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Capitalist Diversity on Europe's Periphery

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Nation Builders and Neoliberals

The Baltic States

The Baltic states stand out for their convergence on radical neoliberal macroeconomic, structural, and social policies. Fast liberalization of foreign trade and investment, fixed exchange rate regimes, tight monetary policies, and rapid privatization have been the hallmark of their transformation strategies. Although the Baltic countries have experienced some of the most severe transformational recessions, they have done little to mitigate the accompanying social hardship. They have also been barely concerned with protecting inherited industries. As a consequence, their industrial capacities have greatly diminished. In contrast, financial, real estate, transport, and communication services have boomed and have attracted the bulk of inward FDI.

Reform radicalism in the subregion has been intrinsically tied to the agenda of nation-state building. Baltic elites saw national independence as their highest priority. They were united in considering Russia's economic and political influence as the biggest threat to their national sovereignty and security. Their transformation strategies aimed at a radical departure from the past, responded to perceived needs of independent statehood, and served the purpose of forging national identities. Due to the shared belief in the urgency of (re)building their nations, Baltic elites were less constrained by the economic and social costs of radical transformation than was the case in other East Central European countries.

Although all three Baltic states have been champions of neoliberalism, they have differed with respect to the speed and coherence of reforms. Estonia has implemented the most comprehensive strategy and has been the first mover in major reform areas, thereby influencing the other two countries. Typically, Latvia has come in a close second, while Lithuania has tended to lag behind. Moreover, in important instances Lithuania has chosen neoliberal solutions only as a result of prolonged political struggles. We see three

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sets of factors that account for the differences amidst the similarities of neoliberalism in the Baltic states.

First, while political elites in all three countries have been engaged in the process of nation-state building cum decolonialization, which has provided the rationale for overall radical strategies, Estonian and Latvian power holders have in addition pursued a nationalizing project to reverse the effects of the massive influx of Russian speakers in Soviet times. Nationalizing, as Rogers Brubaker has put it, aims at "a state of and for a particular ethnocultural 'core nation' whose language, demographic position, economic welfare and political hegemony must be protected and promoted by the state."[1] The nationalizing projects also shaped the party systems in both countries, as they prevented the emergence of parties or governments—in Estonia and Latvia, respectively—that would propose alternatives to the adopted reform paths.

Second, the form and speed of transnational integration can account for some of the differences among the three countries. Estonia was picked early on by Finnish and Swedish investors as a preferred location, which gave it a head start over the two other countries in attracting FDI. In contrast, Latvia banked more heavily on its role as an entrepôt economy for the Russian hinterland by delivering intermediary services for Russia in its transactions with the European economy. Lithuania stands out for its initially limited access to Western capital and its most protracted reliance on domestic sources and continuing trade relationships with Russia and other parts of the former Soviet Union. The initial difference between Estonia and the two other countries was later acknowledged by the EU, which originally picked Estonia as the single Baltic state to join the first wave of countries to start entry negotiations. Thus, in Estonia the nationalizing project that undermined opposition to neoliberalism, and relatively favorable terms of transnational integration, conspired to produce the most consistent neoliberal reform path.

Finally, there has been a regional rationale for neoliberal regime formation, best described by a follow-the-leader logic. Estonia has been considered as the pace-setter for reforms, and its advances have often served as models for the other two Baltic states.

This chapter presents the policy packages chosen by the Baltic governments to master the transformation, and explains the domestic, regional, and international dynamics that account for the specificities. Furthermore, we shall elaborate on the social and economic consequences of these strategies, and on the sources of their support despite the hardships they imposed on the Baltic populations. Both the similarities and the differences among the Baltic states will be discussed.

1. Brubaker, *Nationalism Reframed,* 105. For a similar interpretation see James Hughes, " 'Exit' in Deeply Divided Societies: Regimes of Discrimination in Estonia and Latvia and the Potential for Russophone Migration," *Journal of Common Market Studies* 43, no. 4 (2005): 739–62.

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Origins of the National and Nationalizing Projects

When at the end of the 1980s Baltic historians challenged the official Soviet account of their countries' incorporation in the USSR, they heralded a crucial turning point in Soviet-Baltic relations.[2] The subsequent political mobilization against this unlawful action boosted the quest for Baltic national independence, and paved the way for an official and popular reinterpretation of communism as a period in which the republics had been subject to illegal foreign occupation. Reformers in the three countries agreed upon the need to regain the Baltic states' "Europeanness" undermined by Russia, which they defined as a non-European power.[3] Their view invoked the memory of a golden presocialist past, which would serve as a guideline for the postsocialist future, and stressed an inherent right to national self-determination. Reflecting variations in their history under the Soviet empire, however, they differed in their perceptions of how much the changes inflicted by Soviet occupation had put major features of their national identities at risk. Two issues stand out.

First, under Soviet rule both Latvia and Estonia recorded a massive immigration of Russian-speaking workforce. Thus, whereas in 1945, some 95 percent of the Estonian population belonged to the titular nation, in 1989 the proportion was only 61.5 percent. The respective numbers for Latvia were more than 80 and 52 percent. This stands in contrast to Lithuania, where the share of the titular nation was 79.6 percent in 1989. In 1989, Eastern Slavic groups (most importantly Russians, but also Belorussians and Ukrainians) made up 35 percent of the Estonian, 42 percent of the Latvian, and 11.5 percent of the Lithuanian population.[4] These trends were even more accentuated in the capital cities. By 1980, the share of ethnic Estonians in Tallinn had dropped to slightly more than 50 percent, the share of Latvians in Riga to barely 40 percent, whereas the share of Lithuanians in Vilnius increased from 33 percent in 1959 to 47 percent in 1980.[5]

These trends were cited by Estonian and Latvian radical nationalists when they defined the Russian minorities as threats to the mere survival of their nations. An official of the Latvian People's Front entitled an appeal to the

2. According to the official Soviet interpretation "Stalin's motives for signing the Non-Aggression Pact with Hitler in 1939 were purely intended to secure peace, and . . . the peoples of the Baltic states welcomed their incorporation into the Soviet Union as an alternative to the continuation of the authoritarian rule in their own respective republics." Graham Smith, "The Resurgence of Nationalism," in *The Baltic States: The National Self-Determination of Estonia, Latvia and Lithuania,* ed. Graham Smith (New York: Macmillan, 1994), 132.

3. Abdelal, *National Purpose,* 10–11, 84.

4. Ole Norgaard, Dan Hindsgaul, Lars Johannsen, and Helle Willumsen, *The Baltic States after Independence* (Cheltenham: Edward Elgar, 1996), 172–73.

5. Romuald J. Misiunas and Rein Taagepera, *The Baltic States: Years of Dependence, 1940–1990* (Berkeley: University of California Press, 1993), 216.

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world in 1990: "The Latvian Nation and the Genocide of Immigration."[6] In a similar vein, the head of Estonia's first freely elected government and architect of the country's radical reforms, Mart Laar, commented: "The Nazi 'General Plan Ost' had envisaged 520,000 German colonists to reside in the Baltic States by 1965. Instead, by that date, the Baltic countries had received over a million Russian colonists. Soviet reality surpassed Nazi plans."[7]

Second, during socialism, Lithuania had been much more successful in building up a national ruling elite than Latvia and Estonia. Its Communist Party leaders were native Lithuanians, who consciously packed the republic's top posts with members of the indigenous population. Communist Party rank and file were predominantly Lithuanian too. In contrast, the Latvian and to a lesser degree the Estonian Communist Party leadership and top administration had been in the hands of ethnic Russians, or Latvians and Estonians born and/or educated in Russia. Party membership was also less frequent among ethnic Latvians and Estonians.[8]

As a consequence of these different legacies, Estonian and Latvian reform elites more than those of Lithuania perceived their newly independent states as "unrealized" nation-states, and actively tried to reverse the former trends, which they saw as having led them away from their paths towards nation building. Premier Laar expressed this aspiration well with his suggestion that "transition is somehow some kind of 'return to the future.' Transition turns these countries back to the point at which their normal development was stopped by forceful sovietization."[9] Rather than just building nation-states, political actors in these two countries became engaged in nationalizing projects. The nationalizing agendas have left their most distinctive traces on the new democratic institutions, leading to exclusionary democracies in Estonia and Latvia, in contrast to Lithuania's inclusive democracy. In turn, the different systems of democratic governance have influenced economic and welfare policies, and the management of related social and political tensions.

Exclusionary and Inclusionary Democracies

One of the first crucial choices the nationalist movements in the Baltic republics had to make concerned the question of who would constitute the new states' citizenry. As is well known, ultimately both the Estonian and Latvian movements embraced a legal restorationist solution. According to this interpretation, the Baltic republics differed from other parts of the Soviet Union

6. Quoted in Dreifelds, *Latvia in Transition,* 144.
7. Laar, *Estonia,* 37.
8. Misiunas and Taagepera, *The Baltic States,* 204–8, 274–81, 359–60; Anton Steen, "The New Elites in the Baltic States: Recirculation and Change," *Scandinavian Political Studies* 20, no. 1 (1997): 91–112.
9. Laar, *Estonia,* 22.

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similarly engaged in struggles for more autonomy, reforms, and ultimately independence, since these states had been unjustly occupied and thus had the right to restore their independence fully and immediately. Concomitant to this, legal restorationism also claimed that citizenship could only be granted to citizens of the republics prior to occupation and their descendants, thus excluding all Soviet-era immigrants.

The Estonian Supreme Council embraced the legal restorationist doctrine in 1991. Specific policy implications of the principle were confirmed in a referendum in 1992. As a consequence, about 40 percent of the inhabitants of Estonia were denied citizenship. In Latvia, a similar decision by the Supreme Council left roughly 25 percent of the resident population without Latvian citizenship.[10] Over the 1990s, both countries adopted naturalization laws establishing the procedures by which Russian speakers could acquire Baltic citizenship. Restrictive language laws, frequent amendments, and procrastination in passing these laws have, however, led to slow progress in naturalization. In Estonia after 1993–96 the initial wave of naturalization ebbed. In 2003, some 12 percent of the resident population still did not have any citizenship at all, and around 7 percent had opted for Russian citizenship.[11] Progress was even slower in Latvia. The first significant wave of naturalization occurred as late as in 1999–2001. Even so, in 2003 22 percent of Latvian residents were still noncitizens. A second wave of naturalization coincided with Latvia's EU membership from 2004.[12]

Notwithstanding the large size of the minority population in Estonia and Latvia, the restrictive stance on the citizenship issue was not a foregone conclusion but a matter of choice emerging from political conflicts. Anatol Lieven describes the exclusion of non-Baltic Soviet citizens from the new states as a result of a "protracted duel between the proponents of the First and Second Republic," that is, between the legal restorationists and those who believed that the new states should be built on existing realities and thus should include all residents. Initially, the popular fronts in both countries adopted a moderate stance, with some fractions supporting a "zero option" that would base citizenship on territorial rather than ethnic attributes. This was the choice made in Lithuania. During the independence struggle, however, radical nationalists organized in the Citizen Committees emerged as

10. Norgaard et al., *The Baltic States* (1996), 65, 69. The relatively low number of Russians denied citizenship in Latvia is due to the fact that a significant share of the Russian-speaking population had already held citizenship in the interwar state.

11. Mikko Lagerspetz and Henri Vogt, "Estonia," in *The Handbook of Political Change in Eastern Europe,* ed. Sten Berglund, Joakim Ekman and Frank H. Aarebrot (Cheltenham: Edward Elgar, 2004), 75–76; and Estonia.eu. Official gateway to Estonia. Citizenship, http://estonia.eu/about-estonia/society/citizenship.html (accessed August 1, 2011).

12. Hermann Smith-Sivertsen, "Latvia," in Berglund, Ekman, and Aarebrot, *The Handbook,* 102–3; Minister of Foreign Affairs of the Republic of Latvia, "Citizenship in Latvia" (May 21 2010), http://www.mfa.gov.lv/en/policy/4641/4642/4651/ (accessed August 1, 2011).

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powerful contenders to the more moderate forces in Estonia and Latvia, and ultimately their restorationist position prevailed.[13]

The denial of citizenship to large sections of the Russophone population had important repercussions for Estonia's and Latvia's democracies. It transferred political power to an overwhelmingly ethnic Baltic citizenry, and excluded a large share of the resident population from the right to participate in the democratic polity, as "non-citizens cannot form political parties, run for political office or vote in national elections."[14] This exclusion has undermined the capacity of the party system to represent popular interests. While the literature has been divided on the issue of how far postcommunist party systems are at all able to shape cleavages and represent voters, there is little doubt that Estonian and Latvian parties are among the least representative in terms of encompassing all of their territorial populations. Two combined and closely interrelated factors can account for this.

