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## **The Political Economy of Crisis Adjustment in Central and Eastern Europe**

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## Introduction

The fall of communism in 1989 across Central-Eastern Europe (CEE) has ushered in a decade of transitologists. Epitomized in EBRD's annual Transition Reports, international institutions, global academic community and observers at large have sought to analyse, theorize and advise governments on the building of capitalist democracies from the ruins of socialist command economies (see de Batt, 1990; de Melo et al., 1996; Åslund, 2002; Dylon & Wykoff, 2002). By the 2000s, transitology gave way to comparative analysis, as scholars of various theoretical backgrounds argued for the formation of substantively different varieties of capitalism in the post-communist region (Cernat, 2006; Lane & Myant, 2007; Bohle & Greskovits, 2007; Drahokoupil, 2009; Drahokoupil & Myant, 2011). The 2008/9 financial crisis has opened up new avenues for research, particularly how the different political economies in CEE adjust to external economic shocks. Building on the existing literature, this article begins by proposing a theoretical framework for an analysis of the process of crisis adjustment in CEE with a view to exploring two of its dimensions. The first is economic: has there been an economic recovery and if so, what were its drivers and beneficiaries? The second is concerned with the social costs: how was the burden of fiscal adjustment that accompanied the crisis distributed? Ultimately, the article seeks to identify the implications of this episode for the East European variants of capitalism.

The immediate adverse impact of the crisis on CEE has been well documented. It was noted that the region was the hardest hit out of the whole world, though the severity of the downturn varied among different countries (Berglöf et al., 2009). This was traced to the build-up of pre-crisis vulnerabilities and the specifics of crisis exposure (Mitra & Čihák, 2009; Drahokoupil & Myant, 2011; 2012; Marer, 2013). Using econometric analysis, Connolly argued for the severity of recessions in CEE to have been determined by three macro-financial variables (Connolly, 2012). Others predicted a sluggish recovery (Korniyenko et al., 2012). International Financial Institutions (IFIs), providing direct assistance to some countries of the region, have produced numerous analyses of the pre-crisis growth models, crisis exposure, and future prospects (Mody et al. 2009; Mitra et al., 2010; Bakker & Klingen, 2012; EBRD, 2009). All these accounts have as a rule been pre-occupied with the pre-crisis period and come in the form of pan-regional analyses, or case studies tracking different indicators that are not readily comparable. This article seeks to provide a comparative analysis of the dynamics of post-crisis economic performance in Central-Eastern Europe. To avoid possible conceptual controversies in constructing a single indicator, economic performance of countries is proxied by tracking GDP growth and its composition, developments in foreign trade, and changes in the labour market. Although the choice of variables is arbitrary, together they construct a useful multi-dimensional conception of the economy, from the macro (GDP), through structural (trade) to the human layer (labour market). The

similarities and differences across countries are thus noted, performance is comparatively evaluated and factors underpinning it discussed.

Fiscal consolidation episodes over the last half a century have received considerable attention, though as a rule in their relation to enhancing growth (Mauro 2011; Sutherland et al., 2012; Moral-Benito & de Cos, 2013), while 'there has been little systematic analysis of the distributional effects of fiscal consolidations' (Woo et al., 2013: p.2). Among CEE countries, the Baltic fiscal adjustment strategy has attracted considerable attention, although its distributional impacts have been left implied (Purfield & Rosenberg, 2010; Kattel & Raudla 2011; 2013a; 2013b). Drašković et al. assess the policy responses to the crisis in the Visegrad states for their distributional impacts, categorizing them as social-democratic or neo-liberal, albeit without devising a common yardstick (Drašković et al., 2013). While these have been an important source of inspiration, this article seeks to place the countries' public sector adjustment strategies along a progressive / regressive axis by constructing a composite indicator capturing the distributional impacts of measures pursued. Although the exercise is evidence-based, it requires a degree of simplification and judgement. Nevertheless, it allows for useful comparison, while shedding light on the determinants of measures pursued.

While economic performance and strategies of fiscal consolidation are usually considered in conjunction and are no doubt interrelated, for the purpose of this article, they are treated as two analytically distinct categories that together construct the larger whole. The gathered data provides a basis for revealing the factors underpinning the overall course of crisis adjustment in CEE. Have countries with low pre-crisis imbalances economically outperformed the more vulnerable ones? Have specific policies been decisive in returning a country to prosperity? Concerning the distribution of costs, can the progressiveness of fiscal adjustment be explained by the scope of potential social dislocation, or the extent of organised opposition to welfare retrenchment? And while the dominant assumption throughout the 2000s was that the region's 'social and economic structures... are there to stay and shape the developments for some time to come' (Drašković, 2009: p.279), the article addresses how the experience has shaped the region's variants of capitalism.

The first part constructs an analytical framework for a systematic analysis of crisis adjustment in post-communist Europe and justifies the choice of countries. Hypotheses and methodology are presented in the next sections, followed by the presentation of the findings. The next section assesses these, relating them to the earlier hypotheses. A re-construction of the different dynamics of adjustment and their implications follows. Ultimately, conclusions are drawn.

## 1. Analytical Framework

This section presents first presents a literature review of the attempts to map the basic contours of CEE's political economies, which have inspired the analytical framework adopted in this article.

### 1.1 Conceptualizing Capitalism in Central-Eastern Europe

In what later became a classic in comparative political economy, Peter Katzenstein (1985) observed that in the decades after Second World War 'democratic corporatism' – a distinct set of national institutional arrangements – has enabled a group of small West European states to deal effectively with adverse economic shocks emanating from the global economy. Accordingly, democratic corporatism has been underpinned by a shared ideology of social partnership, a relatively centralized and concentrated system of interest groups at the national level, and voluntary and informal coordination of conflicting objectives through continuous bargaining between interest groups, state bureaucracies and political parties (Katzenstein, 1985; p.32-3). Characteristic of the logic of adjustment has been 'external liberalization and domestic compensation... with a close link between the political and economic requirements of economic adjustment' (Ibid, 1985; p.29). For Katzenstein, the success of adjustment was measured as 'the extent to which social coalitions, political institutions, and public policies facilitate or impede shifts in the factors of production that increase economic efficiency with due regards to the requirements of political legitimacy' (Ibid, p.29). Katzenstein's central thesis was that owing to their political representativeness, economic flexibility and social inclusion, the democratic corporatist arrangements would be reinforced over time. In other words, the small West European states were bound for success.

Although the accuracy of Katzenstein's proposition has become contested (see Jones, 2008; Schwartz, 1994; 2010; Ingebritsen, 2010), democratic corporatism offered an attractive model for the East European states to adopt. In a later article, Katzenstein argued that the transition from socialism to capitalism and accelerating process of Europeanization 'could be viewed as functional equivalents' of the political and economic shocks of 1930s and 1940s, which, in his account, prompted the West European states to instate corporatist institutions (Katzenstein, 1985: Ch.4). Indeed, Iankova argued that out of a need to maintain social cohesion in the turbulent 1990s, 'transformative corporatism' has taken hold in Central-Eastern Europe (Iankova, 1998; 2002). Her account has been dismissed by Ost, who maintained that corporatism in CEE was purely illusory, and only served 'to secure the labour's acceptance of its own marginalization' and 'achieve neoliberal outcomes' (Ost, 2000: p.503). Commenting on the debate, Katzenstein stated that 'if we had to choose one label under which to subsume their [CEE countries] different experiences, then it would probably be European-style welfare capitalism' (Katzenstein, 2003: p.22).

Yet it was precisely the attempt to subsume all of Central-Eastern Europe under one label and insufficient attention paid to the regional variation that was perhaps the weakest spot in the accounts of authors from the corporatist tradition. Explaining this variation has become the central objective for comparative analysts in the 2000s, predominantly under the Varieties of Capitalism (VoC) approach (Hall & Soskice, 2001). The VoC approach represents a powerful account of how specific institutional arrangements induce firms to coordinate their activities on the micro (firm level) and macro (economy level) scale in order to innovate and remain competitive in the global economy. The two superior configurations identified by the authors – the Liberal Market Economy (LME) typified by the US, and Coordinated Market Economy (CME) typified by Germany – fundamentally differ across five core socio-economic institutions. Whereas in LMEs firm relations, corporate governance, financing, industrial relations and skill reproduction are characterized by a logic of arms-length market relations, in the CMEs these are defined by a logic of strategic interaction, cooperation and consensus. Consequently, the LMEs are particularly well fitted to produce radical innovations, while given their longer time-horizon, firms in CMEs specialize in sectors where incremental innovation is key to success. In instances of exogenous shocks, the different institutional settings frame the payoffs of different adjustment strategies that firms might pursue. While the firms in LMEs tend to focus on short-term profitability, lay-off workers and push for more liberalization, firms in CMEs prefer to maintain market shares and employment levels, accepting temporary declines in profitability (Hall & Soskice, 2001: p.55-60).

The 2000s have witnessed burgeoning literature exploring the variation in Central-Eastern Europe through the VoC lenses (Lane, 2007; Lane & Myant, 2007; Hancke et al., 2007). Popular among the authors has been to contrast Slovenia and Estonia, as case-points of a CME and LME respectively (McMenamin, 2004; Lane 2005; Feldmann, 2005; 2006; Buchen, 2007). Some attempted to construct a coordination index capturing the relative positions of CEE political economies along the CME-LME axis (Bobos, 2010). However, the underlying assumption that the framework is readily transposable from the developed Western to the nascent post-communist capitalist economies, despite their fundamentally different histories, political cultures and levels of economic development, is highly questionable. Some authors went so far as to dispute the validity of the assumption that national comparative advantage in CEE is indeed underpinned by complimentary institutional arrangements, and argued that provided secure property rights, it is structural factors – such as geographical proximity, level of education and cost of labour – which, in fact, matter (Greskovits, 2005; Myant, 2007; Drahokoupil, 2009). It could be argued that the mechanical application of the VoC framework to the CEE region has reflected, more than anything, its popularity among academics.

In an attempt to rescue the VoC, Nölke and Vliegenthart centred their analysis on 'the fundamental dependence of the CEE economies on investment decisions of transnational corporations' (Nölke & Vliegenthart, 2009: p.676). The authors have thus constructed a third typology – the Dependent Market Economy (DME) – capturing the Visegrad political economies. In the DME, the central coordination mechanism is the hierarchy within transnational corporations, through which local subsidiaries of TNCs are controlled and financed from the headquarters, and in which technology is transferred within the TNCs production networks. Selective company-level agreements dominate the industrial relations, while the TNCs pursue only limited involvement in skills-reproduction. Given the preference of TNCs for conducting innovation-heavy activities at their headquarters, the DMEs comparative advantage 'is not based on radical innovation (LMEs) or incremental innovation (CMEs), but rather on an assembly platform semistandardized industrial goods' (Nölke & Vliegenthart, 2009: p.679). While the DME typology marks an improvement on the original VoC dichotomy, it also suffers from severe deficiencies. Its application to just four countries of the region and ignorance of the varied regional forms of dependence render its practical utility in comparative research on capitalism in CEE extremely limited. And through its strict emphasis on the hierarchy within TNCs, 'the variation in socio-economic models identified by the VoC research is lost' while 'the coordination mechanisms within MNCs remain black boxed' (Drahokoupil, 2009: p.295). However reinvented, the firm-centred, and thoroughly mechanical VoC approach (Lane & Wood, 2011) seems to offer a poor starting point for the study of the region's crisis adjustment and change.

Departing from the VoC, Drahokoupil and Myant have constructed five typologies of post-communist political economies. Based on their particular form of international integration and key internal characteristics, such as the nature of property rights, the role of the state and the nature of the relation between the state and main economic actors, these are (1) FDI-based and (2) peripheral market economies, (3) oligarchic-clientelistic capitalism, (4) order states and (5) reemittance- and aid-based economies (Drahokoupil & Mynat, 2011: Ch.16). While the latter three are typified by Russia, Ukraine and countries in Central Asia, the authors propose two typologies for the most Western states of the former Soviet empire. Accordingly, the Visegrad and Slovenian economies fit in the first category and are 'distinguished by democratic political systems, integration into the European Union... complex export structures increasingly built around foreign-owned MNCs' granting them 'second-rank positions in international production networks' (Drahokoupil & Mynat, 2011: p.310). Labour protection and welfare provision in the five countries has been relatively high. The South East European and Baltic economies are conceived as peripheral market economies, defined by 'democratic political systems and basic and institutional conditions for business', though relying less

on stable manufactured exports and associated with 'financialized growth and reliance on remittances' which render them 'less equipped to withstand external shocks' (Ibid: p.311). In these states, welfare provision tends to be significantly lower than in the FDI-based variety.

The above taxonomy offers a more workable framework relative to the more mechanical VoC, though it too has its limitations. On the positive side, the strengths and weaknesses of the various economic models and domestic welfare institutions invite an analysis of their adjustment to external shocks, opening up the possibility of change, the shifting of countries from one variant to another, or the emergence of altogether new types. On the other hand, the authors' preoccupation with the whole of the post-Soviet space leaves them with a rather crude lumping of East European political economies. For instance, while the Baltic states are distinguished by markedly higher state capacity than those of South-East Europe (World Bank, 2014), the Slovenian and the Visegrad economies are dominated by different types of economic actors, while their interest representation structures, or extent welfare provision, also vary.

Putting the socio-political fabric at the centre of analysis, Bohle and Greskovits argued for the patterned evolution and consolidation of three distinct variants of capitalism in Central-Eastern Europe – a neo-liberal type in the Baltics, an embedded neo-liberal type in the Visegrad states and a neocorporatist type in Slovenia (Bohle & Greskovits, 2007). In what has been perhaps the most comprehensive work on comparative capitalism in CEE, the authors argued that what differentiates the specific variants is 'the changing relative weight of the ideas and institutional implications of neo-liberalism – which prioritizes the creation of efficient markets, welfare capitalism – which compensates for the costs of radical socio-economic change, and democratic corporatism – with its emphasis on institutional representation of social interests' (Bohle & Greskovits, 2012: p.19). To operationalize these concepts, the different variants have become distinguished by their 'deep, but variable integration into the neo-liberal global and European order, their tendency to pursue marketization and transformation cost compensation with different amounts of vigour and in varied forms, and different ways and varied effectiveness in which these conflicting and contested social objectives are governed' (Ibid). A particular emphasis in the account is put on their fragility, as all have 'to manoeuvre within a space bordered by social disintegration, economic disorganisation and/or political breakdown – without coming dangerously close to any of these' (Ibid: p.15). The political economies in CEE are thus conceived as constantly evolving, embodying inherent conflicts and contradictions, without either a clear end-point or the guarantee of success.



## 1.2 Towards a Social Contract in Central-Eastern Europe

Based on the above literature and for the purposes of this article, the political economies in Central-Eastern Europe are conceived as being based on a distinct two-dimensional social contract between the state and society. First, those economically active have been offered a path to economic prosperity. In newly reconfigured roles for the state and the market, robust economic growth, rising living standards, and new economic opportunities have defined the prospects for the productive parts of population. And second, social cohesion was secured by making specific provisions for the societies' economically inactive or otherwise disadvantaged. Unable to reap the economic benefits of the new age, their acquiescence to the new order was achieved through different welfare arrangements. Inextricably linked, the underlying economic and social structures are subject to pressures from within and without and as a result, never fully settled, but continuously strengthened, challenged, or reshaped through the political sphere. It is this constant contestation of the economic and social spheres through the political process that is at the core of the social contract. The evolutionary dynamic of the CEE's political economies predicts that periods of slow and incremental change are punctuated by deep crises, where economic prosperity and/or social cohesion appear jeopardized, putting the basic contours of the prevalent order under severe stress, potentially prompting significant changes in the underlying economic and social structures.

The economic dimension of the social contract has been underpinned by distinct growth models. Each growth model has been (1) defined by deep, but varied form of international economic integration, (2) underpinned by different leading industry sectors (3) and driven by actors of varied nature and origin. The 'classic phase' of these growth models, when their 'features became the most pronounced, was the 2000-2007 period, coinciding with a global economic boom and with the anticipation and then realization of... becoming full EU members' (Marer, 2013: p.243). With the perils of transition over, spectacular growth rates, rising living standards and falling unemployment rates gripped the region. The second, social dimension has been underpinned by different dominant ideas about the appropriate role of the state in compensating those unable to take advantage of the new economic opportunities. Although some have called for a more 'substantive understanding of compensation that focuses on its role in mitigating even more fundamental anxieties that those stemming from declining 'objective' standard of material wellbeing' (Bohle & Greskovits, 2012: p.50), because of the difficulty of operationalizing such variable, compensation is understood in its material sense and refers to pensions, social and unemployment insurance, along with public services such as healthcare and education. And drawing on Bohle & Greskovits (2012), three distinct social contracts that have emerged in CEE.

The populations in the Baltics have settled on a *neo-liberal nationalist* social contract (see Bohle & Greskovits, 2012: Ch.3). With their banking sectors overtaken by predominantly Scandinavian banking houses at the turn of the millennia and on the back of 'abundant global liquidity' (Mitra et al., 2010: p.15), Estonia, Latvia and Lithuania have embarked on financialized growth characterized by booming non-tradable sectors. The foreign-owned banks offset construction and real-estate booms unmatched in the developed world (Égert & Mihaljek, 2007) by offering what often were negative real interest rates on Euro-denominated consumer loans and mortgages (Bukeviciute & Kosicki, 2012). Their export-specialization in traditional light and heavy industries, such as food, textiles and wood and metal, and labour-intensive services have been unable to offset the domestic consumption booms, resulting in double digit trade and current account deficits and exploding external indebtedness (Bohle & Greskovits, 2012: p.40; IMF, 2014). The march to prosperity in the Baltics has thus been based on a rapid expansion of domestic demand, financed by cheap credit from abroad and accompanied by the gradual erosion of international competitiveness. The extension of credit has also offered an effective substitute for the relatively meagre provision of social compensation, the latter being determined by a preference for low flat-tax systems, stringent monetary arrangements and the marginalization of the Russian minorities as part of the ongoing nation-building projects (McNabb & King, 2014). Exemplified in the prominence of the politics of identity, the populations in the Baltics have accepted a minimal state, perceived as necessary to safeguard national identity and independence.

The Visegrad populations have embraced a *neo-liberal welfarist* social contract (Bohle & Greskovits, 2012: Ch. 4). Although their banking sectors have equally been overtaken by foreign actors, with the exception of Hungary, banks' lending activities have been financed mainly by domestic deposits. However, benefiting from the outsourcing of multinationals, particularly from the automotive and electronics industries, all four have become firmly integrated in the global economy through what has been termed the German-Central European supply chain (IMF, 2013). And although located in relatively downstream activities of global production chains, the acquired technology, capital and know-how has underpinned the expansion and competitiveness of their exports. With 'tiny positive or only small negative net exports contributions to growth' (Marer, 2013: p.247) and safeguarding their labour unit costs, the march to prosperity in the Visegrad economies has been achieved through their penetration of global markets with complex manufacturing exports. To maintain social cohesion, the Visegrad states have institutionalized relatively generous social compensation, often targeting particular groups within society. Owing to the army of disability and early pensioners in Hungary and Poland respectively, the Visegrad states have been referred to as 'pensioners' democracies' (Vanhuysse, 2006), prompting historical studies into the origins of these arrangements (Inglot, 2008).

A third, *neo-corporatist* social contract has consolidated in Slovenia (Bohle & Greskovits, 2012: Ch.5) in its core features closely resembling the democratic corporatist arrangements of Katzenstein’s small West European states. Slovenia’s growth model has been distinguished from that of the Visegrad states by its reliance on domestic economic actors, with the state retaining considerable foothold in the economy via extensive enterprise and bank ownership. Encouraging only highly selective forms of FDI to promote technological upgrading, Slovenia’s production profile came to resemble closely that of the Visegrad states, as it too penetrated global markets with complex manufacturing exports. Only as part of the EU-accession process did the FDI regime become fully liberalized, although foreign presence in key sectors, such as banking, has nevertheless remained minimal (EBRD, 2007: p.192). The strong institutional representation of social interests has translated into the region’s most generous welfare state in terms of both, public services and social transfers (Bohle & Greskovits, 2012: p.36).

As observable in Table 1, the central point within the social contract framework is the capacity of the CEE political economies to economically deliver for their populations, while making specific provisions for the vulnerable or less fortunate in society.

**Table 1 – Prosperity & Social Cohesion in CEE**

	<b>Real GDP growth rate, 2000-2007 averages (%)</b>	<b>GDP per capita in 2007 (% of EU28, PPP)</b>	<b>Unemployment rate in 2007 (%)</b>	<b>Total social expenditure 2000-2007 (% of GDP)</b>	<b>Social benefits per capita ‘00-‘07 (EUR, PPP)</b>
<b>Baltics</b>	7.9	63 (+22.7)	5 (-10.1)	13.7	1,331
<b>Visegrad 4</b>	4.5	66.4 (+10.6)	8.4 (-4.1)	19.7	2,371
<b>Slovenia</b>	4.4	88.2 (+8.2)	4.9 (-1.8)	23.8	4,021

Source: Bohle & Greskovits (2012: p.35) & Eurostat. Data in parentheses indicate % change from 2000.

The Baltic, Visegrad and Slovenian political economies represent the principal growth models and social compensation mechanisms that have consolidated in the CEE region. Moreover, their similar levels of per-capita income, state and administrative capacity and joint integration into the Euro-Atlantic economic and political structures, which although reinforcing their institutional capacities (Bruzst & McDermott, 2012) also constraint their range of policy instruments, render this group of countries suitable for a comparative analysis of the sort undertaken in this article. In this respect, while the Balkan political economies can be argued to have been underpinned by Baltic-style growth models and similarly low levels of material compensation (Bohle & Greskovits, 2012), their lower per-capita incomes, distinctively weaker state capacities, and delayed or incomplete integration into the Euro-Atlantic structures likely render their unqualified comparison with the former group unwarranted.

## 2. Hypothesizing Adjustment

Within the social contract framework, an economic crisis of the proportions recently witnessed may bear profound implications for the continued prosperity of the populations, while the accompanying fiscal stress poses a dilemma over the distribution of the accompanying costs. This section speculates on how these essential economic and social processes are likely to have evolved.

### 2.1 Hypothesizing Economic Adjustment

Revealing the weaknesses of the particular growth models, the crisis has been imported via two dominant transmission channels – financial and trade channel (EBRD, 2009; Drahokoupil & Myant, 2011). The financial channel has been dominant in the Baltics, their growth model being characterized by the build-up of significant external imbalances, their consumption booms financed by quickly reversible capital inflows (Grønn & Fredholm, 2013), rendering them thoroughly dependent on the change of foreign financial sentiment. External imbalances in Slovenia and the Visegrad states have not reached critical levels, although Hungary came close (Table 2.1).

**Table 2.1 – Financial Exposure**

	<b>Current account Balance in 2007 (% of GDP)</b>	<b>Ratio of External Debt to Exports in 2008 (%)</b>	<b>Credit to private sector in March 2007 (% of GDP)</b>	<b>Loans in foreign currency in 2008 (% of total)</b>	<b>Mortgage lending to households in 2007 (% of GDP)</b>
<b>Baltics</b>	-18.4	187.7	256.7	79.5	29.5
<b>Visegrad 4</b>	-5.4	113.2 <sup>a</sup>	176.5	33.5 <sup>b</sup>	10.2 <sup>c</sup>
<b>Slovenia</b>	-6.2	147.6	190.8	–	6.2

*Source:* Various sources quoted from Drahokoupil & Myant (2011), Bohle & Greskovits (2012: p.225) EBRD Transition Reports (2007, 2009)

a) Data for Czech Republic missing

b) In Hungary, the share stood at 63.8%

c) Data for Czech Republic from 2006

Integrated into the global economy through participating in MNC's manufacturing production chains, the Visegrad states have imported the crisis via the trade channel, as foreign demand for their products collapsed. And despite not being dominated by foreign MNCs – although reliant on foreign input into niche industries – Slovenia's integration into the global economy via complex manufacturing exports implied that it too was adversely impacted by the collapse in trade. Owing to their participation in buyer-driven networks, the Baltics have also been hard hit by declines in trade, although on the back of an overall lower share of exports in GDP (Table 2.2).

**Table 2.2 – Trade Exposure**

	<b>Exports in 2008 (% of GDP)</b>	<b>Share of complex manufacturing exports in total exports, 2008 (%)<sup>b</sup></b>	<b>Share of domestic value added in total exports in 2008 (%)</b>	<b>Change in Exports Q1 2009 y-o-y (%)</b>
<b>Baltics</b>	44	33	65	-25.5
<b>Visegrad 4</b>	61.4 <sup>a</sup>	62	56.8	-16.8 <sup>c</sup>
<b>Slovenia</b>	53.7	56	58.8	-22.4

Source: Various sources quoted from Drahokoupil & Myant (2011), Bohle & Greskovits (2012: p.45) Stehrer (2013)

a) Average for CZE, HUN, SVK (V3) at 70.6

b) SITC Classification 5 and 7.

b) Average for V3 at -21.5

The extent of external imbalances and derived vulnerabilities of the different growth models arguably act as strong indicators for delivering prosperity post-2008/9. The reversal of international capital flows, bursting of asset bubbles and the accompanying economic distress, along with the limited production capacities and low integration into the global value chains (OECD, 2013a), brought the Baltic economies ‘to what appeared to be a possibly terminal crisis’ (Drahokoupil & Myant, 2011: p.212). Indeed, there is little evidence that financialized growth ‘benefits long-term growth in emerging markets’ (EBRD, 2009; p.62). The smaller dependence of Visegrad states and Slovenia on foreign finance together with their export-oriented industrial bases means that they are likely to benefit from a global recovery and undergo a quick turnaround. According to this reasoning, the extent to which CEE political economies had become vulnerable ‘is the key to explaining differences in their growth performances... as well as growth prospects’ (Marer, 2013: p.246). Thus, while ‘recovery from the depression may be easier for countries exporting modern manufactured goods... recovery may be extremely difficult for countries that depended on financialized growth’ (Drahokoupil & Myant, 2011: p.332). In this vein, the sustainability of the pre-crisis growth models is likely to be the best predictor of post-crisis economic performance 2009. This is referred to as the ‘economic legacy hypothesis.’

