state enterprises outright. Foreign investment is especially sought for agriculture, infrastructure, energy development, and tourism. Thus far only five foreign firms have pledged major investments in the country; three of these are American.

**Privatization and Legal Reforms.** Land privatization began last September. Each Albanian village was given land that now is being divided up into equal plots for every family. In many respects, all the government did was to legalize what already was occurring as former landowners and peasants toiling the fields began taking land back from the government last summer and fall. The bulk of agricultural land privatization now has been completed. One problem is that the government will not allow land to be sold. This will prevent larger, more efficient farms from forming and weaken the incentive for farmers to increase the value of the land.

Economic Report Card for Albania	
Price Liberalization and Monetary Policy	Incomplete
Fiscal Policy	Incomplete
Trade, Debt, Foreign Investment	Incomplete
Privatization and Legal Reforms	Average
<b>Overall Grade</b>	<b>Incomplete</b>

Privatization of small businesses and transportation is set to begin this year. In the first stage, the government will auction off up to 25,000 shops and most of the country's transport infrastructure like buses and trucks. The government also plans to privatize 300,000 homes over the next year by selling them to their residents.

Laws on private property passed in the summer of 1991 are vague. One strong point, however, is that business licensing now is fast and automatic, unless disapproved by the state.<sup>41</sup> Despite much recent progress, Albania has a long way to go to catch up to its Balkan neighbors, Bulgaria and Romania. The thoroughly disastrous state of its economy, however, offers a powerful stimulus for basic reform.

## FORMER YUGOSLAVIA

### Grade: Incomplete

Yugoslavia's civil war already has given birth to at least three new countries — Croatia, Slovenia and Bosnia-Herzegovina — but also has obstructed needed economic reforms even in the most reform-minded republics. United Nations peacekeeping forces moved into Croatia this month to enforce the U.N.-sponsored truce of January 3 that ended seven months of fighting. Meanwhile, bloody battles raged in Bosnia-Herzegovina between the Yugoslav army and ethnic Serbs on one side, and Croat and Muslim Slavs on the other.

The territory that once was Yugoslavia embodies the widest cultural, political and economic contrasts of any East European state. The Kosovo autonomous region in Serbia has a per capita GNP only one-tenth the Slovenian level of around \$7,000. Efforts to equalize economic development through the 1960s and 1970s, mainly disguised efforts by dominant Serbia to transfer wealth from the richer northern republics, succeeded only in increasing ethnic tensions.

For years, Western intellectuals considered Yugoslavia the showpiece of socialism; and indeed it was rather prosperous compared to the rest of Eastern Europe. However, the country's civil war and Serbian leader Slobodan Milosevich's steadfast refusal to abandon communism, have wreaked havoc on the former Yugoslav economy.

<b>Economic Report Card for Yugoslavia</b>	
<b>Price Liberalization and Monetary Policy</b>	Incomplete
<b>Fiscal Policy</b>	Incomplete
<b>Trade , Debt, Foreign Investment</b>	Incomplete
<b>Privatization and Legal Reforms</b>	Incomplete
<b>Overall Grade</b>	<b>Incomplete</b>

<sup>41</sup> Bureau of National Affairs, *BNA's Eastern Europe Reporter*, January 6, 1992, p. 17.

The flow of goods, labor and capital throughout former Yugoslav territory has been almost completely blocked by civil war. Trade with the rest of the world has nose-dived, and raw materials are impossible to obtain. Yugoslav GNP was down 10 percent in 1990 and was down an additional 45 percent in 1991. In the first six months of 1991, hard currency earnings from tourism fell 30 percent over the same period in 1990. Trade fell from a \$500 million surplus to a \$1.7 billion deficit in the first six months of 1990. Unemployment is running around 9 percent.

**Price Liberalization and Monetary Policy.** Prior to the onset of the civil war in 1990, controls on prices and trade were liberalized significantly, and in early 1990 inflation began to subside after reaching 2,700 percent in 1989. Inflation again is out of control, however, due to a relaxed monetary policy, as the Belgrade government prints money to finance the war.

Internal convertibility of the Yugoslavian *dinar*, introduced late in 1989, has been abolished in order to preserve foreign exchange reserves. These reserves fell from \$8.3 billion in August 1990 to \$3.8 billion in June 1991.<sup>42</sup>

Political and economic crises have caused a run on hard currency savings from banks: over \$1.5 billion was drawn from savings deposits in 1991 and \$3 billion in 1990. These actions proved wise, because on July 18 1991, the Association of Banks of Yugoslavia recommended that banks suspend all payments of hard currency to depositors.

