An Examination of the Former Centrally Planned Economies 25 Years After the Fall of Communism

By **James Gwartney**, jdgwartney@fsu.edu (Florida State University) and **Hugo Montesinos**, hugomoises@gmail.com (Florida State University).

James D. Gwartney is a Professor of Economics and the Gus A. Stavros Eminent Scholar at Florida State University. Hugo M. Montesinos is a doctoral student and resident econometrician at Florida State University.

Abstract

This report analyzes the changes in economic freedom, political institutions, and performance of 25 former centrally planned (FCP) economies following the collapse of communism. The degree of economic freedom among these countries varied considerably. The FCP countries with higher levels of economic freedom in 2015 as measured by the Economic Freedom of the World summary ratings tended to grow more rapidly, achieve larger increases in international trade, and attract more foreign direct investment than their counterparts with less economic freedom. Differences among the FCP countries in the protection of civil liberties, democratic political institutions, and administration of government with less corruption are also identified and analyzed. A regression model of economic growth during 1995-2015 for 122 countries was developed and used to examine the determinants of growth and the performance of the FCP economies relative to high-income and other developing countries throughout the world. Regression analysis was also used to analyze the life satisfaction measure of the World Values Survey. The regression analysis indicates that economic freedom exerts a strong positive impact on both the growth of per capita GDP and the life satisfaction of individuals. Finally, the economic freedom area ratings were used to identify strengths and weaknesses of the FCP economies. Most of the FCP countries registered substantial increases in economic freedom in the areas of size of government, access to sound money, international trade, and regulation. But they have failed to improve their legal systems, and several FCP countries have even experienced recent deteriorations in this area. While the FCP countries achieved impressive growth and closed the income gap relative to high-income countries during 1995-2015, without improvements in the legal area, it is unlikely that this progress will continue. The addendum provides additional details for ten countries that have made the transition from communism to markets most successfully.

Key findings

This report examines the changing economic and political institutions of 25 former centrally planned (FCP) economies following the collapse of communism and analyzes how the changes have impacted performance. The key findings of the study are:

1. Seven of the 25 FCP economies ranked in the top quarter of the 159 countries included in the Economic freedom of the World project in 2015. These seven countries – Georgia, Estonia, Lithuania, Latvia, Romania, Armenia, and Albania – had a 2015 Economic Freedom of the World (EFW) summary rating of 7.5 or higher. Another nine countries – Czech Republic, Bulgaria, Poland, Slovak Republic, Hungary, Kazakhstan, Macedonia, Croatia, and Slovenia – had 2015 EFW summary ratings between 7.0 and 7.5 and ranked in the second quartile worldwide. All of these countries achieved substantial increases in economic freedom during 1995-2015. Another nine FCP economies – Kyrgyz Republic, Tajikistan, Montenegro, Serbia, Bosnia and Herzegovina, Russia, Moldova, Azerbaijan, and Ukraine – have 2015 EFW summary ratings of less than 7.0. This latter group has moved more slowly toward the institutional framework of a market economy.

2. The countries with more economic freedom grew more rapidly than those that were less free. Six of the seven countries in the most-free group achieved a robust annual growth rate of per capita GDP of 4.0 percent or higher during 1995-2015. The exception was Romania, which was a late reformer and achieved a growth rate of 4.56 during 2000-2015 after adopting reforms supportive of economic freedom. Among the nine countries in the middle group, only Poland and Kazakhstan achieved an annual growth rate greater than 4 percent. Among the eight countries in the least free group for which data were available, only Bosnia and Herzegovina and Azerbaijan achieved an annual growth rate greater than 4 percent. The growth rate of Bosnia and Herzegovina was almost certainly exaggerated because of its low 1995 per capita GDP as the result of civil war, while the high growth rates of both Azerbaijan and Kazakhstan were elevated by the increasing and abnormally high oil prices during 2002-2014.

3. International trade (imports plus exports) as a share of GDP increased substantially in most all of the countries in the most free and middle group during 1995-2015. The increases in the size of the trade sector were particularly large for the ten FCP countries that joined the European Union during 2004 and 2007. Net foreign direct investment as a share of GDP also increased substantially during the first decade of the 21st century. These trends are indicative of greater integration into the world economy. However, the foreign investment rate has fallen substantially since 2010. This decline is a sign of potential trouble ahead.

4. The poverty rates rose in several FCP economies during the transition phase of the 1990s and early years of the 21st century. However, the poverty rates declined rapidly thereafter. By 2015, the moderate poverty rate ($3.10 per day in 2011 dollars) was lower than the 1995 rate in all the FCP economies. In 2015, the moderate poverty rate was less than 10 percent in 21 (and less than 5 percent in 18) of the 25 FCP economies.

5. During 1995-2015, the political institutions of most FCP economies moved toward protection of civil liberties, democratic decision-making, and better control of corruption. The following nine countries had 2015 political institutions most consistent with civil liberties protection, political democracy, constraints on the executive, and absence of corruption: Estonia, Lithuania, Latvia, Czech Republic, Poland, Slovak Republic, Hungary, Croatia, and Slovenia. In contrast, the political institutions of Kazakhstan, Tajikistan, Russia, and Azerbaijan were least consistent with protection of civil liberties, democratic principles, and absence of corruption.

6. The per capita GDP of the FCP economies rose substantially during 1995-2015 relative to the high-income countries of Europe and the world. The largest increases in relative income were registered by

Georgia, Lithuania, Latvia, Armenia, Albania, Kazakhstan, Azerbaijan, and Bosnia and Herzegovina. The per capita GDP of each of these countries relative to the mean of the world's 21 high-income countries more than doubled between 1995 and 2015. Five of these eight countries are in the group with the highest 2015 economic freedom ratings.