Notwithstanding the different growth models, all governments possess significant leeway in terms of policy instruments that may be decisive in restoring economic prosperity for their populations. Commenting on the CEE region, some have argued that ‘whether and at what cost various states have been able to manoeuvre through hard times has ultimately depended on the capacities of the political sphere, rather than merely on the specifics of crisis exposure’ (Bohle & Greskovits, 2012; p.224). And there exists considerable literature on the appropriate course of crisis management. A counter-cyclical stimulus is deemed crucial in boosting aggregate demand, offsetting the lack of private spending and preventing further declines in economic activity (Keynes, 1936; Baldacci et al., 2009). Historical experience clearly demonstrates ‘the critical role of an early, strong, and carefully thought out, fiscal response’ (Blanchard et al., 2008: p.12). Monetary policy should generally be accommodative to fiscal

expansion (IMF, 2009a: p.xii), while a currency devaluation is likely to provide a temporary boost to exports (Obstfeld, 2001; Rodrik, 2009; Haddad & Pancaro, 2010). Ultimately, labour market policies (LMPs) can be decisive in improving the employment opportunities of displaced workers, where especially training programmes are associated with positive medium-term impacts (Card et al., 2010). Accordingly, the ideal anti-crisis policy-mix would thus include a sizeable fiscal stimulus to boost aggregate demand, monetary easing to promote exports, and scaling up of funding for LMPs to avoid permanent losses in employment. Countries whose governments were able to fully exploit these policy instruments are likely to outperform. This is referred to as ‘economic policy hypothesis.’

It is important to note that the two factors underpinning post-crisis performance presented above may act in conjunction, so that countries that faced low exposure to the crisis and which pursued the right anti-crisis policies are the most likely to stand out.

## 2.2 Hypothesizing Fiscal Adjustment

The persistent fiscal deficits even during the boom years, the fallout from the crisis, and mounting pressure from the EU have put the consolidation of public finances high on the CEE government’s agenda. The OECD defines fiscal consolidation as ‘concrete policies aimed at reducing government deficits and debt accumulation’ (OECD, 2011a: p.17). As the governments always face a choice and can draw on a multitude of instruments to achieve that end, the crisis has ‘set in motion unusually fierce domestic distributional struggles’ (Bohle & Greskovits, 2009; p.61) over who will bear the brunt of the costs. Depending on which measures the governments pursue (Table 2.3), these can be either progressive, where the costs are mainly borne by capital, high-income earners and wealthy individuals, or regressive, where the brunt of the adjustment is handed onto the more vulnerable parts of society, such as low-income households and dependants on social programmes. The chosen course bears profound implications for income and wealth inequality.

**Table 2.3 – Instruments of Fiscal Consolidation**

<b>Expenditure Cuts</b>	<b>Revenue Increases</b>
Public consumption: education	Personal income taxes
Public consumption: health	Social security contributions
Public consumption: other (except family)	Corporate income taxes
Cash transfers: pensions	Environmental taxes
Cash transfers: unemployment benefits	Consumption taxes (non-environmental)
Cash transfers: sickness and disability	Recurrent taxes on immovable property
Public consumption and cash transfers: family	Other property taxes
Subsidies	Sales of goods and services
Public investment	

Source: Adapted from Goujard et al. (2013: p.18)

It is likely that the greater the threat of severe social dislocation, the stronger the pressure on governments to pursue a more progressive course of adjustment, extend social safety nets and thus

cushion the blow for the most vulnerable ones. The crisis may thus prove to be the functional equivalent of the horrors of the 1930s (Katzenstein, 1985: Ch.3) and in countries undergoing severe economic stress induce a shift towards more socially responsible states (Lauristin & Vihalemm, 2010). This is particularly relevant for the Baltics, as their 'search for an alternative economic model may also involve additional welfare adjustments' (Drahokoupil & Myant, 2011: p.212). Other arguments could be the diminishing capacity of the politics of identity in the Baltics to elicit public support for painful adjustments (Bohle & Greskovits, 2012: p.258), or the strong emphasis placed on the most vulnerable segments of society by international public lenders (Schrader, 2008; Burke, 2010). On the other hand, the generous Visegrad and Slovenian welfare states have been confronted by a need 'to adjust to the emerging post-crisis context of permanent austerity' (Bohle & Grekovits, 2012; p.248). As the crisis exasperated the funding gaps of their generous social programs and transfers, these have been put 'clearly under threat' (Drahokoupil & Myant, 2011: p.212) and their likely scaling down spells out a more regressive course of fiscal adjustment. Thus, the Baltics are likely to pursue a more progressive, while Visegrad four and Slovenia a more regressive course of fiscal adjustment. This is referred to as the 'transformative hypothesis.'

On the other hand, the institutionalization of generous welfare states creates powerful constituents in societies that are fundamentally opposed to welfare retrenchment (Esping-Andersen, 1990), potentially making the welfare state irreversible (Theobroen & Roebroek, 1986). In this vein, Slovenia's extensive welfare state, together with its advanced institutionalization of interest representation, may prove resistant to significant scaling back. And whether perceived as products of long historical legacies (Inglot, 2008) or instrumental divide and pacify calculus on behalf of early reformers (Vanhuysse, 2006), the Visegrad states' generous welfare provisions for specific segments of society have likely induced a 'ratchet effect' (Huber & Stephens, 2001: p.28) with social policies creating their political constituencies 'reproducing popular expectations that the state would provide social protection' (Drahokoupil & Myant, 2011: p.192), making reversals politically unfeasible. As both the strong political representation of social interests or generous welfare regimes never institutionalized in the Baltics, there is less scope for regressive measures to encounter resistance, while a continuation of past policies would predict the emphasis in adjustment being put on competitiveness, rather than equity. According to this reasoning, Slovenia and the Visegrad states are likely to pursue more progressive and the Baltics more regressive fiscal adjustment strategies. This is referred to as the 'path-dependence hypothesis.'

### 3. Data, Methodology and Evaluation

This section presents the data sources and methods deployed in constructing and evaluating the comparative economic performance and the fiscal adjustment strategies.

#### 3.1 Economic Adjustment

The data on the composition of GDP, developments in foreign trade and changes in the labour market has been obtained from national statistical offices and Eurostat and is presented in Appendix I. Data on fiscal and monetary policies was gathered from a range of secondary sources, most prominently international organisations and academic articles, while data on labour market policies from Eurostat. The detailed composition of a fiscal stimulus – whether it is aimed at consumers, firms, or consists of increased spending on goods and services (Blanchard et al., 2008) – is not explored in detail, based on the assumption that any approved fiscal stimulus will tend to be tailored to specific domestic needs, and combine all dimensions. With monetary policy, a sizeable depreciation of currency against the world reserve currencies is understood to constitute stimulus. Contrary to most studies, labour market activation measures are treated as economic policies based on the overall categorization of employment as an essentially economic, rather than a social goal.

To analyse the determinants of economic performance, the conventional approach taken by economists would be to subject the relationship between a dependent and a set of independent variables to econometric analysis and measure their explanatory power and statistical significance. Popular for identifying the determinants of FDI (Sridharan et al., 2010; Özkan-Günay, 2011; Kudriavceva, 2011), or determining the causes behind the depth of a recession (Conolly, 2012), regression analysis could be argued to provide a sensible approach to determinants of post-crisis economic performance. However, owing to the relatively short period under study, small number of countries and the multi-variable conception of economic performance, this article incorporates the quantitative findings into a qualitative approach. Overall economic performance is derived from the changes in and composition of GDP using the expenditure method, to reveal the macro-drivers of growth; developments in foreign trade, with a particular focus on the structure of exports, for structural shifts; and changes in labour force and employment across sectors, indicating the economic opportunities of respective populations.

Economic performance is assessed based on the values that the three variables assume, where data for 2013 are contrasted with pre-crisis levels. These are the criteria:

- A higher level of economic activity (GDP) is preferred to a lower one, as it implies more spending opportunities for consumers.



- Private sector-led growth is preferable to a public sector-led one, as numerous studies point to its superiority in achieving long-term growth (Ghali, 2003; Milbourne et al, 2003).
- Positive trade balance is preferable to a negative one, as the former diminishes vulnerability to capital flow reversals and is particularly relevant for emerging economies (Llaudes et al., 2010).
- Higher share of export growth accounted for by products of complex manufacturing industries (Combined Nomenclature VI, XVI, XVII, XVIII)<sup>1</sup> is considered preferable to a lower one, as it indicates greater technological upgrading of production profiles.
- Lower loss in employment is preferable to a higher one, as the former indicates more adequate skillsets of the workforce and greater utilization of the labour stock.
- More equal employment across the population is preferable to a highly skewed one towards any particular group, as the former indicates greater equality of opportunity.

### 3.2 Fiscal Adjustment

For each country, instruments deployed in fiscal adjustment have been identified with the basic revenue-side versus expenditure-side dichotomy maintained. Data on changes in statutory tax rates can be readily obtained from large accounting firms, such as KPMG, supplemented by the OECD’s and EU Commission’s qualitative and quantitative online tax-databases. Qualitative data on the changes in social spending categories was obtained from a range of sources, most prominently the periodic OECD country surveys, European Commission’s Convergence reports, and previous academic studies. Only measures with clear distributional impacts (Table 3.1) are included in the calculation of the final score and are presented in Appendix 2.

**Table 3.1 – Instruments of Fiscal Adjustment with Clear Distributional Impacts**

<b>Revenue-side Measures</b>	<b>Expenditure-side measures</b>
Corporate income taxes	Public consumption: education
Personal income taxes	Public consumption: healthcare
Social security contributions	Cash transfers: pensions & disability benefits
Consumption taxes	Cash transfers: unemployment benefits
Recurrent taxes on immovable property and wealth taxes	Public consumption and cash transfers: family

Source: Goujard et al. (2013), Angello & Sousa (2012)

No distinction is made between temporary and permanent changes, as the former often represents merely a sell strategy for unpopular measures. Similarly, no attempt is made to distinguish between clear-cut anti-crisis measures and continuity with past policies, as the two are ‘very difficult to separate out’ (Drahokoupil et al., 2013: p.387) and the difference is largely irrelevant for a broader analysis of fiscal adjustment undertaken in this article. Significant measures with no clear-cut distributional impacts are presented, though have no impact on the final score. Consistent with Goujard et al. (2013), changes in public fixed investment is not captured by the indicator, and to avoid

<sup>1</sup> VI. Products of chemicals & allied industries; XVI. Machinery & mechanical appliances, electrical equipment; XVII. Vehicles and associated equipment; XVIII. Optical, medical and measuring instruments, watches

possible controversy, neither are changes in subsidies or sales of public assets. While some deem the phasing out of subsidies as progressive (Goujard et al., 2013: p.78), others perceive their persistence a ‘manifestation of the principle of social protection’ (Bohle & Greskovits, 2007: p.445). Sales of public assets are not assigned a score, as the benefits of increasing the efficiency, and often phasing out of transfers to loss-making enterprises, likely come at the expense of loss of employment and thus subject to a similar dilemma as subsidies. Ultimately, cuts in the salaries and employment levels in the public sector are not assigned a score, based on the observation that these tended to increase substantially during the 2000s, and not subject to market pressures, have no other way of re-aligning to post-crisis realities.

Changes in public spending and tax rates were categorized according to their distributional impacts and assigned a score. Owing to a lack of up-to-date data from the widely used Standardized World Income Inequality Database (SWIID), the small number of countries considered and relatively short period under scrutiny, quantifying the actual impact of measures deployed is not feasible. However, the few previous studies on the distributional impacts of fiscal consolidation strategies reach remarkable consensus on the impacts of different instruments on income and wealth inequality (Angello & Sousa, 2012; Woo et al., 2013; Ball et al., 2013) and these have provided the basis for assigning scores. In the absence of sound alternatives, a composite indicator is constructed capturing the nature of the fiscal adjustment, ranging from +3, indicating an overall very progressive, to -3, representing a very regressive one. All fiscal measures have equal weight, unchanged tax rates or spending categories are not assigned a score, while overall mild or counter-balanced changes may result in the addition or subtraction of half points. Although the exercise is evidence-based, a clear element of judgement is involved. However, the major advantage of the indicator is that it captures changes beyond mere deficit and debt reduction and is thus better indicative of the broader fiscal adjustment. Relying on the summary of relevant literature as laid out in Goujard et al. (2013: p.76-80), these have been the criteria when assigning the scores:

- While across-the-board cuts to public services or social benefits are deemed regressive, improving the targeting of transfers to families is deemed progressive.
- Loosening eligibility criteria, increasing replacement rates and extending duration of unemployment benefits are deemed progressive, while the opposite is deemed regressive.
- Increases in the retirement age,<sup>2</sup> lowering the indexation formula, measures to restrict eligibility for or lowering nominal effective pensions are deemed regressive, and the opposite progressive.

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<sup>2</sup> While Goujard et al. consider increasing the statutory pension age progressive, on the basis that ‘people who would otherwise have retired and drawn a sometimes low pension will keep on drawing a higher salary’ (Goujard et al., 2013: p.77), this is not the assumption made here, owing to the special role that pension regimes have assumed in mitigating poverty in some CEE states and the uncertainty over avoiding workfare-style employment during economic downturns, particularly for the elderly.

- Increasing corporate income taxes and statutory personal income tax rates for high-income earners are deemed progressive, while decreasing them regressive.
- Increasing consumption taxes and social security contributions are deemed regressive, while decreasing them progressive.
- Increases / decreases of the statutory income tax rate in a flat rate system are judged on the basis of the changes in the labour tax wedge for different income groups and, to avoid double counting, are assigned a single score together with social security taxes.
- Increased taxation of wealth and property based on its market value is deemed progressive, while a decrease or abolishing of such taxes regressive.

### 3.3 Limitations of the Methodology

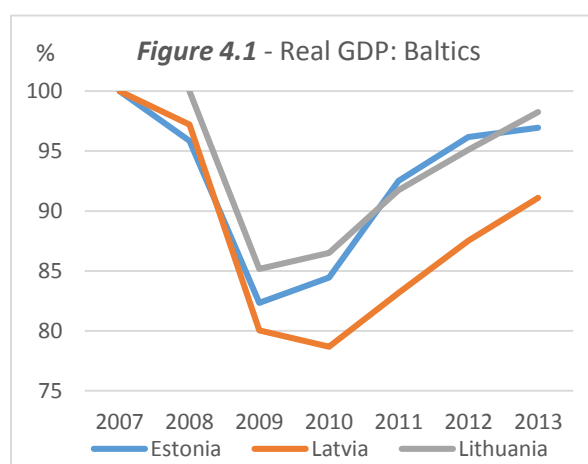
A qualitative approach to assess economic performance loses the statistical significance and certainty offered by econometric methods and is thus more speculative in nature. When analysing fiscal adjustment strategies, as noted, assigning values requires an element of judgement, which diminishes the reliability of generated data. To remedy these in future studies, statistical methods can be applied by expanding the number of countries and possibly the range of explanatory variables, assuming availability of relevant data. On the other hand, model specifications will inevitably require an element of subjective judgement, while the greater detail afforded by a qualitative approach will be lost.

## 4. Economic Adjustment

This section lays out how EU's diverse Eastern bloc of countries has withered the economic storm. To maintain consistence, economic policies are presented with economic performance by country group. A categorization of the findings is then provided.

### 4.1 The Baltics

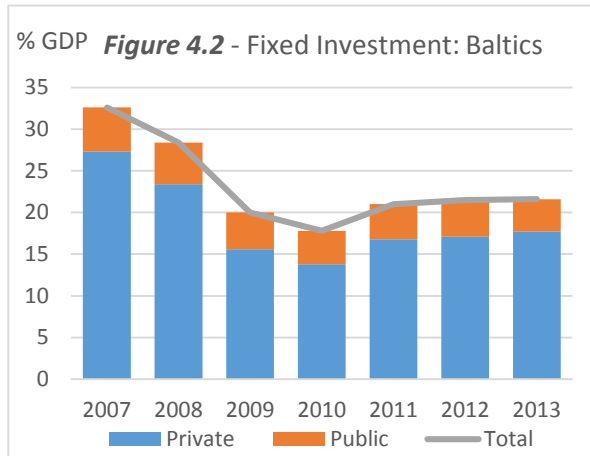
The reversal of capital flows has translated into abrupt and severe declines in economic activity in the over-heated Baltic economies. The cumulative output loss between the peak and the trough for the three countries ranged between Lithuania's 15% to Latvia's 22% (Figure 4.1), the largest in the world. This has put the Baltic governments in an uneasy position, as the collapse in economic activity implied dramatically falling budget revenues and given the uncertainty over the willingness of international investors to finance sizeable fiscal expansion, reigning in deficits took primacy over the pursuit of a counter-cyclical fiscal policy (Purfield & Rosenberg, 2010). Another challenge was the widespread Euroization of the Baltic economies, a cause of concern not least for the Nordic banks, the subsidiaries of which funded the pre-crisis booms. Uncertainty over the scope of bankruptcies following a currency devaluation, which would likely serve to aggravate the already dire economic situation, resulted in the governments' decision not to unwind the currency pegs. Even the Latvian government, in 2009 agreeing to a rescue package from international public lenders totalling over 40% of the country's GDP (IMF, 2009b), has shunned the option of widening the Euro-Lat currency band, despite it being contemplated by the IMF. Thus a mix of domestic concerns over the governments' funding capacities, fears over the economy-wide deterioration of balance sheets, together with the interests of the international financial community, resulted in the chosen strategy being to regain competitiveness through internal devaluation – a reduction in the price and wage level in the economy (Purfield & Rosenberg, 2010; Kattel & Raudla, 2013a).



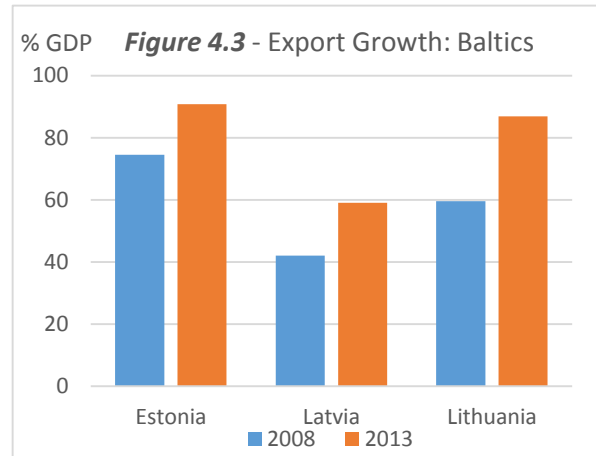
Source: National Statistical Offices

Two outcomes stand out from the course of macro-adjustment in the Baltics. The first is the sheer extent of volatility of fixed investment. After a collapse of, on average, almost 40% between 2008 and 2009, it has undergone significant expansion starting in mid-to-late 2010, heralding a turnaround in economic activity. However, this momentum has lost steam with what seemed like an imminent break-up of the Eurozone in the summer of 2012. Since then, its contribution to growth became mixed

and its overall share in GDP stagnating. On the other hand, owing to successful tapping into EU funds, public investment has remained robust (Figure 4.2, Box 5.1). Second, after 2009, the contribution of net exports to growth has been minimal, and often negative. Although exports as a share of GDP have increased significantly (Figure 4.3) and the countries' current accounts have undergone significant re-balancing, calling the Baltic recovery 'export-led' (IMF, 2014) would be misleading. It was recovering domestic demand – fixed investment in particular – that contributed to the bulk of post-crisis growth.

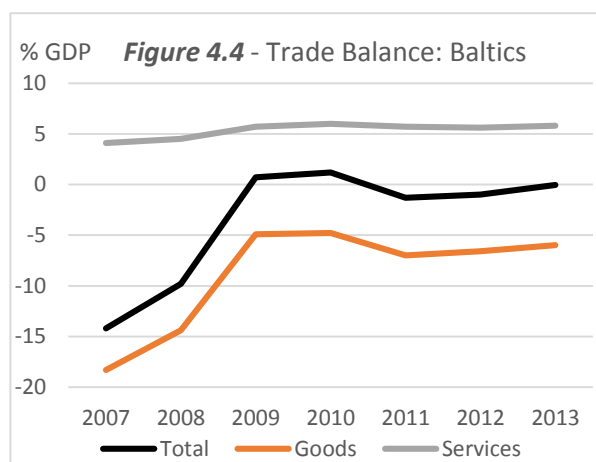


Source: Eurostat



Source: Eurostat

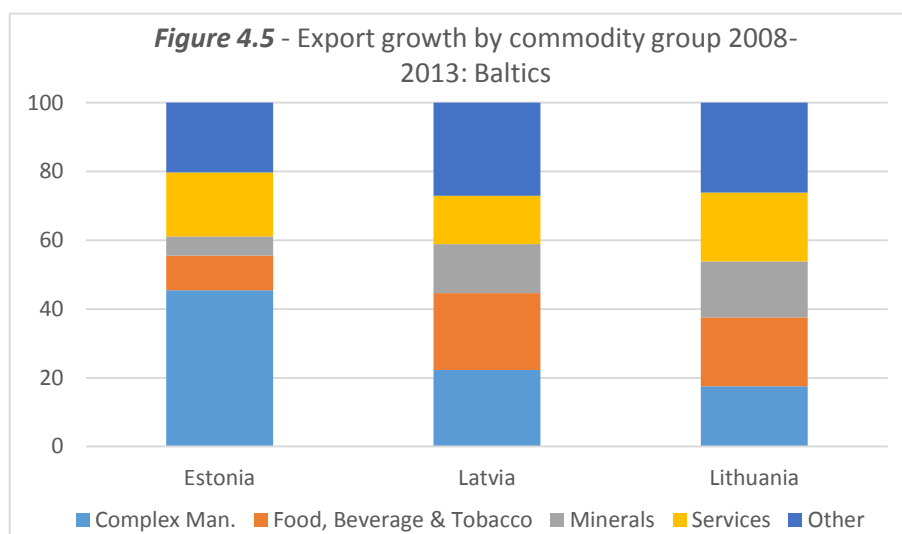
A more detailed look at the trade balance reveals that while it shifted from, on average, a negative 14.7% of GDP in 2007 to slightly below zero in 2013, all three countries continue to rely on their surpluses in services trade, averaging around 5% of GDP, in offsetting the persistent deficits in trade in goods. On the other hand, the latter have declined by more than two thirds, from an average of over 18% of GDP in 2007 to under 6% in 2013 (Figure 4.4). In Latvia and Lithuania a fifth



Source: National Statistical Offices

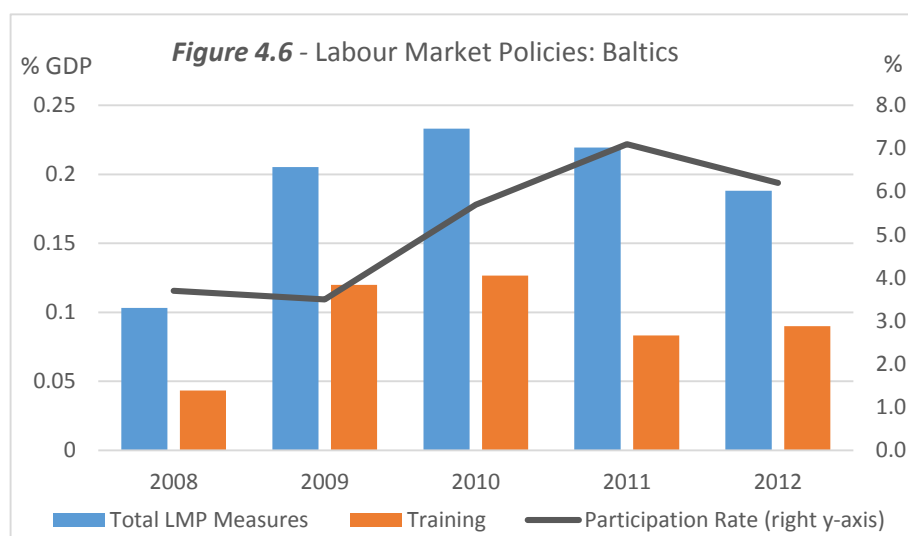
of total export growth was accounted for by food, beverage and tobacco products. In the former, electrical equipment and machinery alone contributed by another fifth, while in Lithuania, products of complex manufacturing industries and mineral products each accounted for around 18%. The pattern is significantly different for Estonia, where almost half of total export growth has been accounted for by products of complex manufacturing industries, while only 10% by products of food, beverage and tobacco industries and even less by mineral products (Figure 4.5). Thus while the bulk of exports growth from Latvia and Lithuania owed to products of food, beverage, tobacco industries and minerals, the technological sophistication of Estonia's exports has markedly improved. The

successful penetration of world markets by these possibly heralds the emergence of new leading industries in the Baltics, substituting for the gap left by the explosion of non-tradable sectors.