**Fiscal Policy.** Yugoslavia's economic collapse and political breakup greatly have reduced tax revenues to the central government. Only 36 billion dinars, or \$257 million, rather than the expected 65 billion dinars, or \$464 million, was raised by Yugoslav federal authorities in the first half of 1991. Federal spending goes now only to support operations of the People's Army and the federal bureaucracy. The huge decreases in federal revenues forced federal authorities to cut the budget by 60 percent in 1991.<sup>43</sup>

### **Slovenia**

Slovenia, located near prosperous trading partners Italy and Austria, is the wealthiest of the former Yugoslav republics and has the brightest economic future. The country declared independence on June 25, 1991, and seceded relatively peacefully on July 18, 1991. The war throughout Yugoslavia, however, has taken its toll on Slovenia, reducing its GNP by 10 percent in 1991. Still, this contraction is less than one-half the average for the rest of former Yugoslavia and much less than war-torn Croatia.

The government introduced Slovenia's own currency, the *tolar*, on October 8, 1991. These were exchanged on a one-to-one basis for Yugoslav dinars. The Bank of Slovenia is offering interest-bearing accounts that are leading people to exchange foreign currencies into tolar-denominated accounts, thus bringing a fragile stability to the new currency. Foreign reserves stand at only \$300 million at present, but plans to pri-

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42 "The Yugoslav Economy: Economic Effects of Political Crisis and Civil War" Deutsche Bank Economics Department, *Focus Eastern Europe*, November 1991.

43 "LB Says Foreign Currency Reserves Increased," *Delo*, (Ljubljana, Slovenia), December 9, 1991, p.3.



vativize state-owned apartments and industries could increase this sum if foreigners are allowed ample participation in the sales.

### **Croatia**

The post-war economic prospects for Croatia are much dimmer than for Slovenia. Pre-war living standards in Croatia were markedly lower than Slovenia, and its economy has been totally shattered by the war. Total war damage exceeds 260 billion dinars, or around \$264 million. Heavily hit have been the transportation, communication, and tourism industries. Foreign trade is at a standstill because of international sanctions and Serbian occupation.

Against this backdrop, Croatia launched its own currency, the Croatian *dinar*, on December 24, 1991. The exchange rate of the new dinar is 1:1:1 with the Yugoslav dinar and the Slovenian tolar, and exchange will be possible at banks and post offices. The prospects for improvement of economic conditions in Croatia and the other former Yugoslav republics are bleak as long as civil strife continues and Serbia continues to destroy neighboring republics.

## **CONCLUSION**

Although some countries are moving much faster than others, most of Central and Eastern Europe at least is moving steadily ahead with economic reform. In particular, most of these countries have achieved considerable success in instituting the macroeconomic measures needed to stabilize their economies: freeing prices on most tradeable goods, balancing the budget, reining in inflation, adopting real interest rates, and moving toward currency convertibility.

Reforms have come slowly, however, on the "micro" level, in enacting the structural and legal reforms needed for a free market economy to develop rapidly. Removing obstacles that block incentives for stimulating production and investment is critical, yet often overlooked. Regulations on private businesses still are burdensome, business licenses are difficult to obtain, and privatization of large industries is occurring at a painfully slow pace. Tax systems, which are some of the most burdensome in the world for private businesses, need to be overhauled. Prohibitive tax burdens on business slow economic growth and development by discouraging hard work, savings, investment, and the production of goods and services.

Also obstructing Central and Eastern Europe's march to a free market are communist apparatchiks, who still are blocking reform at all levels of government. For instance, Poland's ambitious mass privatization plan was rejected last fall by the communist majority in the parliament's lower house, the Sejm.

**Astonishing Growth.** Despite these obstacles, the private sector throughout the region has been growing at an astonishing rate. New private companies have reacted much more swiftly and flexibly to the breakdown in East European trade than state enterprises, in large measure by finding new markets in the West. The Central and East European governments, however, have been unable to measure most of the economic value added by the growing private sectors in their countries, making official statistics on output, national income, and unemployment misleading.

Most of the new democratic governments now realize that the future well-being of their people will be determined by the growth of the economy from the ground up. Technological advances, better services, higher living standards, and vastly improved consumer goods all will result mostly from the creation of dynamic private firms.

There now is much debate in Russia and other former Soviet republics about the pace and sequencing of their own economic reforms. The experience to date in Eastern Europe should largely have resolved this issue. The last two years in Poland and other Central and East European countries demonstrate that a host of reforms must be rapidly implemented simultaneously: price and trade liberalization, recognition of property rights, monetary stabilization, and privatization all are interdependent and cannot be introduced in isolation.

**Lessons for the Developing World.** The fate of reform during the coming year may well determine whether Central and Eastern Europe will achieve the rapid economic growth of Southeast Asia, or wallow in debt, stagnation, and hyperinflation like South America. So far, there is reason for optimism. Hungary has turned the corner and soon should be experiencing steady growth. Most of the Central and East European governments recognize the importance of strict monetary discipline and the need to resist pressures for excessive wage increases in the public sector. Further, as in Southeast Asia, small private companies are growing rapidly, proving adept at finding export markets for their products and hiring away the best workers from the declining state sector.

There are many lessons here for Russia, other former Soviet republics, and the rest of the developing world. Growth and prosperity need not be limited to the major industrial countries of North America, Western Europe, and Japan. Worldwide economic prosperity is attainable if governments only will get out of the way and let the free market work its wonders.

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