First, the restrictive citizenship laws greatly diminished the electoral base for parties representing industrial labor's interests. Russian speakers, many of whom worked in the inherited socialist industries, were overall more supportive of left-wing parties than their ethnic Baltic counterparts.[15] However, the electoral chances of the pro-Russian and left-oriented parties have been severely impeded, as most Russians could not vote while ethnic Baltic citizenry did not turn out in great numbers to support such parties. Moreover, different stances on the issue of independence divided Latvia's two pro-Russian parties. In addition to artificially limiting the core constituency for left-wing parties, issues of nationality and independence have more generally constrained formation of parties that would compete on a Right-Left scale. As Hermann Smith-Sivertsen writes: "Party names tell a story too. In Latvia, not a single party claiming to be socialist, social democratic, workers' or representing the underprivileged or defrauded won significant support in the 1993 and 1995 elections."[16] Instead, parties often chose names evoking patriotic sentiments.

13. Anatol Lieven, *The Baltic Revolution: Estonia, Latvia, Lithuania, and the Path to Independence* (New Haven: Yale University Press, 1993), 216, 274; Graham Smith, Adne Aasland, and Richard M. Mole, "Statehood, Ethnic Relations and Citizenship," in Smith, *The Baltic States,* 181–205; and Vello Pettai and Klara Hallik, "Understanding Processes of Ethnic Control: Segmentation, Dependency and Co-optation in Post-Communist Estonia," *Nations and Nationalism* 8, no. 4 (2002): 505–29.

14. Hughes, " 'Exit,' " 745. In Latvia noncitizens can be members of political parties.

15. Survey data from the New Baltic Barometer give ample evidence that Russian speakers in Latvia and Estonia are stronger inclined to vote for social democratic or left-wing parties than ethnic Balts: see Richard Rose, "New Baltic Barometer V: A Pre-enlargement Survey," Studies in Public Policy 368 (Glasgow: Centre for the Study of Public Policy, University of Strathclyde, 2002), 30; Richard Rose, "New Baltic Barometer III: A Survey Study," Studies in Public Policy 284 (Glasgow: Centre for the Study of Public Policy, University of Strathclyde, 1997), 41–43.

16. Smith-Sivertsen, "Latvia," 99. More precisely, the electoral alliance "Equal Rights" won 5.8 percent of the vote and entered parliament with seven seats in 1993. They were generally

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Second and closely related, the Communist Parties collapsed in Estonia and Latvia. In this way, the only parties that had a membership to speak of were wiped out from the emerging party systems. As a consequence, even more than was the case in other postsocialist states, the new Estonian and Latvian parties originated from elite circles representing at best only a section of civil society. They barely had members, and have not been capable of undertaking or willing to undertake efforts to build up stronger organizational links with the electorate. By way of example, Latvia's Way—a party that played a crucial role in forming and sustaining Latvian governments during the first decade of independence—had only 173 members in 1994. What is more, the party was "created specifically for the purpose of unifying the Latvian elite" with the aim of representing elite interests in efficient policymaking unhampered by lengthy parliamentary debates.[17]

Following Richard Katz and Peter Mair, it can be said that a party of the above kind will inevitably emphasize the tasks of a "party in public office" versus those of a "party on the ground."[18] But more precisely, what Estonian and Latvian parties seem to be all about is to serve as vehicles to transfer "persons in public office." In both countries, the party landscape has been in constant flux because of the " 'political tourism' practiced by organizationally disloyal postcommunist politicians," or newcomers to politics, who have been constantly engaged in party switching, fusion, fission, or start-ups.[19]

Iconic leaders of the independence movement and early reformers, central bankers, successful businessmen and "oligarchs," as well as maverick émigrés, have all been among party builders. Competition for office has been intense—the more so that it has occurred in a highly uncertain and unstructured context, within which virtually anybody could cherish hopes of victory. Rather than reflecting solid ideological polarization, competition has been driven by barely concealed personal ambitions for power. Conversely, coalition governments have not been built on programmatic harmony but oftentimes on alliances against rival personalities.[20]

The specificities of the Estonian and Latvian party systems come to the fore when compared to that of Lithuania, which has not suffered from the

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seen as the remnants of the pro-Moscow Communist Party and as struggling for the socialist legacy. Moreover, even when the group was reorganized into the Socialist Party in 1995 it won 5.6 percent and five seats.

17. Ole Norgaard, Lars Johannsen, Mette Skak, and Rene Hauge Sorensen, *The Baltic States after Independence* (Cheltenham: Edward Elgar, 1999), 79.

18. Richard Katz and Peter Mair, "The Ascendancy of the Party in Public Office: Party Organizational Change in Twentieth-Century Democracies," in *Political Parties: Old Concepts and New Challenges,* ed. Richard Gunther, Jose R. Montero, and Juan Linz (Oxford: Oxford University Press, 2002), 113–36.

19. Marcus Kreuzer and Vello Pettai, "Patterns of Political Instability: Affiliation Patterns of Politicians and Voters in Post-Communist Estonia, Latvia, and Lithuania," *Studies in Comparative International Development* 38, no. 2 (2003): 77–78.

20. Axel Reetz, *Die Entwicklung der Parteiensysteme in den baltischen Staaten: Vom Beginn des Mehrparteiensystems 1988 bis zu den dritten Wahlen* (Wittenbach: Wilhelm Surbir, 2004), 185–90.

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birth defect of disenfranchisement of social groups most negatively affected by transformation. Lithuania adopted the "zero option" in respect of citizenship. Leaders of the Sajudis, the Lithuanian popular front, saw this as a means to "harness the support of the non-indigenous population" to the cause of independence. Although it was made clear that this solution did not invalidate prewar Lithuanian citizenship, "thereby acknowledging the fact that the Republic of Lithuania was a restored and not a new state," president of Sajudis Vytautas Landsbergis resisted the radical nationalist voices for a referendum on citizenship during the struggle for independence.[21] Lithuania's language law also demonstrates the country's commitment to a multiethnic polity. For example, the law stipulates that in communities with populations more than a third of which is non–Lithuanian-speaking, public institutions are obliged to conduct their business in the minority as well as the majority language.[22] Concomitant to this, Lithuania's democratic polity lacks the exclusive features so characteristic of the two other Baltic countries.

Lithuania's Communist Party successfully transformed itself into a new democratic labor party, the Lithuanian Democratic Labor Party (LDDP) early on. In turn, the challenge of the postcommunist party's inherited organizational and membership strength forced its major contender, Sajudis, to reorganize itself as a political party, the center-right Homeland Union. In terms of membership, the Homeland Union was to overtake the LDDP by the mid 1990s. While differences in party membership across the Baltic states remain trivial, initially the Lithuanian party system was somewhat more structured than that of its neighbors. At least in the first decade after independence, only a few parties mattered for politics and the party system remained highly polarized rather than excessively fragmented. Further, elections have produced clear majority governments enabling partisan political choices.[23]

As we will see below, the initial differences among the Baltic democracies and party systems have affected the politics of reform. In Lithuania, crucial institutional and economic decisions did not become depoliticized from the outset, but were only taken after protracted political debates. They also reflected partisan preferences, and to some degree the influence of party constituencies. This has resulted in a somewhat more open and gradual transformation path than was the case in the other two countries.

21. Smith, Aasland, and Mole, "Statehood," 183.

22. Ibid., 192. The Estonian Constitution technically allows the use of minority languages in government administration in areas with more than half of whose population belongs to minorities, but this stipulation has never been formally enacted.

23. Hermann Smith-Sivertsen, "Why Bigger Party Membership Organisations in Lithuania than in Latvia 1995–2000?" *East European Quarterly* 38, no. 2 (2004): 215–59; Ingrid van Biezen, Peter Mair, and Thomas Poguntke, "Going, Going . . . Gone? The Decline of Party Membership in Contemporary Europe," *European Journal of Political Research* (2011), onlinelibrary.wiley.com/doi: 10.1111/j.1475–6765.2011.01995; Kreuzer and Pettai, "Patterns of Political Instability." It is interesting to note that party membership in Estonia increased over the 2000s due to a change in the party finance law.

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The Politics of Early Economic Reforms

Parties and governments in the Baltic states faced a significantly larger problem load than the political leaderships of many other countries, as they had to master all the challenges of what Claus Offe called a “triple transformation” to nation-state, market economy, and democracy.[24] The combined impact of the problem load and the overarching purpose of transformation—national independence interpreted as decolonization—have created ample incentives as well as opportunities for reformers to choose radical and seemingly simple solutions. Not only did these options contribute to the extraordinary depth of the transformational recession, but they have also tied the hands of politicians ever since.

National Money and Stability Culture

The single most important policy choice in this respect was the rapid introduction of national currencies, viewed as foundations for economic independence, powerful symbols of national identity and sovereignty, and the related institutionalization of the independence of newly established central banks with their powers curtailed in Estonia and Lithuania by the establishment of currency boards. The currency reforms occurred against the background of increasing monetary chaos in the final years of the Soviet Union, which forced many ex-Soviet republics to leave the ruble zone even before its final collapse in the summer of 1993. Yet the Baltic states were the first to unambiguously and enthusiastically endorse the idea of introducing national currencies. Estonia (re)introduced the kroon in June 1992, Latvia followed with the lats in March 1993, and Lithuania with the litas in June 1993.[25]

Estonia had prepared for monetary reforms long beforehand, and moved ahead in the most determined fashion. As early as September 1987 a group of economists published a reform proposal that aimed at transferring as many economic powers as possible to the republic. Called IME (the acronym for self-management but also meaning “miracle” in Estonian), the program proposed republican management of taxes, budgets, and property; the authorization of different forms of property including foreign ownership; and more independence in financial and monetary policies. The document also included the suggestion of introducing a national currency. In 1990, the Estonian Supreme Council (re)established the Bank of Estonia. A Monetary Reform Committee was formed, led by Premier Edgar Savisaar. Its mandate was to decide together with the central bank about the necessary steps toward transition to an independent currency. These two institutions became home

24. Offe, “Capitalism by Democratic Design?” 865–92.
25. Lieven, *Baltic Revolution,* 357; Abdelal, *National Purpose,* 46–49.

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to Estonia's most ardent promarket forces, including a group of émigrés residing in Sweden, the United States, and Canada.

The committee eventually settled on a currency board regime, a highly restrictive fixed exchange rate arrangement.[26] Currency board regimes de facto rule out the mediating role central banks assume between external and domestic monetary requirements. Control over monetary policy is placed in the board, which operates separately from the central bank. Its mandate is to convert all national currency offered to it into the reserve currency (and vice versa) at a fixed rate. The domestic money supply is regulated by foreign exchange, as it can only be changed in connection with changes in foreign currency reserves. Discretionary monetary policy is thus precluded. The central bank cannot offer credit to enterprises and the government, and only in exceptional circumstances is it allowed to lend to banks. Thus, it cannot assume the role of lender of last resort.

Estonia also invented a strong protective device against possible future temptations to devalue its currency by issuing futures contracts guaranteeing the same exchange rate for up to eight years ahead. Any devaluation of the currency would, therefore, come at extremely high cost. Estonia decided to peg the kroon to the deutschmark, allowing fluctuation within a 3 percent margin. Initially, it backed its currency mostly with gold reserves deposited in Western banks before 1940 and transferred back to Estonia after independence.

From an international political economy perspective it could be questioned whether the adoption of the currency board followed a domestic economic rationale. From this viewpoint it would seem that these measures were the result of Estonia's and the other Baltic states' quest for international creditworthiness, reinforced by advocacy on the part of the central bankers' transnational epistemic community. In this vein, Juliet Johnson argues that across East Central Europe the process of rapidly instituting national currencies and refashioning the inherited authorities as independent central banks or currency boards "by and for international actors . . . occurred without the need to build extensive domestic support for the new institutions."[27]

Although considerations of international creditworthiness certainly played a major role, neither the suggested overwhelming importance of foreign pressures nor the assumption of lacking domestic political support sits

26. On the introduction of the currency board in Estonia see Seiga Lainela and Pekka Sutela, "Introducing New Currencies in the Baltic Countries," in *The Transition to Market Economy: Transformation and Reform in the Baltic States*, ed. Tarmo Haavisto (Cheltenham: Edward Elgar, 1997), 66–95; Adalbert Knöbl, Andres Sutt, and Basil Zavoico, "The Estonian Currency Board: Its Introduction and Role in the Early Success of Estonia's Transition to a Market Economy," IMF Working Paper WP/02/96 (Washington, D.C.: International Monetary Fund, 2002).

27. Juliet Johnson, "Post-Communist Central Banks: A Democratic Deficit?" *Journal of Democracy* 17, no. 1 (2006): 91.

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well with the evidence of the Baltic countries' strict adherence to the "stability culture."[28] First, initial support for the new currencies and monetary policy institutions could not mainly stem from international backing, as in Estonia crucial decisions were taken in 1992, even before massive external pressure or assistance could materialize. Indeed, Premier Laar recalled that during the spring of 1992 the IMF "initially urged Estonia to postpone monetary reform until its technical capabilities were more advanced."[29] Second, as to the often noted presence and pressure of émigré policy advisers, the fact that Estonia's exclusive Monetary Reform Committee included Jeffrey Sachs's former student Ardo Hansson (who, holding a very fresh Ph.D., hardly could be viewed as a senior representative of global academic and financial circles at the time), seems less a proof of powerful external influences than of a preexisting domestic consensus favoring radical solutions.

