EEI POLICY PAPERS 2009-4

Eastern and Central Europe - Second Wave of Reform and Success

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Design
picture element

Published by:
European Enterprise Institute
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Web site: www.european-enterprise.org

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A word from the publisher

When the Berlin wall came down 20 years ago, many observers feared deep economic crisis for a very long time in Eastern and Central Europe. The countries that left communism and the centrally planned economy were generally advised to reform slowly.

Instead, many of the newly liberated countries reformed radically, and introduced market economic institutions swiftly. After a few years of economic downturn, growth reached high levels and remained on average twice as high as in Western Europe for 15 years.

Eastern and Central Europe have moved decidedly closer to the average incomes of Europe, and their success has been clear. Indeed, they have also exported policies and ideas to their European neighbors, making all of Europe more competitive.

During the economic and financial crisis, however, the critics have emerged again, claiming that the free-market reforms made these countries vulnerable.

This Policy Paper, written by Nima Sanandaji, argues that the crisis will by no means erase the prosperity gained. These countries continue reforming in the midst of the crisis to the benefits of the whole European Union.

Peter Jungen
President, European Enterprise Institute

Summary

Two decades ago a wave of democratic freedom swept over Europe. One by one the communist dictatorships in the East could change into market economic democracies. Since then the nations in Eastern Europe and the Baltic have come to play an increasingly important role in the European community; as business partners and as members of the European Union. Over time they have also grown in importance as international competitors.

The countries have not only reformed away from planned economy, but they have also adopted the market economy in a clearer way than their Western European neighbors. Several of the states in Eastern Europe and the Baltics have been characterized by their good conditions for entrepreneurship combined with low- and flat tax rates.

Prior to the ongoing economic recession, a central issue was how the western tax systems would be able to compete in the long run with the quickly growing economies in the East – where the taxes for labor, business and capital are significantly lower than in the West. How can, for example nations such as Denmark, Sweden, Belgium, the Netherlands, Austria and Finland – where the highest marginal tax rate on labor is at or above 50 percent – compete with the Czech Republic and Slovakia where the tax is flat at 15 and 19 percent respectively?

However, the discussion about Eastern Europe and the Baltics has turned rapidly in response to the financial crisis. Today, media primarily directs the spotlight on how hard these countries have been hit by the crisis, especially above all Latvia and Ukraine. This is an important issue, but at

the same time we should not lose focus on the long term competitiveness and growth potential in Europe's new market economies.

The countries in Eastern Europe and the Baltics have shown a phenomenal ability to turn a decline into growth and development during the last two decades. The entire region was hit by an enormous shock when the communist planned economies fell overnight. But not least the countries that were quick to reform such as Poland, the Czech Republic, Slovenia and Estonia have been able to recapture a strong prosperity development since the fall of communism.

This prosperity development has, as opposed to the prediction of the reform critics, been accompanied by a rapid decline in poverty, increased income for the elderly and increased investments in social care. Nations such as the Czech Republic, Hungary and Slovakia are characterized by having amongst the lowest rates of relative poverty in Europe.

Latvia and Lithuania succeeded to recover and grow despite the fact that their economies had decreased by half from 1991 to 1993. We have good reason to believe that Europe's new market economies once again will grow rapidly when the present recession is turned into a time of prosperity. This regards not least the regions greatest economies, Poland and the Czech Republic, that have passed through the crisis well so far.

The recession does not only represent a financial crisis, but also an ongoing globalization process. Many industries in the Western World are forced to downsize or to declare bankruptcy because they cannot handle the increased global competition from the new market economies, such as

India, China and the Eastern European and Baltic economies.

When the recession is turned in to a time of prosperity global competition regarding jobs will tighten. The competitive tax systems in the East will open up for a more rapid restructuring process and better possibilities for growth and creation of jobs compared with the high tax system in the West. The major question will then once again be how we in the West are to handle the competition from low tax countries where work, savings and entrepreneurship are much more strongly rewarded.

It can today, two decades after the fall of communism in Europe, be worth addressing this long term perspective. Despite the fact that growth and development in Eastern Europe is beneficial for Western European nations, in many ways it also increases the need for tax reforms to strengthen the competitiveness of high tax Western nations.

In order to face the crisis Poland has lowered their highest tax rate from 40 to 32 percent. Bulgaria keeps the newly introduced flat tax of 10 percent and introduced new tax reductions for investors. In the Czech Republic, where the income tax is flat at 15 percent, the majority of the introduced stimulus package is constituted by tax reductions. The Baltic nations have lowered some taxes but have also been forced to raise others as the crisis has worsened. The long term commitment to low tax policies, however, seems to remain strong in the Baltics.

The attitude towards taxes seems to be rather different in Eastern and Western Europe. And the high tax systems in the West can ill afford to ignore the tax competition from the east.

Introduction

On the fourth of June 1989 the citizens of Poland were given the opportunity to exercise their democratic rights. The movement of solidarity won 160 out of 161 available seats in a land slide victory.[1,2] The new government promised ambitious reforms towards democracy and a market economy.[3]

A couple of months later the Berlin wall, the most famous symbol of dictatorship and oppression in the post war era of Europe, fell. Soon freedom spread to other communist nations in Europe. The Soviet Union had let go of its grip on the satellite states, which had opened up for a great wave of democracy.

Today, two decades after the fall of the Berlin wall, Western journalists once again direct their attention to Eastern Europe and the Baltics. But the focus is not on the democratic, economic and social progress that has taken place since the downfall of communism, but rather on the effects of the financial crisis.

Several states in Eastern Europe and in the Baltics, not least Latvia and Ukraine, have been struck hard by the global recession. The reason for this is that they were situated in a state of development where they grew rapidly with the aid of foreign capital when the crisis hit. However, even the nations hit the hardest can, in all likelihood turn the crisis into an upswing in a few years.

The fundamental conditions for growth are strong in the region and above all in reform directed countries that have introduced business friendly politics and low tax rates. Several countries in the region, such as the two largest economies Poland and the Czech Republic, have dealt well with the crisis so far. These countries are already developing well during a time of global recession.

There are those who look down on the progress in the East. It is not the first time either. When communism fell, many implied that the reforms toward market economy in the East were a big mistake.