7. Regression analysis was used to estimate the impact of initial income, economic freedom, population, demographic factors, net foreign direct investment, and net fuel exports on the growth of per capita GDP. This comprehensive model explained approximately two-thirds of the cross-country variation in growth of per capita GDP among the 122 countries for which the data were available during 1995-2015 and 2000-2015. The regression model indicates that economic freedom exerts a positive and highly significant impact on economic growth, even after accounting for the other factors included in the model. The dummy variable for the FCP group with a 2015 EFW rating above 7.5 was always significant, indicating that the growth rates of these countries was more rapid than the world's 21 high-income countries.

8. Regression analysis was also used to examine the determinants of life satisfaction, a measure developed from the World Values Survey. A set of personal attributes (such as employment, relative income, gender, and age) and country specific measures including the summary EFW rating, per capita GDP, the Polity IV democracy score, and language fractionalization were incorporated as independent variables. The results indicate that economic freedom exerts a significant positive impact on life satisfaction both directly and indirectly (through per capita GDP). While the life satisfaction of persons living in FCP countries was well below that of similar individuals in other countries during the 1990s, the gap has declined, and by 2010-2014, it was virtually eliminated.

9. The economic freedom area ratings of the FCP countries increased substantially in areas 1 (size of government), 3 (access to sound money), 4 (international trade) and 5 (regulation of finance, labor, and business) during 1995-2015. In these four areas, the economic freedom ratings of the FCP countries, particularly the 11 that are now members of the European Union, are approximately the same as the ratings of the high-income European countries. 10. There is a huge gap in the quality of the legal systems (EFW Area 2) of the FCP countries compared to the high-income countries of Europe. Moreover, the FCP countries have failed to improve in this area. There are even some signs of deterioration in several FCP countries. Unless the FCP countries improve their legal systems, their future growth will slow and their gains relative to high-income countries come to a halt. This may already be happening, as foreign direct investment has declined sharply and real economic growth slowed since 2010.

A More Detailed Look at Ten Success Stories

Thirteen of the 25 former centrally planned (FCP) economies achieved an annual growth rate of per capita GDP of 3.4 percent or higher during the two decades following 1995. The growth rates of three of these countries – Kazakhstan, Bosnia and Herzegovina, and Azerbaijan – were elevated by extraordinary conditions: rising oil prices in the cases of Kazakhstan and Azerbaijan and an abnormally low initial income level in the aftermath of the civil war in the case of Bosnia and Herzegovina. Furthermore, the political institutions of these three countries are weak. Therefore, they are not included in this section. This leaves us with 10 countries that have navigated the transition from central planning to market direction most successfully. We will take a closer look at each of them, including specific changes that have enhanced their past performance and troublesome factors that are likely to slow their future growth and development.

Georgia (ranked 8th worldwide in 2015 EFW)

Georgia began a major program of economic liberalization in 2004 under the administration of president Mikheil Saakashvili. The reforms included adoption of a flat rate tax, deregulation of business, and relaxation of trade barriers. Since 2009, Georgia has taxed personal income at a flat rate of 20 percent. These economic reforms exerted a substantial impact on economic freedom. Georgia's EFW rating rose to 7.07 in 2004 to 7.50 in 2010 and 8.01 in 2015. Georgia is currently the highest ranked FCP economy in the EFW index. In 2015, Georgia ranked 8th worldwide among the 159 countries included in the index.

While the per capita income of this nation of approximately 4 million people is low, its growth rate has been impressive. Since 2000, it has been one of the world's fastest growing economies. Georgia's per capita GDP (measured in 2011 PPP dollars) rose from $2295 in 1995 to $9025 in 2015, approximately a fourfold increase over the two decades. This translates to an annual growth rate of 7.1 percent. During the most recent decade, the Georgian economy continued to grow at an impressive rate, more than 6 percent annually.

Given its low per capita income, it is not surprising that Georgia's poverty rate is relatively high. Georgia's moderate poverty rate along with that of Tajikistan was the highest among the FCP economies. But progress has been made in this area. Following the move toward economic liberalization, Georgia's moderate poverty rate fell from 43 percent in 2000 to 29 percent in 2015 (see Table 7).

Both expansion in international trade and a high rate of net foreign direct investment played a major role in Georgia's economic success. The average size of Georgia's trade sector (imports plus exports as a share of GDP) rose from 55 percent during 1996-2000 to 100 percent during 2011-2015. This nearly 90 percent increase in the relative size of the trade sector is one of the largest among the FCP group. Similarly, net foreign direct investment into the Georgian economy has been impressive. Measured as a share of GDP, net foreign direct investment was 11.9 percent during 2006-2010 and 8.1 percent in 20112015, up from 5.4 percent during 1996-2000. As previously mentioned, foreign direct investment is

almost entirely private. Thus, the increase in FDI indicates that investors have confidence in the future of the Georgian economy. Because FDI is a source of not only financing for physical capital, but also innovation and entrepreneurial talent, it is a highly important driver of economic growth.

Georgia has narrowed the income gap compared to the 21 long-standing high-income countries of the world. In 1995 Georgia's per capita income was only 6.7 percent of the per capita GDP of the highincome group. By 2015, the parallel figure had risen to 20.3 percent. See Table 13.

How does Georgia fare with regard to political institutions? Freedom House assigned it a rating of 3 for both civil liberties and political rights in 2015, where 1 is the highest rating and 7 the lowest. Both of these ratings were modestly higher than the ratings of earlier years. Georgia's Polity IV score for democracy was 7 in 2015, up from 5 in 2000. (Remember, this scale ranges from -10 indicating least democratic to +10 indicating most democratic.) Its Polity IV score for constraints on the executive in 2015 was 6 (on a 7-point scale) up from a 5 during earlier years. Finally, Transparency International assigned Georgia a 2015 score of 52 (100-point scale) on its Corruption Perception Index, up from 23 in 2005. Among the FCP economies, only the three Baltic states, Czech Republic, Poland, and Slovenia registered a higher 2015 rating than Georgia on this measure. Summarizing, Georgia's rating in the areas of civil liberties, political rights and democracy, and absence of corruption all have room for additional improvement, but they have been moving in the right direction.