Third, at the turn of the 1990s, the currency board arrangement still seemed to be an outdated remainder of a distant past. While currency boards had once been common in the colonies of the nineteenth-century British empire, they all but vanished with decolonization.[30] At the time of its adoption in Estonia, the institution had just started to get more attention in the international neoliberal policy community. It was first adopted in the 1980s in Hong Kong, to reassure investors in light of the territory's return to China, and then made its way to Argentina where a currency board was seen as a possible solution against hyperinflation. In both cases, members of the neoliberal Mont Pelerin Society (MPS) were instrumental in bringing this institutional solution about. Society members Steve Hanke and Kurt Schuler developed a blueprint for monetary stability in Argentina, and subsequently also for Yugoslavia and the former Soviet Union.

It is interesting to note that Kurt Schuler had just started his Ph.D. thesis on the issue when the socialist system broke down. His advisor was George Selgin of Georgia University, who, together with Lawrence White, was a key person advocating "free banking," a system of competitive note issue by private banks. In the nineteenth and early twentieth centuries, free banking had been supported by some liberals against the emergence of central banks and the gold standard. In the 1970s the idea was famously invoked by Friedrich August von Hayek, who advocated the elimination of national currencies in

28. We take the term from Geoffry Underhill, "Global Integration, EMU, and Monetary Governance in the EMU: The Political Economy of the 'Stability Culture,' " in Dyson, *European States and the Euro*, 31–52.

29. Laar, *Estonia*, 114.

30. For the history of currency boards, see John Williamson, *What Role for Currency Boards? Policy Analyses in International Economics* (Washington, D.C.: Institute for International Economics, 1995), 7; Anna Schwartz, "Do Currency Boards Have a Future?" Occasional Paper 88 (London: Institute of Economic Affairs, 1992); Dieter Plehwe, "Transnational Discourse Coalitions and Monetary Policy Reform in Argentina: The Limited Powers of the 'Washington Consensus,' " *Critical Policy Studies* 5, no. 2 (2011): 127–48.

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order to "protect money from politics."[31] Free banking was the most radical neoliberal vision of a depoliticized and denationalized currency system. From the vantage point of free banking advocates, currency boards (albeit still short of an optimal regime) presented at least a middle-of-the-road solution between the disapproved central bank arrangement and the cherished but still unavailable system of private bank currencies.[32]

One of the Estonian reformers' main reasons for settling on the currency board solution was precisely the feature that even if tied to national currency, this institution went furthest in isolating money from politics. Moreover, institutional insulation of monetary policy resonated well with the more general nationalist sentiment that the cause of national independence ought to be removed from the everyday struggles of democratic politics. This symbolic connection was also important because the technicalities and risks of the new monetary authority and instruments had been hardly intelligible for politicians, let alone ordinary citizens. On this aspect Premier Laar recalls that "The fact that politicians that outwardly supported the currency board were at the same time sure that after monetary reform the central bank would continue to deliver 'cheap credits' to inefficient factories and collective farms indicates that many politicians probably never understood exactly what they supported."[33]

In a similar vein, the enthusiastic reception of the stable kroon elevated the symbolic status of the monetary authority and enhanced the popularity of central bankers as nation builders. It was on these grounds that the Bank of Estonia's governor in 1991–95, Siim Kallas could build political capital around his role as "father of the national currency." In 1994, while still in office at the Bank of Estonia, he founded the Reform Party which came in second in the 1995 parliamentary elections and later became Estonia's most influential political party.

The currency board's echo of the gold standard has further contributed to its attraction. Indeed, Kallas was originally attracted "to the transparency and high degree of confidence associated with the gold standard, under which Estonia had achieved a period of monetary stability during the period 1927–33." However, recognizing that in the new international environment the gold standard was impractical, Kallas opted for the currency board as its closest substitute, which he "associated with the same transparency and

31. Friedrich August von Hayek, *Denationalization of Money—The Argument Refined* (London: Institute for Economic Affairs, 1990), quoted by Eric Helleiner, "Denationalising Money? Economic Liberalism and the 'National Question' in Currency Affairs," in *Nation-States and Money: The Past, Present and Future of National Currencies,* ed. Emily Gilbert and Eric Helleiner (London: Routledge, 1999), 148.

32. For a discussion of the advantages of a currency board over free banking in the post-Soviet context, see Steve H. Hanke and Kurt Schuler, "Currency Boards and Currency Convertibility," *Cato Journal* 12, no. 3 (1993): 699–701.

33. Laar, *Estonia,* 121–22.

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high degree of confidence."[34] More generally, the currency board solution represented a close match with the program of Premier Laar's nationalist-neoliberal government which sought a decisive break with the communist past through the fast implementation of far-reaching reforms. Reform speed as well as the institutionalization of nonmajoritarian institutions was crucial to prevent possible resistance and backlashes against reform. Institutional choices also had to respond to the lack of local expertise in complex fields such as monetary, fiscal, and macroeconomic policies. The currency board was an ideal match for all these needs. In institutional terms it was relatively simple, it did not require extensive administrative capacity, and it could be put in place fast.

Latvia (re)established its own central bank in 1990. After independence the Bank of Latvia became a full-fledged central bank with the right to issue its own currency. The Latvian central bank was modeled on the German Bundesbank. Among its most important objectives was to ensure price stability, an objective that was pursued with great vigor under one of the founders of the Latvian National Independence Movement, Einars Repse, who was the Bank of Latvia's president from 1991 to 2001. As with the impressive career of Kallas, in the 2000s Repse also founded a party and as a democratic politician capitalized on his previous role as nation-building central banker.

This institutional choice was inspired by memories of Latvia's successful monetary policies of the 1920s and 1930s. Latvia's interwar stabilization had been singled out as a complete success in a study commissioned by the League of Nations in 1936.[35] It had been achieved by "rigid economies in the sphere of public expenditure," by pegging the new currency to gold, and by observing the principle that the central bank should hold sufficient gold or foreign exchange reserves to offset any temporary disturbance in the balance of payments.[36] This experience provided a resource for the postsocialist Latvian central bank presidents to draw on.

In contrast to Estonia, the Latvian central bank decided to first issue an interim currency, the Latvian ruble. It aimed to bring inflation under control before introducing its permanent currency in order to ensure confidence.

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34. Knöbl, Sutt, and Zavoico, "The Estonian Currency Board," 7, 11. Laar gives a similar justification for his currency regime preference. According to him, economic prosperity in the interwar period was associated with the introduction of the kroon. "The economic turnaround occurred with the introduction of currency reform in 1928. The Estonian national currency, the kroon, was established with the aid of a loan from Great Britain and for the next 10 years the value of the kroon remained stable." It seems of minor importance that the economic turnaround of 1928 was soon to be interrupted by the Great Depression, which forced Estonia to go off the gold standard after only five years, to devaluate its currency, and to join the sterling bloc.

35. Brian van Arkadie and Mats Karlsson, *Economic Survey of the Baltic States* (New York: New York University Press, 1992), 158.

36. Royal Institute of International Affairs, Information Department, *The Baltic States: Estonia, Latvia, Lithuania* (London: Oxford University Press, 1938), 131, 171–75.

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The bank was indeed highly successful in stabilizing the Latvian ruble before it introduced the lats in 1993. The lats was initially allowed to float; in 1994 it was pegged to IMF special drawing rights; and in 2002, the peg was changed to the euro. Although Latvia did not opt for a currency board, its central bank policies so closely paralleled the operation of such an institution that an IMF report concluded that "there has been little difference in practice between the CBA [currency board arrangement] in Estonia and the peg in Latvia in recent years, as foreign reserves usually exceed the monetary base in Latvia."[37]

Both countries thus settled on institutional solutions that, albeit different, took monetary policy as far out of the political sphere as possible. There was little public debate in either country over this choice. This was in contrast to Lithuania, which only settled on a currency board after prolonged and intensive political fights; indeed, the currency board has remained at the center of political debate ever since.[38] Like the other two Baltic countries, Lithuania (re)established its central bank in 1990, and prepared to launch its own currency. Before 1993, when the litas was introduced, Lithuania issued an interim currency, the talonas, to cope with a ruble shortage. After launching the litas, the government still brooded for nine months over the final design of the institution that would regulate it. It was only in 1994 that the parliament passed a law introducing the currency board.

The idea of a currency board had long lacked support in Lithuania. Interestingly, the first proposal for such an institution in the postcommunist world was made to Lithuania rather than Estonia, on the occasion of a visit by Schuler and Selgin in 1990. The two economists, joined by Joseph Sinkey, a professor of finance at Georgia University, paid another visit to Lithuania in 1991, and repeated their recommendation. However, the Sajudis government under Gediminas Vagnorius rejected the proposal. Stabilization was not as high on the priority list of the central bank as it was in Latvia.

The currency board idea gained momentum only under the left-wing government of Adolfas Šleževičius in late 1993. The prime minister hoped that it would contribute to the stabilization of the litas and back the international opening of Lithuania's economy. He was supported in this view by the IMF, which was worried about Lithuania's lax monetary policy, as well as by the Lithuanian Free Market Institute. The latter's director, Elena Leontjeva, served as economic adviser to various left- (and right-) wing governments. She was also a close collaborator of Schuler and Hanke.

37. Knöbl, Sutt, and Zavoico, "The Estonian Currency Board," 20.

38. On the Lithuanian currency reform see Lainela and Sutela, "Introducing New Currencies"; Jerome Blanc, "Les conditions d'établissement d'un *Currency Board:* L'exemple Lituanien, 1990–1994," *Revue d'Études Comparatives Est/Ouest* 35, no. 3 (2004): 119–45; and Jerome Blanc and Jean-Francois Ponsot, "Crédibilité et *Currency Board:* Le cas Lituanien," (GdR Économie Monétaire et Financière 0098 du CNRS, 19èmes Journées Internationales d'Économie Monétaire et Bancaire, Lyon, June 6, 2002).

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Subsequently, the issue of the currency board became the object of intense political struggle between the government, the governor of the central bank, the opposition, and the president. Among central bankers, the currency board was seen as a sign of mistrust of their monetary policy and the achievements of the Bank of Lithuania in bringing down inflation. The right-wing opposition was mostly concerned about the constraints put on monetary sovereignty by the institution's automatic features. Moreover, the opposition represented the interests of industrial exporters, who preferred a weak currency to boost their competitiveness. Finally, President Algirdas Brazauskas—allegedly under pressure from commercial bankers who feared that an important part of their revenue would disappear under the currency board—also opposed the project. Thus it was only under the threat of Premier Šleževičius' s resignation that the parliament passed the "Law on the Credibility of the Litas."

The struggle over the currency board continued even after its introduction. The right-wing opposition took the law to the Constitutional Court, claiming that it violated the exclusive right of the central bank to issue banknotes.[39] The court upheld this view, but the law had meanwhile been amended, so that the court's decision had no impact. With the return to power of a right-wing government under Premier Vagnorius in 1996, a second attack on the currency board was staged. The government prepared a plan for a rapid exit. The IMF, however, about to issue a major loan to Lithuania, opposed the plan. In addition, the central bank favored a more gradual exit from the currency board. The central bank's plan finally prevailed, although it was never fully implemented. As a result, at the end of the 1990s, Lithuania had a currency board whose restrictions on monetary policies were slightly lifted, without however affecting the fixed exchange rate and the foreign exchange cover for base money.

Regardless of the different political paths along which national currencies were introduced and of the varying concrete forms in which monetary stability was institutionalized in the three states, the strength of the popular feeling aroused in the process is indicated by Baltic citizens' hopes and fears about the euro in the second half of the 2000s. Eurozone entry, which requires giving up monetary policy autonomy and national currencies, is clearly less compatible with national agendas than the achievement of monetary sovereignty had been. Accordingly, public opinion polls reveal strong attachments to the national currencies. To a larger extent than in other East Central European countries, Baltic citizens' hopes for protection from international crises and strengthened European identity resulting from the changeover to euro seem

39. The law initially stipulated that the decision over the official exchange rate and the anchor currency should be taken by the government in coordination with the central bank. This was seen as an unconstitutional constraint on the emission of banknotes by the central bank. Blanc and Ponsot, "Crédibilité et *Currency Board*," 7.

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TABLE 3.1
Hopes and fears about the euro: Baltic and other East Central European countries, mid-2000s

	Hopes to feel more European	Fears losing national identity
Estonia	43	48
Latvia	51	66
Lithuania	41	51
Baltic average	45	55
Other East Central European average	56	34
	Hopes better protection from international crises	**Fears losing national policymaking autonomy**
Estonia	38	36
Latvia	31	51
Lithuania	31	37
Baltic average	33	41
Other East Central European average	46	29
	Trusts EU institutions for reliable information on the euro	**Trusts national central bank for reliable information on the euro**
Estonia	64	83
Latvia	59	79
Lithuania	67	73
Baltic average	63	78
Other East Central European average	76	84

Sources: Authors' calculations based on Gallup Europe Flash Eurobarometers: various polls conducted in 2006–8, http://ec.europa.eu/public_opinion/flash/fl183-en.pdf (accessed July 11, 2009).
Note: Data shown as average percent of citizens polled.

to have been overshadowed by worries about losing national policymaking autonomy and national identity. Similarly, for reliable information on the euro Estonians and Latvians (but not Lithuanians) appear to trust their national central banks more than EU institutions. Their preference for the national monetary authority is stronger than in other new member nations.

