New Europe

Report on Transformation

Book produced under the guidance
of Prof. Dariusz K. Rosati

XIV ECONOMIC FORUM
Krynica, Poland
9-11 September, 2004

INSTYTUT WSCHODNI

Editor
Artur Podgórny Negri

Translation
PTS–Professional Translation Services Piotr Wilk

English adviser
Michael Harrold

Typesetting
Biker Studio Graficzne, Nowy Sącz

Printing
Drukarnia BAAD, Nowy Sącz

Publisher
Fundacja Instytut Studiów Wschodnich
Foundation Institute for Eastern Studies
ul. Kozia 3/5 lok. 6
00–070 Warsaw, Poland
tel./fax (+48 22) 827 20 52, 827 20 64, 828 52 84
e-mail: forum@isw.org.pl
www.forum–ekonomiczne.pl

The Report on Transformation has been published thanks to the support of our partners:

ISBN 83-917959-3-4

Warsaw 2004

AUTHORS

Coordinator of the Report
Prof. Dariusz K. Rosati

Helsinki Foundation for Human Rights
Prof. Andrzej Rzepliński
Magdalena Kmak
Karolina Oponowicz

Chair of Political Economy, Warsaw School of Economics
Prof. Ryszard Rapacki
Ph.D. Zbigniew Makowski
Piotr Jaszczyk
Mariusz Próchniak

Foreign Trade Research Institute
Prof. Elżbieta Kawecka–Wyrzykowska
Marzenna Błaszczuk
Urszula Kopeć

Centre for Eastern Studies
Marek Menkiszak

Institute of International Relations, Warsaw University
Prof. Roman Kuźniar
Jacek Gajewski

Gdańsk Institute for Market Economics
Ph.D. Maciej Grabowski
Marcin Tomalak

INTRODUCTION

This year's Report on Transformation is the third we have the pleasure of presenting to our readers. Just as in previous years, the Report describes the political, economic and international situation in 27 countries of Central and Eastern Europe and the former Soviet Union. The Report discusses the progress these countries have made in building democracy and a market economy.

The most important political event in the region in the past year was the eastward expansion of the European Union. Since May 1, 2004, the eight most developed countries of Central Europe have been full-fledged members of the European Union. This means that these countries have formally closed the transformation process, defined as the transition period in moving from an authoritarian system to democracy and a market economy. Other countries of the region are also striving for European Union membership, finding themselves at different stages of the adjustment process and accession negotiations. The year 2004 has also seen further expansion of the North Atlantic Treaty Organisation, which has grown to include seven new member countries from Central and Eastern Europe, including the three Baltic States. This double expansion appears to be the final seal of the new political divide in Europe – on the one side an area of security and integration as part of European and Euro-Atlantic organisations, and on the other side, an area of countries grouped in the Commonwealth of Independent States. This divide currently has all the features of being durable, as it is a consequence not only of the process of the EU and NATO eastward expansion, but also of increasingly visible differences in institutional solutions between the two groups of countries.

The Report maintains its traditional structure. The first chapter comprises the main conclusions of the Report in the form of an overview. The second chapter outlines the political situation in the countries of the region, this time devoting particular attention to the issues of the rule of law and human rights. The analysis shows that, above all, there is a fundamental difference between the Central and Eastern European countries and those in the CIS group. Although the political situation and the rule of law are still not consistently good in the former group of countries, it is nevertheless clearly better than in the latter group. Chapter three analyses the economic situation and progress of market reforms in countries in the region. The main finding is that of a marked improvement in the economic situation in the countries of Central and Eastern Europe, which is accompanied by some slowing of economic growth in the CIS countries, which in the preceding years had been impressive. As in the previous chapter, the analysis shows that the progress of economic reforms is decidedly faster in the first group of countries, while in many CIS countries the reform process has stalled. The fourth chapter consists of country sections, which briefly outline the main economic and political problems in each of the countries, against the backdrop of basic statistical data. Chapter five is devoted to international relations in the region. Its conclusions serve as confirmation of prior observations about the forming of a new division line in Europe. On the one side of that line are countries that are integrating politically and economically with Europe, and on the other side, the CIS countries, which are looking for their own development paths and undertaking efforts aimed at reintegration with Russia as the political-economic centre. The Report closes with a special study, which this year is devoted to an overview and analysis of tax systems and tax policies in the countries undergoing transformation.