Bo Toresson, former party secretary for the Swedish social democrats, for example in 1994 wrote that the road that has so far been tested as an alternative to planned economy is inequasably on its way in to a dead-end". Toresson explained that he had heard statements "[w]ith devastating clarity" that several of the former communist states were on a "catastrophic course towards anarchy".[4]

But history has proved the critics wrong. The wave of freedom in Europe's former communist states became a great success. Above all rapid reform countries such as Poland, the Czech Republic, Slovakia and Estonia have succeeded in building well functioning democratic and economic systems.

The liberation of Eastern Europe and the Baltic States two decades ago was not only one of the most important democratic waves in history, but also an economic success story without precedent. It has shown the strength of the economic systems that rely on low and flat tax rates, which focus on growth and development.

The strength of the economic systems in the East will persist when the crisis is over. It will give the countries a strong competitive advantage when the global economy once again starts to grow and the global competition for jobs intensifies.

The development in Eastern Europe and in the Baltic states opens up many new possibilities for Western Europe. We benefit from the growth and development among our European neighbors. At the same time a future issue arises of how the high tax system in the West can cope with the competition from the East.

It has been a particular situation for high tax nations such as Sweden, Denmark, Finland and Belgium over the years to compete with other western countries that in general have had similar progressive tax systems with only slightly lower tax rates. The situation will be different when the competition from low-taxing countries in the East grows, considering that the taxes in the East are not only much lower but in many cases also flat.

During the last two decades the countries in Eastern Europe and in the Baltic states have taken inspiration from their neighbors in the west in order to build well functioning democracies and free economic systems. Today it is time for the high tax countries in Western Europe to learn from their neighbors in east; to recognize how low and flat taxes stimulate development and reduce bureaucratic hassle as well as strengthen international competitiveness.

The financial crisis and Europe's new market economies

When the financial crisis first struck, there were those who believed that the former communist states of Europe would survive relatively unharmed. By the end of 2008 the New York Times interviewed the chief economist at the European Bank for Reconstruction and Development – an institution created 1991 in order to help the states of the East transcend to free economic systems.

The chief economist, Eric Berglöf, declared that it was remarkable how little the effect the crisis has had on the region as a whole."[5] A couple of months later Berglöf delivered a rather different message. He then concluded that the countries in east were on the verge of being drawn in to the crisis, and that it could potentially affect them severely.

The financial crisis had turned from being mainly an American phenomenon to being a far more global one. Berglöf explained how the crisis via integrated banking systems was about to spread to Eastern Europe and the Baltics. The region's trade-dependent economies were also clearly influenced by the general fall in global demand.[6]

By the end of 2008 the economies of Eastern Europe and the Baltic nations were estimated to in total grow with nearly five percent during 2009.[7] But the growth rapidly turned to recession. The Estonian economy for example, which during 2005 and 2006 had grown with as much as ten percent annually, shrank with four percent during the last quarter of 2008.[8]

By the middle of 2009 it was estimated that the economies of the Eastern States all together would decrease by four percent during the current year. In countries like Latvia and Ukraine the drop was estimated to be over ten percent. [9]

During 2008 the stock markets in several countries – like Lithuania, Romania, Ukraine and Bulgaria – fell by as much as 75 percent.[10] The global crisis had become much more serious than many initially predicted. At the same time a number of economies in the East had shown particular sensitivity to the decline.

Up until 2008 the countries in Eastern Europe and the Baltics had experienced a decade characterized by a rapid development, with an average yearly GDP growth rate of about 7-8 percent for the region.[11] Successful market reforms had laid the ground for a rapid expansion under a time when the global economy went into high gear. But many countries in the region – like Estonia, Latvia, Lithuania, Ukraine and Bulgaria – made the mistake of relying on fixed exchange rates.

The countries' currencies were priced improperly, which in short term perspective encouraged a large inflow of foreign capital. As the money supply rose, inflation accelerated. This contributed to economic overheating, which culminated just before the financial crisis.[12] The countries may also, to some extent, be said to have been unlucky as they were in a state where they grew rapidly with the help of foreign investments when a global financial crisis struck and choked global flows of capital.

The decline in Eastern Europe and the Baltics during 2008-09 is very similar to the Asian crisis of 1997-98. During the Asian crisis the fast growing tiger economies had, largely due to fixed exchange rates that led to wrongfully set currencies, attracted unusually large amounts of foreign capital and thus overheated. The overheating went on to become a drastic economic fall, much like the fall currently being experienced by the Baltic economies.[13,14]

As the crisis spread to the states in East they have had an increasingly difficult time paying off their debts. This has affected domestic as well as foreign banks which lent money to the East. The financial sector of Latvia, for example, went back with as much as 500 million Euros during the first half of 2009. Several Scandinavian banks such as Swedbank and Nordea, which are dominant actors in the country, have in this context been hit very hard.[15]

The development in the Baltics and in Ukraine is however not representative for the entire region. Several nations have coped well with the global downturn. The largest economy in the region is Poland, whose economy is 15 times larger then that of Latvia. The Polish economy has not relied on foreign funding to boost domestic demand in the same way as the Baltic economies and has not hitherto been particularly hard hit by the crisis.

Poland is in fact expected to experience a positive growth during 2009, contrary to many other modern economies. The region's second largest economy, the Czech Republic, has also fared well so far.[16]

It is difficult to predict how deep the downturn will eventually become, both for the region and for the global economy. However, there are good reasons to predict that Europe's new market economies will exhibit a strong ability to re-grow when the global economy turns.

Fundamentally The countries have good prospects for growth, not only thanks to low and flat taxes, but also other growth friendly approaches to economic policy (which will be discussed in greater detail further on in this report).

The recession will thus most likely be a dent in a long term positive growth curve. The comparison with the Asian crisis is once again relevant. Since the Southeast Asian market economies in their foundations have good conditions for development they showed clear signs of growth already a few years after the crisis.[17]

It is reasonable to predict that a similar development will happen in the Baltics and in Ukraine. The Latvian economy is expected to shrink by as much as 15 percent in 2009. This however would simply mean that the economy fell to 2006 levels.[18] If the country can resume its high growth rate after the crisis, recovery can occur in only a few years.

During later years Eastern Europe and the Baltics have shown a phenomenal ability to deal with economic downturns. This regards not least the countries that have been most ambitious in introducing a growth oriented system. In a global perspective, the ongoing financial crisis can be said to be the most serious since the great depression. But for the states in the East it does not come close to the deep crisis that the collapse of the planned economy led to.