Flat Tax Regimes

The Baltic states' inclination to adopt radical and seemingly simple policy solutions also showed in their choice of tax regimes. As in the case of the currency board, Estonia pioneered a maverick solution to the problem of tax reforms by adopting a flat tax in 1994, once more sidestepping the IMF, which advised an increase of taxation rates in the existing system.[40] Until

40. On the flat tax, see Anthony J. Evans, "The Spread of Economic Theology: The Flat Tax in Romania," *Romanian Economic and Business Review* 1, no. 1 (2006): 47–59; Anthony J. Evans

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Estonia's bold step, only a few places, such as Hong-Kong, Guernsey, Jersey, and Jamaica, and some subnational governments in the United States had levied a flat tax. Although marginal in the real world, since the 1980s the flat tax idea was becoming popular among radical neoliberals. The first to speak in favor of such a tax were August Friedrich von Hayek in *The Constitution of Liberty,* and Milton and Rose Friedman in *Free to Choose.* Among its most influential advocates was MPS member and Hoover Institution Fellow Alvin Rabushka, who became fascinated with Hong Kong's tax model. Together with Robert Hall in 1983 he published *The Flat Tax,* advocating "a combination of a cash-flow income tax on business income, and a tax on workers' income, both levied at the same, single rate."[41]

It has to be said that in practice, the term flat tax has been used loosely, characterizing tax systems with a single marginal tax rate on labor income. Hall's and Rabushka's work was most influential in the United States. Yet when Estonia put the idea into practice, it earned international acclaim for its pioneering role: "Simplicity itself. At the stroke of a pen, this tiny Baltic nation transformed itself from backwater to bellwether, emulated by its neighbors and envied by conservatives in America who long to flatten their own country's taxes."[42] For the Estonian government, the flat tax was appealing because it promised to be easy to administer, restrict the size of government, and provide a signal to the outside world that the country was serious about market reforms. The government settled on a 26 percent personal income tax rate, which was broadly midway between the lowest and highest prereform marginal rates, and also lowered the corporate income tax from 35 to 26 percent.

Lithuania followed suit with its flat tax reform, likewise implemented in 1994. The major difference was that it set its marginal tax rate at 33 percent, which was the upper level of the rates imposed prior to the reform. As a consequence, revenues from personal income taxes increased. Lithuania's corporate tax rate was maintained at 29 percent. Latvia introduced its flat tax regime in 1997, replacing a degressive rate structure with a marginal rate of 25 percent. The corporate tax rate was set at the same level.

In all three countries, the flat tax reforms were later followed by other steps to decrease corporate taxation rates. In Estonia in 2000, the second Laar government completely abolished taxation of undistributed profits.

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and Dragos P. Aligica, "The Spread of the Flat Tax in Eastern Europe: A Comparative Study," *East European Economics* 46, no. 3 (2008): 49–67; Michael Keen, Yitei Kim, and Ricardo Varsano, "The 'Flat Tax(es)': Principles and Evidence," IMF Working Paper WP/06/218 (Washington, D.C.: International Monetary Fund, 2006); and Alexander Baturo and Julia Gray, "Flatliners: Ideology and Rational Learning in the Diffusion of the Flat Tax," IIIS Discussion Paper 210 (2007), accessed November 29, 2009 at SSRN: http://ssrn.com/abstract = 980704.

41. Keen, Kim, and Varsano, "The Flat Tax(es)," 5.

42. "Special Report. Simplifying Tax Systems: The Case for Flat Taxes," *Economist,* April 16, 2005, 63.

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Lithuania and Latvia both reduced their corporate income tax rates to 15 percent in 2002 and 2004, respectively. The overall effect of the new tax regimes on government revenues was limited. All three states had experienced a sharp decline of their revenues already in the early 1990s. Whereas under socialism revenues roughly equaled 50 percent of GDP, they dropped to between 30 and 38 percent around 1993–94, a level at which they stabilized. Flat tax reforms, however, led to a shift away from direct toward indirect taxation.[43]

The currency and tax reforms are emblematic for the Baltic states' early institutional choices. They show a clear preference for encompassing, radical and simple institutions that restrict the space and resources for politics proper. While the design of these institutions typically originated in radical neoliberal epistemic communities, they found their way to the Baltic states first through the decisions of Laar's entrepreneurial government, whose ambition was to administer a sharp break with communist legacies, exploit the enthusiasm of national rebirth and the nationalizing project in domestic politics, and also signal to the West the seriousness of the regime shift undertaken in the country.

Nationalist Social Contracts

The currency regimes chosen by the Baltic states are often analyzed and understood in terms of their significance for political and economic independence. However, more has been at stake. As Emily Gilbert and Eric Helleiner argue, national currencies have emerged and largely prevailed since the nineteenth century because of their contribution to binding state and nation. They increased nation-states' capacity to raise taxes, contributed to the formation of national identities, and allowed the realization of a "broader political project which called for inhabitants of a territory, in their new role as 'national citizens' to make diverse claims on the state to provide certain political rights and economic benefits."[44]

Much of the struggles of the twentieth century over national currencies and central banking did indeed involve competing visions of the right of national citizens to make these claims, and of the duty of the state to deliver in political, economic, and social terms alike. The argument here is that because of the extremely restrictive currency board arrangements (or their functional equivalent, the Latvian independent central bank), the Baltic

43. See *Baltic States: A Regional Assessment* (Paris: OECD, 2000), 83; Hans Aage, "Public Sector Development: Difficulties and Restrictions," in Haavisto, *Transition,* 96–118.

44. Emily Gilbert and Eric Helleiner, "Introduction—Nation-States and Money: Historical Contexts, Interdisciplinary Perspectives," in Gilbert and Helleiner, *Nation-States and Money,* 1–20.

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states were only able to offer their citizens a nationalist rather than a welfarist social contract.

The Baltic monetary regime acted as a straightjacket for fiscal, industrial, and social policies. They locked in the goal of monetary stability notwithstanding the implied social costs. Under the currency board arrangements, options for fiscal policy were limited, as governments could not borrow from central banks but had to rely on private actors instead. Since private savings were nonexistent in the early transformation, and external sources of financing insecure, the currency regime imposed strict budgetary discipline. At the same time, the low flat taxes limited public spending from the revenue side. Far from viewing strict fiscal discipline as a harmful restriction on governments' room for maneuver, Laar praised its advantages: "The stringent financial restraints made it easier for the government to decide what to do."[45]

Under the conditions of imposed fiscal discipline financing of welfare states has posed a specific challenge. All three Baltic states inherited from the socialist system "fully articulated, mature systems of social security that carried extensive financial obligations to their populations. These included old age pensions and sickness, disability and survivor benefits covering most workers and their families and financed from state budgets partly through taxes on enterprises, usually with no direct worker contribution."[46] Welfare states were largely financed from the central budget. With their extrication from the Soviet Union, the Baltic states had to find new financial sources for their social systems. In order to provide for independent social insurance budgets all three states introduced high payroll taxes amounting to 33 percent in Estonia, 38 percent in Latvia, and 31 percent in Lithuania. They also established social insurance funds separate from the general budgets. At the same time, they took great pains to limit their expenditures on social protection. This was most striking in the area of pensions.[47]

Pauperizing the Elderly

Pension benefits amounted to more than two-thirds of total social transfers, and were thus the social protection item that was most likely to drive expenditures up. Nevertheless, the first pension acts of the early 1990s, which the Baltic states still issued as republics of the Soviet Union, aimed at more

45. Mart Laar, "The Estonian Economic Miracle," *Backgrounder* (Heritage Foundation), no. 2060 (2007): 4.

46. Cook, *Postcommunist Welfare States,* 35.

47. On the Baltic pension reforms see Elaine Fultz, ed., *Pension Reform in the Baltic States* (Budapest: International Labour Office, 2006); Katharina Müller, "Old-Age Security in the Baltics: Legacy, Early Reforms and Recent Trends," *Europe-Asia Studies* 54, no. 5 (2002): 725–48; Jolanta Aidukaite, "The Formation of Social Insurance Institutions of the Baltic States in the Post-socialist Era," *Journal of European Social Policy* 16, no. 3 (2006): 259–70; and Bernard Casey, "Pension Reforms in the Baltic States: Convergence with 'Europe' or 'the World'?" *International Social Security Review* 57, no. 1 (2004): 19–45.

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generous pension systems than the existing ones. They sought to provide more favorable terms to a wide group of people, establish stronger ties between pensions and earnings, and merge the different schemes of farmers and workers into a single unified system with universal coverage. After independence, however, these laws were quickly replaced by much more restrictive provisions. The newly adopted formulas resulted in highly compressed pension distribution.

In fact, Lithuania was the only Baltic country that integrated individual earnings into its new system of the early 1990s, thus explicitly acknowledging the entitlements earned in the Soviet past. Policymakers in Estonia and Latvia resisted such a calculation on the grounds that it would be "a throwback to the Soviet legacy."[48] Ironically, however, the earnings-related component created severe problems for a number of Lithuanians, as many enterprises accumulated huge wage arrears and failed to pay the social insurance contributions. Overall, pension benefits in Lithuania stayed as meager and flat as in the two other countries.

The fact that the three states effectively managed to keep pensions low and their cost contained during the transition period is truly outstanding in a broader comparison. As Branko Milanovic observes:

> The Baltics started the transition with a low pension-wage ratio (under 40 percent), while Poland, Hungary, Slovenia and former Czechoslovakia had pension-wage ratios between 45 and 60 percent. Four years into the transition, the ratios for the Baltics have gone further *down,* while those in Central European countries, with the exception of the Czech Republic, have stayed the same or gone up. . . . Since the wage (the denominator in our pension-wage ratio) declined even faster in the Baltics, the real cut in the pensions in the Baltics was even more substantial than indicated by the pension-wage ratio alone. Between 1987–88 and 1992–1993, the average pension and pension spending in the Baltics were cut by 45 percent.[49]

The minimal pensions in the Baltic states were associated with a dramatic loss of status for people who had made most of their careers under socialism. In the stark formulation of Daina Eglitis and Tana Lace, the elderly in Latvia were in essence sentenced to become "human waste" that had to bear fully the consequences of their "wasted lives."[50] That this was not purely by

48. Laurie Leppik and Andres Vörk, "Pension Reform in Estonia," in Fultz, *Pension Reform,* 47.

49. Branko Milanovic, "Poverty, Inequality, and Social Policy in Transition Economies," Policy Research Working Paper 1530 (Washington, D.C.: World Bank, 1995), 32–33. Emphasis in the original.

50. Daina S. Eglitis and Tana Lace, "Stratification and the Poverty of Progress in Post-Communist Latvian Capitalism," *Acta Sociologica* 52, no. 4 (2009): 336–38.

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accident is clearly revealed by the following statement by a Latvian minister of welfare, who addressed the pensioners as follows: "You do not need big pensions, because you worked under the Communist regime, and your work accomplished nothing."[51]

There were, of course, less harsh and outspoken narratives of the new contract. Contrasting Latvia with Hungary, the World Bank praised the former: "State pension spending is to be reduced by abolishing favorable treatment for special groups and by paying lower benefits to people who retire earlier and higher benefits to people who defer retirement and continue to contribute. . . . In essence, Latvia's older and younger generations have made a deal. Pensioners have agreed not to press for larger benefits, and workers have accepted the burden of higher contributions in the hope for greater security for themselves in old age."[52] However, data on the distribution of risk-of-poverty rates across age groups reveal that while the Hungarian solution saved many pensioners from such a risk, the Latvian "deal" has effectively pauperized workers by the time they become elderly. Old people run the highest risk of becoming poor in Estonia as well, a feature that is particularly striking in comparison with the Visegrád states (see chapter 4, "Welfarist Social Contracts").[53]

What were the political and policy processes that led to this outcome? The Baltic states were also among the first to embrace the new international "pension orthodoxy," which, concerned with the long-term sustainability of spending, advocated funded schemes and partial privatization.[54] Latvia, being hardest hit by the transformational recession, struggled more than the other two countries with balancing its expenditures. It was therefore the first country to look for more radical solutions. The issue of pension privatization was first brought up under the right-wing government of Valdis Birkavs (1993–94), which included many representatives of financial and business circles. Premier Birkavs appointed Jānis Ritenis, an émigré Latvian who had worked for private insurance companies in Australia, as minister of welfare.

Ritenis advocated a pension system based on a private insurance model, and sought cooperation with the World Bank, which invited a Swedish team

51. Quoted in Milanovic, "Poverty, Inequality, and Social Policy," 33.

52. *From Plan to Market,* 79.

53. With the harsh fiscal austerity programs of 2007–9, the risk of old age poverty became even greater in the Baltic states.