The situation that has arisen in Central and Eastern Europe and in the CIS region over the past fifteen years of transformation has serious implications for the growth prospects of the two country groups. The economic situation of countries from the first group will improve systematically, thanks to the stronger rule of law and the much better institutional basis resulting from access to the single European market, as well as to the inflow of investment financing from Europe in the form of structural funds and foreign direct investment. The economic situation in the second group of countries is marked by greater uncertainty, resulting from a lack of stable rules governing the individual economies and a lower level of international integration. One can therefore expect that the distance that already exists between the two country groups will increase further in the future.

As was the case with previous Reports, this year's Report has been prepared by a group of independent experts, representing different research institutions, including the Chair of Political Economy at the Warsaw School of Economics, the Foreign Trade Research Institute, the Helsinki Foundation, the Gdansk Institute for Market Economics, the Centre for Eastern Studies, and the Institute of International Relations of Warsaw University.

The Report has been prepared on the initiative and thanks to the support of the Centre for Eastern Studies Foundation, but it presents the views of the authors themselves and does not represent a view of any state, government or non-governmental institution. The authors hope that the results of the analyses presented in the Report are of interest to the readers and are a useful basis for the further discussion of problems in the development of the countries in our region.

Professor Dariusz K. Rosati
Coordinator of the Report

A WORD FROM THE PUBLISHER

We have a pleasure of presenting the next, third edition of the Report “New Europe – Report on transformation”. Publication of the Report presented at the Economic Forum was instructed by the Program Council of the Economic Forum and the Institute for Eastern Studies. One of the propositions of enriching the Forum is to elaborate and publish systematically an analytical report every year on the economic and political situation in the region of Central, Eastern and Southern Europe and former USSR countries, with a special emphasis on the key economic and political problems and challenges, which are faced by separate countries.

The Economic Forum, has already been organised for the fourteenth time in Krynica, in Poland. The Forum has already enjoyed the reputation of the most important Central and Eastern European meeting of the people of politics, business and media, interested in building a favourable atmosphere and creating better conditions for the development of co-operation between the countries in the Region.

We would like to thank the following institutions: Chair of Political Economy of the Warsaw School of Economics, Foreign Trade Research Institute, Helsinki Foundation for Human Rights, Gdańsk Institute for Market Economics, Centre for Eastern Studies, Institute of International Relations of Warsaw University and all people, who contributed to the creation of this report.

Zygmunt Berdychowski
Chairman of Economic Forum
Program Council

CHAPTER I

REPORT OVERVIEW

Dariusz Rosati

1. The year 2004 brought the definite sealing of the division of the countries undergoing transformation into two categories. The eight countries of Central Europe – the Czech Republic, Estonia, Lithuania, Latvia, Poland, Slovakia, Slovenia and Hungary – became full-fledged members of the European Union, thus ending the fifteen-year period of transformation that had begun with the political changes of 1989. Another seven countries of Southeastern Europe are committed to following the same path. Some of them – Bulgaria, Croatia and Romania – are beginning or continuing accession negotiations, counting on joining the EU around 2007. The remaining group of countries – Albania, Bosnia and Herzegovina, Macedonia, Serbia and Montenegro – are strengthening their economic and political ties with the countries of Western Europe, in the hope of beginning negotiations on EU accession in the next few years. The second category of countries groups the members of the Commonwealth of Independent States, which are pursuing various reform and development strategies; these strategies are clearly different from those pursued by the Central European and Southeastern European countries. The CIS countries do not intend to seek EU membership, at least not in the foreseeable future, and most of them are clearly looking for different forms of regional integration, more focused on mutual cooperation and building an alternative economic and political alliance as part of the CIS.