The collapse of the planned economy was turned into economic and social development

The economic development in Eastern Europe and the Baltic States since the fall of communism has helped millions to escape poverty. Among others the World Bank has highlighted the constructive reform work in the region as a model example for other countries the have left communism behind them.[19]

At the same time, we should remember that this development has been anything but easy to achieve. The collapse of the planned economy was the start of a very painful process and the former communist states experienced a huge decline in living standards. In Bulgaria, Romania and Slovenia the GDP fell by about 25 percent between 1989 and 1993. In Poland and the Czech Republic, which were hit less than the others, the GDP fell with 12 and 13 percent respectively.

Because of the Baltic States' close dependence on the Soviet Union they were hit hardest. Between 1991 and 1993 Latvia and Lithuania lost about 50 percent of their GDP, while Estonia lost 35 percent.[20] The decline was thus several times that experienced by the current crisis.

All the former communist states in Europe since the fall of communism have focused on reforms towards market economy. In countries such as Poland and Slovakia it was all about rapid and ambitious reforms, while reforms occurred slowly in nations such as Romania.

The introduction of property rights, private enterprise and free opportunities for exchange with other countries has meant that modern economic systems have been emerging in the formerly planned economies. Already a couple of years after the fall of communism clear signs of growth potential in Europe's new market economies where visible, particularly in those countries that had carried out the most ambitious reforms.[21]

Thanks to this, the region could up until the end of the 1990's begin turning the decline into growth and in certain cases even get a positive development of employment. In Hungary, Slovenia, Slovakia and Poland the GDP grew by 21 to 39 percent during the years 1993-1996. In Romania, which has lagged behind in reforms, the economy stagnated during the same period.[22,23]

During the mid 1990's the European Commission and the German central bank, the Bundesbank, noted in two independent studies that the reform-minded economies in the East had grown faster than expected. The countries had by then already gone through the most difficult part of their transition to a market economy and had started to grow from their own efforts to competitive trade partners.[24]

The good development continued during the coming years. As is shown in figure 1, Europe's new market economies grew strongly during the period 1995-2008, significantly faster than their neighbors in Western Europe. The average annual growth in real GDP per capita was above five percent in Estonia, Lithuania, Latvia and Slovakia while it was just below five percent in Croatia and Poland. In the average EU-15 countries the growth was in comparison about two percent per year.[25]

The strong economic development in Eastern Europe and the Baltic States cannot solely be explained as a natural recovery since the fall of communism, but to a large extent due to an ambitious reform policy. This is illustrated by a comparison with the former Soviet republics (excluding the Baltics), who were inferior to introducing a stable framework for economic development.

As the World Bank has shown, the real GDP decreased in the former Soviet Republics from 1990 up until 1998 concurrently with the collapse of communism. The growth between 1998 and 2006 only implied that GDP could resume to a level just below the level of the year 1990.

The economies in Eastern Europe and in the Baltics grew at the same time continuously between 1993 and 2006. In 2006 the decline from the collapse of communism had been regained and the region was close to 50 percent higher GDP compared with the level of 1990. [26]

Critics of the market reforms sometimes claim that the increased standard of living in Eastern Europe and in the Baltics has been focused on a few rich people. There is little if any support for such a claim.

A study made by the World Bank shows that the poor have been more favored than the rich by the growth in the Eastern States. Poverty in reform countries such as Poland, the Baltic States and Hungary has been reduced to very low levels. The development has been slower in Albania and Romania, which carried out less ambitious reforms towards a market economy. [27]

As is shown in figure 2 the relative poverty (defined as the proportion earning less than 60 percent of median income in each country) varies in Eastern Europe and in the Baltic States. Some countries have a higher level compared with Western Europe, some lower. The Czech Republic, Hungary, Macedonia, Slovakia and Slovenia have managed to drive down poverty rate among the population to three percent or lower. In most Western European nations this ratio is four percent or above. [28]

Reforming countries have experienced a significant increase in life expectancy, while former communist states who were late with reforms, such as Russia, have experienced a declining life expectancy. The life satisfaction among citizens in Eastern Europe and in the Baltic States has increased over time, especially in those countries that have had the strongest economic development. [29]

A common objection to reform politics is that the development in the Eastern States would not have resulted in a higher life expectancy for the elderly. This has no support in reality though. The real incomes for people over the age 65 increased for example with 27 percent in Hungary and 43 percent in the Czech Republic between the beginning of the 1990's and the mid 2000's.[30] During the same period, the proportion elderly has risen sharply in both countries.[31]

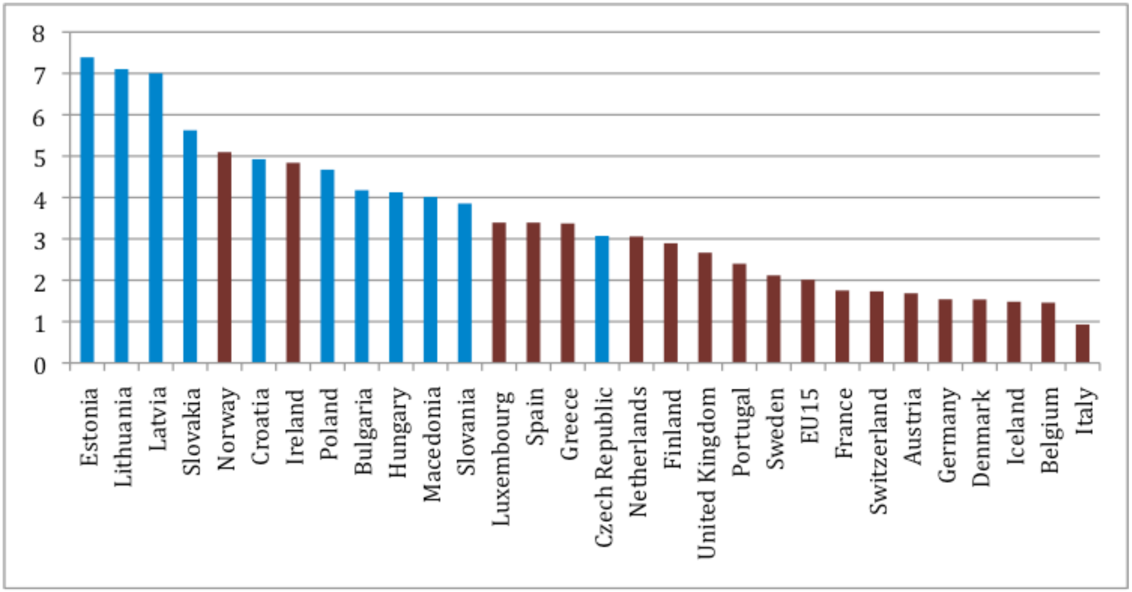
Another common objection is that the countries in the East could not have succeeded combining growth with increased means for social care. This is incorrect as well. Statistics for social spending is not available for all Eastern European and Baltic countries for the entire period since the fall of communism, but in all countries the spending per capita was higher in 2006 compared with the earliest year for which data can be found.