54. The term "new pension orthodoxy" was coined by Lo Vuolo, "Reformas Previsionales en América Latina: El Caso Argentino," *Comercio Exterior* 46, no. 9 (1996): 692–702, quoted in Katharina Müller, "The Political Economy of Pension Privatisation in the Baltics," in Fultz, *Pension Reform,* 402. Since the early 1990s, the World Bank has advocated radical pension reforms in Latin America and Eastern Europe. In its 1994 report *Averting the Old Age Crisis* (Washington, D.C.: World Bank), the bank encouraged partial privatization and individualization of pensions. The World Bank recommended a three-pillar model, which includes a first, state-managed pay-as-you-go tier; a privately managed, mandatory and prefunded second tier; and a third, privately managed voluntary tier.

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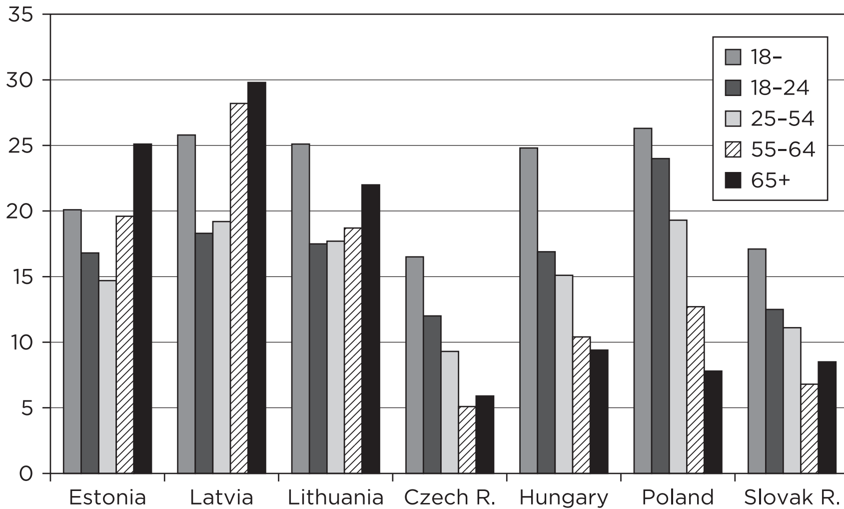

Figure 3.1 At-risk-of-poverty rate after social transfers by age group, percent in 2006. Authors' calculation based on EUROSTAT, http://epp.eurostat.ec.europa.eu (accessed August 8, 2011). At-risk-of-poverty rate refers to the share of persons with an equivalized disposable income below the risk-of-poverty threshold, which is set at 60 percent of the national median equivalized disposable income after social transfers.

to support his reform efforts. The Swedish experts eagerly embraced this opportunity, and de facto used Latvia as a testing ground for their recently launched reforms back home. As a result, Latvia was the first East European country to introduce a multi-pillar pension system as advocated by the World Bank. It went beyond that, however. The first, pay-as-you-go (PAYG) pillar was based on the Swedish template of a notional defined contribution scheme, a system that "mimic[s] a lifetime contribution based pension that would be offered by an insurance company."[55] This scheme is meant to impose discipline on contributors, and sends strong incentives to delay retirement, as retirement benefits are entirely dependent on an individual's contribution.

A key issue of the transition to the notional defined contribution scheme was how to calculate the initial pension "capital" from the old system. The government decided to credit insurance periods up until 1995 based on past

55. Louise Fox and Edward Palmer, "Latvian Pension Reform," Social Protection Discussion Paper 9922 (Washington D.C.: World Bank, 1999), 9. The notional defined contribution (NDC) scheme is a method that emerged in the 1990s to record earnings-related benefits in the public pension system. Pension contributions are recorded in individualized accounts, and future benefits take into account past contributions, the "rate of return," which is typically linked to the growth of the wage sum, and the life expectancy of the cohort to which the beneficiary belongs. In contrast to private funded schemes, the money is not invested. Under NDC the pension scheme remains a pay-as-you-go system.

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service years, but at current earning levels. Moreover, contributions rather than actual wages were taken into account. The transition formula had major distributional consequences. It disadvantaged all those with a long employment record who were unemployed, held inferior jobs, worked in state-owned enterprises, or were employed in firms where wage arrears or underreporting had prevailed during the crucial years of 1996–99. At the same time, those in the private sector who understood the new system and were in a position to manipulate their earnings for the relevant period became major winners of the reform.[56]

In Estonia, the second wave of pension reforms started when the incoming centrist minority government under Prime Minister Mart Siimann set up a Social Security Reform Commission in 1997, with the mandate to prepare a reform outline. Siimann appointed Hansson (previously a member of Estonia's Monetary Reform Committee) as chair of the commission. The commission included experts from the National Social Insurance Board and the Ministry of Finance. After only a month of deliberation, the commission proposed the introduction of the World Bank's multipillar system. At the same time, it favored a low replacement rate for reasons of financial viability. It also gave a highly unfavorable opinion on recalculating the pensions on the basis of previous earnings. The commission's pension proposals laid the foundations for the subsequent pension reforms.[57]

In Lithuania, the gateway to more radical pension reforms was the deficit accumulated by the Lithuanian Social Insurance Fund from 1996 onward. Because of the prolonged crisis, the substantial decrease in economic activity, and the large number of companies defaulting on their social insurance contributions, the fund's income did not keep up with the expenses. While the magnitude of the deficit was small—it amounted to 0.1 percent of GDP in 1996–98, and could easily have been covered by a slight increase in the contribution rate—it spurred a heated media campaign against the fund.[58]

The conservative government under Premier Vagnorius (1996–99) started to prepare for radical reforms. However, it got in the line of fire between the divergent privatization models advocated by the Confederation of Industrialists and the Free Market Institute. The latter was also backed by the World Bank. As a result, the 1999 Pension Funds Law remained an ambiguous piece of legislation. Although it provided the legal framework for funded pensions, it did not stipulate mandatory participation, and never even mentioned private

56. Inta Vanovska, "Pension Reform in Latvia," in Fultz, *Pension Reform,* 181.

57. Leppik and Vörk, "Pension Reforms"; Aidukaite, "The Formation of Social Insurance." For a comparison between the Estonian and Latvian pension reforms see Margit Tavits, "Policy Learning and Uncertainty: The Case of Pension Reforms in Estonia and Latvia," *Policy Studies Journal* 31, no. 4 (2003): 643–60. In light of the findings in other literature, Tavits seems to slighty overstate the coordinated, deliberative, and endogenous character of the Estonian pension reform.

58. Romas Lazutka, "Pension Reform in Lithuania," in Fultz, *Pension Reform,* 306.

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pensions explicitly. All in all then, as was the case with the currency board, Lithuania only half-heartedly embraced the option of pension privatization.

Generally, pension benefits in all the Baltic states remained low and their distribution compressed. The reforms that were carried out reflected an overall concern with macroeconomic stability rather than social compensation. They aimed at ensuring medium- and long-term affordability of the pension system, improving its transparency, reducing redistribution, and increasing the contribution of welfare to economic growth and development. Not only pensions, but also unemployment insurance and social assistance exhibited similar features.[59]

Ethnic Aspects of Social Policy

The social losses resulting from radical marketization and economic restructuring disproportionately burdened Estonia's and Latvia's mostly Russian-speaking manufacturing labor force. Manufacturing workers' high occupational status under Soviet rule had manifested itself in privileged access to firm-based social provisions, but with the collapse of inherited industries not only did they lose their job-related benefits, but they also suffered more frequent and longer periods of unemployment and losses of employment quality—such as wage arrears and compulsory unpaid holidays—than members of the ethnic majorities.[60]

However, protective industrial policies were not adopted to slow down the process of disruption of the predominantly Russian labor force's life, nor were adequately funded unemployment benefit and retraining programs offered to ease the resulting social stress. Indeed, while the refusal of state assistance to troubled industrial firms—such as in the form of subsidies and grace periods for restructuring—had been justified by the requirements of fiscal discipline and monetary stability, identity politics helped to cement the hegemony of the stability-oriented agenda in yet another way.

On the one hand, denial of industrial protection could be more easily justified on grounds of perceived vulnerability of the national economy to postcolonial influences. In the case of Estonia, in Premier Laar's words, after 1940 a "large Soviet military garrison and the continued influx of Russian speaking colonists who acted like a 'civilian garrison' replaced the lost population. In order to effect colonialization, rapid industrialization was launched by Moscow."[61] By implication, after independence, radical deindustrialization could be perceived as a means of decolonization.[62]

59. Aidukaite, "The Formation of Social Insurance."

60. See Adne Aasland, "Citizenship, States and Social Exclusion in Estonia and Latvia," *Journal of Baltic Studies* 33, no. 1 (2002): 57–77.

61. Laar, *Estonia,* 37.

62. For a formulation focusing on the general impact of systemic change rather than on the ethnically patterned variants of social exclusion, see Eglitis and Lace, "Stratification

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TABLE 3.2
Ethnic aspects of social dislocation, 1993

	Ethnic Estonians	Estonian Russians	Ethnic Latvians	Latvian Russians	Ethnic Lithuanians	Lithuanian Russians
Initially enjoyed firm-based benefits[a]	24	43	22	34	24	33
Currently unemployed	6	11	10	15	8	10
Loss of employment quality in the past year[b]	24	38	27	33	26	22
Very worried about losing job	10	43	39	53	48	49

Source: Richard Rose, William Maley, Vilmorius Lasopec, and EMOR, "Nationalities in the Baltic States," A Survey Study, Studies in Public Policy 222 (Glasgow: University of Strathclyde Center for the Study of Public Policy, 1994), 6–8, 10.
Note: Data shown as percent of affirmative answers.
[a]Enjoyed at least one of the following job-related benefits: food, meals, housing, consumer goods, care for children, holiday facilities, medical care.
[b]Experienced at least one of the following: unemployment, short-time pay, compulsory holiday without pay.

The imminent atrophy of business and labor organizations has not been viewed as too painful a loss, even if it led to highly fragmented industrial relations that impaired the prospects for more socially embedded monetary coordination. Led in part by similar fears of Russia's continuing economic influence, by the abrupt withdrawal of public assets, and by the desire to set strict prudency standards, the Bank of Estonia urged the liquidation of banks that allegedly laundered revenues of Russian organized crime. The monetary authority also encouraged acquisitions by Western commercial banks that rapidly emerged as market leaders.[63]

On the other hand, passive and active labor market policies fell short of compensating for the ethnic bias in social losses, especially given that social spending has been overall meager in the Baltic states in comparison with the Visegrád countries and Slovenia, let alone many older EU member nations. Furthermore, not all Estonian and Latvian social policies have been blind to ethnicity.

and the Poverty of Progress," 336: "The most apparently superfluous category of the population in the post-Soviet context is the classic icon of Soviet progress and productivity, the heavy industrial worker." For the way workers' role after socialism has been discursively redefined see David Ost, *The Defeat of Solidarity: Anger and Politics in Postcommunist Europe* (Ithaca: Cornell University Press, 2005) for the Polish case, and Daina Eglitis, "Class, Culture, and Consumption: Representations of Stratification in Post-Communist Latvia," *Cultural Sociology* 5, no. 3 (September 2011): 423–46, for the Latvian context.

63. Laar, *Estonia,* 191–93.

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To the contrary, the welfare states in these countries have been more generous in those areas that could be linked to the nationalizing projects. Relative to GDP they have spent as much or even more on education, and also employed a higher share of the workforce in the public sector, than many of their East Central European peers. In Estonia and Latvia, the latter policy has reinforced an inherited ethnically divided labor market, and protected the ethnic Baltic populations somewhat better than the Russian speakers from adverse market shocks. At the onset of the transformation, non-Balts in Estonia and Latvia were overrepresented in the industrial, transport, and maritime sectors, whereas ethnic Balts were concentrated in agriculture, education, and the state bureaucracy.[64]

Independence gave members of the titular nation the opportunity "to use the institutional structure of their ethnic republic in order to take over 'the state' more effectively and thus turn society more rapidly towards an ethnic Estonian direction"[65]—as was also the case in Latvia. By means of restrictive language and citizenship laws, both societies limited the access of the Russophone population to career opportunities in government, public administration, the professions, and many categories of the economy at large. Latvia developed the most discriminatory regime, with "more than 33 separate categories of employment barred for non-citizens."[66] Satisfactory command of the majority language was required for employment in both the public and several branches of the private sector, with the required degree of fluency varying according to the employee's position. Remarkably, industrial workers were de facto exempted from language requirements.[67]

As a consequence, the new states' public sectors became more "Estonianized" and "Latvianized" as the 1990s wore on. According to a survey carried out by Richard Rose and his collaborators in 2000, at the beginning of the 1990s, 31 percent of employed ethnic Latvians and 32 percent of ethnic Russians had jobs in the public sector. In 2000, 35 percent of the former and a mere 21 percent of the latter were employed in public services. The developments in Estonia were similar. Whereas at the beginning of the decade, 22 percent of ethnic Estonians and 25 percent of ethnic Russians reported employment in the public sector, by 2000 27 percent of the former and only 16 percent of the latter claimed to have jobs in this sector. In contrast, the share of Lithuanian Russians working in public service increased slightly from 35 to 38 percent, although not as much as that of ethnic Lithuanians for whom the numbers were 30 and 37 respectively.

