

STATE vs MARKET IN CENTRAL AND EASTERN EUROPE

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Abstract: *Although old, the debate on whether government's intervention in economic activities can stimulate economic growth once again rose within the countries of Central and Eastern Europe. They have passed a harsh transition process, pressed on by the intention to join the EU, which involved accelerating the degree of economic freedom and fostering growth, respectively. Despite meaningful progresses, these countries have still a lot left to do in order to strengthen a solid legal system that is able to guarantee a liberal economic system, protected from political influence.*

Keywords: state; market; economic freedom; Central and Eastern Europe.

JEL Classification: P51, O570.

The way in which the government intervention directly or indirectly influences the economic efficiency or the growth rate of nations has been, over time, the object and the subject of intense disputes between the partisans of economic liberalism, of economic socialism or of the mixed economic models. From the classic liberalists or the Austrian School advocates, to the supporters of the utopian socialism or Marxists and until the advocates of Keynesian interventionism, *state versus market* debate has always been a lively debate. The global economic crisis, occurring in 2007-2008, and the specific context of Central and Eastern Europe countries – that have experienced the centralized economic system for a long time and also a difficult period of transition to a market economy system, after the communist regime had collapsed – have, somehow, radicalized the dispute, at a time when, at least in Europe, economic systems in varying degrees converged to a "welfare state" economy. Thus, we have started to talk again about "too much state" or "too much economic freedom" as causes of the crisis but as solutions for getting over the crisis as well.

Considering the context, an analysis of the correlation between the degree of economic freedom and economic growth in the countries from Central and Eastern Europe, it seems appropriate. When using "economic freedom" we refer to the liberal sense of the concept, so we have subsumed to it more indicators: the freedom of choice, free trade, the freedom to enter that exit the market, economic coordination by market forces / free competition, private ownership of means of production. Considering this sense of the concept, we tried to analyze the degree of economic

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freedom of countries in Central and Eastern Europe and the economic consequences of greater or less freedom.

For measuring economic freedom, we have considered an indicator defined by the Fraser Institute*, namely EF2010 (Economic Freedom 2010), which evaluates the economies of various countries according to five major areas, as in the following table:

Table 1 - Major areas, components and sub-components of the EF2010 Index

Size of the Government	Legal System and Property Rights	Sound Money	Freedom to trade Internationally	Regulation
*Government Consumption *Transfers and Subsidies *Government Enterprises and Investment *Top Marginal Tax rate: *Top Marginal income Tax Rate *Top Marginal Income and Payroll Tax Rate	*Judicial Independence *Impartial Courts *Protection of Property Rights *Military Interference in Rule of law and politics *Integrity of the legal system *Legal enforcement of contracts *Regulatory restrictions on the sale of real property *Reliability of police *Business costs of crime	*Money growth *Standard deviation of inflation *Inflation: most recent year *Freedom to own foreign currency bank accounts	*Tariffs: Revenue from trade taxes; Mean tariff rate; Standard deviation of tariffs rates *Regulatory trade barriers: Non-tariff trade barriers, compliance costs of importing and exporting *Black Market exchange rates *Controls of the movement of capital and people: foreign ownership/investment restrictions, capital controls, freedom of foreigners to visit	*Credit market regulations: ownership of banks, private sector credit, interest rate controls/negative interest rates *Labor market regulations: hiring regulations and minimum wage, hiring and firing regulations, centralized collective bargaining, hours regulations, mandated cost of worker dismissal, conscription *Business regulations: administrative requirements, bureaucracy costs, starting a business, extra payments/bribes/favoritism, licensing restrictions, cost of tax compliance

Source: own selection from “Economic Freedom of the World 2012 Annual Report”,
<http://www.freetheworld.com/2012/EFW2012-complete.pdf>

Each area covers a specific number of evaluated components and sub-components, so that, totally, the indicator takes into account 42 distinct variables, as shown in Table 1. Each of the variables has a rating scale of 0 to 10. The score of each component is calculated as the average of the scores of its subcomponents, so the score of each area is the average of its components and the overall score is the average of its areas.