Source: Eurostat

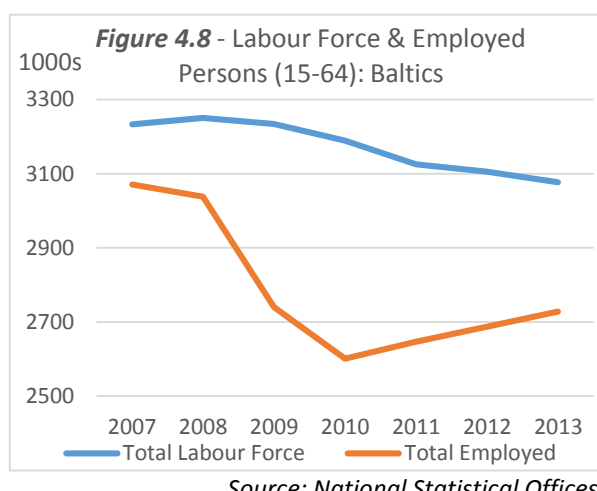
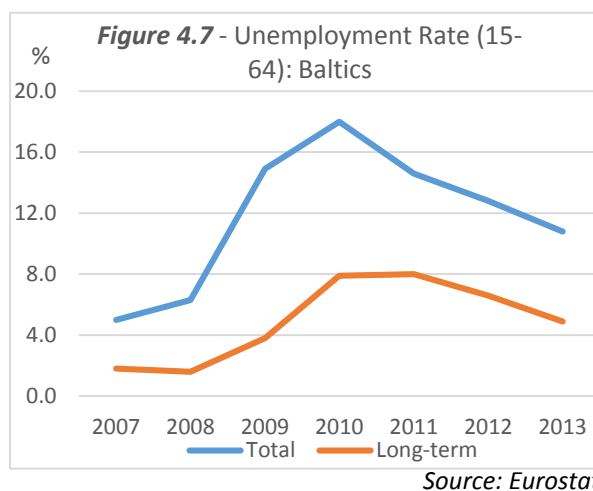
Nevertheless, the swift Baltic economic rebalancing has taken a heavy toll in the labour market. Although the initial response of the governments was to increase spending on LMPs, on average it never surpassed 0.25% of GDP, with roughly half of the funds devoted to training. However, both the overall LMP spending and spending on training have followed a declining trend. Participation in LMPs has remained particularly very weak, at its peak just 7% of those looking for work (Figure 4.6).



Source: Eurostat

After a spike from an average of 5% in 2007 to a peak of 18% in 2010, the total unemployment rate still remains in double digits in Latvia and Lithuania, with long-term unemployment following a similar trend (Figure 4.7). However, the fall in the unemployment rate owes not so much to job creation, as to the decline in total labour force, which varied from under 2.5% in Estonia to over 10% in Latvia. And despite the pick-up in economic activity and job creation from 2011, total labour force continues to

decline in all three countries (Figure 4.8). Reflecting the shift away from non-tradable sectors, the most severe declines in employment have been in construction, decreasing by an average of almost 40% and by almost 50% in Latvia. The already low level of employment in manufacturing prior to the crisis decreased by over a sixth and by 2013 its share in total employment declined to 16%. On the other hand, employment in knowledge-intensive services – IT and finance and insurance in particular – has been preserved or even expanded (Eurostat, 2014). The labour shedding thus appears to have hit the lower-skilled workers particularly hard, while opportunities for their skill upgrading have remained severely limited.

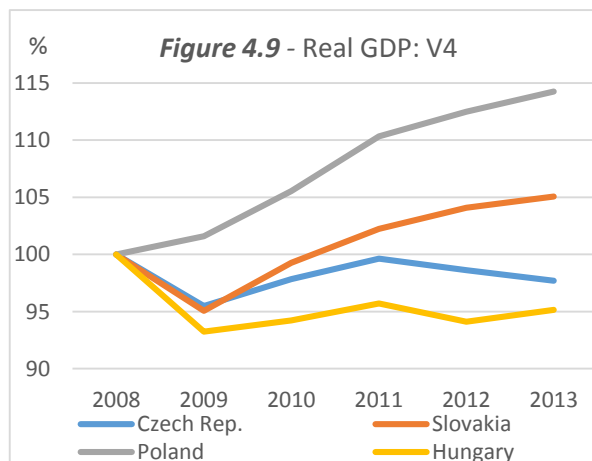


## 4.2 The Visegrad Four

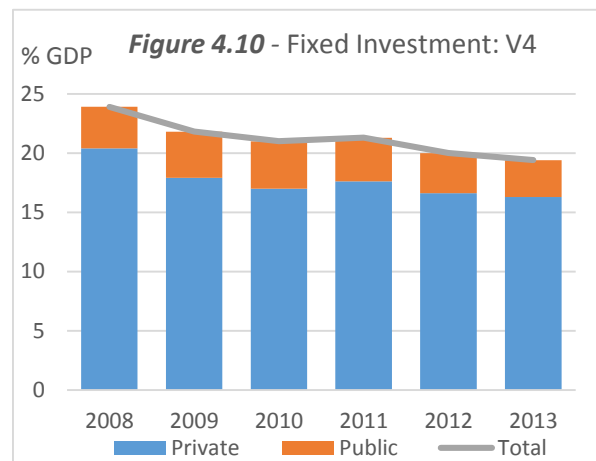
When confronted by the first signs of an economic downturn, the Visegrad governments have not found themselves as constrained as their Baltic counterparts. However, this was not the case in Hungary, which already in 2008 required international assistance totalling 17% of GDP (IMF, 2009b). As Hungary’s funding capacity was severely limited and its IMF programme focused mainly on reducing debt (IMF, 2008), its fiscal policy remained pro-cyclical. In the remaining three, collapsing exports and domestic demand prompted the implementation of mild fiscal stimulus packages. A stimulus ‘of around 2% of GDP’ was planned by Czech authorities (OECD, 2014a: p.13), though some of the measures were ‘already decided and approved’ before the crisis ‘so that so that the new fiscal stimulus... amounted to only 1.1% of GDP’ (Drahokoupil et al., 2013: p. 394). Poland’s 2009 anti-crisis package of 0.7% of GDP (OECD, 2010a: p.34), represented an ‘immediate relief rather than a significant economic stimulus’ (Drahokoupil et al., 2013: p. 398). The Slovak government has by February 2009 adopted ‘62 explicit anti-crisis measures’ (Drahokoupil et al., 2013: p.399) with the total implemented stimulus package amounting to 1.4% of GDP (OECD, 2010b: p.29). Moreover, successive rounds of monetary easing in Poland resulted in a devaluation of Zloty against the Euro by 34% to trough, securing it ‘the mildest decrease in export volumes from among CE4’ (OECD, 2010a: p.27). The Czech

and Hungarian currencies depreciated by 10% and 20% respectively (OECD, 2011b; Drahokoupil & Myant, 2011: p.317). Slovakia, which adopted the Euro in January 2009, did so with ‘an exchange rate which turned out to be overvalued in the face of the crisis’ (Fidrmuc et al., 2013: p.17) and thus likely found itself at an initial disadvantage to its regional peers.

The depth of economic recession varied across the Visegrad countries, ranging, from a slump of almost 7% in Hungary, to uninterrupted growth Poland with important variation in the later revivals of economic activity (Figure 4.9). The overall economic adjustment can be divided into three stages. First, in 2009 the initial fiscal stimulus measures in Slovakia, Czech Republic and Poland, together with net exports, partially offset the decline in fixed investment. In Hungary, only net exports have remained positive, resulting in the deepest slump. In the second stage, as of 2010, domestic demand rebounded with net exports representing a drag on growth. For the three smaller countries, the third stage, beginning in late 2011, is in direct contrast to the Baltic recovery, as domestic demand collapsed again with positive contributions to growth only from foreign trade, though substantial enough to prevent a slide back into recession only in Slovakia. Poland’ domestic demand remained robust until mid-2012, significantly aided by the EU co-funded extensive public investment linked to the 2012 European Football Championship. However, despite not having experienced the Baltic-style build-up of asset bubbles in non-tradables prior to the crisis, all Visegrad states are facing a continuous decline in private fixed investment (Figure 4.10), implying a significant diminishing of their potential output.



Source: National Statistical Offices

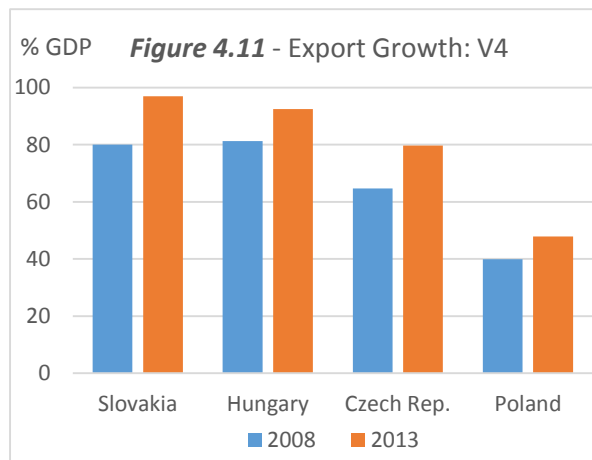


Source: Eurostat

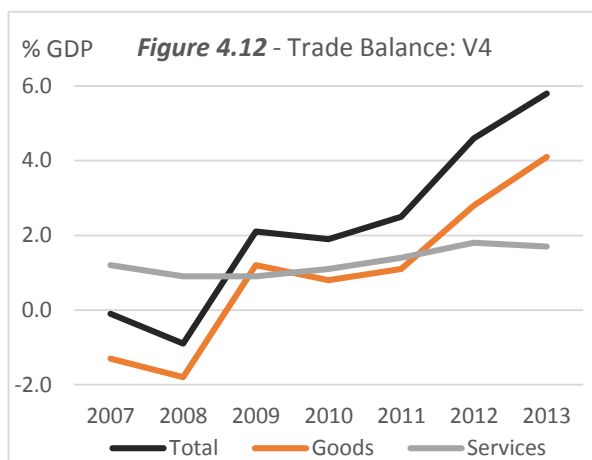
The outcome is that between 2008 and 2013 exports have significantly increased their share in GDP in all four countries with Slovakia in fact recording the largest increase (Figure 4.11). While all economies, apart from Czech Republic, were running trade deficits in the 2000s, by 2013 they were recording record surpluses, ranging from 2.4% of GDP in Poland to 8% of GDP in Hungary. With



surpluses in services trade increasing only slightly, the major shift occurred in merchandise trade, the balance moving from minus 2 to a surplus of 4% of GDP between 2008 and 2013 (Figure 4.12).

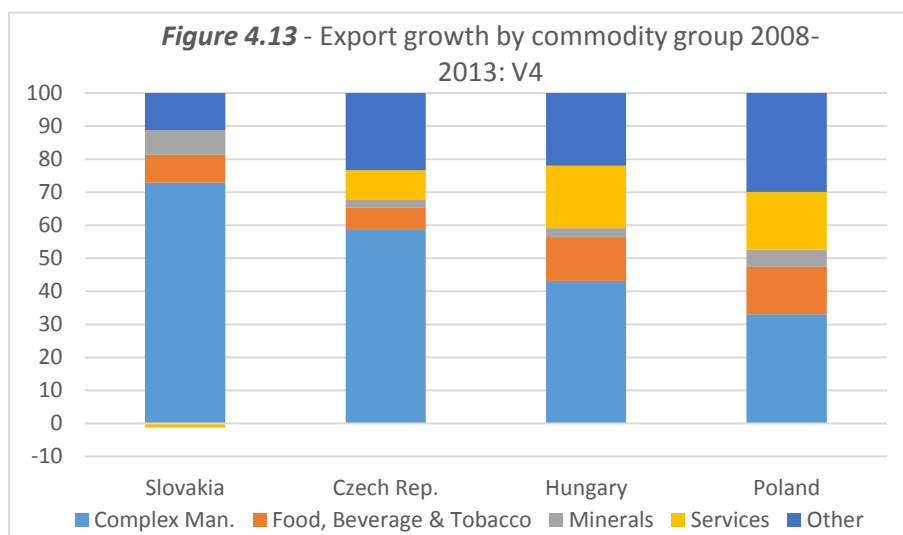


Source: National Statistical Offices



Source: Eurostat

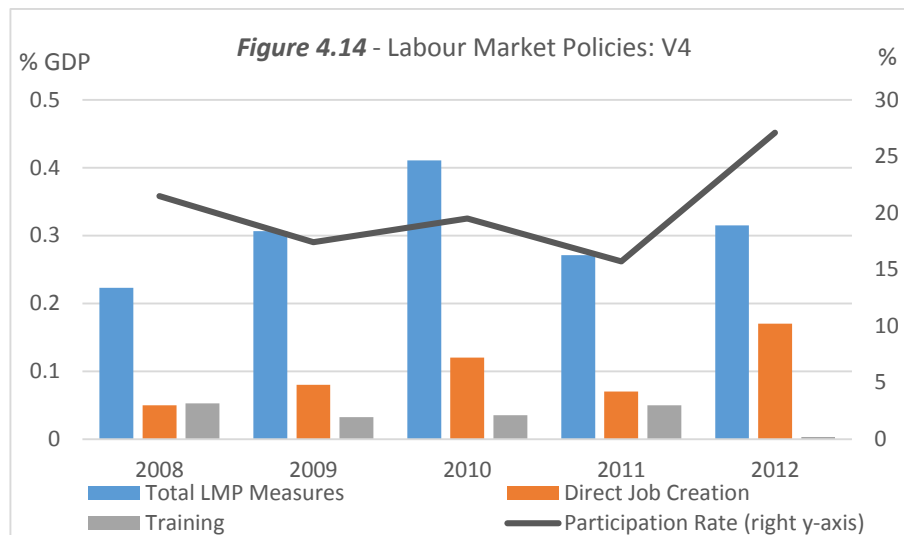
In Slovakia, Hungary and the Czech Republic, products of complex manufacturing industries accounted for 73%, 59% and 43% respectively of the increase in total exports. Expressed in current prices, Slovakia has recorded an almost 50% increase in the exports of vehicles and transport equipment, with notable increases across all CM categories in Czech Republic and Hungary. Also representing the largest category in Poland, products of complex manufacturing industries accounted for a third of export growth, with food, drink and tobacco products accounting for just under 15% (Figure 4.13). Thus, the evidence from the three smaller countries, and to some extent in Poland, suggests that the foreign-owned manufacturing plants have retained their strategic roles and have accounted for the bulk of export growth.



Source: National Statistical Offices

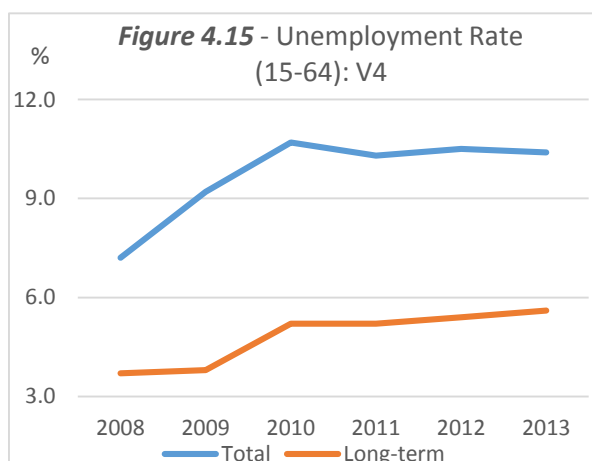
The recoveries in the Visegrad states have been export-led, but jobless. The governments have scaled up funding for LMPs, peaking at just over 0.4% of GDP in 2010 with around a fifth of those looking for

work participating, significantly more than in the Baltics. However, very little of the LMP funding goes towards training with an overall greater preference of governments for employment incentives or direct job creation (Figure 4.14). The latter is particularly prominent in Hungary, where the government has launched numerous rounds of public works, by 2012 employing more than 200,000 people. This is despite empirical evidence for Hungary showing that ‘various public works schemes experimented in the past have failed to improve the employability of participants and to provide a foothold in the open labour market’ (Budapest Institute, 2011: quoted from OECD, 2012a: p.91).

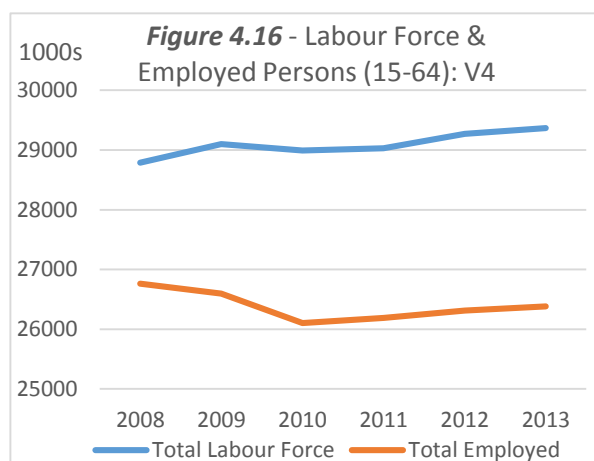


Source: Eurostat (Data from 2012 for Slovakia & Hungary only)

The boost from LMPs notwithstanding, the total unemployment rate has increased significantly across Visegrad states, moving sideways or further increasing as time progresses (Figure 4.15), remaining in double digits in all apart from the Czech Republic. However, the overall labour force has grown, and together with the overall weakness of private sector job creation, plays a role in the persistence of high unemployment (Figure 4.16). In terms of industry sectors, the decrease in the number of people working in construction has been much milder than in the Baltics, ranging from 20% in Hungary to under 5% in Poland. Despite an overall decline of employment in manufacturing, jobs in the export



Source: Eurostat



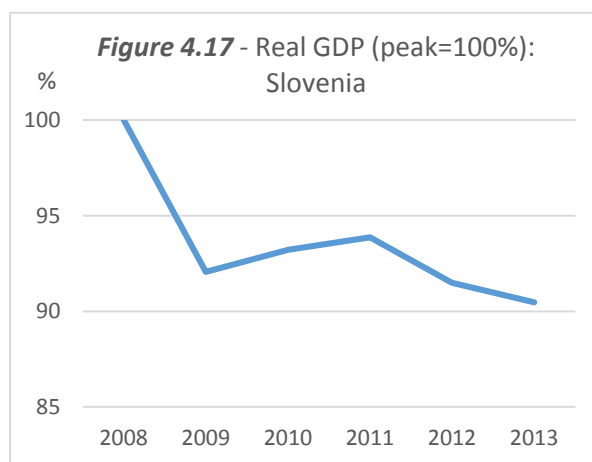
Source: National Statistical Offices

oriented automotive and electrical industries have been preserved, or even slightly increased. And similar to the Baltics, there has been an expansion in the total number of people employed in knowledge-intensive service industries (Eurostat, 2014). Thus, while the employment premium for highly-skilled and those working in the export-oriented foreign industries has increased, the evidence suggests that large parts of the populations have been unable to join them in their success.

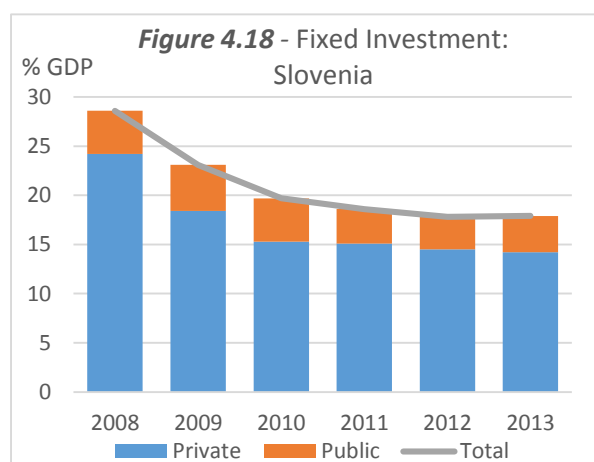
### 4.3 Slovenia

By 2010, Slovenia implemented the most extensive Keynesian style, demand-stimulating fiscal stimulus out of the CEE countries, amounting to over 2% of GDP (IMF, 2011: p.4). On the other hand, having joined the Euro in 2007, Slovenia, like Slovakia, could not devalue its currency at the onset of the crisis and detrimental to its competitiveness were a series of minimum wage hikes, by 23% in 2010 alone (EBRD, 2010; p.145). In later stages, Slovenia has been engulfed by ‘a severe banking crisis’ (OECD, 2013b: p.8), although the country has avoided an international bail-out.

Having declined by almost 8% in 2009, the level of economic activity has been slowly recovering until early 2011, when the economy slid back into a recession, in which it has remained since (Figure 4.17). The decomposition of GDP reveals that between the last quarter of 2008 until the latter half of 2013 Slovenia experienced the most protracted decreases in fixed investment out of all eight countries, severely diminishing its future growth potential (Figure 4.18) and since early 2011, the only positive contribution to growth has come from foreign trade. In the last quarter of 2013, the trend has been somewhat reversed, with fixed investment marking the first year-on-year increase in five years and net exports turning slightly negative. After what had together been fourteen quarters of negative real GDP growth since late 2008, growth in overall economic activity turned positive, possibly signalling a much needed turnaround.

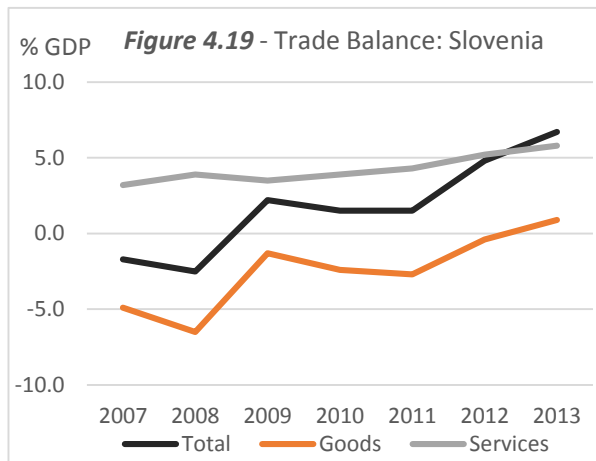


Source: Statistical Office of the Republic of Slovenia



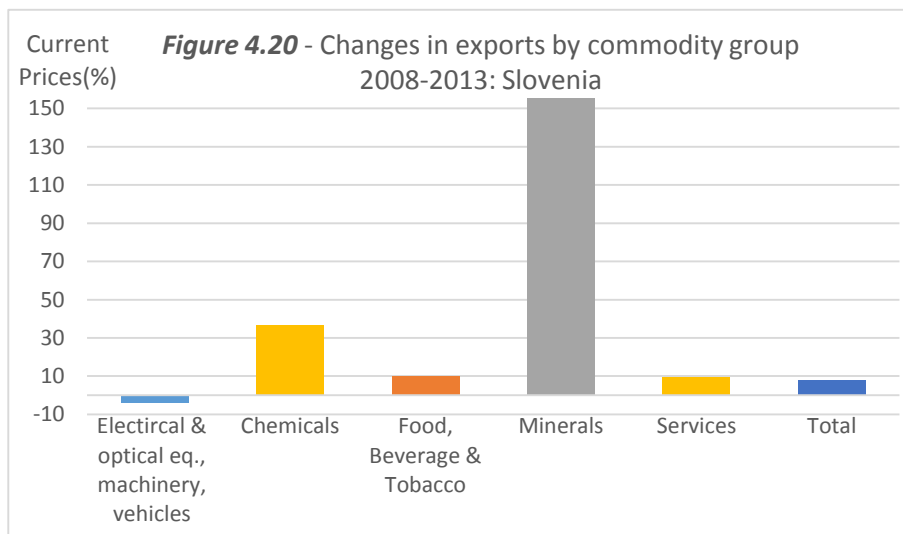
Source: Eurostat

Although net exports have constituted the only positive contribution to growth throughout the protracted recession, the performance of the export sector has been disappointing. While the overall trade balance improved between 2008 and 2013 from negative 2% to positive 6% GDP (Figure 4.19), this largely owes to the collapse in imports, rather than a rise in exports. Expressed in current prices, exports of goods have increased by 7.5%, while imports fell by almost 10% with



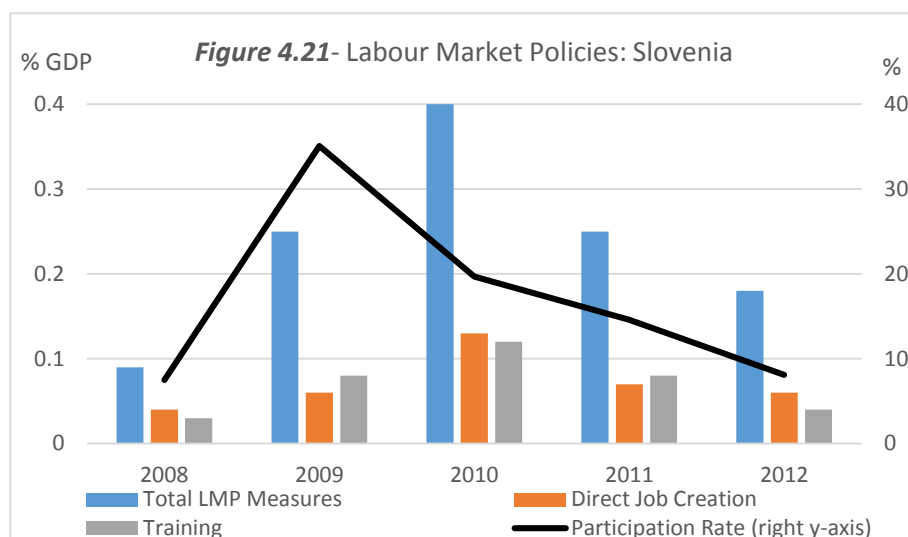
Source: Eurostat

exports of services up by 10% and imports down by 3%. Particularly surprising is the weak performance of the export-oriented complex manufacturing sector with declines in the exports of machinery, electrical equipment and vehicles in terms of volumes and prices, though it has been partially offset by the almost 40% increase in exports of chemicals. Also preventing a deeper slump was the more than 150% increase in the exports mineral products. However, the leading domestic exporters from complex manufacturing industries have clearly lost market shares to their Visegrad peers (Figure 4.20).