In the Czech Republic the spending nearly doubled per capita during 1995-2006 while it increased with 60 percent during 2000-2006 in Estonia. In Lithuania it increased with 223 percent during 1996-2006.[32]

Europe's new market economies have shown a remarkable ability to turn the fall of the planned economy in to a long term social and economic development. The reason for the success of the development in the reform countries is not just because they have adopted the system of market economy that already existed in the West, but that they have gone further in their ambitions.

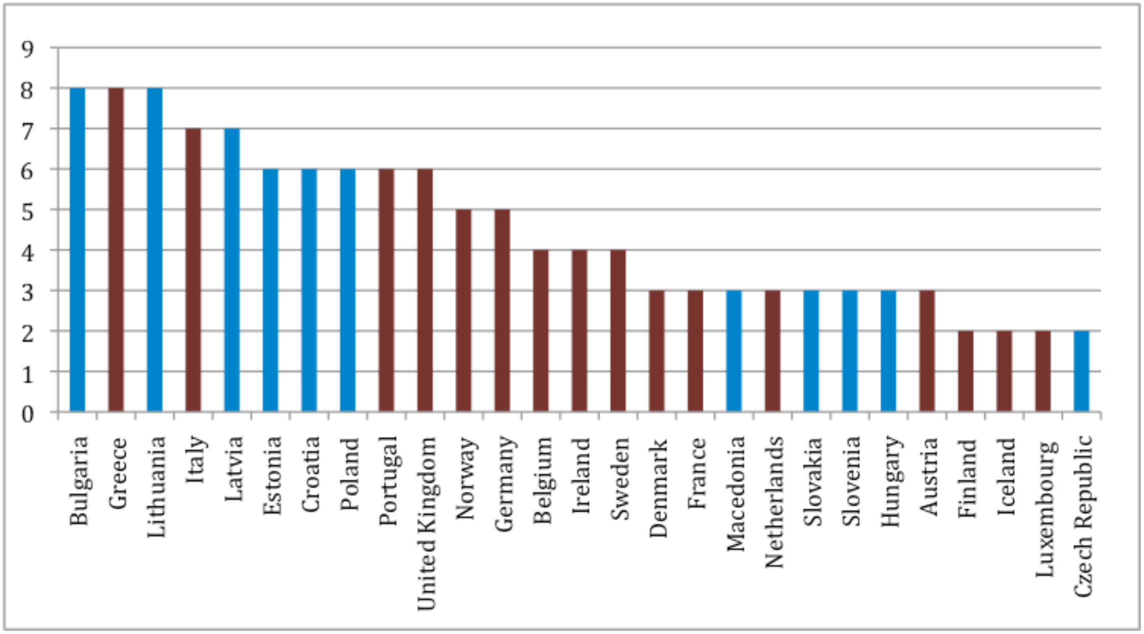
They have implemented economic models that in a larger extent than its neighbors in west are aimed at growth and development.

Figur 1. Average annual growth rate 1995-2008



Source: Eurostat. Blue columns represent Eastern European and Baltic States.

Figur 2. Ratio of poor among entire population year 2007



Source: Eurostat. Data is given for year 2007 with exception for Bulgaria (2006) and Croatia (2003). Source: Eurostat. Blue columns represent Eastern European and Baltic States.

Flat and low taxes has paved the way for development

During the first years since the fall of communism the reform work in the East was focused on rebuilding fundamental frameworks for economic development and on privatizing previously government-owned industries.

Other important objectives have been to improve infrastructure, education, research and public services. The Eastern European countries and Baltic States have in these aspects come far, but not yet reached the levels of the Western nations.

At the same time reform countries such as Poland, Hungary, Slovakia, Slovenia, the Czech Republic and the three Baltic States have come to be characterized by a skeptical attitude towards high taxes. The fall of communism has resulted in a willingness to open up large parts of the economy to private enterprise. Reforming countries have invested in creating an attractive system for entrepreneurs.

In common with other growth economies the Eastern European and Baltic States have introduced (generally limited in time) tax reductions for foreign investors and for companies that have localized their businesses there. Even tax free zones have been created. [33]
A central explanation for the good development that the region has experienced is that the politics have not only focused on short term tax reductions, but also on the overall tax reforms that have encouraged growth. Low tax rates have been introduced in several Eastern European and Baltic countries in order to stimulate growth.

As is shown further on in this report the highest marginal taxes have with time decreased. This development has surprised many that had expected that the as the countries developed they would, in similarity with Western Europe, adopt systems with high taxes and a large public sectors. Reforming countries in the East have come to choose a different development strategy, which focuses on growth rather than deployment policies and government interventions in the economy.

Estonia and Lithuania were in 1994 the first to introduce flat tax system, where basically the same rate is paid by wage earners regardless of income. [1] Flat tax systems have proven to have many advantages compared with progressive tax systems:

- Lower marginal tax rates create greater incentives for employment, entrepreneurship and capital accumulation.
- The distorting effects of taxes are reduced the simpler and the more uniform a tax system is designed. The taxes that twist the behavior the least are in general the best for the national economy.
- Double taxation is avoided.
- Flat taxes are easy to grasp, which reduces the administrative costs associated with taxes and declaration.
- Easier and clearer rules lead to decreased tax evasion.[34,35]

1 It should be noted that no country in the world has completely flat taxes, as there are always special regulations and exceptions. Those countries mentioned in this publication have relatively, but not entirely, flat taxes. These systems differ substantially from the more progressive systems inother countries, which also have even more complicated exceptions.

Reforms in Estonia and Lithuania have proven to be a great success and flat taxes have over time spread to more and more countries in the region, such as Latvia, Bulgaria, Slovakia and Romania. [36,37]

The success that the introduction of the flat taxes and other market oriented reforms has implied is exemplified by the development in Estonia. The country was characterized by enormous economic problems after the liberation from the Soviet Union in 1991. The economy was in a free fall state in 1992 and the inflation reached 1000 percent.

