VARIATIONS OF MARKET ECONOMY
COMPARATIVE STUDY
16 COUNTRIES OF THE REGION

Edited by
Prof. Krzysztof Jasiecki

# CENTRAL AND EASTERN EUROPE 30 YEARS OF CAPITALISM

## 1989-2019

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## COMPARATIVE STUDY

**16 COUNTRIES OF THE REGION**

**Prepared by Centre for Europe**

**Warsaw University**

**Edited by**

**Prof. Krzysztof Jasiecki**

**China-CEE Institute**

**BUDAPEST, December 2020**

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# Acknowledgments

This book contains the results of research carried out as part of the project "Variations of market economy in Central and Eastern Europe. Achievements and challenges", which was implemented in 2019 by the Centre for Europe at the University of Warsaw (CE UW) and the Centre for International Relations (CSM) in Warsaw. It was necessary, among other things, to create an international consortium of institutional partners, which included (apart from Poland) representatives of research centres and experts from Hungary, Serbia and Lithuania. The research was commissioned and funded as the Research Project Tender (RPT) by the China-CEE Institute in Budapest as part of the "30 Years of Transition of Central European Countries: Reflection and Prospect" program. It covered sixteen CEE states participating in the "16 + 1" format[1], officially referred to as "Cooperation between China and Central and Eastern European Countries".

The concept of the research project prepared by the CE UW and the CSM was presented to the consortium's foreign partners and was the subject of many consultations via e-mail and WhatsApp. Between 24 and 25 of April, 2019, a kick-off workshop was held in Warsaw to discuss and agree on the main directions of analyses, including their theoretical framework, the structure of national reports and methods of consulting and modifying the prepared articles to develop their final versions.

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[1] In May 2019, the "16+1" format was transformed into a "17+1" platform enlarged with Greece's entry. Since the project already started earlier, the Greek case is not presented in this publication.

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# Preface

This book presents the results of the project, which main goal was to identify the key directions, institutional distinguishing features and results of economic and social development of selected Central and Eastern European (CEE) countries, which for the three decades have been carrying out systemic changes after the collapse of the command and distribution economy. The results are also characterised by the key issues and challenges facing both individual countries and subregions of this part of Europe.

The book consists of four chapters. The first two are theoretical, the third one contains empirically oriented national reports, and the fourth one summarises the work carried out. Annexes and a bibliography complete the publication. The first chapter analyses the diversity of the contemporary variants of European capitalism in the perspective of research devoted to these issues in neo-institutionalism, comparative economics and economic sociology (in the categories of Comparative Capitalism, Varieties of Capitalism and Diversity of Capitalism). It presents the debate on models of capitalism in the West after World War II, taking into account the controversy surrounding the tendency towards institutional convergence or divergence of its variants. A special catalyst was first the neoliberal Washington Consensus, and then the financial and economic crisis of Western countries, symbolically initiated by the collapse of the Lehman Brothers in 2008.

This chapter characterises the main threads of the discussion on the definition of market economy diversity, as outlined by the most frequently cited creators (and their successors) of competing concepts of "ideal types" of capitalism. It presents the advantages and disadvantages of these approaches, especially when applied to the CEE states in the period of systemic transformation, European integration and the structural crisis of capitalism. It puts forward standard and non-standard approaches to this

issue in discussions on various typologies of capitalism variants in European post-socialist countries ("transnational capitalism", "liberal capitalism", "dependent market economy", "foreign led capitalism" etc.) together with the criteria for their separation. Political and economic crises in the EU further strengthen the centrifugal, disintegrating and differentiating tendencies in the form of various concepts of the "multi-speed European Union", which overlaps with the transition to the next phase of civilisation development (Digital Capitalism, 4.0. Industry, etc.). Each of these phenomena significantly modifies the institutional shape of the market economy.

The second chapter presents the concept, methodology and data sources used in the project. The conceptual framework is outlined by the perspective of "comparative capitalism", rooted in the debate on variants of the modern market economy after the collapse of the Soviet Union in 1991. The use of such new terms as "emerging markets" or "transition economies" drew attention to the importance of different levels of development, and the institutional shape of many economies involved in globalisation processes. The principles of Anglo-Saxon capitalism, which at the time reached its apogee of political significance, exerted a particularly great influence on the direction of the development of the CEE states in the 1990s, particularly that this variant was largely supported by the EU. The countries of this region, however, have their specificity of development, which differs from other "emerging markets", which from the perspective of economics and economic sociology is conducive to the study of their institutional and economic shape. This section sets out some of the common CEE features of the development of new capitalism. They combine – in different ways in individual countries – elements of historical heritage from before World War II, a centrally planned economy, as well as rules and institutions adopted from different variants of modern Western capitalism, which has resulted in hybrid varieties of "patchwork capitalism" or "mixed type capitalism". Most often (with a few exceptions) they take the direction of evolution institutionally approaching the variants

of capitalism in Southern Europe. These similarities are particularly visible in the form of the large role of the state, imitative economic development, as well as the weakness of the knowledge sector and relatively low level of innovation of enterprises. Despite liberal labour relations in most states of the region, the variants of capitalism in the CEE countries diverge from the Anglo-Saxon model due to the weakness of the capital market.

What has been specified are the key research dimensions that create the basic methodological structure of economic and social profiles in the countries concerned in nearly three decades of economic changes: the political context and quality of institutions, the general economic outlook, the quality of entrepreneurship, modernisation based on FDI, the knowledge sector and the public opinion attitude towards transformations. The structure of each of these areas consists of characteristics of particularly significant processes and trends, indicators and statistical data embedded in international comparative rankings, including those of the World Bank, the International Monetary Fund and Eurostat. The analysis of the economic profiles of individual countries is an attempt to capture the most typical and characteristic elements, as well as to show the divergent and specific factors in their development. The differences in the level of economic development in various periods of the transformation in individual countries with reference to the EU average have been presented, as well as the justification for the analytical separation and division of CEE into several subregions with their different cultural and institutional features.

The third chapter contains sixteen case studies of CEE economies considered in four sub-regional groups: 1) the Visegrad Countries (the Czech Republic, Hungary, Poland, Slovakia); 2) the Baltic states (Estonia, Latvia, Lithuania); 3) the Southeast European states (Bulgaria, Croatia, Romania, Slovenia) and 4) the Western Balkans (Albania, Bosnia and Herzegovina, Montenegro, North Macedonia, Serbia). Motivated by theoretical findings, the choice of common dimensions and development indicators for individual states enables them to be compared with both other

CEE countries and other European countries, including EU Member States. (However, detailed comparisons of CEE with other EU countries are beyond the scope of this study.) In the context of the issues presented, the main hypothesis of this publication has been formulated. It reads as follows: the CEE countries create different variants of the market economy that lead to different economic and social effects. However, the 2008-2009 financial crisis in the EU and its course and consequences in the countries of the region have shown that the existing institutional solutions require significant system adjustments in all the countries studied.

The successes and challenges of economic and social policy in the countries of the region are characterised, which largely determine the possibilities of their development in the coming years. One of the catalysts for the new situation are also changes in social expectations, which find political expression in many CEE countries in the form of radical changes of leaders and elites. Political and institutional changes in Hungary since 2010 and those in Poland since 2015 are clear signs of such tendencies. At the same time, in other countries, including in the Baltic states, the continuation of reforms initiated in the 1990s prevails. In this context, the thesis on the special role of foreign direct investment (FDI) in the processes of modernising the economies of the region and the structural consequences of this phenomenon is being discussed. This role is subject to re-verification in connection with the financial and economic crises in the EU. Against this background, the criteria and manifestations of differences between the CEE countries are being considered.

In the political dimension, various "symbiotic" connections of economic liberalism with statism, paternalism, the oligarchic rule, the crony model of capitalism or elements of authoritarianism ("illiberal democracy") are relatively common. These phenomena occurred with great force at the beginning of the post-socialist transformation. In some countries of the region, they significantly weakened during the accession negotiations and joining the EU due to institutional and regulatory adjustments; especially the introduction of EU law (*aqui communitaire*). They began to intensify

again after the global financial crisis in 2008, and the accumulation in the EU of financial, economic, security and migration crises.

Chapter four presents the main findings generalising the results of national case studies in four separate CEE subregions, and a comprehensive summary of the project results. The characteristics of the subregions, however, to a large extent go beyond the content of country reports due to the need to outline a slightly broader reference system for the analysis of the processes and trends considered. Hence, this part contains synthetic historical introduction regarding all the discussed subregions, and it examines similarities and differences between the countries that make them up (e.g. in terms of the quality of institutions or achieved economic results). Generally, the subregions are represented by a structure similar to the parts referring to individual countries, but with greater emphasis on comparative aspects regarding different subregions or the whole of CEE. In turn, the summary of the study is a synthetic review of the most important project results, taking into account both the shaping and evolution of variants of capitalism in CEE, and the main causative factors in the region, including economic, cultural and security connections.

What is also discussed are the factors working for seeking new economic development strategies in many countries of the region, such as the depletion of the existing sources of growth, fears of falling into the "middle income trap", crisis and centrifugal trends in the EU, whose manifestation have become such phenomena as Brexit and the concepts of "Europe of many speeds", changes in the geopolitical situation (the militarisation of the Russian Federation's foreign policy, tensions in transatlantic relations between the US and the EU, trade and technological wars initiated by the administration of President Trump, etc.). Certain new environmental, civilisation and cultural challenges, including the demographic factors resulting from the aging of societies have recently also intensified in the CEE countries. The latter are all the more significant because after 1990 the countries of the region recorded the largest decline in the fertility rate in the world and large economic emigration to Western countries.

Work on the book was completed at the beginning of 2020. The coronavirus pandemic caused radical changes and diversifications of the economic situation in the Central and Eastern European countries. As in other regions of the world, a new phase of economic development has begun. Therefore, the book could be considered a synthetic summary of the evolution of economic systems in the region in 1989-2019, and a potential starting point for further research.

Krzysztof Jasiecki

# Chapter 1 Varieties of contemporary capitalism: literature review

Krzysztof Jasiecki

## 1.1. A new debate on the models of capitalism

After the Second World War, the dominant division in the literature dealing with contemporary economy was dominated by "capitalist" and "socialist" systems. Sometimes, attention was paid to the mixed systems combining the two (Yugoslavia was given as an example). What was also discussed were the degrees of greater or lesser state involvement in economy and social policy, often referencing Sweden as the "the middle way". Studies of the Comparative Capitalism have mainly been preoccupied with highly developed countries in Western Europe, the US, and Japan, and particular institutional features, such as the developmental state or capital market-based financial systems. In turn, researchers dealing with Asia, Africa and South America introduced other distinctions of the level of economic development. They distinguished "less developed countries" and "poor countries", or "emergent countries" and "developing economies" (Meier and Rauch 2007). Since the 1970s, the success of Japan and later of South Korea and some other Asian countries has stimulated numerous comparisons of Asian forms of capitalism and those of the West. Research confirmed that the issue of various versions of the economy and different models of capitalism has not disappeared from the interest of the social sciences, political economy, economic sociology, and business history. Especially that many types of capitalism have coexisted, even including new models of economy, like "state capitalism" in China (Wilkins 2010; Whitley 2010).

However, in the period of global rivalry between the "capitalist West" and the "communist East", such differences were usually considered less significant in the light of bipolar political controversy which lost significance along with systemic changes in Central and Eastern Europe, as well as with the collapse of the Soviet Union in 1991. When one of the powers at that time ceased to exist, for almost three decades domination

persisted of the neo-liberal Anglo-Saxon model of economic development. It focused on: reducing the role of the state (and collective benefits such as healthcare, pensions or education), the promotion of international competitiveness, spending cuts, deregulating markets, privatizing the public sector and state-owned enterprises, and the importance of individual responsibility. This approach was codified in the form of the Washington Consensus with its principles of liberalizing financial markets and macroeconomic stabilisation identified above all with the reduction of inflation (Williamson 1990). On the international forum, the International Monetary Fund (IMF) and the World Bank became the main advocates of the Washington Consensus. Their decisions were crucial for gaining support for *transitional countries* [2] that were lagging behind in the processes of economic globalisation and, partly, those of political liberalisation. Governments for whom the Washington Consensus-style reforms became a point of reference began to transform economies in a similar way, and the Anglo-Saxon version of capitalism was often considered a universal model to follow. In Western Europe, under the pressure of US successes, there was also an increase of structural problems related to the decline in competitiveness and profitability of enterprises, as well as rising costs of labour and those of social benefits. The reforms introduced were reflected in the European Community in the principles of the single market, development of financial services, competition policy, reduction of income redistribution and labour market flexibility. They were institutionalised in the form of convergence criteria included in the Maastricht Treaty of 1992, and later by the creation of the European Central Bank and the eurozone in 1999.

However, the view about the transformation of capitalism according to the patterns of one institutional variant was being increasingly criticised. The implementation of neoliberal reforms led to very diverse results, including those contrary to their declared goals. Their effect included both the convergence of levels of economic development and the accumulation of

[2] The *transitional countries* category included 3 southern European states, 20 countries of Latin America, 25 of Central and Eastern Europe and the former Soviet Union, as well as 30 African, 10 Asian and 5 Middle Eastern states (Carothers 2002).

intra- and inter-national and regional disparities. On a global scale, such reforms produce various imbalances, economic polarisation and income stratification, as well as poverty and social exclusion, which also confer different institutional characteristics to countries and regions. Economic globalisation has accelerated multidirectional development trends, manifested by a greatly diversified distribution of assets, access to finance capital and technology, expenditure on research and development, as well as differences in the standards of human rights and environmental protection. Globalisation creates new rules of interdependence in the world, but not its uniformity. It involves a new diversity of prospects, opportunities and resources. Such directions in systemic changes were also reflected in the terminology which takes into account a different level of economic development as well as the quality of the institution and the historical specificity of the country. In addition to the adherent to neoclassical economy distinction on *advanced economies* and *developing countries,* new categories appeared, such as *emerging markets*, as well as *transition economies*. High-performing Asian economies, like the Four Tigers and the newly industrializing economies, started to be recognised (World Bank 1993).

The processes of globalisation, especially the increase in foreign trade and foreign direct investment, altered the nature of economies, especially in host states. They brought about new challenges and created new versions of the strategic approach to building national wealth (Kotler *et al.* 1997; Guillen 2001; Nolke 2012). In such circumstances, economic modernisation does not involve duplicating patterns of one economic system throughout the world, but rather breeds further varieties of capitalism. The processes of likening economic institutions are accompanied by strong tendencies to maintain their separateness and the emergence of new configurations of production factors that create different faces of capitalism. The trans-nationalisation of economic transactions also confirms the view that market economy connotes not only an economic system, but also political, social, cultural, and religious conditions and traditions. The extend of heterogeneity in "beliefs" within any country is inseparable from our thinking about a "capitalist economy" and the varieties of capitalism (Wilkins 2010: 641). As a result, globalisation

broadens the spectrum of institutional configurations that organize economies and relations between the state and the social classes and strata that make them. Each market economy has many public and private institutions. Political economy demonstrates that these institutions (which produce “the rules of the game”) differ tremendously and systematically among countries, with significant consequences for economic performance. “The analysis of these differences is the subject of the new comparative economics” (Djankov *et al.* 2003: 1). This approach is mainly concerned with the impact of differences in institutions on economic performance.

In the context of such changes, economists and sociologists stress that we are participating in another "war of systems" in which different varieties of the market economy are relatively successful in different periods and under different conditions. What can be recalled here is the long-term controversy surrounding the Anglo-Saxon, German and Japanese models (Ingham 2009). The re-emergence of such a phenomenon is confirmed by the global financial crisis of 2008 and its consequences in the form of discrediting the Washington Consensus recommendations, increasing the role of the state as well as the rise of the economic and political power of Asian countries with China at the forefront (Frankopan 2018; Musacchio and Lazzarini 2014) [3] . This counter-movement should be seen as part of wider developments in global liberal capitalism. The new direction is termed as organised capitalism, with a stronger focus on the national level. This is reflected in the Brexit and the election of Donald Trump in the US, the rise of anti-systemic parties in continental Europe and the erosion of global liberal institutions (Rodrik 2018; Nolke 2017). These tendencies lead to further economic and political fragmentation of the world, which at the same time increases the role of the largest states. They also overlap with technological changes known as the Fourth Industrial Revolution (4IR). The distinctive feature of the 4IR is the growing use of artificial intelligence and the Internet of things, which is beginning to change strategies for

[3] The limitations and crisis tendencies of neoliberal globalisation were previously indicated by well-known American researchers, both leftist (Krugman 1999; Stiglitz 2002; Wallerstein 2003), and right-wing (Ferguson 2004; Huntington 1996, 2004).

economic development, the labour market and social life. These developments are redefining the pathways to prosperity, and they are already creating new divergences and polarisations within and between economies and societies. They also change the political and institutional context of economic and social development (Schwab 2018).

## 1.2. Defining institutional models of capitalism

The processes of globalisation result in the fact that interest in the comparative perspective keeps growing in studies on contemporary capitalism. The genesis of such an approach is related to the work of researchers who, like Andrew Shonfield (1965) and Michel Albert (1991), characterised various typologies of national models of capitalism. These typologies have their theoretical roots and are developed in the French regulatory school, in neo-Marxism and in new institutionalism. In the last dozen or so years, discussions in the sphere of comparative characteristics of capitalism (Comparative Capitalism) have been determined to the greatest extent by two classic books on this subject. They defined, although in a slightly different way, conceptual and methodological frameworks in research on market economies conducted in the new institutional economy, comparative political economy, economic sociology, organisation and management, as well as political science. At the same time, despite their genesis and initial coverage of only highly developed OECD countries, they became an inspiration for comparative market economy studies conducted also in other countries, in Latin America, Central and Eastern Europe, and in Asia.

In the first of those publications, Peter A. Hall and David Soskice in *Varieties of Capitalism. The Institutional Foundations of Comparative Advantage* (2001) presented two models of capitalism. They are based on the criterion of the dominant way of coordinating economic activities and the criterion of the ability of the economy to create innovations. The use of the criterion of coordination focuses attention on the methods used by companies in order to connect their strategies with the institutional and social environments. In this approach, the economy is treated as a system

in which enterprises operate based on relations with other actors of economic life. The ability to create radical innovation and/or incremental innovation in enterprises was adopted as the second classification criterion of models of capitalism. For Hall and Soskice, the joint consideration of these criteria became the premise for distinguishing two models of capitalism: the liberal market economies (LME) and the coordinated market economies (CME). Using the results of many studies, they distinguished five key institutional dimensions important for defining the capitalist models from the perspective of business coordination: 1) the sphere of industrial relations; 2) vocational training and education; 3) corporate governance; 4) inter-firm relations and 5) relations with employees.

Anglo-Saxon countries, with the United States at the forefront, were categorised as LMEs. This model is characterised by the dominance of coordinating the economy through the market, prices and contractual relations based on the cost calculation typical of neoclassical economics. The management retains full control over the company and has the freedom to hire and dismiss staff. Financing company's development takes place to a large extent through the stock exchange which is frequently subject to shareholders' evaluation, while the management boards of companies pay close attention to the current reactions of investors. The working conditions depend mainly on the macroeconomic policy, market control of wages and inflation. Education and vocational trainings are run by institutions offering education focused on general skills. Companies avoid investing in specialized employee qualifications (with the exception of the management) because the competitive market "pilfering" employees gives them opportunity to leave for other enterprises. On the other hand, it is not profitable for employees to invest in specialised qualifications due to low protection of employment and significant turnover of human resources in companies. In management, the corporate structures concentrate their power at the managerial level, which facilitates managing the company and employees in the conditions of high pressure from the financial markets and the necessity of high resource mobility. Companies focus on profits, current revenues and valuation of shares on the stock market. This model is distinguished by the weakness of trade unions, which have no significant

impact on the level of remuneration. Relations between companies are defined by antitrust regulations that counteract price and market collusion, as well as a legal system that favours the interpretation of written contracts.

Hall and Soskice (2001: 19-21) recognised Germany, Japan, Switzerland, Benelux and the Scandinavian countries as the model example of coordinated market economies (CME). In their opinion, in this variant of capitalism activities in the sphere of industrial relations are aimed at cooperation of economic entities supported by public policies and social dialogue institutions, such as sectoral collective agreements, tripartite neo-corporatism, participative work organisation or long-term cooperation of investors with companies. The CME model is characterised by strong trade unions and employee councils in enterprises as well as a high level of employee protection. The labour market is characterised by low liquidity. The level of remuneration is agreed on by trade unions and organisations of employers, which also coordinate a system of vocational training raising specialist qualifications of employees in line with the profile of enterprises (which is financed by employers and the state). Companies are geared to a consensual management style. Due to the large influence of employee representation and business networks, managers have relatively limited power in enterprises. They are also connected by networks of strong links between shareholders and members of employers' associations. This allows for an internal exchange of information that opens up access to capital more depending on the reputation of the management than on the value of the stock. Such means – the so-called "patient capital" accounted for in the long term – make managers focus less on the current profitability of companies. A significant role in agreeing on industrial standards, establishing business law or transferring technology (due to their links with companies and the research and development sector) is played by sectoral organisations.

The dichotomous typology of the liberal economy and of the coordinated economy is criticised for excessive simplification of reality. Its creators were aware of such a weakness since they created a separate category of countries that could not be explicitly included in the liberal model or in the coordinated one, consisting of France, Italy, Spain, Portugal, Greece and Turkey. They described it as "Mediterranean capitalism". They recognised

as its differentiators the large agricultural sector and significant state intervention in out of the market coordination of corporate finance and in more liberally organised labour relations[4] (Hall, Soskice 2001: 21). Although the countries of "Mediterranean capitalism" are generally considered to be closer to the model of coordinated capitalism than to liberal capitalism, discussions on this subject have opened up space for formulating proposals that go beyond this dichotomy. A well-known earlier example of this approach was the Esping-Andersen concept (1990), which distinguished three models of the capitalist welfare state – liberal, corporatist and social-democratic. The differences between them are seen as the result of political conflicts or the domination of culturally rooted traditions that have an overwhelming influence on the shapes of institutional models. As in other typologies, the liberal model is associated with Anglo-Saxon countries. On the other hand, Germany created a conservative (corporatist) model, also referred to as "continental", appearing inter alia in Austria and Switzerland. The third, social-democratic, variant occurs in the Scandinavian countries. With time, this typology has been extended by a fourth option – a southern European welfare state, based on the important role of the family and other informal institutions (Crouch 2009).

The need for a separate treatment of Southern Europe, as well as the wider issue of institutional "hybrids", which do not fit in the typology of liberal and coordinated economies, were also noticed by other researchers. Spain and Italy can serve as an example of countries well illustrating both issues, which are sometimes referred to as "mixed market economies" (MME). In their case, the key role of political institutions – especially that of the state – is emphasised in the sphere of regulation and production of goods, high politicisation and clientelism of interest groups as well as fragmentation of the main economic actors. Systemic hybrids are usually the effect of „borrowing" institutions from various models of capitalism, for example combining the Bismarck tradition of the pension system with liberal elements in health care. Due to historical conditions and the social

[4] Concerning the "Mediterranean capitalism", the authors emphasised that their approach should not be regarded as limited to only two "ideal types" because each economy produces its own specific capabilities and coordination mechanisms.

situation, including traditions of interventionist dictatorships, regional differences, conflicting patterns of political culture and poor articulation of interests, "hybrid" institutions in Spain and Italy are often dysfunctional, and coordination mechanisms – both market and non-market – ten to be unreliable and imperfect (Molina and Rhodes 2007; Hall and Gingerich 2009). The course of the economic crisis in the countries of Southern Europe since 2008 has largely confirmed the negative role of "hybrid" coordination institutions in the economy.

The issue of "hybridisation" understood as a deviation from "pure" models of capitalism, combining institutional components derived from their various variants, is also discussed in relation to other countries and regions of the world. It illustrates the problem of limitations of any typologisation of capitalism, which in the face of empirical data are usually incomplete and require supplementing with new categories and sub-categories for it is extremely difficult to develop criteria that – in a way that does not raise any significant doubts – would have the value of an exhaustive, typological approach to the diversity of modern capitalism. As proved by, among others, Hall and Gingerich (2004) and Schneider and Paunescu (2012), using the coordination index, many states fall into the spectrum between the two "ideal types". Capitalism is more diverse than any typologies[5] describing it. Some researchers even express the view that in the conditions of globalisation, the typological purity and clarity of institutional models are losing importance, as manifested by the adjustments of states benefiting in this respect from various, even contradictory, inspirations and models. France, which in different periods and proportions borrowed German or Anglo-Saxon solutions (Schmidt 2002, Albert 1991), is indicated as an exemplification of the introduction of such "hybrid" forms.

Another of the leading voices in the debate on the varieties of capitalism was the book by French economist Bruno Amable, *The Diversity of Modern Capitalism* (2003). The researcher went beyond the dichotomous typology of LME and CME, presented by Hall and Soskice. In Amable's concept,

[5] Relevant differences also exist within the "pure" categories. Hall and Soskice (2001: 34) distinguished two subcategories within coordinated capitalism: industry-based coordination, such as in Germany, and group-based coordination, exemplified by Japan and South Korea.

the central position is occupied by the notion of institutional complementarity that was once introduced by Aoki (1994). According to the economic understanding of this concept, Amable defines complementarity as such a relationship between two institutions in which the presence of one institution increases the effectiveness of the other. For example, if the dominant role in the financial services system is played by banks, the high efficiency of the labour market is ensured by a regulated and stable system of employment. Banks assume a long-term perspective, which fosters the absorption of short-term fluctuations in demand for labour. In this concept, models of capitalism can be considered from the angle of the specificity of links among economic institutions. They form specific interrelationships that produce, to a greater or lesser extent, a synergy effect. However, the establishment and connection of such institutions is usually an expression of a political compromise among various interest groups forcing different goals. Each institutional change violates the existing system of interests and requires strong social support necessary for its implementation to be built around it. The conceptual framework proposed by Amable differs in several important respects from the concepts of Hall and Soskice.

First, it identified five slightly differently defined key areas constituting the pillars of the institutional architecture of each country's economy. These are: type and scope of competition on the product market, the labour market and the impact of market participants on wages, the systems of financial intermediation and ownership supervision, the social security system as well as the education and knowledge creation sectors. Secondly, for each of the highlighted areas, having conducted empirical tests, Amable selected a set of indicators best reflecting the operation of its institutions. Their separation provided variables used to detect complementarity and explaining the shape of the institutional architecture of individual areas. In his study, he applied two statistical methods: the analysis of the main component variables and cluster analysis, which provided the possibility of dividing the entire analysed group of countries into smaller and more homogeneous clusters. In each cluster there is a similarity of institutional architecture and strong institutional complementarity. Thirdly, the application of such a multidimensional and statistically sophisticated

procedure enabled Amable to distinguish five models of capitalism coexisting in the most developed economies of the world. They have similar institutional and economic patterns that result from their geographic proximity or common trajectory of political and historical development. In this way, the following models have been identyfied:1) market-based capitalism as a collective category covering countries in one cluster, such as Australia, Canada, the United Kingdom, the United States of America; 2) Asian capitalism (Japan, Korea); 3) continental European capitalism (Switzerland, the Netherlands, Ireland, Belgium, Norway, Germany, France, Austria); 4) social-democratic model (Denmark, Finland, Sweden) and 5) Mediterranean capitalism (Greece, Italy, Portugal, Spain). The researcher states that the distinguished models are of the "ideal type" nature, none of which can be fully identified with them (Amable 2003: 114). The model-defined variant of the market economy has never existed in its entirety. Understanding the institutional rules requires, however, a certain simplification of reality, which justifies the use of abstract models which task is to focus on the key aspects of the adopted concepts.

The further development of research of the market economy models confirmed the limitations of the dichotomous concept of capitalism and proved the need to use more models of the market economy. The key assumptions of the dichotomous concept, its theoretical framework, methodology and main indicators are insufficient for the full characterisation of the market economy, both at the level of state variants, as well as regarding dependencies among centres of political power, international corporations and domestic economic development. The dichotomous typology of capitalism has, however, triggered new approaches in which national economies are characterised by distinct institutional configurations that generate a particular systemic "logic" of economic action. In turn, the inclusion of non-OECD countries in the study drew the attention of researchers to the existence, emergence and development of very diverse forms of capitalism. Among the new research on this issue, institutional analyses of Asian countries have become particularly significant due to the growing role of this region of the world. According to the results of the research, almost all Asian forms of capitalism – with the exception of Japan – are fundamentally different from

the Western variants, which means that their characteristics require going beyond the established theoretical scientific framework developed in a completely different historical and cultural context (Witt, Redding 2013; Witt *et al.* 2017; Nolke 2019). For other reasons, also research into the economies of the CEE countries creates new problems and challenges in the field of Comparative Capitalism.

## 1.3. The diversity of the new capitalism in the CEE countries

Recalling the theoretical perspectives became the starting point and reference system for studies on capitalism also in Central and Eastern Europe. Due to the direction of political changes and the accession of many of the CEE countries to the EU in the middle of the previous decade, the theoretical and methodological framework of Comparative Capitalism was applied to the conditions of the countries which introduced post-socialist systemic transformations. Yet a number of circumstances make their direct application in the CEE countries very difficult. Research into the diversity of capitalism was initially limited to OECD countries. Concepts and methodologies created for their needs reflected the conditions existing in highly developed states. For example, one of the limitations regarding CEE was to emphasize the large separateness of liberal capitalism and coordination capitalism. However, in this region such institutional and social configurations are just beginning to shape. They are also largely fluid and incoherent, conditioned by specific circumstances. In individual countries of the region they are formed in various proportions by the interpenetration of the legacy of state socialism (statism), the expansion of capitalism in large agglomerations (neoliberalism) and exclusion among the "losers of transformation" (blue-collar workers, the rural areas etc.).

Unlike in Western countries, the creation of a market economy in CEE coincided strongly with the processes of globalisation and European integration. This process is going on not only within the borders of nation states. To a large extent, it is associated with changes in the whole group of countries, which gives it a supranational character, sometimes referred to as Transnational Capitalism in CEE (Bohle, Greskovits 2007). Its genesis is also of a special nature. In the early 1990s, many countries of the

region were just beginning to build their own state institutions after the breakup of the Soviet Union, Czechoslovakia and Yugoslavia. Most of those countries are small, less developed than the countries of the "old" EU, less organised internally and have little political influence. Changes in CEE also took place in circumstances that were, in many aspects, opposite to the tendencies prevailing in Western countries. In the 1990s, the intensifying integration within the EEC/EU coincided in the CEE region with disintegration and political and economic fragmentation, and the expansion of Western multinationals in this region overlapped with the collapse of state enterprises and the emergence of small businesses as the basis of the private sector. Deindustrialisation and restructuring of the economy, as well as budget constraints and the implementation of neoliberal reform programs gave rise to social problems in many CEE countries not occurring in such a scale in Western Europe. Under these conditions, researchers who took as a reference the institutional models characteristic of highly developed economies encountered problems of adequacy of those models to the "new capitalism" in CEE. The specific role of the post-socialist state as the main organizer of systemic changes, as well as the influence of globalisation and integration with the EU on the transformations in the countries of the region previously excluded from the mainstream of economic transformations can be indicated as such problems. The distinctive feature of most the CEE countries has been the relative economic backwardness and the occurrence of numerous developmental deficits, including "civilisation competences". It is also necessary to consider the large discrepancy between formal and informal institutions, which makes the systemic changes rather poorly embedded in the axiological systems of the societies in the region (Jasiecki 2013).

These are radically different circumstances in comparison with the established and deeply rooted models, institutions and social behaviours analysed by the studies of Comparative Capitalism. As a result, several competitive positions emerged in response to the challenges related to the new problems of the region. Proponents of one of them believe that the new variants of the market economy in CEE are of a temporary nature. Due to the not fully formed or variable nature of market and non-market coordination methods, it is difficult to consider them as a separate type of

capitalism (Hancke *et al.* 2009: 290). The view is also expressed that the differences among the CEE countries – both EU members and non-member states – are not deep and persistent enough to be considered in terms of rigid institutional boundaries (Zielonka 2007: 57). Focusing on the centres of modern capitalism, however, provides language for the late comers that are trying to join the ranks of advanced economies. Comparisons in the categories of Comparative Capitalism, Varieties of Capitalism and Diversity of Capitalism are stimulating and useful.

A manifestation of such thinking about the "new" economy in CEE are two theoretical approaches sometimes referred to as the standard conceptual framework or non-standard approaches (Rapacki *et al.* 2018). The first one refers to the dichotomous typology of the liberal economy and the coordinated economy by Hall and Soskice. By means of various groups of indicators, indexes calculated for various institutional areas or cluster analysis, it aims to determine the approaching, similarity or belonging of the CEE countries to one of the two variants of capitalism, LME or CME, listed in this typology (Knell, Srholec 2005, 2007; Hanson 2007; Babos 2010; Ahlborn *et al.* 2016). This approach aims to understand the emerging capitalism in CEE by "entering" its emerging national varieties into existing typologies and capturing the convergence processes into two main models. It proved useful in the analysis of various institutional dimensions of economies in the CEE countries – coordination of economic activity, industrial relations, labour market, social policy or financing development. It also facilitates the separation of the directions of the evolution of the institutional architecture of the states of the region in a way that signals their specificity, main similarities (the Baltic states) or differences (e.g. Slovenia versus Estonia). However, the conclusions from this kind of analyses are often ambiguous and not very consistent. Depending on the adopted initial assumptions and applied research methods, the same transformation countries, e.g. Poland, may have different characteristics. They are classified into different categories of varieties of capitalism, or as "mixed types" considered to be different from the "pure" models (Ahlborn *et al.* 2016: 29). This lack of unambiguity triggered the mutation of the standard concept which refers to the dichotomous typology of capitalism by Hall and Soskice. Going beyond this typology, Andreas Nolke and

Arjan Vliegenthart (2009) added the third category they refer to as a "dependent market economy" (DME). They have applied this term to the V4 countries, but it also has references for the entire CEE region. This proposal is embedded in reflection on the economies that are less developed than the western ones and refers to the Latin American tradition of "school of dependence" (e.g. Cardoso, Faletto 1979). Within this approach, in the V4 countries which are an exemplification of the DME model, the most significant way of economic coordination are the hierarchical connections occurring within the transnational corporations (TNCs). They control strategic sectors – financial services, telecommunications, trade, exports and some selected largest companies from the top 500 list. The economies of the V4 countries operating within this model show a comparative advantage in the scope of assembly and production of relatively complex durable goods, for example cars.

The relative success of the DME model is based on the use of low-cost potential (compared to Western countries) and relatively well-qualified employees managed by TNCs, which, in the companies they control, have combined local labour resources with innovations introduced through foreign direct investment (FDI). The organisation of the innovation system in these countries differs significantly both from the organisation typical of LME economies (where innovations are transferred through market rules) and from CME, where innovations are widespread through cooperation of companies, industry organisations, science and government agencies. As a result, the DME model favours imitative innovation, especially importing new technologies, rather than creative innovation, e.g. research and development[6]. Consequently, the benefits of its operation may turn out to be temporary, influenced mainly by TNCs. A similar way of thinking also occurs in other papers which, although they derive from different theoretical premises, define the CEE countries as a "liberal, dependent variant of capitalism", "foreign led capitalism", capitalism "from outside" etc. (King 2007; King, Szelenyi 2005).

[6] The concept of "dependent market economy", generalizing the transformational experience of the V4 countries, also inspired similar attempts to develop a model characterizing the specificity of the development of the Baltic states, referred to as the "flexible market economy", FME (Kuokstis 2011).

Another variation of the standard position is created by books and papers referring to the theoretical framework and classification scheme of models of capitalism presented by Bruno Amable (2003). They examine whether new variants of capitalism in CEE are heading towards one of the Western European models distinguished by him: the market-based model, the social-democratic model, the continental European model or the Mediterranean model. In this sense, they significantly broaden the areas of comparison. They also give them a more multidimensional character, indicating the phenomena and processes of convergence towards the four West European models, including in the form of homogeneous clusters consisting of countries that meet specific criteria. Such comparisons have proved that in some areas the CEE countries may be approaching one model of capitalism, e.g. the Mediterranean model, and in others to the continental one (Mykhenko 2005; Próchniak *et al.* 2016). Other comparisons have led to the conclusion that the differences between the "old" EU states representing the four models of capitalism according to Amable is much larger than the differences among the CEE countries (Farkas 2016). Similarly, as in the case of analyses concerning comparisons with the dichotomous typology of capitalism, the conclusions resulting from the characteristics of changes in this region are not unambiguous. Some researchers claim that the CEE countries have built their own institutional architecture pattern, corresponding to their historical heritage, in line with the initial conditions of systemic transformation (Farkas 2016). However, the majority claim that the construction of post-socialist capitalism is still ongoing and has not yet taken its final shape. This thesis is also confirmed by the systemic changes introduced in recent years, including in Hungary (since 2010) and in Poland (since 2015).

Comparisons of the CEE countries with the four models of capitalism identyfied by Amable lead to paradoxical conclusions. On the one hand, they illustrate the considerable homogeneity and stability of the pattern of the institutional evolution of the region since the 1990s, resulting from a similar starting point and participation in the process of European integration. However, they also show signs of the institutional closeness of the CEE countries simultaneously to more than one model of capitalism. This phenomenon is referred to as "patchwork capitalism". In relation to

Poland, this term is characterised by lack of a comprehensive vision of the target model of the capitalism that is being built, co-existence of construction elements taken from various institutional orders in Western Europe (especially from the Mediterranean, continental and Anglo-Saxon models), as well as the overlap of the centrally planned economy legacy, the course of systemic transformation and political compromises (Rapacki 2018: 213-214).

On the other hand, the non-standard approach to post-socialist capitalism in the CEE countries assumes that the unprecedented nature of the changes in the region prevents the direct application of the theoretical proposals by either Hall and Soskice, or by Amable. On the other hand, other factors determining the shape of capitalist models emerging in the region are indicated. One such influential proposal focuses on the forms of participation of its states in the global economic exchange (Myant, Drahokoupil 2011). The balance and current turnover structure, as well as the commodity structure of their exports are considered the most important criteria differentiating countries, which allows to distinguish six forms of integration of the CEE countries with the global economy. At the same time, these forms define a certain hierarchy of relations with the external environment: export-oriented FDI in complex sectors; export-oriented complex sectors without FDI; simple manufacturing subcontracting to multinational corporations; commodities exports; dependence on remittances and aid, and dependence on finalised growth. They have been juxtaposed with the internal determinants of varieties of capitalism such as the scope of the rule of law and the nature of property rights, the economic role of the state and the type of relationship between the state and the business sector. Based on a comprehensive analysis of these criteria, five types of capitalism were distinguished in post-socialist countries: 1) FDI-based second rank market economies; 2) peripheral market economies; 3) oligarchic (clientelist) capitalism; 4) order states and 5) remittance and aid-based economies.