64. Colin W. Mettam and Steven W. Williams, "Internal Colonialism and Cultural Divisions of Labour in the Soviet Republic of Estonia," *Nations and Nationalism* 4, no. 3 (1998): 383–88; Pettai and Hallik, "Understanding Processes," 515; Norgaard et al., *The Baltic States* (1996), 174.

65. Pettai and Hallik, "Understanding Processes," 516.

66. Hughes, " 'Exit,' " 745.

67. Norgaard et al., *The Baltic States* (1996), 179–81; Pal Kolsto, *Political Construction Sites: Nation-Building in Russia and the Post-Soviet States* (Boulder: Westview, 2000), 105–16.

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On the other side of the coin, the private economy became "Russified": in 2000 47 percent of employed ethnic Latvians and 57 percent of ethnic Russians found occupation in privatized or newly founded private firms. The respective numbers for ethnic Estonians were 54 percent and for ethnic Russians in Estonia 62 percent. In Lithuania, a similar proportion of both groups was employed in the private sector.[68]

What is more, in Estonia and Latvia, Russophones were almost entirely removed from top public and partly even from top private positions. In a study of elite change in the Baltic countries after independence, Anton Steen found out that by 1993–94 the core institutions of the state, and the top state bureaucratic positions in Estonia and Latvia were almost entirely in the hands of the majority nation. The picture of the economic elites is somewhat more mixed: in Latvia, Russians constituted 13 percent of the elites in state enterprises, and 30 percent of the elites in private enterprises. In Estonia, the respective numbers were 15 and 6 percent.[69]

Related to the above, it is interesting to observe that nation builders though they were, neither Estonian nor Latvian neoliberal reformers experimented much with the kind of privatization techniques that led to various (albeit transitory) forms of national capitalism in many other East Central European states. In the latter countries both insider-dominated methods allowing management employee buyouts (MEBOs) on a massive scale, and outsider-oriented voucher privatization programs promoting the emergence of masses of small owners based on citizenship rights had been initially popular. The sole exception was Hungary, where the service of crippling foreign debt made it almost imperative for the state to secure large hard currency inflows by selling firms mostly directly to foreign strategic investors. As none of the Baltic states assumed responsibility for former Soviet debt, they were less constrained than Hungary when choosing among methods of privatization. Yet in contrast to Slovenia, Croatia, and Romania (or even Hungary or Poland where to a lesser extent MEBOs were also used) Estonia and Latvia opted for direct sales to foreigners as the primary, and vouchers as secondary, technique.[70]

Beyond efficiency considerations, these decisions might have reflected nationalizing concerns too. Permitting massive management-employee buyouts, especially in the privatization of large enterprises, would have inevitably empowered ethnic Russian managers and workers, while Western strategic owners were seen as less of a threat to sovereignty. Vouchers limited the entry

68. See for these and other data on the social consequences of the ethnic divide Richard Rose, "New Baltic Barometer IV: A Survey Study," Studies in Public Policy 338 (Glasgow: Centre for the Study of Public Policy, University of Strathclyde, 2000), 5, 14.

69. Steen, "The New Elites," 103–8.

70. *Transition Report 2000* (London: EBRD, 2000), 160, 184, 188; OECD, *Baltic States*, 125–33. It is interesting to note that the early privatization schemes before independence favored insiders.

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of residents without citizenship into the ranks of the new propertied class. In light of the above, it is unsurprising that Lithuania, with its first preference for vouchers and initially only limited use of direct sales, was an outlier in this respect as well.

All in all, then, the Baltic states have offered their population a nationalist rather than a welfarist social contract (the latter being the version of the Visegrád states, to be discussed in chapter 4, "Welfarist Social Contracts"). Under this contract spending on forms of social protection accessible to citizens and noncitizens alike—health care, pensions, and active and passive labor market policies—has been subject to strict controls. At the same time, in the few areas where Baltic welfare generosity has stood out—namely, spending on higher education and certain kinds of state employment—access has been controlled via citizenship requirements or language proficiency tests administered in the official language. Hence, the Estonian and Latvian welfare states' overall relatively meager performance should also be judged against the yardstick of the nationalizing project in which these countries' elites have been engaged—that is the project of building a state for the core titular nation. In Lithuania, the nationalist social contract has remained symbolic, as it has not offered much shelter or opportunities for selected groups.

Exclusionary democracies and nationalist social contracts go a long way toward accounting for the relatively limited challenges to radical neoliberal policies in the Baltic countries.[71] Still, the economic transformation has had grave social consequences. Workers in the Baltic states suffered a dramatic loss of income in the early transformation period. Real wages fell by as much as two-thirds in 1990–99, and even with the recovery thereafter, by the end of the millennium they only reached between 40 and 60 percent of their 1989 levels.[72] Employment levels decreased sharply, leading to significantly lower labor force participation and high unemployment. The transformation has also been accompanied by a significant increase in income inequality, especially in Latvia, where the Gini coefficient increased by 17 percentage points between 1990 and 1994. In Estonia and Lithuania, it increased by 10 and 11 points respectively.[73] Income differentials widened particularly among the poorer segments of the population. Parallel with rising unemployment and income inequalities, poverty also became widespread.[74]

To account for the relative societal quiescence and unchallenged neoliberalism in light of these grave social dislocations, factors other than

71. See Vello Pettai, "Political Stability Through Disenfranchisement," *Transitions* 3, no. 6 (4 April, 1997): 21–23, on how the ethnopolitical aspects of Estonian and Latvian politics minimized resistance to the neoliberal economic reforms.

72. OECD, *Baltic States*, 151.

73. Peter K. Cornelius and Beatriz S. Weder, "Economic Transformation and Income Distribution: Some Evidence from the Baltic Countries," IMF Staff Papers 43.3 (Washington, D.C.: International Monetary Fund, 1996), 587–604.

74. Milanovic, *Income, Inequality and Poverty,* 68–71.

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exclusionary democracies, fragmented and nonrepresentative party systems, and nationalist social contracts have to be factored in. In this respect, it certainly helped that in time, the pains of transformation started to bear some fruit. Out of the deep transformational recession, first the Estonian "rising star of the Baltics," and then the Baltic tigers emerged.

Constructing the Estonian Success Story

One of the most remarkable aspects of the Baltic states' transformation is how fast these countries could change their image as fragile, backward, ethnic conflict–ridden post-Soviet successor states into internationally acclaimed models of democratic capitalist success. A conjuncture of ideational, structural, domestic, and international factors made this happen.

The Baltic success story took its origin in Estonia, and it owed its existence as much to a powerful narrative of success as to the fact of Estonia's relatively satisfactory economic performance. Arguably, the most influential interpreter of the Estonian transformation is two-time Prime Minister Laar whose radical reform package is said to have laid the foundations for Estonia's rise from the ruins of communism. Laar spent considerable efforts at promoting Estonia internationally. In the early 1990s, his government sponsored an international media campaign to draw attention to the "Estonian miracle." One of its offshoots was *Newsweek*'s label for Estonia as "A little country that could." Laar later used this as the title for his own book on the reforms, which was published and promoted by the Center for Research into Post-Communist Economies, a neoliberal think tank founded by members of the Institute of Economic Affairs and the Atlas Economic Research Foundation. Laar also gave many interviews to mostly neoliberal and libertarian journals and newspapers.

Laar's narrative of the Estonian transformation has a number of ingredients. He is adamant in his rejection of any socialist legacy. Even more than the physical legacies—the ruins of Soviet industrialization and infrastructure—he deplores the mental legacies, and stresses the need for changes in people's attitudes. He relentlessly underlines the need for radical and speedy reforms as the only way to do away with inherited liabilities. The issue of national vulnerability looms large. Estonia is invariably presented as a small country that has again and again been a battlefield of big powers. Yet, out of foreign occupation and dominance, Estonians have come unaltered in their cultural identity and their craving for freedom. In particular the period of the first independence is a source for pride and also inspiration, the more so as many of the challenges of the interwar period are seemingly repeating themselves after the breakdown of communism.

Among the most striking elements in Laar's narrative is his stress on the country's and its leaders lack of preparedness for the tasks that initially faced

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them and, hence, the improbability of success. "It is very fortunate that I was not an economist," Laar says in an interview.

> I had read only one book on economics—Milton Friedman's *Free to Choose*. I was so ignorant at the time that I thought that what Friedman wrote about the benefits of privatisation, the flat tax and the abolition of all customs rights, was the result of economic reforms that had been put into practice in the West. It seemed common sense to me and, as I thought it had already been done everywhere, I simply introduced it in Estonia, despite warnings from Estonian economists that it could not be done. They said it was as impossible as walking on water. We did it: we just walked on the water because we did not know that it was impossible.[75]

This narrative, then, is built on the notion that even under the most unlikely circumstances, success could happen. This is nothing short of a miracle. What is this success? In Laar's account, it is the fast economic recovery made possible by radical reforms. Recovery is being built on foundations very different from those of the socialist system. It is characterized by the creation of an ultraliberal business-friendly environment that helps attract large amounts of FDI; a balanced budget and strict monetary policy that give Estonia a strong reputation as a reliable borrower; a fully open trade regime that has led to a rapid reorientation of foreign trade; and a social protection system "inspiring people to assume responsibility for their own future."[76]

In this context, the rapid deindustrialization so characteristic for the Baltic states (see table 1.7) is not seen as problematic. Industrial legacies are identified with wasteful, useless, and unwanted production, built up by the Soviets with the aim to colonize the country. While Estonia lost most of its complex industries in the process of deindustrialization, and this sector's recovery has mostly been carried by traditional industries, Laar takes pride in the fact that Finnish investments have transformed some segments of the machinery and electrical equipment industries, which now contribute significantly to exports.

In a similar way, some of the disastrous social consequences of the multiple shocks inflicted on the Estonian economy are interpreted in a favorable way, as they have led to a change of attitude among the people, and especially among the Russian community, who were made to understand that they could not rely on the state any more to help them out, but had to take their fate in their own hands. In this sense, the Estonian way of

75. Mart Laar, quoted in "Walking on Water," *Brussels Journal,* August 27, 2005, http://www.brusselsjournal.com/node/202 (accessed November 23, 2009).
76. Laar, *Estonia,* 271.

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resolving the ethnic question has also turned out to be a success. While it was necessary to deny Russian speakers the right to vote in parliamentary elections and referendums, as they were not supportive of radical reforms, the very success of these reforms has given Russians hope for upward mobility as well. With the new individualistic values flourishing, ethnic tensions are disappearing.

A major ingredient of Laar's account of Estonia's success finally is that the country has been pulling itself up by its own bootstraps. Resolutely going its own way, more often than not defying the advice of IFIs and Western advisers, and consciously cutting Estonia off from international sources that provided "aid rather than trade" was the hallmark of "the little country that could."[77]

There is overall ample evidence that in a comparative (Baltic) perspective, Estonia's economic performance is superior. Dissenting voices have, however, pointed to a number of factors other than reform radicalism that may have contributed to this relative success. Two accounts deserve attention here. The first alternative interpretation challenges the perception of legacies being merely obstacles to reform.[78] It argues that Estonia had privileged initial conditions, as it had served as an economic laboratory for economic experiments ever since the 1960s. Estonian experiments often provided models for broader reforms throughout the Soviet Union. Under Mikhail Gorbachev's perestroika, Estonian reform plans became more ambitious. As soon as it was possible, Estonia encouraged the establishment of semiprivate "people's enterprises" as well as joint ventures with foreign companies, initiated small-scale privatization, and gradually liberalized its prices. Moreover, as mentioned above, in September 1987 leading economists published a reform proposal that anticipated many of the reforms that were to be implemented after independence.

What this adds up to is that "Estonia 'hit the ground running' once the communist system collapsed, and did not waste valuable time in the early days of the transition."[79] Further, the country also had inherited structural advantages vis-à-vis its peers that made its reform tasks less daunting. Its share of light industry was higher than that of the two other republics, and as light industries had remained under regional rather than centralized control, the number of all-union enterprises with centralized decisionmaking was significantly lower in Estonia than in Latvia and Lithuania.[80] While this interpretation of Estonian success does not challenge the overall representation of

77. Ibid., 248.

78. See, e.g., Ritsa A. Panagiotou, "Estonia's Success: Prescription or Legacy?" *Communist and Post-Communist Studies* 34 (2001): 261–77. For a discussion of Estonia's reform legacies, see Van Arkadie and Karlsson, *Economic Survey;* Misiunas and Taagepera, *The Baltic States.*

79. Panagiotou, "Estonia's Success," 273.

80. John Hansen and Piritta Sorsa, "Estonia: A Shining Star from the Baltics," in *Trade in the New Independent States,* ed. Constantine Michalopoulos and David G. Tarr (Washington, D.C.: The World Bank/UNDP, 1994), 115–32; Norgaard et al., *The Baltic States* (1999), 143–46.

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Estonia as a radical reformer, it qualifies that view to some degree by pointing to the legacies the early postindependence reformers could build on. It also suggests that Estonia could become more successful than its peers only as a result of these favorable legacies.