Reforms of privatization, strengthened property rights and the introduction of a flat tax, however, bore fruit in coming years. Already in 1995 and 1996 the Estonian economy could grow with about four percent annually. Entrepreneurship lifted the previous planned economy. During 1992 Estonia had about 2000 businesses. Two years later that number had grown to 70 000.

Estonia's GDP per capita reached 35 percent of the European average in 1996. Eleven years later that number had nearly doubled to 65 percent. During later years the majority of the Eastern European and Baltic countries had experienced strong economic development, but it is clear that the most rapid development has occurred in the countries that to the largest extent put their efforts on privatizations, simplification of rules for entrepreneurship and flat taxes.

On average the GDP per capita increased as a portion of the average in Europe with 25 percentage units in the three reform countries Estonia, Poland and Hungary between 1996 and 2007. In the former European communist states that kept the progressive tax systems the rate of increase was only about 14 percent. [38]

Opponents of flat taxes often mean that they mainly benefit the rich. That appears not to have been the case in the reform countries of Eastern Europe and the Baltics. Partly because the higher growth rate generated by flat taxes has generally favored development, but also because equality in many cases has increased in Eastern European countries with flat taxes, compared with progressive taxes.[39]

Data from Eurostat shows that the Gini-coefficient (that measures the level of economic equality) in Estonia decreased from 36 to 33 during 2000-2006. This means that the countries economy has become more equal. [40] Another example that flat taxes can be combined with economic equality concerns Slovakia. In 2002 a series of reforms where performed in the country that increased reward for work and that was aimed at improving international competitiveness.

The income tax, that previously had been as high as 38 percent, was replaced with a flat tax of 19 percent. A number of special rules and deductions were introduced that meant that taxes were even lower for families with many children and/or low income. At the same time the government transactions became stricter.

The World Bank studied the reforms in Slovakia and found that the tax- and benefit reforms not only in general was advantageous for those who were working in the country, but also improved the economic situation for the majority of households that had the right to government benefits. This is a clear illustration of how the introduction of low and flat taxes can also aid those with lower income.[41]

Low and flat taxes have been an important condition for the development of Europe's market economies. As discussed later in this report these tax systems are more competitive compared to most West European tax systems when it comes to taxation of not only work, but also capital and businesses.

But is there no risk that the economic crisis means that reforming countries will abandon the system with flat taxes?

Tax competition at center during crisis

It has been the belief in the West that low and flat taxes introduced in the reform countries in Eastern Europe represent an interim phase of development, and that the region will move toward higher taxation as the standard of living increases.

History has spoken against this. In figure 3 the development of the highest marginal taxes in the Baltic States is shown since the mid 1990's. In all three Baltic States the tax has over time been pressed down. In Estonia it has fallen from 26 to 21 percent, in Latvia from 25 to 23 percent and in Lithuania from 33 to 21 percent.[42,43]

In figure 4 the development of the highest marginal taxes for Poland, the Czech Republic and Bulgaria are shown. Taxes have declined dramatically in Poland, the Czech Republic and Bulgaria since 1995 – with 13, 28 and 40 percentage units respectively.[44,45]

In Eastern Europe and in the Baltics there is, and has been, an insight that lower and simpler taxes are beneficial for the national economy. There is also a clear tax competition between countries in the region, a competition where the goal is to create growth friendly tax systems that attract capital, businesses and talented individuals.

The tax competition is not only present in Eastern Europe and in the Baltics but also internationally. This is illustrated by the fact that flat taxes over time spread to growth oriented countries also beyond Eastern Europe and the Baltics, such as for example Russia, Georgia and Mexico.[46,47]

Market economy systems have during later years been established in a growing number of countries – such as the Eastern European States, former Soviet Republics, China, India, Mexico and Vietnam. The global competition for investments, businesses and talents has risen with the increasing number of countries that have reformed their economies towards free systems.

A fundamental competitive advantage in the new market economies has become low, and growth-friendly taxes. Therefore the new market economies, like the Asian tiger economies, tend to have a lower tax level compared with the traditional industrial countries in the West.

Tax competition from the new market economies also affects the richest competitors in Western Europe. Almost all of the EU-member states have either pressed down or kept their highest marginal taxes since 2000. The only exceptions are Portugal and Sweden that have increased their levels. [48]

For those who follow the media reports in the West today, it can sound like the low tax policies in Eastern Europe and the Baltics are changing direction in line with the global crisis. But is this really true? In reality, the picture is more complex.

When the crisis struck many countries faced it with tax cuts. In particular, the Baltic economies have been forced to raise some taxes as the crisis deepened.
Overall, though, tax cuts are still more prominent as emergency measures compared with raised taxes, not least in the largest economies in Eastern Europe:

- In Estonia a planned reduction of the flat tax rate, which was supposed to happen in early 2009 was postponed. The government instead decided to increase the VAT and the payroll tax. [49,50]

  The long-term policy is also focused on continuing to depress tax rates. The flat tax is planned to be lowered to 20 percent 2010 and then gradually to 18 percent 2012. [51] It remains to be seen whether the tax will actually be reduced at this rate, but the government's long-term dedication to low and flat taxes does not seem to have changed by the crisis anyway.

- In Lithuania the flat tax was reduced from 27 percent to 24 percent between 2007 and 2008. During 2009 it was reduced further down to 21 percent. [52,53] Before the crisis the ambition was for greater reductions to be carried out. At the end of 2008 the ruling coalition in Lithuania decided to in the beginning of January 2009 lower taxes on income, capital and VAT to a flat rate of 20 percent. [54]

The dramatic decline led to that there was no room for lowering income tax from work to 20 percent, even though the tax on dividends paid to individuals has been reduced to this level.[55] The government has also had to raise corporate and consumption taxes. To a large extent, the downturn has so far dealt with cuts in public spending, reflecting unwillingness to further raise taxes.[56]

- In Latvia, the worst hit by the crisis, the flat tax was recently lowered from 25 to 23 percent, a measure that the World Bank refers to as a better way to stimulate the economy compared with increased expenditure. [57,58,59]

On the ninth of June 2009 the country's Prime Minister Valdis Dombrovskis announced that the flat tax would be replaced with a progressive tax, by among other things lowering the tax for low income earners. [60] Two days later, however, the government decided that the tax would be increased and that flat tax rate would not be replaced by a progressive tax.[61]

It is possible that a progressive tax will eventually be introduced in Latvia. It is at least as likely that the planned tax cuts that have not been completed because of the crisis may get an impact during the next boom.