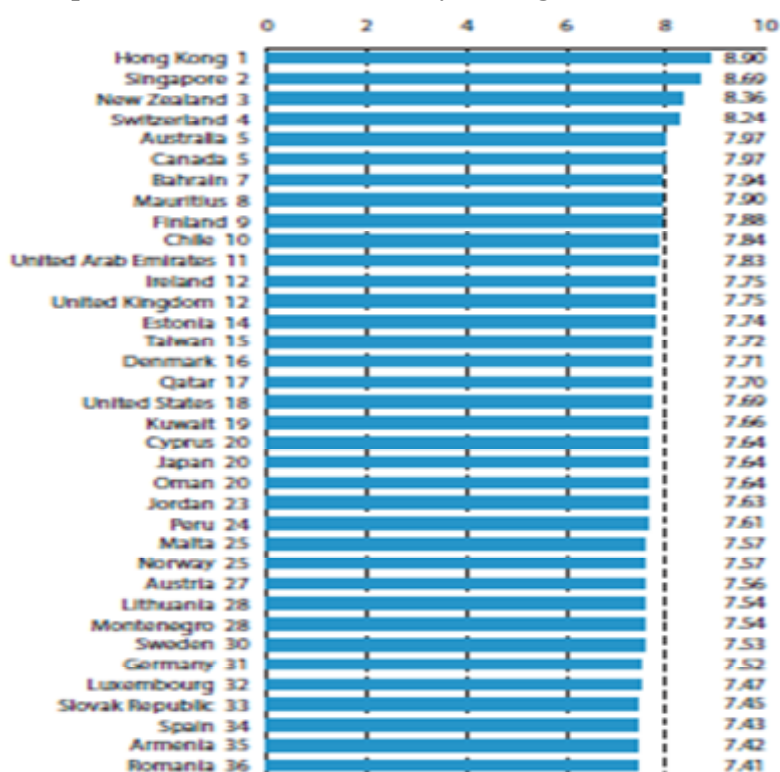
For the year 2010, 144 countries there were considered and evaluated according to the reminded indicator. As shown in Figure 1, the first 36 countries which recorded the highest score of the economic freedom indicator are forming the first quartile. Romania ranks the 36th, the last position in the first quartile, with a higher score than Netherlands (37), Belgium (41), France (47) or

* See www.fraserinstitute.org and www.freetheworld.com.

Hungary (64). If we refer to the broader level of economic development, the correlation between economic freedom and economic development or between the economic freedom and the standard of living does not seem to be strictly positive. However, if we analyse the situation from the perspective of the growth rates dynamics for the evaluated period, the positive correlation is restored.

Moreover, according to the report, major positive changes in terms of economic freedom are driven by the former communist countries, such as Poland, Bulgaria, Romania and Albania, while the big "surprise" comes from the U.S., which has recorded a significant decrease in the index of economic freedom during this period. The same dynamic perspective seems to link the decreasing degree of economic freedom to the slowing down in economic growth.

Figure 1 - First quartile of countries ranked by the degree of economic freedom (2010)



Source: "Economic Freedom of the World 2012 Annual Report",
<http://www.freetheworld.com/2012/EFW2012-complete.pdf>, p. 10

Decentralization measures, withdrawal of the state from the economy, restoration of the free market and the transfer of state-owned means of production to the private sector, accomplished during the transition to a market economy in many ex-communist countries, have meant an acceleration of the degree of economic freedom fostering economic growth. Increasing efforts in order to connect to the European Union's economy have considerably speeded up the process. In

Table 2 we have performed a clustering of countries in Central and Eastern Europe considering the score of the economic freedom indicator.

As it can be seen, the countries that joined the European Union are grouped to relatively similar positions in the first and second quartile:

Tabelul 2 - Summary of Economic Freedom Ratings (Central and Eastern Europe)

Quartile	Position	Country	Index rating
1st Quartile	14	Estonia	7.74
	28	Lithuania	7.54
	28	Montenegro	7.54
	33	Slovak Republic	7.45
	35	Armenia	7.42
	36	Romania	7.41
2nd Quartile	42	Albania	7.34
	42	Georgia	7.34
	45	Bulgaria	7.33
	48	Poland	7.31
	58	Czech Republic	7.16
	61	Latvia	7.12
	64	Hungary	7.08
3rd Quartile	73	Macedonia	6.94
	84	Croatia	6.76
	85	Moldova	6.75
	92	Slovenia	6.63
	93	Bosnia and Herzegovina	6.61
	95	Russia	6.56
4th Quartile	102	Serbia	6.41
	122	Ukraine	5.94

Source: own selection from "Economic Freedom of the World 2012 Annual Report",
<http://www.freetheworld.com/2012/EFW2012-complete.pdf>

But what does it block the rise of the Central and Eastern European countries to the first quartile with the highest degrees of economic freedom? For these countries the prospect of EU membership formed the centerpiece of democracy promotion, providing powerful incentives that shaped policy preferences, identities, and the agendas of political actors in the region. (Ekiert, 2008) But it seems that it was not enough.