2. Obtaining EU membership means, for the eight countries of Central Europe (EU-8) that they have built lasting democratic systems of the rule of law and competitive market economies, based on the systemic solutions dominating in Western Europe. The closing of the transformation process is of course not equivalent to a slowdown of the process of future systemic and structural transformation – which is an inherent component of the process of development – but rather signifies the end of the process of transformation from a totalitarian system to a modern democracy. In the countries of Southeastern Europe (SEE-7), the process of transformation has not yet been completed, with some countries still at the initial stage. However, in all these countries, the changes are heading in the same direction and have the same strategic goals. Unlike these two groups of countries, the countries of the CIS region not only are not striving for European Union membership (Ukraine and Moldova could be exceptions to this rule), but also are following their own paths of development, building political and economic systems that in many regards differ from those adopted in Europe.

3. The political situation is relatively stable in the EU-8 countries, the institutions of democratic representation are functioning properly, while certain political-social tensions that have arisen or persist in some of these countries have been caused mainly by the deterioration of the economic situation among some groups of the population and by high unemployment. In some countries, government crises have occurred, as a result of controversy over public finance reforms or due to the revelation of corruption scandals. Changes of government have taken place for example in Poland, the Czech Republic and Latvia. Meanwhile, Europe's first ever procedure for removing an incumbent president from power, based on charges of breaching the Constitution, was carried out in Lithuania. Among the SEE-7 countries, there are still numerous tensions that are remnants of the sharp ethnic conflicts of the 1990s, but in all these cases, the situation has gradually been moving towards normality. An important event was Croatia's success in obtaining the status of candidate for EU membership. The political evolution in Serbia and Montenegro is also noteworthy, as despite internal tensions, a pro-European direction of foreign policy is gaining strength; at the same time, however, the break-up of the country into two separate states is becoming an increasingly likely prospect.

4. Accession to the European Union has been the main political theme in the EU-8 countries over the past year and a half. In mid-2003, all the acceding countries conducted national referenda, in which the people of each country separately expressed their support for EU entry, although both the voter turnout, as well as the degree of support, differed significantly between individual countries. The idea of integration received the greatest support in Slovenia and Lithuania, while voters in the Czech Republic and Latvia were the least enthusiastic. The public debate that took place before the referendum and, later, the discussion of the draft of the European Constitution, has led to the polarisation of views among political parties and has mobilised extreme and radical groups. Elections to the European Parliament in June 2004 became an arena for confrontation between pro- and anti-European forces, although the results of the elections ultimately confirmed that domestic affairs were the most important issue for voters.

5. In the majority of the EU-8 and SEE-7 countries, the judicial system is functioning without major disturbances, and human rights and civic freedoms are generally respected. The main problems in this area include delays in court proceedings (Poland, Slovakia, the Balkan countries), and corruption in the justice system and sometimes also the dependence of the courts on politics (Romania, Hungary, Balkan countries). Prison systems are also experiencing difficulties, mainly as a result of overcrowding (Poland, Baltic States, Balkan countries). There are frequent cases of mistreatment of prisoners, as well as refugees (Baltic States, Hungary, Balkan countries). In some countries, the situation for ethnic groups and minorities remains difficult. The rights of the Russian-speaking populations continue to be violated in the Baltic States, just as those of the Romany population in most countries of Central and Eastern Europe are violated, too.

6. Corruption remains one of the most prominent problems in the functioning of government structures in Central and Eastern Europe. It is particularly widespread in the justice system, the police and the customs administration, as well as among central and local government administrations, particularly in contacts between the public and the private sector. However, last year saw some progress in fighting corruption. The disclosure of several corruption scandals (including in Poland) has led to increased awareness of the threat of corruption and contributed to regulatory changes, which should make it easier to fight corruption in the future. The situation in this area remains the most problematic in Hungary, as well as in Romania and other Balkan States.

7. The political situation remains stable in the CIS countries. Georgia is the only exception, with the Revolution of Roses leading to the downfall of compromised president E. Shevardnadze and the assumption of power by the democratic opposition at the end of 2003. Young opposition leader M. Saakashvili became the new president of the country. In other countries of the region, serving presidents and their political bases continued to consolidate their power. As a result of presidential elections in Russia and Armenia, the incumbent presidents strengthened their positions. Meanwhile, in Azerbaijan we have witnessed a dynastic succession of power, with the son of previous president Aliyev replacing his father in office. The incumbent presidents of Belarus, Kazakhstan, Kyrgyzstan, Turkmenistan and Uzbekistan have consolidated their authoritarian power, sometimes bordering on dictatorship, and have made successful efforts either to extend their mandate by successive multi-year terms, or to prepare for turning power over to their supporters (Ukraine).