To summarize, it is not possible, despite the deep crisis, to find any real disruption from the low tax politics in the Baltic States – the countries are trying as much as possible to resist raising taxes, above all on work. Latvia and Lithuania have also recently lowered their flat tax rates heavily in order to stimulate the economy.

In the Eastern European reform countries the tax reforms have at the same time focused on lowering tax rates.

- Bulgaria introduced a flat tax in early 2008 of about 10 percent for companies and individuals. Before the reform the tax on work was at most 24 percent. In 1996 that was fully 50 percent. The country has kept the low tax rate during the crisis. Also a five year tax reduction for investments in certain businesses has been introduced. [62,63] The opposition has stated that the emergency policy should be more focused on tax cuts. [64]

- The socialist government of Hungary introduced a new tax package in February 2009 that was later adopted in May. The ”Solidarity tax” on companies was abolished at the same time as the corporate tax was raised – which in total corresponded to a lowering of the total corporate tax for companies with higher incomes and that the tax rate became generally flat for companies. The payroll taxes were lowered by five percent and the roof for the lowest tax level along with the VAT was raised. [65,66,67]

  The Solidarity tax is also planned to be abolished for private individuals in 2010. That would lead to the lowering of the highest tax level in Hungary from 40 to 36 percent.[68,69]

  - In Slovakia the emergency policies are focused on a series of tax reductions directed to investors and above all smaller companies. Special tax concessions have been directed towards research and development in the private industry.

    Reforms that were introduced in 2009 have also focused on simplifying the tax system for businesses. The basic deduction for earned income has been increased, and the payroll tax has been lowered. The consumption taxes on gasoline and alcohol have been raised and the government has further discussed raised tax on alcohol and gambling.[70,71,72] The government has also promised to lower the administrative costs associated with the tax system.[73]

- In Poland the income tax was lowered in the beginning of 2009. The lower tax rate was lowered from 19 to 18 percent at the same time as the highest tax rate of 40 percent was lowered to 32 percent. In addition to this tax benefits were introduced for investors.[74] The Polish Prime Minister Donald Tusk promised in late July 2009 that taxes would not be raised to deal with the crisis.[75] The OECD noted that the Polish government in the long term is contemplating the introduction of a flat tax rate, possibly by harmonizing the tax on work with the corporate tax of 19 percent.[76]

- In the Czech Republic an incentive package equivalent to 3 billion Euros has been introduced to meet the crisis. The majority of the package consists of tax cuts.[77] Corporate taxes have been lowered from 21 to 20 percent. Payroll taxes have been lowered from 12.5 to 11 percent. The VAT rate has been lowered for work intense services and VAT deductions have been introduced for passenger cars owned by entrepreneurs.[78]

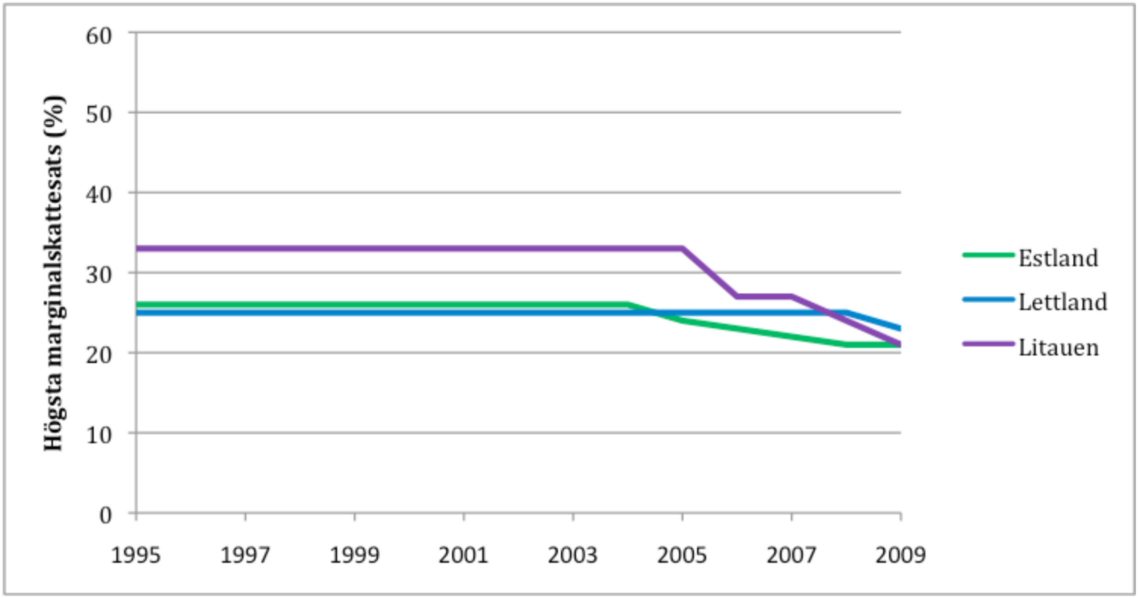
In general the Eastern European reform countries have a very clear focus on lowering taxes on work and entrepreneurship. In those cases where taxes have been raised it has above all concerned consumption taxes. The picture that the reform countries in east would have violated the low tax politics has no support either in the Baltics or in Eastern Europe. This is not true if we look at the market economy as such either.

The financial crisis has led a rise in skepticism against the market economy in many countries; including in Eastern Europe and the Baltics. The discontent that emerged in the crisis countries in East, for example in Latvia, however, addressed primarily the political power rather than free markets.