The main challenges that were faced by these countries were: the ability to develop the administrative capacity necessary to implement the acquis; the ability to extend and deepen the reforms that will eventually result in the transformation of their economies into market-oriented systems comparable to and competitive with those in the current EU; the ability to reduce the high levels of unemployment while also addressing the underlying structural imbalances that have given

rise to large government, trade, and current account deficits; the ability to finance the transition to membership in the face of the less-than-generous terms offered by the EU; the considerable skepticism about, and even outright opposition to, their accession to the European Union. (Cameron, 2004)

The complexity of the situation of the Central and Eastern European Countries is determined, for example, by the fact that these new member states of the European Union have undergone a triple crisis in the last two decades: first, they had a *transformation crisis* in the early nineties and with the EU entry they fell into the *post-accession crisis*, followed immediately by the *global crisis*. (Ágh, 2012)

Grouping the mentioned countries, taking into account the scores obtained in each area, but in some components and subcomponents of interest as well, reveals a significant picture:

Table 3 - Economic Freedom ratings 2010 (Central and Eastern European Countries)

	Size of Government (1)	Legal System and Property Rights (2)	Sound Money (3)	Freedom to Trade Internationally (4)	Regulation (5)	Credit Market Regulations (5A)	Labor Market Regulations (5B)	Business Regulations (5C)
	Rating and Rank	Rating and Rank	Rating and Rank	Rating and Rank	Rating and Rank	Rating and Rank	Rating and Rank	Rating and Rank
Estonia	6.06 (93)	7.29 (25)	9.43 (30)	8.08 (14)	7.84 (26)	9.81 (10)	5.96 (88)	7.74 (21)
Lithuania	6.79 (57)	6.45 (45)	9.37 (34)	7.49 (54)	7.60 (37)	8.70 (64)	7.65 (38)	6.45 (54)
Montenegro	6.00 (94)	6.47 (42)	9.57 (21)	7.77 (35)	7.90 (25)	9.78 (12)	8.01 (20)	5.91 (79)
Slovak Republic	6.29 (80)	5.78 (61)	9.71 (5)	8.04 (17)	7.40 (49)	9.16 (42)	7.33 (50)	5.72 (90)
Armenia	7.64 (29)	5.56 (72)	9.18 (47)	7.59 (48)	7.12 (60)	8.80 (60)	6.61 (68)	5.94 (73)
Romania	7.04 (49)	5.72 (65)	9.02 (52)	7.86 (30)	7.39 (50)	9.38 (26)	6.93 (58)	5.58 (81)
Albania	8.04 (15)	5.36 (78)	9.73 (4)	7.3 (64)	6.29 (111)	7.04 (117)	5.93 (89)	5.91 (78)
Georgia	6.24 (83)	5.71 (66)	8.8 (62)	8.2 (11)	7.75 (32)	8.18 (85)	7.8 (29)	7.28 (28)
Bulgaria	6.46 (68)	4.99 (90)	9.51 (24)	7.9 (25)	7.76 (30)	9.98 (8)	7.74 (30)	5.57 (101)
Poland	6.35 (76)	6.33 (48)	9.39 (31)	7.27 (67)	7.2 (56)	8.24 (83)	7.42 (45)	5.93 (75)
Czech Republic	4.96 (125)	6.16 (52)	9.45 (27)	7.77 (33)	7.47(46)	9.22 (38)	7.67 (36)	5.51 (105)
Latvia	5.22 (115)	6.4 (46)	8.93 (56)	7.9 (26)	7.14 (59)	8.37 (79)	6.82 (62)	6.23 (61)
Hungary	3.94 (139)	6.34 (47)	9.6 (17)	7.92 (24)	7.62 (36)	9.28 (34)	7.32 (51)	6.27 (59)
Macedonia	6.11 (90)	5.23 (84)	7.97 (87)	7.29 (65)	8.11 (16)	9.84 (9)	7.85 (28)	6.65 (48)
Croatia	4.96 (124)	5.76 (63)	8.42 (73)	7.71 (37)	6.95 (70)	9.01 (50)	6.4 (76)	5.45 (106)
Moldova	7.19 (42)	5.48 (75)	7.38 (96)	6.92 (85)	6.77 (84)	9.13 (45)	5.59 (104)	5.6 (99)
Slovenia	4.54 (134)	6.2 (51)	8.3 (75)	7.65 (44)	6.47 (104)	7.5 (108)	5.42 (109)	6.49 (52)
Bosnia and Herzegovina	5.53 (108)	4.57 (98)	8.27 (77)	7.64 (46)	7.02 (66)	9.49 (24)	6.43 (75)	5.13 (114)
Russia	6.75 (59)	5.27 (80)	8.47 (70)	6.08 (127)	6.24 (114)	7.77 (103)	6.05 (86)	4.9 (125)
Serbia	5.78 (99)	4.92 (91)	7.94 (90)	7.03(80)	6.38 (109)	8.5 (76)	5.7 (97)	4.95 (122)
Ukraine	6.62 (64)	4.79 (93)	5.6 (138)	6.72 (96)	5.97 (124)	8.14 (89)	6.08(84)	3.69 (141)