8. The political systems of the CIS countries are significantly different from those prevailing in Western and Central European countries. They are presidential-parliamentary systems (Ukraine, Moldova) or presidential systems (other CIS countries), in which the presidents have very broad

executive authority, as well as legislative powers in the form of the right to issue decrees. The role of the governments is limited to executing the orders and instructions of the president, while the controlling role of parliaments is weakened by formal and actual dependence on the president. So-called presidential administrations, formed of the closest aides to the president, play a significant, and at the same time distinct, role. They have broad authority and actually fulfil the function of a "parallel" government, without being subject to any democratic mechanism of social or political control.

9. The concentration of power in the president's hands and the weakness of representative bodies, the lack of democratic tradition and insufficient development of the institutions of a civil society, cause the CIS countries to experience numerous violations of democratic principles, the rule of law, human rights and civic freedoms. There are widespread practices of corruption, the misuse of their authority by public administration officials, and bureaucratic obstructions and delays. Public officials frequently abuse their power, particularly the police and other uniformed services. The freedom of the media is limited and in some countries independent media practically do not exist (Belarus, Turkmenistan, Uzbekistan). Attempts at further limiting the independence of the media in the largest country in the region – Russia – raises concern. At the same time, the broad scope of power held by the presidents leads to tendencies of limiting or even eliminating the activities of a political opposition. There have been numerous instances of threats made to opposition politicians, independent journalists and representatives of non-governmental organisations. In some countries – Russia, Ukraine, Belarus – there have been unexplained cases of murder and the disappearance of opposition politicians and journalists.

10. The economic situation improved notably in the Central and Eastern Europe region over the past year. Most countries experienced acceleration in economic growth, with the Central and European economies growing at annual rates of 3.5%–6.7% in the first half of 2004, almost twice as fast as in the previous year. Poland and the Baltic States have seen particularly impressive rates of growth. The main source of higher growth in these countries was the dynamic expansion of exports, mainly to EU markets. This expansion was supported by the removal of remaining trade barriers and – in the case of Poland – by a favourable exchange rate. Meanwhile, consumer and investment spending has been growing at a slower pace. The countries of Southeastern Europe have been growing at only slightly lower rates, amounting to between 3% and 6%. However, the recovery in economic growth has not led to a notable improvement on the labour market, and high unemployment persists in most of the analysed countries. As in previous years, the highest levels of unemployment are observed in Poland and Slovakia (17%–20%) and in the majority of countries of the former Yugoslavia (as high as over 30%).

11. The majority of countries have also seen an improvement in the macroeconomic balance. Inflation ratios reached historical lows in 2003 (less than 3% on average). Only in Romania and Serbia and Montenegro did prices continue to rise at a double-digit rate. The lowest levels of inflation – under 1% – were seen in the Czech Republic, Poland and Bosnia and Herzegovina, while Lithuania experienced deflation. The growth of prices has accelerated somewhat in 2004, mainly as a result of increases in the prices of oil and other natural resources on global markets, but this process has a largely transitory character. Export expansion has also made it possible for most countries to improve their external balances.

12. A moderate relaxation of the economic policy stance has occurred, with relatively low real rates of interest and high budget deficits maintained. High public sector imbalances have been

observed particularly in Central European countries; in Poland, the Czech Republic and Hungary, general government deficits exceeded 6% of GDP in 2003. In parallel, the level of public debt has been rising, exceeding 50% of GDP in Poland and becoming dangerously close to 60% of GDP in Hungary. The fast pace of economic growth in 2004 could lead to a temporary improvement in the fiscal position in these countries, thanks to higher tax revenue, but in order to achieve a lasting resolution of fiscal problems, deep reforms are required, particularly on the expenditure side of public finances. In line with tradition, the Baltic States and Slovenia have displayed considerable budget discipline, with deficits under 2% of GDP and debt levels no higher than 25% of GDP.