This approach focuses mainly on structural differences between post-socialist countries and Western European countries. These differences reproduce hierarchical interdependencies in the international system of division of labour, which is more advantageous for more developed

countries. Small countries with limited resources find it difficult to change this system. However, as shown by Myant and Drahokoupil, a country can position itself differently in this system. Another concept, often cited in discussions on the non-standard approach to the diversity of capitalism in the CEE countries, is based on a different analytic scheme. Its authors, Bohle and Greskovits (2012), extended the three-element analytical scheme by Karl Polanyi, containing the factors of politics, social protection and the market (Polanyi 1957). They gave it the shape of a hexagon which consists of several criteria for assessing dimensions, such as: the government, corporatism, the welfare state, macroeconomic coordination, market efficiency and democracy. Using these criteria, the researchers distinguished four different types of post-socialist capitalism:

1. Pure neoliberal type found in the Baltic states. This type of capitalism combines a radical market orientation with a small scope of compensation for transaction costs incurred and a very limited influence of citizens and their organisations on political decisions.
2. Embedded neoliberal type, represented in the V4 and Croatia. Its distinguishing feature is building a socially accepted compromise between market transformations and social cohesion in the area of governance, in which the postulate of inclusion of citizens is often difficult to reconcile with the effectiveness of democratic institutions.
3. Neo-corporatist capitalism taking place in Slovenia. The market reform strategy has been combined with social protection programs and compensation of reform costs to those who are losing on systemic transformation. Its distinguishing feature was the functioning of multi-level rules conducive to negotiating agreements and reaching compromises among employers, employees and the state.
4. Non-regime countries with an undefined profile of capitalism located in South-Eastern Europe. This typology has been used, among other things, in EU research on the relations among labour markets, industrial relations and welfare states (Industrial Relations in Europe 2012).

In the current of non-standard concepts, going beyond the typologies by Hall, Soskice and Amable, there is also a perspective of the origin of the transition from a centrally planned economy to a market economy (King, Szeleny 2005). According to the criterion of the way capitalism was formed, it is possible to distinguish its three post-socialist varieties: 1) capitalism "from below", which was created and developed in rural areas in China and Vietnam. It hybridises the coexistence of the command economy and large state-owned enterprises with the activities of private companies; 2) capitalism "from above", also referred to as "patrimonial capitalism" (Russia, Ukraine, Romania). It was initiated by the party and state elite of the previous system and with the implementation of market reforms it transformed into an oligarchic model (Aslund 2008); 3) capitalism "from without" or "from abroad", also referred to as liberal capitalism, initially occurring most strongly in Hungary, the Czech Republic and Poland. It appeared as a result of the neoliberal transformation of the political system by the elites. The key role in its birth and development was played by foreign investors and cooperation of domestic enterprises with TNCs. This type of capitalism shows many similarities to the DME model distinguished by Nolke and Vliegenthart (2009).

An overview of the main trends in the literature on the diversity of capitalism in the CEE countries leads to the conclusion that the discussion on this subject is far from complete. It provides a broadly defined theoretical framework, concepts, methodologies and typologies that allow in a neo-institutional perspective for in-depth, comparative analyses of various aspects of economic transformations in the region. Attention is drawn to the separateness of the CEE countries, including the specific intertwinement of external and internal factors (such as the DME model) or the impact of forms of participation in international economic exchange on the varieties of capitalism. The typologies of post-socialist countries are also inspiring, considering the factors of politics, social and market protection, or the transition to a market economy according to the criterion of the ways of forming capitalism. The fact that these concepts often do not lead to unambiguous conclusions is a derivative of the special conditions in which institutions in post-socialist countries were created. The specifics

of transformation, including the interpenetration of the influence of various external and internal factors, make the models of capitalism in the CEE countries less cohesive than in Western countries.

It is also the result of a high pace of change and their early rooting in social and institutional structures. The occurrence of many phenomena and tendencies in varying degrees affecting the character of capitalism on a larger international scale in recent years is also worth considering. They redefine the rules of international relations and force the search for new development strategies, including ways of adapting to the radically changing political and economic environment. Among such trends there are: the collapse of the neo-liberal paradigm in international economic relations since 2008, the de-institutionalisation of the world order carried out by President Donald Trump in the US, and the exit of the United Kingdom from the EU. There has been a reversal of the policy of states, which were the main promoters of globalisation towards economic protectionism and nationalism. The EU crisis reinforces the centrifugal tendencies of the "multi-speed Union", and the dynamic technological development accelerates the transition to the next phase of civilisation development ("Digital Capitalism"). National models, which were so visible in the 1990s to the then prolific comparative international relations literature, quickly started to be seen as "in flux" or "in crisis" (Meardi 2018: 5). These are the circumstances that redefine the issue of both possible strategies for economic development as well as for the optimal model of capitalism in the CEE-16 countries.

# Chapter 2 The concept, methodology and data

Krzysztof Jasiecki

## 2.1. A conceptual framework

The main purpose of the thesis is a synthetic description of selected key phenomena, processes and trends in the economies of the 16 CEE countries since the beginning of the post-socialist system transformation in the 1990s. It provides a kind of review and compendium of information on the region's economic development during nearly three decades of systemic changes. The specificity of this study is determined by the fact that it was prepared with particular emphasis on the theoretical perspective and methodological categories of Comparative Capitalism, including discussions inspired by the results of research by Hall and Soskice (2001) and Amable (2003). The conceptual framework of the work is outlined by the context of this perspective, rooted in the debate on the models of modern capitalism after the fall of Soviet Union in 1991. The use of new terms, such as: "emerging markets" and "transition economies", drew attention to the importance of the differentiations of the development levels and the institutional shape of many economies becoming involved in globalisation processes. The principles of Anglo-Saxon capitalism, which then reached its apogee of political significance, had a particularly great impact on the direction of development of the CEE countries; especially that in in the 1990s this model was largely supported by the EU. This was related to the interests of the strongest EU countries which saw the opportunity of strengthening their competitiveness through expansion into post-socialist countries that were undertaking major systemic reforms.

Some countries of the region, in order to leave their long-standing dependence on the Soviet Union and later the on Russian Federation, sought to integrate with Western political and economic institutions as promptly as possible. However, the course of the transformation in the CEE countries showed that the diversity of political preferences of the ruling elites and societies, differences in initial conditions, economic structures, geographical locations and development trajectories brought about significant differences going beyond one universal pattern of systemic

transformations. At the same time, the process of the EU enlargement to the east contributed in many countries of the region (especially in the accession states) to theoretical and methodological changes which entailed new definitions of statistical categories and indicators of economic and social development adopted by the World Bank, Eurostat and the OECD. The new geopolitical and economic locations, along with discussions about the transformation of capitalism at the beginning of the 21st century, favoured the application of Comparative Capitalism to CEE. Research undertaken in this perspective, both in the standard and non-standard variant (characterised in Chapter 1), provided a cognitive impulse for comparing the emerging new economic orders with various varieties of Western capitalism (Hancke *et al.* 2007; Nolke, Vliegenhart 2009; Bohle, Greskovits 2012; Farkas 2016; Ahlborn *et al.* 2016; Próchniak, Rapacki *et al.* 2016; Rapacki 2018). Such broadening of the area of research interest opened analogous discussions on economic transformations also outside the CEE region – in Russia, in the Commonwealth of Independent States (CIS), in China and in Vietnam (King, Szelenyi 2005; Lane, Myant 2007; Maynt, Drahokoupil 2011). Scientists from CEE gained new opportunities to participate in joint projects with Western research centres that had previously addressed this issue.

In the project, we speak of the already significant research achievements of Comparative Capitalism, referring mainly to European post-socialist countries. These achievements provided fundamental theoretical inspirations in choosing the subject of analyses. In our case, it is the domestic (national) level covering 16 CEE countries, which gives the project a pioneering character. We are focused on the economic profiles of individual countries considered in terms of synthetic case studies. They were compiled within four groups of countries distinguished by different institutional, economic and geographical characteristics. In this context, the analysis of economic profiles is an attempt to capture what is the most typical and characteristic, as well as to show what is divergent and specific in the development of the countries studied. A similar approach is also applied in the sub-regional dimension, within the distinguished larger geographical and political entities, such as the Visegrad Group or the Baltic states (see sub point 2.3.).

The directions of discussions on the transformations in CEE characterised in the review of literature, although far from unambiguous findings, indicate certain tendencies and regularities. On the one hand, they allow to narrow the field of observation because only some of the models of capitalism functioning in Western European states have their equivalents in European post-socialist countries. At the same time, they prove the need to go beyond comparisons with these models and to search for specific features of the CEE countries, in many essential aspects having different institutional and development characteristics. This approach is reflected, inter alia, in discussions about the place and role of European post-socialist countries in the international division of labour or highlighting such key dimensions of economic organisations as the financial system or regimes of industrial relations. Due to its synthetic nature, the thesis focuses only on selected macroeconomic and social aspects against the background of the most important political and economic changes. In reference to the previously discussed standard and non-standard concepts of capitalist models in CEE, for the purposes of our project the following general characteristics have been adopted:

- In terms of institutional models, most of them are (or, until recently, were) considered as "liberal market economies" (LME). Often, however, in different areas, such as the financial system, the social protection system or innovation, they have features that differ from the LME model. Hence, in the analyses describing the configurations of institutional patterns in reference to specific countries, many terms are used to indicate their hybrid shape. In some countries of the region, these patterns are still subject to significant changes. The common denominator of the CEE economies is combining – in various proportions – the elements of historical heritage from before World War II, the centrally planned economy and the co-existence of principles and institutions taken from different variants of modern Western capitalism. The CEE countries are distinguished by their concurrent institutional proximity to more than one model of capitalism in the EU-15 ("patchwork capitalism", "mixed type capitalism"). Most often, but

not only, this proximity takes the form of convergence to the model of Southern European capitalism.

- In the political dimension, a relatively common manifestation of the phenomenon of "hybridisation" is the occurrence of various "symbiotic" connections between economic liberalism and statism, paternalism, oligarchic rule, the crony model of capitalism or elements of "authoritarianism" ("illiberal democracy"). This phenomenon occurred with great force at the beginning of the post-socialist transformation. In some countries of the region, it significantly weakened during the accession negotiations and joining the EU due to institutional and regulatory adjustments, especially the introduction of EU law (*acquis communautaire*). It began to intensify again after the global financial crisis in 2008 and the accumulation of economic, security, migration etc. crises in the EU.
- Unlike in the highly developed states, a significant and frequently leading role of foreign investors is a special feature of the countries of the region. In almost all CEE countries during a certain period, foreign investors, in particular MNCs, took control over strategic sectors – financial services, telecommunications, trade and exports as well as in the group of the largest enterprises. In theory, this situation was reflected in the models of "dependent market economies", "foreign led capitalism", "capitalism from abroad," etc. Circumstances of entering into transformation, similarly to the role, scope and forms of foreign capital participation in the economies of the region, however, are significantly differentiated, which differently positions individual countries in terms of the quality of institutions and place in the international division of labour. The global financial crisis and the eurozone crisis partly changed the attitude towards the development strategy based on FDI and the EU funds. New development strategies that are aimed at greater mobilisation of internal economic resources are being discussed and implemented. Some countries are also taking measures to strengthen their economic autonomy by partially reversing the direction of systemic transformations and by reducing

dependence on transnational corporations and FDI, though, among other things, increasing the share of domestic capital in selected sectors and new regulations supporting domestic enterprises.

- Three variants of collective labour relations are distinguished in the CEE countries: 1) the neoliberal model (in the Baltic states, Bulgaria and Romania); 2) the model of rooted neoliberalism combining preferences for the operation of market forces in the economy with greater state spending on social policy (the Visegrad Group countries) and 3) the neo-corporate model (Slovenia) similar to the models found in some small countries of Western Europe, such as Austria. With a few exceptions, their common denominator in the region is lower than in the Western countries labour relations standards resulting, among other things, from the weakness of the civil society institutions, the inconsiderable strength of the trade unions, and also from the often passive models of political culture and the lower level of economic and civilisation development.
- A common feature of capitalism models shaped in the region is the weakness of the knowledge sector and the low ability to generate innovation. The vast majority of them implement the imitative development model. However, there are significant differences in this respect among countries and groups of countries. These variations in some countries can be seen as one of the important indicators of the possible evolution of the countries of the region from semi-periphery countries to semi-core countries – more compatible with highly developed countries.

Based on the literature on the subject (see Próchniak, Rapacki *et al.* 2016; Jasiecki 2013; Holmes 1997), three assumptions have been made regarding the factors influencing the genesis and evolution of the capitalism models established and developing in the CEE countries. Firstly, before 1990 different development trajectories played an important role in terms of long duration. They were conditioned by, among other things, the size of the country, its political role, historical traditions, the level of economic development, civilisation ties and cultural identities, as well as the impact of various models of socialism in individual countries or groups thereof (e.g. a strongly centralised model of command economy in the Soviet style,

a socialist economy based on decentralisation and employee self-government in Yugoslavia, market socialism in Hungary or a mixed model in Poland with the dominant share of private ownership in agriculture).

Secondly, dependence on country-specific internal factors conditioned the differences in the institutional matrix of the former socialist countries on their way to the market economy. In this respect, the initial conditions of the systemic transformation, the period of entry into reforms, as well as the durability and inertia of the legacy of the command economy, e.g. in the axiological, mental and behavioural dimensions, played a special role (although decreasing with time).

Thirdly, the impact of external factors, including foreign debt, and above all the prospect of joining the EU and the subsequent membership in this organisation, was important. This category also includes circumstances such as the country's location in Europe taking into account its geopolitical situation and the policy of neighbouring countries, its position in relations with highly developed countries, its attractiveness to global networks of transnational corporations, and the pressure exerted by international organisations, especially in the initial period of the political transformation.

For the purpose of the thesis, some concepts beyond the mainstream interest of Comparative Capitalism, which in the vast majority referred to countries with stable political and economic institutions, require clarification. Due to the social and institutional specificity of many CEE countries, in recent years terms such as: authoritarian state capitalism, oligarchisation, crony capitalism, favouritism, paternalistic linkages, corruption and clientelism have often been used in reference to those countries. The basic premise for using such terminology is the controversial, growing role of political factors in economic governance in many countries of the region. In characterising the public intervention in the economy, the term "state capitalism" is used. In the Anglo-Saxon tradition, it is defined as the system in which the state interferes in the economy systematically or temporarily. The opposite is laissez-faire, in which the state does not interfere in the economy. According to this definition, capitalism does not exclude part of the national economy from remaining state property or the introduction by the state of a different scope

of private sector regulation, justified by reasons of public health and safety, protection of competition rules or protection of the environment. In this approach, state interference is limited, ancillary and supportive; it does not replace the dominance of market mechanisms. The concept of state capitalism is, however, also used to describe more extensive forms of economic statism (from the French *étatisme* – of the state), i.e. direct state intervention in capitalist economies through the creation of enterprises or their nationalisation, price and wage control, and social legislation. They are often combined with totalitarian, authoritarian or dictatorship governments.[7]

Since the 1980s, the dominance of the neoliberal approach which prefers deregulation, privatisation, commercialisation and outsourcing has significantly reduced the state's functions in the economy. However, the global financial crisis in 2008 initiated actions that in many countries reversed this trend. The rise of the political, regulatory and ownership role of the state in the economy has been again treated as one of the methods of counteracting crises that the private sector and society cannot cope with. This trend occurs even in the most free-market countries, such as the US and Great Britain, and is particularly significant in countries located on the outskirts of the West, such as: China, Russia, Turkey, Venezuela, Brazil, Iran, Saudi Arabia or Kuwait, and having different political and institutional traditions. What can also be observed here is a new kind of relation between politics and the economy in countries that are delayed in their entering upon global markets during the crisis of global capitalism. The CEE countries, which have been implementing market reforms since relatively recently, are not an exception in this respect. In this perspective, as long as state interference does not replace market mechanisms and takes place within the institutional framework of a democratic society, it can be considered as a new moderate version of state capitalism using the tools of

[7] The most advanced version of state capitalism was implemented in the Soviet Union, where an extremely centralised command and distribution economy dominated. However, the role of the state in the economy can be very diverse. After World War II, the German social market economy model, the French dirigisme, Japan and some Asian industrial "developmental state" variants were successful manifestations of its innovative application. In a different system configuration, solutions characteristic of state capitalism enabled the launch of China's spectacular economic development after 1978.

political power to achieve stability, predictability and security of economic development. In the terminology of research on the diversity of capitalism, this would be another variant of a coordinated market economy with a leading role of the state.

However, if the state intervention begins to replace the dominance of market mechanisms, and the government monopolises power centres, appropriates judicial and control institutions, marginalises the civil society and independent opinion-forming centres, then from the perspective of the CEE experience, such activities are associated with the danger of changes leading to the unpredictability of the system, destruction of the economy and demoralisation of the people. In the long run, such tendencies can result in threats to private property rights, the erosion of the market economy, as well as that of political democracy, citizens' subjectivity, and individual and minority rights. A growing politicisation and arbitrary control of the state sector, as well as regulations introducing uncertainty of operating conditions, may turn into a version of "plundering" political capitalism, contrary to the needs of economic development. In this context, some special features of transformation in the CEE countries have long been highlighted.

In the last decade of the 20th century, all the societies of this region went through a period of socio-economic imbalance, usually interpreted as "distortion" on the road to liberal order. The political elites of these countries were tempted to opt for the rhetoric of protection and guarantee of the privileged position of the state in the economic and social spheres. This rhetoric justifies the selective treatment of the rule of law, including limited respect for private property (for example, as not accepted by a significant part of the society because of the controversy surrounding its creation and legitimacy). In the conditions of high political tensions or economic crises, these are circumstances conducive to the emergence of a new type of undemocratic regimes or authoritarian rule, the emergence of leaders ruling over the all-encompassing state apparatus and having at their disposal a rich set of facade election procedures (Holzer, Balik 2009). The distinguishing feature of the new political systems is the competitive struggle between democratic and authoritarian tendencies, and sometimes also oligarchic ones defined as "rule in the hands of a few people." Such

tendencies are favoured by the lack of strong legal institutions, which in the face of state failure usually increases the role of informal rules (Aslund 2008). They are characterised as state captures, crony capitalism, favouritism, paternalistic linkages, corruption and clientelism.

Since the beginning of the post-socialist transformation in CEE, it has been noted that the political parties and social environments that introduced the reforms usually became their main beneficiaries. The rapid reconstruction of the state and the economy often marginalised the participation incorporating the interests of social actors from outside the elites regulating access to power and benefits. Such circumstances of systemic changes, resulting from the initial domination of state ownership, have created systemic premises for corruption. Its manifestation has become, inter alia, the creation of various government agencies with budget funds often outside parliamentary control, deliberate creation of faulty laws or privatisation preferring selected individuals and social groups (Grzymała-Busse 2007; Karklinis 2005; Jasiecki 2002). The intensification of such phenomena and tendencies may in the long run lead to a regression of public institutions, which is generally reflected by, among other things, lower efficiency of the government, decreased quality of regulations, departing from the rule of law, and weakening parliamentary, media and civil control over the executive power.

## 2.2. Dimensions and indicators

The structure of economic country profiles was generally inspired by an attempt at a synthetic look at three decades of economic transformation in 16 CEE countries. National data have been generalised and used to characterise groups of countries with similar development characteristics. Each economic profile is preceded by an introduction which contains a brief general characteristic of each individual country, including its geographical location, borders with neighbouring countries, size, population, largest cities, etc. The key issue in the project was the choice of capitalism models against which the studied countries are compared. Due to the adopted research assumptions, including the synthetic nature of the analyses, it became necessary to define key dimensions and substantive content of the thesis, as well as to choose sources, data, rankings and

indicators. They form the basic structure, a specific core of Economic Profiles of the 16 CEE countries, in order to capture their economic development during nearly decades of economic transformation, with the possibility of generalizing national data into groups of countries with similar developmental and institutional characteristics. The project has identified six main thematic areas which have also been assigned the preferred types of sources, mostly widely available. They are usually treated as a reference in discussions on internationally compared issues.

1. Political context and quality of institutions. This section describes the main political events at the macro level that have had a significant impact on the economy. It outlines the process of creating key political and economic institutions and that of introducing important regulations (especially in the countries involved in the accession and EU membership); it also presents the evolution of the quality of governance and the main problems of transformation. The source data used (rankings, comparisons and indicators) come from the most significant and renowned international organisations that collect statistics on economic and social development, as well as set out methodological standards that are key for making comparisons of countries and regions of the world. These institutions include, in particular, the World Bank (including The Worldwide Governance Indicators/WGI – government effectiveness, regulatory quality, rule of law, control of corruption, voice and accountability as well as other indicators and reports), the United Nations (UNDP reports, Human Development Index/ HDI) and Global Competitiveness reports prepared for the World Economic Forum in Davos.
2. General economic outlook. This area features the characteristics of the main qualities of the capitalism model in each country, the dynamics of economic growth and the structure of national income, macroeconomic balance, economic migration, an indication of the period of GDP recovery to the level before the transformation, presentation of selected elements of industrial relations and state expenditure on social policy, a comparison of the country's development level to the EU average in various periods of the

transformation (including the direction and pace of income convergence). In order to present the findings of this part, literature on Comparative Capitalism has been used, with particular emphasis on the CEE countries, and in the empirical layer data have been employed from the European Bank for Reconstruction and Development (EBRD), the Organisation for Economic Co-operation and Development (OECD), the European Trade Union Institute (ETUI), Eurostat et al.

3. Quality of entrepreneurship. This dimension includes entrepreneurship conditions in the early period of the transformation and the evolution of this issue, social attitudes and the main directions of changes related to building the institutional environment of entrepreneurship. Various institutional aspects of the issue are characterised in many dimensions in the research by the Global Entrepreneurship Monitor (GEM), the Global Competitiveness Index (GCI), the Index of Economic Freedom of Heritage Foundation and in the Doing Business reports by the World Bank.
4. Modernisation based on FDI. The issues that are raised here deal with the role and importance of foreign investment in certain economic changes, such as deindustrialisation and reindustrialisation, conditions of the FDI inflow and their participation in the economy, with particular emphasis on the financial sector and privatisation of the largest enterprises, as well as challenges related to attracting foreign investors against the background of weaker domestic capital development. The data employed here come from UNCTAD's World Investment Report, the capital market (stock market capitalisation), the information on the share of foreign capital in the ownership of banks and major enterprises (the Top 500 List), Deloitte Central Europe Top, the indices of domestic credits to the private sector etc.
5. The knowledge sector. The following aspects are characterised here: the premises for the development of the sector, its change after the beginning of the systemic transformation, the volume of financial outlays and their structure as well as problems and

challenges related to the consolidation and reproduction of the imitative model of economic growth. An important aspect of changes in the sector is the development of human resources. Multidimensional data comes from the UE Innovation Scoreboard, the World Bank and the EU Digital Economy and Society Index ranking (DESI).

6. Public opinion attitude towards transformation. This part deals with the social perception of selected issues of systemic changes in the past three decades. This group of issues includes, among other things, assessments of the transformation process and the role of the state in the economy, attitudes towards foreign investors, the perception of the accession and EU membership (in the euro area as well) and some other foreign policy issues, such as assessments of the membership in the NATO. The data comes from various publications by domestic opinion polling centres, work of sociologists and from Eurobarometer.

The structure of each of these six areas consists of three integral parts: the general characteristics of particularly significant processes and trends, statistical data and indicators embedded in the phenomena under consideration, and a summary of the main achievements and challenges that require action and solutions.

## 2.3. Regional and state divisions in Central and Eastern Europe

The CEE countries are characterised by a large diversity of political and economic potentials, the size of population and the area of the country. These differences are matched by differences in historical, social and cultural development, including religious, linguistic, national and ethnic ones. The interaction of such phenomena and trends in the region is reflected in often divergent directions of political changes and economic transformations. Their course led to the coexistence of several different processes: 1) building the foundations of state and national independence; 2) democratic and economic consolidation of new systems; 3) close links with Western countries, as well as 4) political changes in undemocratic directions and delaying market reforms, or 5) subsequent systemic

transformations modifying or reversing earlier reforms. In fact, in Central Europe, despite the break-up of Czechoslovakia, the restoration of independence and market reforms took place peacefully and were relatively quickly combined with the prospect of membership in NATO and in the EU. However, most of the states emerging after the break-up of Yugoslavia in 1991 were shaped in the conditions of political uncertainty, war, armed conflicts and ethnic tensions, and a large drop in GDP. Different varieties of presidential or authoritarian rule, political and business, and even mafia, oligarchies, which along with the weakness of the rule of law and high corruption created institutional brakes hindering economic development, became a problem for many post-socialist South-Eastern European states. As a result, some states of the region, such as Bosnia and Herzegovina or Kosovo, became so dependent on the influx of transfers and foreign aid that their ability to unassisted development is being pondered (Bartlett 2007; Myant, Drahokoupil 2011).

The characterised phenomena and tendencies have far-reaching consequences. They cause that the CEE countries differ significantly from one another in the type of political changes, the stage of consolidation of political institutions, the type of political leadership, the role and ways of operating of political parties and parliaments, the position of the judicial authorities, the influence of religion on politics, civilisation patterns defining their traditions (Catholic, Protestant, Orthodox, Muslim, etc.), as well as the dynamics of economic transformation, the scope of economic freedom, industrial relations or the development of civic society. Their social structures are different, as are the scale of material differences, the scopes of affluence and of exclusion. This type of diversity is clearly reflected in the sphere of institutions and economic development.

The highly heterogeneous economies of CEE were additionally strengthened by different sequences of changes and trajectories of development of individual countries and regions. An important manifestation of this phenomenon was also the division into states that, sooner or later, entered into market reforms – the early reformers and the late reformers. The IMF and the World Bank included Croatia, the Czech Republic, Hungary, Poland, Slovakia and Slovenia in the first groups of states. Albania, Bulgaria, North Macedonia, Yugoslavia and the Baltic

states were included in the other group. As a result, since the 1990s the combined use of many criteria has consolidated the division into five groups of CEE countries representing different political, economic and social models: 1) the Baltic states (Estonia, Latvia, Lithuania); 2) Central Europe (the Czech Republic, Hungary, Poland, Slovakia); 3) South-East Europe (Bulgaria, Romania) together with the Balkan states and two groups of countries belonging to the Commonwealth of Independent States (CIS); 4) internally diverse CIS-9 (including Azerbaijan, Kazakhstan, Russia, Ukraine) and 5) CIS-3, states still governed by the Soviet style, distinguished in the economy by a lower level of structural changes, e.g. a small share of the private sector (Belarus, Turkmenistan, Uzbekistan) (Aslund 2008).

For the needs of the study, a typological characteristic of the 16 CEE countries was adopted, which distinguishes four groups of states: the countries of Central Europe (V4), the Baltic states, the countries of South-Eastern Europe and the Western Balkans countries. This characteristic refers to frequently quoted publications (Bohle, Greskovits 2012; Farkas 2016) confirming with the use of historical analyses and many institutional, economic and social variables the specificity of these groups of states as regional subcategories. This division also has an important political and historical dimension because it reflects the order in which specific states (and groups of states) enter the processes of economic reforms. States belonging to those groups also distinguish certain common trajectories of economic development related to decisions made at the early stage of systemic changes, which, however, may be subject to reorientation over time. The case of Slovakia, the only post-socialist Central European country of the euro zone, and that of Estonia, successfully implementing one of the most ambitious programs in the EU of digitizing the state, can serve as confirmation of this possibility.

1. The states of Central Europe, also often referred to as **the Visegrad Group** or the Visegrad Countries. The name of this group comes from the town of Visegrad in Hungary, where in February 1991 the meeting of the leaders of three states took place: Czechoslovakia (Vaclav Havel), Hungary (Jozef Antal) and Poland (Lech Wałęsa). The purpose of the meeting was to initiate regional cooperation in

the field of system changes under the slogan "Returning to Europe". They were to lead first to strengthening democracy and carrying out market reforms, and later on to their membership in NATO and in the EU. After the break-up of Czechoslovakia in 1993, the V Three became the Visegrad Four (V4) consisting of the Czech Republic, Hungary, Poland and Slovakia.[8] The V4 countries were at the time the leaders in economic transformations in CEE and created a positive example of cooperation and good, stable neighbourly relations, particularly significant and well-associated by the international community against the background of the war in former Yugoslavia and the collapse of the USSR, which led to centrifugal tendencies and new conflicts in the region. Poland is the largest post-socialist country in CEE, but the Czech Republic currently is the most developed European post-socialist state and Slovakia is very dynamically developing country.

2. **The Baltic states** – Estonia, Latvia and Lithuania. Between 1918 and 1939 these countries formed independent states. During the Second World War, however, they were brutally annexed by the USSR and could once again gain independence only after the collapse of this state in 1991. Since 1992, the Baltic states have been distinguished by the most neoliberal economic policy among the CEE countries. This was a consequence of the geostrategic political choice of the elites of those states which, after the tragic experiences of the Soviet occupation, decided to integrate politically and economically with the institutions of Western countries as soon as possible. Such deep integration, including joining NATO and the EU, is treated as a guarantee of the national security of the Baltic states in relations with Russia. Hence, among other things, decisions regarding the largest possible openness to the expansion of foreign investors, and later the rapid fulfilment of the conditions for entry into the euro area.
3. **The South-Eastern European states**: the EU members – Bulgaria, Croatia, Romania and Slovenia. In contrast to the V4 countries and

[8] The names of the states are given in the alphabetical order within the four sub-regional groups characterizing their local geographical and political identifications.

to the Baltic states, the states of this region are more politically and institutionally differentiated, which is, among other thing, the aftermath of the armed and ethnic conflicts of the early 1990s, which occurred among the new states after the break-up of Yugoslavia (especially Croatia). In turn, Bulgaria and Romania introduced programs of market economic reforms later than the other CEE countries. Currently, the basic criterion for the distinction among the countries of the region is their membership in the EU. According to the criterion of GDP per capita (Purchasing Power Parity, PPS), Slovenia is the most developed country in the region, which is higher than Greece and Portugal (UE-15).

4. **The Western Balkans**, the EU candidate countries – Albania, Montenegro, North Macedonia, and Serbia. The potential EU candidate is Bosnia and Hercegovina (B&H). This group mainly includes the countries created after the breakup of SFR Yugoslavia and additionally Albania. In the 1990s, the countries of the region (excluding Albania) experienced varying degrees of warfare and ethnic conflict that led to economic decline. They are the least economically developed in Europe. Only Ukraine and Moldova are poorer.[9]

[9] Kosovo, whose political status is not universally recognised, has been omitted.

# Chapter 3 Case Studies

## 3.1. The Visegrad Countries

### 3.1.1 Czech Republic

Małgorzata Bonikowska, Bruno Surdel

#### Introduction

The Czech Republic is a dynamically developing Central European country with an area of 78.865 square kilometers, and a population of 10.637.794 people. Over the 30 years of transformation and opening up, it has built and expanded its position as the clear leader among the nations who launched their transition in 1989. It has been partly possible thanks to Czechia's own historical experience with well-developed industry and a resilient urban culture that have established foundations for a strong economic performance and high political culture with an emphasis on rule of law and social compromise.

The capital city of the Czech Republic is Prague with a total of 1.301.132 inhabitants. The next two big cities are Brno with 379.275 inhabitants, and Ostrava with 321.712 inhabitants.

Czechia (which is another official name for the country) is a land-locked nation bordered by Austria, Germany, Poland and Slovakia. The country's population is composed of a majority of Czechs (64.3%), followed by Moravians (5%) and Slovaks (1.8%). As other Central European and Western nations, also the Czechs face a demographic challenge which an ageing society. The number of people over the age of 60 made up 25.8% of the total population in 2018, while in 1990 it was "just"17.6%. On the other hand, the 0-14 population constituted 15.7% in 2018, while in 1990 this number was 21.7%.

## 1. Political context and quality of institutions

Socio-political transformation in Czechoslovakia started in November 1989 with the so-called "Velvet Revolution", and its first stage was completed with the peaceful split of the federal state into two separate and independent states of the Czech Republic and Slovakia on January 1, 1993. On the same day, a new Constitution entered into force, which became a formal foundation and an embodiment of the opening up and reforms of the whole economic, political and social fabric of the country. The Constitution established "an unitary and democratic state governed by the rule of law, founded on respect for the rights and freedoms of man and of citizens"[10]. The head of state is the President, elected by popular vote (since 2013), while the prime minister is the head of government. At the local level, the the changes included the establishment of a territorial self-government with municipalities independently administered by their representative bodies[11]. The country has been decentralised and administratively divided into 14 regions since 2000.

In the political sphere, a de facto one-party state was replaced with a pluralist system whose main feature has been party competition, free market of ideas and emergence of the civil society as well as nongovernmental organisations (NGOs). The very symbol of all those changes and the whole process of transformation in the socio-political sphere became two personalities: Vaclav Havel – Pleace Nobel Price holder, political activist and novelist, and Vaclav Klaus – a prolific economist and then a long-time politician, prime minister, and finance minister, who dominated the economic dimension. Both were also presidents of the Republic: Havel (first as the President of the Czechoslovakia) from 1989 until 2003, and Klaus from 2003 until 2013. The Eurosceptic Vaclav Klaus was the founder and a long-time leader of the powerful liberal-conservative ODS party (Civic Democratic Party), which formed or co-formed many Czech governments since the partition of Czechoslovakia in 1993.

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[10] Constitution of the Czech Republic of 1.1.1993, 1.1.

[11] Constitution of the Czech Republic, 101.1.

The Czech politics over its thirty years of transformation and opening up has been defined by the development of a new political culture – sometimes marred by scandals – where coalition governments with two main political party blocs have been playing the biggest part: the above-mentioned ODS and the Social Democrats with its preeminent charismatic politician: Milos Zeman. The Social-democratic prime minister and the first directly elected Czech president (2013) has increasingly become a divisive figure, adopting a populist anti-migrant, anti-elitist rhetoric domestically. He became, however, very pragmatic in his foreign policy, in particular, towards Russia and China. Thanks to that mix of egalitarianism and populism, Miloš Zeman could win his second term as the Czech President in January 2018. The general rise of populism in the whole of Europe, especially since the migrant crisis in 2015-16, had its Czech peculiarity in the victory of the ANO (YES) party of the billionaire Andrej Babiš in the parliamentary elections in October 2017. His party also won the elections to the European Parliament in the Czech Republic in May 2019. However, in late June that year Prime Minister Babiš faced massive protests against his alleged fraud of the EU funds and the abuse of power. The demonstrations were estimated as largest since the transformation started in 1989.

The political and social developments in Czechia have been clearly mirrored in WGI Political Stability Rank and Rule of Law over the years of transformation. Shortly after the establishment of an independent state, the indicators reached 87.7 and 79.9 respectively (1996) to decrease in the early 2000s due to political scandals and coalition turbulances of that time (60.32; 71.29 in 2000). The indicators started gradually improving in the aftermath of the Czechia's accession to the European Union in 2004 (68.45; 72.73), and a change of political climate with centrist and then new Social Democratic governments of late 2000s and 2010s (82.94, 80.09 in 2010; 84.29, 83.65 in 2017).

Similar issues can be noticed with regard to corruption control indicators with 74.73 score in 1996, and "just" 62.44 in 2000. After a visible deterioration in early 2000s, the corruption has remained one of the Czech Republic's problems with which the country has been struggling with only a slow progress and many setbacks over time (69.76 in 2004 – the EU

accession year; 66.67 in 2010; 70.67 in 2017). One of the instruments to fight the corruption at the state level is the Supreme Control Office founded in 1993. On the other hand, government effectiveness has been growing since the transformation started with some issues in the same period as other indicators (72.13 in 1996; 78.33 in 2004; 81.25 in 2017).

Despite the above-mentioned occurrences, Czechia has evolved into a stable democratic country with considerable achievements in the field of rule of law, human rights (Office of the Ombudsman since 2001), accountability and stability.

Economically, the transformation in Czechia was characterised by the abandonment of the model of a centrally planned economy (CPE) and fast reforms (so-called "shock therapy" launched in 1991) aiming to introduce as soon as possible a market economy or social market economy with the Western European countries serving as a developmental model. The rationale for the speed of reforms was based on the assumption that the popular support for reforms might be gradually waning with the citizens realizing that there was a price to be paid by them for a comprehensive reconstruction of the country in all its aspects – with the economy, state institutions, law, and the deconstruction of the former socialist welfare system. Another important issue was to complete most essential reforms fast to avoid the threat of a macroeconomic collapse. One of the most painful – but necessary – changes was dismantling of the full employment system where people were actually obliged to work into a job market system based on demand and supply. The "shocking" result was unemployment – formally absent in the CPE where unprofitable firms, factories and jobs were kept working. Similarly, the newly-introduced commodity market was founded on the same idea which, however, ensued in a painful price liberalisation.

The tremendous challenges faced by the reformers included creation of new state and financial institutions of which a pre-eminent one became an independent central bank. As of 1 January 1993, it split into the Czech National Bank (CNB) and the National Bank of the Slovak Republic. The newly created CNB became the state central bank whose primary purpose

is to maintain price and banks' stability as well as overseeing markets[12]. The transformation into a modern, western-style economy required the establishment of a capital market with a stock exchange which had to be done from scratch and resulted in the creation of the Prague Stock Exchange (PSE) and the RM-System. The PSE is rather small as there are just 16 companies listed there (2019), and is designed to conduct trade through brokers. On the other hand, in the RM-System stock owners can trade directly.

Deep structural changes in all spheres of the social, economic and political life were largely driven and motivated by the process of accession to the European Union which started in 1998, and comprised (inter alia) of adopting EU's accumulated legislation: the acquis communautire (now: "acquis"). The Czechs were also committed to accede other international organisations and alliances. Efforts had paid off as the Czech Republic joined the International Monetary Found (IMF) already in 1993, the OECD in 1995, the North Atlantic Treaty Organisation (NATO) in 1999, and the European Union on 1 May, 2004. On 21 December 2007, the country became a member of the Schengen area – free movement zone within the European Union. It, however, has not adopted the common curency – euro – and does not plan to do so, partly due to the turbulances in the eurozone during the global economic depression after 2007.

The integration into the European and world structures brought Czechia more stability in economic and political terms and established the country as a reliable partner for international institutions and – more specifically – reintroduced it into the Western world.

## 2. General economic outlook

The Czech Republic's economic model can be roughly described as a dependent social market economy with the most important role of the private business – including a pre-eminent presence of the foreign investments, mature modern western-styled economic institutions wich had

[12] Constitution of the Czech Republic, Article 98.1.

assured the country a remarkable success in terms of the overall development over the transition and transformation era.

For several years, the Czech Republic has experienced a continued economic growth. Since 2004, the year that it joined the European Union, the country has been making strides to reach the European Union's average growth. According to data from the EU, growth in real GDP terms had reached 4.3% in 2017, however in 2018, it dropped to 2.9%. This growth was mainly driven by strong household consumption. Public finances of the country are in a good shape with government balance being in surplus. One of the main issues that is faced by the country is the shortage of experienced within the labor force and the ageing of the country's population.