Georgia's EFW ratings in areas 1 (size of government), 3 (access to sound money), 4 (international trade), and 5 (regulation) are high and they have been improving. This is a reflection of the liberalization policies followed since 2004. However, like other FCP economies, legal structure is a weakness of the Georgian economy. Georgia's 6.57 2015 rating was the second highest among the FCP countries, trailing only the 7.51 rating of Estonia. But, Georgia's Area 2 rating is still 1.3 units below the average of the 16 high-income European countries. Without continued improvement in the legal structure area, Georgia's "economic miracle" is likely to stall in the near future.

Baltic States: Estonia, Lithuania, and Latvia (ranked 10th, 13th, and 17th worldwide respectively in 2015 EFW)

All three of these countries had 2015 EFW summary ratings greater than 7.5 and they all ranked in the Top 20 among the world's freest economies. Moreover, all three have achieved remarkable increases in economic freedom since the mid-1990s. Estonia's EFW summary rating rose from 6.12 in 1995 to 7.48 in 2000, and on to 7.95 in 2015. The movements toward economic freedom of Lithuania and Latvia have been equally impressive. Lithuania's summary EFW rating rose from 5.51 in 1995 to 6.90 in 2000, and to 7.92 in 2015. Latvia's EFW rating followed a similar path climbing from 5.59 in 1995 to 7.13 in 2000, and to 7.75 in 2015. Worldwide, in 2015 Estonia ranked 10th, Lithuania 13th, and Latvia 17th among the 159 countries included in the EFW report. In contrast, Estonia ranked 57th, Lithuania 80th, and Latvia 75th among the 123 countries for which data were available in 1995. The increases in the EFW ratings and rankings of these three small countries since 1995 reflect a truly remarkable record of economic liberalization.

The Baltic states were among the first FCP economies to move to a flat rate personal income tax system. The initial rates adopted during the mid-1990s were relatively high: 24 percent in Estonia, 33 percent in Lithuania, and 25 percent in Latvia. These rates have gradually been reduced. In 2015, the flat rates were 20 percent in Estonia, 15 percent in Lithuania, and 23 percent in Latvia. Flat rate tax policies, along with a liberal trade regime and deregulation of business since 2005 were major contributors to the rising EFW ratings of the Baltic states.

The movement toward economic freedom has been accompanied by solid economic growth. During 1995-2015, the per capita GDP of Estonia grew at an annual rate of 4.49 percent, Lithuania 5.44 percent and Latvia 5.26 percent. Growth rates in this range result in the doubling of per capita income approximately every 15 years. As the result of their rapid growth, the Baltic states have narrowed the income gap relative to the world's 21 high-income economies. In 1995, Estonia's per capita income was only 33 percent of the 21 high-income countries, but by 2015 the relative income of Estonia had risen to

61.6 percent of the figure for the high-income group. Lithuania and Latvia also narrowed the income gap relative to the 21 high-income countries. In 1995 the per capita incomes of Lithuania and Latvia were only 27 percent and 24 percent of the mean income of the 21 countries with the highest incomes. However, by 2015 the per capita income of Lithuania and Latvia had risen to 61 percent and 52 percent respectively of the comparable figure for the 21 high-income economies. See Table 13.

Large and expanding trade sectors accompanied the rapid growth of the Baltic states. Estonia's trade sector was already quite large (144 percent of GDP) during the late 1990s, but by 2011-2015 it had risen to 164 percent of GDP. Measured as a share of GDP, the size of the trade sector of Lithuania rose from 88 percent during 1996-2000 to 159 percent during 2011-2015. Similarly, the trade sector of Latvia rose from 86 percent of GDP during 1996-2000 to 122 percent of GDP during 2011-2015. See Table 5.

The net foreign direct investment (FDI) of Estonia was high throughout most of 1995-2011, but considerably lower in Lithuania and Latvia. Measured as a share of GDP, Estonia's net FDI was 6.3 percent during the late 1990s, and more than 11 percent during 2001-2010 before receding to 4.1 percent during 2011-2015. On the other hand, the net FDI in Lithuania and Latvia was in the 2 percent to 5 percent of GDP range throughout most of the two-decade period. See Table 6.

The poverty rate in the Baltic states was relatively low and it declined throughout most of the period, reflecting their high per capita income and rapid growth. The moderate poverty rate of Estonia was only 5 percent in 1995 and it declined steadily to less than 1 percent in 2015. The moderate poverty rate was much higher (25 percent) in Lithuania in 1995, but it declined substantially, receding to less than 1 percent in 2015. The moderate poverty rate of Latvia rose to 15 percent in 2000, but by 2015 it was also in the 1 percent range. See Table 7.

The strong economic performance of the Baltic states has occurred within a framework of civil liberties, political democracy, and minimal corruption. The civil liberties and political rights of the Baltic states were rated as "free" (rating of either 1 or 2 on a 7-point scale) by Freedom House throughout 19952015. In 2015, both Estonia and Lithuania received a rating of 1, the highest Freedom House rating for

both civil liberties and political rights. Latvia's 2015 rating was slightly lower in both areas, with a rating of 2. See Tables 8 and 9.

The Baltic states also received high Polity IV ratings for both democracy and constraints on the executive. Lithuania achieved the highest possible Polity IV ratings – a 10 for democracy and 1 for constraints on the executive – throughout the entire 1995-2015 period. The 2015 Polity IV ratings for democracy of Estonia and Latvia were slightly lower, a 9 for Estonia and an 8 for Latvia. Estonia and Latvia, like Lithuania, also received the highest Polity IV rating for constraints on the executive throughout the two decades. See Tables 10 and 11.