The long term trend before the crisis pointed to that a growing number of people in the region became supporters of free markets. Above all the new generation that grew up after the fall of communism has in a significantly larger extent come to view market economy as a positive phenomenon. [79]

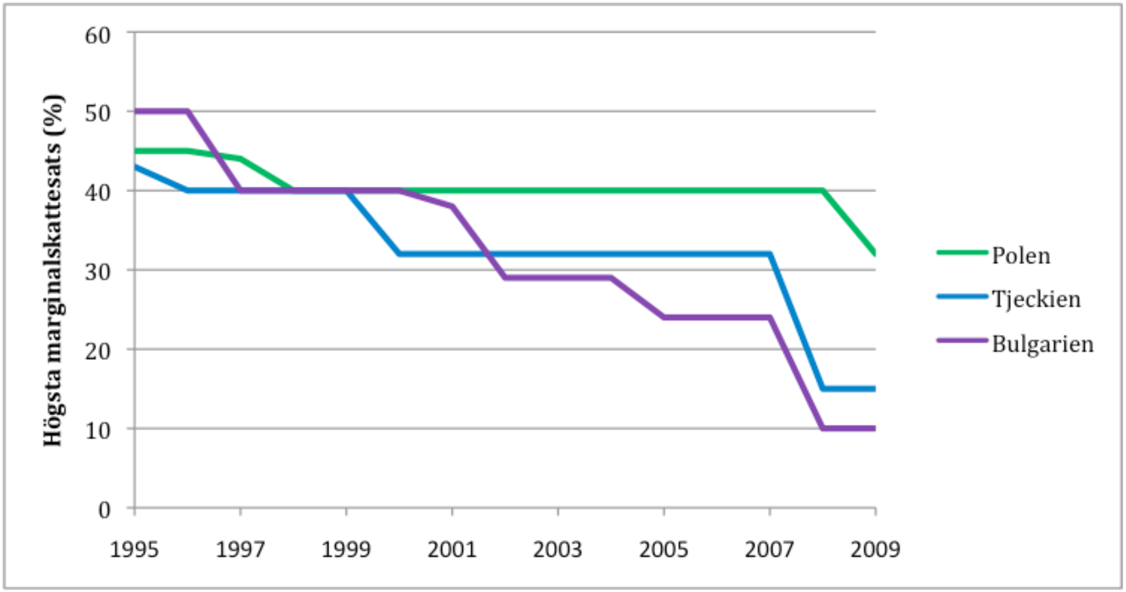
The ambition to create and maintain growth-oriented economies with a simple and low tax environment remains strong in the East. A relevant question in this context is how competitive the Western tax rates are in comparison with the reform countries in Eastern Europe and the Baltics.

Figure 3. The development of the highest marginal taxes in the Baltics



Source: European commission and Ekonomifakta.se.

Figure 4. The development of the highest marginal taxes in three Eastern European countries.



Source: European commission and Ekonomifakta.se.

Western European taxes in relation to reform countries in the East

The tax systems play a decisive role in the development in individual countries. If the world's economies were isolated from each other the tax systems would be important because they affect how well the different economic systems reward work, savings and entrepreneurship. In a world where individuals, companies and capital can flow between countries the tax system affects the development in an even stronger sense – because low taxes become a clear and present competitive advantage to attract investments, companies and talents.

Anyone who wants to invest turns to the country with the lowest taxes on capital. Anyone who wants to start a new factory prefers to turn to a country with low taxes on capital. If the factory energy is intense then low energy taxes is also a central parameter. The individual entrepreneur who plans to withdraw all or a part of his income will benefit from doing this in a country that has low taxes on work.

International research has clearly shown that high taxes inhibit growth. From a wide research review the OECD estimates, for example, that the growth rate increases by a half percentage for every ten units of percentage that the total tax pressure is reduced with. [80]

In table 1 tax levels in Sweden, Denmark, Finland, Belgium and Austria – Western European nations with high tax levels – are compared with the Baltic nations, the Czech Republic, Bulgaria, Slovakia and Poland. The difference is quite striking, not only when it comes to the level of taxation on work, but as well on capital, energy and entrepreneurship.

Denmark is the nation with the highest tax rate on personal income. The eastern country in the comparison that is closest to Denmark when it comes to the highest personal income tax is Poland. Yet the Danish tax rate is a massive 84 percent higher than in Poland. The highest marginal tax in Denmark is at the same time 490 percent higher than in Bulgaria.

Denmark also has higher corporate taxes and considerably higher capital taxes. The capital tax rate in Denmark ranges from being 349 percent higher than in Bulgaria to being 75 percent higher than the tax rate in the Czech Republic. At the same time, the energy taxes in Denmark are more than three times as high as any of the Eastern countries in the comparison.

The highest marginal tax rates are similarly much higher in Sweden, Finland, Belgium and Austria than in any of the Eastern nations. So are the corporate tax levels. The lowest corporate tax levels among the Western nations can be found in Denmark and Austria, while the highest rate in the Eastern countries can be found in Estonia. Still, the level in Denmark and Austria is 19 percent higher than in Estonia. The greatest difference can be found between Belgium and Bulgaria, with the corporate tax rate being 240 percent higher in Belgium.

Capital taxes are also higher in the Western compared to the Eastern nations in the comparison. The smallest differences in this case exist between Austria and Czech Republic, where the capital tax rates are only slightly higher in Austria. However in most comparisons, the difference is quite striking between the Western and Eastern nations. In Sweden for example, the capital tax rate is 259 percent higher than in Bulgaria. Lastly, also the energy taxes are consistently higher in the Western compared to the Eastern nations in the comparison.

The tax rates among the Western nations are typically several times higher than in the reform countries in the East – never being lower. This of course gives a strong competitive edge to the Eastern nations, where the economic systems reward work, entrepreneurship and capital formation more strongly than in the high tax Western nations,.

Considering the long term ambition of Eastern Europe and the Baltics to keep the tax pressure down, and the importance of taxes on economic development, and the fact that the region is catching up in terms of wealth to the West, the tax competition from Eastern Europe and the Baltic nations will likely only increase in importance.

It would be a great mistake to neglect the marked difference between taxation that exists between high tax nations such as Denmark, Belgium or Austria and Europe's new market economies.

Table 1. Comparison between tax systems

	Estonia	Latvia	Lithuania	Czech Republic	Bulgaria	Slovakia	Poland
Highest individual income tax (%)	21.00	23.00**	21.00***	15.00	10.00	19.00	32.00
Corporate tax (%)	21.00	15.00	20.00	20.00	10.00	19.00	19.00
Capital tax (%)	10.30	14.60	12.10	25.60	10.00****	17.50	22.80
Energy taxes, % of the average for the EU-27	58.39	51.01	55.70	69.13	45.64	55.70	67.79

	Sweden	Denmark	Finland	Belgium	Austria
Highest individual income tax (%)	56.50*	59.00	48.60	53.70	50.00
Corporate tax (%)	26.30	25.00	26.00	34.00	25.00
Capital tax (%)	35.90	44.90	26.70	31.10	26.10
Energy taxes, % of the average for the EU-27	146.31	220.81	75.17	77.18	106.04

Source: The European Commission as well as sources marked by an asterisk. The highest individual income taxes and corporate taxes are given for 2009. Capital taxes are given for 2007 except for Poland (2006). Energy taxes are given for 2006 and are initially estimated as Euro per ton consumed oil equivalent.