In the early 1990s, one of the first challenges faced by the transforming economy was the need of a rapid re-adjustment in terms of trade resulting from the collapse of the Council for Mutual Economic Assistance (CMEA) in 1991, which made many large Czech firms change their structure of production and refocus on Western European markets. It coincided with a decline in industrial production and GDP – which is a common feature of all CEE countries – and introduction of essential economic reforms, among them, price and foreign trade liberalisation in 1991-1993. The GDP growth reached just 0.1 in 1993. Structural changes in industrial production were accompanied with similar trend as regards employment in the agricultural sector which was also related to the adjustment to the requirements of the market economy based on the profitability, demand and supply. The overall employment and capacity reduction in those industries was clearly visible since the reforms were launched, and was somewhat reversed only in 2010s. On the other hand, that occurrence was offset by rapidly growing services industry which has been dramatically expanding and accommodating the workforce from other sectors of economy. The services produce over 60% of GDP (2016) while the agriculture just 2.5%. When it comes to the foreign investment in services, it is, however, concentrated predominantly in the capital city of Prague.

The next stage of reforms was characterised by remarkable growth in 1994-1996, with the real GDP increasing by 2.6% in 1994, 4.8% in 1995, and

4.2% in 1996 (Eurostat). However, the crisis in the international currency markets – coinciding with the completion of the domestic reforms of price and trade liberalisation – changed that positive trend, and the Czech Republic entered recession which lasted between 1997-1999. The banking sector was hit the strongest, as it was dominated by the foreign investment, and was excessively exposed to the turbulances on the intenational markets. Main players in the banking industry have been Austrian Erste Group (Ceska Sporitelna), UniCredit Group, Raiffeisenbank and Société Générale Group.

The stock market capitalisation shrank as the precentage to the GDP in 1997 as compared to the results of the previous year (21.27 in 1996; 17.51 in 1997; World Bank data). The economic recovery came in early 2000 with the growth picking up to 4.3% that year and then 4.9% in 2004. The stabilisation of the overall economic situation was caused by similar factors to what had previously triggered the stagnation and recession, namely inflow of foreign capital and direct investment. The global financial crisis did not spare Czechia as its economy shrank by 4.8% in 2009 with foreign capital fleing to safe markets.

The banking sector, however, was largely saved from the problems thanks to prudent policies and structural reforms made after the previous crisis in 1997-1999. According to the data provided by the Czech Banking Association, there are 46 banks in the country, with nine of them under local control[13]. The dominance of foreign banking institutions (91.7% of total assets in 2017; European Central Bank data) is a Central and Eastern European phenomenon. Foreign owners control 38 financial institutions in Czechia, among them 14 banks and 23 bank branches[14]. Meanwhile, the bank concentration was somewhat reduced from 62.6 % in 2004 to 50% in 2014 (World Bank).

The economic recovery in the aftermath of the global recession was very slow (2.3% growth in 2010; 1.8% in 2011), and short as another recession

[13] Ibidem.
[14] Czech Republic's banking sector: Facts & Figures. Czech Banking Association. https://www.ebf.eu/czech-republic/ Retrieved 18 May, 2019.

followed in 2012 with the economy shrinking again (0.8% in 2012; 0.5% in 2013). The Czech Republic's economy gained momentum in 2015 with 5.3% real growth but it is still rather uneven (2.6% in 2016; 4.3% in 2017; 2.8% expected in 2019).

The described developments impacted the unemployment rate, measured as a percentage of labour force which has been rather volatile since the establishment of the seperate Czech Republic in 1993 when it reached 4.41% (Eurostat). It has been cyclically affected by the economic downturns in 1997-2000 (4.8-8.8%), 2003-2004, 2009-2010 (6.7-7.3%), and 2012 (7.0%). The unemployment rate had decisevely improved in recent years, reaching 2.8% in 2018 and 1.9% of labour force in early 2019, as the Czech Republic has become one of most dynamically developing countries of Central and Eastern Europe.

It is interesting to compare the data above with how the trade union movement evaluated over the transition period. Its clearly visible in the data that it has been gradually weakening which may be also linked to the emergence and thriving of the small and medium-sized companies and foreign investment in the larger industrial plants. Trade union density rate reached 27.2 in 2000, 20.6 in 2004, 16.1 in 2010, and it was just 10.5 in 2016 (OECD).

The social cost of the transformation and reforms can be seen not only in the brand new phenomenon of the unemployment mentioned above. This has been also about socio-economic disparities – apparently tightly associated with the establishment of the new system. The effects of the inequality have been only modestly mitigated by the state policies, as the governments were inclined to give the citizens incentives to gain new qualifications rather than providing lavish benefits. The benefits were reserved for the socially weakest strata of citizens. The reforms of the socialist welfare system brought about also a comprehensive reform of the healthcare. The General Health Insurance Company was established in 1991, and the state guaranteed a standard health care for all with the option of extra services paid seperatly and privately by the citizens. Total government's spending on the healthcare has been rather stable since the

establishment of the independent Czech Republic with 5.8% of GDP in 1996, 6.1% after the accession to the European Union in 2004, and 5.9% in 2016 (Eurostat).

At the outset of the transformation era, the Czech Republic was struggling with the macroeconomic instability but – on the other hand – there was a relatively low level of foreign indebtedness and the country maintained a rather balanced public budget. The government debt had been rising gradually since the international crisis of 1997 (11.6% in 1996; 12.6% in 1997%) with a short respite before 2008. Then it dramatically soared in the aftermath of the global depression (28.3% of GDP in 2008; 44.9% in 2013) as Czechia suffered a prolonged recession. The situation only stabilised in recent years with the debt approaching 34.7% in 2017, and 32.7% in 2018 (Eurostat). It is supposed to further shrink to about 29% of GDP in 2019.

Another result of the price and trade liberalisation, which was one of the main tools of the "shock therapy", was inflation with the rate (as the percentage of the GDP) reaching 21.0 in 1993, when the Czech Republic was established – partly due to the introduction of the value added tax (VAT); then it fell to 1.9 in 2002, and reached just 1.6 in 2018 it. The trend is rather stable with expectations for the inflation rate not to exceed 2% in the whole of 2019 (Deloitte, 2019).

## 3. Quality of entrepreneurship

The Czech Republic is one of the most energetically developing economies in terms of entrepreneurship. According to the Economic Freedom Index (Heritage Foundation), it is ranking fluctuated from the 32$^{nd}$ place in the year of the EU accession (2004) to 34$^{th}$ in 2010, and a robust 23$^{rd}$ in 2019. In comparison, its eastern neighbour – Slovakia – was only placed 65$^{th}$ in the global list of free economies.

One of the main underpinnings of the overall economic transformation in the Czech Republic was privatisation, which begun within the federal Czechoslovakia before 1993. The so-called "little privatization" included mainly the trade and services sector, after which the "big privatisation" followed, with large plants being transferred to the population by the means

of voucher books where joint stock companies were to be setup in the process. The key phase of the privatisation process ended in 1994, when already 78% of the state property was transferred to private ownership. In 2019, the volume was much larger as more than 90% of firms were privately owned. Another side of the introduction of the private business was the birth and expansion of small and medium-sized companies (SMEs), which have since been playing a critical role in the Czech economy.

According to the European Commission's data, SMEs represent 99.8% of all entreprises in that country, which is the same proportion as in the rest of the EU, and produce 54.7% of the total value added. They also cover two thirds of total employment in the non-financial sector (66.8 % in 2015; 67.2% in 2017; while the EU average is 66.6% in 2015 and 66.4% in 2017). Their productivity has reached 22,800 euro, which makes more than the half of the EU average of 43,900 euro[15].

To the most extent, the Czech SMEs are active in the manufacturing industries. The overall growth, however, in the mentioned sector has been fuelled rather by large companies and not by SMEs. In recent years (2012-2016), the value-added growth reached 26.4% in big entreprises, while in the SMEs sector it was "just" 9.5%[16]. The growth dynamic has been driven by the motor vehicle manufacturing industry, which is a domain of big foreign-owned firms, and based on the rise of both domestic and international demand in recent years.

Within the SME sector, a strong performance has been recorded in information and communication, as well as transportation and storage, thanks to a boom in those industries and Czechia's attractive location in Central Europe. Rising intra-EU trade has significantly contributed to the growth and supported the demand for Czech freight forwarding services.

Another observed phenomenon is an increase of companies' registration, which has surpassed the level which was achieved ahead of the global

[15] European Commission, 2018 SBA Fact Sheet. Czech Republic.
[16] European Commission. 2017 SBA Factsheet. Czech Republic.

recession of 2007-09, and amounts to 20,569 net firms registration in 2016 – the best result since 2010[17].

In the Ease of Doing Business report 2019, the Czech Republic was ranked 35th out of 190 countries. In comparison to 2010, when it did poorly with 74th rank, and 2015 (44th) the country made a tremendous progress. It is also doing better than Slovakia, which landed at the 42nd place in the same ranking in 2019.

To start a business, one needed to go through 8 procedures and wait 24.5 days in 2019, while it was the same 8 procedures and 15 days in 2010, and 9 procedures and 19 days in 2015. It is a progress compared to 2005 – the after-accession year, when these numbers amounted to 40 days and 10 procedures.

Obtaining a construction permit took full 246 days and 21 procedures in 2019, while these numbers were 150 and 36 respectively in 2010, and 143 days and 24 procedures in 2015.

The situation is worse when it comes to Getting Credit rankings. In 2010, Czechia was ranked 43rd, in 2015 – 23rd, and in the 2019 ranking the country was placed at the 44th position – the same as Slovakia. On the other hand, there are improvements concerning a ranking which is vitally important for business, namely Enforcing Contracts. While in 2010 Czechia was ranked 82nd (Slovakia 61st), the score was 37th in 2015 (Slovakia – 55th), and 99th in 2019 (Slovakia – 47th). The picture is very complex, as the procedure has become much more time-consuming and now it takes 678 days, while it was 611 days in 2010, the same 611 days in 2015, but just 300 days in 2005.

The red tape still is the issue in Czechia despite the government's commitments to improve the situation, and to deliver substantial administrative changes in that respect. On the other hand, the country is doing well in the essential field of the intellectual property rights (IPR) with the legal framework and its enforcement being in line with the European standards in this respect.

[17] Ibidem.

## 4. Modernisation based on the FDI

The reforms introduced after 1989, and in particular the accession to the European Union had triggered the inflow of the foreign capital and investments to Czechia, predominantly from the EU countries (85% of all FDI). According to the European Commission's estimates, the portion of FDI in GDP has increased six-times in the Czech Republic since 1993 – when it peacefully divorced from Slovakia – and has continued to significantly contribute to the country's overall development thanks to foreign greenfield investments, job creation as well as taxes and social contributions. That happened in spite of the remarkable outflow and repatriation of dividends ahead of and in the aftermath of the global economic depression of the late 2000s, which made 99 billion euro out of the generated income of 148 billion euro between the EU accession year (2004), and 2017. In comparison, the FDI inflow to Czechia reached 67 billion euro in the same time (Szabo 2019). Meanwhile, estimates of the US Department of State say that the total FDI in Czechia has reached 156 billion USD in 2017, which has been a significant increase in comparison to 2016 (121.9 billion USD)[18].

Czechia desperately needed foreign capital and investment as after the decades of a real-socialism economy it lacked financial resources to push its development forward based on its own means. That, however, made the country's economy and – to some extend – also economic policies dependent on the multinational corporations with headquarters located mainly in the "old" Europe.

The biggest suppliers of FDI have been the Netherlands and Germany, and they mainly focus on wholesale as well as retail and motor vehicle manufacturing. On the other hand, the FDIs in the financial sector (one third of the total FDI stock) are dominated by Belgium, Austria, France and Italy. In the automotive industry the crucial position has been achieved by the Skoda Auto AS, which is a subsidiary of Volkswagen Finance Luxemburg S.A. (Szabo 2019).

[18] 2019 Investment Climate Statements: Czech Republic. July, 2019. U.S. Department of State.

As the Eurostat Foreign Affiliates Statistics (FATS) assesses, multinational corporations (MNCs) have created nearly one-third of all jobs in Czechia. In the same time, MNCs have managed to achieve a 60% higher apparent labour productivity than the Czech average. That results have been, however, possible thanks to the investment friendly environment established in the country. The Czech government provides various investment incentives, among them corporate income tax relief (up to 10 years) and cash grants for work place creation and training (up to 50% of training costs)[19].

## 5. Knowledge sector

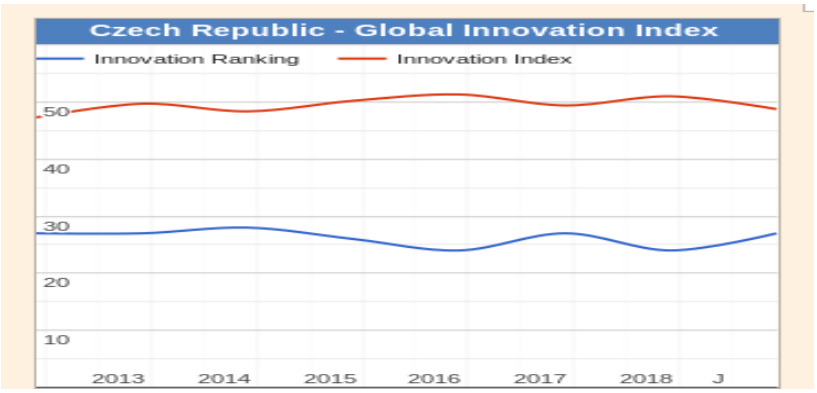
The education system in the Czech Republic has been heavily affected by the transformation, with its structure and curriculum being subject to sweeping reforms to adapt it to the modern standards, in particular, to the best practices in the most developed Western countries. One of the significant changes was the introduction of private schools and universities, which now have much more linkages with the real economy and business, and some of them are championing in research and innovation. This is however, not enough and much more needs to be done on the national level.

The European Innovation Scoreboard (EIS) demonstrates interesting processes as regards the developments in the knowledge sector in the Czech Republic. The country has been better off than Germany when it comes to the completion of the tertiary education and achieved 73.13 in 2018 (45.2 in 2011), while the above-mentioned country – 61.94 (34.33 in 2011). This is however less than Czechia's nearest neighbour, Slovakia: 94.03 (44.78 in 2011), and Poland which was given 147.01 (140.30 in 2011) in the same category. On the other hand, doctorate studies show a different picture, as Czechia achieved 84.62 which is better than Poland with 26.54 (23.08 in 2011) but much less then Germany – 190.98 (192.31 in 2011), and Slovakia –138.55 (230.77 in 2011). One of the most credible indicators of the overall development in the knowledge sector are scientific publications produced by scholars and their citation. In that category, Czechia was given 47.97 (37.28 in 2011; scientific publications among top 10% most cited) which

[19] Ibidem.

is much better than Slovakia with 34.85 (15.46 in 2011) and still better than Poland with 46.07 (19.05 in 2011) but compared to Germany with 113.68 (105.79 in 2011) it is a very modest result.

When it comes to innovation – according to the European Union findings – Czechia has not yet set up a mature innovation climate and it remains a moderate innovator. On the other hand, the EIS data show that the country has been gradually climbing up the innovation ladder with 85.86 score in 2011, and 89.40 in 2018. Since the beginning of the transformation process, expenditure in research and development increased from 0.89 % of GDP in 1996 to 1.17 in 2004, and to 1.68% in 2016. It translates into EIS's 70.12 and 88.79 scores as regards public spending for R&D in 2011 and 2018 respectively. But the result was much better in 2015 – 126.15. We can observe a similar trend when it comes to the business R&D expenditure, as the score was just 63.95 in 2011 but it increased to 94.85 in 2018. Meanwhile, high-tech exports showed a fluctuation from 4% of the total in 1993, to 13% in 2004, 15% in 2015, and 13% in 2017. Czechia lags behind the Western Europe in patents applications with 21.07 score in 2011, and 21.12 in 2018. In the same time, Germany achieved 193.41 and 161.70 respectively. But the country is doing better than its eastern neighbour Slovakia, which was given 9.92 in 2011 and, 16.32 in 2018.



| Czech Republic - Global Innovation Index | | |
|---|---|---|
| Date | Innovation Ranking | Innovation Index |
| 2018 | 27º | 48.75 |
| 2017 | 24º | 51.00 |
| 2016 | 27º | 49.40 |
| 2015 | 24º | 51.32 |
| 2014 | 26º | 50.22 |
| 2013 | 28º | 48.36 |
| 2012 | 27º | 49.70 |
| 2011 | 27º | 47.30 |

Source: World Intellectual Property Organisation (WIPO)

In the Global Innovation Index 2018, Czech Republic was ranked as 27th most innovative country in the world, while its neighbor Slovakia achieved 36th rank, and Poland – 39th. There has not been, however, much improvement since 2011, when Czechia also landed at 27th position. One of the greatest weaknesses is the insufficient government expenditure on education, which is just 4% of total GDP. The country is ranked 79th in the world when it comes to government expenditure on that sector (World Bank data).

As the digital economy takes increasingly hold in the Western Europe and East Asia, the Czech Republic is trying to catch up but still lags behind the best performers. It is, however, doing much better than its brotherly neighbor of Slovakia. In the European Commission's Digital Economy and Society Index (DESI), the country was ranked 15th out of 28 in 2015 (Slovakia – 21st), 18th in 2017 (Slovakia – 20th), and 17th in 2018 (Slovakia – 20th).

Over the decade, the Czech government has launched programs to boost start-ups in the knowledge sector, one of them being the "Entrepreneurship and Innovation for Competitiveness" for years 2014-2020 with grants in ICT, Technologies and Consultancy[20].

[20] European Commission. 2017 SBA Factsheet. Czech Republic.

## 6. Public opinions towards transformation

There are differences in opinions when it comes to weighing on the impacts that the transformation has brought forth. Those that gained from it are understandably full of praise for it. On the other hand, transitioning to a market economy has made life difficult for those who had low levels of education and pensioners. As the cost of housing, transportation, education and health care services has been on a steady rise, the life has become challenging also for young families. This has been mirrored in the fertility rates. But, interestingly – even if low – the birth statistics were growing in the years after the EU accession of the Czech Republic. According to Eurostat data, the fertility rate was 1.45 in 2007, 1.51 in 2010 and the value rose to 1.69 in 2017.

It is interesting to learn how the Czechs see the biggest achievement of the transformation which is the EU membership, as well their own economies and life satisfaction over the years.

The Eurobarometer survey demonstrated that in the spring of 2018 "only" 37% of the Czechs trusted the European bloc – which made an increase of 2% compared to the previous survey in autumn of 2017. On the other hand, 56% of surveyed people in Czechia distrusted the EU. One year after the EU accession (2005) the numbers were quite different: the trust in the EU was shared by 52% of Czechs. That year, the Czechs were also rather satisfied with the life they led as that opinion was expressed by 83% of surveyed Czechs. However, in 2018, a staggering 67% of the surveyed claimed that their voice did not count in the EU (but as much as 75% in 2017), with just 29% being of the contrary opinion (22% in 2017). Meanwhile, however, a robust 70% of Czechs saw their national economic situation as "good" (68% in 2017, but just 43% in 2015).

Visibly, transition efforts and the tremendous development in people's lives over the last 30 years have been noticed and appreciated by the citizens of the Czech Republic. However, the European Union – one of the main drivers of the transformation and modernisation in both socio-political and economic sphere – has suffered in the Czechs' eyes. This is

not only the local, Czech phenomenon, as the European project as such is subject to tighter scrutiny in many of the 27 member states. It results from a perceived overregulation and alleged democratic deficits. On the other hand, the political elites in Czechia have been highly critical of the European Union over the last decade – which is both a result of the thriving populism and the European policies, in particular when it comes to the migration from outside of the EU.

**Conclusions**

Since 1993, when the Czech Republic was established as a separate and independent state, it has made a tremendous progress both in economic terms and as regards its international standing. Czechia is a country based on the rule of law and the European concept of parliamentary democracy and human rights. It has become an evident leader among the free economies of Central and Eastern Europe with feasible ambitions to catching up to the most developed members of the European Union. The citizens are now definitely better-off than they were before 1989 – under the centrally planned economic system.

There also challenges, among them an overly dependence on the foreign capital and investments in its industries and in the financial sector. A problem Czechia shares with other Central European countries – and much of the Western Europe – is the ageing of its population which exerts pressure on the labor market. The problem is much known also in Czechia's neighbors Slovakia and Poland – which similar to the Czech Republic attract the foreign work force from Ukraine.

In the political and institutional spheres, which dangerously have intermingled with the business sphere, there are issues related to alleged corruption and abuse of power at the highest level of government. And they must be addressed if the Czech Republic wishes to keep its pace of the overall development.

Czechia tends to see itself – at least in policy papers of its governments – as having ambition to become a leader in research and development and innovation in that part of Europe. It needs, however, much more real efforts on the part of central authorities as well as both domestic and foreign firms.

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### 3.1.2 Hungary: from pioneering transition to pioneering state capitalism

Miklós Szanyi

## Introduction

Hungary is a land-locked small country located in East-Central Europe, in the Carpathian basin. Its area is 90.530 square kilometres, mostly suitable for agricultural production. The country is relatively poor of mineral resources due to the lack of mountains, moreover its known natural gas and oil reserves were exhausted during extensive production periods between 1930 and 1970. Its population was 9.778.371 inhabitants in 2018, out of which 18.9 % was aged less than 15 years and 14.5% – over 65. Total population increased until 1980 and peaked with 10.71 million. Since then the country witnessed declining demographic trends and constant aging of the population that was only partially balanced by immigration. Most people live in towns (71.06 % in 2017), but the country has only one real metropole, the capital city Budapest (1.756 thousand inhabitants, together with its suburbs cca. 2.300 thousand). The main economic and political process in the country after 1990 was transition from centrally planned economy to market economy. This process fundamentally influenced business conditions, macroeconomic performance, institutions and the way of life in the country.

## 1. Political context and quality of institutions

Transition to market economy enjoyed widespread social and political consensus during the 1990s in Hungary. Therefore, the establishment and reintroduction of liberal market economic institutions as well as a democratic political system was rather quick and straightforward. The achievements in the process were earmarked by Hungary's accession to the OECD (1996), NATO (1997) and the European Union (2004). The country gained also economically from the systemic change: the level of GDP increased very significantly between 1995 and 2007. The robust

development process lost steam already before the 2008 crisis and recovered only slowly.

In the transition process of the 1990s, Hungary has become a fully-fledged market economy with institutional system comparable to the classic continental model of capitalism. It can be noted that the institutional background has not been imbedded deeply in the society and also the democratic political system elements remained fragile. Hence, with the world wide advance of state capitalism (Musacchio, Lazzarini 2014; Nölke 2014) Hungary's democratic political institutions as well as liberal market economy structures were rolled back considerably after the 2008 crisis (Voszka 2013). Thus, the concept of competition state (democratic competition in politics, free market competition in the economy) was pushed to the background (Szanyi 2016). These changes diverted the country's development path from the set of transatlantic models described by the well-known contributions of the Varieties of Capitalism (VoC) literature (e.g. Hall and Soskice 2001; Amable 2003; Nölke and Vliegenhardt 2009) towards a system which resembles the Latin-American clan state model. (Phillips 2004). The current Hungarian government made efforts to change some elements of the international environment too, especially within the EU institutions. The most recent worldwide advance of state capitalism supported these ambitions by certain parties and governments not only in "classic" etatist regimes like Russia, but also in other EU member states (Poland, Italy, France).

Hence, the Hungarian variant of capitalism is a rather peculiar hybrid that also changes over time rather quickly. The basic market economic institutions are present but since the rule of law is weak, their effect is very limited. This gives way to a new type of crony capitalism. The process of Hungary's sinking down to political and economic chaos that was experienced in many countries of Latin America is nevertheless blocked by several factors. Firstly, Hungary became a workbench of the European economic space, most importantly of Germany. Germany can effectively press the Hungarian governments not to go too far in rolling back liberal economic institutions that would endanger German economic interests. Secondly, also the European Union has an anchoring role since Hungary

signed many of the important treaties that constitutes the EU's acquis. Thirdly, political rent seeking is bound to a properly performing income generating economy. Rolling back of market economic institutions could seriously endanger dynamism of the economy which can become fatal if external growth sources (EU-transfers, FDI) dries up. In this sense, the Hungarian model is a symbiosis of the FDI-led economic model and a crony model of capitalism.

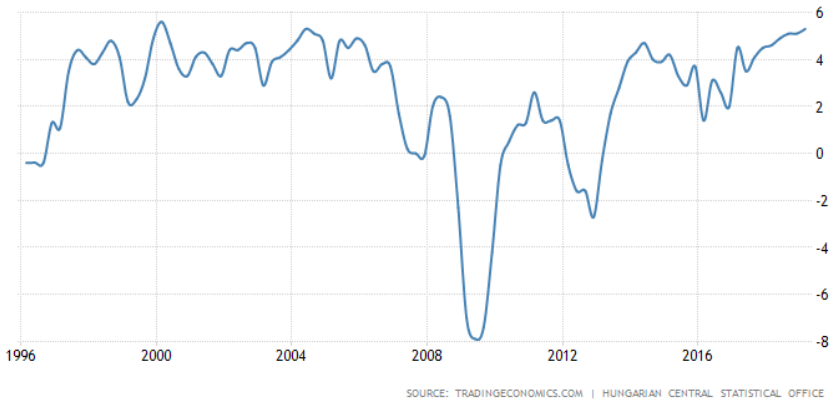
This process is reflected in deteriorating regulatory efficiency, increasing corruption, declining rule of law, suppressed voice and accountability. Institutional shortcomings of Hungary's development deteriorated most recently. Five out of six aggregate measures in World Bank's Worldwide Governance Indicators show decline between 2000 and 2017. Voice and accountability declined from 85$^{th}$ to 58$^{th}$ position (on the scale 1 – worse to 100 – best). This is a clear reflection of the authoritarian measures of the Hungarian government after 2010. Government effectiveness changed from 82 to 70, regulatory quality from 83 to 73, the rule of law from 81 to 70, control of corruption from 78 to 59. After steady decline from 78 to 69 in 2012, the measure political stability and absence of violence indicator improved to 74. While even the lower values of the measures are above average (over 50), the trend is rather worrying. There is a rapid decline of governance quality in Hungary despite of EU membership. In fact, the Hungarian government's most recent policies openly query the importance of many values reflected in the good governance indicators. Thus, even if unintended, the deterioration is triggered in many cases by government action.

## 2. General economic outlook

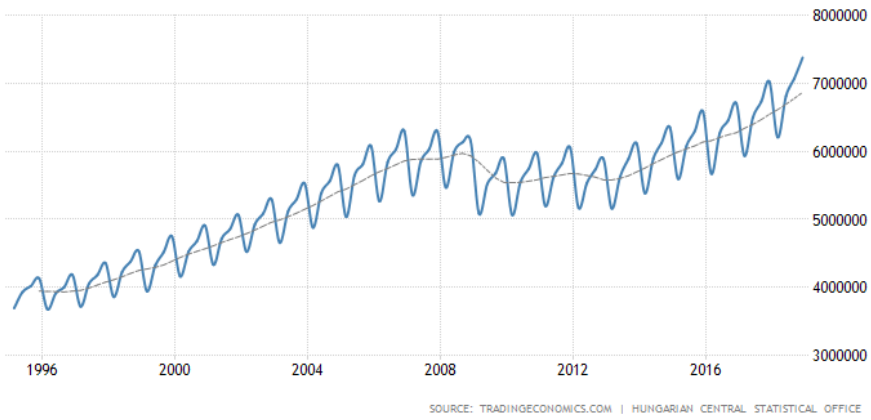
Economic growth of the country was significant after the period of transition crisis. Between 1990-1994, the level of cumulative GDP dropped by 30%, and the economy recovered to the pre-transition level only in 1998 (Kornai 1994). The then achieved relatively high growth rates (2-5% GDP growth) could not be maintained throughout the 2000s mainly due slower growth in the main trading partner of the country (Germany) and the mounting government debt that called for austerity measures in 2006-7. This together with the negative effects of the global financial crisis in 2008

resulted in negative growth in 2009 (-6.6%) and also in 2012 (-1.6%). Thereafter economic growth was significant ranging between 2.1% (2013) to 4.9% (2018). Average GDP growth between 2010-2017 was 3.1% compared with the 2.1% average growth rate of the EU28. This was achieved with the help of successful macroeconomic policies and the significant stimulation effect of financial transfers from the European Union. But the 10-year average growth rate was only 1.0% in 2018 (reflecting also the impact of the 2008/9 crisis).

**GDP growth rates**

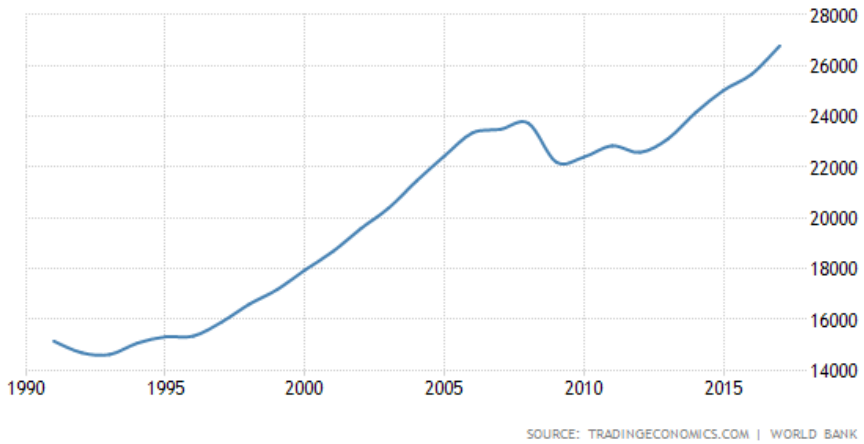



**GDP HUF million, constant price**



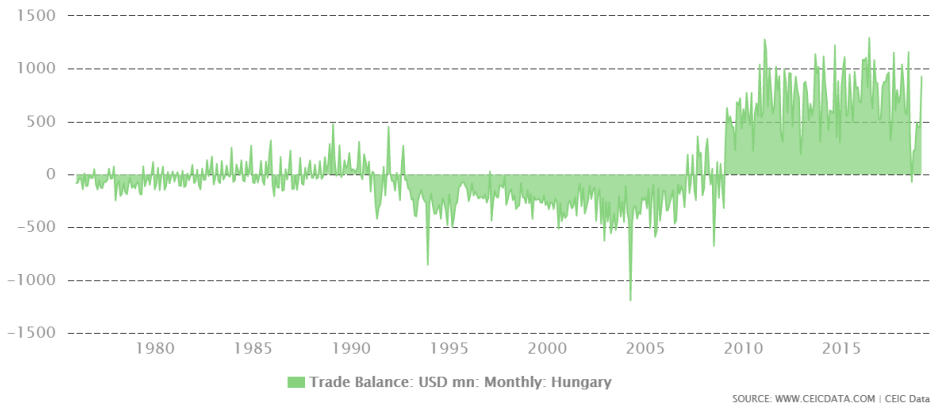
Hungary's relative level of development (GDP per capita) almost doubled from its lowest level in 1993. Yet, it is fairly low compared to the average of the EU28. It was 61% in 2006 and increased to 68% by 2017 (Eurostat) mainly due to above average economic growth but also due to declining population figures (smaller denominator).

**GDP/capita (USD, PPP)**




Industrialisation up till the 1990s and deindustrialisation afterwards shaped the economic structure of Hungary. The role of agriculture in employment declined from post second world war levels to 5.4 % in 2018. The low employment level together with relatively high agricultural output indicates increased productivity in the branch which is due to concentrated land ownership and up to date technological levels. Deindustrialisation was deepest in the transition crisis period (1990-1994). The liquidation of obsolete industrial capacities was only partially offset by new industrial investments carried out mainly by foreign companies. Employment in industry reached 26.9% in 2018 showing a 2% point increase over the low of 2012. The increase was also due to reindustrialisation efforts taken by the Hungarian government. The 2018 67.7% level of services (private and public) employment reflects the results of many post-transition processes: a quick recovery of the previously underdeveloped personal services sector,

the penetration and aggressive expansion of multinational services firms, strong specialisation of the labour force on low-end business services (call centres). Significant part of the GDP is realised in net goods and services exports. From 2007 onwards but especially after 2009, Hungary achieved substantial surpluses in the trade balance. Trade statistics show a very high level of openness of the country. Among the EU28, Hungary had one of the highest share of exports and imports as percentage of GDP (86.5% and 81.7% respectively in 2018 according to data of the Central Statistical Office).




Labour market conditions have been regarded as rather flexible in Hungary. For many years also wage costs were low, and the rather quick rise in labour productivity produced falling unit labour costs in the country, especially during the 1990s. After the year 2000 and especially after the EU accession wages started to increase in real terms. The process was also intensified by negative demographic changes, aging and significant outmigration. After 2010, labour shortage emerged in various market segments, most importantly in blue collar manufacturing employees (skilled workers). In response to changes in the labour market Hungarian government decided in 2018 to amend laws regulating employment conditions. Employers were entitled to increase possibilities of overtime work hours with relative minor excess compensation (Slave Law). The new regulation called for protest demonstrations. Also, major strikes were launched in some important industrial facilities (Hankook, Audi) that were successful and could enforce increases in employees' wages.

The share of wages in GDP was 36.3% in 2017. All employee compensations plus employer's social contributions made up 50.7% (Eurostat). The flexibility of the Hungarian labour market was largely achieved due to the weakness of labour organisations in the country (they were slashed on political reasons during the early years of the transition period). The trade union density rate was a mere 12% in 2010, and the share did not increase significantly ever since. The potentially accessible labour force could be increased in labour shortage situation by an increase of the activity rate to 71.2% by 2017. Also, unemployment rate went back to an all-time low level of 3.7% which is probably below the natural rate of unemployment. The significant reduction was achieved through the introduction of social works in the most depressed rural regions. This construction cannot be treated as regular employment but rather as social aid. Very much worrying is the total slowdown of productivity growth in Hungary. Between 2010 and 2018 labour productivity increased only slightly by 5.5% while all other transition economies scored double digit figures, many of them over 20-30% (Eurostat). This figure clearly shows that economic progress stalled in Hungary. No new, more productive investments were carried out and we can suspect that unproductive employment forms are also reflected in this figure. Last, but not least, the quality and skill ability of the employed might have deteriorated too. Significant outmigration occurred after the labour market liberalisations in more developed EU countries luring away rather the competent workforce especially in the blue collar segment. Estimations count with 300-500 thousand active people to move, and there is another significant share of the population in Western Hungary that commutes mostly to jobs in Austria.

Dynamics and structural development of the Hungarian economy was largely determined by the new role of the country in international labour division controlled by multinational corporate networks. The Hungarian economy was successfully integrated in global world economy. Yet, the process was rather extensive, quantitative: existing production input sources were reorganised in new global business models based mainly on the usage of available unskilled labour. Hungary has been regarded as a

classic example of dependent market economy (Nölke and Vliegenhart 2009): dependent from multinational business decisions.

### 3. Quality of entrepreneurship

The four decades of communist rule and central planning exercised a deep impact on social attitudes to and experience with entrepreneurship. Hungary was called the showcase country of the communist bloc. This meant a relatively loose Soviet control over the economy. Hungary was simultaneously also a test lab of economic and social reforms in the soviet bloc. Starting as early as in 1968, Hungarian governments experimented with economic reform initiatives in order to introduce performing price system, collective and personal incentives and more direct links to the non-communist world economy. However, these reform steps did not change the basic character of the economy. 70-80% of production remained under direct government control and central planning. Prices and salaries were also largely kept under control. During the 1980s, Hungary accumulated a high foreign debt.

Yet, under the debt pressure Hungarian government made new efforts at improving economic performance of the country in 1988. Key market economic institutions were introduced in the legislative: Company Law and Commercial Law were passed, two-tire banking system was created, price and wage controls were eased. These changes in the legal system proved to be important drivers of the transition process already in 1989 (privatisation through asset tunnelling) and in 1990 when the first free elections were held and the first government of the new Hungarian Republic was formed. High foreign debt, accumulated experience with some market economic institutions, corporate managers' contacts to Western businesses were the main determinants of the transition policies of the new Hungarian government. Another important driver was of course the international advising community.

Hungary applied the gradual approach in the transition process (Roland 2000). There was no big bang. Priority was given to speedy institutional development, the creation of basic market economic institutions. At the same time, serious efforts were made to continue increasing efficiency on

the micro level that could also contribute to the reversal of the transformational recession and the macroeconomic stabilisation of the economy (Szanyi 2016). The establishment of credibility of economic policy and breaking the inherited paternalistic linkages of firms to polity was also high priority (Szanyi 2002). Hence, microeconomic transformation was urged in several ways. The government decided to slash company and market subsidies from 1992 onwards. Liberalisation measures were introduced relatively quickly, price control was lifted almost entirely, imports were liberalised rather quickly, exclusive business licenses were withdrawn.

The quickly intensifying pressure of competition was not accommodated by any measures (e.g. by currency devaluation), companies were encouraged to solve their problems through the privatisation process, mainly relying on foreign companies' investments. Thus, privatisation policy preferred sales to foreign investors and FDI was encouraged also by many other advantageous regulations. At the same time companies were legally forced to manage the new challenges. Unfortunately, the "supply side shock therapy" called for a massive wave of bankruptcies (Szanyi 2002). Approximately one third of the previous state ownership stock was eliminated, a further one third was privatised to foreign companies. The remaining stock either was kept in state ownership or privatised through other tools (vouchers, employee-management buyouts, insider actions).

Against this background it is not very surprising that the entrepreneurial class has not been particularly strong in numbers or in skills and capacities up till the 2000s. Several studies confirmed these deficiencies (Laki 1994, 2002; Stark and Vedres 2012). Instead of technological and business innovations Hungarian entrepreneurs continuously put efforts in accumulating network capital: good connections with policy makers. Instead of targeting economic rents stemming from innovation and leadership they concentrate on rents stemming from political connections (Kolosi and Szelényi 2010; Laki 1994, 2002). Therefore, analytical measures of entrepreneurship are fairly disappointing and show no sign of improvement in Hungary.

The Global Entrepreneurship Monitor (GEM) provides a rather mixed picture about the conditions and capabilities of entrepreneurship in the country. The GEM spider chart shows that the level of physical infrastructure is ranked highest (around 4 on the 1-5 scale), and this is equal to the regional average, meaning that East-Central Europe has an overall good quality infrastructural background. Adequate levels were shown in higher level entrepreneurial education (with numerous internationally recognised universities and business schools), commercial and legal infrastructure and internal market dynamics. Entrepreneurial finance received somewhat lower score but was still very much in line with the regional average score. Going backwards on the ranking we see internal market burdens and entry regulation and R&D transfer at even lower level and below the regional average. The worse performing features with figures around grade two and below regional average scores were government entrepreneurship programs, governmental policies both from the aspects of support and relevance moreover taxes and bureaucracy. The bad scores of the three government policy related indicators calls attention to serious problems in formulating coherent and supportive strategy for business and entrepreneurship promotion. But the situation is even worse in the case of social and cultural norms which is in connection also with the complete lack of entrepreneurial education at the school stage.