Turning to the Corruption Perception Index (CPI) of Transparency International, all three of the Baltic states have achieved steady improvements in their ratings. Estonia's CPI rating (on a 100-point scale in which higher numbers are indicative of less corruption) rose from 57 in 2000 to 70 in 2015. The CPI ratings of Lithuania and Latvia were a little lower than Estonia, but they followed a similar path. The CPI of Lithuania rose from 41 in 2000 to 61 in 2015, while the rating for Latvia rose from 34 in 2000 to 55 in 2015. See Table 12.

During the past two decades, the Baltic states made modest reductions in the relative size of government, moved toward monetary stability and eventually joined the European Monetary Union, and reduced both trade and regulatory barriers. Their EFW ratings in Areas 1, 3, 4, and 5 reflect these moves toward economic liberalization. Compared to other FCP countries, the Area 2 (legal structure) ratings of the Baltic states are high and improving. Estonia's 7.51 Area 2 rating in 2015 is the highest among the FCP countries and only slightly lower than the average Area 2 rating (7.88) of the 16 highincome European economies. The 2015 Area 2 ratings of Lithuania and Latvia were a full point lower than Estonia's. This is an area where they need to improve.

In summary, the Baltic states are among the most economically free countries in the world. Their 2015 EFW ratings place them in the Top 20 worldwide. Similarly, their growth rates were among the top 15 worldwide during 1995-2015. The per capita GDP of each more than doubled during this period. Their political institutions are also democratic with constraints on the powers of the executive and a low level of corruption. Their location is also advantageous – it facilitates their economic integration with Scandinavian and other northern European countries. Clearly, these three economies made the transition from central planning to a free market economy in a highly successful manner. If they continue on a path of economic liberalization, their economic future should be bright.

Romania (ranked 20th worldwide in 2015 EFW)

In 2015, the EFW rating of Romania was 7.75, ranking it 20th among the 159 countries for which the EFW data were available. Two decades ago, economic liberalization of this level would have seemed like an impossible dream. Romania's 1995 EFW rating was 3.83, placing it 118th among the 123 countries included in the EFW index that year. The situation improved only modestly during the next five years. In 2000, Romania's EFW rating was 5.37, pushing its ranking up to 107th among the 123 countries rated.

However, beginning in the early years of this century, Romania moved rapidly toward economic liberalization. Its EFW rating rose to 7.24 in 2005 and on to 7.72 in 2015. This is a remarkable shift toward economic freedom during the first 15 years of this century.

Adoption of a flat rate personal income tax, movements toward sound money, and reductions in tariff rates and other trade restrictions were key elements of Romania's economic liberalization. Romania's top marginal tax rate was 60 percent in 1995 and 40 percent in 2000. In 2005, however, a flat personal income tax rate of 16 percent was adopted, and that rate remains in effect. After experiencing inflation rates of 35 percent in 1995 and 46 percent in 2000, Romania moved to a regime of inflation targeting. Under this system, the inflation rate has declined steadily to rates of less than 10 percent since 2005 and less than 5 percent since 2012. The mean tariff rate fell from 18.8 percent in 1995 to approximately 5 percent during the last decade. Romania joined the European Union in 2007, and this contributed to additional trade liberalization. As a result, Romania's rating in Area 4 (Freedom to Trade Internationally) in the EFW index rose from 5.54 in 1995 to 7.79 in 2005 and to 8.48 in 2015.

Reflecting its failure to reform, Romania's per capita GDP stagnated during 1995-2000. Measured in 2011 PPP dollars, Romania's per capita GDP in 2000 was $10,523, slightly lower than the 1995 figure of $10,546. However, as economic reforms were adopted, real economic growth accelerated. Per capita

GDP rose to $14,656 in 2005 and $20,538 in 2015. Thus, per capita GDP approximately doubled during 2000-2015, as the Romanian economy grew at an impressive annual rate of 4.56 percent during this 15year period. See Tables 2 and 3.

The economic reforms led to broad improvement in performance. As trade barriers declined, the size of the trade sector increased. Measured as a percent of GDP, Romania's international trade expanded from 61 percent in the late 1990s to 81 percent during 2011-2015. Romania's net foreign direct investment also increased. During the first decade of this century, its net FDI comprised approximately 5 percent of GDP. See Tables 5 and 6.

The moderate poverty rate (income of less than $3.10 per day measured in 2011 dollars) rose during the stagnation of the late 1990s and the initial phase of the reforms, soaring to 19.8 percent in 2005. But, it subsequently declined sharply, receding to 4 percent in 2015. See Table 7.

Turning to political institutions, Romania has shown improvement in this area. On the Freedom House scale of 1 to 7 (where 1 is the highest rating), Romania's 1995 ratings were 3 for civil liberties and 4 for political rights. However, Romania's rating in both of these areas rose to 2 (placing it in the "free" category) in 2000 and it has remained there ever since. Romania's Polity IV score for democracy was 9 in 2015, up from 8 in 2000 and 5 in 1995. (the Polity scale ranges from -10 indicating least democratic to +10 indicating most democratic.) Romania's Polity IV score for constraints on the executive in 2015 was 7 (the highest possible rating) up from a 5 in 1995. Finally, Transparency International assigned Romania a score of 46 (on a 100-point scale) on its Corruption Perception Index in 2015, up from 29 in 2000 and 30 in 2005. See Tables 8-12. Thus, Romania's ratings in the areas of civil liberties, political rights, and democracy are among the highest of the FCP countries. While there has been improvement in the control of corruption, this is a major shortcoming where additional improvement is needed.

The weakness of its legal system is the most important current deficiency confronting the Romanian economy. Romania's 2015 EFW Area 2 rating was 5.95, up only modestly from 5.46 in 2000. This Area 2 rating is approximately 3 points lower than the average of the 16 high-income European economies. Romania's ratings are particularly low for the following legal system Area 2 components: A (judicial independence), B (impartial courts), C (protection of property rights), E (integrity of the legal system), F (legal enforcement of contracts) and H (reliability of the police). The 2015 rating for each of these components was less than 6.0 (on the EFW's 10-point scale). Moreover, compared to the high-income European countries, the gap for most of these components was huge. Without substantial improvement in these legal protection areas, it is unlikely that Romania will continue to grow rapidly and narrow the gap compared to the high-income countries of the world.