13. The Central and Eastern European countries employed diverse monetary policy rules and exchange rate regimes in the years 2003–2004. The Baltic States and Bulgaria are at one end of the spectrum, having used fixed exchange rate regimes for many years, mainly in the form of currency boards. The central banks in these countries are required to purchase and sell every amount of foreign currency in return for domestic currency, implying a non-autonomous monetary policy. This solution usually works well in small, open economies, particularly if accompanied by fiscal discipline. The success of this system in stabilising the economy cannot be questioned, particularly in the case of the Baltic States. Poland is at the other end of the spectrum, with a fully floating exchange rate regime and a monetary policy pursued according to the direct inflation targeting principle. a similar policy is carried out in the Czech Republic, although at the same time the central bank does occasionally intervene on the foreign exchange market. Other countries employ various combinations of partly floating exchange rates and relatively autonomous monetary policies.

14. The progress of structural reforms in Central and Eastern European countries has been diverse. Some new EU members are still experiencing difficulties in this regard, despite formally meeting the institutional criteria of membership. These problems mainly relate to public finances, the labour markets, and sectoral "entry and exit" barriers. Most of these countries are facing a need for fundamental reforms and reductions in current public expenditure, including on social protection. There is also a pressing need for actions aimed at increasing the flexibility and mobility of the labour force, simplifying procedures for starting new businesses and improving access to business financing. Estonia has, relatively speaking, the best regulatory framework in this regard and is rightly considered the most business-friendly country in the region. Meanwhile, the situation in the countries of Southeastern Europe is much worse, with reforms lagging particularly in Albania and Macedonia, as well as in Bosnia and Herzegovina, where the process of consolidation of the state is still at the initial stage. The European Bank for Reconstruction and Development (EBRD) is performing regular evaluations of the progress of structural reforms. On a scale of 1 to 4.5, the progress of reforms in the first group of countries was assessed in the 2.8–4.3 range in 2003, with the lowest scores given for competition policy and infrastructure. The Southeastern European countries received scores between 1.9 and 4.0, also scoring low on competition policy and capital markets.

15. The deterioration in the assessment of economic freedom and business conditions in many countries of the region over the past year is a cause for concern. The Baltic States, in particular Estonia, are maintaining their lead, but *Heritage Foundation*, the monitoring organisation, is indicating a deterioration of indicators in several countries, including Hungary, the Czech Republic, Croatia and Latvia. Other countries, particularly those from the Balkan region, fare much worse in this analysis. Similar results are observed in the analysis of the scale of corruption in individual countries. Data published by *Transparency International* indicate that Slovenia is still enjoying the best reputation in this regard, but generally the level of corruption in the analysed

group of countries is relatively high, with some countries, including Poland, experiencing further deterioration in the situation, as compared to the previous year. Business conditions, including, *inter alia*, regulations determining the ease of entering a sector, efficiency of the justice system and bankruptcy procedures, vary greatly among countries, with a relatively favourable situation observed in Hungary, Bulgaria and the Baltic States and, excluding legal proceedings, also in Poland and Slovenia.

16. The prospects of economic growth for the EU-8 group of countries in the medium term are very good. Economic growth is going to continue gaining pace, mainly thanks to further export expansion and a gradual improvement in investment. The latter variable will be positively affected by the rising inflow of structural funds from the EU and from foreign direct investment. FDI inflow into the region in 2004 is expected to increase by 50% as compared to the previous year, mainly thanks to EU accession and the global improvement of cyclical conditions. However, the durability of the recovery in the long run will largely depend on successful implementation of the necessary structural reforms, particularly in the area of public finances and labour markets. The growth prospects for the SEE-7 countries are somewhat less favourable, but provided that they maintain the pace of market reforms, they should also be able to record relatively high rates of economic growth.