On the list of WEF's Global Competitiveness Index (GCI) Hungary scored 48$^{th}$ out of 140 countries. The ranking has improved from the low 62$^{nd}$ position in 2008 steadily, mainly because of improved macroeconomic indicators (rank 115$^{th}$ out of 134 countries in 2008 and 43$^{rd}$ of 140 in 2017). The other main pillars of the GCI did not change so dramatically, and they are roughly at the level (usually somewhat below) of the high-income group average or the Europe-North-America average. In pillar 1 (institutions) "efficiency of legal framework in challenging regulations" is ranked 134 (from 140!), but several other measures were over 100: "judicial independence", "property rights", "conflict of interest regulation". Burden of government regulation scored 95, future orientation of the government 96. Thus, several key institutions especially in the area of property right enforcement are weak thus hindering business

performance. Some other relatively weak points of Hungarian competitiveness were also shown in pillar 6 “Skills”.

The business freedom measure of Heritage Foundation declined in Hungary most recently (2019). Now the country is only moderately free and countries like Kosovo and many others are ahead of it. The score is 65. Especially telling is the explanation of the decline. “Hungary made important reforms from a centrally planned to a market-driven economy, but the government has become more interventionist in recent years. The government plans to use sectoral taxes to manage the budget deficit and public debt to avoid renewed European Union sanctions under the EU’s excessive deficit procedure. Systemic economic challenges include pervasive corruption, labour shortages driven by demographic declines and migration, widespread poverty in rural areas, vulnerabilities to changes in demand for exports and a heavy reliance on imports of Russian energy." These are the most important flaws and challenges.

## 4. Modernisation based on FDI

During the mid-1990s up till the 1996/7, sale of public utility service networks and commercial banks FDI penetrated the Hungarian economy through privatisation deals. The modernisation of the newly acquired facilities soon begun, and the improved performance of firms was also reflected in more macroeconomic stability and economic growth (Szanyi 2016). Thereafter also major greenfield FDI projects were launched. Capital investment activity in the country became increasingly controlled by multinational companies’ local affiliates. Complete new industries were established (electronics, automotive). On the other hand, many of the traditional flagship branches and firms of Hungary shrunk or disappeared providing much fuel to intense discussions even many years later. Hence, the restructuring process established facilities that were shaped in the then already prevailing GVC concept of labour division. This meant that Hungarian affiliates carried out only certain segments of the production process and were highly specialised mainly on labour intensive activities. The country’s main FDI attraction potential was access to cheap skilled labour force alongside with opening up new market potential (Nölke and Vliegenhart 2009). Thus, by the year 2000 Hungary became leader in FDI

attraction in East-Central Europe and accumulated a rather significant stock of FDI.

After conducting a substantial amount of research on FDI and the work of multinational firms in Hungary, most researchers reached a kind of general consensus in the issue. Firstly, FDI and foreign penetration in the transition process was not only unavoidable, but definitely the best option to restore competitive economic structures in the economy. Hungary's economy became highly competitive internationally. On the other hand, Hungarian business could not keep pace with this quick development, due mainly to its own shortcomings and the counterproductive regulatory system that did not support its effective modernisation in times of increased competition. Hungarian capital owners were crowded out from big business. Therefore, today there is no match or adequately strong counter weight in the economy: large parts are dominated by multinational companies (Szanyi 2016). According to data included in UNCTAD's World Investment Report the officially registered share of FDI in total fixed capital formation ranged between 7 and 38% in the period after 1990 up till 2018. The total stock of inward FDI of Hungary was 22.870 million USD in 2000 and 93.332 million USD in 2017 (UNCTAD). By 2017, Hungary also increased its outward FDI stock from 1.280 million USD to 28.611 USD.

During the 2000s this leader role faded out with the advance of investments in other countries of the region. Hence, the Hungarian economy lost somewhat in dynamism. Due to opportunistic behaviour of the various governments in this period foreign debt started to accumulate again, growth was fuelled by state-sponsored private and public consumption. Another feature was the increasing direct influence of succeeding Hungarian governments over the economy. Partisan firms participated in public procurement tenders enjoying unjust advantages in the procedure. Also, market regulation changed several times favouring political insiders. To some extent re-nationalisation also occurred in order to support certain political goals (e.g. slashing public utility prices). These tendencies intensified after the 2004 accession to the European Union, and especially after the 2008 crisis (Szanyi 2016). Most recently, the still considerable economic growth has had three main drivers. EU accession and successful

applications to various EU funds provided stimulating cash transfers to the tune of around 5% of the GDP. FDI promotion was spread to expansion of already existing facilities that maintained investment momentum of the foreign-owned sector of the economy. Thirdly, despite of long-term development and economic stability risks many policies of the current government successfully stabilised the economy. Also political stability increased.

Concerning financial sector data, we can see that Hungary has a continental type system with a strong influence of commercial banks and relatively weak capital markets. The stock market capitalisation was only 12.31% of the GDP (2015), and there are only a handful of listed companies in the country. The security market is dominated by government papers. The level of domestic savings has increased significantly after 2010 from 26% to 30.36% of the GDP in 2017. This may give some credit to the National Bank's conversion plans. The stock of domestic credits to private sector declined greatly between 2010 to 2017 from 60.8% to 33.4% of the GDP (Hungarian National Bank data). The reduction of private sector debt was achieved mainly by the write-offs of non-performing foreign currency mortgage loans held by the banks. After the 2008 crisis and the rapid appreciation of the Swiss franc, a big share of the mortgage loan stock failed causing serious tensions in the banking sector but also creating political debates over the case. Because of the political importance of the issue the Hungarian government provided assistance to cover the costs of the elimination of the bad loans.

The figures show that investments do not use up all of the private savings, thus, there is a significant amount of liquidity that can be channelled towards government securities. The investment rate was 22.41% in 2017. Just like it is usual in the German type economic model, banking sector's overall economic influence is also supported by a high concentration ratio. The largest 3 banks concentrated 66.5% of total banking sector assets (OECD).

## 5. Knowledge sector

Dynamic efficiency and future growth potential can be evaluated with an overview of the situation of innovation and entrepreneurship. Science and education has enjoyed high priority in Hungary during the late 19th and early 20th century. At that time compulsory primary education was introduced, some universities enjoyed worldwide reputation due to their scientific activities (Nobel Prize winners). The soviet-type political and economic system eliminated the incentives and decimated the financial resources especially for high quality scientific research. At the same time the US-led technology embargo cut off the country from vital technology transfers. Thus, science and education was weakened, though the basic infrastructure for high quality work remained in place. Unfortunately, the crony-type capitalist model that evolved after the 1990 political transition in Hungary did not increase incentives for developing the knowledge-based economy in the country. The quality of output in all levels of education started to decline. Business remained rather immune to innovations: the development of network capital remained the primary source of business development and not innovation (Laki 2002).

The EU Innovation Scoreboard collects important comparative data (27 indicators) about the quality of innovation infrastructure, innovation performance and innovation support. Hungary's overall ranking declined very slightly between 2010 and 2017. The country was 21st of the EU 28 and belonged to the low section of moderately innovating countries. Two measures have stood out permanently: employment in fast growing enterprises and medium and high tech product exports. This later indicator however does not really mirror high tech local value added: in many cases the low segments of high or medium tech production (e.g. assembly) is carried out by multinational firms' affiliates in Hungary. In further two measures (international scientific co-publications and broadband penetration) Hungary could substantially improve its scores. At the same time, in half of the measures deterioration was observed. This was especially marked in the case of small firms' innovativeness. R&D spending increased from around 1% of the GDP during the late 1990s to 1.2 %, but this is still far behind the EU average or the highly innovative

countries' expenditure figures. The government's new strategic plan targets 2% R&D spending in the medium term.

Despite of advances in some areas of digital economy and society (e.g. improved access to broadband infrastructure) Hungary is ranking rather low in the Digital Economy and Society Index (23rd out of the 28 EU member countries in 2018). The DESI Country Report also highlights improved connectivity in the country and also the resulting increased usage of internet services. Measures of both of these aspects are slightly above the EU average. However, in the three other dimensions Hungary lags far behind. The level of human capital (enabling knowledge and skills) is already significantly lower than the European average, but integration of digital technology and especially digital public services have dramatically low level. In case of digital public services Hungary is only 27th in the list of 28 EU member countries. This is despite of the effect of the National Info-Communication Strategy 2014-2020. Nevertheless, DESI improved also in Hungary from 35 to 45 between 2014 and 2018.

Hungary is a moderately innovating country with some strengths and many weaknesses. Good quality education used to be one of the key factors of Hungarian success in the area, looking back to very significant government efforts during the modern history of the country. This system started to erode due to several reasons but mainly because of the lack of government attention. Hence, output from the various levels of education have sharply deteriorated during the past 20 years. Another weakness is the low level of interest in innovations, which has also been a problem already during the times of central planning and thereafter. The main problem is here the lack of stable economic and regulatory environment and cronyism that provides easier and more countable business options for entrepreneurs. Therefore, most indicators in this section are not very good, except of the share of high-tech exports (13.8% in 2017). This fairly high share is mainly due to multinational companies' activity, but the real knowledge intensive value added content in this turnover may be significantly lower. R & D expenditure was 1.21% of the GDP in 2016, a figure mostly reflecting multinational firms' local activity. Indigenous business has negligible share, and state's share is also lower than in other countries, around 40%

of total spending. Public expenditure on education was 9.24% of the GDP and declining (true, school-age population is also falling), the higher education rate was 26% in 2016.

## 6. Public opinion attitude towards transformations

Hungary had been a reform-communist country during the 1970s and the 1980s. The Hungarian "goulash communism" not only meant slightly higher living standards, but also relatively looser political and economic control. Some freedom of decision was provided to company managers, citizens were also allowed to travel or to launch small businesses. The experiments with "economic reforms" served as a social valve: Hungary became "the happiest barrack" in the communist camp. At the time of the political transition and throughout the 1990s, Hungary enjoyed the benefits of these premises. Hungary was the eminent scholar in the establishment of the structures of the competition state in the ECE region. The society hoped that the quick implementation of the institutions of the most competitive transatlantic capitalist models will catapult the country to similar levels of development very soon. At that time a kind of euphoria characterised the country, which was also fuelled by the newly won political independence and the strong support of advanced countries (mainly Austria, Germany and France in terms of economic integration and the US in entering NATO). This process clearly had a very strong political charge against the Soviet Union and later the Russian influence in the ECE region. This process was supported by strong consensus in the society and among political parties.

Some details of the transition process were discussed already during the 1990s. Right-wing politicians for example criticised the FDI dominance and the lack of effective support of the domestic business. The privatisation process stalled during the first Orbán-government (1998-2002), but by that time majority of state owned enterprises were either privatised or went bankrupt (Szanyi 2016). That government started to work against the Euro-Atlantic orientation of the development path of the country. While cronyism during the 1990s targeted mainly the privatisation process, during the 2000s also parallel with the advance of EU-membership negotiations the main source and vehicles of (political) rent seeking changed. The main

objective was to create partisan business in branches that received large-scale cash transfers from the European Union (e.g. all types of construction). This process earmarked the policies of both left- and right-wing governments, but was pushed to the extreme by the second FIDESZ government after 2010 (Szanyi 2016).

Parallel with this political and economic process public opinion was also massively influenced by the governments and after 2010 by the government-controlled mass media. Consequently, public support of the flagship development projects (NATO-membership, EU-membership) lost substantial public support. Strong criticism of the European institutions and policies was very frequently supported by populist argumentations in the social campaigns that delivered massive support of the government's domestic and international policies. A new element in this game of winning the sympathy of the public was the strong emphasis on xenophobic sentiments against refugees and migrants, and also against social and ethnic minorities. These campaigns changed the attitudes of the less educated social strata especially. The results of this campaign are clearly seen in changes of Eurobarometer survey results. The 2017 survey data indicated that Hungarian people are much more worried by immigration and terrorism than the European average (58 and 45% against 39 and 38%). These figures stand against the facts that after the really troublesome peak of immigration in 2015 the process lost steam completely (as the government argues, this is due to the successful countermeasures). It is also known that the majority of people scared of migration live in small villages and in the countryside, where basically no migrants were seen even in 2015. Another fact: the total number of terrorist attacks conducted by immigrants in Hungary was zero during the last 5-10 years. Surprisingly, trust in the European Union was higher in Hungary than in the EU on average (49% versus 41%). The same surprisingly high level of trust was shown towards the media in effective state monopoly (49%) and the Hungarian government (48%) (Eurobarometer 88). These figures show the deep split of the society: despite of rather obvious lack of tangible evidence in some public matters state media effectively influence the public opinion. As comparison, the first three worrying issues in 2004 were economic problems, terrorism was only 9$^{th}$ on the list (5% against the EU average

16%). Trust in the EU was also much higher (64%) but not in the government (40%) (Eurobarometer 62).

## Conclusions

The socio-economic model of Hungary is a mixed one. Loosely embedded market economic institutions provide a rather instable economic environment. This has negative effects on FDI and also on domestic business development. High and increasing political corruption requires capital owners to spend time and efforts with networking with government officials instead of increasing their competitiveness through new investments. The other part of the economy consists of highly efficient multinational affiliates. They have contributed to the overall modernisation process of the Hungarian economy. Unfortunately, their local embeddedness is not always strong. They moved substantial parts of their GVC-s to the country, but also the main suppliers are foreign owned. A relatively new problems is the lack of skilled labour. This shortage has also pushed up real wages. Consequently, price competitiveness of Hungarian locations has eroded. Due to lack of labour but also because of hostile policies of the Hungarian government confidence in Hungarian investments has eroded. Economic growth was maintained through strong growth effects of EU transfers. Unfortunately, the transfers have only temporary stimulation effect. Mainly because they are spent on the development of infrastructure which only has indirect and lagged longer term growth effects besides the current spending effect. It is rather worrying that the economy and social system of the Hungarian crony capitalism undermines also the institutions which are important for long-term development. Education, national health system, is deteriorating very quickly. The mounting problems are also reflected in the still rather modest but significand outmigration and worsening demographic trends.

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### 3.1.3 Poland: A Story of Success

Krzysztof Jasiecki

## Introduction

Poland is a relatively large country in Central Europe with an area of 312.696 square kilometres. The population is just over 38 million and, in this respect, it takes the sixth place in the EU. It has a uniform ethnic character – 97% of the population declares Polish nationality and a religious one – approximately 90% of its citizens declare themselves as Catholics. It is located between the Baltic Sea in the north and the Surety and the Carpathians Mountains in the south. From the north it borders with Russia (with the Kaliningrad region) and Lithuania, on the east with Belarus and Ukraine, on the south with the Czech Republic and Slovakia, on the west with Germany, and across the Baltic Sea with Sweden. The Polish borders with Ukraine, Belarus and Russia are also the external borders of the EU. Poland is administratively divided into 16 voivodeships (provinces). The rate of urbanisation (60.2%) is rather low by European standards. The capital of the country is Warsaw, which has 1.8 million inhabitants. Other large agglomerations include Kraków (770 thousand), Łódź (690 thousand), Wrocław (640 thousand) and Poznań (538 thousand).

### 1. The political context and quality of institutions

The key phase of the transition to the market economy in Poland began with the political changes in 1989. Its distinctive feature was the simultaneous departure from authoritarian state socialism and the command-and-distribution economy towards the creation of democratic political institutions, market economy and civil society. Integration with Western organisations became an important part of the new policy. This was a consequence of a political search for a way out of stagnation after the collapse of the economy in the late 1970s, the creation in 1980 of *Solidarity* – the anti-system trade and social union (about 10 million members), the introduction of martial law in 1981, and later unsuccessful economic reforms. The systemic changes were undertaken as a result of agreement between the reformist power elites of the "old political system" and the moderate opposition leaders with Lech Wałęsa at the forefront. After the

parliamentary elections in 1989, the new government began to implement economic reforms in accordance with the neoliberal line of the Washington consensus (Sachs 1993; Balcerowicz 1995). Their radical nature resulted from the crisis of the economy, including the downfall of the export market after the collapse of the Council for Mutual Economic Assistance (COMECON) and a very high foreign debt. However, the new governments initially had a broad political and social support thanks to the backing of Solidarity, among other things. The fundamental direction of systemic changes was also soon strengthened by Poland's actions towards its membership in the OECD, NATO and the EU. Their implementation facilitated the reduction of Poland's debt by nearly 50% against foreign state creditors and banks (negotiated in 1991 and 1994, respectively).

Among the most important transformations of that period one can point out the adoption of new constitutional principles, including a catalogue of freedoms and personal, political and economic rights (with guarantees for private ownership), division of powers of the authorities, and the rules of public finances. The independence of the National Bank of Poland was strengthened and the reduction of the budget deficit according to the EU principles was implemented. These rules were codified in the new Constitution of 1997. The new policy found expression in the creation of the foundations of a market economy based on the model of Western countries. The regulatory framework for this process is also defined by the EU law with the Polish law harmonised with it. Commercialisation and privatisation of the public sector continued, as well as did the rapid development of the private sector. This was supported by the new legislation, partly referring to Polish regulations from before World War II. Important market economy agendas, such as the stock exchange, were created (1991) along with new regulatory institutions, including the Antitrust Authority and the Competition and Consumer Protection Authority. At the end of the 1990s, the authorities introduced four major reforms: the administration reform increasing the territorial self-government competence, the pension reform introducing individual capitalisation of funds, the health care reform based on the competition of health funds and the reform of education. An institutional architecture was created to support economic development, and the combination of national reforms with the accession to the EU in 2004 contributed to political stability and increased the predictability of Poland's development. Such

trends were positively received by international business organisations, Western countries and foreign investors. Since the 1990s, Poland has been one of the leaders of systemic changes in CEE. It was explained, among other things, by pointing out the improvement of the quality of economic policy, including the improvement of the macroeconomic environment and of the structure of enterprises, related to privatisation and changes in corporate governance. Positive directions of the changes were confirmed by the indicators of the following: the growing of economic freedom, lover investment risk, the growing share of trade in GDP, increasing the share of loans to the private sector and reducing corruption (Gros, Suhrcke 2000: 134-135). Poland was among the countries that finalised their post-socialist transformation. It entered the phase of economic development with problems characteristic of western countries, such as increased investment in education and new technologies (World Bank 2008: 42). In 2010, in terms of the quality of management in the EU countries according to the methodology of the World Bank, Poland was ahead of Italy, and behind Greece and Lithuania (Charron *et al.* 2013: 4). In the next ranking it improved its position and overtook, among others, Greece and Italy, although found itself behind the Czech Republic (Charron *et al*. 2015). However, there is still a distance from the Scandinavian countries as well as from certain post-socialist countries, such as Estonia and Slovenia.

Although Poland is the only EU country that escaped the recession during the crisis of the euro area, this crisis became a catalyst for major political and institutional changes. It revealed the limitations and contradictions of the country's development strategy implemented since the 1990s. Despite the great economic success, the crisis showed a significant potential for public dissatisfaction that favoured political projects to correct the state system. The implementation of systemic changes was linked to a number of controversial consequences, such as the reduction of social functions of the state, the collapse of state enterprises, mass unemployment and significant polarisations, exclusions and differences of socio-economic, generational, regional etc. nature. Disputes emerged pertaining to the role of the state in the systemic transformation, the activity of elites (and their corruption), the assessment of the communist past, the effects of market reforms, the presence of foreign investors, political and economic sovereignty and the cultural identity of Poles in the EU. Since the late 1990s, right-wing and conservative parties have intensified their criticism

of the transformation. The first significant, though unsuccessful, attempt to implement the alternative concept of political and economic development ("the Polish way of modernisation") was taken by the government coalition led by the Law and Justice (PiS) party between 2005 and 2007. PiS has continued these changes since its victory in the elections in 2015. It also refers to the policy pursued in Hungary by the government of Viktor Orban since 2010, which often serves directly as a roadmap for Poland. The PiS government centralises political power and changes the system of checks-and-balances in favour of the executive branch. They subordinate the public media and the civil service to the ruling party, limit the autonomy of the Prosecutor's office and the Judiciary, and increase control over territorial self-government and NGOs.

In accordance with the idea of a developmental state, they support "national champions" based on state owned companies and large state-initiated projects. Such a model combines the growth in state intervention in the economy with an expansion of the redistributive state in social policy (Gardawski 2018; Golinowska 2018). However, this direction and method of introducing changes raise significant internal and EU controversies. In Poland, they relate to the opposition parties' allegations of an autocratic style of governing, the dismantling of democratic institutions and the creation of authoritarian "state capitalism". In the EU, Poland is accused of departing from the liberal standards of the rule of law and the division of power (Jasiecki 2019, Dąbrowska *et al.* 2019). The changes in Poland are also reflected in reports of the World Bank. Since 2016 the indicators of voice and accountability, political stability and the absence of violence have gone down significantly, the government effectiveness remained and control of corruption have gone up (WGI 2018). Post 1989 Poland has experienced the greatest development success in the past 300 years. One of the greatest achievements is building a solid base of the market economy, as well as its membership in the EU, the OECD and NATO. An institutional framework has been created that favours the development of the country in close connection with Western organisational structures that raise business standards. In turn, the key challenge remains the achievement of a new political consensus concerning the shape of the state system which, in many aspects, has been radically changed since the end of 2015. The policy of the new government, ideologically justified by the criticism of liberal and leftist elites, has led to large social polarisation and conflicts, which

weakens the synergy needed for stable economic development of Poland. This is a situation that makes it difficult to make the necessary reforms in the state administration, the justice system, health care, the pension system and education, essential for supporting the economy. It also creates tensions in relations with the EU and important economic partners. The current government is opposed to joining the Euroland; staying outside of the euro area facilitated counteracting the consequences of the economic crisis in the EU in 2008-2009. However, in the perspective of consolidating the EU economy around Euroland (accelerated by Brexit), remaining outside of the euro zone may lower Poland's position in the Union both in the political and economic dimensions.

## 2. The general economic outlook

The model of capitalism shaped in Poland after 1989 combines, differently in subsequent periods of reform, liberal institutions with post-socialist statism and neo-corporatism. The distinctions are as follows: 1) the dominance of the private sector and market coordination in the economy with a greater role of the state than in Western Europe; 2) institutions of dialogue between the government, the trade unions and employers' associations, which function mainly in the public sector (the tripartite commission, the Social Dialogue Council); 3) significant deregulation of the labour market, especially for small enterprises; 4) a large share of foreign capital; 5) a limited scope of the welfare state and 6) an important position of informal economy. The emerging model of domestic capitalism remains dynamic. So far, its unambiguous theoretical and typological qualifications have not yet been identified. Depending on the adopted criteria, it can be included in the liberal market economy model (King, Szelenyi 2005), hybrid economies (Schneider, Paunescu 2012), weakly coordinated market economy (Mykhnenko 2007) or embedded capitalism (Bohle, Greskovits 2012). It is also referred to as inconsistent and institutionally changing patchwork capitalism (Rapacki 2018). Since 2015 it has also been characterised as an attempt to create a new variant of statism or a developmental state. Despite (or as a result of) such a lability, Poland remains one of the leaders in economic growth in the EU and CEE. As the only EU Member State since 1992, it has been continuously developing, reaching an average annual GDP growth of 4.2% in this period, and slightly less, 4%, since the accession to the EU (World Bank 2019). Poland was also the first country in CEE which in 1996 exceeded GDP

level from before the transformation breakdown. After a two-year recession and subsequent macroeconomic stabilisation and the creation of basic market institutions in the early 1990s, the implementation of reforms changed the country's economy in terms of quantity and quality. The GDP structure has significantly increased the share of services and reduced the role of production (especially heavy industry) and agriculture. The role of foreign trade and exports grew significantly, which was conducive to a wider integration of Poland into the international division of labour based on market criteria. There was a reorientation of trade from Eastern Europe to Western Europe related to tariff changes and strengthening links with EU and OECD countries. This contributed to the improvement of the quality of domestic production and services that have become more competitive. A manifestation of this phenomenon is the fact that Germany has been the main economic partner of Poland since the 1990s, and the current trade with EU countries accounts for nearly 80% of exchange with foreign countries (Yearbook Trade 2018: 42). Poland has become a country implementing the export-oriented growth model in cooperation with international corporations.

The above changes were related to radicalised transformations in the labour market and in industrial relations. Unemployment arose on a scale unknown in Poland after the Second World War, which particularly increased before the accession to the EU, reaching 20% in 2002-2003. It is currently the lowest since the beginning of the transformation and has fallen below 4%. On the other hand, there has been a phenomenon of employee deficit, which limits the possibilities of economic development (a temporary adaptation is the acquisition of economic migrants from the countries of the region, mainly about 1 million workers from Ukraine). Market reforms, technological changes, deregulation of the labour market and the rapid development of small businesses, as well as the preferences of private employers have greatly weakened the trade unions. There has also emerged the phenomenon of conflict union pluralism resulting from various political affiliations of the trade unions. Trade union density in Poland has decreased from 36.7% in 1990 to around 12% in recent years. Indicator of the change in the role of the unions and the position of employees in the labour market is also the main level of bargaining, which has been shifted from the sectoral level onto the level of enterprises. At the

beginning of the 1990s, collective agreements covered the majority of employees, in 2000 – 25%, and in 2012 they included less than 15%. Currently, they prevail mainly in the public sector and in state-owned enterprises as well as in some companies with foreign investors (OECD 2018).

A particular problem of the labour market in Poland is the scope of employment forms that do not provide employee rights, social security and development opportunities. Agreements, such as temporary contracts in the period of counteracting the global crisis reached in Poland, as well as in Spain, the highest level in the EU (in 2008 they amounted to almost 21%, in 2014 – 22.4%, and later dropped to 20%). A new, large social category was created, which included, apart from those employed under temporary contracts, numerous self-employment groups as well as workers employed on a temporary basis or through employment agencies. The precariat, characterised by a very unfavourable position on the labour market (Standing 2011), is produced by this group. An important feature of the new economic model is the social protection system. Before the global financial crisis in the analyses of relations between labour markets, industrial relations and welfare states, Poland was defined as "embedded neoliberalism" (Bohle, Greskovits 2012). In this approach, it is neoliberalism constrained to some extent by state regulation and social protection. The main feature of the model is the generous payment of relatively small funds to people outside the labour market (mainly pensioners) and marginal financing of career activation. Spending on social protection benefits as a GDP percentage value in Poland fluctuated in the period 2000-2006 between 19.1 and 20.6%, and then slightly decreased to 17.9-19.9%, against the average for the entire EU of over 27%. In turn, expenditures on health care in Poland since the beginning of the transformation have belonged to the lowest in the EU (about 5% of GDP in 2017 against the EU average of 8%) (Eurostat 2019). In the conditions of a rapidly aging society, this system is deteriorating (Golinowska 2018). For similar reasons, the importance of pension benefits is growing. Their amounts account for 11.5-12% of GDP per year (Eurostat 2019). Due to the very low fertility rate (1.2 to 1.4), long-term unemployment and the persistently low employment rate, as well as declining contributions, the

existing system based on the Bismarck tradition of obligatory insurance is jeopardised. The situation was worsened after the accession to the EU by mass emigration to Western countries of about 2 million Poles. Under such circumstances, the pension reform program implemented in 1998, based on laying up benefits in capital funds, proved to be dysfunctional. During the global crisis, as in Hungary and in Latin America, it began to be renounced. In 2011, the Polish authorities transferred most of the assets from individual private accounts to the state social security institution and initiated a gradual increase in the retirement age. However, since 2015, the new government has returned to the earlier age bracket and has been launching voluntary funded pension funds in the workplace. As a result, the directions for reforming the pension system are contradictory.

The most important change in the social policy of the state in this period, apart from reducing the retirement age, became the family benefit program 500+ (a PLN 500 child benefit). It involves the transfer of additional funds (125 euro) for the second and subsequent children, and in 2019 it was extended to cover all children. This program has significantly reduced income differences and equalised opportunities primarily in large families. The index of financial inequalities within Polish society has decreased. Compared to 2015, by April 2017 the difference between the wealthiest 25% and the least well off 25% people in Poland fell from the level of 5.9 to 4.4 (Morawiecki 2017). The financing of the program became possible thanks to, among other things, the increased collection of VAT and CIT. In 2016, the minimum wages were raised to a level exceeding the expectations of the trade unions. The minimum pension was also increased. Indicator of the direction of changes is the development convergence of Poland in comparison with other EU countries: from about 30% of GDP per capita in the PPS Index (EU15) in the early 1990s to 70% (EU28) currently. Poland has stable macroeconomic parameters and favourable short-term development forecasts. The current increase in spending on the social policy, gives strong development impulses estimated for the next two years.

Poland in recent years is growing more than twice as fast as the eurozone countries. After the crisis in the euro area in 2008 and the 2015, change of the ruling elite, the state's coordination of the economy and its redistributive, social character are being strengthened. At the same time,

attempts are being made to pursue three policies: statist – based on large state corporations, economically liberal in the sphere of economic regulations and pension and folk systems – satisfying the needs of the lower social strata directly over the network of social institutions (Gardawski 2018: 390). This can be seen as shaping another version of patchwork capitalism with the leading role of the state. The current authorities have reversed the logic of transformation and are focusing primarily on social policy and distribution. In this context, the following two risks are being discussed: 1) limited availability of funds for investment in the economy; 2) consolidating the method of social transfers at the expense of institutional changes in the sphere of public services. Payments of benefits have become an element used to carry out a political change (towards the conservative-clientelist model) and permanent dependence of social groups with lower incomes on the social policy of the state. The significance of political participation and institutions of social and civil dialogue has been marginalised to favour arbitrariness in decision-making. This applies to, among other things, the directions of socio-economic development, the rules of income distribution, environmental protection and climate policy, and migration policy. The chosen course may turn against the needs of economic development as not motivating to undertake employment, as exemplified by the pension reform (Golinowska 2018: 141-144). One can also point to the controversy over the energy and climate policy or the policy towards women, which deviate from the EU standards.

## 3. The quality of entrepreneurship

One of the qualities of the post-socialist transformation was the introduction of systemic changes in conditions difficult for private entrepreneurship and market reforms. In Poland, reforms were initiated and supported by the new authorities, as well as had significant public support resulting, inter alia, from the functioning of private entrepreneurship (on a small scale) in the former system and the expansion of the private sector at the turn of the 1980s and 1990s. However, there were a number of adverse conditions for economic transformation. Among them, one can indicate the institutional and regulatory environment shaped for the needs of a centralised state command and distribution economy, high level of concentration and sectoral monopolisation of enterprises, hyperinflation

and investment capital deficit. There were also socially rooted elements of non-market economic culture, such as ambivalent attitudes to wealth, low level of economic knowledge or strong demands towards the state. This differed significantly from the cultural patterns of developed capitalist countries. Some of these conditions (e.g. bureaucratic inertia) and patterns (lack of trust in the institutions) still affect the character of Polish entrepreneurship. They also occur in subsequent versions – relatively low efficiency of public institutions in relations with business or negative stereotypes of entrepreneurs (Jasiecki 2013: 265-267).

After 1989, involvement in Poland in new business ventures belonged to the highest in Europe and was comparable to Ireland. However, the structure of this activity was similar to that of countries with a lower level of development and resulted from similar motivations and conditions. In the first years of market reforms, the creation of new enterprises was only partially due to the perception of an opportunity to achieve a higher social or material status. It was often exacted by a lack of employment or fear of losing a job. The vast majority of small companies were established (and this is still happening) based on one's own investment or on that of close family, with little use of backing from banks. They were characterised by rather low quality, measured, among other things, by employment and turnover rates, as well as by low competitiveness and innovation. Small enterprises were at a much lower level of development than those in Western countries (GEM 2004: 63-66). Currently as well, the major part of the economy consists of small and medium-sized companies that operate mainly in services and trade, in construction and in industrial processing. In comparison with the EU average, the SME sector is in Poland dominated to a much greater extent by microenterprises employing fewer than 9 employees (96% of all companies). The conditions and ways of running a business, the standards of industrial relations and the nature of business activities were not conducive to building the prestige of business owners, even those who have been clearly successful, which distinguishes Poland from the inhabitants of more developed EU countries.

The improvement of the entrepreneur's image has begun to be visible only recently. On the wave of economic growth, more Poles are also beginning to see business opportunities in their environment. At the same time, paradoxically, fewer of them are planning to set up their own businesses, which has resulted from the improvement of the situation in the labour

market and avoiding the risk of running one's own business. This paradox is confirmed by the widely known motivations of graduates of economic universities who prefer employment in large corporations, especially those with foreign capital, as those opening more prospective career opportunities. Despite significant economic growth, improvement of the institutional business environment and business development, entrepreneurs invariably point to the same stumbling blocks preventing development. They concern public policies of the state, primarily in the following areas: unstable legal regulations, low transparency of the tax system, fiscalism and uninform treatment of economic entities, and low effectiveness of institutions of the business environment. The existence of such most problematic factors for doing business is confirmed, among others, by the Global Competitiveness Report 2016-2017, pointing additionally to such issues as policy instability or inadequately educated workforce.

However, analyses and comparative studies published in the period of systemic changes show a gradual improvement in the position of entrepreneurs in relations with business environment institutions. Until a dozen or so years ago, Poland occupied distant positions in the ease running a business, competitiveness, economic freedoms and protection of property rights among both EU and those Central and Eastern European countries that introduced regulatory reforms faster (Sulejewicz 2006). For example, reports by *Doing Business* show the evolution of the conducting business activities in Poland. They clearly deteriorated in 2007-2011, which can be associated with the global crisis. After that period, the overall position of the country in the ranking has improved significantly (a jump from position 55 in 2013 to 24 in 2017). Also, in the *Index of Economic Freedom Heritage Foundation* in 2008 Poland moved from the lower category of Mostly Unfree to the Moderately Free category. In 2016, Poland was on the verge of being included in the group of economies characterised as Mostly Free. Poland has also shifted favourably in the Global Competitiveness Report rankings. In 2016 it occupied position 43, in 2017 it reached position 37, and in 2019 has shifted to position 33.

After almost three decades of transformation, Poland began to shift from the phase of Efficiency-driven economies to the phase of Innovation-driven economies. The country is moving away from traditional industrialisation and economies of scale with the domination of large companies with their

supply chain open to small and medium-sized companies, to a research and development-based economy, knowledge intensity and a growing service sector. The distinguishing feature of this stage of economic development is increasing the innovative potential of entrepreneurial activity, which poses new challenges for enterprises and institutions of the business environment (GEM 2014: 28). This transition is facilitated by improvement in the field of entrepreneurship education, the development of commercial and service infrastructure, as well as the evolution of cultural and social standards that favour self-sufficiency and self-initiative, and emphasise personal responsibility in managing one's own life. An opportunity is created by the generation change taking place in the Polish business, which can be strengthened by the state supporting the creation and commercialisation of knowledge (GEM Poland 2018: 8). Although international rankings confirm that there has been a significant improvement in the economic environment in Poland, compared to most European countries, the conditions for the creation and development of enterprises focused on innovation are average. New challenges appear in the sphere of political and institutional changes. Since 2017, there has been a gradual decline in Poland's position in systemically key areas, such as Government Integrity, Judicial Effectiveness, Business Freedom, Monetary Freedom, Trade Freedom (Index of Economic Freedom 2019) and Judicial Independence, Freedom of the Press, Property Rights, Strength of auditing and reporting standards (Global Competitiveness Report 2018). This may jeopardise the quality of entrepreneurship and undermine the positive role of the state in the transition to an innovation-oriented economy. The problem is pointed out by critics of reversing privatisation and the increasing state interference in the economy, as well as in the ownership of enterprises in the network sectors, such as banking and energy (Błaszczyk 2016; Kwiatkowski, Bałtowski 2018). A dilemma also emerges, whether the large expansion of social policy will not start to reverse social behaviour from preferences for own initiative and personal responsibility, which are beneficial for strengthening economic development. In the CEE countries the state-owned companies are rarely economically efficient (Pula 2017).

## 4. Modernisation based on FDI

Due to the tendency to duplicate the Soviet development pattern after World War II, the processes of accelerating the efficiency changes did not affect Poland. The collapse of the strategy of economic development

undertaken in the 1970s based on importing technologies from the West resulted in a mounting foreign debt. At the beginning of the 1980s Poland was an insolvent country in relations with Western creditors. The introduction of martial law in 1981 resulted in the freezing of trade with capitalist countries. As a result, differences between Poland and economically developed countries increased, both in terms of technology level and income. On international markets, Poland's economy was represented mainly by coal and the exports of highly processed industrial goods played a minimal role (Kaliński 2012: 121).

Since 1989, the situation in this area has changed significantly. The expansion of the private sector, new market financial institutions and the inflow of foreign investment started to play a key role in the modernisation of the economy. After a decade of ownership changes, the share of the private sector in GDP was estimated at 75% in Poland (Bandelj 2008: 212). Liberalisation of trade and capital flow, privatisation of enterprises and banks, and opening to foreign investment accelerated the economic development. Market reforms related to the accession and membership in the EU reduced the protection of the domestic market and enabled the entry of large transnational corporations into the economy. However, the Polish economy is still characterised by low stock market capitalisation, relatively small domestic credit to private sector and a low level of domestic savings. As a result, the deficit of the domestic investment capital meant that the leading role in restructuring and modernising was quickly taken over by enterprises with foreign capital, mainly from Western Europe, which dominated the financial services, telecommunications, export production and retail trade. At the beginning of the global crisis, their share in the potential and economic activity of all enterprises stabilised at 39-40%. They controlled about 65% of total exports from Poland and employed over 28% of employees (Chojna 2010). Banks with predominantly foreign capital in the ownership structure of the sector accounted for 12% in 1993, 51% in 1999, and 78% in 2003 (Szelągowska 2004).

This type of economic development model fundamentally differs from the liberal market economy based, as in the Anglo-Saxon countries, on financing through the stock exchange and private capital. The changes in Poland are closer to European continental capitalism based on banks, but in practice the economy was primarily based on external capital: at first on FDI and later also on structural funds from the EU. Domestic financial

resources were only a supplement to external capital. Hence, the emergence of specific capitalism with the leading role of foreign investors (King 2007), a new variation of dependent market economy (Nolke, Vliegenthart 2009) or semi-peripheral capitalism (Myant, Drahokoupil 2011) could be observed in Poland and in other countries of the region. In Poland, an economic model has been shaped based on the dominance of MTCs coexisting with a large (in comparison with western countries) state sector and a dynamic, but relatively weak, domestic private sector, the vast majority of which is made up of microenterprises. For example, in 2012 more than half (50.7%) of companies from the list of 500 largest Polish enterprises accounted for 280 companies with a prevailing share of foreign capital. The second group (34.8%) was composed of 46 large enterprises controlled by the state treasury. The third group consisted of 170 private domestic capital companies, whose valuation, however, was only 14.5% of the total value of companies ("Rzeczpospolita" 2012). The above tendency was modified by the global financial crisis of 2008, which resulted in limiting the inflow of foreign capital to Poland. A stronger export orientation of companies with the participation of foreign investors meant that these enterprises were more affected by the consequences of the collapse of demand on external markets than the domestic ones. The protectionist tendencies in the countries of the origin of capital also intensified (e.g. in Italy) being motivated by the protection of domestic jobs. The crisis opened the possibility of structural change in the Polish economy.