Armenia (ranked 29th worldwide in 2015 EFW)

There were not EFW data available for Armenia prior to 2004. In 2005, the EFW rating for Armenia was 7.31, placing it 44th among the 141 countries included in the index that year. By 2015, Armenia's EFW rating had risen to 7.6, ranking it 29th among the 159 countries included in the index in 2015. Armenia's 2015 EFW is the sixth highest among the 25 FCP economies.

Improved monetary policy has helped push Armenia's EFW rating upward. Following hyper-inflation in the early 1990s, Armenia's inflation rates have been relatively low since 2000. The average inflation rate in the period 2000-2015 was 4.14 percent, with a maximum of 9.01 percent in 2008.

Following the Nagorno-Karabakh War, Armenia's per capita GDP was $2,173 in 1995. By 2005, it was $5,357 (more than doubled). By 2015, it was $8,180. The implied growth rate of annual per capita GDP during the 20-year period 1995-2015 was 6.85 percent. See Tables 2 and 3.

The size of the trade sector of Armenia, measured as imports plus exports as a percent of GDP, was relatively stable during the period 1995-2015 ranging around 75 percent. Armenia's net foreign direct investment averaged 5.6 percent in 1996-2000, before increasing to 7.4 percent in 2006-2010, but receding to 3.9 percent in 2011-2015. See Tables 5 and 6.

Consistent with Armenia's impressive growth of per capita GDP, the percent of people living below the moderate poverty line (income of less than $3.10 per day measured in 2011 dollars) has declined since 2000. Moderate poverty rates were 41.4 in 1995, 47.6 in 2000, 24.7 in 2005, 21.7 in 2010, and 15.2 in 2015. See Table 7.

The political institutions of Armenia generally received the lowest ratings among the group of seven most economically free FCP economies. On the Freedom House scale of 1 to 7 (where 1 is the highest rating), Armenia's 1995 rating for both civil liberties and political rights was 4. In 2015, Armenia's civil liberties rating was still 4, and the comparable figure for political rights was 5. The Polity IV rating for Armenia rose from 3 in 1995 to 5 in 2015 on a scale ranging from -10 (least democratic) to +10 (most democratic.) Armenia's Polity IV score for constraints on the executive in 2015 was 5 up from a 3 in 1995 on a scale ranging from 1 (least constraints) to 7 (most constraints). Finally, Transparency International assigned Armenia a score of 35 (on a 100-point scale) on its Corruption Perception Index in 2015, up from 25 in 2000. See Tables 8-12.

With growth rates of 6.85 percent over a 20-year period, Armenia is a clear success story among the FCP economies. Nevertheless, there is room for improvement in Armenia's political and economic institutions. Even though Armenia shows improvement in all EFW areas since 2004, the 2015 rating in Area 2 (Legal System and Property Rights) was 5.78, still a relatively low rating.

The deficiencies of Armenia's legal system are widespread. Its 2015 ratings for the following Area 2 components were less than 6.0 (on the EFW's 10-point scale): A (judicial independence), B (impartial courts), C (protection of property rights), D (Military interference in rule of law and politics), E (integrity of the legal system), F (legal enforcement of contracts), and H (reliability of the police). If Armenia is going to sustain its impressive rate of growth, it needs to make substantial improvements in its legal system and continue moving forward with economic liberalization.

Albania (ranked 32nd worldwide in 2015 EFW)

In 1995, the EFW rating of Albania was 5.1, placing it 96th among the 123 countries included in the index that year. Albania was, therefore, in the least-free EFW quartile in 1995. By 2000, the rating of Albania had increased to 6.20, pushing its rank up to 73rd among the same 123 countries, an increase of 23 positions in the worldwide EFW ranking. By 2015, the summary EFW rating of Albania had increased to 7.54, placing it 32nd among the 159 countries included in the most recent year. This 2015 rating placed Albania in the most-free EFW quartile worldwide and among the 7 most economically free FCP economies.

The substantial increase in the EFW summary rating of Albania stems largely from improvements in monetary policy, reductions in trade barriers, and lower top marginal tax rates. Following triple-digit inflation rates in the early-1990s, the monetary policy of Albania shifted dramatically toward restriction during the late 1990s. Since 2002, inflation rates in Albania have been lower than 5 percent. The EFW Area 3 rating (Access to Sound Money) of Albania rose to 9.59 in 2015 from 3.26 in 1995. In Area 4 (Freedom to Trade Internationally), the rating of Albania was 8.11 in 2015 up from 5.90 in 1995. Reductions in mean tariff rates from 7.29 percent in 2000 to 3.80 percent in 2015 have contributed to this result. In EFW Area 1 (Size of Government), the rating of Albania was 6.54 in 1995 and 7.96 in 2015. The flat personal income tax rates of 25 percent in 2005, 20 percent in 2006, 10 percent from 2007 to 2013, and 23 percent since 2014, have contributed to the higher rating in this area.

Reflecting the improvements in economic institutions, Albania grew at an annual rate of 5.03 percent over the 20-year period 1995-2015. This impressive growth rate allowed Albanians to almost triple their per capita income, from $4,129 in 1995 to $11,025 in 2015. The growth rates have slowed in the more recent periods: 4.78 percent in 2000-2015 and 3.78 in 2005-2015. See Tables 2 and 3. While the most

recent growth rates are still impressive, the slowing down is consistent with a more modest economic liberalization since 2005 as compared to the reforms that took place in the prior decade.