Source: Own selection from "Economic Freedom of the World 2012 Annual Report",

<http://www.freetheworld.com/2012/EFW2012-complete.pdf>

As shown in Table 3, the countries from Central and Eastern Europe, already part of the European Union, are placed to similar positions, according to most of the indicators, generally in the second and, sometimes, the third quartile. A closer look to the data provided by the mentioned report brings attention to the fact that the evolution of the scores in areas or components like the size of the public sector or free international trade is similar to that of other developed European countries, which is not surprising considering the efforts of countries in Eastern Europe to align to Western Europe, regarded as political, economic and social landmark. Also, the relatively small scores regarding the size of the public sector are fully justified by the general trend in Europe to converge towards "welfare state" economic systems, characterized by the coexistence of state's paternalistic attitudes in relation to its citizens with free market mechanisms.

The generally high scores in the "Security money" or "credit market regulations" components for all the countries in Central and Eastern Europe reveals their engagement towards ensuring monetary stability in order to develop an efficient economic system.

Significant differences between the countries within European Union and the other are found in "legal system and property rights", "business regulation" and "labor market regulation" components. It is obviously that these already known issues are those that prevent the development of a healthy market economy in non-EU countries from Central and Eastern Europe.

Also, a close and comparative look reveals that although considering the sub-component "Labour market regulation" the countries 'already in the EU are becoming part of the trend of developed countries, in terms of a more generous social system, the scores related to the "legal system and property rights" and "business regulation" being the "problem" scores.

In fact, this is evident from the analysis of Table 4, grouping the countries from Central and Eastern Europe by the highest and the lowest scores considering these specific components or subcomponents.

Table 4 - Highest and Lowest Areas of Economic Freedom Ratings 2010 (Central and Eastern European Countries)

	Highest Rating	Lowest Rating	Lowest Subcomponent Rating
Estonia	9.81 (10) 5A	5.96 (88) 5B	Conscription 3
Lithuania	9.37 (34) 3	6.45 2+5C	Bureaucracy Costs 2.94
Montenegro	9.78 (12) 5A	5.91 (79) 5C	Licensing Restrictions 3.9
Slovak Republic	9.71 (5) 3	5.72 (90) 5C	Bureaucracy Costs 2.76
Armenia	9.18 (47) 3	5.56 (72) 2	Judicial Independence 3.01
Romania	9.38 (26) 5A	5.58 (81) 5C	Bureaucracy Costs 3.08
Albania	9.73 (4) 3	5.36 (78) 2	Judicial Independence 3.29
Georgia	8.8 (62) 3	5.71 (66) 2	Judicial Independence 3.63
Bulgaria	9.98 (8) 5A	4.99 (90) 2	Impartial Courts 2
Poland	9.39 (31) 3	5.93 (75) 5C	Bureaucracy Costs 2.68
Czech Republic	9.45 (27) 3	4.96 (125) 1	Transfers and Subsidies 2.91
Latvia	8.93 (56) 3	5.22 (115) 1	Top Marginal Income and Payroll Tax rate 3 (47)
Hungary	9.6 (17) 3	3.94 (139) 1	Top Marginal Income and Payroll Tax rate 1 (56)
Macedonia	9.84 (9) 5A	5.23 (84) 2	Judicial Independence 3.15
Croatia	9.01 (50) 5A	4.96 (124) 1	Top Marginal Income and Payroll Tax rate 0 (62.67%)
Moldova	9.13 (45) 5A	5.48 (75) 2	Judicial Independence 1
Slovenia	8.3 (75) 3	4.54 (134) 1	Top Marginal Income and Payroll Tax rate 1 (60%)
Bosnia and Herzegovina	9.49 (24) 5A	4.57 (98) 2	Impartial Courts 3.09
Russia	8.47 (70) 3	4.9 (125) 5C	Bureaucracy Costs 2.36
Serbia	8.5 (76) 5A	4.92 (91) 2	Judicial Independence 2.38
Ukraine	8.14 (89) 5A	3.69 (141) 5C	Licensing Restrictions 2.35

Source: own processing after "Economic Freedom of the World 2012 Annual Report",
<http://www.freetheworld.com/2012/EFW2012-complete.pdf>

Legend:

1. Size of the Government
2. Legal System and property Rights
3. Sound Money
4. Freedom to trade Internationally
5. Regulation

5.A. Credit Market regulation

5.B. Labor Market regulation

5.C. Business regulation.

CONCLUSION

Therefore, although significant progresses regarding the degree of economic freedom have been carried out, virtually all countries from Central and Eastern Europe still have a lot left to do in order to build an economic system that is not politically governed, which to be able to guarantee the



legal system and which to allow the private initiative a greater degree of economic action by deregulation, cut in red tape and fiscal easing. Although it is true that a welfare state is supported by an extensive taxation, history has proven on numerous occasions that a welfare state cannot be maintained without a free and dynamic market.

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