The restructuring of the economy (including the improvement of the export structure), exacted by opening the market to international competition and Poland's membership in the EU, created new development impulses for domestic enterprises. They gained access to western markets and EU funds. The advantage of companies with foreign capital over domestic enterprises in in terms of efficiency, share of high and medium technology products (Chojna 2010: 348) also started to decrease. However, the global crisis revealed limitations and risks related to the dominance of external financing of the economy and a large share of foreign ownership in domestic enterprises. It showed that the origin of capital has important economic and political importance, and that it is necessary to have strong domestic institutions, especially government agencies, banks and enterprises. They create opportunities and instruments for responding to

new challenges, such as reducing external financial and economic shocks, counteracting crises and stimulating economic growth, e.g. by increasing lending or significant infrastructure investment.

In Poland the disappointment with the economic and political crisis in the EU began to favour the conviction that the development strategy based on Western investment and technology imports was running out. The *Poland 2030* report prepared for the government (Boni 2009) warned against the accumulation of threats (including dependence on foreign capital), which may in the long run lead to a developmental drift, understood as phasing out the modernisation undertaken along with post-socialist transformation and accession to the EU. The report postulated a change of the development model towards modernisation of the GDP structure through increased public investment and EU funds. Since 2015 the new government has been pursuing this policy in a much more radical manner, including through the implementation of the *Responsible Development Strategy*. This document defines the imbalance between foreign and domestic capital in the economy as one of the main development traps in Poland. It focuses on strengthening domestic capital, among other things, by creating institutions for financing domestic business (the Polish Development Fund), initiating major infrastructure projects (the Central Communication Port) and launching flagship technological programs (the Electromobility Program) as well as by building new capital funds. One of the elements of the strategy is the concept of "domestication" (repolonisation) of banks, i.e. a renewed increase in the share of Polish capital in the banking sector. The most significant manifestation of this concept was the purchase of the PKO S.A. bank from the Italian UniCredit group, which was taken over by the Polish capital consortium. Currently, 52% of the banking sector is in the hands of domestic capital. Similar processes are taking place in some other strategic sectors, particularly in the energy sector (over 60%) (Błaszczyk 2016). The latest list of the 500 largest enterprises operating in Poland shows that the group of companies controlled by foreign capital has been steadily decreasing from 280 in 2011 to 230 in 2018 (Mazurkiewicz 2019).

The positive side of the modernisation of Poland after 1989 based on FDI was a large inflow of foreign investment, which resulted in GDP growth and the transfer of modern technologies and management. Competitiveness

has improved, exports and internationalisation of domestic business have grown significantly. In the *Global Competitiveness Index 2018* ranking, Poland is in the lead of the region's countries (37th place), behind the Czech Republic, Estonia and Slovenia. This model has negative sides as well. The liberalisation of trade with the West and opening to free flows of capital in the condition of high asymmetry of economic resources have designated the country as the source of low-paid, medium-level staff and sub-contractors for international corporations (Amsden *et al.* 1998; Jasiecki 2013). After the global crisis, the structure of company ownership and the domination of foreign capital began to be seen as a factor limiting the development opportunities for domestic enterprises. This is reflected in the economic weakness of the new middle classes and the business elite. The fundamental problem is balancing the proportion of domestic capital and foreign capital in the strategic sectors of the economy (which has succeeded in banking), while at the same time linking the potential of foreign investors with the further development of the country. The challenge is to create conditions for the development of Polish enterprises to join the group of world champions. It is being discussed what methods could be used to achieve these goals and whether it is more optimal to build strong Polish companies based on the state sector or on the private sector.

## 5. The knowledge sector

The poorly developed knowledge sector and low innovativeness in comparison with the leading western countries were one of the main reasons for the collapse of the centrally planned economy in Poland. As a result, the distance between Poland and highly developed countries continued to deepen in this area (Kaliński 2012: 119-121). The change in the political system in 1989 initiated the reversal of this trend, primarily based on the transfer of funds and modern technologies from the EU. Due to the deficit of domestic capital, the withdrawal of the state from the activity in economic policy (which partly resulted from the neo-liberal preferences of the new power elites and the early stage of institutional changes), the knowledge sector found itself in a crisis. Its manifestation was visible especially in low R&D expenditures, low employment in innovative sectors, a low number of university graduates and an insignificant share of high-tech products in the trade balance. In the new

circumstances the favourable changes occurred in higher education the fastest. The expansion of private universities followed the wave of commercialisation of education. The gross enrolment index increased almost fourfold, which in the period of the largest educational boom in 2004/2005 reached the level of 41.2%, i.e. higher than the average for the EU and the OECD. However, the spontaneous nature of the changes caused a decrease in the level of education and a mismatch in the qualifications of graduates to the needs of the labour market. Higher education was dominated by economics and marketing, administration and social sciences. All this strengthened the phenomenon of unemployment, which largely affected university graduates, some of whom were forced to undertake low-paid jobs below their qualifications or to pursue foreign economic emigration. In other areas of the knowledge sector, changes are characterised in terms of poor cooperation between various spheres of public activity and the private sector. Institutional solutions aimed at fostering the synergy of resources proved to be of little use (Baczko 2013: 5). An important synthetic measure of the conditions for the low level of development of the Polish knowledge sector is the share of expenditures on R&D in GDP. For more than two decades, they oscillated around 0.5%, and after 2004 they approached 1% of GDP (World Bank 2018). They remain several times as low as in other EU countries. However, there is an ongoing favourable structural change. Despite the continually low expenditures, the share of the enterprise sector is gradually increasing (GUS 2018). Still, in the rankings of the *Innovation Union Scoreboard*, published since 2010, Poland is placed in the lowest group of modest innovators in the EU, slightly above Romania and Bulgaria which place last. It is difficult to consider the situation favourable in the area of high-tech exports products as increased by 3.0% in 2007 to 8.5% in 2017, but it is only half of the EU-28 average (Eurostat 2018). However, Poland's share in exports of medium-high technology products significantly has improved.

The above tendencies clearly show that Poland's opening to new knowledge and technologies is mainly associated with foreign investors, especially transnational corporations. They created the main channels of transfer of modern scientific and technical thought, stimulated the demand for innovation and modernisation competences. At the same time, however, their activity is often connected with limiting the potential or taking over the best domestic enterprises and controlling the market, imposing market

power rules, reducing the domestic R&D infrastructure and shaping the tendency to imitate that reduces innovation. The weakness of the domestic knowledge sector is one of the reasons for adaptive adjustments at the expense of the innovativeness of the Polish economy. Enterprises manufacture and assemble mainly products "invented" in other countries (cars, TV sets and other standardised products of mid-tech). Only a few niches of national innovation in the area of high technologies have been created, such as the aviation sector and the computer games sector. For this reason, since the end of the 1990s, it has been postulated to break the formula of "imitative diffusion" and to pursue the transition to a more innovative "creative diffusion". Poland has entered a phase when the continuation of the imitative growth model is becoming increasingly difficult and more expensive. The experience of others shows that solutions that could increase the productivity of domestic companies (especially when approaching the global technological limits) are regulated by innovators from highly developed countries, thus trying to maintain a competitive advantage in, among other things, the form of a technological monopoly. The main method of counteracting this is to increase the national innovation potential, which also strengthens the absorption and diffusion capacity of competitive novelties. Otherwise, Poland's economic development would depend more and more on hard-to-access foreign know-how. Especially that the global crisis increased competitive pressure on international markets. Previous attempts to strengthen the national knowledge sector have produced limited results. Another one of them was the Responsible Development Strategy presented in 2016, announcing, among other things, reindustrialisation, support for the development of innovative companies, creating capital for development, supporting the foreign expansion of Polish enterprises. Sustaining measures are the currently implemented reforms in education, higher education and science.

After 1989 the Polish knowledge sector opened to influences and ties with highly developed countries. Access to new technologies and knowledge increased, which resulted in an increase in the share of high-tech and more technologically advanced products in exports as well as increased competitiveness of production and services. Poland is gradually building its innovation potential in the form of developing R&D facilities and a high number of individuals with higher education. This is noted by international companies which open research and development centres in Poland (Dell,

Microsoft, Samsung, Siemens and others). At the same time, however, the conviction about long-term threats to development resulting from the persistence (or growth) of the distance in the sphere of the knowledge sector is increasing. Even the significant EU funds expended so far have not sufficiently stimulated "creative innovation". The low level of national R&D expenditures, especially those financed by the domestic private sector, remains a challenge. One of the fundamental reasons for the limited success of Polish innovation policy is the dominance of fragmented microenterprises in the Polish economy and limited demand for innovative products.

## 6. The public opinion attitude towards transformations

From the perspective of three decades of post-socialist changes in Poland, we can distinguish several issues that are particularly important for understanding the social perception of the transformation. The political changes of 1989 are generally assessed positively. Opinions in this matter, however, were subject to significant fluctuations, depending on many circumstances, including the economic situation, political changes and the situation of social groups and specific persons. The strongest critical views were manifested in the period of preparations for accession to the EU, i.e. in 2001-2002, when more than half of Poles were dissatisfied with the reforms. This tendency was permanently reversed after Poland became a member of the EU. Since that time, the assessment of transformation as giving more benefits than losses predominates (especially since 2014, very positive above 50%) (CBOS 2019). The perception of the social effects of transformation varies depending on the dimensions being perceived. One of them is the attitude to the role and tasks of the state.

Due to historical reasons (experiences of the command economy) and economic ones (significant material deprivation after 1989), Polish society is pro-statist. Since the mid-1990s, more than half of Poles have always believed that the role of the state is to provide citizens with a high level of services, fulfil redistributive functions and create an active economic policy in the scope of developing entrepreneurship, combating unemployment, supporting innovation and new technologies and initiating large state investments (CBOS 2017, Rae 2015). The issue of foreign investors' expansion has become a new aspect of systemic changes. From the beginning of the transformation, it is believed that the presence of foreign

capital is beneficial for the Polish economy. At the same time, since the end of the 1990s, the belief has been growing that this share is too large. More than half of the citizens believe that the economy should be based more on domestic capital (CBOS 2017). On the one hand, this may mean that the state should play an active role in this area, and on the other hand, that the share of domestic private capital in the economy is too small.

The other aspects of change after 1989 that have accompanied the transformation include the issue of membership in the EU. Poles rank the accession to the EU among the greatest successes of the country in the past 100 years and they treat it almost equally with regaining independence in 1918 (CBOS 2018). It enjoys great public support, and the balance of the effects of Poland's integration with the UE is assessed positively. Currently, the overwhelming majority (¾) believe that if Poland had not become a member of the European Union, our country would not have developed. The factors most appreciated in this respect are economic and financial benefits, especially the free flow of capital, investing by Polish companies abroad, developing trade and receiving direct payments by agricultural producers. Poles also recognise that the EU membership is conducive to improving the state security and, in general, to maintaining peace in Europe, as well as strengthening the importance and position of Poland. Since 2014 the Poles' approval of the membership varies between 70-90%, which means that the country is classified as one of the most "Euro-enthusiastic" in the EU (CBOS 2019).

However, the challenge in relations with the EU is the issue of participation in the eurozone. The social support for membership in the euro area has changed over time. The largest acceptance occurred in 2002 before the accession to the EU. The financial problems of Greece, other countries of the Euroland and less developed economies of the EU have caused that the introduction of the single currency, despite the "Euro-enthusiasm" of Poles, is currently supported by only about 20% of them. The most frequently cited reservations are concerns about unfavourable exchange rates, unfavourable differences in the level of development between Poland and the euro area countries, the conviction that the eurozone has not yet solved its problems and restricting Poland's ability to pursue an independent monetary policy. Positive arguments for the adoption of the euro, such as the elimination of exchange rate risk, greater currency stability and the need to remain in the mainstream of European integration do not constitute a

weighty counterbalance against the formulated doubts. In turn, the geopolitical dimension of the transformation is related to the membership of Poland in the NATO, perceived as the guarantor of the country's security. The vast majority of citizens are in favour of joining NATO. Support for membership, though it remains at a high level, decreased periodically due to Poland's participation in the war in Afghanistan and the location of US military bases and installations on the territory of the country. On the other hand, it increased (up to around 80%) in periods of particular tensions, such as the terrorist attack on the World Trade Centre or the annexation of the Crimea by Russia (CBOS 2017).

The success of the Polish transformation is consolidating the belief that systemic changes have given the society greater benefits than losses. The public opinion recognises Poland's membership in the EU and NATO as the greatest achievements after 1989. Limiting the role of the state, the weakness of the private sector and the high costs of reforms sustained the statist social expectations, strengthened by the slowdown in development after 2008. The conviction that although the presence of foreign capital is beneficial for the economy, its growing share is at the expense of domestic capital. However, the conviction about the favourable course of the transformation turned out to be quite superficial. Significant groups of "losers" were politically mobilised by the right-wing groups that took power in 2015. The new government has largely met social expectations for increasing the role of the state in public policies, including the support of national capital and the reduction in the presence of foreign investors. The challenge will be to reconcile such activities with the implementation of the new economic policy, based on the leading role of the state in the economy and financing long-term economic development in conditions of great social transfers. The new situation that every Polish government will face is the tension in the relations between the European Union and the United States. It has an exceptional quality in Poland, resulting from the traditionally pro-American foreign policy and, at the same time, very strong economic ties with the EU, especially with Germany.

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### 3.1.4 Slovakia

Małgorzata Bonikowska, Bruno Surdel

## Introduction

Slovakia is a land-locked country with an open, export-oriented economy, located in the Central Eastern Europe with a total area of 49.035 square kilometers and an ageing population of 5.443.120 million. In 2018, the age group of 0-14 constituted 15.6% of the total population in comparison to 25.5% in 1990, while people who are over 60 made up 22.3% compared to 14.8% in 1990. The capital city of Slovakia is Bratislava, which has 429.564 inhabitants. After Bratislava, the two biggest cities in Slovakia are Košice with 239.095 inhabitants, and Prešov with 94.718 inhabitants. The Slovaks constitute 80.7 % of the population, followed by Hungarians (8.5%), Romani (2%), and others 1.8% (mainly Czechs, Ruthenians, Ukrainians, Russians, Germans, Poles). It shares borders with Poland in the north, Ukraine in the east, Hungary in the south and Austria in the west. In terms of agriculture, 40.1% of the land has been developed by that industry, another 40.2% is predominantly covered by forestation, and 19.7% used for other purposes. Among principal natural resources of Slovakia is lignite, small amounts of iron ore, copper as well as manganese ore.

## 1. Political context and quality of institutions

For the most part of its modern history, Slovakia had been part of the common state of the Czechs and Slovaks: Czechoslovakia. An independent statehood of the Slovak Republic has a rather short history, as it started only recently, after the dissolution of Czechoslovakia in January 1993. The event was preceded by the "Velvet Revolution" of 1989 – the peaceful divorce from the socialist system and the centrally planned economy. It heralded an entirely new era of opening up and a deep transformation of those two nations. The political and constitutional reality had received the features of a democratic parliamentary system, which had to be built from its foundations based on Western models. Slovakia – for historical reasons

– did not have such institutional experience and capacity as its brotherly neighbour, Czechia, where the former federal and earlier – central authorities and government agencies were located. In Slovakia, the statehood with all its internal features and external complexities needed to be constructed "from scratch".

Apart of tremendous social and political changes brought by the separation, the freshly gained independence also caused negative economic phenomena: the output decline associated with the disruption of industrial and economic linkages of that part of former Czechoslovakia. The volume of the created GDP reached the 1989 level only a decade later – in 1999.

The disintegration of the Council for Mutual Economic Assistance (CMEA) in 1991 constituted a painful experience for all former socialist countries but finally it paid off as it forced on them restructuring of their economies, as well as re-designing of their export orientation towards the Western or world markets – based on quality, supply and demands. Eventually, and out of necessity – it triggered development and growth of the domestic industries.

The very first phase of the comprehensive structural transformation was conducted already within the federal state of Czechoslovakia in 1989-92, with the price and trade liberalisation in 1991. After initial shocks, Slovakia's economy showed resilience, and in the mid-1990s its appeared already adapted to the new external and domestic conditions with remarkable improvements in terms of overall performance.

The principle goal of the initial stages of transition was to transfer Czechoslovakia back to the market economy which it left in late 1940's. A strategy of reforms was approved of by the country's parliament in 1990. The selected scenario meant adoption of a Western-style liberal capitalism with market liberalisation, privatisation of state-owned enterprises, currency convertibility, and a painful adaptation to the very competitive and demanding international trade. The necessary reforms included (among other things) the tax reform and the health and pension insurance system. Meanwhile, on the institutional level, the National Bank of Slovakia was

established, which energised the development of both the Slovak banking sector and the capital market.

However, the transition did not go smoothly, as Slovakia became a kind of "practice field" for all later Central European nationalist and populist movements. The populists under the leadership of a charismatic politician, Vladimir Meciar, who was the prime minister of Slovakia between 1990 and 1998, resisted many reforms, claiming that Slovakia needed to choose its own way of transformation with the larger role of the state. The said "Slovak way" was actually embraced by the Slovak government which was against the continuation of the strategy drawn up in Prague – the capital of the federal state. These developments, including a rising populism of leading elites and the alleged democracy deficit with authoritarian style of politics, as well as thriving corruption and a low political culture had negative consequences for Slovakia's march towards European integration.

Precisely, it was excluded from the first wave of EU accession (1997) negotiations and did not become the member of the NATO alliance in 1999 (unlike its neighbour – Czech Republic) which had brought disastrous fruits in the short term. Foreign companies and multinationals, in particular from western Europe, were rather reluctant to invest in Slovakia until the general internal climate changed towards more acceptance of the European standards of rule of law and liberal democracy.

The hoped tectonic shift came in 1998, when a new centre-liberal (Christian Democrats – Slovak Democratic Coalition, SDK-SDKU) coalition government with the prime minister Mikulas Dzurinda (1998-2006) was formed after the Slovak voters voted for change in parliamentary elections. That development led to the re-thinking and re-designing of the way of reforms, to be more reconcilable with the world standards and mainstream economic thought. What ensued was a more liberal approach characterised (among other things) by resuming the privatisation of state-owned firms and industrial behemoths. The market-oriented reforms included further liberalisation of prices based on what was perceived as economic reality. The improved political atmosphere allowed for Slovakia to resume and accelerate its pace of moving towards the European integration, which had been slowed down in previous years.

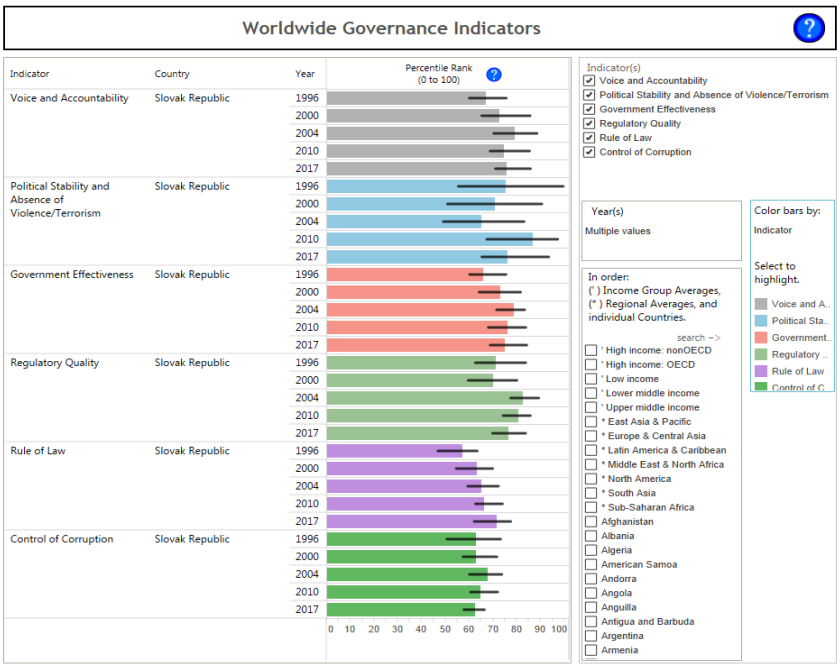
It was the integration with the European Communities that gave an additional impetus to the conducted reforms, as Slovakia had to adopt the European Union's very elaborated and complex legal system – acquis communautaire. This is requirement and precondition to each candidate country. Slovakia decided to finally introduce necessary structural changes in very sensitive areas which were critical for the success of the chosen path of transition to an efficient market economy. The remaking affected the labour code, health care, public finances as well as the justice system.

The transformation produced favourable fruits both in terms of international standing and economy. Slovakia joined the European Union and NATO in 2004, and then the eurozone in 2009. The structure of national economy has drastically changed with services producing 60% of GDP in 1998 (32% in 1989). The country enjoyed a sound growth rate of 5.3% in 2004 and 6.8% in 2005, and saw unemployment rate being reduced from 17.4% in 2003 to 13.3% in the post-accession period in 2006.

The global depression had a negative impact on Slovakia's economy as it contracted by 5.4% in 2009 but managed to partly recover already the very next year with a growth of 5.0%. The path of reforms has been furthered until now with a remarkable continuation, stability and longevity of government coalitions after the EU accession. Social Democrats (SMER-SD) replaced Dzurinada's government in 2006, and have retained power until now with only a short break after the international economic crisis struck Slovakia (2010-2012, Christian Democrats). The powerful prime minister Robert Fico stayed in power for more than eleven years between 2006 and 2018. However, since the autumn of 2017, the political atmosphere in Slovakia has changed significantly. In March 2018, after the murder of an investigative journalist, Jan Kuciak, which had shocked the nation, Robert Fico resigned, challenged by mass protests. Kuciak had exposed connections between some figures in the government and the organised crime. Nevertheless, the Social Democrats did not lose power and under the new leadership of Petter Pellegrini, they continued to rule the country (until 2020).

However, the ensuing and growing popular dissatisfaction and discontent with the corruption, and interventions in the media gave rise and victory to

an anti-corruption female activist Zuzana Čaputová who won the largely ceremonial presidency in March 2019.




**Source:** Kaufmann D., A. Kraay, and M. Mastruzzi (2010), The Worldwide Governance Indicators: Methodology and Analytical Issues
The Worldwide Governance Indicators are available at: www.govindicators.org
**Note:** The Worldwide Governance Indicators (WGI) are a research dataset summarizing the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, international organizations, and private sector firms. The WGI do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources.

All the challenges and turbulence in Slovakia's political life over the recent have been mirrored in the Worldwide Government Indicators from the World Bank. In the voice and accountability, which captures perceptions of the extent to which citizens are able to participate in selecting their government, as well as freedom of expression and freedom of association, there is a visible decrease between 2015 and 2017.

Political stability experienced a slight drop from 76.06 in 2010 to 75 in 2017. Government Effectiveness score went through a minor dive from 76.08 in 2010 to 75 in 2017. Regulatory Quality score was 80.86 in 2010 and dropped to 76.44 in 2017, however showing an improvement in comparison to the score of 2015. The Rule of Law indicator has been experiencing a very small improvement since 1996. The data shows that corruption has worsened in Slovakia. The control of Corruption index was 64.76 in 2010, however it dropped to 62.5 in 2017. The Transparency

International displayed a similar trend in its Corruption Perceptions Index of 2018 (CPI). With a score of just 50 out of 100, Slovakia had its worst result since 2013, and lost three places in comparison with the 2017 index. Slovakia was ranked 57th worldwide and was the 6th most corrupt country in Europe. Interestingly, just 47 people had been charged in relation to corruption in 2018 – the lowest figure since 2009. It shows that relatively many criminal acts of corruption are carried out without any punitive measures taken against them[21].

## 2. General Economic Outlook

Slovakia's history of transformation into a market economy after 1989, and even more since the separation from Czechia in 1993, necessarily brought complexities and turbulences as the country with its very statehood, economy and institutions had to be re-invented and designed all over again. Initial years after the divorce from Czechia were marked by an attempt to find its own, third way of development between the West and East, which ended up with a failure: emergence of an authoritarian leadership and a thriving corruption. The era was presided by the above-mentioned charismatic, populist politician, Vladimir Meciar, whose ruling style and privatisation methods triggered domestic and international criticism. Reportedly, the "internal" privatisation had created a sort of clientelism, with an enriched network of political allies. What's worse, Slovakia became an isolated country in the very middle of Europe. Foreign Direct Investments as percentage of GDP decreased from 1.2% in 1993, to 0.6 in 1997 (World Bank).

This was only in 1998, when Slovakia finally changed its course and its economy was put on a path to strong economic growth – associated however, with painful socio-economic after-effects – something which the previous prime minister Meciar tried to avoid. However, essentially for the economy, already in 1999 about 85% of GDP was created by private companies. One of the sensitive issues became unemployment, whose rates

[21] The perception of corruption in Slovakia has been the worst since 2013, The Slovak Spectator, 29.01.2019; (retrieved 20.05.2019) https://spectator.sme.sk/c/22040306/the-perception-of-corruption-in-slovakia-has-been-the-worst-since-2013.html

were 13.64% of the total labour force when the Christian-Democrats' government took power in 1998 but they rose significantly to 17.56% in the EU accession year in 2004. Conducted reforms, among them the vital reduction of the inefficient, costly public sector, and most importantly the much expected inflow of foreign investments to privatised state-owned behemoths gave rise to the unemployment. But in the medium term, they produced also much needed growth which combined with the stunning governments' longevity contributed to the gradual improvement in employment indicators with the unemployment rate at 13.86% in 2010 – just after the worst global economic depression. The further growth has reduced the unemployment to 5.76% in early 2019 (Eurostat). It has been possible thanks to the reforms introduced by the government and aimed at assisting vulnerable groups. [22] On the other hand, the economic transformation had a significant impact on the trade union density rate which shrank over years from 32.3 in 2000, to just 10.9 in 2015 (OECD).

The thoughtful economic policies after 1998 had managed to attract remarkable foreign investment to the country with FDI's contributing just 1.7% in 2009 in the aftermath of the global crisis but 6.2% in 2018 (World Bank). The EU membership brought Slovakia a critical bonus with EU cohesion and structural funds which also increased the pace of the overall development and contributed to the domestic demand.

Slovakia is an open, export-oriented country which has specialised in automobile and electronics. Over the transition years, thanks to its developmental dynamism and resilience, the country was named a "Tatra Tiger", from its (rather distant) resemblance to the Asian economic Tigers – Korea and Singapore. The joint value of exports and imports in Slovakia amounts to 189.2 % of GDP.

What makes Slovakia attractive is similar factors as is in the case of its neighbor country – Poland: a favorable geographical location, relatively low labor costs and wages but – on the other hand - skilled and competent labor force.

[22] Country Report Slovakia 2019, European Commission.

Export and investment have been the driving forces that fuel Slovakia's economic growth. While its economy grew just 1.9% in 1993, it was already 6.8% in 1996. In 2004 - the year of the EU accession, GDP growth reached 5.4 but it contracted -5.4% in the crisis year of 2009. As of the first quarter of 2019 the economy grew 3.7%. The Organisation for Economic Cooperation and Development (OECD) estimates the Slovak economy to expand at a sound rate of 4.3% in 2019 and 3.6% in 2020 – the highest rate in the OECD club. From other economic indicators over the transition period, the private consumption made 53% of GDP in 1996, in 2004 – 56%, and 54% in 2017. Investment was 35.4% of GDP in 1997, 21.7 % of GDP in 2009 and it increased to 22% in 2018.

The inflation indicators fluctuated over time: while inflation reached 15.6 in 1993 when Slovakia gained its independence, it decreased to 4.5% in 1996. After the turbulences on the international markets between 1997-1998, it rose to 9.4% in 2000 but shrank to 2.4 in the after-accession year of 2005. The global depression saw a deflation of -2.6% in 2009 in Slovakia, but the inflation rose again to 1.9% in 2018.

Among increasingly visible economic challenges the country is facing now, there is a growing pressure on the labour market in Slovakia – the phenomenon well known from the other Central and Eastern European countries, including its northern neighbour – Poland – which attempts to fill the gap with more than a million workers from Ukraine. In Slovakia, regional differences as regards the labour force result not only from the aging population but also from the outflow of skilled graduates and workers to the west of the country and abroad – to more economically developed EU countries. The situation is somewhat mitigated by 65.000 migrant workers, mainly from Ukraine and Serbia, thanks to the relaxed employment legislation in that respect[23].

As other, more advanced – and the most advanced economies of the sort of Japan – also Slovakia needs to redesign and resize its investments in innovation, digitisation and automation of the production lines, which can help it remain competitive on the ever more demanding international

[23] Ibidem.

markets. This, however, creates challenges for the employment, as automation is predicted to put at risk up to 55% of all jobs in the country[24]. The urgent and related issue is labour productivity, which has dropped according to Eurostat data from 8.5 out of 10 in 2007 to 2.1 out of 10 in 2018. In the initial years of transformation, it was 4.6 in 1996, and 5.1 in the post-accession year of 2005. The situation is exacerbated by regional shortages of skilled labour force, which makes it necessary for more investment in human capital in the country.

Slovakia's longevity of the ruling elites with the corruption penetrating the very fabric of the state has been detrimental to the economic freedom which has decreased over time. In the Economic Freedom Index of 2019, Slovakia was placed at the 65th position in the global list of economies which is a far cry from what has been achieved by its nearest neighbour: Czechia, which landed at the 23rd position in the global ranking. The present Slovakia's economic freedom has been much worse even when compared to its own results in 2004 (35th rank) or 2010 (35th). In its international trade, Slovakia still applies quotas, subsidies and other non-tariff trade barriers.

### 3. Quality of Entrepreneurship

The business climate in Slovakia has not improved much over years, in fact it has deteriorated in comparison with the situation the decade ago, and in 2018 it reached just 43.67% of the 2010 level.

The entrepreneurs themselves as the main barriers hampering conducting of business in the country see the low effectiveness of state management, access to state aid, bureaucracy, application of the principle of equality before the law, as well as clarity, stability and applicability of legal regulations. Continuous imposing of new obligations on businesspeople and insufficient co-ordination of data collection among public

[24] Europe's Digital Progress Report 2016. A report complementing the Digital Economy and Society Index (DESI).

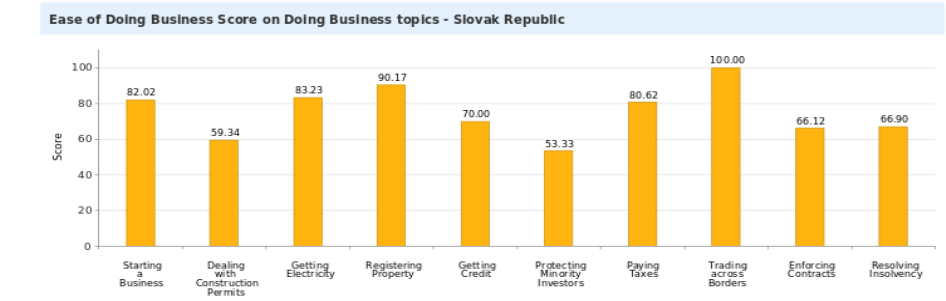
administration's units are seen as an obstacle for a significant improvement of the entrepreneurial environment in Slovakia[25].

Slovakia landed at the 42nd place out of 190 countries in the 2019 edition of the Ease of Doing Business Index, which is much worse than its northern neighbour Poland (33rd), and Czechia – its former state partner from the federal Czechoslovakia (35th). More importantly, the score is not better than in the aftermath of the global depression in 2010 (also 42nd) and worse than in 2015 (37th). To start a business, one needed going through 8 procedures and wait 26.5 days in 2019, while it was 6 procedures and 16 days in 2010, and 7 procedures and just 11.5 days in 2015. Obtaining a construction permit took full 300 days and 14 procedures in 2019, while in 2010 these numbers were 287 and 13 respectively; in 2015: 286 days and 10 procedures. In terms of taxes, the corporate income tax rate in Slovakia is 21%.

The overall situation has also deteriorated remarkably when it comes to Getting credit rankings. In 2010, Slovakia was ranked 15, in 2015 – 36, and the 2019 result is even worse as the country was placed at the 44th position. On the other hand, there are improvements concerning a ranking which is vitally important for business, namely "Enforcing contracts". While in 2010, Slovakia was ranked only 61, in 2015 the score was 55, and in 2019 – 47. The picture is, however, much more complex and improvements illusory as the procedure has actually become much more time-consuming and now it takes 775 days, while it was 565 days in 2010, and 545 in 2015.

[25] The Business Environment Index (IPP), April, 2019; Business Alliance of Slovakia (PAS) – Podnikatelska alliancia Slovenska. https://www.alianciapas.sk/2019/04/09/ani-po-osmich-rokoch-sa-nezastavil-prepad-hodnotenia-podnikatelskeho-prostredia/ (retrieved 16.05.2019).

Remarkably, the social and health contribution on the part of employers have reached 35% of salaries.




Source: World Bank

On the other hand, however, Slovakia launched its e-Government project in 2008, and updated it significantly in 2015 within the framework of the National Concept of e-Government 2015-2010. Using that medium, businesspeople and ordinary citizens are able to process online more than 800 electronic services, among them also registration of permanent and temporary residence, vehicle registration, tax submission and customs declarations.[26] Nevertheless, the country still lags behind in that field. In the European Commission's Digital Economy and Society Index (DESI) the country was ranked 19th out of 28 in 2014, 21st in 2016, and 20th in 2018.

### 4. Modernisation based on FDI

The accession to the European Union in 2004 had a sort of domino effect for the Slovakian economy, in particular, for the inflow of foreign direct investments (FDI) and capital, mainly from the "old Europe" and the Unites States. Leading source countries of FDI in Slovakia have been Germany, Austria, Luxembourg, Netherlands, as well as Italy and its nearest neighbour: Czech Republic. FDIs to the country amounted to 2 billion euro

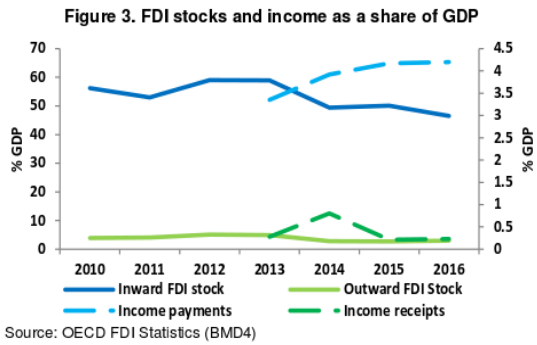
[26] Europe's Digital Progress Report 2016. A report complementing the Digital Economy and Society Index (DESI).

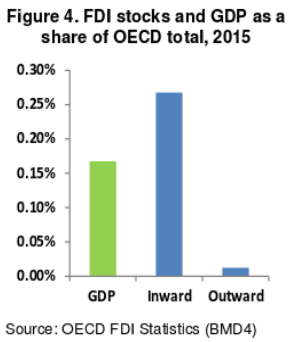
in 2017[27], and are present to a significant extent in banking, manufacturing, as well as information and communication technology. Manufacturing industry with high level of FDI and exports includes motor vehicles, equipment, machinery as well as electronics. OECD data show that foreign markets have decisive impact on as much as 45% of economic activity in the country, and Slovakia's exports reached 84 billion USD (2016) which makes 104% of GDP[28].

The phenomenon has been closely related to freshly found trust in the country's business opportunities and its overall stability – which was the bonus generated by the membership of the prestigious EU club. But equally important was privatisation conducted ahead of the EU accession and liberalisation of the legal environment for the foreign investment. The mentioned privatisation in 1999-2001, linked to the political shift and the opening up of Slovakia, included main banks among 25 financial institutions in the country. Investment came from Austria, Belgium, and Italy, and left just four banks in full local ownership. According to the data provided by the Slovak Banking Association, as much as 50% of banking assets in the country are in control of three major financial institutions, Slovenska sporitelna, VUB Banka and Tatra banka[29]. The banking system as such is appreciated as sound and stable[30].

[27] 2019 Investment Climate Statements: Slovak Republic. U.S. Department of Sate. https://www.state.gov/reports/2019-investment-climate-statements/slovak-republic/ Retrieved 19 July, 2019.
[28] International foreign direct investment and global value chains. Slovak Republic, trade and investment statistical note. OECD 2017.
[29] Slovakia's banking sector: Facts % Figures. https://www.ebf.eu/slovakia/ Retrieved 19 May, 2019.
[30] 2019 Investment Climate Statements: Slovak Republic. U.S. Department of Sate. https://www.state.gov/reports/2019-investment-climate-statements/slovak-republic/ Retrieved 19 July, 2019.

FDIs have become a vehicle of modernisation for Slovakia despite the definitely profit-seeking based motivation for investments in the country and repatriation of a significant part of profits in the form of distributed dividends when the investments gained maturity. According to the OECD data, FDI in Slovakia has had an accumulated stock with a value equivalent to 46% of GDP which is comparable to the country's exports which produce around 45 % of the GDP (OECD 2017).




Another remarkable peculiarity of FDI in Slovakia is that foreign firms maintained as much as 20% of private sector jobs (OECD 2017), and surpassed local companies in their export intensiveness by 200%. These firms also display a higher import intensity compared to the locally owned ones. There are, however, significant disparities when it comes to investments, with the capital city Bratislava and big cities attracting most of them[31].

## 5. Knowledge Sector

The best European and world trends have found their way to Slovakia as there is a steadily growing number of science specialisation graduates at domestic universities. But still the graduates in sciences, technology,

[31] Country Report Slovakia 2019, European Commission.

engineering and mathematics make just 21%, which is below the average of the European Union (26 %)[32].

The European Innovation Scoreboard (EIS) clearly shows how the knowledge sector has been performing over the recent decade. Slovakia has been doing better than the Czech Republic when it comes to the completion of the tertiary education 94.03 (2011: 44.78), while Czechia achieved 73.13 in 2018 (2011: 45.52). But the rate is still below the EU 39.35% average – 34.3. Moreover, the country finds it difficult to catch up with its western neighbour in the critical field of scientific publications (scientific publications among top 10% most cited) where Slovakia's score is 34.85 (2011: 15.46), while Czechia was given 47.97 (2011: 37.28), and its northern neighbour Poland –46.07 (2011: 19.05). For a comparison, two among the best Western European performers in that category, Germany and Sweden achieved 113.68 (2011: 105.79), and 132.49 (2011: 125.28) respectively.