17. The economic situation in the CIS region improved markedly in 2003. The main factor of this improvement was the acceleration of economic growth in Russia to 7% annually, brought about by the favourable situation on the global fuels and natural resources markets, the reduction and simplification of the tax burden and a certain improvement in the efficiency of the functioning of government structures. Thanks to the recovery in Russia, the economic results of the other countries have also improved. Economic growth in Belarus and Moldova reached 6%-7% and accelerated to more than 9% in Ukraine. The countries of the Trans-Caucasus region and Central Asia were growing at an even faster pace of 7%-14%, with Uzbekistan the only exception; there the economy stagnated. In line with the projections made in the previous edition of this Report, in the current year the rate of growth has declined across the CIS region, although it still remains at a high level.

18. In line with the acceleration of growth, the macroeconomic balance in the CIS countries has also improved. In the European countries of the CIS, a decline in inflation has been observed, although it still remains at a level several times higher than in the Central European countries. Inflation also remains moderately low (3%-7%) in other CIS countries, with the exception of Tajikistan, Uzbekistan and Turkmenistan, where it exceeds 10%. Unemployment is traditionally low in the CIS countries, generally below 12% (with the exception of Kyrgyzstan, where it is 17%) and it has shown a clear declining tendency in recent years thanks to good cyclical conditions. The balance of payments situation has been changing in different directions in different countries, mainly as a result of varying shifts in the terms of trade caused by increases in oil and gas prices. Fuel-exporting countries such as Russia, Kazakhstan, Turkmenistan and Uzbekistan have increased their balance of payments surpluses, while other countries have seen an increase in their deficits.

19. Macroeconomic policy in the majority of CIS countries has featured a diverse stance. In the European CIS countries fiscal policy has been loosened, although the size of the imbalances remains moderate and according to official figures, budget deficits have not exceeded 2% of GDP. It needs to be noted, however, that public finance statistics are not fully indicative and credible, due to the existence of numerous quasi-fiscal categories of public expenditure (particularly in the state

enterprise sector). In other CIS countries, the size of the deficits was similar or larger (Kyrgyzstan, Georgia). Monetary policy was similarly diverse. In some countries it has had an accommodative character, with strongly negative real interest rates (Russia, Belarus). In most other countries, real interest rates remained at very high levels (10%–30%), resulting in greatly limited access to credit financing.

20. The progress of structural reforms – in such areas as building efficient markets for material, human and capital resources, competition rules, regulations setting sector "entry" and "exit" barriers, the tax system and public finances, privatisation, pension and disability benefit systems, the health care system, the commercial court system and the protection of property rights – is generally much slower in the CIS countries than in the countries of Central and Eastern Europe. There are also significant differences between individual CIS countries. In some areas (tax, privatisation, financial markets), some of the countries – particularly Russia, but to some extent also Kazakhstan, Kyrgyzstan, Ukraine, Armenia and Georgia – have made noticeable progress. In other areas, such as the scope of commercial freedom, and the state of competition and of the financial markets, progress is only slight. Meanwhile, the other countries are virtually not moving forward at all, having closed the first stage of reforms in mid-1990s. The situation is the worst in Turkmenistan, Uzbekistan and Belarus, where market reforms have hardly been commenced yet.

21. The holding up of the reform process and the persistence of a certain transitory state in the majority of CIS countries indicates that a hybrid economic system is being created and reinforced in these countries, featuring limited economic freedom, a very large scope of discretionary state intervention, highly distorted and fragmented market mechanisms and poor rule of law and protection of property rights. These features mean that the economic systems of the CIS countries resemble more those of developing countries than of European countries. In such political conditions, it is difficult to attract foreign investors and to mobilise domestic savings to boost investment. It is also not possible to conduct modernisation of the economy, which is necessary from the viewpoint of their international competitiveness. As a result, consolidation of the economic system in the described shape does not guarantee either lasting economic growth or a systematic improvement of the material and spiritual living conditions of the populations of most CIS countries.