A second interpretation of Estonia's transformation is much more critical when it comes to the structural changes that have been taking place, and thus qualifies the notion of success. This interpretation—much in line with our own analysis—points to the fact that radical liberalization of trade and investment and limited support for industrial restructuring destroyed much of the basis for innovation and competitiveness, as it led to "wiping out the most knowledge- and technology-intensive industries of the relatively less competitive economy."[81] It also sheds a more critical light on Estonia's industrial sector of pride—its export-oriented machinery and electrical equipment industries. A large share of this sector's output is reexported either directly or following some processing. In terms of value added, Estonian "high-tech" production occurs mostly in the lowest segments of the sector, typically in assembly subcontracting operations.[82]

Moreover, some authors also point to another important source of revenue that is quite consistently downplayed in most narratives of the Estonian success, namely transit of Russian oil and oil products as well as other commodities. With the Soviet collapse, Estonia—like the other two Baltic republics—could charge world prices, payable in hard currencies, for transit and loading fees. Managing transit of Russian oil and oil products thus became a profitable industry, contributing—depending on the estimates—between 4 to 10 percent to the country's GDP.[83] Estonia's dependency on transit trade does not fit particularly well with the dominant narrative of success, as it involves continuing dependency on Russia and on a particular sector that had previously been firmly controlled by Soviet authorities. Consider the following statement by Lagle Parek, chairwoman of the Estonian National Independence Party and Estonian interior minister in 1992–93:

81. Marek Tiits, "Industrial and Trade Dynamics in the Baltic Sea Region—the Last Two Waves of European Union Enlargement from a Historic Perspective," Working Paper 1 (Tartu: Institute of Baltic Studies, 2006), 23.

82. Niels Mygind, "The Internationalization of the Baltic Economies," BRIE Working Paper 130 (Berkeley: BRIE, 1997); Robert Burgess, Stefania Fabrizio, and Yuan Xiao, "The Baltics: Competitiveness on the Eve of EU Accession," Country Report 3/114 (Washington, D.C.: International Monetary Fund, 2004); Uwe Dullek, Neil Foster, Robert Stehrer, and Julia Wörz, "Dimensions of Quality Upgrading in CEECs," wiiw Working Paper 29 (Vienna: Wiener Institut der Weltwirtschaftsforschung, 2004); Marek Tiits, Rainer Kattel, and Tarmo Kalvet. "Made in Estonia," Working paper, (Tartu: Institute of Baltic Studies, 2006), 17–18, 52–53; Tiits, "Industrial and Trade Dynamics," 23.

83. David J. Smith, *Estonia: Independence and European Integration* (London: Routledge, 2002), 123; Andreas Saarniit, "Estonia's Transit Trade," *Kroon and Economy* 1 (2006): 43–48; Juhani Laurila, "Determinants of Transit Transports between the European Union and Russia," BOFIT paper 1 (Helsinki: Bank of Finland, Institute for Economies in Transition, 2002).

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> [In our party] we do not in fact want Estonia to become "a new Hong Kong." That way, we might become richer economically, but Estonians do not fit that role, because spiritually they are closer to the soil. As a people we have always aspired to education and culture, even amidst the greatest difficulties, so we deserve today something a bit better than the role of a Hong Kong. I hope that in the course of time . . . Estonia will be a country that creates values, and does not mediate them; because true joy comes from making something, not just circulating or processing it."[84]

The qualifications and alternative interpretations of Estonia's success notwithstanding, major elements offered by Laar's narrative became cornerstones of the dominant view. This was partly because they resonated well with the outlook of influential international actors. As Laar recalls in the above-cited interview, the world started to notice that something was happening "in 1994 when people first started to talk about the Estonian economic miracle. Then this reputation began to grow. Of course we always tried to find new things to add to this reputation and to really be successful. We have been quite good in this. After a first wave of reforms we had a second and a third wave too."[85]

Not surprisingly, Estonia's economic miracle and the policies that allegedly made it possible initially drew most attention among radical neoliberal and libertarian circles. However, increasingly Estonia also became a poster child of more mainstream international organizations. Several factors account for this.

First, some of Estonia's early policy innovations actually anticipated an emerging international consensus. This was the case with the currency board. The early Washington consensus on exchange rate regimes, formed after the Latin American debt crisis, favored fixed or managed exchange rate regimes. After the Mexican currency crisis of 1994, however, a new policy consensus started to emerge that favored regimes that adjusted automatically, that is without government interference in market forces. In a world characterized by high capital mobility, only currency board or fully flexible exchange rate regimes were seen capable of averting currency crises.[86] By this time, the Estonian experience could already serve as an example of the advantages of currency boards. From then on, the IMF recommended this institution to all postsocialist countries that faced currency crises. Currency boards, once a maverick solution, thus started to expand to other countries of the region.

Second, there might have been a need on part of international and supranational organizations to highlight the possibility of success beyond the

84. Quoted in Lieven, *Baltic Revolution*, 331.
85. Laar interview, "Walking on Water," 2005.
86. Dominick Salvatore, James W. Dean, and Thomas D. Willett, eds., *The Dollarization Debate* (Oxford: Oxford University Press, 2003), 3.

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Visegrád group. This became most apparent in the decision of the EU to include Estonia in the first round of applicants with whom entry negotiations were started. The road to Europe has been bumpier for all three Baltic states than for most of the Visegrád countries and Slovenia. These countries' belated start with economic and political reforms, as well as concerns about relations with Russia and the fate of the Russian minorities in Estonia and Latvia, made the EU more hesitant in its commitment. The EU's stance changed after its northern enlargement, with the Scandinavian countries supporting the Baltic states' membership.

Nonetheless, it was far from obvious that any of the Baltic states would qualify for immediate entry negotiations, as they fell short of meeting the Copenhagen criteria. This notwithstanding, both Estonia and Lithuania assumed that they were in a better position than their peers. Whereas Estonia pointed to its economic reform credentials, Lithuania referred to its track record with respect to political and minority rights.[87] The choice to include only Estonia sent two important signals to the Baltic region. On the one hand it made clear that despite their Soviet past, these countries had the same chances for joining the EU as any other former communist country, provided that they established a good record of reforms. On the other hand, the EU decision signaled that priority was being given to economic transformation. While the commission had an issue with the treatment of Russian-speaking residents, it was the fact that it regarded Estonia "as a functioning market economy, able to cope with the competitive pressure and market forces within the Union"[88] that tipped the balance in its favor.

Third, the consolidation of neoliberalism that took place over the 1990s and 2000s also contributed to spreading the specific interpretation of Estonian success internationally. One manifestation of this was the proliferation of international rankings related to "economic freedom" and economic competitiveness. These rankings typically seek to promote specific and standardized understanding of a single best economic practice, allow for easy regime comparisons, and single out particular successful countries that constitute models to follow. The rankings are often built on the perceptions of members of the international business community. Estonia invariably comes up in a top position among its peers.[89]

87. Norgaard et al., *Baltic States* (1999), 171.

88. "Agenda 2000—Commission Opinion on Estonia's Application for Membership of the European Union," European Commission DOC/97/12 (Brussels, July 15, 1997).

89. See, e.g., the World Economic Forum's ranking of progress toward implementing the aims of the Lisbon agenda, in which Estonia always tops the list among the accession countries, e.g., *The Lisbon Review 2010: Towards a More Competitive Europe?* (Geneva: World Economic Forum, 2010), http://www3.weforum.org/docs/WEF_LisbonReview_Report_2010.pdf (accessed March 1, 2011); the WEF's global competitiveness ranking, e.g., *The Global Competitiveness Report 2011–2012* (Geneva: World Economic Forum, 2011), http://reports.weforum.org/global-competitiveness-2011–2012/ (accessed August 15, 2011); and the World

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In contrast to Estonia, neither Latvia nor Lithuania succeeded during the 1990s in presenting themselves as successful transition economies. In Latvia, the idea of becoming a "new Hong Kong" offering offshore banking and trade services for the Russian hinterland fell on more fertile ground than in Estonia. Especially the government under Andris Šķēle (1995–97) has attempted to boost the role of transport and the port economy, trying to build on Latvia's locational advantage as the main transport corridor for East-West trade. It created free port areas and special economic zones, including tax reduction for investors. In addition to transport, Latvia's financial sector has also sought to strategically exploit the country's specific geographical location. Parex Bank, Latvia's first private bank, founded in 1988, built its strategy around attracting deposits from the former Soviet Union. In the early 1990s, Parex advertised its services with the slogan "We're closer than Switzerland." Indeed, for Russian depositors Latvia offered a good mix of a place relatively easy to go to that at the same time offered better legal guarantees than banks back home.[90]

Yet it was hard to sell the new Hong Kong as a success story. First, ambivalences related to dependence on Russia loomed large, and not all governments shared Premier Šķēle's enthusiasm for exploiting the specific opportunities of port cities. It did not help matters that Russia repeatedly used its economic position to interfere in Latvia's domestic policies. For instance, oil transports were interrupted several times in order to influence Latvia's treatment of the minority population. Second, the Russian hinterland itself was repeatedly subject to economic troubles that had serious repercussions on the transport and financial sectors. Russia also tried to decrease its dependency on Baltic transit by playing the three countries against each other, expanding its own port capacities, and undertaking pipeline projects aimed at bypassing the Baltic states. As a consequence, transit traffic has not grown nearly enough to compensate for the economic decline in other areas.[91]

Third, the entrepôt economy provided a fertile soil for corruption. Thus, international actors repeatedly accused Latvia's banking sector of money laundering. Also, the three men most often referred to as Latvian oligarchs—the long-term mayor of the oil port of Ventspils, Aivars Lembergs, former Prime Minister Andris Šķēle, and Transport Minister Ainārs Šlesers—are thriving on the transit economy. It is also telling that the list of the ten richest

Bank's *Doing Business* rankings, http://www.doingbusiness.org/EconomyRankings/ (accessed November 8, 2009).

90. Eiki Berg, "Where East meets West? Baltic States in Search of New Identity," in *Regions in Central and Eastern Europe: Past and Present,* ed. Eiki Berg (Hokkaido: Slavic Research Center, 2007), 49–67; Lieven, *Baltic Revolution,* 363–65; Pauls Raudseps, "Latvia: Bridge Collapse," *Transitions Online,* no. 3 (December 2008), www.tol.org (accessed November 9, 2009); "Latvian Banks Serve as Transit for Russian Money," *Baltic Times,* November 1, 2004.

91. Laurila, "Determinants"; Alf Brodin, *Baltic Sea Ports and Russian Foreign Trade: Studies in the Economic and Political Geography of Transition* (University of Göteborg, Department of Human and Economic Geography, 2003).

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people in the Baltics is headed by Latvians who are involved in either banking or the transit economy. The only Estonian who made it to the group is also a "transit businessman."[92]

Lithuania, finally, was mostly perceived as unstable and struggling in the 1990s. It was identified as being the least thoroughgoing in following the "Baltic way" of radical reforms, thus achieving the least impressive economic results. It was also much less able to compensate for deindustrialization by reliance on the transit sector, having smaller port facilities than Latvia and no border with Russia except for the Kaliningrad enclave. Yet in the new millennium the initial laggard Baltic states caught up with Estonia, and this way a "Baltic miracle" was in the making. We will now turn to the factors behind this outcome.

Internationalization, European Integration, and the Baltic Economic Miracle

The Baltic economic miracle of the 2000s owes its existence to a number of important changes in the international environment. Over the 1990s, international actors and factors mostly acted as constraints on these countries' economies. The collapse of the Russian economy and later the Russian financial crisis sent shockwaves through the Baltic states, while their production profiles were too weak to successfully compete on Western markets. As to the IFIs, as argued above, Estonia did not always heed the advice it got from them. Moreover, as its attempts at going it alone seemed to bear fruits, international actors were increasingly prepared to give Estonia a vote of confidence on whatever further steps it planned to undertake. This was not the case with Latvia and Lithuania whose economic recovery was much more troubled. International organizations held these countries on a shorter leash.

At some point, however, things started to change. The specific conjuncture of the EU accession process and a world economy in which credit was becoming abundant allowed for a paradoxical development. While many of the original institutions and policies of the Baltic states were reinforced, there was no need for correcting the model's drawbacks, as the global credit economy was effectively sidelining external constraints stemming from a decline in international competitiveness.

EU accession provided the reform paths undertaken since the 1990s with a specific purpose and a definite time horizon, and thus empowered reform-minded political actors that might otherwise have backtracked. It also contributed to Latvia's and Lithuania's catching up with the Estonian reform

92. The list of the richest people was drawn by the *Baltic Times* in 2003–4, http://www.baltic-course.com/archive/eng/index.htm-read = 381.htm (accessed November 28, 2009).