The Slovakian work force is still competitive and rather cheap thanks to a low wage level in comparison with the Western part of the European Union but very skilful, which proved attractive for such foreign investors as Volkswagen, Samsung and SIEMENS. These and other foreign companies, however, tend to carry out their critical research (R&D) at home rather than in Slovakia. On the other hand, Slovak small and medium sized firms (SMEs) do not feel the pressure or need – and even more importantly – they lack necessary resources to invest sufficient means in R&D. European Innovation Scoreboard (EIS) data show very slow dynamics of the above-mentioned process. While in 2011, for business R&D expenditure Slovakia received 20.18 score, in 2015 it was 25.33 and in 2018 we see an increase to 39.06.

The overall R&D expenditure as a percentage of GDP in all sectors in the economy has been rather low since the transformation was launched. In 1996 it reached just 0.89%, in the EU accession year of 2004: 0.50. In the aftermath of the global crisis it decreased to even lower levels of 0.47% in 2009. In 2015 the spending rose to 1.18%, but in 2016 it was below 1%

[32] Ibidem.

(0.79) compared to the OECD average of 2.3%. The EIS Summary Innovation Index has demonstrated a very slow progress with 63.28 score in 2011, 67.04 in 2015 and in 2018: 69.10. Meanwhile, public investment in research and development is not encouraging too, as Slovakia was given 30.90 score for 2011, 68.25 for 2015, and just 40.24 for 2018.

## 6. Public opinion attitudes towards transformation

The very culmination of the transformation and opening up of Slovakia and the other Central and Eastern European countries was their membership in the European Union and an active participation in the integration process. Over the years, however, the euro-enthusiasm has faded, partly as a result of a growing dissatisfaction with the Brussels' migration policies. The massive inflow of migrants to Europe since late 2015 triggered a strong sentiment in many CEE countries, including Poland, Czechia, Slovakia and Hungary. It fuelled populism and populist movements across the European Union, with Italy as another remarkable example.

Eurobarometer survey demonstrated those sentiments as in the spring of 2018 "only" 44% of Slovaks saw their country's EU membership in bright colours and they trusted the European bloc – which made a decrease of 4% compared to the previous survey in autumn of 2017. On the other hand, 45% of surveyed people distrusted the EU in Slovakia, which is quite similar to the trend in Hungary and even Belgium. Furthermore, 48% of participants claimed that their voice did not count in the EU (52% in 2015), with 45% being of the opposite opinion (40% in 2015). Interestingly, the result was much better than in the western neighbour Czechia, where 67% said that their opinions are not listened to in Brussels (68% in 2015). In the same survey, 53% of Polish participants (47% in 2015) thought that their voice counted in the European Union.

The cited results corresponds to some extent to how Slovaks see their national economic situation, as 55% (77% in 2015) assessed it as being "bad" while just 41% (20% in 2015) represented a different, "good" opinion. Meanwhile, 70% of Czechs and 66% of Poles viewed the developments in their respective economies as "good" (43%, 38% respectively in 2015).

It's very informative to compare the above data with what was returned by the participants of a similar survey in 2005, so just one year after Slovakia's accession to the EU. At that time, the trust in the EU was shared by 55% of surveyed Slovaks, and 52% of Czechs and Poles. But an overwhelming majority of participants from those three countries expressed the opinion that their voice did not weigh much in Brussels (69% of Slovaks, 75% of Czechs, and 54% of Poles). In the same time, the new citizens of the European Union were quite satisfied with the life they led in their countries, as was the case with 63% of Slovaks, 69% of Poles and 83% of Czechs.

Evidently, in the early days of the EU membership the promises the European bloc and the overall transformation had brought rather positive fruits in terms of the public mood. However, the process has been apparently too slow for the citizens even if 30 years of transition to the market economy and reforms have thoroughly transformed Slovakia and put it on the way to gradually catching up with the western economies. To blame are both the level of economic development at the start in 1989, as well as the following blunders of the political elites.

**Conclusions**

Slovakia's fifteen years of the EU membership, celebrated in 2019, has been marked by a significant stability of its political situation – in particular in terms of a stunning longevity of the country's subsequent governments, as well as stable banking system, a robust growth of 4.3% (2018), fuelled by exports (automotive sector) and private consumption. The country is known as the globally biggest per capita car producer[33]. The economy, re-thought and re-constructed thanks to Slovakia's European aspirations, witnessed a relative resilience in the age of the global economic depression and its aftermath.

Slovakia – also an eurozone member – is a "success story" with a sound economic growth of 4.1% and low poverty rates, despite the sometimes turbulent decades of social, political and economic transformation and

[33] 2019 Investment Climate Statements: Slovak Republic. U.S. Department of State. https://www.state.gov/reports/2019-investment-climate-statements/slovak-republic/ Retrieved 19 July, 2019.

transition into a market based economy and a Western-oriented, modern parliamentary democracy[34].

However, the recent scandal with the murder of an investigative journalist has brought a tectonic shift in citizens' political sentiments and shaped the course of the latest presidential election. What, however, is more important, the situation has clearly shown the serious issues Slovakia has to face and overcome to genuinely adopt the European standards and best practices in its socio-political and economic life. These are much related to the stagnant rule of law with ensuing challenges of a thriving, endemic corruption, weak justice system and public administration, institutional frailty, regional disparities and – last but not least – fruitless politicking marked by a sheer clientelism. These factors have a negative impact on entrepreneurship and investment in the country[35].

On the purely economic side, the country is in a urgent need to re-design its growth model, investing much more in the human capital, and in R&D, an innovation and knowledge-based economy. A good step in that direction is the *Smart Industry for Slovakia Strategy*, focusing on developing a curriculum for schools proper for an Industry 4.0 age with much more attention to be paid on the better links between universities and businesses. But still the country's education is relatively inadequate for the modern, competitive market[36]. On the positive side, there has been noted an increased attractiveness of the much-needed vocational education which is undergoing reforms. The necessary changes are also being introduced to the university education to improve its performance and quality with an independent accreditation system[37].

In socio-economic sphere, there are challenges with the health care and pensions systems which are not sustainable and need to be addressed partly due to an aging population. These are, however, questions the whole of the

[34] Country Report Slovakia 2019, European Commission.
[35] Ibidem.
[36] Europe's Digital Progress Report 2016. A report complementing the Digital Economy and Society Index (DESI) country profile.
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Central and Eastern European region has to answer, and tasks it needs to resolve in the near future.

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## 3.2. The Baltic States

### 3.2.1. Estonia

Andrzej Turkowski

### Introduction

The Republic of Estonia is situated in north eastern Europe along the Baltic Sea coast. Together with Latvia and Lithuania, the three states are commonly referred to as "the Baltic states". Finland lies to the north of Estonia (across the Finland gulf), Russia – to the East (with St. Petersburg approximately 350 kilometres away), Latvia and Lithuania – to the south. Sweden is the western neighbour across the Baltic Sea.

Estonia is most often considered as a small state, with approximately 1.3 million inhabitants and a territory of 45 thousand square kilometres. The capital of Estonia is a port city of Tallinn (population of approximately 450 thousand); other bigger cities are Tartu, Narva and Pärnu.

Estonia is flat and heavily forested a country, considerable part of its territory is covered with wetlands. Almost 10% of the Estonia's total territory are islands (over 1,500), of which the largest are the islands of Saaremaa and Hiiumaa. Oil shale is one of the crucial natural resources in Estonia, accounting for 85% of total electricity production; other resources include sea mud, construction sand, lake mud, and construction gravel.

For a considerable part of its history, Estonia has been under foreign rule (Danish, Swedish, German, and Russian) It regained independence in 1918, but soon was forcibly incorporated into the USSR (in 1940). The collapse of the Eastern block and the Soviet Union allowed Estonians to regain sovereignty and introduce dramatical political and socio-economic changes.

#### 1. Political context and quality of institutions

Estonia (as well as the other Baltic states) entered the last decade of 20$^{th}$ century as one of the most developed (industrialised) part of the Soviet Union. Its centrally planned economy was based on industrial production

and agriculture, and as other economies of the Eastern bloc, it then suffered from high inflation, goods shortages, low productivity (Lieven 1993). As the eastern block and the Soviet Union disintegrated, Estonia embarked on a path which entailed not only establishment of independent state institutions, but also radical political and economic reforms. They were guided by a strong determination of its elites to fully integrate with the West, as soon as possible. This path resembled more these of the CEE states than of the other post-Soviet countries, and led the country into the IMF (1992), WTO (1999), NATO (2004), EU (2004), OECD (2010) and the eurozone (2011).

Despite relatively recent regaining of an independent statehood, Estonia has been widely perceived as a politicly stable country. On the one hand, its political parties have not been as stable as in most of the Western countries, but on the other – Estonian elites have managed to set and maintain the course of deep socio-economic reforms. For most of the post-Soviet period, the Western-oriented, fiscally prudent and entrepreneurship-friendly approach has not been questioned by any major political faction.

Consequently, the country has made significant progress measured by Worldwide Governance Indicators (WGI). In years 1996-2014 it progressed (in terms of percentile rank) in all six Aggregate Indicators of WGI: Voice & Accountability: from 74.0 to 85.2 (moving from 48$^{th}$ to 23$^{rd}$ position), Political Stability and Absence of Violence/Terrorism: from 68,8 to 72,3 (moving from 52$^{nd}$ to 50$^{th}$ position), Government Effectiveness: from 70.7 to 81.3 (moving from 50$^{th}$ to 38$^{th}$ position) , Regulatory Quality: from 90,7 to 93,3 (moving from 27$^{th}$ to 15$^{th}$ position), Rule of Law: from 62,2 to 86,5 (moving from 63$^{rd}$ to 25$^{th}$ position), Control of Corruption: from 57,6 to 87,5 (moving from 54$^{th}$ to 26$^{th}$ position).

The country has enjoyed a strong rule of law, in alignment with the EU practices, solid legal base for prevention of corruption (between 1998-2018, Estonia moved from 26$^{th}$ position to 18$^{th}$, according to the Corruption Perceptions Index), equal treatment of companies, as well as a highly competitive tax system. Apart from that, Estonia became famous for its resolution to create modern, ICT-based state infrastructure, thanks to which it has recently been dubbed by the New Yorker as the "Digital Republic" (Heller 2017).

However, in recent years, the Baltic country has witnessed a rise in popularity of the radical, right-wing political forces – Conservative People's Party of Estonia (EKRE). Most of its campaign platform concerned an anti-establishment and socially conservative sentiments in the society, as well as Euroscepticism, including a criticism of the EU immigration policy. In the economic sphere, in contrast to other populist parties in the EU, EKRE has not pushed for redistributive, left-wing economic measures, but rather for protection of local Estonian companies on the otherwise liberal, free market (Petsinis 2019).

After almost 30 years of transformation, Estonia has one of the most prudent public finance systems in the EU (BTI 2018 Country Report. Estonia 2018), with the lowest ratios of government debt-to-GDP. Generally favourable state of public finance has been reflected in a relatively high credit ratings (Standard & Poor: AA-; Moody's: A1; Fitch: AA-).

**The graph shows Estonia's general government debt-to-GDP ratio in years 1995-2017.**


Source: OCED

Another main achievement of Estonian elite relates to digitalisation, thanks to which the country has been branded as one of the most digitalised societies. All bureaucratic processes in Estonia can be done online, apart from transfers of physical property, marriages and divorces. Modernisation

of state institution and willingness to attract international companies is also reflected in a highly transparent business environment. For example, in Estonia business and land-registry information is considered public. Moreover, the country has managed to affirm its niche within the West – it hosts cyber security centres of NATO and the IT-agency of the EU.

Over almost 30 years the country has also progressed as measured by the Human Development Index. Between 1990 and 2017, the HDI value increased from 0.733 to 0.871 – by 18.8%. However, it is still below the average for countries in the very high human development group and below the average for countries in the OECD. Between 1990-2017, a life expectancy at birth increased by 8.3 years, mean years of schooling increased by 3.4 years, expected years of schooling – by 3.0 years and the country GNI per capita – by about 81.4% ("Human Development Indices and Indicators: 2018 Statistical Update" 2018).

On the side of shortcomings, Estonia's vulnerability is related to ethnopolitics. In particular, there is an important cleavage between the ethnic Estonian majority (69% of population) and the Russian-speaking minority (25%) (BTI 2018 Country Report. Estonia 2018). The latter includes Russians who arrived during the Soviet times, and their descendants. They often form separate communities, in terms of legal status, as well as cultural and information space. This cleavage, so far not fully reflected in the political struggles, has become more challenging given the above-mentioned rise of nationalist and xenophobic sentiments among ethnic Estonians (manifested by electoral success and entry into the ruling coalition of the EKRE) as well as growing tensions between the West and Russia.

## 2. General economic outlook

The trajectory of economic transformation of Estonia and the other Baltic states has stand out because of the extent of adopting the radical neoliberal reforms. It has been argued that the core of Baltics states' growth model included "open capital markets, with net capital imports driving investment and subsequent economic growth" (Hübner 2011). Other scholars pointed out that the most important process concerned liberalisation, aimed at

attracting FDI in high value service sectors such as banking and real estate (Bohle and Greskovits 2012).

In terms of theoretical models, given the low public spending on social protection, high income inequality, and low social dialog, Estonia's economic system has been characterised as "neoliberal" (Aidukaite and Hort 2019). Its other distinctive features include fervent pursuit of macroeconomic stability and economic openness (Bohle and Greskovits 2007, 2012).

Stressing the fact, that economic reforms in the Baltic states were "broadly based and rapid and typically implied free markets, limited government intervention and high-powered incentives", Staeher characterised the resulted economic system as "liberal-market" (Staehr 2017: 500-501). At the same time, Buchen pointed to both similarities and differences with the "classical" Liberal Market Economy (LME). He also argued that in case of the latter – because of a practice of circumventing of the relevant legislation as well as a relatively small stock market – the "Estonian system cannot be described as a shareholder model as one would expect for an LME" (Buchen 2007: 84-85).

In terms of economic policies, the first phase of reforms introduced by Estonia included establishing a free trade regime, realising privatisation program and attracting foreign investors, introducing currency boards, flat income taxes as well as individualised pension saving (Staehr 2017). Among the Baltic states, Estonia has stood out as the leader on this path, or as the "clearest exponent of the liberal-market economic system" (ibidem). Indeed, it was Estonia that pioneered introducing some of the solutions subsequently adopted by the other Baltic states, including a currency board or a flat tax system.

As a result, the structure of Estonian economy was considerably changed (Kalvet 2016). The transformation brought a decrease in primary activities (agriculture, forestry and fishing) and an increase in the share of services, including in the modern ICT sector. Over 71% of the Estonian GDP is derived from the service sectors, 25% from industrial sectors, and approximately 4% from primary branches, including agriculture (according

to Estonica.org). Nevertheless, the Estonian economy is still dominated (in terms of employment, export and specialisation) by low- and medium-value-added sectors, like transportation, textile, furniture and paper products.

The transformation of the Estonian economy has been praised for decisive market liberalisation, macroeconomic stability, simplified tax systems as well as the reduction in the size of their public sector (Åslund 2012). On top of that, the country is known for its business-friendly environment, high educational attainment, high labour market participation (with highly educated and flexible labour force), a robust financial sector, an innovative ICT sector and solid public finances (OECD Economic Surveys: Estonia. Overview 2017). The Bertelsmann Transformation Index in 2019 ranked Estonia as the most successful of 129 transformation countries in the world (BTI 2018 Country Report. Estonia 2018).

At the same time, the deep, negative effects of the 2008 economic crisis, comparable to those related to the collapse of the Soviet Union (Erixon 2010) casted doubts over Estonia's economic system. The large scale inflow of FDI before the 2008 crisis – which resulted in a shift in the composition of investment towards non-tradable sector and meant that debt service was financed with new inflows of capital – seriously aggravated the effects of the global economic downturn (Hübner 2011).

The table below shows the GDP growth rate between 1995-2018. Following a sharp downturn in the early 1990s, the Estonian economy grew on average by 7.1% a year without interruption from 1995 until the Great Recession in 2008. After strong downfall in 2008-2009, the average GDP growth in years 2010-2018 was 3.62%.

**The GDP growth rate between 1995-2018 in Estonia.**

| | | | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. | GDP (adjusted seasonally) [1] | | | | | | | | | | | | | | | |
| 1.1. | Current prices (EUR m) | SA | 2,777.4 | 3,644.1 | 4,489.4 | 5,049.5 | 5,375.8 | 6,166.3 | 6,972.3 | 7,772.0 | 8,709.5 | 9,709.6 | 11,250.7 | 13,503.2 | 16,219.5 | 16,507.8 |
| 1.2. | Chain-linked volume growth (%) | | - | 5.3 | 11.7 | 4.3 | -0.4 | 9.8 | 6.4 | 6.1 | 7.5 | 6.4 | 9.1 | 10.5 | 7.2 | -5.0 |

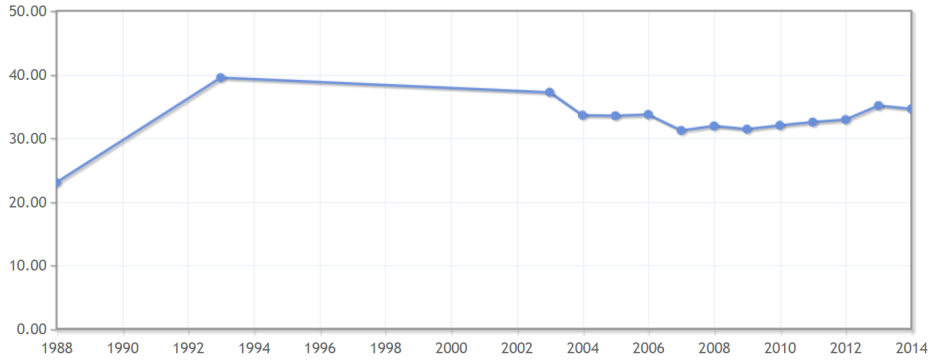
| | | | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. | GDP (adjusted seasonally) [1] | | | | | | | | | | | |
| 1.1. | Current prices (EUR m) | SA | 14,157.9 | 14,708.3 | 16,660.5 | 17,927.6 | 18,926.0 | 20,050.7 | 20,646.3 | 21,675.5 | 23,603.1 | 25,640.4 |
| 1.2. | Chain-linked volume growth (%) | | -14.2 | 1.7 | 7.6 | 4.3 | 2.0 | 2.8 | 2.1 | 3.5 | 4.7 | 3.9 |

Source: Eesti Pank

Although Estonian economy to a high degree recovered after the economic recession, it continues to be dependent on the inflow of foreign investment and external demand (BTI 2018 Country Report. Estonia 2018). Export, in value-added terms, contributes 44% of total GDP (data from 2014) and accounts for over 50% of the turnover of foreign owned firms. Moreover, 44% of Estonia's domestic value added meets foreign final demand (Estonia: Trade and Investment Statistical Note 2017).

From the point of view of societies, some scholars pointed out to the weak welfare state measures and low spending on social protection (Bohle, Greskovits 2012, 2007). Adaptation of strongly neoliberal socio-political reforms has caused strong inequalities (including between cities and rural areas), which have persisted from the early 1990s until today. Measured by the Gini index, Estonia is the fourth country among the eurozone members, with the greatest income inequalities (after Latvia, Lithuania and Romania).

**Changes in the GINI index in Estonia.**




Source: www.indexmundi.com (the World Bank, Development Research Group data)

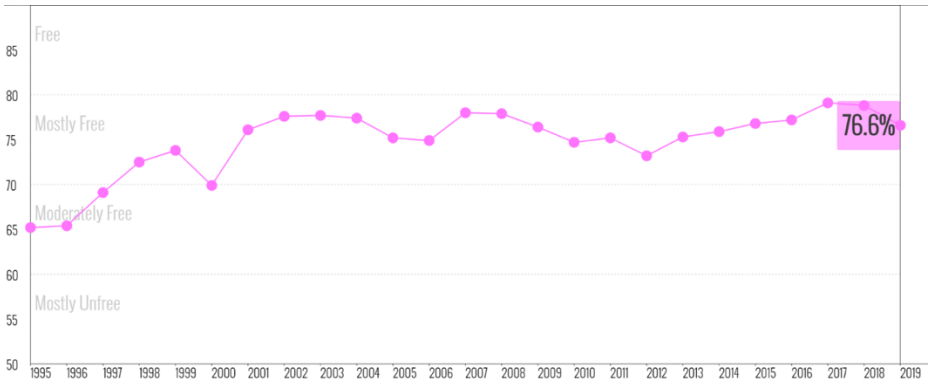
Last but not least, the Baltic country has to face a demographic challenge. The number of people living in each of the three Baltic states peaked right before independence (Vārpiņa 2018). The following changes in political (which led to a return of a part of the Russian-speaking communities) and economical spheres caused significant emigration. Since 2000, about 5% of Estonia's population has emigrated (Vārpiņa, 2018) mainly to Ireland, UK and Finland (Statistics Estonia, stat.ee). Even more serious was a drastic drop in fertility rates (often seen as a reaction to a lack of security and economic stability). The fertility rate in Estonia fell to the lowest point at the end of the 1990s – with 1.28 in 1998. In 2001, the average rate was 1.34 children per woman, reaching the higher point in 2007 – 1.7; after the economic turbulences caused by the global economic crises it dropped again, standing in 2017 at 1.6 (Vārpiņa 2018; Tammur & Rahno 2011, Statistics Estonia, stat.ee).

As a result, according to the Estonian Human Development Report 2016/2017, the country will not be able to maintain its population size without immigration (Tammaru *et al.* 2017). At the same time, it has to be said that problems in this respect are not as significant as in case of the other two Baltic states. The emigration has never been as strong as in the neighbouring countries, and the number of population has stabilised in recent years. Moreover, in 2015 for the first time in 25 years the number of immigrants to exceeded the number of the people who emigrated (ibidem).

## 3. Quality of entrepreneurship

An inherent part of the Estonian economic system is a highly favourable and conductive business environment, which both domestic and foreign companies enjoy. Some economists went that far to call Estonia (and the other Baltic states) an "investor's heaven" – due to relatively low levels of regulation, corporate taxation and labour rates, which at the same time is relatively highly skilled (Hübner 2011). Companies are subject to 0% income tax in respect to all reinvested and retained profits and a 20% income tax in respect to distributed profits (14% in cases where dividends are paid to legal persons). Additionally, labour market in Estonia has been characterised by the overall modest role of trade unions (Buchen 2007). The number of unionised workers in Estonia fell from 93% in 1990 to 14% in 2000 (Ladó 2002).

**Estonia's performance in the Heritage Foundation's Index of Economic Freedom.**




Source: heritage.org.

Socio-economic transformation in Estonia included a fairly radical and controversial privatisation process conducted in the 1990s. Although initiatory conditions of privatisation favoured insiders, they were replaced with a model of direct sales to foreign entities (Buchen 2007). As a result, the economy is dominated by the private sector, with a high share of ownership by foreign companies, especially from the Nordic countries. Foreign owned firms directly support 38% of private sector jobs in Estonia and 41% of value added (Estonia. Trade and Statistical Note 2017). The

national government remains full or majority owner in a handful of companies which operate critical infrastructure, including sectors of energy, as well as maritime, railway and air transports.

Significant place in the pro-business activities of Estonia's authorities relates to start-ups. For development of the local start-up ecosystem particularly important were successes of several major start-ups, including Skype. In order to amplify these successes, on top of competitive taxation, governments introduced loose regulations around tech research as well the program of e-Residency, which allows entrepreneurs to register and run business online, also from abroad. As a result, there are currently approximately 550 start-ups in Estonia. According to 2018 statistics, they employ 3763 people in their offices in Estonia (Startup Estonia, startupestonia.ee).

Efforts aimed at providing favourable business conditions for domestic and international companies have been reflected in various rankings and indexes. In particular, Estonia's tax code has been evaluated as the most competitive among the OECD countries five times in a row (Tax Foundation). In was also placed well above the world average and among top European countries in other key rankings, including 15th position in the 2019 Index of Economic Freedom, 16th place in the 2019 Doing business ranking, and 32nd place in the 2018 World Competitiveness Report. On top of that, Estonia was ranked 13th in the 2019 Startup Ecosystem Rankings. It can be read as signalling successes of Estonia's policy of accommodation to external expectations and serving as a "transformation role model."

## 4. Modernisation based on FDI

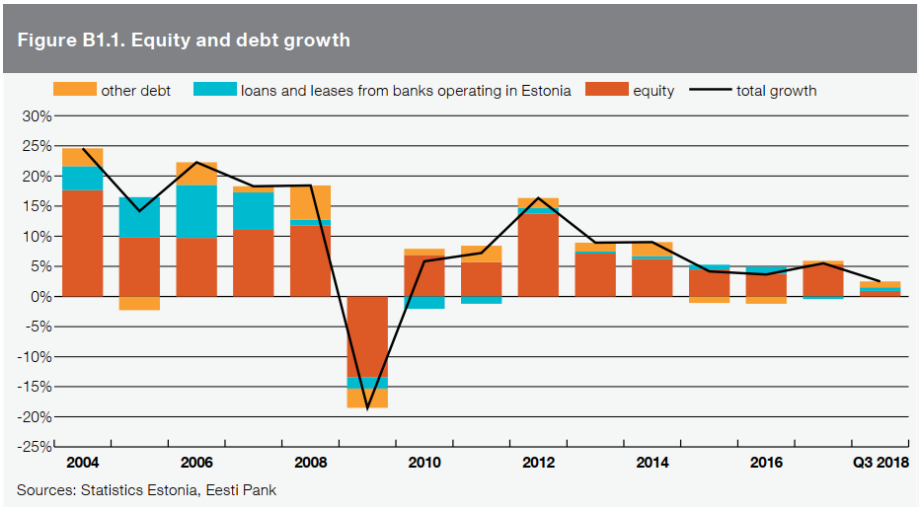
Mirroring the structure of the economy, including a relatively large share of foreign-owned companies, Estonian financial system is characterised by a relatively high share of loans between parent companies and their subsidiaries (The Structure of the Estonian Financial Sector 2017). Important sources of funding from aboard include reinvested profits of foreign-owned companies (Financing of the Economy 2019).

The financial system itself, since its consolidation at the late 1990s/ early 2000s, has been dominated by banks. For its part, the banking market is

characterised by high concentration and dominant position of foreign capital. There are 16 banks operating in Estonia, of which 8 are licensed credit institutions and 8 are operating as branches of foreign credit institutions. Their assets amount to 25.2 billion euro or 110% of GDP. Five largest credit institutions account for approximately 90% of the total assets of the Estonian banking sector. The Scandinavian banking groups hold 90% of the banking sector assets (Estonian Banking Association, www.pangaliit.ee), and the Swedish banking groups alone hold 78% of the total assets (Financing of the Economy 2019). Although, the whole financial sector in Estonia was severely hit during the crisis of the late 1990s and the 2000s, currently the banking sector is evaluated as strong, well capitalised and profitable (Country Report Estonia 2019 2019).

The other parts of the financial sectors are relatively less developed. Estonia's ratio of capital markets to GDP is one of the lowest in the EU. Due to the limited size of Estonian economy Tallinn Stock Exchange, which was established in 1996 (since then changed its owners and has been renamed as Nasdaq Tallinn), belongs to the smallest in the EU. At the end of 2016, market capitalisation of the stock exchange reached 2.3 billion euro or 11% of GDP. While, in 2005-2009 an average of 85 million euro of transactions were made each month, in the period 2010-2016 the monthly average was 14 million euro (The Structure of the Estonian Financial Sector 2017).

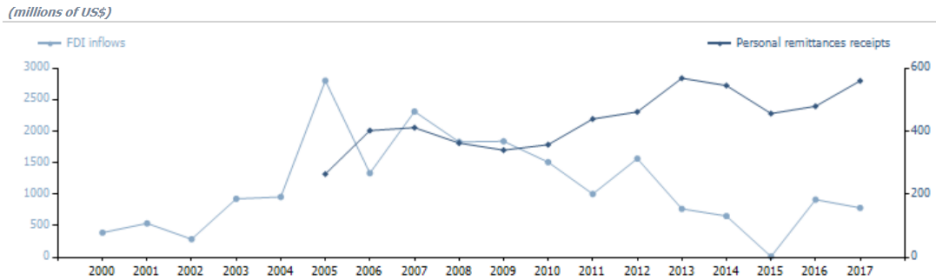
Structure of financing of companies in Estonia has drastically changed after the crash during the global financial crisis.




Source: Eesti Pank, *Financing of the Economy* 2019

FDI played an important role for the grow of the Estonia's economy, especially until the global economic crisis. FDI peaked in 2007 at 15.4% of GDP, of which large part (60%) flew to financial intermediation and real estate sectors (Economic Surveys: Estonia 2009). Subsequent crisis years have witnessed a drastic drop in inflow of FDI and less substantial role of FDI inflow for generation of GDP growth (BTI 2018 Country Report. Estonia 2018). FDI inflows declined from 10% of GDP in 2007 to 0.6% in 2015, reaching 3.8% in 2016 (Economic Surveys: Estonia 2009).

**Financial flow trends in Estonia in years 2000-2017.**

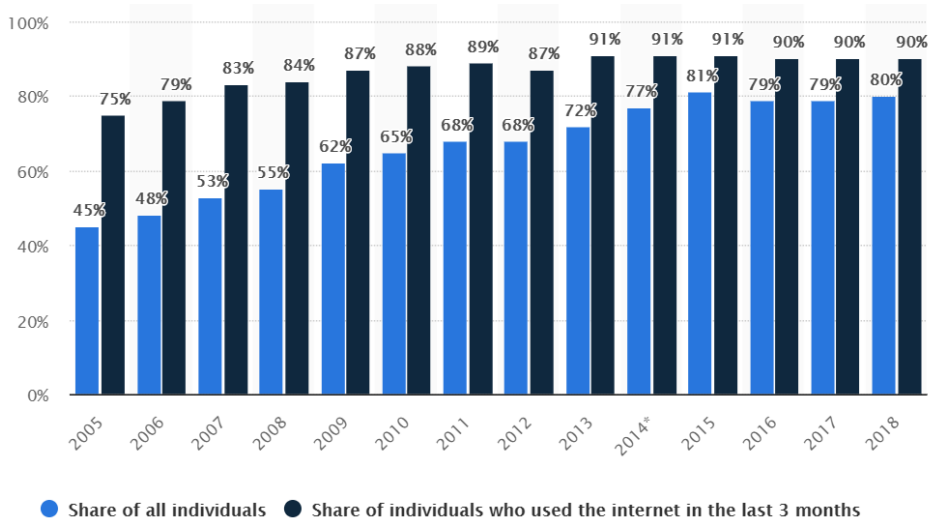



Source: UNCTAD, General profile: Estonia

Estonia's financial system reflects processes and tendencies in the larger economy. It was developed rapidly and integrated within the EU, in particular within the Nordic and Baltic region (Estonia: Trade and Investment Statistical Note 2017). Thanks to engagement of the foreign

capital, it has also been modernised, including in terms of Internet banking. On top of that, Estonian authorities have been particularly diligent in applying EU regulations to financial system, including the banking sector (Juuse and Kattel 2014).

**Online banking penetration in years 2005-2018 in Estonia.**




Source: statista.com

At the same time, open and externally-dependent character of Estonian economy continues to generate vulnerabilities and potential risks. In particular, the banking sector, concentrated and dominated by foreign entities, is vulnerable to spill-over effects (Country Report Estonia 2019 2019). Relatively small size of the market creates obstacles for development of the stock market (The Structure of the Estonian Financial Sector 2017). It's is reflected (and enhanced) by the fact that local capital markets are usually classified by large index providers as frontier markets.

## 5. Knowledge sector

Estonian authorities have made considerable efforts for development of innovation potential of firms operating in the local market. These efforts have been conceptualised within three governmental R&D strategies, known as "Knowledge-based Estonia" and to a high degree financed from the EU funds. This includes the current long-term budget (2014-2020). National Reform Programme "Estonia 2020" includes a goal to increase

the share of R&D expenditure to 3% of gross domestic product (GDP) by 2020.

Expenditures on R&D more than doubled between 2003 and 2012 (from 0.8% to 2.2% of GDP), but declined quickly to 1.4% by 2014 (BTI 2018 Country Report. Estonia 2018). In 2017, the R&D intensity index was 1.29% (Statistics Estonia, stat.ee), and business R&D intensity amounted to 0.61 % of GDP (Country Report Estonia 2019).

An important characteristic of Estonian R&D system is reliance on competitive project-based public policy (supply-side) measures, directed both into public universities and private companies. In 2017, total R&D expenditures amounted to 304.3 million euro, 40% or 122 million euro of which accounted for government funding. Ca 36.3% of government spending on R&D comes from foreign funds (mainly European structural funds) (Statistics Estonia, stat.ee).

Private sector R&D activities are highly concentrated and occur mostly in larger and export-oriented companies (Kattel and Stamenov 2018). In terms of sectors, business R&D expenditure is largest in the information and communication technology (40%) and manufacturing (25%) sectors (Country Report Estonia 2019 2019). Around 40% of private R&D expenditure is done by about 100 manufacturing companies (Mürk and Kalvet 2014). Overall, in 2015 there were 225 companies reporting R&D expenditure and this number has been quite stable over the past years (Statistics Estonia, stat.ee). In 2017, SMEs carrying out product or process innovation stood at less than 30% of the EU average, and for marketing or organisational innovation at less than 20 % (Country Report Estonia 2019 2019).

In the public sphere, majority of activities and resources related to R&D concern universities. Reform measures in the higher education systems implemented since 2000 have been aimed at promoting concentration, increased efficiency and effectiveness of the system of higher education. Within the framework of the EU Innovation Scoreboard, Estonia's performance in years 2010-2017 has worsen, what was reflected by a change of its status – from "strong innovator" to "moderate innovator".

In many aspects measuring development of the knowledge economy, including research and development intensity indicator, Estonia positions itself ahead of its peers from the Baltic and East European region. It has been classified on the 1st place in the EBRD Knowledge Economy Index, scoring particularly high in areas of institutions for innovation and ICT infrastructure (Pospisil 2019). Moreover, Estonia is the highest-ranked country for the CEE region in the Global Innovation Index (24th place).

The strengths of Estonia's knowledge system result from its intellectual assets, human resources and innovation friendly environment (European Innovation Scoreboard 2018. Country profile: Estonia 2018). Moreover, education enrolment levels and the general quality of education are positively assessed (BTI 2018 Country Report. Estonia 2018). For its part, the higher education reform brought an increase in scholarly output and intensity of international cooperation. In terms of business R&D activities, Estonian economy scores well in certain intellectual property production, including trademark and design applications (above the EU average) and patent application (above the other Baltic states) (Country Report Estonia 2019).

At the same time, Estonia significantly lags behind in comparison with Western and Northern EU member states. In terms of labour productivity, it ranks below both the EU average and some CEE states. The average productivity measured by value added per hour worked reaches 74.7% of the EU28 average, 56% that of the euro area countries (Eurostat) and 50% the average of the upper half of the OECD countries (OECD Economic Surveys: Estonia. Overview 2017).

Structural problems for development of knowledge economy includes contract profile of most Estonian manufacturing and service companies with relatively low position in value chains (Estonia: Trade and Investment Statistical Note 2017), what causes low demand and expenditures for business R&D. Moreover, the public spending is highly dependent on the EU funds, and so the medium and long term financial stability (beyond the 2020 EU budget perspective) is uncertain (Kattel and Stamenov 2018). Apart from that, another weak points include: low proportion of innovative SMEs, decline of non-R&D innovation expenditure, weak collaboration

between companies and the public sector (Country Report Estonia 2019) as well as shortages in qualified labour force (Kattel and Stamenov 2018). Overall, according to the OECD the most important challenge for Estonian authorities is to "ensure the transfer of knowledge and spill-over of high productivity from export-oriented firms to the rest of the economy, and to encourage the application of research and innovation in the business sector as a whole" (Estonia: Trade and Investment Statistical Note 2017).

## 6. Public opinions towards transformation

Public opinion polls show that the strategic aim of integration of Estonia with the West was initially mostly supported by the elite and only after some time gained more support of the wider population. In years before the accession Estonian population demonstrated the lowest support for joining the EU among the potential member states (Vetik 2003). In 1995, the rate of support was 44%, dropping to 38% in 2002. At the same time, after the accession the support rate jumped to over 70% in 2006, and 85% in 2007.

In case of NATO, percentage of those certainly and rather in favour of the membership raised from 54% in 2002 to 80% in 2010, falling to 71% in 2018 (Kivirähk 2018). Importantly, this upward trend did not concern the Russian-speaking population, among which support towards NATO membership was much lower for most of this period (32% in 2018).

One may argue that the above mentioned gap between the elite and the rest of society has been also reflected by authors of the BTI report, which indicates that in Estonia "the system of interest representation and mediation has been weak". This includes the relatively low impact of both NGO and trade unions. At the same time, satisfaction with the state of democracy in Estonia is close to the EU average (BTI 2018 Country Report. Estonia 2018).

Ambiguous attitude of Estonians towards the socio-economic model implemented after 1991 is visible also in the Study Life in Transition Survey (LTS) of the EBRD. It shows that after almost 30 years of transformation about 38% of respondents favour a market economy, in contrast to approximately 28% pointing to planned economy, and 33% saying it does not matter. These figures are stable in comparison to 2016,

and in line with the averages for Central Europe and the Baltics, but still significantly below the average rates for Germany (Life in Transition Survey 2016).

## Conclusions

Analysis of almost three decades of political, economic and social changes reveals some important conclusions. Given the extent of the reforms, Estonia can be seen as one of the starkest examples of the 1989 transformation in Eastern Europe. Adoption of this "transformation role model" policy was possible both because of the strong consensus within the elite and because of the relatively small size of the country.

Its realisation brought Estonia's integration with the Western institutions, formation of a highly business-friendly environment as well as modernisation of a (part) of the Estonian economy, especially the service sector. The country has also managed to make significant progress in terms of modernisation (digitalisation) of public services. Its specialisation has been affirmed by important international institutions (the EU and NATO). Overall, Estonia's performance has been affirmed by main external proponents of the changes taking place in this part of former Eastern bloc, what has been reflected in high positions Estonia has occupied in various rakings and indexes.

On the other hand, negative demographic tendencies, the severe effects of the global economic crisis and more recently – a rise of populist and anti-elitist sentiments have revealed significant vulnerabilities related to strong inequalities within the society and external dependence of the economy. After recent electoral success of the anti-establishment EKRE, Estonian elites seems to have realised necessity to correct the socio-economic model, implementing socially oriented measures. The question of their success in meeting challenges ahead of the country, will to a high degree indicate the success of the orthodox post-communist transformational model in CEE.