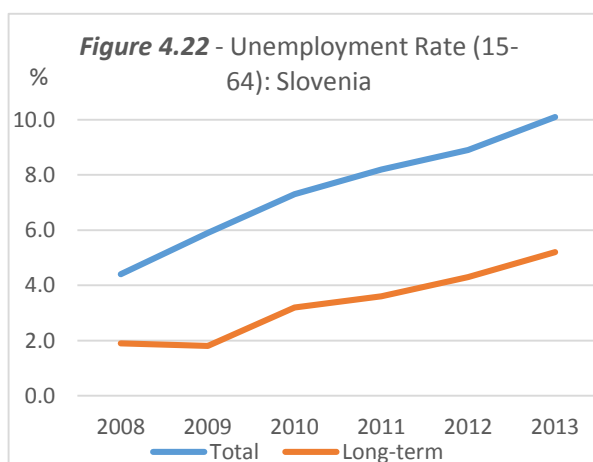
Source: Statistical Office of the Republic of Slovenia

Despite the unfavourable developments in the wider economy, the amount of support received by jobseekers in Slovenia, initially on a par with the Visegrad states, has been decreasing over time and of these funds, under a third tends to be allocated to training. The withering spending on LMPs over time has also translated to declining participation, as out of 100 people looking for work, less than 10 have taken part in 2012, down from 35 in 2009 (Figure 4.21).

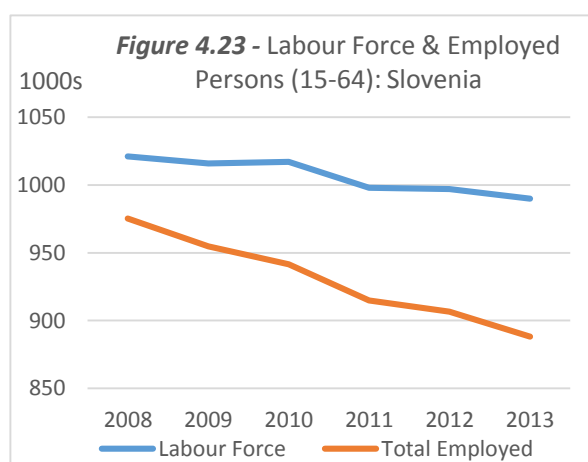


Source: Eurostat

Slovenia's unemployment rate has been on a steady rise, reaching double digits by 2013, up from 4.4% in 2008, with long-term unemployment following the same trend (Figure 4.22). The total labour force has been gradually shrinking, marking a 3% decrease by 2013 (Figure 4.23), although significantly milder than the average decline in the Baltics during the same period. The total loss of employment in construction stood at 20%, putting Slovenia between the Visegrad and Baltic states. Unlike in the Visegrad states, and mirroring the under-performance of the sector, the number of people employed in complex manufacturing declined by over 22%, with a similar decline in overall manufacturing, representing the greatest decline of all eight states (Eurostat, 2014). On the other hand, just as in the Baltics and Visegrad states, jobs in the knowledge-intensive services sector have somewhat expanded, as the crisis appears to have adversely impacted particularly the lower-to-medium skilled workers.



Source: Eurostat



Source: Statistical Office of the Republic of Slovenia

#### **4.4 Economic Adjustment: Categorization**

Table 4.1 summarizes the policy responses of CEE governments. The Baltic governments went against the conventional wisdom, pursuing no explicit fiscal stimulus, defending their currency pegs and

scaling up LMPs only moderately. The Visegrad governments have implemented mild counter-cyclical fiscal policies, significantly devalued their currencies (except Slovakia) and outspent the others on LMPs. Having implemented the most extensive fiscal stimulus package, Slovenia was unable to devalue its currency, and its LMP spending has been declining from a relatively high initial rate.

**Table 4.1 – Policy Responses**

	Fiscal Stimulus	Monetary Stimulus	LMPs
<b>Baltics</b>			X
<b>Visegrad 4</b>	X	XX	XX
<b>Slovenia</b>	XX		X

Source: Author's analysis

As is evident from Table 4.2, no particular country, or country group, has clearly outperformed across all economic indicators. In terms of individual countries, Poland emerged superior in its unhindered growth of economic activity, although its share of private fixed investment in total GDP has declined to the second lowest figure in CEE. And despite the positive developments in Poland's overall trade performance, the share of complex manufacturing products in total exports in fact declined. The Baltic economies have undergone significant re-balancing and expanded exports, though their export sophistication offers a mixed picture with Estonia clearly ahead of Latvia and Lithuania, while all three have yet to reach pre-crisis levels of economic activity. In the smaller Visegrad states, the fragile recoveries have been export-led with domestic demand – private investment in particular – recording significant declines, even relative to the overall lower levels of economic activity in Hungary and Czech Republic. Perhaps most striking is the absolute implosion of Slovenia across all economic indicators, as it recorded the most significant decline in economic activity, private fixed investment and a disappointing export performance, not captured by mere trade balance.

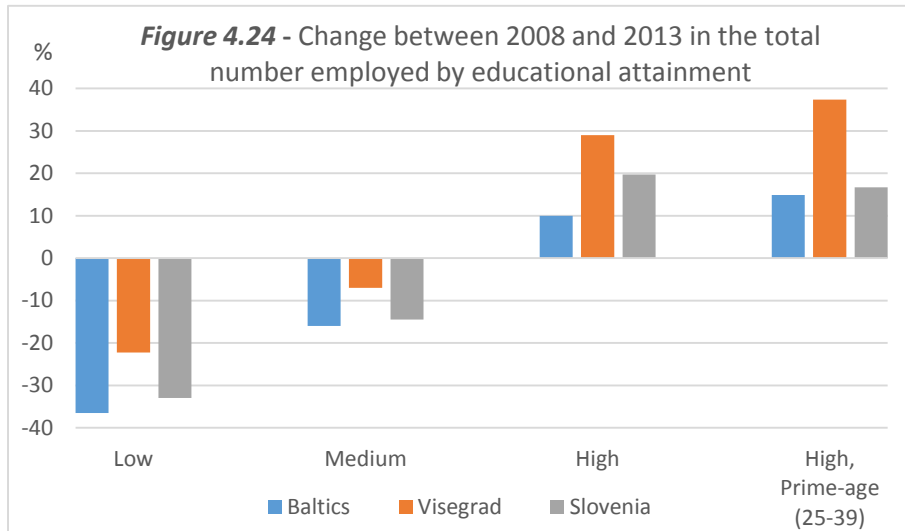
**Table 4.2 – Economic Outcomes**

	GDP in '13 (% of pre- crisis peak)	Private Fixed Investment in '13 (% of GDP)	Trade balance in '13 (% of GDP)	Products of CM industries as % of total exports in '13	Hidden unemployment rate in 2013 <sup>a</sup>
<b>Estonia</b>	97	21 (-9.5)	0.8 (+10)	31.3 (+5.5)	11 (+6.4)
<b>Latvia</b>	91	17.2 (-10.2)	-1.9 (+18)	20.4 (+0.9)	21 (+14.9)
<b>Lithuania</b>	98	14.9 (-5.5)	1 (+14.3)	23 (-3)	15.7 (+11.4)
<b>Poland</b>	115	14.6 (-3.1)	2.4 (+5.3)	40.4 (-2.4)	8.7 (+1.1)
<b>Czech rep.</b>	97.5	19.3 (-2.9)	6.4 (+3.7)	53.8 (+1.3)	7 (+2.6)
<b>Hungary</b>	95	14.2 (-4.6)	8 (+7.5)	55 (-3.9)	7.5 (-0.4)
<b>Slovakia</b>	105	17 (-5.8)	6.3 (+8.7)	56.9 (+4.2)	13.5 (+4.5)
<b>Slovenia</b>	90.5	14.2 (-10)	6.7 (+9.2)	43.1 (-1.1)	13 (+8.6)

Source: Author's calculations based on Eurostat & national statistical offices. Latest trade data for Poland from 2012. Data in parentheses indicate change from pre-crisis level.

a) Calculated by dividing the total number employed in 2013 over labour force in 2008.

The one dimension where all countries have underperformed is in employment and private sector job creation, although somewhat masked by the public works scheme in Hungary. As visible from Figure 4.24, the crisis has clearly served to amplify the employment premium of education. There occurred a significant labour shedding of lower-to mid-qualified workers across all countries, with the highest average decline of almost 40% in the Baltics. On the other hand, the total number of employed highly educated workers increased in all groups, most significantly in the Visegrad four, especially those in their prime-years.



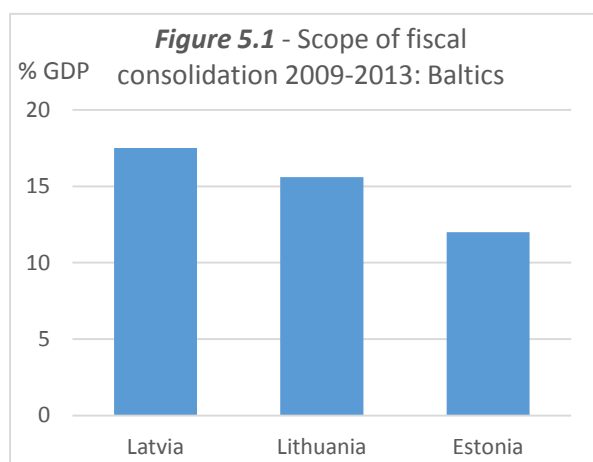
Source: Eurostat. Based on ISCED 2011. Low – primary and lower secondary (0-2); Medium – upper secondary and post-secondary, non-tertiary (3-4); High – short-cycle tertiary, bachelor, masters or doctoral (5-8)

## 5. Fiscal Adjustment

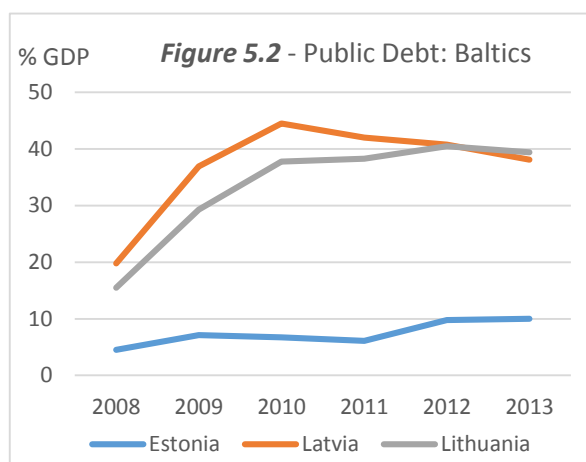
This section first lays out the data on the scope of fiscal consolidation undertaken and the evolution of public debt in each country. It then presents how the costs of consolidation were distributed within the broader fiscal adjustment. All findings are presented by country groups with the respective scores laid out at the end of the section.

### 5.1 The Baltics

As Figure 5.1 demonstrates, between 2009 and 2013 the Baltics have undertaken extensive fiscal consolidation measures, even by global historical standards (IMF, 2010: Ch.3), from over 17% in Latvia, to 12% of GDP in Estonia. By end 2013, the rapidly rising debt levels of Latvia and Lithuania appear to have stabilised with Estonia retaining one of the lowest in EU (Figure 5.2).



Source: OECD, EU Commission, IMF. Note that Estonia's figure also includes consolidation of almost 2% of GDP at end 2008 (Kattel & Raudla, 2013b).



Source: Eurostat

#### 5.1.1 Spending-side Fiscal Adjustment: Baltics

Consistent with the economic strategy of internal devaluation, the Baltic governments had initially signalled an overwhelming preference for spending-side fiscal consolidation (Purfield & Rosenberg, 2010: p.21). With respect to public consumption, public sector employment was reduced by between 6.5% in Estonia to 20% in Latvia, and salaries of public officials were cut from 8% in Estonia to 20% in Latvia with higher ranking public officials faced a greater cut (Kattel & Raudla, 2013b: p.737). Spending on healthcare was slashed severely in all three countries with Lithuania and Latvia also squeezing budgets for education. Latvia instigated the most drastic cuts with 'the education and health ministry budgets being reduced by one-half and one-third respectively' (Purfield & Rosenberg, 2010: p.21).

Concerning social transfers, statutory pension age was increased in all three countries, with the formula for pension indexation amended in Estonia to the extent that 'the projected decline in the benefit ratio could pose a risk to the adequacy of pension entitlements' (EC, 2013a: p.12). Latvia and



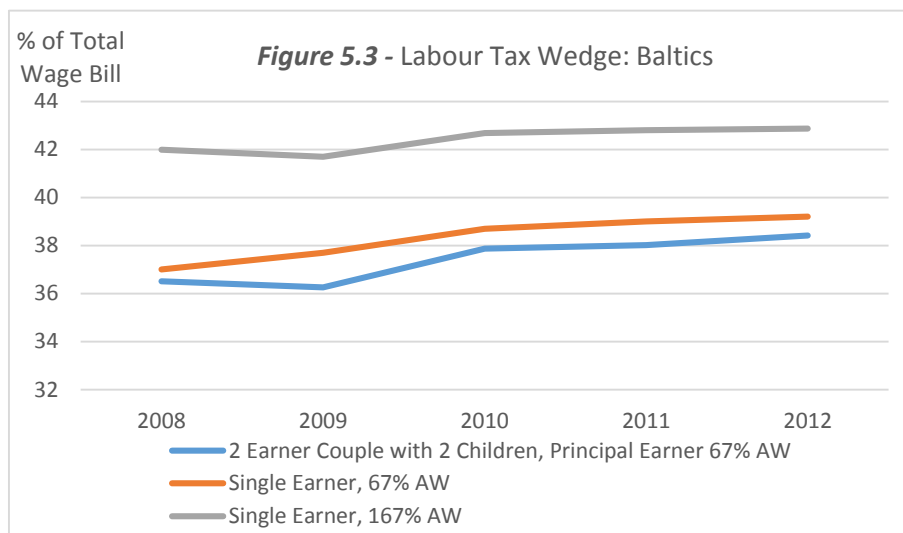
Lithuania implemented nominal cuts to pensions, although in the former, the constitutional court ruled the move unconstitutional and ordered the Latvian government to pay the difference until 2012 (Purfield & Rosenberg, 2010: p.19). In Lithuania, the constitutional court ordered the government to compensate the pensioners for the cut, however, without specifying the scope or a timetable (EC, 2012a). The generosity of unemployment benefits, for which only around a quarter of the unemployed have been eligible in each country, was cut in Latvia once above a certain threshold (Kattel & Raudla, 2013b: p.737), their duration was reduced (Dovladbekova, 2012: p.3) and eligibility criteria further tightened in 2012 (EC, 2012b; p.14). In Estonia the planned extension of coverage to persons who lost employment by mutual agreement was abolished (OECD, 2011c: p.99). Family benefits in Estonia were left unchanged, though have a 'regressive character, as the largest share goes to the top income quintile' (Ibid: p.90-1). In Latvia, 'childbirth allowances were cut by almost 35 per cent, child care and paternal benefits by 40 per cent and child care allowance for a child younger than 1 year by 38 per cent' (Dovladbekova, 2012: p.3). In Lithuania, family benefits were cut by 10% in 2009 (Kattel & Raudla, 2013: p.737) and maternity benefits slashed in 2012 (EC, 2013b: p.11) so that by 2013 the government 'has managed to retrench all universal family benefits' (Aidukaite, 2013: p.96).

### **5.1.2 Revenue-side Fiscal Adjustment: Baltics**

On the revenue side, corporate income taxes (CIT) and personal income taxes (PIT) have remained largely unchanged. Although increasing the CIT by 5% to 20% in 2009, Lithuanian government quickly reversed the move concerned that it would 'aggravate the [economic] downturn and adversely impact mobile capital and labor tax bases, impair competitiveness, and deter investment' (Purfield & Rosenberg, 2010; p.21). Lithuania's PIT was lowered in 2009 by 3% to 21%, a rate which includes a 6% healthcare insurance tax, so that income from an unlimited civil liability company is 'subjected to 15% personal income tax rate, in the case if taxable profits exceeds 4000LTL (1159EUR)' (Gencs Walters, 2011). The extensive debates on introducing progressive income taxation in Lithuanian parliament in 2013 'have been inconclusive' (EC, 2013b: p.10). Estonian governments remained committed to keeping both statutory CIT and PIT rates constant at 21% throughout adjustment with plans to lower both by 1% in 2015 (KPMG, 2014), while keeping reinvested corporate income untaxed. Latvia's single personal income tax bracket was in 2010 increased from 23 to 26%, though brought down in 2011 to 25% with plans to gradually lower it to 20% (EC, 2013c: p.14). Corporate income taxes were kept stable at 15%.

On the other hand, regressive revenue enhancements have been extensively used. In 2009, value added tax (VAT) increased by 3% in Latvia, 2% in Estonia and 1% in Lithuania to 21%, 20% and 19% respectively. Lithuania's VAT was further hiked by 2% in 2010, and Latvia's by 1% in 2011, though in

the case of the latter, the move has been reversed after a year. The number of items exempt from VAT, or to which reduced rate is applied decreased (KPMG, 2014), with the list being reviewed annually in Lithuania (Leontjeva, 2013: p.107). Social security contributions, high prior to the crisis, were further increased in all three countries, as the growth in the tax wedge for low-income earners far outpaced that of high-income earners (Figure 5.3). In summer 2010, Lithuania introduced a relief from social security contributions for first-time employees, though the scheme was abolished two years later (EC, 2014a). In Estonia, social insurance contributions were ‘capped at the level of three times the average wage, 4000 eur in 2014’, a change which failed to ‘address the most important challenge of average tax rates for low wage earners that are high in international comparison’ (OECD, 2011c: p.113-4). Commenting on Latvia, the European Commission noted that ‘the focus on low income earners has been insufficient’ (EC, 2013c: p.14).

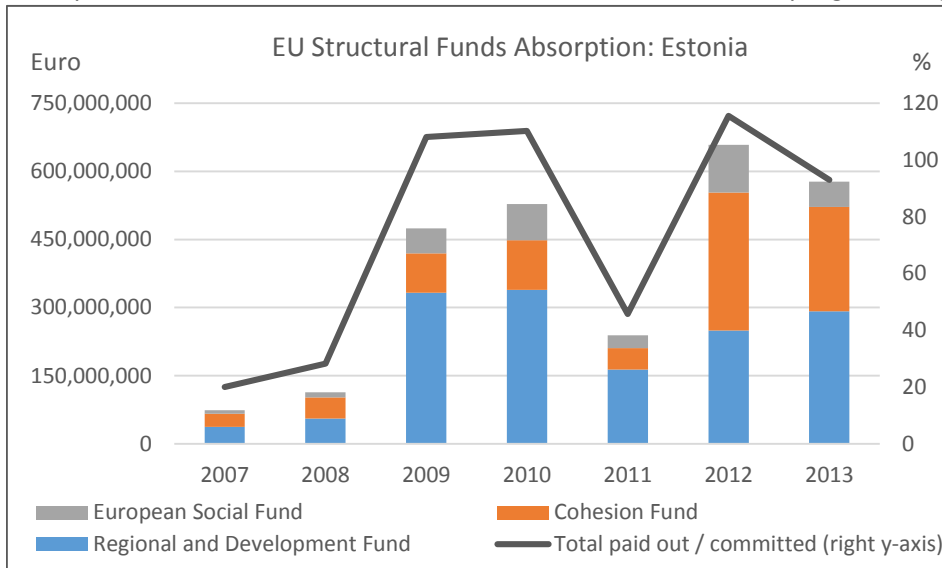


Source: European Commission, OECD. Data for Single person earning 67% of average wage for Estonia only.

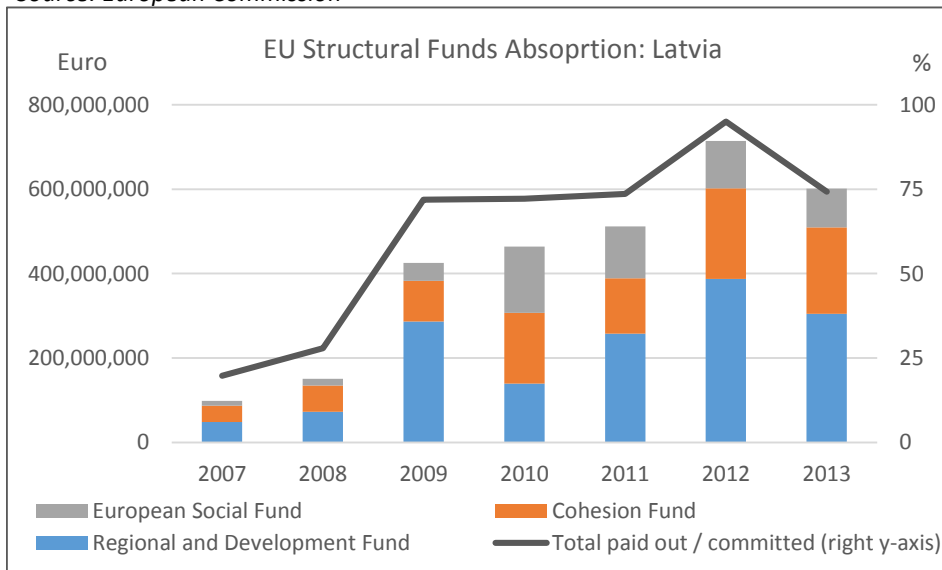
There has been an overall reluctance to put in place effective property and wealth taxes, despite not being considered detrimental to growth (Goujard et al., 2013). Estonian property taxes have remained unchanged and remain the lowest in EU (EC, 2013a: p.13), despite having ‘contributed to the previous housing boom’ (OECD, 2011c: p.114), while land taxes on small and medium size residential plots were abolished. Lithuanian government in 2011 imposed a 1% tax ‘on total family-owned property valued above LTL 1 million’, which, however is ‘characterised by numerous exemptions which undermine its efficiency’ (EC, 2014a: p.10) and an overhaul of the land tax, ‘moving it from a fixed rate of 1.5% to introducing a bracket of 0.01-4%.’ (Leontjeva, 2013; p.109-10). Latvian government in 2010 introduced a real-estate tax, whose base was broadened and made more progressive in subsequent years (EC, 2014b: p.14). In 2013 a reform was introduced, which ‘gives local governments flexibility in choosing appropriate tax rates’ although its ‘results would need to be assessed at a later stage’ (EC, 2013c: p.14-15). Additional revenue enhancements pursued by the Baltic governments are discussed in Box 5.1.

### Box 5.1 Additional revenue enhancements in the Baltics

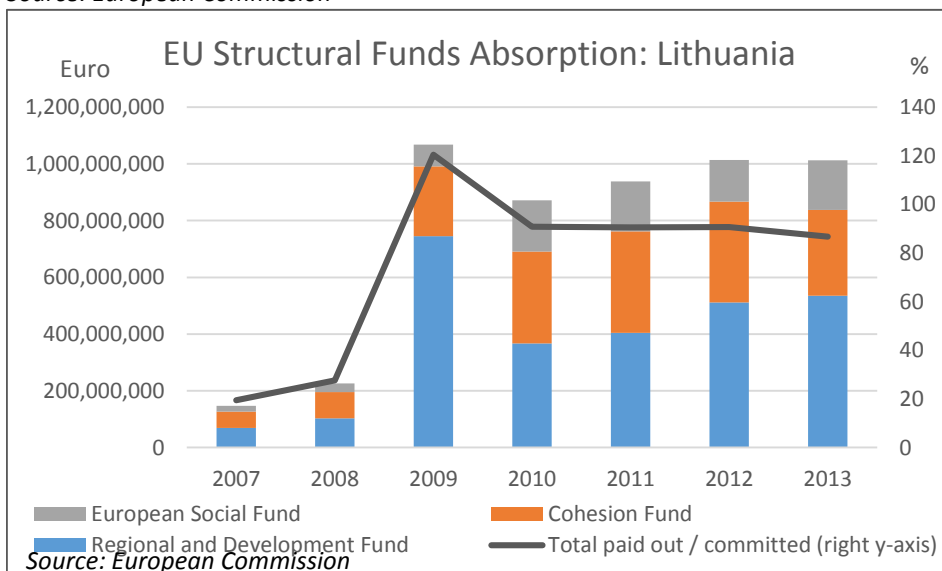
With the first signs of a looming EU-wide fiscal consolidation, in late 2008 the European Commission amended the rules governing the disbursement of EU funds, retroactively simplifying the administrative procedures and enabling front-loading. This has clearly been exploited by the Baltics, Estonia and Lithuania in particular, whose absorption rates in 2009 in fact exceeded the amount committed for a given year (Graphs below). By end 2013, Estonia has been paid out almost 80% of its allocated funds in the 2007-2013 programming period – highest in the EU – with Lithuania and Latvia not far behind. The funds have been used to support the bulk of public fixed investment, active labour market policies and prevented further cuts in the meagre social assistance. In fact, external financing still constitutes more than 20% of the budget in Estonia (Mürsepp, 2013: p.59) with the figures for the other two Baltic countries most likely similar.