As expected, lower tariff rates and, in general, more freedom to trade internationally, resulted in large increases in the trade sector of Albania. Measured as imports plus exports as a percent of GDP, the size of the trade sector in Albania almost doubled from 47 percent in 1996-2000 to 82 percent in 2011-2015. Similarly, economic liberalization fostered foreign direct investment (FDI) into the Albanian economy. As a percent of GDP, net FDI almost quadrupled in the 20-year period 1995-2015. Measured as a percent of GDP, net FDI in Albania averaged 2.3 percent in the period 1996-2000, 3.8 percent in 2001-2005, 7.9 percent in 2006-2010, and 8.6 percent in 2011-2015. See Tables 5 and 6.

The moderate poverty rate (income of less than $3.10 per day measured in 2011 dollars) in Albania has been steadily declining since 1995. It fell slightly from 12.9 percent in 1995 to 12.1 percent in 2000. But, the reduction in the moderate poverty rate has accelerated since 2000, receding to 9.8 percent in 2005 and 6.4 percent in 2015. See Table 7.

Albania has shown small improvements in the area of political institutions, but there remains much progress to be made in this area. On the Freedom House scale of 1 to 7 (where 1 is the highest rating), Albania's 1995 ratings were 4 for civil liberties and 3 for political rights. By 2015, the civil liberties rating for Albania rose to 3, but its political rights rating remained at 3. In both of these areas, Albania has been in the "partly free" category since 1995. However, Albania's Polity IV score for democracy rose from 5 in 1995 to 9 in 2015. (Remember, this scale ranges from -10 indicating least democratic to +10 indicating most democratic.) Its Polity IV score for constraints on the executive in 2015 was 7 (the highest possible rating) up from a 5 in 1995. Finally, Transparency International assigned Albania a score of 36 (on a 100-point scale) on its Corruption Perception Index in 2015, up from 24 in 2005. See Tables 8-12.

Albania's ratings in EFW Area 2 (Legal System and Property Rights) and Area 5 (Regulation) are particularly low. The legal system deficiencies are both widespread and severe. Its 2015 ratings for the following Area 2 components were less than 5.0 (on the EFW's 10-point scale): A (judicial independence), B (impartial courts), C (protection of property rights), E (integrity of the legal system), and F (legal enforcement of contracts). For example, Albania's 2015 rating for independence of the judiciary was 2.75 and its rating for impartial courts was 2.97. Only two of the FCP economies (Moldova and Ukraine) had a lower 2015 component rating for judicial independence. Similarly, only six FCP countries (Slovak Republic, Croatia, Serbia, Bosnia, Moldova, and Ukraine) had a lower 2015 component rating for impartial courts.

In spite of weak political and legal institutions, Albania's growth rate has been impressive. Economic liberalization has been the major underlying factor of this growth. However, without improvements in the political, legal, and regulatory institutions, this rapid growth is unlikely to be sustained.

Bulgaria (ranked 48th worldwide in 2015 EFW)

The 1995 EFW rating of Bulgaria was 4.82, placing it 101st among the 123 countries included in the index. In 2000, Bulgaria's EFW rating was 5.52, placing it 104th among the same set of 123 countries. By 2005, Bulgaria's EFW rating rose to 6.95 placing it 64th among the 141 countries included in the index that year. In 2015, the EFW rating of Bulgaria was 7.39, placing it 48th among the 159 countries included. Among the FCP economies, Bulgaria has had the second largest increase in EFW since 1995, second only to Romania.

A substantial share of the increase in Bulgaria's EFW rating stems from its improvement in Area 3 (Sound Money). During 1996-1997, Bulgaria experienced hyperinflation (an inflation rate of 50 percent or more per month). Moreover, it had defaulted on its international debt and the real economy was in shambles. It was against this background that Bulgaria adopted a currency board in July of 1997. Under a currency board system, a monetary authority issues a domestic currency that is convertible into an anchor currency at a fixed rate. Credibility is achieved because the monetary authority is required to hold foreign reserves in the anchor currency that are sufficient to fully cover the domestic currency issued. Since the 1999 launch of the euro, the Bulgarian lev has been tied to the euro at a 1.95:1 ratio.

The currency board soon brought the hyperinflation under control. From 2001 to 2007, the inflation rate averaged 6 percent and was never above 10 percent. After a brief spike upward in 2008, the inflation rate in Bulgaria averaged 1.68 percent during 2009-2015. Bulgaria's EFW rating in access to sound money (Area 3 of EFW) reflects these changes. Its Area 3 rating rose from 1.99 in 1995 to 8.89 in 2005 and 9.36 in 2015.

Bulgaria has also adopted important reforms in other areas. The top marginal income tax rates in Bulgaria were 50 percent in 1995, 38 percent in 2000, 29 percent in 2001, and 24 percent in 2005. In 2008, Bulgaria adopted a flat marginal income tax rate of 10 percent, culminating a path of steady reductions in personal income tax rates. This 10 percent flat tax remains in affect.

Trade liberalization also contributed to Bulgaria's increased EFW rating. Its rating in Area 4 (international exchange) rose from 7.22 in 2005 to 8.13 in 2015. Bulgaria joined the European Union in 2007, and the EU's lower tariffs contributed to its higher Area 4 rating during this period.

Bulgaria has achieved remarkable growth since 2000. During 2000-2015, the per capita GDP of Bulgaria expanded at an annual rate of 4.36 percent. As a result, Bulgaria's per capita GDP nearly doubled during a 15-year period, increasing from $8,958 in 2000 to $17,000 in 2015. See Tables 2 and 3.

Bulgaria is now more fully integrated into the world economy. The size of the trade sector (imports plus exports as a percent of GDP) was similar in 1996-2000 (88 percent) and 2001-2005 (85 percent). However, the figure rose to 111 percent during 2006-2010 and to 126 percent during 2011-2015. See Table 5. Net foreign direct investment in Bulgaria, as a percent of GDP, rose steadily from 4.6 percent in 1996-2000 to 16.8 in 2006-2010, before dipping to 3.9 percent in 2011-2015. This recent drop in net FDI is a troublesome sign for this economy. See Table 6.