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### 3.2.2 Latvia

Simonas Algirdas Spurga

## Introduction

The Republic of Latvia is one of the three Baltic states with an area of 64.589 square kilometres and the population of 1.934.379 (ranking 24th in the EU in terms of population size). In terms of both the area and the number of inhabitants, it is the second largest Baltic state. Situated between Estonia and Lithuania, with a 498 km long coastline along the Baltic Sea, it also shares a land border with Russia to the east and Belarus to the southeast. Latvia's population has been multiethnic throughout the country's history; today, Latvians constitute the largest ethnic group at 62.2% of the population, followed by Russians (25.2%), Belarusians (3.2%), and others. Correspondingly, there's no one dominant religious affiliation in Latvia, as around 26% of the population is Christian Orthodox, 20% identifies as Roman Catholic, while 17% is Lutheran. Latvia's urbanisation rate amounts to 68.5%. The largest city is the capital Riga (632.614 inhabitants), which constitutes almost a third of the total population, followed by Daugavpils (82.604), and Liepāja (68.945).

## 1. The political context and the quality of institutions

Unlike the other new EU member states in the CEE region, Latvia (together with Estonia and Lithuania) was formally incorporated into the Soviet Union after the Second World War. The institutions were deeply integrated in the Soviet command economy, with key decisions being taken in Moscow.

Having had an independent state in the inter-war period, Latvia was able to regain independence in May 1990 against the background of dramatic changes in the socialist block that took place at the time. Independence was declared, with the Popular Front of Latvia previously winning over two-thirds of the vote in the parliamentary elections in March 1990. In September 1991, the United Nations admitted all three Baltic states as full members, which confirmed the official international recognition of their statehoods.

This was the beginning of a long road in not just in transition to a market economy, but also in the overall state building. The transition encompassed establishing democratic political institutions, private property rights, a new legal system (based on the restored and amended interwar Constitution of 1992), as well as integration into the international structures, such as NATO and the EU. The main task in the economic agenda was macroeconomic stabilisation, much needed due to imbalances resulting from decades of central planning and the economic shock caused by the collapse of the Soviet Union. The transition also encompassed foreign trade and price liberalisation, elimination of subsidies, and privatisation of state-owned assets. Having left the Soviet command economy, the country now had to adapt to market prices for energy and raw materials, and solve the legacy of the industries that were deemed inefficient and unsustainable in the market economy. The 50 years of Soviet ruled left Latvia with an underdeveloped service sector, while the industries were built to supply the whole Soviet Union, the market that was now closing, with specialised goods.

Latvia, just as the other Baltic states, proceeded with shock therapy macroeconomic reforms in a swift and broad-based manner. One of the most critical undertakings was leaving the ruble zone and achieving monetary stability. Latvia introduced its national currency (the Lats) in July 1992, and subsequently adopted a regime similar to a currency board arrangement with a fixed exchange rate. This was an early example of a relatively radical approach towards reorienting the economy to a new macroeconomic regime, with little regard to short-term transition costs. Initially in 1994, the national currency was pegged to the IMF's Special Drawing Rights (or SDR), an international reserve asset based on a basket of currencies (Feldmann 2008). The currency board-like system was updated in 2005, when Lats was re-pegged to the euro.

Arguably, the implementation of a quasi-currency board may have been of the most successful and decisive policy measures in the initial transition period. The regime served as a nominal anchor for macroeconomic stabilisation and shielded against speculative attacks on the Lats; also, the currency peg well fitted an open economy like Latvia, in which foreign trade and dependence on imports of raw materials and energy play an increased role. Ultimately, the arrangement helped reduce inflationary

pressures, put downward pressure on interest rates and strengthen foreign trade.

Another feature of Latvia's transition, much like in the other Baltic states, has been fiscal discipline (fostered by the currency board arrangement) and low tax environment. The government introduced a flat personal income tax in the mid-90s, a move which was considered radical at the time. The general government total expenditure settled at around 37-39% in the 1990s, and constituted 38.5% in 2018 (compared to an EU average of 45.6%). As with the adoption of a quasi-currency board regime, fiscal policy signalled a small role of the state, compatible with an LME-type model of capitalism.

The market reforms and changes to various regulations were also aimed at reducing the role of the state. These were expedited by the aspiration and the strategic goal of "returning to Europe" and integrating with the EU. In 1995, a comprehensive Association Agreement was signed by Latvia and the EU, after which successive governments sought to harmonise legislation and regulation, preparing for the prospect of the EU accession. Membership in the EU was sought to gain access to the Single Market for Latvian exports, attract foreign investment, access the EU's structural funds, and modernise both the economy and the public administration. Nevertheless, Estonia was the front-runner in this regard. The country was part of the so-called Luxembourg group of accession countries that were invited to begin accession negotiations in 1997, whereas Latvia only received such an invitation in 1999. Seeking to not trail behind, Latvia accelerated reforms leading up to accession to the EU in 2004.

As a result of trade liberalisation with the EU, as well as the effects of the 1998 Russian financial crisis which forced the enterprises to restructure and reorient their operations, Latvia's exports were increasingly oriented towards the EU: by 2000, almost two thirds of exports went to the EU-15. Trade liberalisation was also catalysed by Latvia's accession to the WTO in 1999. In 2004, Latvia also joined NATO, which provided a further positive signal to foreign investors.

Latvia's public life has been influenced considerably by the presence of the so-called oligarchs, business leaders often accused of corruption. Corruption and fears over state capture dominated the political debate more

so than in the other Baltic states, and brought down the government several times. Latvia ranked persistently below Estonia and Lithuania in terms of Transparency International's Corruption Perceptions Index (CPI). In 2018, it ranked 41st in the world (in comparison to Estonia which ranked 18th).

Another important factor influencing domestic politics has been the salient cleavage along the ethnicity lines. Historically, Latvia was multi-ethnic since at least the arrival of the Teutonic Knights in the early 13th century. During the Soviet era, Latvia was subject to intense russification, with some 700.000 Russian-speakers (approximately one-third of Latvia's population) settling in the country. The relatively well developed Latvia (with Riga being the dominant city in the region prior to the Soviet occupation) primarily relied on immigration by Russian-speaking migrants to advance the Soviet phase of industrialisation. In 1989, at the end of the Soviet period, Latvians constituted only 52% of the population (CSB, 2019), with the prospect of the titular nation becoming a minority.

This had a tremendous effect on nation's political landscape. In the neighbouring Lithuania, the former communists, mostly titular Lithuanians, were able to rebrand themselves and win the election in 1992. In Latvia, the 1993 election was won by the nationalist centre-right. Going forward, the centre-right coalitions, often plagued by scandals associated with the activity of the oligarchs, have nevertheless been able to mobilise voters and hold the office ever since. Forces representing the Russian-speaking population of Latvia have mostly clustered around centre-left. The social democratic Harmony attempted to reach out to the ethnic Latvian electorate in order to expand its vote share, but this has so far only worked in municipal rather than national elections. In centre-right, meanwhile, ethnic Latvian parties differentiate themselves via charismatic leaders rather than competing policy offers. The lack of policy-oriented agendas (e.g. no party has its own think-tank) remains a fundamental weakness of Latvia's fragmented multi-polar party system.

Throughout the years, the centre-right coalitions have kept a relatively stable pace at developing a liberal model of capitalism in Latvia, with characteristics of a LME-type economy. However, a lack of social safety net (due to a small welfare state as well as underdeveloped civil society) has meant that some of the negative outcomes produced by the market-based model have been mitigated only modestly. Latvia has one of the

highest levels of income inequality among the EU Member States, with a Gini coefficient of 34.5 in 2017 (lower than 37.6 in Lithuania but higher than the EU average of 30.3). In 2018, the income of the richest 20% of the Latvian population was 6.8 times higher than that of the poorest 20%; a gap significantly larger than in the EU as a whole (5.1 times in 2017).

As in the neighbouring Lithuania, the social response to the issues outlined above has included high rates of emigration. Latvia's current population of 1.94 million inhabitants is considerably lower than the 2.38 million figure recorded in 2000 or 2.67 million in 1989. As a result of international long-term migration, the number of people in Latvia dropped by 126.100 in 2010-2018. Net migration reached -35.640 in 2010 (equivalent to a population of a sixth-largest city in Latvia), although it declined to -4.905 in 2018 (CSB 2019). The demographic decline remains one of the main challenges to Latvia's long-term growth to date.

Recently, Latvia's government has made efforts to alleviate inequality. In 2018, a tax reform package shifted the tax system towards a progressive three-tier income tax with an increased level of non-taxable income, reducing the tax burden on low-wage earners.

## 2. The general economic outlook

The beginning of the transition in Latvia saw the combination of a rapid rate of annual inflation as well as a freefall in economic output. In 1992, inflation rate amounted to a staggering 958.6%, before finally falling to single digits in 1997 (EBRD 1998). The rapid rise in consumer prices was the outcome of a mixture of different factors, including price liberalisation, the increase in energy prices, and the uptick money supply in the Soviet Union. In addition, the forced savings were accumulating during the Soviet period due to price controls and repressed inflation, and were now contributing to an increased demand (Kim 1999).

The cumulative drop in Latvia's GDP during the period 1990-1993 could have amounted up to 49% (Economic Commission 2000). Although similar estimations of the size of the contraction have probably been exaggerated, the fall in the output was enormous. Moreover, the impact of disintegration of the Soviet economy was relatively larger in Latvia compared to the other Baltic states. The country accommodated larger and more important military installations than Estonia or Lithuania; this particular type of

capital stock now was essentially useless and hard to reorient towards producing consumer goods. On the other hand, Latvia also had sizable ports along its long coastline, e.g. in Ventsplis and Liepaja. Riga had the only container port between St Petersburg and Poland. This made Latvia an important maritime and transit route to Europe and the US.

Riga also boasted sizable industrial enterprises (e.g. producing phones, radios, vans and minibuses), which dominated the Baltic industrial landscape. In the context of radical diversification of supply chains and the closure of the Soviet market, the production in these industries fell drastically. The Riga Autobus Factory went bankrupt in 1998. The State Electrotechnical Factory (or VEF), the crown jewel of Riga's industry, folded in 1999.

The general economic upheaval and radical macroeconomic reforms ultimately contributed to the banking crisis in the mid-1990s. As much as 15 commercial banks were closed or went bankrupt, accounting for up to 40% of assets in the banking sector (Aslund and Dombrovskis 2011). The crisis took toll on the economy, and the GDP contracted by 2.1% in 1995, just after turning positive the year prior. Another hit to the economy was the 1998 Russian financial crisis, although the economy managed to post positive output growth numbers in 1998 and 1999.

On the back of structural reforms, economic transformation and export diversification, Latvia was able to put up extraordinary growth numbers from 2000 right up to the global financial crisis. The accession to the EU in 2004 further boosted optimism; growth averaged more than 10% in the period 2004-2007. Given that growth tempos were similar in all three Baltic states, the term 'Baltic Tigers' was born to describe the fast-pace convergence of the three countries, similar to the dynamism seen in the four "East Asian Tigers".

However, large capital inflows, expansion of cheap credit, surge in real estate prices and the current account deficit all signalled that the economy was overheating. The global financial crisis wiped out 3.6% of the Latvia's output in 2008, 14.4% in 2009 and 3.9% in 2010, resulting in three straight years of dramatic GDP contraction. In the context of the fast-falling aggregate demand, the unemployment rate reached 19.5% in 2010. In contrast to Estonia and Lithuania, Latvia was the only country which had a

large domestically owned bank, the failure of which aggravated the situation. Of the three Baltic states, only Latvia applied for international financial assistance which was provided by the IMF, the EU, and certain EU member states.

Nevertheless, Latvia managed to bounce back and avoided the double-dip recession seen in the large part of the euro area. During crisis period, Latvia refused to devalue its currency, despite the pressure exercised by the IMF, which provided funding to Latvia under a Stand By-Arrangement (SBA). Over 90% of loans were in foreign currencies (primarily in euro), generating fears in Latvia that devaluation would lead to mass defaults on loans and the subsequent collapse of the banking sector. The IMF was sceptical about Latvia's capacity to adjust without devaluing.

Instead, Latvia chose a strategy of "internal devaluation" underpinned by a front-loaded fiscal austerity, downward adjustment of wages and structural reforms to regain competitiveness (Purfield and Rosenberg 2010). Firms were able to cut spending and salaries or quickly liquidate their operations, which was in part possible due to the absence of powerful labour unions, and quickly increase their exports. Latvia achieved output expansion in 2011, and in the following years up to 2018 grew at an average rate of 3.6%. Unemployment shrank, while severe material deprivation has been steadily decreasing since 2011, and has fallen below pre-crisis levels (9.5% in 2018 as compared to 24% in 2007; European Commission 2019). As a result of this, Latvia has often been labelled as a model case for austerity and internal devaluation.

Arguably, Latvia's success in responding to the crisis can in part be explained by its model of capitalism, which combines a number of LME-type characteristics together with an overall small role of the state in the macroeconomic regime (inactive fiscal policies, low government expenditure, fixed exchange rate).

First, reorientation towards exports in Latvia (as showed by the goods and services export growth amounting to 13.4% already in 2010) was enabled by low barriers to entry and generally high levels of product market competition, a staple of the market-based economy. Such environment helped spur reallocation of resources from non-tradable sectors and domestic markets to export-oriented activities and international markets.

Second, policy makers were able to rely on the high flexibility of the labour market, which has been characterised by the modest role of trade unions and the very low coverage of collective agreements. Trade union density rate has been trending downwards and last stood at 12.6%, according to the ILO data. Similarly, the collective bargaining coverage rate only amounts to 13.8% (ILO 2018). Also, in all Baltic states the enforcement of labour regulations is particularly lax. As a result, wages during the crisis were relatively flexible downwards, and labour mobility was high. This expedited the adjustment process in Latvia.

Third, pressures in the labour market and on government finances in Latvia were eased by substantial emigration. Part of the explanation behind high levels of emigration during the downturn may be found in the education system in Latvia, which is oriented towards fostering "general" and more easily transferable skills rather than sector-specific skills (more often found in a CME; Martinaitis 2010). The labour force can thus more easily apply its general skills abroad. Also, the economic hardship was not cushioned by the small welfare state, which further encouraged outward migration (Kuokštis 2015). The minimum wage, unemployment and other types of social benefits have for the most part been low in Latvia, consistent with low levels of government spending.

Finally, the key element to Latvia's recovery was the decline in unit labour costs, which, in addition to somewhat lower wages, was in large part due to rise in productivity from 2009 onwards (Krugman 2013; Blanchard *et al.* 2013). This was especially true with the exporting firms, as they were able to adjust quickly and reorient themselves towards foreign trade. Such ability to adapt to fluctuations of economic conditions could also be a function of low levels of state protection for business, e.g. limited subsidies and nascent industrial policy (Bohle and Greskovits 2012; Kuokštis 2015). In other words, Latvian businesses were ready to respond quickly in an independent manner. Latvia also lacked flexibility of the exchange rate which would cushion the blow and restore competitiveness of exporting firms. Therefore, Latvian businesses never expected to be bailed-out in any form or compensated for the downturn, and were able to adjust on their own.

Therefore, LME-type elements of the Latvian model of capitalism may have helped the country overcome a particularly deep recession during the

global financial crisis. After the stress period, Latvia joined the eurozone in 2014. Prior to the crisis, the Latvian government did not curb inflation to meet the so-called convergence criteria for the membership in the currency union, as that could have put breaks on the fast-pace economic growth and convergence. However, after the crisis joining the euro area was now the preferred and logical exit strategy from the currency board regime. Arguably, this was one of the major policy achievements in the post-crisis era. The euro facilitated access to the Single Market, lowered borrowing costs, and also improved Latvia's financial safety net through participation in the European Stability Mechanism (the euro area's lending facility) as well as access to the Eurosystem liquidity.

Despite this narrative, Latvia does not entirely fit into the LME classification on multiple key dimensions. The first striking difference from a pure LME type is corporate governance, which is somewhat more similar to the Mediterranean model. Latvia can be characterised by large ownership concentration in businesses, as opposed to a dispersed ownership characterising firms in the LME, whereby entrepreneurs are usually also the managers of their enterprises (Norkus 2008).

This type of ownership concentration may have been predetermined by the fact that Latvia lacks a developed financial market, a particularly important element to the vitality and dynamism of an LME. Market capitalisation of listed domestic companies in Latvia only amounts to 2.5% of the GDP, down from the peak in 2005-2006, which was still less than 13% of the domestic output (CEIC 2019). Instead, the domestic banking system plays the primary role in financing the Latvian corporate sector. In all the three Baltic states, there was an L-shaped decline in market capitalisation after the global financial crisis. This clearly shows the lack of convergence towards an LME-compatible role of the financial markets.

The described traits of the Latvian capitalism underlie the lack of innovation capacity by firms, be it radical or incremental. Consistent with a rather low R&D intensity, Latvia has not been exporting high-technology goods, but rather low-to-medium complexity, resource- or unskilled-labour-intensive products.

## 3. The quality of entrepreneurship

Gaps in deregulation, arbitrage between free and regulated prices, and some failures of privatisation in the initial stage of transition induced state-capture and allowed the creation of a new class of the so-called oligarchs (Aslund and Dombrovskis 2011) – business leaders, often accused of corruption, employing their resources to influence national politics. With strong-vested interests, they continue to play an important role in the domestic political and economic life in Latvia. Some of the most important oligarchs emerged in the transit and port business, with Aivars Lembergs, having consolidated political power, serving as mayor of port city Ventspils since 1988. Lembergs continues to exercise considerable influence over the Union of Greens and Farmers, one of the key centre-right parties in Latvia. Andris Šķēle, who served two terms as Prime Minister, made his fortunes in port business, shipping, as well as retailing. Crucially, he also served for a while as acting General Director of the Latvian Privatisation Agency. Ainārs Šlesers, former minister of transportation and deputy mayor of Riga, has recently been engaged in joint venture with Šķēle, owning the Riga Commercial Port group. All three men were leading power brokers within major right-leaning political parties that until 2011 participated in almost all of Latvia's governing coalitions. They were suspected of exercising great influence in major privatisations and state procurements.

Looking to advance its accession to NATO and the EU, Latvia established the Corruption Prevention and Combating Bureau (KNAB) in 2002 – a single agency to handle corruption investigation and prevention. KNAB proved its effectiveness in applying fines for campaign finance violations, spurring popular support for anti-corruption reform, and carrying out high-profile investigations (including cases involving the three aforementioned oligarchs). The 2011 "Oligarchs Case" paved way for the snap parliamentary election. President Valdis Zatlers called the referendum to dissolve parliament in response to its refusal to sanction a search at the property of Ainārs Šlesers, who was an MP at the time. The president also singled out the three oligarchs as "threats to Latvian democracy" (Kuris 2013). The new government coalition that was formed subsequently involved none of the oligarchs' parties, although the Union of Greens and Farmers was able to return to power in 2016.

Another salient issue is shadow economy (estimated at 24.2% of GDP in 2018; SSE Riga 2019) and the widespread use of the so-called envelope wages (paid in non-taxed cash), which essentially creates an unequal playing field for business enterprises.

Despite the relatively large role of vested interests, risks related to state capture, and shadow economy, Latvia still managed to create business environment conducive to entrepreneurship. This was expedited by the aspiration and the strategic goal of "returning to Europe" and integrating with the EU. An important factor also was the accession conditionality which yielded positive progress in terms of institutional convergence. In all three Baltic states, the areas of public policy and regulation that were directly affected by the accession to the EU seemed to improve quicker in terms of efficiency relative to policy areas and institutions that were not hard-pressed by the integration with the EU. In 2016, Latvia also joined the OECD, which provided an additional positive reform stimulus. The recently implemented reforms include improving the management of state-owned enterprises, ensuring political non-interference, and separating the state's management and regulatory functions. While frameworks for the management of state-owned enterprises and insolvency procedures have been improved, implementation remains a challenge (Terauda and Auers 2018).

Therefore, the EU accession process and later membership in the EU and other international organisations were the main anchors which kept Latvia reforming and developing competition-friendly institutions. Although it has trailed behind Estonia and Lithuania, its performance has been satisfactory in the wider regional context. Based on the 2018 OECD's Indicators of Product Market Regulation, Latvia is among the top performers in the OECD, ranking 10$^{th}$ with regard to the aggregate score on competition in the product markets (in comparison to Poland ranking 22$^{nd}$, Hungary 14$^{th}$ and Lithuania 5$^{th}$). Latvia has also ascended in the World Bank's Doing Business index. Ranking at the 19$^{th}$ place in the 2019 Doing Business score, it trails behind Lithuania and Estonia, but nevertheless leads the rest of the countries in CEE, with favourable scores in getting credit, paying taxes and enforcing contracts.

Moreover, over the past years the Global Entrepreneurship Monitor (GEM) has shown that Latvia has a high concentration of members of the

population (14.15% in 2017) who are either nascent entrepreneurs or owner-managers of a new business. In the EU, it only lags behind Estonia in this regard. A clear improvement from pre-crisis trends can be observed: in 2007, this share was merely 4.46%. This is consistent with steady improvements in business regulation. The share of the population agreeing that in their country most people consider starting a business a desirable career choice was 57 % in 2017. In particular, there is a dynamic entrepreneurship scene emerging in Riga, especially in the IT-sector and around some specific universities, such as Riga Technical University.

As noted, Latvia's model of capitalism is characterised by business ownership concentration. A popular legal corporate form is the private company, the owners of which are also the managers of the enterprise. In this regard, capitalism in Latvia is different from both the LME "stockholders" model, where corporate control over managers is ensured by the existent incentive mechanism stemming from competition and takeover threat, and from the CME "stakeholders capitalism", where managers can be supervised by the stakeholders with vested interests, e.g. banks that provide financing (Norkus 2008). Given this, Latvia features a significant SME share of employment in total employment (79.4% in Latvia, versus 75.9% in Lithuania, and 78.2% in Estonia). SMEs also produce a comparatively large share of value added in the economy, and their turnover share has been well above the EU average. Given the large role of the SMEs and the importance of a level domestic market competition for their functioning, developing a competition-friendly environment has been the focus during the transition.

## 4. Modernisation based on FDI

After the dissolution of the centralised planning system with no private ownership, Latvia proceeded with a large-scale process of privatisation. The initial progress with privatisation was slow and was more successful in terms of privatising small enterprises, while the pace of privatising large operations was sluggish. At first, more emphasis was given on privatisation through vouchers, which meant that there were few opportunities for foreign investment inflows. The voucher system was designed so that the residents who settled in Latvia after 1945 could get a relatively little share; the fact that a large share of entrepreneurs did not belong to the titular Latvian nation postponed privatisation through auctions, which would have

allowed to attract capital more easily. In 1994, privatisation authority was centralised and consolidated within the Latvian Privatisation Agency, which sped up the process and essentially moved the privatisation of large enterprises from a standstill. The strategy of the agency was, first, to find the core investor in a tender or an auction process, and only then to draw minority shareholders with vouchers through public offerings (Mygind 1997). Unlike in the neighbouring Lithuania, the chosen method was relatively conducive to attracting FDI. Foreign investment ultimately strengthened on the back of investments from the US, Germany, Sweden, and Switzerland (Berzups 1995). The legislation concerning foreign ownership of land was initially restrictive, but in the end of 1994, foreigners were allowed to buy and own land in Latvia.

Overall, privatisation in Latvia was only partially successful. The most profitable state-owned companies (those involved in the transit business or monopolies in areas such as natural gas) endured a complicated and politicised privatisation process. The state still maintains a stake in some large enterprises. For example, the government holds a 51% share in the telecommunications company Lattelecom, and owns the electric utility company Latvenergo, which has a 90% share of the market (BTI 2018).

Despite the problems at the beginning of the transition, Latvia still managed to attract significant foreign investment inflows. Today, privatisation is no longer the main source of FDI for the country; instead, a significant portion of FDI comes from re-investments and the classic merger and acquisition operations. The total stock of FDI stood at 49.6% of the GDP in 2018, which marks a steep increase from a mere 3% at the beginning of the transition in 1992 (UNCTAD 2019). Largest inflows come from Sweden, Russia, and Cyprus (although the latter is a proxy for investors mostly from Latvia itself, and Russia).

Favourable business environment, facilitated by the harmonisation with the EU law, has had a positive impact on FDI inflows. From 2018 onwards, Latvia started applying corporate income tax rate of 20% only at the moment of the distribution of profits, while the undistributed profits are no longer taxed, incentivising investments and business expansion. This measure, previously adopted in Estonia, should have a positive impact on further FDI. However, Latvian policy makers will still have to address issues undermining the foreign investment climate, including a lack of legal

certainty in court decisions, inadequate insolvency procedures, as well as demographic challenges related to the shrinking workforce.

In Latvia, almost a quarter of foreign investments are allocated in financial and insurance activities. As a result, foreign-owned banking entities play a large role in the domestic banking system. By 2007, of the four largest banks accounting for 75% of banking assets three were Nordic institutions; this share has lately decreased to above 50%. In terms of the banking sector, Latvia has historically had a large share of non-resident deposits in the banking system. The Nordic-owned banks have usually provided retail banking services to clients on any income level and mostly Latvian residents. However, the locally owned banks and other foreign-owned entities have specialised mostly in providing services to high-income clients and non-residents, mostly from Russia, Ukraine, and other CIS states, with no close links to the domestic economy (Rupeika-Apoga *et al*. 2018). The share of non-resident deposits was as large as 56% in 2015. Recently, after the liquidation of the ABLV Bank over a money laundering scandal and related AML measures by the regulatory authority, the share has decreased to around 20%. Still, the non-resident business model continues to be well-entrenched within the domestic banking market, and banks servicing foreign clients have so far failed to refocus their business model (IMF 2018). In this respect, Latvia has differed substantially from the banking sector in Lithuania. Crucially, risks associated with a large stock of non-resident deposits (such as money laundering) continues to pose a threat of withdrawal of Nordic banks from the market.

Overall, dependence on foreign capital means that Latvia has some features of a dependent market economy (DME). Such dependence will only increase given that access to EU structural funds is likely to be lower in the next programming period. However, Latvia still differs from DME in many dimensions, both in terms of comparative advantage (Latvia does not specialise in the assembly of semi-industrial or high-complexity goods), and in terms of institutional characteristics, e.g. employment protection, industrial relations and skill orientation. Given that most investments have flown into financial intermediation and insurance services, it could be concluded that Latvia lost the competitive struggle to attract FDI into high value-added manufacturing industries to countries in Central Europe (e.g. Slovenia).

## 5. The knowledge sector

The lack of innovation capacity by firms is one of the main obstacles in conceptualising Latvia as an LME type economy, or indeed applying the VoC innovation dichotomy in the first place (as the two models of capitalism have comparative advantage in either incremental or radical innovation). Latvia has been able to achieve efficiency-based (in part due to low labour costs) rather than knowledge-based growth. As noted, Latvia has comparative advantage in manufacturing of low-to-medium complexity, resource- or unskilled-labour-intensive goods. The share of medium and high-technology firms is only 15% in the overall structure of the manufacturing sector (the EU average is 47%), while the share of low-technology industries is 55% (Griniece and Nausedaite 2017).

Overall, the country's research and innovation system is characterised by low R&D intensity. The gross domestic expenditure on R&D as a percentage of GDP has been flat, constituting 0.55% in 2007 and 0.51% in 2017. It has remained well below the EU average of 2.06%, and also lags behind expenditure rates in Estonia and Lithuania (1.29% and 0.89% respectively). Latvia is also characterised by low proportion of private investment in R&D, whereby in a mature research and innovation system the industry usually does the lion's share of R&D. Therefore, there has so far been little reason to claim that Latvia can switch its current production profile into a more complex one, thus converging to an LME-type economy.

Beyond R&D, issues with the knowledge sector are related to an inefficient higher education system. Public expenditure on tertiary education is low and thinly spread over a large number of institutions, and until recently the funding model lacked performance-based components. With a population of just 2 million, Latvia has over 50 autonomous higher education entities. Also, the weight of structural funds in the financing of the system makes the sustainability of the current model problematic in the long run. Already in 2013, the IMF warned that the current system is unsustainable due to a disproportionately high number of institutions and limited financing (IMF 2013). These inefficiencies have contributed to the skills mismatch in the Latvian labour market, adding to the shortage of qualified labour force despite the proportion of people in the age group 30-34 who have a higher education degree (42.7%) being above the Europe 2020 target of 40%. The

most talented Latvian students continue to emigrate to study at other European universities. Accordingly, the system of agencies involved in implementing research and innovation policy has been fragmented, making it difficult to build a critical mass of capacity, quality and scale.

However, during the post-crisis period there has still been considerable improvement in Latvia's research and innovation system. The OECD has recognised Latvia for improving in its framework of R&D, noting the consolidation of research institutions, introduction of quality-based financing models, and incentives to boost research (OECD 2017). For example, a support program for the development of new products and technologies has been set under the government's Smart Specialisation Strategy using the EU structural funds, managed nationwide by eight Competency Centres that provide coordination and exchange of information and knowledge. The Competence Centres have been perceived very positively by different actors in the Latvian innovation system. This contributed to an increasingly successful cooperation between enterprises and scientific institutions in the development of new products.

As a result, Latvia has been moving upwards in the European Innovation Scoreboard, and switched from the category of "modest innovators" to "moderate innovators" in 2015. In the period 2010-2018, the innovation performance of Latvia increased by 16% relative to that of the EU. Accordingly, the share of high technology products in total exports has increased from 4.6% to as much as 11.2% in 2018, higher than the share in Poland, Lithuania, or even Finland. Examples of firms improving their added value include private enterprises with business-to-business products in the wood product sectors, oriented towards incremental product improvement rather than more radical innovation (Sturn *et al*. 2018).

## 6. The public opinion and attitudes towards transformation

According to the European Bank for Reconstruction and Development's Life in Transition Survey, the support for democracy in Latvia increased slightly from 38% in 2010 to 41% in 2016, although remained at low levels in comparison to 61% in Lithuania or 54% in Estonia. Support for the market economy was particularly weak, at 24%, well below the average for the CEE region. In fact, as much as 34% claimed that they would favour, under certain circumstances, a model of planned economy. Trust in the EU

in 2017 (49% of the population) was lower than in Lithuania (65%) or Estonia (53%; Eurobarometer 2018). Only 15% of inhabitants agreed that they could influence decision-making process, while a negligible percentage claimed to engage directly in party politics (Terauda and Auers 2018). Overall, the government faces challenges in building trust, limiting the performance of the democratic system. This is despite the fact that trust in national political institutions has gradually increased with the economic upswing. Trust in government was equal to 27% in 2017, up from 13% in 2010 (Eurobarometer 2018).

Arguably, persistently high levels of inequality and rapid changes in the national production regime may have left a part of the population, and especially the older generation feeling left out of the newly-established market-based system. For instance, during its transition Latvia has moved from the Soviet-industry based to a more service-based economy. The service sector is now the biggest contributor to the domestic output, while manufacturing and other industries comprise only 17%. There have also been significant changes in the composition of industrial activities. This could have had an impact on both the real and perceived changes in the socioeconomic position of a large number of citizens, including the industry workers that were unable to apply their sector-specific skills in the independent Latvia.

Moreover, the media and the public sphere have been divided in Latvia between contradictory pro-EU and pro-Russian narratives. Arguably, the Russian-language media has been demonstrating bias towards its linguistic audience, often calling into question the current pro-Western direction of the Latvian state. In essence, Latvians and Russian-speakers live in two very distinct communities, with separate newspapers, TV and radio shows, and social media. This has exacerbated tensions within Latvia's bilingual population, and may have contributed to the disappointing level of support to the country's transition. Another issue that has negatively affected public trust is elements of state capture, with the country being routinely shaken by the scandals related to the activity of the locally-bred oligarchs.

## Conclusions

Latvia's transition can be considered to be generally successful in the regional CEE context, although the country somewhat lags behind its Baltic

sisters, Estonia and Lithuania. A certain gap in relation to its neighbours can often be observed both in headline economic data (growth and GDP per capita), as well as various indicators on institutional quality and governance. This may be due to a confluence of systemic factors pertinent to Latvia's transformation. First, at the beginning of the transition, the impact of disintegration of the Soviet economy was relatively larger in Latvia compared to the other Baltic states. Sizable industrial enterprises which dominated the Baltic industrial landscape were put under strain, and this may have had a long-term scarring effect. Second, the salient cleavage along the ethnicity lines has played a particularly sizable role in Latvia's transition. The titular Latvians have mobilised around the centre-right, where ethnic Latvian parties differentiate themselves via charismatic leaders rather than competing policy offers. Centre-right coalitions, often plagued by scandals associated with the activity of oligarchs, have operated under a shadow of state capture – the issue that has dominated the Latvian political debate to a bigger extend than in the other Baltic states.

Nevertheless, Latvia's Westwards orientation has been solidified over the years with the country joining the EU, NATO, and the euro area. Especially the goal of joining the EU, as well as the euro area, has catalysed and maintained a market liberal reform agenda that ensured low barriers to entry and high levels of product market competition. Despite its relative success so far, Latvia has generally achieved efficiency-based – in part due to low labour costs – rather than knowledge-based growth. For its economic model to be sustainable long-term, Latvia will have to improve on its FDI and R&D intensity to achieve cutting-edge, rather than catch-up growth.

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### 3.2.3 Lithuania

Simonas Algirdas Spurga

## Introduction

The Republic of Lithuania is the largest and the most populous Baltic state with an area of 65.286 square kilometres and the population of 2.794.184 (placing 22nd in the EU in terms of population size). It is also the most ethnically homogenous Baltic State, with Lithuanians constituting 84.1% of the population, followed by the Poles (6.6%) and Russians (5.8%) as the two largest minority ethnic groups. The country is situated along the south-eastern shore of the Baltic Sea, bordered by Latvia to the north, Belarus to the east and south, Poland to the south, and Kaliningrad Oblast (a Russian exclave) to the southwest. It has 262 kilometres of coastline consisting of the continental coast as well as the coast of the Curonian Spit, the 98 km long sand-dune spit that separates the Lagoon from the Baltic Sea coast. At the narrow mouth of the Curonian Lagoon lies Lithuania's major warm-water port of Klaipėda. The terrain is marked by numerous small lakes and swamps, and a mixed forest zone that covers over a third of the country. Limestone, clay, gypsum sand, and dolomite are Lithuania's primary natural resources, but the coastal shelf offers some 1.600.000 cubic meters of oil deposits (discovered in the 1950s), and the southeast provides high yields of iron ore and granite. At the urbanisation rate of 67.7%, Lithuania's largest cities are the capital Vilnius (549.181 inhabitants), Kaunas (287.665) and the port city of Klaipėda (148.090).

### 1. The political context and quality of institutions

Unlike the other countries in the CEE region, the Baltic states were formally incorporated into the Soviet Union after the Second World War. The Soviet era brought Lithuania intensive industrialisation and economic integration into the Soviet command economy. To some extent, the transition to a market economy in Lithuania had already started in the end of the 1980s, on the back of the Perestroika reforms in the Soviet Union. Nevertheless, in 1990, by the time Lithuania declared independence, still almost all of the labour force worked in the public sector, while the country lacked most of the relevant national institutions to implement the economic

transformation. Thus, the transition encompassed not only market reforms, but also the restoration of statehood itself.

These features allowed for a relatively radical and fast-paced nature of Lithuania's post-communist transformation, starting with a clean slate and essentially rebuilding the carcass of the state. The command economy framework in the Soviet Union was well embedded and ingrained, lacking most of the semi-market economy features of the independent socialist states in CEE. Domestic industry was almost completely detached from the supply chains of the capitalist world. In this context, Lithuania chose to start from scratch and, together with developing a new political entity, create new economic structures, rather than adopt the existing ones.

However, deep integration with the Soviet command economy also meant that dissolution from the Soviet Union was relatively painful in an economic sense, which resulted in the goal of macroeconomic stabilisation being put at the forefront. At the outset of the transition, large-scale output contraction went hand-in-hand with rapid inflation and an overall economic hardship. In 1990, right after the declaration of independence, Lithuania was subject to a 76 days long economic blockade by the Soviet Union, which encompassed gas and oil supplies and had a devastating effect. The transformation also meant radical diversification of supply chains, and an inflow of new substitutes caused large portion of domestic industry production to fail. Numerous types of industry sectors (especially in electronics and machinery) failed despite injections of public funds, loan guarantees and other measures.

As a large part of the industry in the Soviet Union was centred on the military production, its share at the end of the 1980s could have constituted as much as the quarter of the total economic output (Aslund 1990). In the context of a transition to a market economy, this particular type of capital stock in Lithuania was now rendered essentially unusable and its value significantly diminished, while efforts to refocus the industry to produce consumer goods were only partially successful.

These issues provided a fertile ground for the former communist nomenclature, which transformed itself into the Lithuania's Democratic and Labour Party, to be voted back into the government in October 1992, winning an absolute majority in the parliament. The re-emergence of the

Soviet political leaders was the defining feature of Lithuania's transition and unique in the context of the Baltic states.

One of the necessary preconditions for the election of the former communist officials was the relatively little immigration to Lithuania during the Soviet rule. Unlike Estonia and Latvia, Lithuania was essentially unindustrialised before the Soviet occupation. From the 1950s onwards, there was enough surplus labour from agriculture to supply local workers for the large-scale industrial enterprises: the titular nationality comprised about 70% of the industrial employment, in comparison to Latvia's 38% (Mygind 1997; Norkus 2008). As a result, the Lithuanian society as well as its governing nomenclature remained relatively homogenous. This meant that the Soviet officials, themselves Lithuanians, were not necessarily perceived as "foreign agents" in the eyes of the electorate of the independent Lithuania. It was a fundamentally different setting in comparison to the other Baltic states, particularly Estonia, where the local Soviet elite was removed from the political life during the transition in part due to ethnicity-based political cleavages.

The demographic factor influenced one major economic reform, namely the privatisation of small and medium enterprises and state-owned assets. In the Lithuanian case, the key difference from the other Baltic states was the chosen method of privatisation, particularly concerning the first stage from 1991 to 1995. Citizens were provided with investment vouchers which let them participate in assets selling, and employees of the enterprises were often given a preferential status. On paper, the voucher system favoured small domestic investors – including the Lithuanian labourers themselves – and a rather equal distribution of wealth. However, the chosen method proved unsuccessful. The principal outcome was that the control of the privatised companies would remain in the hands of the former Soviet era managers, while opportunities for the real and new investment and foreign capital injections would be reduced. With ex-communists now in power, the old managers were able to utilise their connections with the former nomenclature, engage in rent-seeking, and carry on with unproductive economic activities (Aslund 2002; Norkus 2008).

Lithuania's privatisation strategy was different from Latvia and Estonia, in which other means, namely auctions and tenders, were employed to sell

properties and attract foreign investors. In these countries, majority of the workers did not belong to the titular nation, so the interests of the working class were phased down. Indeed, this is in line with the observed pattern that countries with little ethno-linguistic fractionalisation tend to redistribute more relative to countries with more fractionalisation (Sturm and de Haan 2015). In Lithuania, the working class proved to be stronger in a political sense, and distributional issues were put to the forefront.

Arguably, the ethnic and political homogeneity element in Lithuania, which created the conditions for the election of the former nomenclature in 1992, and laid the ground for the relatively unsuccessful privatisation process, created a distinctive path-dependant trajectory for Lithuania in the years ahead. This may be part of the explanation why Lithuania's transition is usually not considered as successful as that of Estonia's – a theme that will reoccur in the analysis at hand.