22. The growth prospects of the CIS countries are diverse and depend on the advancement of the process of building a market economy, a political system and economic policy. In the short term, the size of natural resources, in particular fuels, is also significant. One can expect the rate of growth in Russia and other CIS countries that export natural resources and fuels to become gradually slower, as a result of the exhaustion of simple growth reserves and the stabilisation of the situation on the fuel market. The weakening of economic activity in Russia will in turn lead to a slowdown of growth in other CIS countries, which so far have not been able to diversify their economies and find other suppliers and other markets for their goods. In the long run, however, the rate of growth in the region will depend on the progress of market and political reforms.

23. The foreign policy and international cooperation of the countries of Central and Eastern Europe has focused on integration with European and Euro-Atlantic structures. The EU accession of the EU-8 countries, as well as the further expansion of NATO, including the entry of the three Baltic States, is another important step towards creating a strategic alliance covering the Euro-Atlantic region. However, this "double expansion" did not occur without any disruptions or tensions. Differences and issues of dispute arose in European politics and in relations between individual

countries. The most important of these was the attitude towards the military intervention in Iraq and, against this background, the attitude towards U.S. policy, as well as the views on different provisions of the Constitutional Treaty. Differences on these issues reflected on the one hand the ambition of Germany and France to strengthen their own position in the expanded European Union and reinforce the role of the EU in the international arena. On the other hand, they reflected different perspectives on security and participation in an integrated Europe, represented by some other countries – mainly the United Kingdom, Spain and Poland. In the end, the signing of the Constitutional Treaty at the EU summit in June 2004 and the change in the status of coalition forces in Iraq as of July 1, 2004, appear to be a sign of easing tensions and readiness of the countries in the Euro-Atlantic region to return to close cooperation.

24. The foreign policy and international cooperation of the CIS countries was the product of several, not always consistent, tendencies. The first clear tendency was that of increased involvement by Western countries and structures. This increase did not only have a purely quantitative aspect – the growing number of cooperation initiatives and more prominent presence – but also a qualitative one – the emergence of new instruments of deeper influence on the internal situation and policies of these countries. The activities of three players increased the most noticeably: NATO, the EU and the United States. Secondly, Russia has undertaken more active efforts to strengthen its influence in the CIS region. It was doing so by using, among others, multi-lateral instruments – first of all by strengthening existing integration structures and building new ones. On the one hand, Russia used various measures to encourage CIS countries to cooperate, while on the other hand, it sought to discourage Western structures and countries from increasing their presence in the region. Thirdly, there was mounting political destabilisation in the ranks of the countries in the CIS region. In some countries, this is often related to the electoral cycle and the efforts by the ruling elite to ensure the safe handing over of power. This has often been accompanied by increased activity by the internal political opposition. Another source of instability has been the still unresolved regional and local conflicts. We are therefore dealing either with political crises, increased tension, or the emergence of new conflict situations. Rising tensions of a socio-economic nature were another source of instability in some countries. Against this background, Russia has been working more actively to strengthen its influence by bilateral action. Fourthly and finally, the threat of terrorism and religious extremism has become more evident. This was particularly true for Russia and Uzbekistan, helped by internal problems and the repressive policy of the authorities.

25. None of the regional and local conflicts consuming Central and Eastern Europe were resolved over the past year. a difficult situation persisted in the Balkans. No progress in building a federation state was reached in Bosnia and Herzegovina, the trend towards break-up deepened in Serbia and Montenegro, a state of intense conflict persisted in Kosovo, and new ethnic tensions emerged in Macedonia. Tensions were also present in Moldova, due to the separatist policy of the Trans-Dniester regional authorities. There has been no progress in resolving the dispute between Azerbaijan and Armenia over Nagorno-Karabakh. Finally, an intense conflict persists in Chechnya, where the Russian authorities have not succeeded in liquidating local militants and securing control over the territory for the pro-Russian authorities. All these conflicts, which are a remnant of the “imperial” ethnic policy of previously existing federal states (the Soviet Union, Yugoslavia), have far-reaching negative economic and security consequences.