Source: European Commission



Source: European Commission



Source: European Commission

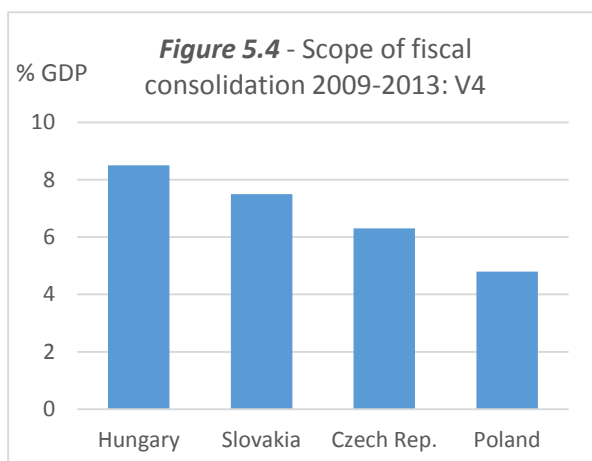
Lithuania and Latvia not far behind. The funds have been used to support the bulk of public fixed investment, active labour market policies and prevented further cuts in the meagre social assistance. In fact, external financing still constitutes more than 20% of the budget in Estonia (Mürsepp, 2013: p.59) with the figures for the other two Baltic countries most likely similar.

Another source of revenue came from re-directing part of the pension contributions from the privately funded pillars to the public PAYG one. In 2009, the Latvian government cut the contribution rate to the former from 8% to 2%. The share was subsequently increased to 4% in 2013 with plans to stabilize it at 6% in 2016.

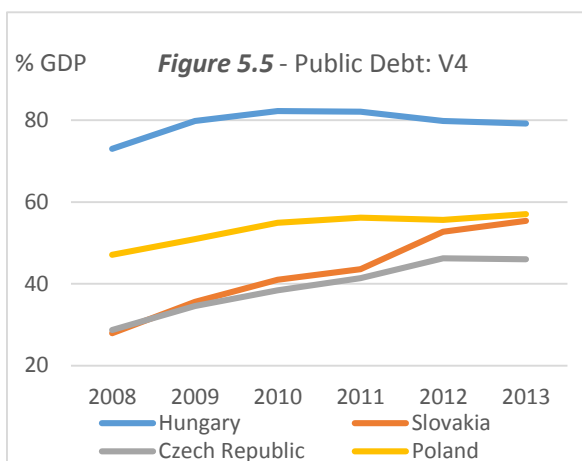
The Lithuanian government in 2009 equally lowered the rate allocated to the private pension pillar from 5.5% to 3% and capped it at 2% later that year. As of 2013, employed persons are encouraged to pay additional 1% of their wages into private funds (2% as of 2016), for which the state will add an equal proportion of the average wage. In 2009, the Estonian government has abolished the 4% state contribution to private funds, although it left the possibility to make private contributions of 2%. With fiscal stabilization complete by the end of 2012, the government has reinstated the pre-2009 formula of 2+4% (Volskis, 2012).

## 5.2 The Visegrad Four

Although substantial, the scope of fiscal consolidation undertaken by the Visegrad governments has been significantly lower than in the Baltics (Figure 5.4). On the other hand, particularly in Poland and Slovakia, public debt levels do not show signs of stabilization, while Hungary's has risen dangerously and remains the highest in the region (Figure 5.5).



Source: OECD, EU Commission. Not included is Hungary's fiscal adjustment that 'amounted to about 7% of GDP in 2007-8' (OECD, 2010b: p.19), as it wasn't related to the 08/09 crisis.



Source: Eurostat

### 5.2.1 Expenditure-Side Fiscal Adjustment: V4

In an attempt to phase out inefficient expenditures, rules-based fiscal frameworks were adopted across the V4 (OECD, 2010a; 2012b; OECD, 2014a) with Hungary and Slovakia also establishing Fiscal Councils – independent bodies composed of experts producing fiscal sustainability forecasts. A debt-brake was incorporated into the constitutions of all states apart from Czech Republic, where it has nevertheless been subject to extensive debate. Regarding actual public consumption, salaries of public sector employees were cut by between 2.5% in Czech Republic to 10% in Slovakia (Drahokoupil et al., p.397; OECD, 2012b: p.56). Poland represented an exception with generous pay increases in 2008/9 across the public sector (OECD, 2010a). Hungary implemented significant expenditure cuts in education and healthcare, though these were only minor in the other three countries (OECD, 2012c).

In terms of social transfers, Hungary instated two rounds of far-reaching pension reforms. The 2009 reform increased the statutory retirement age, changed the indexation formula, abolished the 13<sup>th</sup> month pension and reduced pension benefits in proportion to the degree of early retirement (OECD, 2010c: p.29). By 2011, the Hungarian government 'announced a large-scale review of disability rights with an objective to bring back into the labour market 110 000 people out of a planned review of 220 000 disability pensioners under the age of 57', cutting by half 'the generosity of sickness allowances' while retesting existing beneficiaries 'according to new assessment criteria' (OECD, 2012a: p.103-4).

The pension reform in Poland, initiated already in 2008, sought to significantly tighten access to early retirement by excluding numerous professions from eligibility, so that the effective number of eligible people dropped from roughly a million to 250,000, though granting some compensation to those who lost their retirement rights (OECD, 2010a: p.43). The statutory retirement age has been unified at 67 for both genders, though the generosity of the survivors' pension regime was maintained (OECD, 2014b: p.33). In Slovakia, pension age was 'increased in line with gains in life expectancy', while pension growth was made 'progressively linked to the inflation rate of a retiree consumption basket' intended to make the 'pension system more progressive' from its previously low level (OECD, 2012b: p.21). In Czech Republic, a law in 2011 has foreseen the annual raising the statutory retirement age by two months without setting a definite target with the indexation formula later amended as well (OECD, 2014a: p.40).

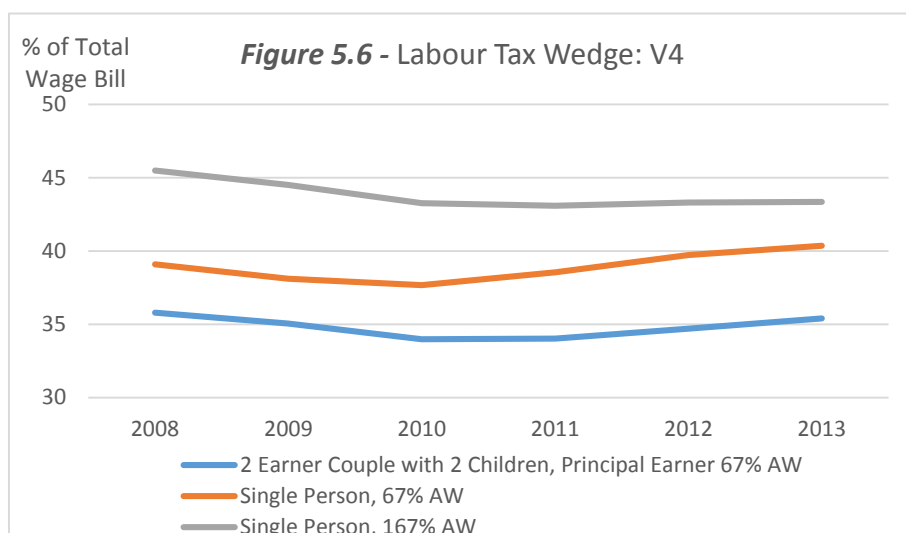
Unemployment benefits were slashed in the Czech Republic by 22% in 2011 and the eligibility criteria tightened (Drahokoupil et al. 2013: p.396). In Hungary, the duration of unemployment benefits was shortened from 9 to 3 months, eligibility criteria were tightened and amount capped at the level of the minimum wage (OECD, 2012a: p.93). In Poland, the government combined an increase in the generosity of unemployment benefits with a reduction in benefit duration (OECD, 2010a: p.35), although the system is characterized by 'strict eligibility criteria' so that only '20% of unemployed are eligible' (OECD, 2014b: p.31). Transfers to families are the one expenditure category that was not cut in any of the countries. Hungary's maternity leave policy has retained 'the most generous cash benefits and tax breaks in OECD' (OECD, 2012a: p.101). In 2011 the Slovak government in fact extended the length of maternity leave by one month to 34 weeks, accompanied by a rise in the replacement rate from 60 to 65% (OECD, 2012b: p.35). Poland's child tax credit system, introduced in 2007, has later been expanded (OECD, 2010a: p.36, OECD, 2014), while in the Czech Republic, tax-deductions for a child were in 2011 increased by over 15% (Schwarz, 2012: p.39) with the plans to further increase the tax benefits for the second and subsequent child (Office of the Government of the Czech Republic, 2014: p.10).

#### **5.2.2 Revenue-side Fiscal Adjustment: V4**

Consumption taxes have been raised in all Visegrad countries. An increase of 1% occurred in Slovakia and Poland to 20 and 23% respectively. In the Czech Republic, two rounds of VAT reform saw the rate hiked by 2%, to 21% with the reduced rate increasing over the same period by 5% to 15% (Schwarz, 2013). However, the largest VAT increase occurred in Hungary, from 20% in 2009 to 27% by 2012, the highest rate in all of EU. Preferential rates for basic foods, at 18%, and medicines, at 5%, have been introduced (KPMG, 2014).

Hungary and Slovakia raised the corporate income taxes (CIT), the former by 3% in 2010, thus matching the regional peers at 19%, though keeping a preferential rate for SMEs, while the latter hiked it to 23% in 2013, after a left-leaning government took office (KPMG, 2014). While in Slovakia the hike was accompanied by the abolishment of the flat tax regime and the introduction of a new personal income tax (PIT) bracket for above-average earners at 25%, the government in Hungary went the opposite way and adopted a flat tax regime at 16%, cancelling the two remaining the tax brackets at 17% and 32% (OECD, 2012a: p.90-1). In Czech Republic CIT was brought down to 19% by 2010 from 21% in 2008, although a previously non-existent 20% tax on lotteries was introduced. As of January 2013, annual income above the level of four times the average wage is subject to a solidarity tax of 7 percent, while any amount below that is taxed at a flat 15% rate (KPMG, 2014). The top marginal bracket for PIT declined in Poland from 40 to 32% in 2009, and has been unchanged since.

Figure 5.6 shows the evolution of the labour tax wedge in V4. Low-income earners in Slovakia and Poland lose a larger portion of their income in 2013 than they did in 2008, while the level remained stable for Czech Republic. Owing to the introduction of the new tax regime, in Hungary ‘the tax wedge increased for low-income earners (especially those without children) and declined significantly for high-income earners’ and beyond large fiscal costs ‘the negative income distribution effects... call into question the sustainability of the flat tax’ (OECD, 2012a: p.92). Indeed, the significant drop in tax wedge for high-income earners is accounted for almost uniquely by Hungary (between 2008 and 2013 a decline of over 10%, to 49%), while it remained roughly the same in Czech Republic and Poland, increasing only in Slovakia in later stages.



Source: European Commission, OECD

Property or wealth taxes were increased slightly only in Czech Republic (EC, 2012c). In Slovakia, an increase in real estate taxes based on the market value of property was ‘considered by the government, but ultimately not included in the 2013 budget proposal’ (OECD, 2012b: p.61). Property

taxes in Poland and Hungary, particularly low in international comparison, have remained unchanged. As explored in Box 5.2, the Visegrad governments resorted to more unconventional revenue-enhancing measures.

### **Box 5.2 Additional revenue enhancements in the Visegrad Four**

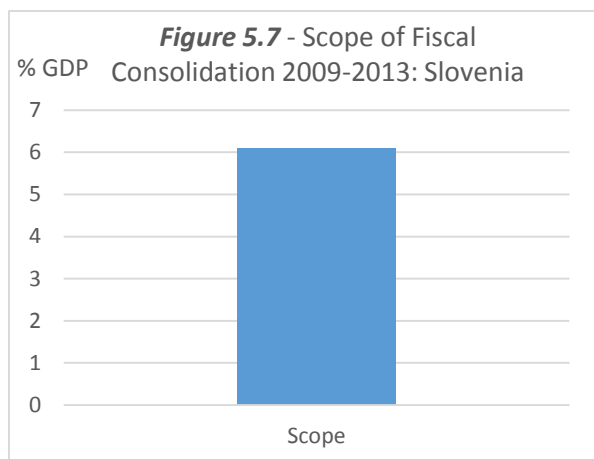
With the exception of Poland, which by 2013 has been paid out more than 70% of total allocated funds from EU's current programming period, the absorption rate of the three smaller states has remained relatively weak, below 50% for Czech Republic and Slovakia. Moreover, the Polish government has in 2010 announced an ambitious privatization plan, having also relied on one-off dividends from state-owned companies (OECD, 2012d: p.13). While the latter move became popular in later stages in Slovakia, two other revenue enhancements became prominent across the V4.

The first one was the overhaul of the pension systems in all four countries. The most drastic one occurred in Hungary, where the government in 2011 in effect nationalized the private pension pillar, 'putting in doubt private property rights over financial assets' (EBRD, 2011: p.135). Instituted at the end of 1990s, by 2011 the total assets under private management constituted 10% of GDP, granting the Hungarian public finances a comfortable surplus that year. The Polish government has in 2011 announced a gradual decline in contributions to the second, funded defined-contribution pension pillar from 7.3% to 2.3% of gross wage, crediting the difference to the public PAYG one (OECD, 2012d: p.19). In February 2014, 51.5% of the net assets of private pension funds (OFEs) were transferred to the public social security institution. Government bonds that the OFEs held, which formed a major part of the assets transferred, were cancelled. The move has lowered public debt by about 9.3% GDP (OECD, 2014a: p.26). In Slovakia, soon after coming to power in 2012, the Fico government has amended the previously courageous contributions formula of 9+9% to 4+14% in favour of the public PAYG pillar (OECD, 2012b: p.23). While an outright confiscation of assets has not occurred, the future of the privately funded pillar appears uncertain. In Czech Republic, the Nečas government, which came to power in summer 2010, has prepared a comprehensive reform of the pension system, foreseeing the establishment of a previously non-existent privately funded pillar. Owing to a number of factors, such as very low participation in its initial stage or concerns over the accompanying budget shortfalls, the Sobotka government, in power since late 2013, has abolished the reform altogether. A multi-stakeholder commission of experts has been established to work out an alternative proposal.

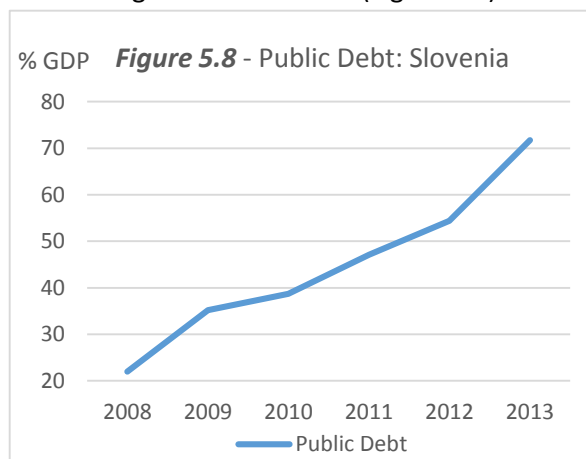
The second measure, popular particularly in Hungary and to a lesser extent in Slovakia, has been the imposition of a 'crisis-tax' on specific industry sectors. In the former, the initial temporary levy on financial institutions introduced in 2010 has been permanent in 2012, with an insurance premium tax coming to force in 2013 for insurance companies, which were previously exempt from special tax. A financial transaction tax was equally introduced in 2013. Other sectors facing special taxes since 2010 include energy, utilities and telecommunications (OECD, 2014c; p.61-62). In Slovakia the tax base of the bank levy, introduced in 2012, was broadened in 2013 to include household deposits. Also in 2013, temporary taxes on profits in regulated sectors (energy, insurance, communications, and postal services) were introduced (OECD, 2012b: p.20-2). In Czech Republic, the Sobotka government has kept open the possibility of introducing sectoral taxes after 2015, should further consolidation be needed.

### 5.3 Slovenia

Although Slovenia has undergone comparatively mild fiscal consolidation (Figure 5.7), reflective of the poor economy and successive bank-recapitalization needs, its public debt has recorded the largest increase between 2008 and 2013 in all of CEE and shows no signs of stabilisation (Figure 5.8).



Source: EU Commission, OECD



Source: Eurostat

#### 5.3.1 Expenditure-Side Fiscal Adjustment: Slovenia

While successive governments have foreseen the reduction of employment and wage cuts in public sector (OECD, 2012c: p.220) significant reforms largely failed to go through (OECD, 2013b: p.21). Concerning healthcare provision, policy on sick leave benefits and the amount of payments for extra time in health institutions has been made more restrictive, although from a comparatively generous level, while the price of medicines has been brought down. In education, rationalisation measures, rather than across the board cuts, were pursued (Ibid: p.21-22).

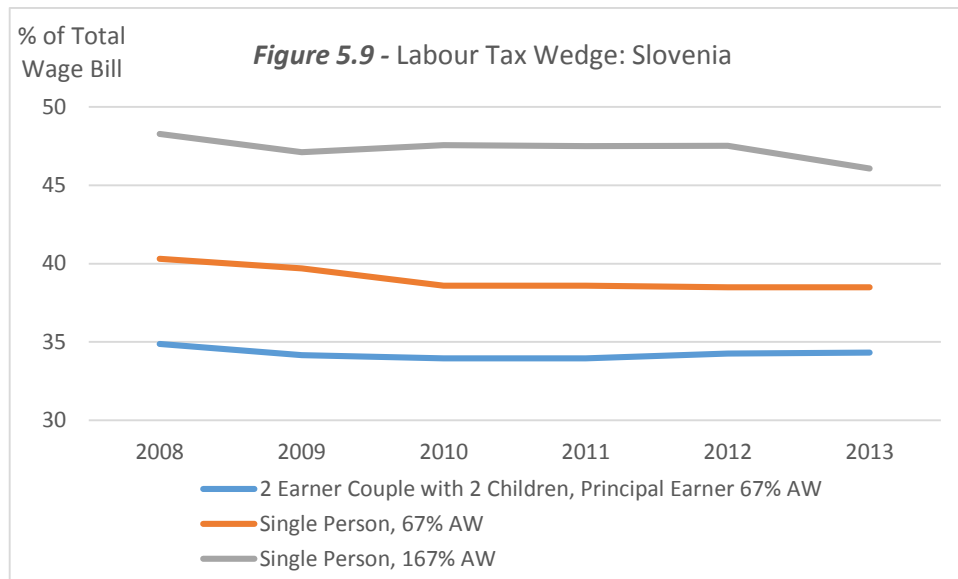
In 2011 an extensive pension reform intended to reign in future pension expenditures has been rejected in a national referendum. A significantly watered-down version, amending the indexation formula and equalising the statutory retirement age for both genders by 2020, passed through parliament in December 2012 (OECD, 2013b: p.23). Concerning family benefits, 'subsidies for school and student meals were lowered, parents required to cover 30% of childcare costs for second child, the parental benefits for childcare were cut, the indexation of child benefits was frozen with eligibility conditions tightened for higher-income earners' (Ibid: p.23). The replacement rate of unemployment benefits for unemployment spells longer than one year was reduced from 60 to 50%, although the duration of benefits up to 25 months was maintained (Ibid: p.23-24), while the eligibility criteria 'have been somewhat relaxed' (Ibid: p.34).

#### 5.3.2 Revenue-side Fiscal Adjustment: Slovenia

The multi-annual programme of corporate income tax rate reductions, which started in 2012 and which has foreseen the decline in CIT to 15% by 2015 from 20% in 2011, has been abandoned in 2013,



as the CIT stabilized at 17%. On the other hand, in 2010, the flat rate on capital gains (dividends, interest, and capital gains) was increased by 5% to 25%. In 2013, the threshold for the personal income tax bracket at 41% was lifted from 1.3 times to 1.5 times the average wage and a new tax bracket of 50% was introduced for earning above 69,315 Eur (EC, 2013d: p.21-22). As a result of the changes, the labour tax wedge declined slightly for all major income groups (Figure 5.9). As the 50% PIT, which kicks in at annual income above three times the average wage (KPMG, 2014), the likely increase in tax-wedge for very high-income earners is not captured by the figure.



*Source: European Commission, OECD*

Consumption tax was increased by 2% to 22% in July 2013 as a measure of last resort, though the government continues to apply the preferential VAT rate 'to almost all categories of goods and services allowed for by the VAT Directive 2006/112/EC' (EC, 2013d: p.22). Property and wealth taxes were extensively used. In 2012, an anti-crisis tax on immovable property was introduced on properties above a certain value (1 million EUR, later brought down to 500,000) with progressive rates ranging from 0.1% to 1.5%, while taxes on motor vehicles and pleasure boats were also increased (EC, 2014c).

#### **5.4 Fiscal Adjustment: Categorization**

The most popular revenue-side measure, implemented at some point by all governments, was an increase in the consumption tax. On the expenditure side, cuts to public services, healthcare in particular, dominated. Table 5.1 shows the share of regressive spending-side, revenue-side and overall measures implemented in the course of fiscal adjustment. The extent of regressiveness of measures was ignored. The implemented expenditure side measures in the Baltics were uniformly regressive, they accounted for three quarters in the Visegrad states, while in Slovenia, cuts tended to be targeted or complimented by neutralizing measures. On the revenue side, Latvia and Lithuania made some use of property taxation, the experience has been mixed in the Visegrad states with corporate and income

taxes moving in both directions together with limited use made of taxing wealth. Progressive revenue-side measures outweighed the regressive ones only in Slovenia. Figure 5.10 presents the total scores.

**Table 5.1 – Regressive Measures**

	<b>Spending-side</b>	<b>Revenue-side</b>	<b>Total regressive</b>
<b>Baltics</b>	100	75	90
<b>V4</b>	77	67	71
<b>Slovenia</b>	67	40	57

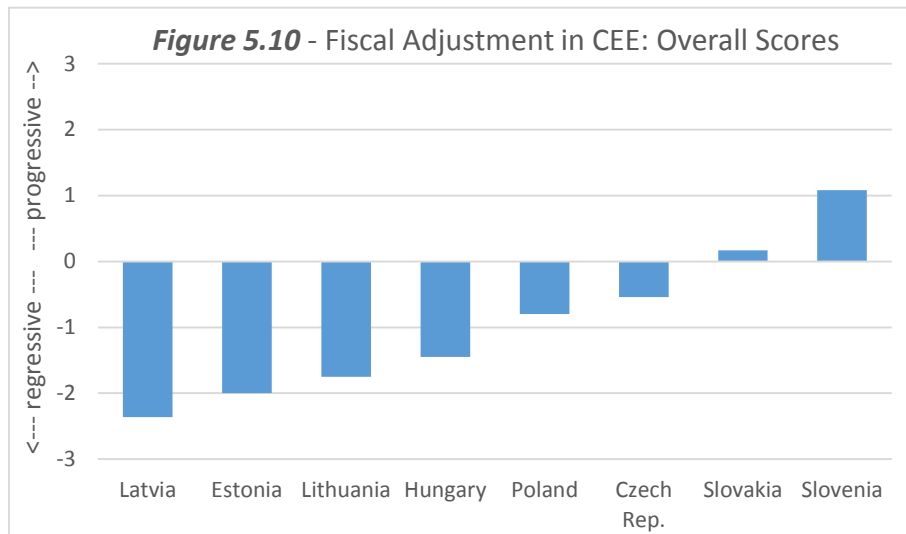
Source: Author's analysis

The fiscal adjustment in the Baltics has been decisively regressive. Characteristic of the spending-side consolidation were across-the-board cuts of the operating costs of public services and no extension of the meagre social transfers. Very little effort has been made to improve social assistance targeting, a significant part of which continues to be redistributed to high-income households (OECD 2011c; EC 2012b; EC 2013c). The primary means of progressive fiscal consolidation – progressive personal income taxation and corporate income taxes – have remained unused, while the tax wedge for low-income earners has increased disproportionately. Property and land taxation have remained very low by international comparison. At 26% in 2011, Lithuania has preserved the lowest tax-to-GDP ratio in the EU (EC, 2013b: p.13) with Latvia and Estonia close behind.