*Ekonomifakta.se[81]. **World Bank and Worldwidetax.com[82,83]. ***Deloitte Lietuva[84]. ****Deloitte[85].

Concluding remarks

Twenty years have passed since the former communist states in Europe fell one after another and were replaced by democratic systems. Most countries which at that time were freed from dictatorship and planned economy started ambitious reform work towards a market economy.

To recover from the collapse of the planned economy and to climb in prosperity has been a long process, but the reform countries have come a long way in this aspect – not least thanks to low and flat taxes that encourages growth and development.

The new market economies in the Baltics and Eastern Europe have been on a developing level which meant that they could not seriously compete with rich Western European nations for jobs for a long time, at least not within more developed sectors. This is now about to change.

Certain countries, like the Czech Republic, Slovakia and Slovenia have already begun to reach up to the wealth of the Western World. These countries are increasingly establishing themselves as leading actors in the global market.

To give an up to date example, the automotive industry of Slovakia nearly doubled during 2007. As the car companies from both west and Asia established themselves in the country Slovakia came to be the country that manufactured most cars in the world per capita.[86] There are signs that the country's automotive industry has fared well so far during the financial crisis, which otherwise has seriously threatened the automotive industry in the Western World.[87]

In a time when both Swedish car manufacturers SAAB's and Volvo's future are uncertain it is relevant to discuss how the significantly higher taxes in Sweden are disadvantage for the automotive industry compared to in Slovakia. The difference is nevertheless not small; capital taxes are more than double in Sweden and energy taxes are almost three times as high.

Other Eastern European and Baltic reform countries have still much to catch up to the West in terms of standard of living. Poland and the three Baltic States have for example only reached about half of the rich Western European states in terms of GDP per capita. [88]

Low-wage competition from these countries is strong, but this should not be misinterpreted as the only competition from the region is from Polish plumbers and Estonian Call Centers. Also in these countries there are well developed industries that already today make them important competitors to Western European corporations.

Poland has, for example, recently proved to be an attractive market not only for western technology companies, but also for several Asian ones. The country has in a short time become a global center for manufacturing LCD monitors.[89]

Poland is also after Italy that country which produces most Household Appliances in Europe. Lower production costs which are coupled with the low tax pressure have made Poland very attractive for manufacturers such as Electrolux. In 2008 Electrolux decided to move a production facility from Great Britain to Poland, where the company already conducted four plants and a service center. [90]

The Baltic States are competing today with us, not just about capital and where companies should locate their offices, but also on talent. When the Swedish IT-entrepreneur Niklas Zennerström and his Danish colleague Janus Friis founded the international success companies Kazaa and Skype they pursued their ventures not in Sweden or Denmark but in Estonia. [91]

The Baltic States are now in a particularly deep crisis, but there are reasons to believe that this decline will be similar to that of the Asian crisis. Like the Asian tiger economies the Baltic economies have maintained their fundamental strong growth potential which could help them to grow again already in a couple of years. In the long run the crisis could lead to constructive changes such as the introduction of floating exchange rates that in the long run strengthens the competitiveness.

Reform countries in Eastern Europe have not been hit that hard by the global crisis so far and the turnover is already occurring. The fact that large economies such as Poland and the Czech Republic have dealt particularly well with the crisis is at least as important as the crisis in the smaller Baltic economies.

The value of the exports from the Eastern States grew by 190 percent between 1996 and 2006.[92] Considering the growth friendly politics in the region the growth will in all likelihood be strong also during next boom. Therefore, focus should be pointed towards the long-term competitiveness from the East.

Market economies are systems built on ”creative destruction”, that older industries over time become extinct and are replaced with new and innovative businesses. After economic recessions a reconstruction process occurs where capital and labor is drawn to the sectors where the conditions are best for development.

Capital, corporations and even to some degree individuals are drawn not only to different industries in individual countries, but also to different countries. As more and more economies in the world open up to entrepreneurship and development anyone who wants to start a business, invest money or move to a country to work is able to choose between attractive countries to seek out.

A central question is where will the jobs and investments go to when the crisis turns around. In all probability Western European nations as well as the economies in Eastern Europe and the Baltic States will again grow when the global crisis turns. But the growth rate depends on the policies made, as well as how well politics is adjusted to the situation of international competition. In that regard, the industrial countries in the West have to adjust more and more to the low tax competition from the reform countries in the East, in first hand through reforms of their own tax systems towards a lower and flatter taxation.

Two decades ago Western Europeans viewed Eastern Europe and the Baltic States as a region in crisis after the collapse of the planned economy, but with the hope of creating democracy and free economies. Today once again the attention is drawn to the crisis in the East, this time a global crisis involving also the West. Little attention is being paid to the fact that the nations in the East have, overall, dealt with the crisis relatively well; and that they have strong fundaments to grow from when the global recession ends. The lack of a long-term perspective is remarkable. Europe's new market economies have shown signs of strength with economic systems that combine free entrepreneurship with low and flat taxes. Already today some of these tax systems have given the countries a competitive advantage compared with high tax nations in the West and the competition will only become clearer over the years.

In the West we have good reasons to mimic our neighbors in East, above all if we do not want to be omsprungna in a global competitiveness. This does not only concern countries such as Denmark, Finland, Sweden, Belgium and Austria, which are characterized by high tax rates.
As much as we can gain from the development among our neighbors in east we can also loose on a tax system that taxes on work, savings and investments on a higher level than our European neighbors.

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When the Berlin wall came down 20 years ago, many observers feared deep economic crisis for a very long time in Eastern and Central Europe. The countries that left communism and the centrally planned economy were generally advised to reform slowly.

Instead, many of the newly liberated countries reformed radically, and introduced market economic institutions swiftly. After a few years of economic downturn, growth reached high levels and remained on average twice as high as in Western Europe for 15 years.

During the economic and financial crisis, however, the critics have emerged again, claiming that the free-market reforms made these countries vulnerable.

This Policy Paper, written by Nima Sanandaji, argues that the crisis will by no means erase the prosperity gained, and they are set for a rapid return after the crisis. Also, these countries continue reforming in the midst of the crisis.

European Enterprise Institute