The percent of people living below the moderate poverty line in Bulgaria (income of less than $3.10 per day measured in 2011 dollars) has been relatively small and stable during the 20-year period 1995-2015.

The moderate poverty rate was 1.1 percent in 1995, it rose to 5.0 percent in 2000, and it has fluctuated below the 5 percent level since 2000. See Table 7.

The ratings of Bulgaria's political institutions have been relatively stable. On the Freedom House scale of 1 to 7 (where 1 is the highest rating), Bulgaria's ratings were 2 for civil liberties and 2 for political rights in both 1995 and 2015. Its Polity IV score for democracy increased from 8 in 1995 to 9 in 2015 on a scale ranging from -10 (least democratic) to +10 (most democratic.) Bulgaria's Polity IV score for constraints on the executive has been consistently 7 (the highest possible rating) throughout 1995-2015. Finally, Transparency International assigned Bulgaria a score of 41 (on a 100-point scale) on its Corruption Perception Index in 2015, up from 40 in 2000 and 35 in 2005.

Like other FCP economies, the 2015 EFW rating of Bulgaria in the legal structure and protection of property rights (Area 2) is low. Further, its rating in this area has declined from 6.57 in 1995 to 4.98 in 2005 and to 4.88 in 2015. The problems in this area are widespread. Bulgaria's 2015 ratings were 5.0 or less (on the EFW's 10-point scale) for seven of the nine EFW components in this area: A (judicial independence), B (impartial courts), C (protection of property rights), E (integrity of the legal system), F (legal enforcement of contracts), H (reliability of police) and I (business costs of crime). These weaknesses undermine the confidence of investors. The recent decline in foreign direct investment (see Table 6) may already reflect this factor. Without improvement in its legal system, it is unlikely that Bulgaria will be able to sustain its recent growth performance.

Poland (ranked 51st worldwide in 2015 EFW)

In 1995, Poland's EFW summary rating was 5.28, which placed it 90th among the 123 countries in the index. Since 1995, Poland's EFW rating has steadily improved. It rose to 6.58 in 2000, 6.89 in 2005, 7.12 in 2010, and 7.34 in 2015. Thus, Poland's EFW summary rating increased by 2 full points during the two decades. In 2015, Poland ranked 51st worldwide among the 159 countries in the EFW index.

Poland’s steady increase in economic freedom has been accompanied by strong economic growth. During 1995-2015, per capita GDP grew at an annual rate of 4.11 percent. As a result, Poland’s per capita GDP more than doubled, increasing from $11,300 in 1995 to $25,299 in 2015. The 2015 figure was the sixth highest among the FCP countries.

Poland’s economic growth has been enhanced by increased openness and growth of international trade. The trade sector (imports plus exports as a share of GDP) of Poland rose sharply from 53 percent during 1996-2000 to 79 percent in 2006-2010 and 91 percent during 2011-2015. See table 5. Poland joined the European Union in 2004. This substantially expanded the size of its tariff-free market and contributed to the subsequent rapid expansion in the size of its trade sector. Net foreign direct investment has been substantial and steady. Net FDI averaged approximately 3 percent of GDP during the two decades. See Table 6.

Poland’s poverty rate was relatively low throughout 1995-2015. The moderate poverty rate (income per day of less than $3.10 measured in 2011 dollars) was less than 1 percent in 2015 and it was less than 2 percent throughout 1995-2015. See Table 7.

The political institutions of Poland are among the highest rated of the countries in the FCP group. Freedom House has assigned Poland its highest rating of 1 (on a 7-point scale) for both civil liberties and political rights every year since 2005. Poland is one of only four (the other three are Lithuania, Slovak Republic, and Slovenia) FCP countries that received the highest 2015 Freedom House ratings for both civil liberties and political rights. Poland’s Polity IV score for democracy was 10 each year during 20052015, up from 9 in 1995. (Remember, this scale ranges from -10 indicating least democratic to +10 indicating most democratic.) Poland’s Polity IV rating for constraints on the executive was a 7, the highest possible score, throughout 1995-2015. Lastly, Poland’s score on the Transparency International Corruption Perception Index was 41 (on a 1-100 scale) in 2000; it dipped to 34 in 2005, but rebounded to 53 in 2010 and 62 in 2015. See Tables 8-12.

Poland has registered steady improvements in EFW areas 3 (Access to Sound Money), 4 (International Trade), and 5 (Regulation). Its recent low and stable rates of inflation stand in stark contrast with the monetary and price instability of the early 1990s. Poland’s Area 3 rating was 9.39 in 2010 and 9.62 in 2015, up from 6.03 in 1995. Poland’s Area 4 EFW rating rose from 7.20 in 1995 to 7.95 in 2015. In Area 5, Poland’s ratings were 4.3 in 1995, 6.98 in 2005, and 7.64 in 2015.

As in the case of other FCP countries, the legal structure (Area 2) is a major weakness of the Polish economy. During 2000-2015, Poland’s Area 2 ratings ranged from a low of 5.03 in 2003 to a high of 6.32 in 2011. In 2015, its area2 EFW rating was 5.79. This is more than two full points below the 7.88 average Area 2 rating of the 16 high-income European countries. In five of the nine area-2 components, the 2015 ratings of Poland were less than 6.0 (on the EFW’s 10-point scale). These five components were: A (judicial independence), B (impartial courts), C (protection of property rights), F (legal enforcement of contracts), and H (reliability of the police).

Further, the recent actions of the Law and Justice party (PiS) has politicized the judicial system and weakened the rule of law. Legislation adopted in 2017 empowers the minister of justice with the authority to dismiss judges of the common courts for reasons most deemed to be purely political. Additional legislation that would provide the executive branch with the authority to effectively control the Polish judiciary, including dismissal of Supreme Court justices, is under serious consideration. Unless this situation is reversed, investor's confidence and capital formation will decline. In turn, this will undermine the future growth of the Polish economy.