The regressiveness of fiscal adjustment in the Visegrad states varied, though it never reached the levels in the Baltics. With the exception of Hungary, cuts to public services have been comparatively mild. Although little effort went into improving the targeting of social assistance and transfers to the unemployed tended to be scaled back, support for families with children increased, both via generous tax expenditures and scaling up of direct transfers. The latter, together with the extensive pension reforms, particularly in Hungary and Poland, bear significant implications for the nature of the Visegrad welfare regimes. Concerning revenue enhancements, Czech Republic and Slovakia have implemented some form of progressive income taxation in later stages, with the latter also increasing corporate taxes. Nevertheless, the tax wedge for low income earners – especially those without children – has tended to increase, while very little use was made of property and wealth taxation.

Fiscal adjustment in Slovenia has been overall progressive. Across the board cuts were not pursued in any of the spending categories, while the approved pension reform is comparatively mild. Emphasis has been given on scaling back social transfers to high-income households. In fact, between 2007 and 2011 (for which latest data is available) 'spending on social benefits and transfers in kind increased markedly by 3.5 percentage points of GDP... far exceeding the CEE average of 1.5% or the OECD average of 2.2%' (OECD, 2013b: p.25). Revenue enhancements, often implemented as measures of last resort, were progressive, such as property and wealth taxation, or the increased progressiveness

of the personal income taxation. Only in Slovenia has the tax wedge for low-income earners slightly decreased, while the VAT hike was cushioned by the generous exemptions regime underpinning it.



Source: Author's analysis

## 6. Assessment

This section elaborates on the factors behind the region's varied economic performance and different courses of fiscal adjustment, relating both to earlier hypotheses. It is followed by a final reconstruction of the different logics of adjustment and the implications of this episode for the variants of capitalism in CEE.

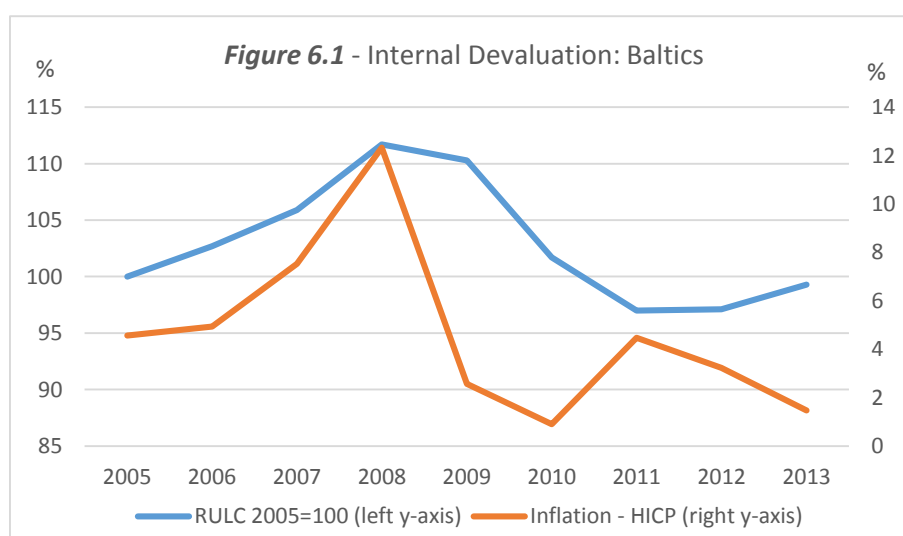
### 6.1 Economic and Fiscal Adjustment

It was hypothesized earlier (section two) that countries, which had accumulated fewer external imbalances prior to the crisis were likely to outperform the more vulnerable ones (economic legacy hypothesis). An alternative, 'economic policy hypothesis' held that it was in fact the choice of policy instruments implemented in the wake of the crisis, in particular fiscal and monetary stimulus and smart labour market policies, that are likely to get the country to prosper. It was also noted that combining the two factors – low external imbalances and adequate stimulus – should make a country clearly outperform. While it is clear that factors beyond the proposed economic legacy and economic policy hypotheses decisively impacted the performance of countries, the crucial role of fiscal stimulus appears to be confirmed. Perhaps the most striking finding is that there has been no country that would clearly outperform across the three dimensions of economic performance observed in this article, as even the apparently superior growth models have been exposed as entailing grave weaknesses.

The combination of 'economic legacy' and 'economic policy' hypotheses seem to go some way in accounting for the performance of the Visegrad states on GDP and trade. As has been noted elsewhere, Poland's limited pre-crisis imbalances, sizeable fiscal stimulus and currency devaluation have been crucial in safeguarding economic growth and boosting exports (OECD, 2010a; p.28-30: EBRD, 2009: p.204-205: IMF, 2013). By pursuing these factors to their logical ends, Poland's superior level of economic activity owes to its extreme positions on both the legacy and policy factors. Along with a balanced external account, Poland has been characterized by limited trade openness. With trade-to-GDP ratio at roughly half that of its regional peers, the trade channel, through which the crisis was imported, has not been as pronounced, thus rendering Poland the least vulnerable of all eight countries. Concerning the policy nexus, what stands out is Poland's successful tapping into EU funds, which funded not just a one-off, but a prolonged fiscal expansion, sufficiently substituting for the faltering private investment. This experience seems to support the notion that 'while a sizable upfront stimulus is needed, policy makers must commit to doing more... if conditions so warrant.' (Blanchard et al., 2008; p.7-8). In this vein, Czech Republic's weakness of overall economic activity, despite its low pre-crisis exposure and an initial policy mix similar to Poland's, likely owes to its greater openness –

magnifying the crisis shock – and lack of persistence in stimulus measures, fiscal in particular. Hungary, which was also impacted via the financial channel and did not pursue fiscal stimulus measures, underperformed the most from among V4 in terms of GDP, while owing to its small size and dominance of few large exporters, Slovakia has undergone a purely export-led recovery, despite a sizeable initial slump and weak domestic demand. On the other hand, the significant growth of Slovakia’s exports confirms that a currency devaluation may provide, at best, a very temporary form of stimulus.

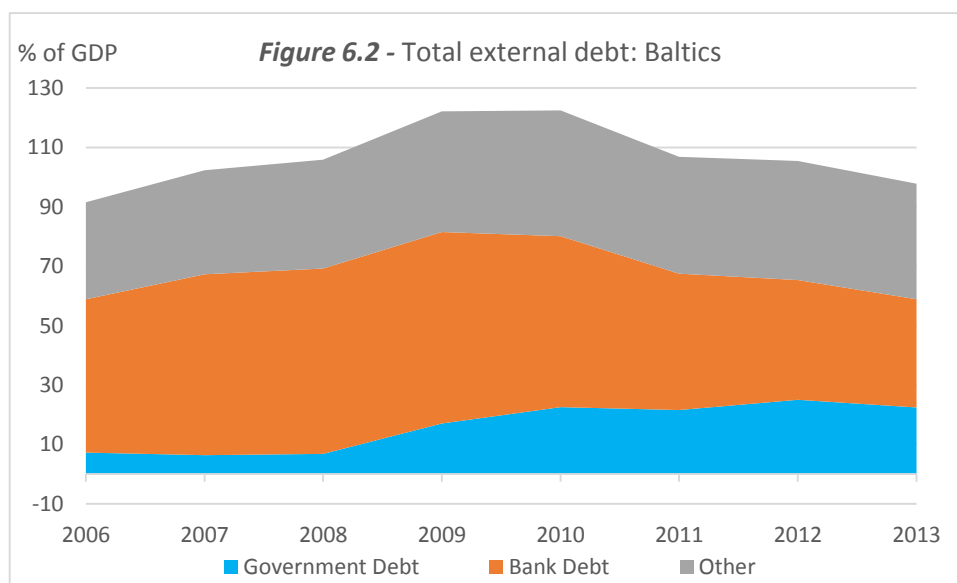
However, the experience of the Baltics and Slovenia seem to contradict both the economic legacy and policy hypotheses. While the Baltics were characterized by the greatest pre-crisis imbalances and committed themselves to an unorthodox strategy of economic adjustment, following steep recessions, all have embarked on uninterrupted growth, significantly expanding exports. On the other hand, Slovenia, which accumulated significantly less external imbalances prior to 2008 and implemented a sizeable fiscal stimulus, has fared the worst on GDP and trade. The extent to which the Baltic recovery owes to internal devaluation has been subject to considerable controversy (see Weisbrot & Ray, 2011; Medaiskytė & Klyvienė, 2012; Kattel & Raudla, 2013a). While real unit labour costs have declined by on average less than 20% from their pre-crisis peak, deflation – its other key component – never took off (Figure 6.1). On the other hand, clearly observable from the composition of GDP since early 2010, extensive absorption of EU funds appears to have provided a crucial counter-cyclical impulse throughout adjustment. In this respect, Slovenia’s fiscal stimulus, though extensive, has been one-off, though the extent of its contrasting experience with the Baltics points to the importance of other crucial factors determining post-crisis performance.



Source: Eurostat

The first is the health of the financial sector and the effectiveness of steps taken to restore it. The banking sectors in the Baltics, which funded the pre-crisis consumption booms, clearly underwent

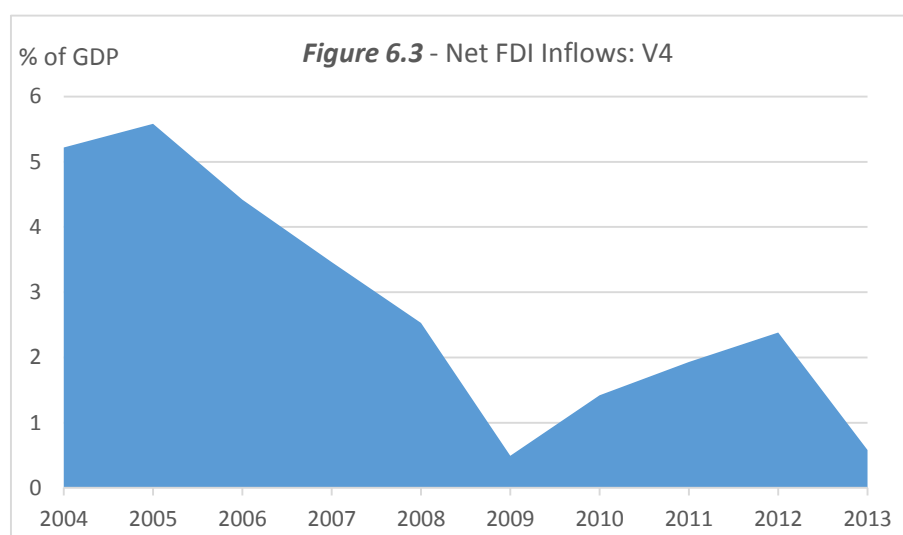
deleveraging (Graph 6.2), with the authorities often having ‘undertaken wide-ranging reforms to facilitate market-based household and corporate debt restructuring’ (EBRD, 2009: p.141). In Slovenia however the crisis exposed deeply rooted political cronyism, soft-budget constraints and corruption in the state-owned banks (OECD, 2013b: p.47-8). This appears to have prevented the timely restoration of healthy bank balance sheets and the realization of losses from a flawed business model over-reliant on lending to construction. In Slovenia by 2013, ‘deleveraging has barely started’ (Ibid: p.59) and non-performing loans, above 18% of total loans, continue increasing, while in the Baltics they represent but a fraction of the figure and follow a downward trend (World Bank, 2014). The weakness of the financial sector also goes some length in accounting for the disappointing performance of Slovenia’s complex manufacturing export sector, as its operation is dependent on debt-financing. The Baltics’ emergent leading exporters, mainly from food, drinks and tobacco industries, are less dependent on debt-financing and have significantly benefited from favourable price developments on world markets (IMF, 2014). To account for Estonia’s superior export-upgrading, anecdotal evidence suggests that it was the main beneficiary of the outsourcing of Nordic manufacturing companies, prompted by a scramble for profitability unleashed by the crisis (IMF, 2014; Kattel & Raudla, 2013a). Thus, the health of the financial sector – not immediately visible, but also crucial in the Visegrad four – and external developments – the Visegrad economies benefiting from a rebound in global demand for their exports – have also been crucial in impeding or promoting a recovery.



*Source: National Central Banks, Statistical Offices & author’s calculations*

While the extremely poor employment outcomes in the Baltics can be accounted for by the destruction of jobs in the previously overblown non-tradable sectors, Slovenia’s by the enduring malaise of the wider economy, the real puzzle seems to be why the Visegrad countries, despite their balanced pre-crisis growth models, considerable stimulus measures, healthy banking sectors and

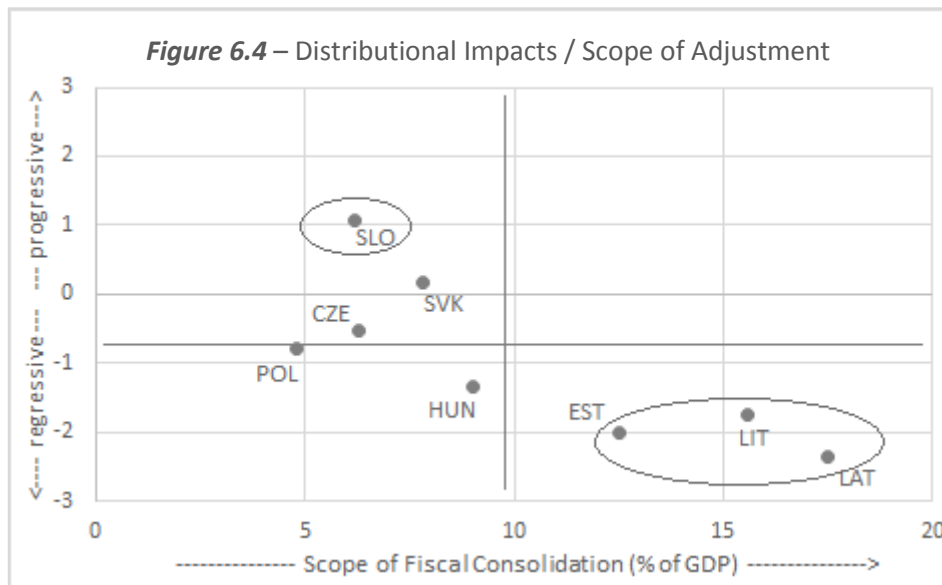
favourable external developments, have so underperformed in employment. Two factors seem warranted. On the one hand, much of the pre-crisis growth and employment was accounted for by the expansion of previously non-existent basic services (Drahokoupil & Myant, 2011: p.190). This one-off boost seems to have been exhausted. The other, and perhaps key, element seems to be their pathological dependence on foreign capital. While the pouring in of foreign investment constituted ‘an important building stone of the previous growth model, FDI did not contribute to the recovery from the financial crisis’ (Fidrmuc et al., 2013: p.9; Figure 6.3). As large employment-generating foreign ventures have become extremely scarce, with the large manufacturers focusing on safeguarding the profitability of existing operations, the limits of the Visegrad growth model have been revealed. And together with limited employment opportunities, recent research indicates that the status quo also implies very low potential for the development of indigenous innovation capacities (Scepanovic, 2013) constraining the capacity of the Visegrad political economies to deliver rising prosperity beyond a certain point. The extent to which this has been noted and incorporated into coherent policy plans in the region’s capitals represents a research agenda in itself.



Source: UNCTAD, National Statistical Offices

With respect to distributing the burden of fiscal adjustment, it was hypothesized earlier that because of looming mass lay-offs, the Baltic governments may face significant pressures for a more progressive course of fiscal adjustment, while Slovenia and the Visegrad states may be forced to scale down on under-funded social programmes, making their courses of adjustment significantly regressive (transformative hypothesis). The alternative, ‘path-dependence hypothesis’ held that the progressiveness of fiscal adjustment is likely to be determined by the extent of entrenched social opposition to welfare retrenchment, predicating a regressive course of adjustment in the Baltics, and progressive ones in Visegrad states and Slovenia. Plotted on a scatter diagram against the scope of

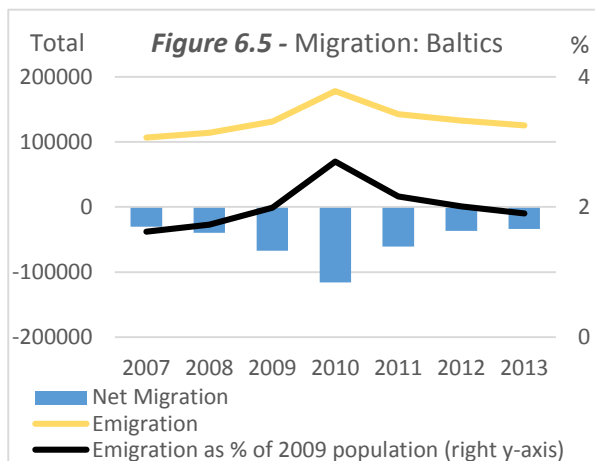
consolidation undertaken, the data provides significant support for the path-dependence hypothesis in the Slovenian and Baltic cases (Figure 6.4).



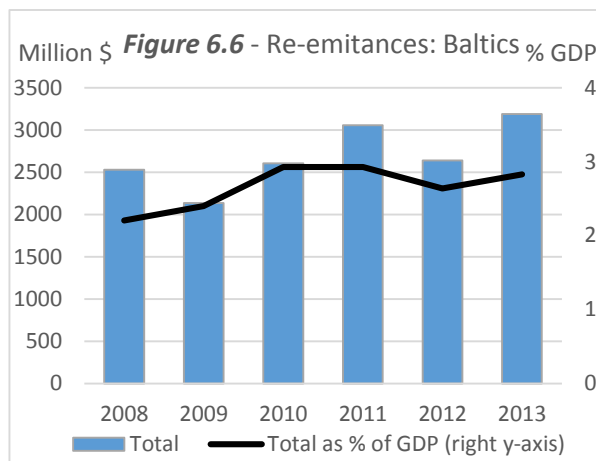
Source: Author's analysis

In Slovenia, targeted rather than across-the-board cuts of public services and social programmes dominated, while the revenue enhancements were overwhelmingly progressive. When attempted, the strongly represented social interests have acted to arrest the pursuit of far-reaching expenditure cuts, as the 2011 referendum on pension reform demonstrates. In the Baltics, overarching concerns over international competitiveness have not been balanced by organised welfare constituents, making a thoroughly regressive fiscal adjustment possible. Consistent with path-dependency, positive feedback loops from previous instances of fiscal consolidation most likely contributed too (Kattel & Raudla, 2011), while the course was 'further supported by an external anchor, the Maastricht criteria and the goal to join the euro-zone... providing a mandatory exit strategy for the governments' (Kattel & Raudla, 2013a: p.180). Indeed, Estonia managed to adopt the Euro in 2011, Latvia in 2014, with Lithuania's Eurozone entry confirmed for 2015. However, it appears that two crucial factors made the significantly regressive Baltic strategy socially permissible. The first has been the extensively used exit option. According to official statistics, on average more than 100,000 Lithuanians, 30,000 Latvians and 6,000 Estonians have emigrated between 2008 and 2013, with a clear peak in 2010 (Figure 6.5), though the actual numbers are likely much higher, as not all register when leaving. Thus, the significant drops in labour force have not translated into increased inactivity or pressure for extension of social safety nets, but mass outflows of the productive population. Second, the mildly increased inflow of remittances appears to have played a supporting role for those who stayed behind, substituting for public welfare provision (Figure 6.6).





Source: National Statistical Offices

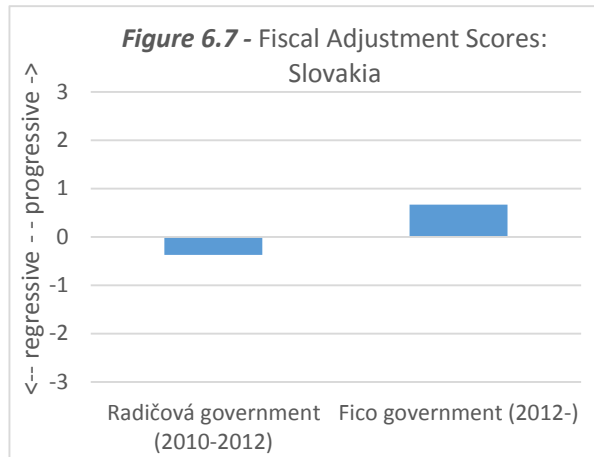


Source: World Bank, IMF

The varying and mostly regressive character of fiscal adjustment in the Visegrad states does not fit so well with the path-dependent hypothesis, which had predicted an overall progressive course, and the persistence of sheltered groups, particularly the army of disability and early pensioners in Hungary and Poland respectively. However, these programs, traditionally perceived as crucial in safeguarding social cohesion in these countries, were swiftly scaled back. While the limited political representation and hence weak organised opposition to retrenchment go some way in accounting for what made the course possible, what perhaps made it politically desirable is the generational re-orientation of the Visegrad welfare states towards younger people, families in particular. The logic of Vanhuyse's instrumental calculus would dictate that the unfavourable demographic forecasts and increasingly limited economic opportunities for the young rendered their acquiescence to the post-crisis state of affairs a priority for the Visegrad governments. However, such account fails to explain the distinctly varied character of fiscal adjustment measures in the V4.

Given the unprecedented ideological polarization on the political spectrum in the Visegrad countries (Drahokoupil et al., 2013), one account could hold that the progressiveness of fiscal adjustment was likely to be determined by the ideological affiliation of a government. Accordingly, once in power, centre-right parties would pursue a regressive course, while centre-left governments a more progressive one. This could be tested on the example of Slovakia, which was the only country among V4 that has experienced the alternation of right-wing and left-wing governments in its course of fiscal adjustment. Figure 6.7 shows the respective scores on the progressiveness indicator and provides some support for the hypothesis, though it must be contextualized. While the centre-right Radičová government, in power from spring 2010, increased the VAT and implemented some cuts to public services, it also instated the more generous maternity leave and balanced increasing the retirement age by a more redistributive formula. The centre-left Fico government, in power since early 2012, has

abolished the flat personal income taxation, increased corporate income tax and implemented no more cuts to public services, although, as a result of changes in social security, the tax wedge for low-income earners has markedly increased, while the government shied away from increased property taxation and maintained the higher VAT rate, despite a law from the Radičová cabinet foreseeing its return to the pre-crisis level in early 2014.<sup>3</sup> Although not captured by the indicator, it is also worth noting that the Fico government relied extensively on one-off revenue enhancements, while the Radičová government on improving the efficiency of the public sector. The fiscal adjustment in the Visegrad states thus appears to be heavily influenced by idiosyncratic factors, and the sheltering of one particular societal group – families – calls for a more detailed analysis.



Source: Author's analysis

## 6.2 Crisis Adjustment and its Implications

Characteristic of the Baltic course of adjustment has been extreme political rigidity, unmatched economic flexibility and enhanced social Darwinism. On the economic side, the sectoral re-orientation of the Baltic economies heralds the dawn of new leading export-oriented industries. However, these are not well oriented towards fast-growing markets (IMF, 2014: p.15,53), and their technological sophistication is – though to a lesser extent for Estonia – relatively low. In fact, Baltic merchandise exports have by 2013 stagnated on an annual basis, with Estonia even recording a slight decline (Statistics Estonia, 2014). In light of withering exports and still weak bank lending to businesses, which constraints private investment, the drivers of future growth remain uncertain. Moreover, the shrinking labour force and deep skill mismatches may induce labour shortages in specific industries, causing upward wage pressures, thus eroding the painfully gained competitiveness. Indeed, the Estonian Central Bank finds that in 2013 'labour costs rose throughout the year distinctively faster than productivity' (Eesti Pank, 2014: p.4). On the social side, in implementing the drastic measures in defence of the prevailing social contract, the Baltic governments have effectively outsourced the social cost, as emigration remained the sole option for many. In so doing, the medium to long-term economic development and sustainability of public finances may have been seriously jeopardized. With uncertain and likely progressively diminishing EU transfers, the maintenance of even the meagre social

<sup>3</sup> Specifically, the law stipulated that should the annual public deficit reach less than 3% of GDP, as it did for 2013, the government is to lower the VAT to 19%, down from 20%. Fico's cabinet has abolished the law.

spending seems to rely on the engagement of the foreign diasporas (OECD, 2013d). Thus, even as the prevailing growth model imploded, the economic and social policies have in all three countries remained strictly within the neo-liberal paradigm. The fact that the crisis of such proportions did not produce any economic or social alternatives in either of the Baltic countries indicates how deeply the ideology has been rooted.

The course of adjustment in the Visegrad states has been characterized by political sclerosis, economic rigidity and selective social compensation. The surprisingly weak recoveries in the Visegrad states served to reveal a fundamentally dualistic character of their economies. While the term is most frequently used in relation to developing countries (Rodrik, 2011, 2014), the Visegrad economies, too, have at their core a foreign-owned, high-productivity industrial sector deeply integrated in the global economy, whose output significantly expanded once global demand picked up, thus underpinning post-crisis growth. However, investment into new capacities and economic activity beyond these leading sectors has remained particularly weak. The Visegrad states' dependent status, together with a neglect of the build-up of domestic capacities, have created a real danger of settling in a low-level equilibrium, which, although not posing concerns over short-to-medium term sustainability, would imply leaving significant economic potential untapped. Although Poland has retained a lower dependence on the export sector, its over-reliance on public infrastructure projects spell out specific dangers, with the labour market suffering from the same weaknesses as its regional peers. On the social side, the fiscal adjustment has brought with it a fundamental reshuffling of sheltered groups. Indeed, the scope and likely impact of the pension reforms seriously puts in doubt the continued validity of perceiving the Visegrad states as 'pensioners' democracies' (Vanhuysse, 2006). The generational shift is all the more pronounced given the partial or complete nationalization of accumulated private pension funds to meet present expenses, posing a direct threat to the financial security of future pensioners. The overall significant reliance on unconventional one-off measures to curtail the growth of public debt has served to postpone, rather than resolve, the issue of underfunded welfare provision. Given the absence of concerted policy action, the future appears to be one of greater economic polarization and persistent fiscal stress. These internal pressures can be expected to find diverse forms of political expression, from the popularity of anti-establishment, through illiberal to outright xenophobic parties.