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effort. The EU's agenda in the subregion was broad and encompassing, ranging from improving the political situation for minorities, through a general reinforcement of the privatization and restructuring agenda, to very specific sectoral policy reforms. Arguably, one of major efforts of the EU was directed towards advancing administrative, institutional, and regulatory capacities. This approach was in line with the central position of regulation in the EU's policymaking. At its core, the *acquis communautaire* governing the internal market and the common policies has been an exercise in regulatory state building on multiple levels of European governance.[93]

There is a clear affinity between the Baltic states' reform choices and a regulatory state model. As their most interventionist state institutions had been under central control, the disentanglement from the Soviet Union allowed for an easier dissolution of some of them. Moreover, Baltic reformers rejected the features of a "positive" state, such as high taxation, redistribution, and direct production of goods and services. For that reason, their institutions were, from the beginning, geared to regulating rather than otherwise intervening in the economy. The Baltic states also shared the socio-economic vision institutionalized in the EU: preference for market-enhancing competition policy over excessive state aid, for assistance to new domestic start-ups over subsidies to huge foreign firms, and for reformed social policies that reintegrated people into the workforce over pension-dominated welfare provisions.

In this context, it is of great significance that EU accession helped the Baltic states to develop regulatory capacities. Capacity building has been supported by a variety of programs and has received an important amount of technical and financial assistance. However, the overall record is mixed. Whereas the new EU member states, including the Baltics, have an excellent record of transposing EU directives into national law, there is some doubt as to whether they also have developed the ability to implement directives, and to expand beyond core EU areas. Even so, the Baltic states perform better than most other new members when it comes to (administrative) capacity building. In a number of fields—transposition of EU directives into national law, fiscal discipline, investment climate, and innovation in public management—they have laid stronger foundations than their peers. They also have a better record in making use of monetary transfers stemming from EU funds. Moreover, in contrast to other countries, their reform efforts continued at full speed even after EU accession.[94]

93. Majone, "From the Positive to the Regulatory State"; Bruszt and McDermott, "Transnational Integration Regimes," forthcoming.

94. See "EU-8: Administrative Capacity in the New Member States: The Limits of Innovation," Report 36930-GLB (Washington, D.C.: World Bank, 2006). For the crucial field of public service reforms, see Jan-Hinrik Meyer-Sahling, "Sustainability of Civil Service Reforms in Central and Eastern Europe Five Years after EU Accession," (Gov/Sigma Paper 44, (Paris: OECD, April 2009); and for country differences in the degrees of politicization of

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Another area in which EU accession significantly reinforced the economic path embarked on earlier by the Baltic states concerns economic restructuring. While privatization and enterprise restructuring had been on these countries' agendas early on, it was in the course of EU accession that they completed large-scale privatization. The EU paid particular attention to the restructuring, privatization, and regulation of infrastructural sectors, such as energy, telecommunications, and the financial sector. Especially in the latter two it encouraged foreign ownership, assuming that selling off these sectors to outsiders would greatly enhance their efficiency. Foreign investment indeed started pouring in, and as a result, foreign banks took over the local banking systems. In Estonia and Lithuania, more than 90 percent of bank assets were transferred into foreign ownership. Latvia still kept one important financial institution, Parex Bank, in domestic hands, but even so, 60 percent of that country's banking assets was in foreign hands. Bank ownership was very concentrated, with two Swedish banks, Swedbank and Skandinaviska Enskilda Banken (SEB), being the major players.

At the same time, some drawbacks of Baltic policies were also reinforced during the accession process. This was especially true of the limited attention paid to the social costs of transformation. The limited formal competence of the EU in social affairs, an emerging workfarist orientation underlying EU initiatives in the field of social policies, and the existing social *acquis communautaire* all combined to strengthening selected institutions and individual social rights, without tackling substantive problems of social equality and integration. Thus, during the accession process new labor codes and tripartite or bipartite institutions and laws strengthening gender equality, antidiscrimination, and occupational health and safety were implemented. With the exception of unemployment, however, the massive social problems in the Baltic states were not dealt with in the accession negotiations. Pension reforms as well as health care reforms were monitored by the EU. Yet the major concern was not with fostering the well-being of pensioners, but with the connections of these social issues to public finances, and financial markets.

In this situation, however, global and European market actors came to the rescue of the Baltic populations, compensating them for the meager public welfare provisions. Indeed, during the 2000s, the three Baltic states turned into the fastest-growing economies of the continent. While the impressive economic growth did not reduce social inequalities, it nevertheless provided for rising living standards and a brighter economic outlook for most. Baltic growth during the early to mid-2000s relied almost entirely on domestic demand, fueled by high investment and rising consumption particularly in the construction and real estate sectors. Foreign bank ownership

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the civil service, Jan-Hinrik Meyer-Sahling and Tim Veen, "Governing the Post-Communist State: Government Alternation and Senior Civil Service Politicization in Central and Eastern Europe," *East European Politics* (forthcoming).

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greatly facilitated the availability of credit. Helped by the massive credit inflow from their parent companies, Nordic banks started to set nominal interest rates at the same levels as in their home countries. As inflation was higher in the Baltic states than in Western Europe, real interest rates became at times even negative. The foreign-owned banks also promoted euro-denominated borrowing at low costs. Against the background of euro-pegged national currencies and the preparations for EMU membership this practice was not considered overly risky. As a consequence, private loans increased dramatically, and within them, the share of euro-denominated loans soared (see table 6.1).

The banks aggressively lobbied for and marketed new financial products for households and enterprises. Among the most important was mortgage lending. Governments and foreign banks collaborated to set off a mortgage boom of unprecedented proportions. As usual, Estonia's second Laar administration took the lead, introducing a number of tax provisions favorable to home ownership in 2000. These included tax deductibility of mortgage interest payments, provision of housing loan guarantees and subsidies, and abolition of corporate tax on reinvested profits. The latter measure encouraged enterprises to invest their profits in the booming real estate sector. Latvia and Lithuania followed with similar measures.[95] Encouraged by state policies that sought to foster mortgage loans and by the overall bright economic outlook, which was also reflected in a strong increase of real wages, banks tended toward increasingly risky lending practices. The enormous expansion of mortgage lending set off unprecedented construction booms and house price increases. Nominal house prices in 2002–6 surged annually by 24 to 36 percent in the Baltic states—growth rates "unseen in the industrial world."[96]

Building on the work of Colin Hay and his co-authors on the Irish mortgage boom after EMU entry, as well as of Colin Crouch, this device can be dubbed "privatized house price Keynesianism."[97] The origin of the Irish

95. For the housing and mortgage boom, see Baudoin Lamine, "Estonia: Analysis of a Housing Boom," *ECFIN Country Focus* 6, no. 5 (2009): 1–7; Sebastian Leitner, "Baltic States: Perils of a Boom-Bust Scenario Ahead," *WIIW Monthly Report* 4 (2007): 1–8; Zuzana Brixiova, Laura Vartia, and Andreas Wörgötter, "Capital Inflows, Household Debt and the Boom-Bust Cycle in Estonia," William Davidson Institute Working Paper 965 (Ann Arbor: The William Davidson Institute at the University of Michigan, 2007); Balázs Égert and Dubravko Mihaljek, "Determinants of House Prices in Central and Eastern Europe," BIS Working Paper 236 (Basel: Bank for International Settlements, 2007).

96. Égert and Mihaljek, "Determinants," 4. These authors do not provide data for Latvia, but according to all available sources, Latvia was at the high end of the housing boom in the Baltic countries.

97. Colin Hay, Jari M. Riiheläinen, Nicola J. Smith, and Matthew Watson, "Ireland: The Outlier Inside," in *The Euro at 10: Europeanization, Power, and Convergence,* ed. Kenneth Dyson (Oxford: Oxford University Press, 2008), 182–203; Colin Crouch, "What Will Follow the Demise of Privatised Keynesianism?" *Political Quarterly* 79, no. 4 (October–December, 2008): 476–87.

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housing boom lies in the difference between the interest rates set within the euro area and those that should have prevailed in Ireland to combat its inflation which was higher than the EMU reference. The lower euro interest rates made mortgage loans and their repayment cheaper, while the concomitant increase of house prices allowed owners to obtain ever higher mortgages. A similar mechanism was at play in the Baltic countries, where the availability of low-interest loans, especially in euros, made credit in general and mortgages in particular advantageous.

In both cases, moreover, it was private banks that exploited the opportunities stemming from transnationalization. House price Keynesianism thus assumed a privatized form. As Crouch argues, privatized Keynesianism involves a shift from countercyclical state policies to secure income and employment in times of recession to the growth of private credit markets for low- and middle-income groups, which compensates for stagnating salaries and job insecurity and maintains consumer confidence.

A specific (and un-Keynesian) aspect of the Baltic states' privatized Keynesianism was that it occurred simultaneously with rising wages. High growth rates brought unemployment significantly down in all three countries, thereby producing increasing labor shortages. In addition to the market-induced decrease of unemployment, the Baltic populations also made use of their newly acquired right to emigrate when their countries joined the EU. According to a Eurobarometer survey of 2005, between 7 and 8 percent of the Baltic (and Polish) populations anticipated moving to another EU country. This was by far the highest share in all EU member states, old and new. Among the reasons for individuals' wish to migrate, factors related to work—higher household incomes and better working conditions—played a crucial role.[98]

Baltic (and Polish) would-be emigrants carried through on their intentions. Estonian analysts estimated that between 2004 and 2007 average gross emigration from Estonia, Latvia, and Lithuania amounted to more than 5, 8, and 12 percent of the population, respectively. That meant that after 2004, annually 7,100 Estonians, 19,800 Latvians and 42,300 Lithuanians left for EU-15 countries.[99] The same study found that "the average emigrant from Estonia was most likely a young person between 15–34 years of age, a blue-collar worker and male. Contrary to evidence from other countries and earlier time periods, employees with a low level of education were more likely to emigrate than highly educated workers."[100] Most migrants came from the

98. Tom Vandenbrande, ed., *Mobility in Europe: Analysis of the 2005 Eurobarometer Survey on Geographical and Labour Market Mobility* (Dublin: European Foundation for the Improvement of Living and Working Conditions, 2006), 23–25.

99. Martii Randveer and Tairi Rõõm, "The Structure of Migration in Estonia: Survey-Based Evidence," Working Paper 1 (Tallinn: Eesti Pank, 2009), 23.

100. Ibid., 2.

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private rather than the public sector, and the share of non-Estonians among migrants was slightly higher than their share in the labor force. Emigration also affected Tallinn less than Estonia's northeast and south.

Judging from scattered evidence, migration patterns from Latvia seem to be similar to those from Estonia. There is also evidence that the government of Aigars Kalvītis welcomed the beneficial effects of out-migration on Latvian labor markets. The state employment agency provided job seekers with information about opportunities abroad. Some media even commented that the agency was more engaged in identifying foreign than Latvian employment opportunities.[101] In contrast, Lithuanian migration seems to somewhat deviate from the Estonian and Latvian patterns. According to the OECD, in Lithuania highly skilled nonmanual employees and skilled workers form almost 40 percent of the emigration outflow.[102]

Overall, the economic boom and the credit economy greatly improved the living conditions of the less internationally mobile portions of the Baltic populations, while EU accession offered better possibilities for those willing to move.[103] It is remarkable that this could be achieved without governments having to change their priorities for balanced budgets and market solutions. As in the first postsocialist decade, during the 2000s governments stayed committed to prudent fiscal policies. High growth rates made it easier to reconcile pension and public sector wage growth with fairly balanced budgets. Moreover, the availability of consumer credit extended by foreign banks provided a market device for raising living standards of the population way beyond what their actual wage increases—impressive as they were—would have permitted.

The unfolding economic miracle, finally, also led to an increase of the Baltic populations' satisfaction with democratic and economic regime performance. Satisfaction with the political system, the support for which had been quite shaky during much of the 1990s, rose significantly in all three countries, with the most marked increase coinciding with the EU accession process. Among all accession countries, the rise in satisfaction with democratic regime performance between 1992 and 2004 was highest in Lithuania and Estonia, followed by Latvia in fourth place. The level of regime satisfaction in 2004 was highest in Estonia, followed by Lithuania. In contrast, Latvians' satisfaction with democratic regime performance, although it rose significantly, was still very low. Satisfaction with the economic performance of the regime also improved over time, the biggest increase, once more, coinciding with the EU accession period. Estonians were, however, consistently more

101. Emigration of Latvian workers continues to increase; Eurofound report, http://www.eurofound.europa.eu/eiro/2005/12/feature/lv0512104f.htm (accessed November 28, 2009).

102. SOPEMI-OECD, *International Migration Outlook 2008*, http://www.oecd.org/dataoecd/57/11/41255896.pdf (accessed November 28, 2009).

103. Guglielmo Meardi, "More Voice after More Exit? Unstable Industrial Relations in Central Eastern Europe," *Industrial Relations Journal* 38, no. 6 (2007): 503–23.

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satisfied with the functioning of the economic system than either Latvians, who stayed mostly negative, or Lithuanians, who only started to positively evaluate the system in 2004.[104]

104. Richard Rose, "Diverging Paths of Post-Communist Countries: New Europe Barometer Trends Since 1991," *Studies in Public Policy* 418 (Glasgow: Centre for the Study of Public Policy, University of Strathclyde, 2006), 23; Piret Ehin, "Political Support in the Baltic States, 1993–2004," *Journal of Baltic Studies* 38, no. 1 (2007): 1–20.

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