26. The economic cooperation between the countries of the region continued to concentrate in 2003 around two centres – the European Union and the CIS. The Central European countries striving for EU membership were strengthening the process of integration as part of CEFTA. Similarly,

in preparing for joining the EU structures, the three Baltic States were continuing their mutual cooperation as part of the zone of free trade in industrial goods and based on partial liberalisation of trade in agricultural products. Processes of regional reintegration within the CIS are taking place at a very slow pace. Economic cooperation among these countries mainly has a bilateral nature, with limited cooperation as part of some multilateral initiatives. Reintegration processes are determined by considerable differences in the economic potential of individual CIS countries and in particular by the overwhelming domination of Russia. This country is clearly the main trading partner for all other countries in the region, when it comes to trade within the CIS group. As a regional leader, Russia also has the most influence over the integration initiatives thus far undertaken within the CIS, with their nature depending on Russia's stance. The latest integration initiative as part of the CIS is the signing of the agreement on creating a Common Economic Area among Russia, Belarus, Ukraine and Kazakhstan, which took place on September 19, 2003.

27. The European Union accession of eight new member countries from Central and Eastern Europe has changed the terms on which these countries trade and cooperate with the CIS countries. Fears have emerged on the part of Russia and other CIS countries, regarding poorer access to the markets of the new member countries (it should be noted that studies do not confirm these fears). There have also been attempts to use the moment of expansion to gain additional concessions from the European Union. Negotiations on this matter between Russia and the EU were difficult and were eventually concluded by the signing of an agreement on April 27, 2004, just a few days before the EU expansion. The agreement envisages a significant reduction in the level of customs protection of markets of the new member countries (from 9% to 4% on average), some easing of anti-dumping procedures for exports from Russia and other CIS countries, maintaining the free movement of goods and the preferential movement of persons with the Kaliningrad district, as well as a pledge to sign a new framework agreement on cooperation between Russia and the European Union.

28. In the 15 years since the beginning of systemic reforms, nearly all the countries undergoing transformation have adopted the three basic taxes, typical for market economy countries, namely personal income tax (PIT), corporate income tax (CIT) and value added tax (VAT). However, there is a great diversity of detailed solutions, rates, deductions, exemptions and tax bases in these countries. The initial condition for potential future improvements in the system has, however, been met. In recent years, a clear tendency of the broadening of tax bases and reducing top income tax rates can be observed. However, in many countries of the region, there are still serious problems with the further improvement of the functioning of the tax system, increasing its transparency and consistency and limiting psychological phenomena, i.e. implementation problems. For some countries, this is a very important problem, particularly in connection with the so-called quasi-fiscal activity in the area of energy resources and the size of the informal economy.

29. The structure and level of tax revenues in the countries undergoing transformation is diverse and usually also clearly diverges from the situation in the EU countries. The ratio of tax revenues to GDP ranged from 25% in the CIS countries, to 36% in the SEE countries and 40% in the EU-8 countries (for comparison, in the EU countries the rate is equal to 40% of GDP), exhibiting a declining tendency over the past decade. As part of tax revenues, the share of income taxes in the countries undergoing transformation is half of that in the European Union countries, with a similar share of indirect tax revenues. Revenues from PIT on average amounted to 5%-6% of GDP, while revenues from CIT were around 2%-3% of GDP – half of the amount collected in the EU countries. This discrepancy has been growing, particularly in recent years when a significant reduction in income tax rates, and limiting the progression and simplifying the collection procedures, has taken place

in the Central and Eastern European and CIS countries. These figures show that the tax systems in the countries undergoing transformation are in many regards more modern and efficient than those in Western Europe (structure of tax revenue, dominance of indirect taxes, overall level of the tax burden).

30. An important feature of the economies in transformation is the high share of the informal economy in GDP. This share ranges from 15%–18% in the Czech Republic and Slovakia, to 30%–35% in the Balkan countries and as much as 50% in the countries of the Trans-Caucasus, Ukraine and Belarus. A typical feature of all of these countries, without exception, is the increase in the share of the informal economy over the past ten years. Studies on the informal economy confirm that its share is negatively correlated with the rate of economic growth, meaning that countries with a high share of the informal economy are growing at a slower pace than other countries. One of the reasons for this is that the share of the informal economy is usually higher in the conditions of a high tax burden. In addition, corruption is an inherent feature of informal commercial activity and corruption is a quasi-tax negatively affecting the level and efficiency of economic activity.