In Slovenia, the crisis unleashed unprecedented political fragility, absolute economic implosion, which were however cushioned by the persistence of generous social compensation. The banking crisis that engulfed the largely state-owned banks will most likely serve to accelerate the unravelling of the neo-corporatist socio-economic structures, their gradual erosion dating from before the crisis (Stajonevic, 2010; Guardiancich, 2011). The unique Slovenian growth model appears to have been broken by the

crisis, while an alternative has yet to be found. However, the course ahead will most likely involve the privatization of the viable and restructured SOEs and state banks, heralding the penetration of foreign economic actors, possibly bringing the next growth model closer to that of the Visegrad states. On the other hand, much depends on whether the previously dominant complex manufacturing sector can be revived and what actors might bring this recovery about. And having largely withstood the crisis thus far, the pressures for welfare state retrenchment are likely to be further amplified, compounded by the explosion of public debt. While it is still too early to make a final call, Slovenia most likely entered a transition comparable to the one in 1990s and accompanying it is the uncertainty over the future social and economic status for large segments of the population. This is bound to fuel further instability in the political sphere and, much like in the Visegrad states, bring to prominence populist, single-issue or anti-establishment parties further eroding the neo-corporatist structures.

## Conclusion

The crisis of 2008/9 has presented a challenge of unprecedented proportions for the CEE's political economies, where three outcomes stand out. First, the pre-crisis standard of high growth rates, rising living standards and new economic opportunities for the CEE's productive parts of populations appear to have ceased to apply. Even the seemingly balanced pre-crisis growth models have been exposed as entailing grave weaknesses. While in the Visegrad four overall economic activity has rebounded on the back of manufacturing exports, the persistent weakness of private sector investment and job creation points to problems beyond repair by mere stimulus measures. In Slovenia, flaws in the state-dominated banking sector have resulted in an unforeseen and prolonged economic deterioration with no clear end in sight. Though somewhat alleviated by external factors, the extremely painful adjustment in the Baltics has implied radically changing economic prospects for large segments of the society. These developments bear profound implications for the nature of the social contract, as the crisis appears to have amplified societal rifts, particularly along education lines. As the political economies are drifting towards greater economic exclusiveness, the prospect of future prosperity is no longer universally valid. Second, despite the changing economic landscape, the contradicting goals of maintaining social cohesion and fiscal consolidation have largely been resolved in a way consistent with the prevalent logics of social compensation. Although predominantly regressive in the Visegrad four, the regime of selective compensation has changed in form, not in kind, as the previously sheltered group – pensioners – was substituted by a new one – families. Similarly, the severely regressive versus progressive courses of fiscal adjustment in the Baltics and Slovenia respectively have translated into no significant changes in the nature of the welfare regimes, which continue to present antipodes. However, in their attempts to preserve the existing arrangements, all three groups of states have drawn on resources whose future availability or attractiveness have severely diminished. A population exodus in the Baltics, the use of accumulated private pension funds in the Visegrad four, and funding public spending at the cost of skyrocketing public debt in Slovenia are tools that have been purely one-off, or whose use in the future would threaten a complete socio-economic breakdown. The persistence of the existing social structures thus endangers future vulnerability. Ultimately, the crisis appears to have tilted the balance more in favour of the neo-liberal paradigm. Its hardening in the Baltics, persistence in the Visegrad states and likely gradual convergence to some form of it in Slovenia indicate an explicit lack of alternatives in the realm of ideas. Thus, on course to greater economic polarization and increasing strain on existing mechanisms of social compensation, the future of the political economies in CEE, and their courses of adjustment in future episodes of global instability, are highly uncertain.

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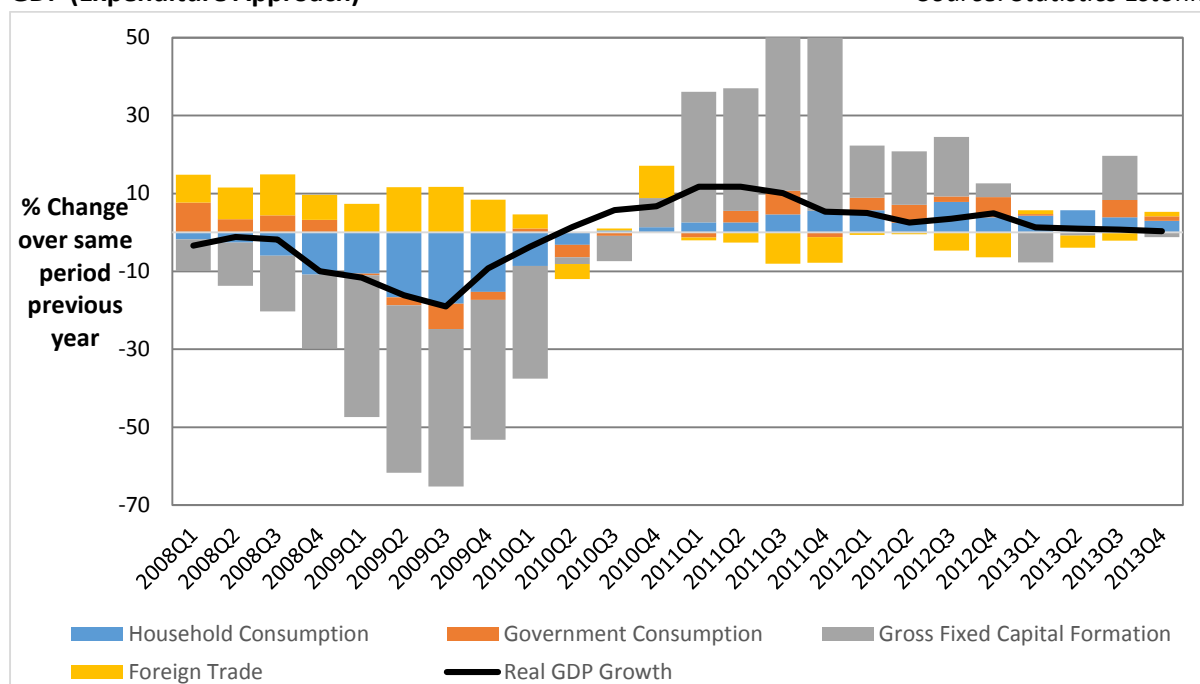
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## Appendix I – Economic Adjustment

### Estonia

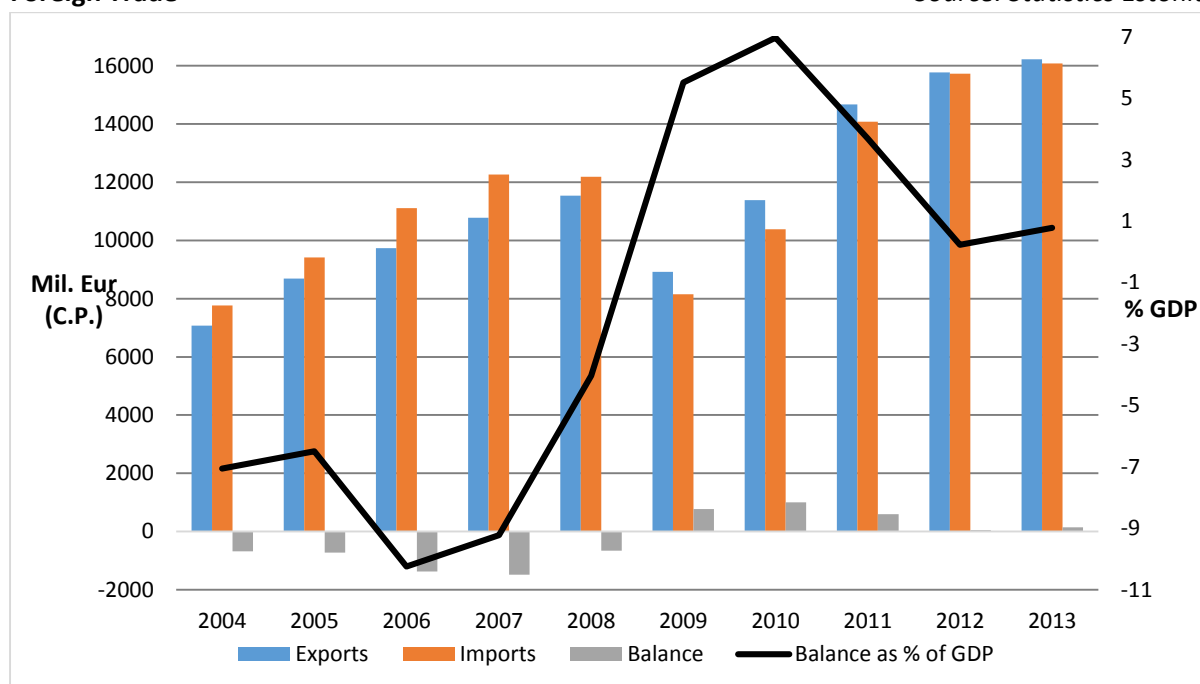
#### GDP (Expenditure Approach)

Source: Statistics Estonia



#### Foreign Trade

Source: Statistics Estonia



#### Labour Market (Age 15-64: Unit 1000s)

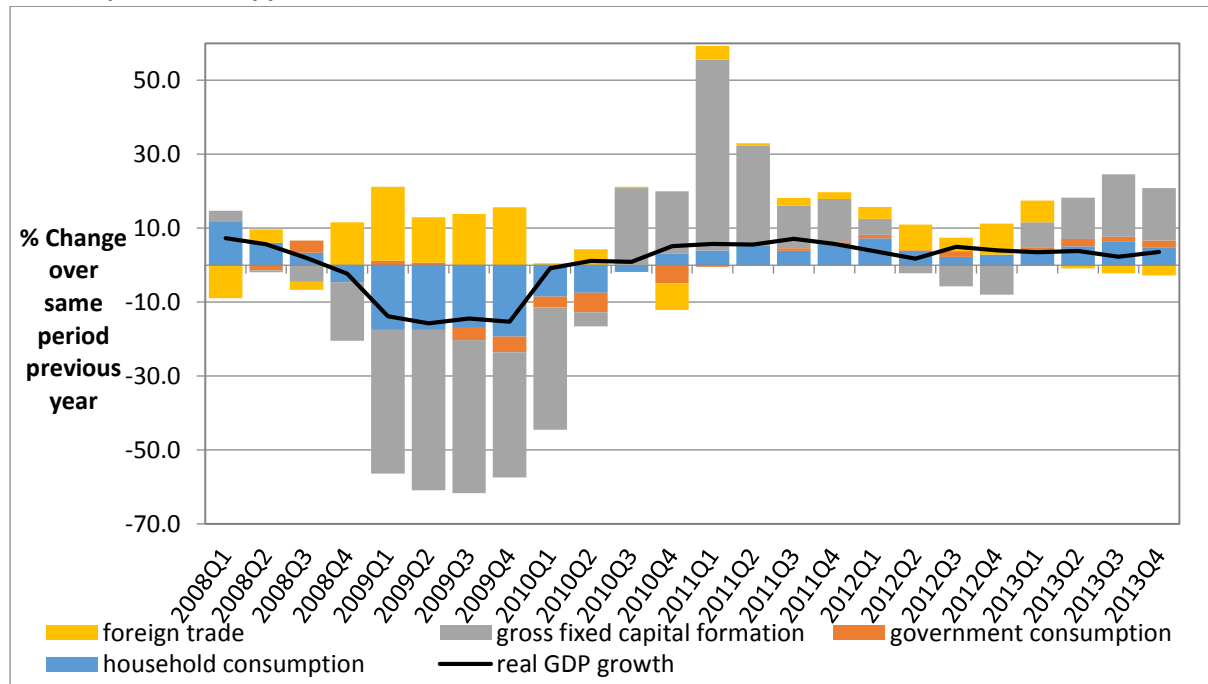
Source: Statistics Estonia

	2008	2009	2010	2011	2012	2013
Labour Force	669.6	665.7	661.5	665.4	658.5	654.6
Total Employed	632.2	573.5	548.2	581.5	591	596.6

## Lithuania

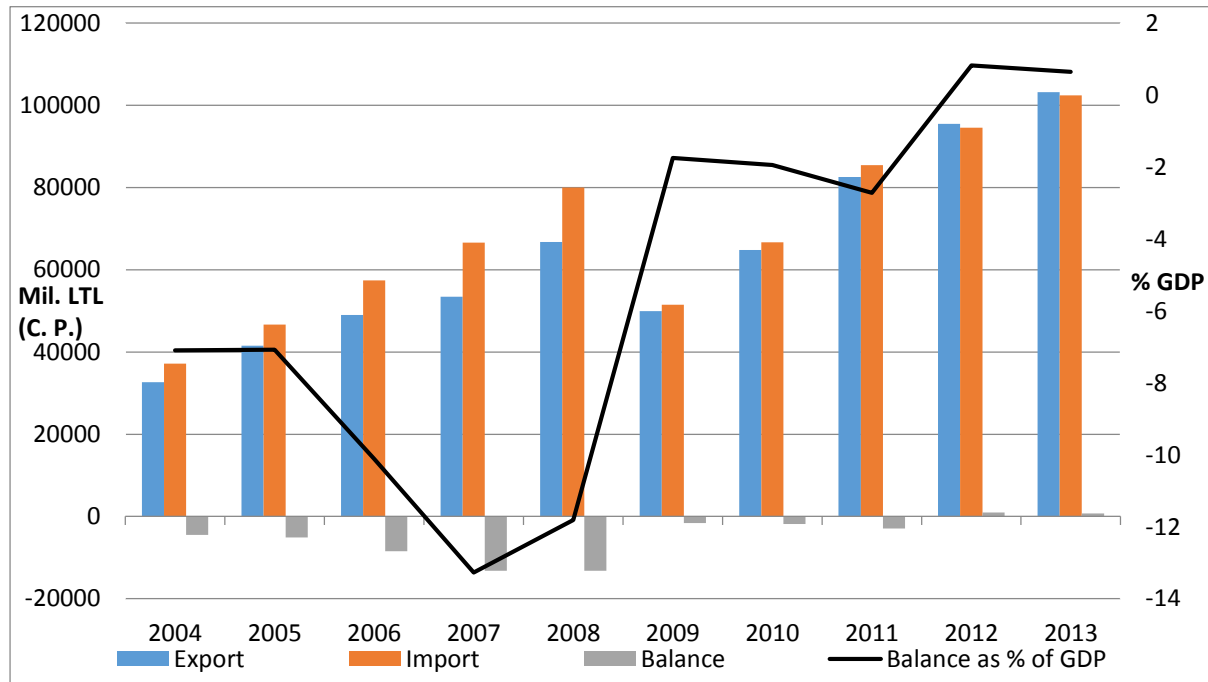
**GDP (Expenditure Approach)**

*Source: Statistics Lithuania*



**External Trade**

*Source: Statistics Lithuania*



**Labour Market (Age 15-64: Unit 1000s)**

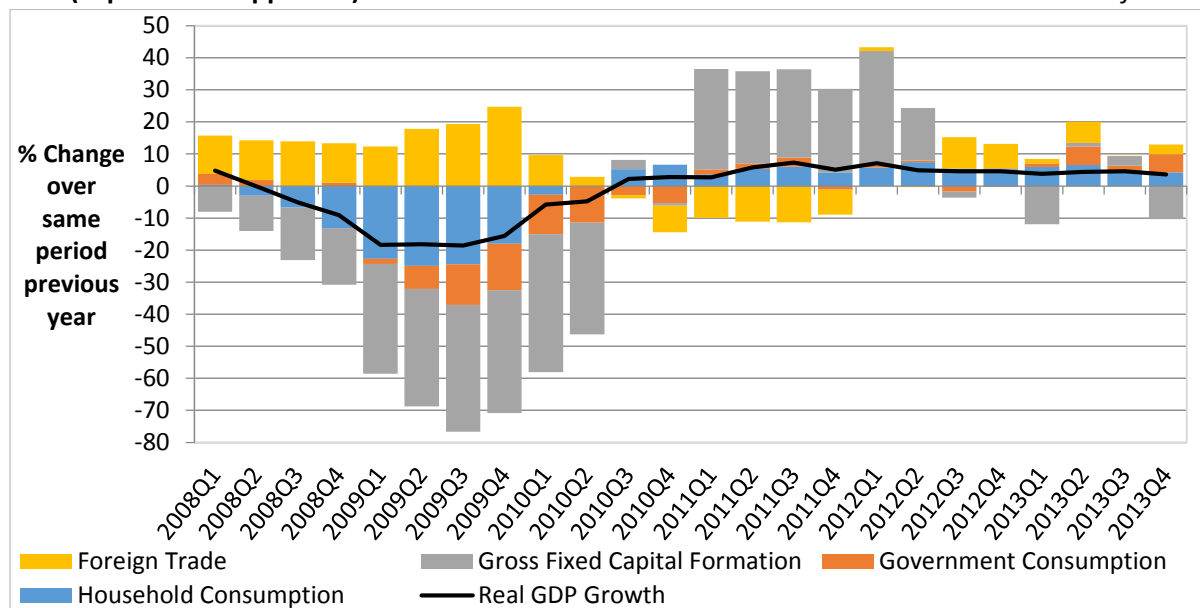
*Source: Statistics Lithuania*

	2008	2009	2010	2011	2012	2013
<b>Labour Force</b>	1484.3	1499.6	1494.1	1453.5	1441	1436.4
<b>Total Employed</b>	1396.9	1289.7	1224.2	1225.7	1244.4	1264.3

## Latvia

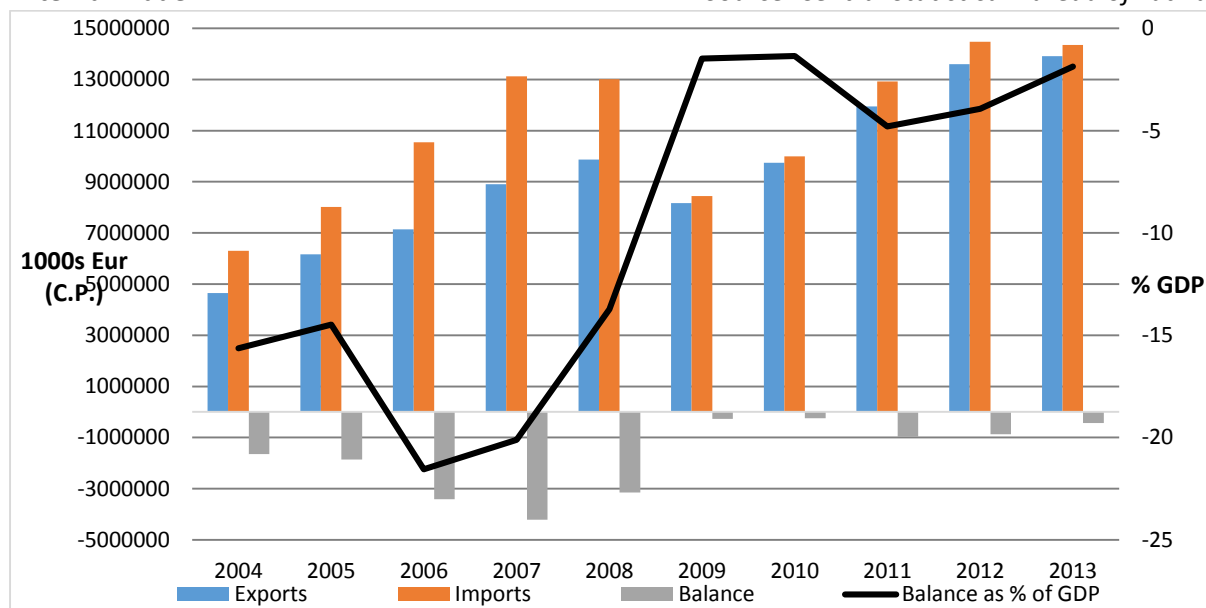
### GDP (Expenditure Approach)

Source: Central Statistical Bureau of Latvia



### External Trade

Source: Central Statistical Bureau of Latvia



### Labour Market (Age 15-64: Unit 1000s)

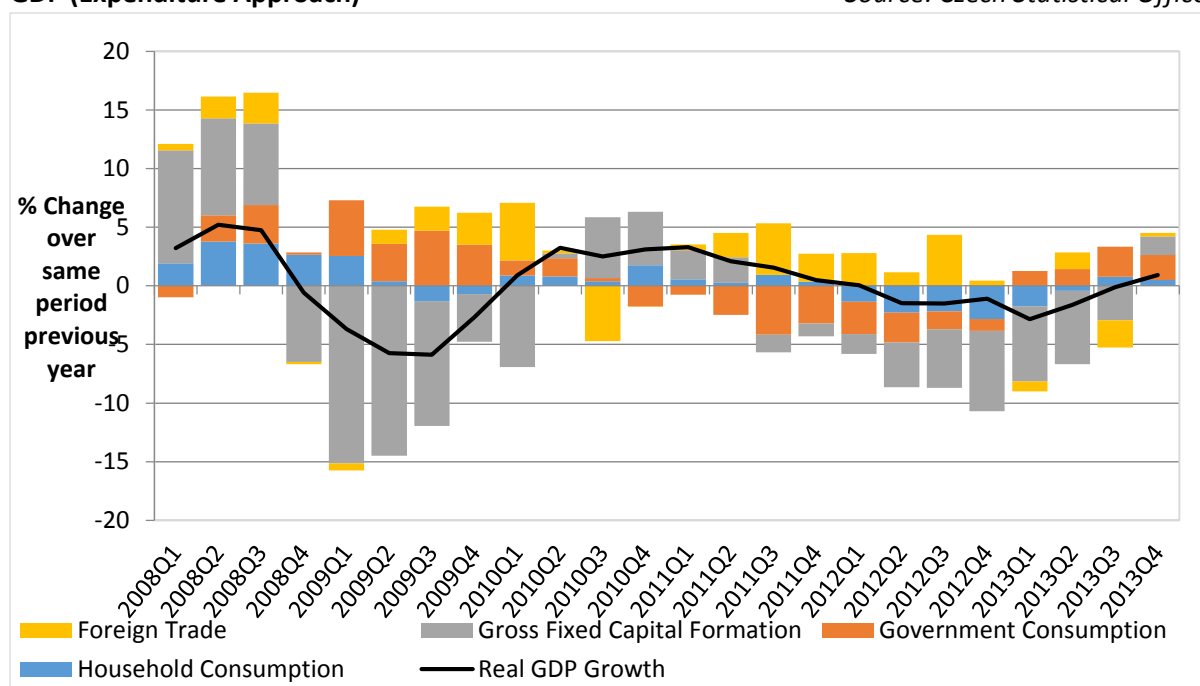
Source: Central Statistical Bureau of Latvia

	2008	2009	2010	2011	2012	2013
<b>Labour Force</b>	1096.9	1068.7	1033.6	1006.7	1006.2	985.9
<b>Total Employed</b>	1008.8	876.8	828.8	840.6	851.8	866.5