Slovak Republic (ranked 53rd worldwide in 2015 EFW)

Following the breakup of Czechoslovakia into the Czech and Slovak Republics in 1992, the latter faced a very difficult situation. Under communism, the Slovakia region was heavily involved in defense production. As these facilities were closed, unemployment in the Slovak Republic soared. This created

an unstable situation. As the Slovak Republic began the transition from communism, privatization and economic reforms were slow to come. The 1995 economic freedom rating of the Slovak Republic was 5.25, placing it 83rd among the 123 countries in the index. Slovakia's summary EFW rating improved to 6.85 in 2000, moving it up to 57th among the 123 countries ranked that year. Additional reforms, including the adoption of a flat rate personal income tax in 2004, were undertaken and the 2005 rating climbed to 7.63. In 2005, the Slovak republic ranked 20th among the 141 countries in the index. Since 2005, however, both the EFW rating and ranking of the Slovak Republic have steadily declined. By 2015, Slovakia's rating had fallen to 7.31 and its ranking slipped to 53rd among the 159 countries currently in the index. Thus, since adoption of the 19 percent flat rate tax in 2004, Slovakia's zeal for economic liberalization has waned. Even this iconic reform has now been partially reversed.

The economy of the Slovak Republic grew rapidly during 1995-2015, particularly during the first decade of this century. During the two decades following 1995, per capita GDP grew at an annual rate of 3.88 percent. As a result, per capita GDP more than doubled, increasing from $13,184 in 1995 to $28,254 in 2015. The 2015 figure was the third highest among the FCP group, trailing only the Czech Republic and Slovenia.

Declining trade barriers and growth of the trade sector have played a key role in the growth of the Slovak economy. The trade sector (imports plus exports as a share of GDP) of the Slovak Republic soared from 110 percent during 1996-2000 to 157 percent in 2006-2010, and 180 percent during 2011-2015. Even though it is more populous than several of the other FCP economies, Slovakia's trade sector is the largest among this group. See Table 5. The Slovak Republic joined the European Union in 2004. This expanded the size of its tariff-free market and thereby contributed to the rapid growth of Slovakia's trade sector. Net foreign direct investment also increased. During the first decade of this century, net FDI averaged more than 5 percent of GDP.

Unlike many other FCP economies, the poverty rate in the Slovak Republic has been low since the mid1990s. The moderate poverty rate (income per day of less than $3.10 measured in 2011 dollars) was less than 1 percent in 2015 and it never rose above 3 percent during 1995-2015.

The political institutions of the Slovak Republic are among the best in the FCP group. Freedom House has assigned the Slovak Republic its highest rating of 1 (on a 7-point scale) for both civil liberties and political rights every year since 2005. Slovakia's Polity IV score for democracy was 10 in both 2010 and 2015, up from 9 in 2000 and 2005 and 7 in 1995. (the Polity scale ranges from -10 indicating least democratic to +10 indicating most democratic.) Regarding constraints on the executive, Polity IV gave the Slovak Republic its highest rating of 7 throughout 2000-2015. The Slovak Republic is one of only four FCP countries (the other three were Lithuania, Poland, and Slovenia) to receive the highest Freedom House ratings for both civil liberties and political rights and the highest Polity scores for both democracy and constraints on the executive. Lastly, Transparency International assigned the Slovak Republic a score of 51 (on a 100-point scale) on its perception of corruption index in 2015, up from 35 in 2000 and 43 in 2005. See Tables 8-12. The Transparency International score is well below that of the Czech Republic, the Baltic states, and several other FCP countries. There is plenty of room for improvement in this area. Polls indicate that the confidence of citizens in the country's public institutions has been declining and that corruption in government is a major reason underlying the decline. Reductions in corruption would help make the political institutions of the Slovak Republic both stronger and more trustworthy.

The EFW area ratings reveal a great deal about both the strengths and weaknesses of the Slovak economy. Steady improvements have been achieved in EFW areas 3 (access to sound money) and 4 (international trade). Slovakia's Area 3 rating rose from 6.69 in 1995 to 9.15 in 2005 and 9.74 in 2015. In 2009, the Slovak Republic joined the European Monetary Union and adopted the euro as its currency. This enhanced confidence in its monetary arrangements and contributed to its high Area 3 ratings of recent years. The Area 4 EFW rating of the Slovak Republic also rose steadily from 6.93 in 1995 to 8.15 in 2005 and 8.30 in 2015. The picture for Area 5 (Regulation), however, is more mixed. Slovakia's Area 5 rating rose substantially from 4.90 in 1995 to 7.77 in 2005. However, during the past decade, it has receded to 7.42 in 2010 and 7.36 in 2015. Some argue that regulations mandated by the EU have been a major contributing factor underlying the increased regulation and declining Area 5 rating since 2005.

As in the case of other FCP countries, the legal system (Area 2) is a major weakness of the Slovak Republic. Moreover, the evidence indicates that little progress has been made in this area. Slovakia's EFW Area 2 ratings were 6.55 in 1995, 6.35 in 2000, and 6.63 in 2005. However, since 2005, the trend has been downward. Slovakia's Area 2 rating fell to 5.78 in 2010 and 5.64 in 2015. Thus, its Area 2 rating declined a full point between 2005 and 2015. In 2015, Slovakia's Area 2 ratings were particularly low for the following components: (A) Judicial independence, 3.04; (B) Impartial courts, 2.0; (C) Protection of property rights, 5.29; (F) Legal enforcement of contracts, 3.33; and (H) Reliability of police, 4.31.

While the growth rate of the Slovak Republic was impressive during 1995-2015, troublesome signs are now present. These include high levels of corruption, increased regulation (as indicated by the recent declines in the Area 5 rating), and most importantly, weakness of its legal system. Without improvements in these areas, it is unlikely that the Slovak Republic will maintain its strong growth in the future.