## Czech Republic

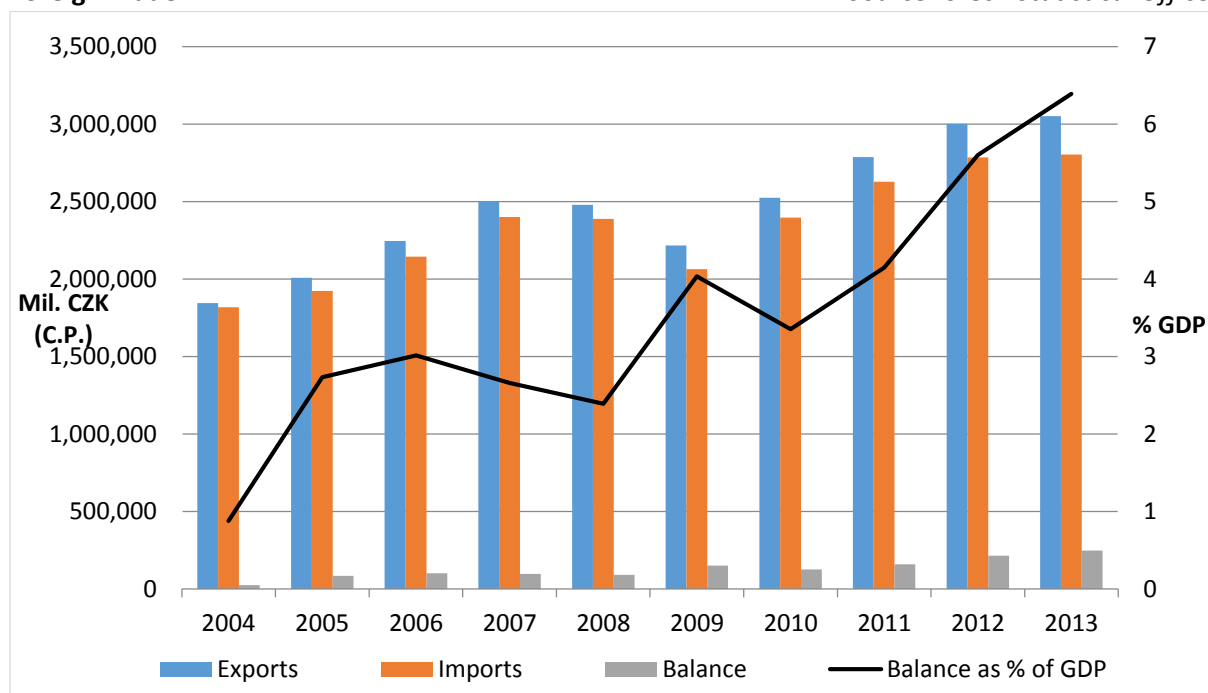
**GDP (Expenditure Approach)**

Source: Czech Statistical Office



**Foreign Trade**

Source: Czech Statistical Office



**Labour Market (Age 15-64: Unit 1000s)**

Source: Czech Statistical Office

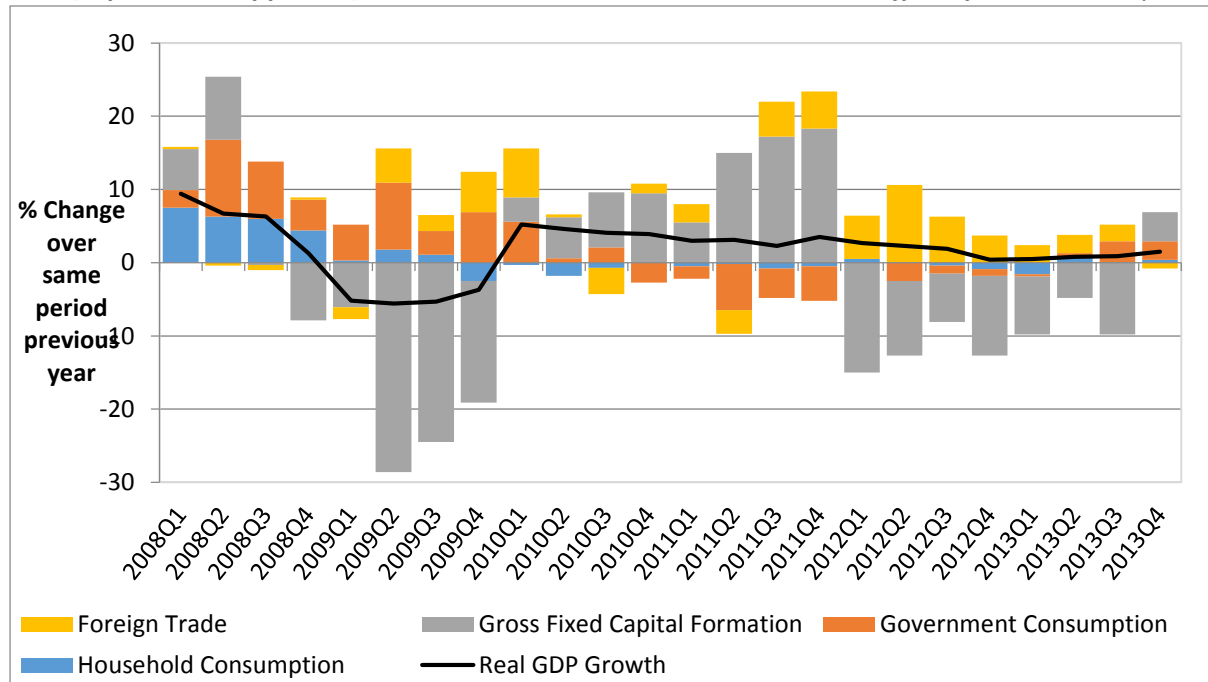
	2008	2009	2010	2011	2012	2013
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## Slovakia

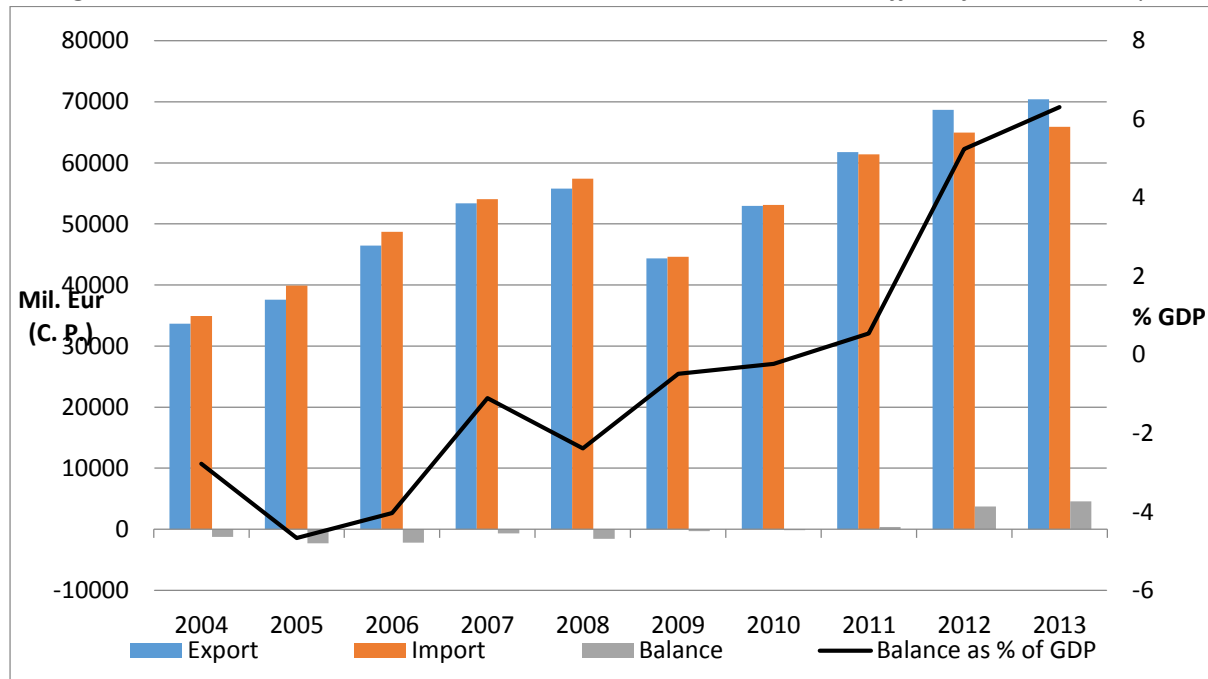
### GDP (Expenditure Approach)

Source: Statistical Office of the Slovak Republic



### Foreign Trade

Source: Statistical Office of the Slovak Republic



### Labour Market (Age 15-64: Unit 1000s)

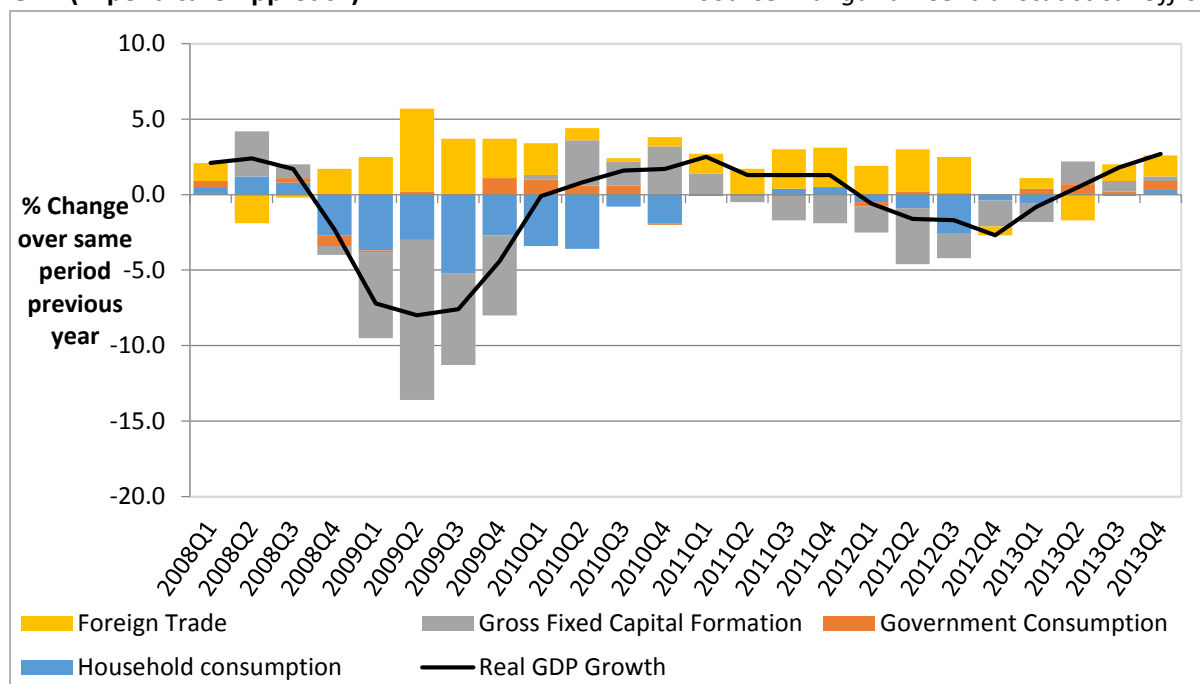
Source: Statistical Office of the Slovak Republic

	2008	2009	2010	2011	2012	2013
<b>Labour Force</b>	2680.8	2680.2	2695.9	2667.5	2694.5	2703.3
<b>Total Employed</b>	2423.7	2356.2	2307.4	2303.4	2317.5	2317.7

## Hungary

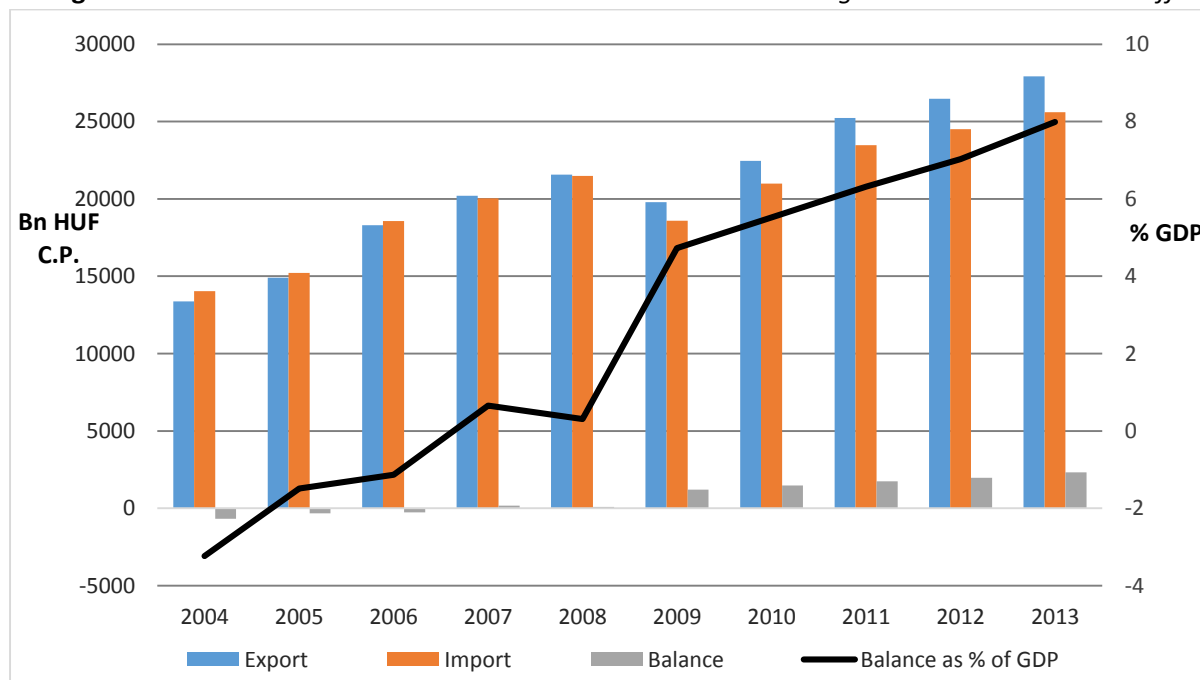
### GDP (Expenditure Approach)

Source: Hungarian Central Statistical Office



### Foreign Trade

Source: Hungarian Central Statistical Office



### Labour Market (Age 15-64: Unit 1000s)

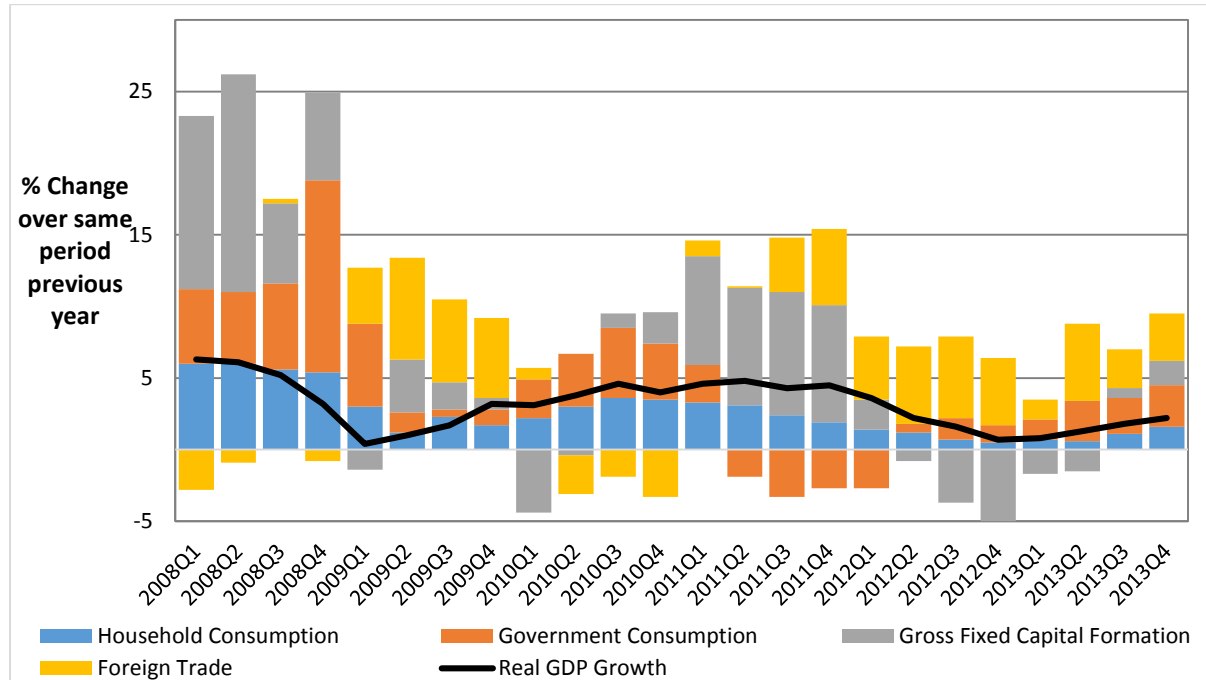
Source: Hungarian Central Statistical Office

	2008	2009	2010	2011	2012	2013
<b>Labour Force</b>	4177.9	4171.6	4224.6	4246.6	4317.5	4354.7
<b>Total Employed</b>	3849.2	3751.2	3750.1	3779	3842.8	3906.3

## Poland

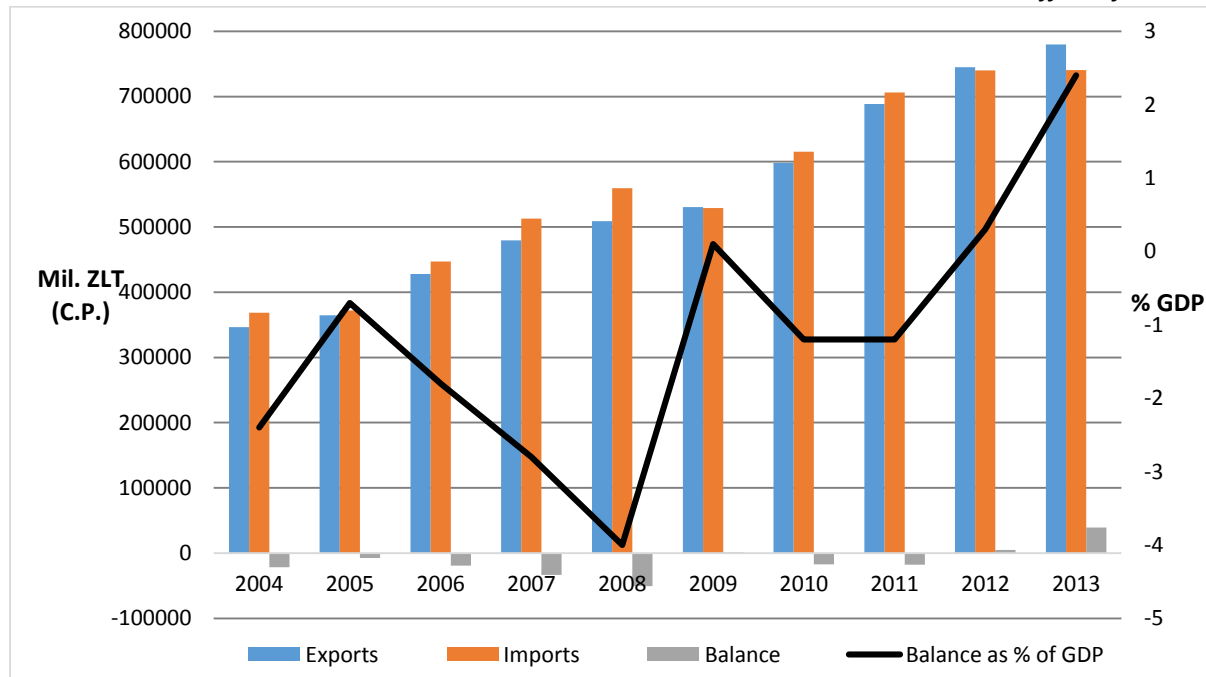
### GDP (Expenditure Approach)

Source: Central Statistical Office of Poland



### Poland - External Trade

Source: Central Statistical Office of Poland



### Labour Market (Age 15-64: Unit 1000s)

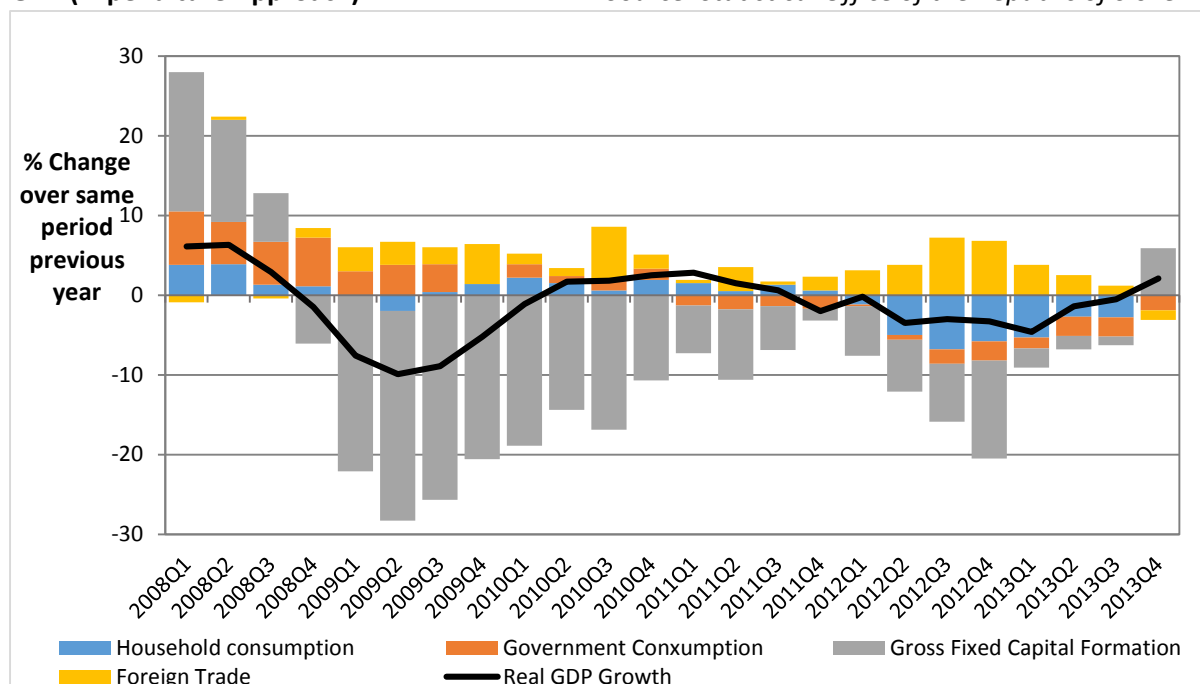
Source: Central Statistical Office of Poland

	2008	2009	2010	2011	2012	2013
<b>Labour Force</b>	16764.75	17039	16878.5	16968.25	17085.8	17101.5
<b>Total Employed</b>	15557.4	15629.5	15233	15312	15340.3	15313.3

## Slovenia

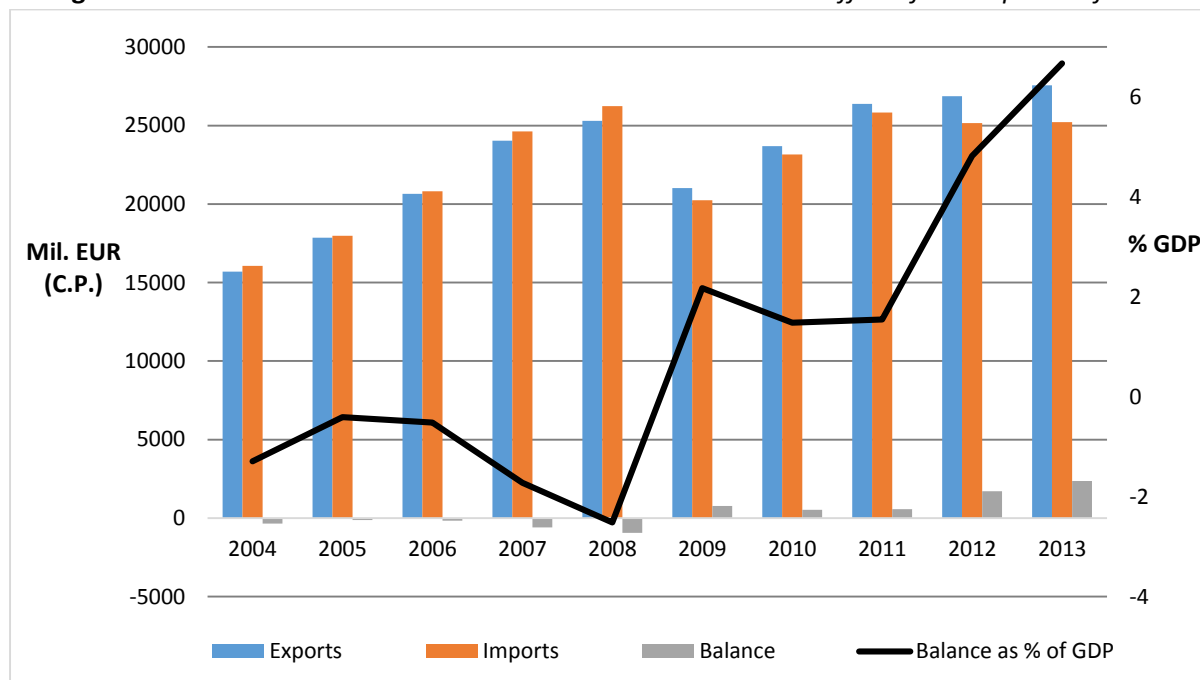
### GDP (Expenditure Approach)

Source: Statistical Office of the Republic of Slovenia



### Foreign Trade

Source: Statistical Office of the Republic of Slovenia



### Labour Market (Age 15-64: Unit 1000s)

Source: Statistical Office of the Republic of Slovenia

	2008	2009	2010	2011	2012	2013
<b>Labour Force</b>	1021	1016	1017	998	997	989.9
<b>Total Employed</b>	975.2	954.8	941.5	914.8	906.5	888.1

Appendix II – Fiscal Adjustment

	Changes on the Revenue Side 2008-2013							Changes on the Expenditure Side 2008-2013					Score	
	CIT	PIT	Social Security	VAT	Targeted taxes (property, wealth)	Public consumption: Education	Public consumption: Healthcare	Cash transfers: Pensions & Disability	Cash transfers: unemployment	Cash Transfers: Family				
<b>Estonia</b>			---	-			--	--						-2
<b>Latvia</b>			---	--	++	---	---	--	---	---				-2.36
<b>Lithuania</b>			--	-	+	--	---	---	--	---				-1.75
<b>Czech R.</b>	-	+		-	+		-	-	---	+				-0.54
<b>Slovakia</b>	++	++	---	-			-			++				0.17
<b>Poland</b>		-	-	-		-	--	--		+				-0.8
<b>Hungary</b>	++		--	---		-	---	---	--					-1.43
<b>Slovenia</b>	-	+++	+	-	+++		-	-	+	-				1.08