Indeed, at first glance, both Lithuania and Estonia followed similar strategies with regard to economic transformation. In both countries, the shock therapy reforms were rapid and broad-based, and involved strict policy decisions such as establishing currency boards – in some respects the ultimate market-liberal non-intervening monetary policy (Staehr 2017).

The currency board regime in Lithuania was adopted in 1994, and Litas (the national floating currency introduced in 1993) was pegged to the USD at a ratio of 4 to 1. Arguably, the implementation of the currency board may be one of the most successful policy decisions in the initial transition period. It shielded against speculative attacks on Litas, and provided credibility to the young monetary system. Also, the fixed and stable foreign exchange rate proved to be beneficial to an open economy like Lithuania, driven by foreign trade and dependant on a wide array of imports, including raw materials and energy. The arrangement helped reduce inflationary pressures, put a downward pressure on interest rates and strengthen foreign economic relations. As a result, foreign trade and economic growth accelerated. The currency board system was updated in 2002 when Litas were re-pegged from the USD to euro.

On top of the strict yet simple and transparent monetary policy, all Baltic states have also had generally prudent but inactive fiscal policies, aiming for balanced budgets without counter-cyclical properties. This is also in the

spirit of a limited public intervention (Ibid 2017). Fiscal discipline was complementary with the currency board regime which restricted money supply in the economy: to ensure trust in the peg, the liabilities of the Bank of Lithuania denominated in the national currency could not exceed the gold and foreign exchange reserves held at the central bank.

Both the currency board and fiscal prudence were at least initially necessitated by the deep macroeconomic crisis the country was in after the collapse of the Soviet state. Leaving the rouble zone and achieving monetary stability during the initial transition period led to institutions that embedded a strict, transparent, and yet relatively inactive macroeconomic policy stance. This strengthened the spirit for government intervention, including in Lithuania.

As regards taxation, Estonia introduced a flat income tax in 1994, followed by Lithuania the same year, and Latvia the following year (at present, Lithuania's flat income tax rate stands at 20%). Consequently, the Baltic states exhibit considerably smaller governments (as measured by general government expenditures) than would be expected given their income levels.

These characteristics contributed to a dominant treatment of Lithuania (together with the other Baltic countries) as liberal market economies (LMEs) in the literature. Although there are multiple issues with such an assignment, Estonia, having earned its reputation as an "overachiever" and the most avid reformer, has been usually described as the economy closest to the ideal type of an LME. In any case, the reform choices and the resulting economic system set Lithuania and the Baltic states apart from the other countries in the CEE, which have mostly chosen a more interventionist and coordinating role for the government (Bohle and Greskovits 2007, 2012).

In the second decade of the transition, Lithuania completed the two policy goals that underpinned the domestic policy agenda for a number of years: joining the EU and NATO in 2004. The achievement of the goals set in 1990 provided a positive shock to the economy. The membership in the EU's Single Market, as well as EU's financial assistance helped spur economic expansion. One of the ways to illustrate the effect of the membership in the EU is to look at the data on international trade. In 2004,

Lithuania's exports of goods and services amounted to 40% of GDP. In 2018, the figure was larger more than twice and stood at 82.3% of GDP.

The year 2004 also saw a major stress test performed on Lithuania's political system – the impeachment of the President Rolandas Paksas, who was removed from office in April 2004 due to dealings with a Russian businessman, which violated the Constitution. Paksas became the first European head of state to be impeached and removed from office. The Constitutional Court subsequently forbade Paksas from running for public office in the country. According to Norkus (2012), the fact that an exceptionally severe conflict between the different branches of government (the parliament and the President in this case) was resolved without formally violating the legal proceedings meant that the state of democratic consolidation in Lithuania successfully underwent a major "shock treatment" (similar to "stretching", or "exposure to high temperature" to which newly produced goods are exposed in industry and engineering). In fact, the experience further strengthened the state of liberal democracy in Lithuania. The political turmoil did not distract the government from joining the EU less than a month after the ouster. It also contributed to relatively peaceful relations between the right-wing conservatives and the left-wing ex-communists, which manifested in the conservatives supporting the minority left-wing government in 2006-2008.

Right after joining the EU, one of the most consequential policy mistakes was the revision of the national regulations which allowed to substantially increase the administrated electricity prices in 2005 (Kuodis 2008). This, along with the overall overheating of the economy, contributed to the overshoot in consumer price inflation and resulted in Lithuania failing to adhere to the EU's convergence criteria, and, consequently, failing to adopt the euro before to the global financial crisis. Because of this, Lithuania had an unfavorable access to capital markets during the 2008 financial crisis compared to the euro area countries in the region. The risk premia was mainly due to the exchange rate risk, which stemmed from the possibility of currency devaluation.

This possibility was not purely theoretical. During the global financial crisis, there were a lot of speculations about re-pegging litas as a way of adjusting to the crisis and regaining external competitiveness (reportedly, this strategy was also advocated by the IMF). A mere possibility of such a

scenario would bring concrete financial cost to Lithuania, as it undermined investor confidence.

In 2015, Lithuania finally – on a second attempt – achieved another major domestic policy goal, namely membership in the eurozone. Overall, adopting the euro has proved to be beneficial to a country which previously relinquished an independent monetary policy for the sake of alternative policy objectives. The membership has facilitated trade in the Single Market, and has also decreased financing costs for both the public and the private sector (Bank of Lithuania 2013). In addition, the euro has improved Lithuania's financial safety net through participation in the European Stability Mechanism (the euro area's lending facility) as well as access to the Eurosystem liquidity. Subsequently, the latest major policy achievement for Lithuania was the accession to the OECD in 2018.

Arguably, the policy achievements and the headline growth have not always contributed sufficiently to the quality of Lithuania's institutions. For instance, in terms of the WGI's Government Effectiveness indicator, Lithuania ranked persistently below Estonia, and last stood at the 80$^{th}$ percentile in 2017. Just to compare, from 2003 onwards, Estonia would usually rank above the 80$^{th}$ percentile, and was placed at the 84$^{th}$ percentile in 2017.

The principal explanation behind Lithuania's sub-par performance in terms of public services and institutions could be the low levels of redistribution in comparison to the GDP, which remained subdued in relation to the other countries in the region, including the Baltics. In the beginning of the transition in 1995-1996, Lithuania's general government expenditure averaged 35.6% of the GDP, compared to Estonia's 40.2% of the GDP. In 2018, the share of Lithuanian government spending comprised 34% of the GDP, compared to 38.5% in Latvia and 39.5% in Estonia, as well as 41.5% in Poland and 42.4% in Slovenia.

This can in part be accounted for by the LME type characteristics of the Lithuanian model of capitalism (e.g. flexible labour markets and light employment protection), which could be complementary with a generally small role of the state. However, the institutional arrangements of the model of capitalism alone cannot explain disparities even with the rest of the Baltics.

The low expenditure level is a function of the low levels of tax revenues, which themselves are related to compliance issues as well as a large number of tax exemptions, including the reduced income tax rates applied on various economic agents (e.g. small-scale entrepreneurs). For instance, the VAT gap in Lithuania comprised 33% in 2015 (with Latvia's below 25% and Estonia's at around 15%; European Commission 2017). This represented almost 5% of Lithuania's GDP. The policy gap (reduced rates and exemptions) amounted to almost 45% of the VAT gap, with the rest explained by the compliance gap (fraud schemes, tax evasion, etc.).

The modest rates of redistribution have been an acute problem in Lithuania. The general government of Lithuania finances a wide array of benefits and services in the areas of health care, education, and social security, carrying over the state functions previously performed by the Soviet Republic (and catering to the "legitimate expectations" of the citizenry in transition). Because of the low levels of redistribution, salaries of the public sector workers, pensions and social benefits have been underfinanced, contributing to nagging issues of corruption in the public sector (for instance, it is still customary for a patient to reimburse the doctors and health service providers in cash, even if the services are formally free of charge).

Arguably, the particularly low levels of funding of the public sector have presented numerous challenges to social cohesion. They may have also provided an unfavourable turf for the development of some of the LME-type institutions, as the negative collateral damage of developing a neoliberal market-based economy were not appropriately cushioned by the welfare infrastructure. To this day, the tax and benefits system is having little impact on reducing income inequality in Lithuania. In 2017, the income of the richest 20% of households was 7.3 times greater than of the poorest 20%, reflecting the low levels of benefit adequacy (with the ratio in the EU only being larger in Bulgaria and Romania). The Gini index climbed to 37.6 in 2017, comparing negatively to the index values in Estonia and Latvia, as well as the EU average which stands at 30.3.

Inequality can also be observed in terms of regional disparities. In 2017, the median incomes of rural households were only 67% of those of urban households, one of the lowest shares in the EU (European Commission 2019). This has translated into corresponding political cleavages, with the

grievances of the "losers" of the transition being mobilised by forces that operate most effectively in rural areas and smaller urban centres. The parliamentary election in 2016 saw the Lithuanian Farmers and Greens Union, an agrarian political party led by an industrial farmer, being elected into the government. The party was particularly successful in the single-seat constituencies, where it outperformed the centre-right conservatives who won the nationwide ballot but only captured a handful of single member constituency seats, mostly in urban areas.

The overall social response in Lithuania to the issues outlined above consisted of high rates of emigration and relatively low birth rates. The net migration has been declining recently and amounted to -3.292 persons in 2018; however, during the financial crisis it constituted as much as -77.944 persons in 2010, a number that would comprise the 6th largest city in Lithuania (OSP 2019). Since 1990 the number of residents living in Lithuania has dropped by 883.000 people, which constitutes approximately 24% of the population. The demographic decline remains one of the main challenges to Lithuania's long-term growth to date.

## 2. The general economic outlook

The defining feature of the initial transition period in Lithuania was the combination of a rapid rate of annual inflation, as well as a freefall in economic output. Prices were rising by 382.7% in 1991, as much as 1162.6% in 1992, and 188.7% in 1993. In part, the rapid inflation was the result of price liberalisation, as well as the increase in energy prices and the increased money supply in the Soviet Union. However, the very source of the issue lied in the command economy structure of the past. The macroeconomics of the Soviet consumer goods market could be characterised by repressed inflation and, therefore, forced savings (Kim 1999). These were due to the persistent mismatches between the incomes earned and paid, whereby the salaries are higher than the income actually earned in the economy. In the context of price controls and the resulting deficits of consumer goods, the forced savings added to the monetary overhang and substantially increased the demand in later periods. Price liberalisation allowed for the surplus in savings to flow freely into the consumer market.

The drop in Lithuania's GDP could have amounted up to 63% in 1989-1993 (Economic Commission 1998). Nevertheless, such estimations of the size of the contraction have probably been exaggerated. At the beginning of the transformation, the official statistics of post-communist countries failed to adequately assess the impact of novel economic activities and the large number of newly-established companies on the GDP. At the same time, the size of the economy during the Soviet period was well overestimated, simply because the system of centralised planning created incentives to produce larger production data due to premiums for ministers, managers and workers being dependent on the gross output.

Lithuania returned to growth in 1995-1996, but it was interrupted again at the onset of the Russian financial crisis in 1998-1999. The crisis was a major stress test for the Lithuanian economy. However, it allowed Lithuania to achieve a transformative and positive outcome, as Lithuania's export markets shifted from East to West as a result of the turbulence. Exports to the countries of the Commonwealth of Independent States made up 45% of total Lithuanian exports in 1997 and 35.7% in 1998; this share dropped to 18.2% in 1999 (Bank of Lithuania 1999). The reorientation of the exports markets created incentives for the companies to produce higher quality and higher value added goods. Due to this, the shock of 1998-1999 was followed by Lithuania's economy coming back to the path of sustained growth.

On the back of the export diversification, further structural reforms and the boost provided by the accession to the EU, Lithuania was able to put up impressive growth numbers from 2000 right up to the global financial crisis. Given that growth tempos were similar in all three Baltic states, the term "Baltic Tigers" was born to describe the fast-pace convergence of the three countries. During the period 2000-2007, Lithuania reduced its distance vis-à-vis EU15 by 21.6% in terms of purchasing power adjusted real GDP per capita (from 32.2% to 53.76% of the EU15 average).

However, it has since been clear that growth in the 2000s was above potential, and the economy was overheating. Subsequently, the global financial crisis wiped out 14.8% of the Lithuania's output in 2009. Nevertheless, the country managed to bounce back again and avoided the double-dip recession seen in the large part of the euro area. During crisis period, Lithuania decided not to devalue its currency. Its response instead

featured a strategy of "internal devaluation" underpinned by a front-loaded fiscal austerity, nominal wage reduction and structural reforms to regain competitiveness (Purfield and Rosenberg 2010). Firms were able to cut spending and salaries or quickly liquidate their operations, which was in part possible due to the absence of powerful labour unions.

In a way, the crisis catalysed Lithuania's entry into the euro area. Lithuania's response showed to European policy makers and investors that Lithuania was able and willing to adjust to crises without currency devaluation – and by following an adjustment path similar to that in the euro area countries.

Moreover, the fall in aggregate demand, combined with fiscal consolidation, helped reduce inflation. After the crisis period was over, the economic expansion was much more in line with fundamentals, which helped achieve Maastricht-compliant price level growth. The Law on Fiscal Discipline was put in place to safeguard against an excessive growth in general government expenditures. For its part, the Bank of Lithuania introduced a set of macroprudential instruments to prevent unsustainable expansion of credit and real estate prices that characterised the pre-crisis period. All this opened a window of opportunity for euro adoption which finally happened in 2015.

Turning to the numbers, in the period 2010-2018, Lithuania was growing at a relatively sustainable rate, with overall increase in the real GDP per capita of 47.8% (compared to 44.7% in Latvia and 37.3% in Estonia). The hasty per capita expansion can be explained by the fact that Lithuania was able to achieve stable output growth despite the relatively fast pace of demographic decline (amounting to 11% in the period 2010-2018).

In 2018, the purchasing power adjusted real GDP per capita in Lithuania stood at 81% of the EU28 average, equalling Estonia for the first time in Lithuania's transition history. Overall, Lithuania has experienced a very rapid (although somewhat erratic and volatile) catch-up with the standards of living found in the "old" member states of the EU. On many fronts it has done comparatively better than a number of CEE countries beyond the Baltics, including Poland and Hungary.

What is the general economic/production framework under which Lithuania has been able to achieve these economic outcomes? In terms of

Lithuania's model of capitalism, it represents a mixed case, falling somewhere between the Anglophone market-based model and the Mediterranean model, as defined by Amable (2003), with features of a dependent market economy (DME), as defined by Nölke and Vliegenthart (2009).

In fact, a large part of the literature has assigned Lithuania to or claimed its convergence with the LME model (Buchen 2007; Norkus 2008; Adam *et al*. 2009; Hancké 2010). Indeed, some of the important dimensions bear large resemblance to a typical LME-type economy. For instance, the labour market in Lithuania has been notable for the modest role of trade unions and the very low coverage of collective agreements. Trade union density rate historically has been below 10% and last stood at 7.7% in 2016, according to the ILO data. Similarly, the collective bargaining coverage rate only amounts to 7.1% (ILO 2018).

In 2017, the new Labour Code entered into force, which also relaxed some of the formal employment protection. The legislation decreased the notice period and severance payments in case of redundancy. In any case, the formal labour-market regulation in the Baltic countries was not indicative of the true situation (Eamets and Masso 2005; Vilpišauskas 2009). A lax enforcement of the regulations meant that the Lithuanian labour markets should be seen as particularly flexible, which is consistent with the market-based/LME-type model. Subsequently, flexible labour market has translated into weak employer-employee interdependence. Average job tenure duration in Lithuania (the length of time workers have been in their current or main job or with their current employer) was 7 years in 2017. This was lower than 8.2 years in Estonia, 8.5 years in Latvia or 11.8 years in Slovenia (OECD 2018).

In terms of the welfare state, the government made efforts to expand social protection on the back of the overheating economy prior to the global financial crisis; these efforts were cut short by the fiscal consolidation implemented as a response to the recession. As a result of this, the "hybrid" nature of Lithuania's welfare system has strengthened, as it has been increasingly trending towards a targeted model with the most wide-ranging means-testing among the Baltic states (Aidukaite 2013). In 2016, Lithuania spent only 15.4% of the GDP on social protection, which was one of the

lowest shares in the EU (compared to 16.6% in Estonia or more than 23% in Slovenia).

Despite these characteristics, Lithuania does not entirely fit into the LME classification on a multiple key dimensions. The first striking difference of from a pure LME type is corporate governance, which is somewhat more similar to the Mediterranean model. Lithuania's economy can be characterised by a large ownership concentration in firms, as opposed to dispersed ownership patterns observed in the Anglophone countries. Moreover, the major shareholders often have great influence on the management of the company (Norkus 2008). Such patterns of corporate governance are consistent with the fact that Lithuania features a large SME share in the economy.

The type of corporate governance and firm type dominant in Lithuania was predetermined by the fact that the country lacks a developed financial market, a particularly important element to the vitality and dynamism of an LME. Market capitalisation of listed domestic companies in Lithuania only amounts to 7.4% of the GDP, down from the peak in 2005-2006, when the figure reached about a third of the domestic output. The figure compares to a meagre 2.5% of the GDP in Latvia, and 10% in Estonia (CEIC 2019). In all the three Baltic states, there was an L-shaped decline in market capitalisation at around the global financial crisis. The domestic banking system plays the primary role in financing Lithuanian corporate sector, with the stock of loans to non-financial corporations amounting to almost 20% of the GDP. In this regard, Lithuanian capitalism is closer to the Mediterranean type rather than the market-based model, with trends clearly showing the lack of convergence towards an LME-compatible role of the financial markets. This relates to yet another issue in characterising Lithuania as an LME: it is a net importer of capital (a feature of a dependent market economy).

The described traits of the Lithuanian capitalism underlie the lack of innovation capacity by firms. Due to this, applying the VoC innovation dichotomy (incremental vs radical) becomes complicated with respect to a country which lacks overall capacities to innovate, create and export new or modified technologies. That is the reason why Hall and Soskice (2003) claimed that Mediterranean economies, being mixed-type systems, would *ceteris paribus* eventually converge towards one of the two ideal types,

instead of representing a separate and stable model of capitalism (as in the Amable typology). As a consequence of the low R&D intensity, Lithuania has not been exporting high-technology goods, but has instead focused on services, as well as resource- and unskilled-labour-intensive products (Bohle and Greskovits 2007).

Thus the main elements of the Lithuanian model seem to be the following: comparative advantage in services, as well as manufacturing of low-to-medium complexity, resource- or unskilled-labour-intensive goods; low levels of innovation and particularly low private sector investments in R&D; concentrated firm ownership structure with a large role of the SMEs; low barriers to firm entry and intensive product market competition; underdeveloped financial markets, and, as a result, sizable FDI in financial intermediation; flexible labour markets and weak loyalty of the employees; training systems increasingly oriented towards general skills (Martinaitis 2010); small share of government welfare spending (consistent with low employment protection).

A certain degree of complementarity can be observed in this regard. Lithuanian firms do not generally pursue high-value added production, and salaries constitute a large share of production costs. Therefore, the corporate sector has to some extent been the beneficiary of the relatively low labour costs, low unemployment benefits and underdeveloped industrial relations.

Taking the Lithuania's production profile into account, workers have had little incentive to invest in sector-specific skills. Notably, creating incentives for the workforce to develop specific skills generally requires employment and social protection in the form of a relatively generous welfare state (Iversen *et al*. 2001). This is because investing in specific rather than portable general skills is risky. It increases the worker's dependence on particular employers as well as the overall vulnerability to market fluctuations. Given the risk of the investment, the welfare state (the wage protection, the unemployment protection, etc.) must act as an insurance mechanism.

However, in Lithuania FDI has not been targeted at immovable assets in manufacturing which would require repressed labour mobility and incentives for firm or industry specific skills formation. Therefore, a

generous welfare state would be less complementary with the Lithuanian form of capitalism as opposed to some other countries in CEE, e.g. Slovenia. In fact, FDI has primarily flowed into financial intermediation, and in particular the banking sector. This allowed for an increased credit supply for the households and the overall economy, thus partly compensating for the low pay in the low skilled labour-intensive sectors (Drahokoupil and Myant 2010).

Moreover, the Lithuania's production regime is also somewhat complementary with Lithuania's macroeconomic course. The strict monetary regime (the currency board, and the adoption of the euro in 2015) has been compatible with the dominance of the SMEs, which require a general framework of macroeconomic policy stability. This can be put in contrast with the potential needs of domestic large-scale industrial complexes. Had interests of large industries been able to dominate the Lithuanian landscape, they may have required a flexible macroeconomic protection in the form of depreciated exchange rates to manage competitiveness. In addition, the presence of a large industrial base is more consistent with a lax fiscal policy which can finance the generous welfare state, thus creating incentives for the workforce to invest in sector-specific skills. Instead, the prudent fiscal policy of Lithuania that emphasises balanced budgets has been provided on the back of the low level of social protection.

Finally, as emphasised by Kuokštis (2011), flexibility of the labour market, weak social protection and the uncomplicated and centralised firm governance structure allowed for the Lithuanian firms to carry out "internal devaluation" during the crisis, that is cut nominal wages or liquidate operations altogether. In turn, this made it possible for the Lithuanian authorities not to devalue the national currency, as well as to stick to the currency board regime.

Overall, the present institutional configuration of the Lithuanian model of capitalism does not seem to have put the country on a path of convergence with a model of capitalism compatible with radical or incremental innovation. On the contrary, the apparent coherence of the current institutional design may lock Lithuania in the current set-up, compatible with a comparative advantage in services, as well as manufacturing of low-to-medium complexity, resource- or unskilled-labour-intensive goods.

## 3. The quality of entrepreneurship

One of the areas in which Lithuania was particularly successful in terms of developing its model of capitalism was building business-friendly institutional environment and developing product market competition. This has also been reflected in the WGI indicator for Regulatory Quality. For most of the 1996-2017 period, Lithuania ranked above the 80th percentile in the sample. Here again, Estonia has been the top performer in the Baltics, finding itself at the 92nd percentile already in 2008 and at the 93rd percentile in 2017. Nevertheless, Lithuania's relatively good performance can be explained by a high emphasis on implementing a level playing field, competitive environment for business, and trade liberalisation throughout the transition.

Based on the 2018 OECD's Indicators of Product Market Regulation, Lithuania is among the top performers in the OECD, ranking at the 6th place with regard to the aggregate score on competition in the product markets. Although its performance has been sub-par in terms of the distortions induced by state involvement (regarding public ownership or involvement in business operations), Lithuania ranks 1st in the OECD club with regard to the barriers to domestic and foreign entry (regarding the administrational burden on start-ups or barriers to trade and investment). For instance, legislative changes between 2014-2016 enabled entrepreneurs to start a business online and establish limited liability companies without minimum capital.

Lithuania has also ascended in the World Bank's Doing Business index. Ranking at the 14th place in the 2019 Doing Business score, it now leads the entire CEE region. The country last received particularly favourable scores regarding the ease of registering properties, contract enforcement and dealing with construction permits. Historically, Lithuania performed well in the World Bank's ranking; for instance, it was placed at the 15th position in 2005.

Arguably, the favourable business environment in Lithuania is a result of a consistent policy implementation, despite the leanings of the political forces in the government. In fact, the ex-communists who won the 1992 election were among the greatest deregulators at the beginning of the transition, which helped Lithuania gain a reputation as one of the poster

boys for the Washington consensus (Aslund 2015). Later on, reforms fostering competition were spurred by the need to harmonise with the business environment in the EU so as to enter the fifth wave of the EU enlargement in 2004. In 2018, Lithuania also joined the OECD, which provided an additional positive reform stimulus. Overall, accession conditionality yielded positive progress in terms of institutional convergence. Nevertheless, the shadow economy (estimated at 18.7% of GDP; SSE Riga 2019) remains a key issue in creating a level playing field for business enterprises, especially as regards the widespread use of the so-called envelope wages (paid in non-taxed cash).

As noted, Lithuania's model of capitalism is characterised by business ownership concentration. A popular legal corporate form is the private company, whose owners are also the managers of the enterprise. The stocks of such enterprise are not traded in the stock market. In this regard, capitalism in Lithuania is different from both the LME "stockholders" model, where corporate control over managers is ensured by the existent incentives mechanism stemming from competition and takeover threat, and from the CME "stakeholders capitalism", where managers can be supervised by the stakeholders with vested interests, e.g. the banks that provide financing (Norkus 2008).

Consistent with this, SMEs dominate the business landscape in Lithuania (e.g. in terms of turnover), much more so than in the other CEE countries (which still have large-scale industrial / manufacturing enterprises). Lithuania features a significant SME share of employment in total employment (75.9% in Lithuania, 79.4 % in Latvia and 78.2 % in Estonia). SMEs also produce a comparatively large share of value added in the economy, and their turnover share has been well above the EU average. Given the large role of the SMEs and the importance of a level domestic market competition for their functioning, developing a competition-friendly environment has been the focus during the transition.

## 4. Modernisation based on FDI

At the beginning of the transition in 1991-1995, Lithuania underwent a relatively unsuccessful spell in privatisation of state-owned assets. The chosen method meant that citizens were provided with investment vouchers to participate in the selling of assets. The measure showed to be

unsuccessful, as the control of the privatised companies would usually remain in the hands of the former Soviet managers, while opportunities for foreign capital injections were reduced. The other Baltic states applied an approach more targeted towards auctions and tenders, and thus attracted foreign capital.

Despite the rocky initial start, Lithuania still managed to attract significant foreign investment inflows. The total stock of FDI stood at 34.3% of the GDP at the end of 2018 (Bank of Lithuania and Statistics Department 2019). It has risen significantly from 1992 (1.33%), with membership in the EU providing an additional stimulus for FDI inflows. However, the current figure is still smaller in comparison to Estonia (around 90%) or Poland (around 45%) (UNCTADSTAT 2018). In terms of the FDI patterns, the investments primarily flow into financial intermediation and insurance services (as opposed to manufacturing, which has been the sector attracting the most FDI in other countries in the CEE region, e.g. Slovenia). It thus could be concluded that Lithuania lost the competitive struggle to attract FDI into high value-added manufacturing industries.

As a consequence of these FDI patterns, one feature of Lithuania's domestic banking system is that it has been dominated by foreign-owned banking entities. Almost 83% of the banking sector assets belong to the subsidiaries and branches of the Nordic banks, while the level of concentration is the third-highest in the EU (Bank of Lithuania 2019). Arguably, this type of market concentration as well as financial sector interconnectedness with the Nordic region poses financial stability risks should imbalances in the Nordic countries undergo a correction. At the same time, the interests of foreign-led financial sector may have contributed to the strict and stability-oriented monetary and fiscal regimes in Lithuania.

The ownership concentration in the banking sector has encouraged the recent drive of the government and the Bank of Lithuania to promote FinTech-friendly environment in the country, both through legislative work as well as various specific measures by the supervisor (such as streamlining licencing procedures). This has resulted in a fast growth of the FinTech sector in the country, with an increasing number of foreign entities beginning their operations. Over 2018-19, Lithuania has been placed second in the EU in terms of the number of electronic money institutions.

Authorities hope that FinTech can become the catalyser of high value-added FDI inflows to Lithuania.

Overall, dependence on foreign capital and relatively large share of foreign ownership means that Lithuania has some features of a dependent market economy (DME). However, it still differs from DME in many dimensions, both in terms of comparative advantage (Lithuania does not specialise in the assembly of semi-industrial or high-complexity goods), and in terms of institutional characteristics, e.g. employment protection, industrial relations and skill orientation.

## 5. The knowledge sector

Lithuania's export structure (analysing the flows of goods of Lithuanian origin) is dominated by the low-to-medium complexity production with limited value-added, including furniture, fertilizers, and food products (OECD 2019). In fact, evidence of a "low-quality trap" can be found for Lithuania as regards the low-end specialisation within industries, relying on low-cost factors of production rather than innovation-led growth.

For instance, the growth in the export share of highest-complexity products has essentially stalled. In 2018, Lithuania had a 7.9% share of high-tech exports in its total exports. This share had increased by only 0.6% since 2006. It remained well below the EU28 average (17.9% in 2018), and below Estonia's figure (11.5% in 2018). Therefore, there has so far been little reason to claim that Lithuania is moving out of its current production profile into a more complex one, thus converging to a pure LME-type economy. The more positive dynamic has been Lithuania's ascend in the European Innovation Scoreboard. Only Estonia has achieved the ranking of a "strong innovator" in the Baltics. However, Lithuania, a "moderate innovator", has been moving up in the rankings since 2010, and the country last ranked 20$^{th}$ (which marks a rise from the lower-end positions occupied in previous years). The recent improvements in large part relate to increasing business expenditure on non-technology innovation and venture capital investment. The government has also supported the knowledge sector through financial incentives (in particular, an R&D tax credit for enterprises) and regulatory measures.

The share of the R&D expenditure as a percentage of GDP in 2017 was 0.89% in Lithuania, below the EU 2020 target of 1.90%. For Estonia, the

share was 1.29%, almost two thirds of the EU28 average, which is more compatible with the ideal LME model. Notably, the private sector spending has not effectively catalysed the public R&D spending: a notable characteristic of Lithuania is that government spending on R&D has been larger than the EU average (0.25% of GDP versus 0.23% of GDP in 2017); however, the business enterprise sector spends only 0.32% of the GDP, well below the EU average.

Overall, innovation outcomes in Lithuania have been generally disappointing, especially in business R&D expenditure and innovation activity, signalling lacklustre involvement by the private enterprises (IMF 2017). There are number of issues that lay behind these tendencies. First, the financing of R&D in Lithuania is also skewed toward the public sector. The largest share of the financing has been directed towards supporting infrastructure and knowledge base of the public sector, while incentives for business R&D receive less attention. Most R&D activities in Lithuania take place within public universities and R&D institutions, dependant on public funding flows. Research products are not supported with sufficient marketing or commercialisation efforts.

Second, the issue of skills mismatch has been gaining prominence. One third of companies in manufacturing industries agree that they lack engineers, technology designers, and other specialists for their research and innovation activities (Paliokaitė *et al*. 2018). To this end, there have recently been attempts to restructure the higher education system. In June 2017, the parliament approved a resolution to optimise Lithuania's public universities, merging the existing higher education institutions into two comprehensive universities in Vilnius and Kaunas, in addition to regional science centres. However, the ambiguity of the plans proposed so far means that there has been little progress as regards the consolidation of existing universities.

Finally, the institutional framework of innovation promotion has been highly fragmented, although recently there have been efforts to centralise innovation policy under the Ministry of the Economy as the lead institution. The R&D infrastructure is scattered across different universities, institutes, innovation clusters and science and technology parks.

The fact that Lithuanian companies are facing a shortage of R&D financing also relates to the issue of underdeveloped capital markets, with only few alternatives to bank financing. Moreover, the Lithuanian high-tech firms tend to be small in size and value added, consistent with the observed dominance of the SMEs and the prevailing type of firm governance discussed in previous sections. This further limits the scope for R&D investments (high-tech manufacturing amounts to 4% of total value added in the economy; Ibid 2018).

Finally, some of the institutional features of Lithuanian capitalism (e.g. low levels of social expenditure, low employment protection) helped maintain low unit labour costs and create a comparative advantage in production based on efficiency rather than knowledge. Indeed, innovation and knowledge sector outcomes can be explained by the particular model of capitalism of Lithuania, which lacks institutions that would be favourable to either incremental or radical innovation.

## 6. The public opinion and attitudes towards transformation

One of the ways to assess Lithuanian public opinion with regard to transition is to analyse attitudes towards life under the Soviet rule. Among other things, these attitudes have been shown to be a good predictor of party allegiances: indeed, electoral choices of the population and consequently the national party system can be best explained by the cleavage in positive versus negative perceptions regarding the Soviet past (Ramonaitė 2007). Crucially, this is also the case with the views towards the contemporary capitalist regime as well as the state of democracy in general.

Looking at the survey results from a longer-term perspective, the share of pro-Soviet attitudes has been on a consistent decline. Around a quarter of Lithuanian population last tended to agree that life was better in the former Soviet Union as opposed to the current Republic of Lithuania (EESC 2017). This can be compared with the 44.4% share in 2004, meaning that viewing the Soviet past in a positive light was still a dominant sentiment 16 years ago. Nevertheless, this share has been decreasing except for a small bump upwards following the financial crisis. At the same time, the number of people having negative views towards the Soviet regime has been increasing.

Historically, pro-Soviet attitudes have been most pronounced among the older parts of the population. According to some of the latest figures, almost half of the retired members of the society feel worse-off than under the Soviet regime. Importantly, studies have shown that such attitudes are best explained by subjective individual perceptions of changes in the respondent's social status (Ramonaitė 2013).

Arguably, persistently high levels of inequality and rapid changes in the national production regime may have left the older generation feeling left out and unable to access the fruits of the newly-found economic growth. For instance, Lithuania's economy has essentially transitioned from an industry to a service-based growth model, with the service sector value added contributing as much as approximately 70 % of the GDP (with the share growing approximately 10% over the last couple of decades (Galdikienė 2016). Moreover, there have been significant changes in the composition of industrial activities. This could have had an impact on both the real and perceived changes in the socioeconomic position of a large part of the population, including the industry workers that were unable to apply their sector-specific skills in the independent Lithuania.

Despite the relatively high shares of positive attitudes towards the Soviet past, their consistent decline has generally coincided with the increase in the positive attitudes regarding the EU. In 2018, trust in the EU in Lithuania was highest among all the Member States (Eurobarometer 2018). These attitudes are often reflected in the context of the specific areas of EU's integration. For instance, an overwhelming majority (as much as 95% of the population) in Lithuania support the free movement of people. In turn, satisfaction with life has been increasing among Lithuanians since joining the EU. More than two thirds of the population are now satisfied with the life they lead. Crucially, this is up from approximately half at the beginning of the membership in the EU.

However, Lithuanians have displayed unfavourable attitudes towards the membership in the eurozone. Only a minority of respondents say that having the euro is a good thing for the country; the latest figure of 42% was in fact lowest in the euro area (Eurobarometer 2018). The inability to gather support for the common currency has so far been one of the main failures of Lithuania's authorities in terms of shaping public attitudes towards Lithuania's economic transformation. Here again, one of the possible

underlying explanations is the persistently high inequality, which has not been decreasing despite the (legitimate) expectations of higher prosperity on the back of the euro adoption. The euro has also been perceived as the catalyst of relatively high inflation in Lithuania, although in reality increasing prices have mostly been a function of a general process of convergence with the more advanced economies. Overall, in the period 2015-2019, nominal wages in Lithuania grew over five times faster than prices – and yet, for the general population, it has been easier to associate the euro with increasing prices much more than with faster growth and increasing wages.

## Conclusions

Lithuania's transition, although somewhat volatile, has generally been successful – and, looking at the headline figures for growth and GDP per capita, can even be considered a true success story in the CEE region. Lithuania achieved all the major policy goals related to the Westwards-oriented transformation, such as membership in the EU, NATO and the euro area. Having attained the hard-fought macroeconomic stability at the beginning of the transition – on the back of swift, credible, predictable, yet also radical market-liberal macroeconomic policy making – Lithuania was able to withstand the global financial crisis and return to sustainable and relatively fast-paced growth right up to the COVID-19 shock.

Fast-paced economic expansion in Lithuania has been achieved in part due to its strong record in creating a transparent and stable framework for intensive product market competition, which underpins its model of capitalism, characterised by flexible labour markets, FDI flows into financial intermediation, as well as a strong role for the SMEs. However, despite achieving favourable economic outcomes, Lithuania is yet to address two major issues that it has not resolved on its transition path. First, Lithuania still has to tackle the issue of inequality, which to a certain extent stems from low redistribution levels in the economy that have remained subdued in relation to the other countries in the region, including the Baltics. Inequality poses risks not only to social cohesion, but also growth and economic sustainability itself. Second, due to the observed patterns in FDI and R&D intensity, Lithuania's model of capitalism does not seem to be compatible with neither radical nor incremental innovation. This also

puts into question the sustainability of the economic trends that Lithuania has enjoyed so far, and poses a risk of stalled convergence.

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## 3.3 The Southeast European States

### 3.3.1 Bulgaria

Miklós Szanyi

### Introduction

Bulgaria is a small country in the Eastern Balkans at the South-Eastern shore of the Black Sea. Its area is 108.560 square kilometers mixed terrain with fertile arable landscape in the North (Danube basin) and East, and mountainous terrain in the central and Western parts of the country (25% of the area, e.g. Rodope Mountains). Today the population of the country is 7.050 thousand inhabitants, down from its peak of almost 9 million in 1987. The change of the population is due to declining birth rates and most importantly massive outmigration. Estimations state that some 1-1.2 Million people moved from the country to other locations between 1990 and 2005, mainly young active population. This process poses serious threats for the Bulgarian economy even in the short run. Concerning the process of aging, the statistical figures already show the negative consequences: the age cohort 65+ included 21.0% of total population in 2018, meanwhile children (aged 15-18) accounted to only 14.2%. Largest cities were Sofia (1.236 thousand inhabitants), Plovdiv (343 thousand) and Varna (335 thousand). In total 74.67% of the population was urban (2017).

### 1. Political context and quality of institutions

Bulgaria has a rather turbulent history. The current country is the third Bulgarian state. Bulgarians lived several centuries long under Byzantine rule, then, after a brief period of independence under Ottoman rule. Both big empires left their legacy in the country. Therefore, the cultural, political and economic heritage of the country was fairly different from the "mainstream" Euro-Atlantic models (Djankov and Hauck 2016). Hence, the Bulgarian variant of the capitalist models is also very peculiar, it is a mixture of Western-type institutions in Eastern-type environment. This means that some of the standard Western institutions like property right enforcement bodies do not work here in the same manner than in core

Europe. This is also reflected in the various synthetic measures. Close ties, paternalism and cronyism marred this capitalist model. It is somewhere in between the Mediterranean and the Russian model, with much weaker state than in this later one. In fact, business-polity relationships have always been a problem area in the country, with corrupt business taking the lead over politics (Schoenman 2014). Corruption, organised crime, and the resulting state capture position (Hellman *et al.* 2000; Wedel 2001; Innes 2013) are still very problematic, and the European Union keeps on controlling Bulgarian efforts at eliminating the issues in the country (Appel and Orenstein 2018). Some progress has been achieved, but the country is by far not free of the problem (Racovita 2011).

Another important caveat of the historic development path is the area of human and social development. The mass scale migration out of Bulgaria is a very serious problem for the country (Krastev 2002), even if dissidents support their relatives through remittances that contribute to the stimulation of the economy. Yet, the steady decline of the active population has led to serious labour shortages, which is a primary impediment of future economic growth. The human endowment problem is exacerbated through the byzantine-type of society. Personal ambition, entrepreneurship but also the desire to be tapped in the most current updating of social and economic life is not strong enough in the country. Moreover, it is the more receptive young generation which moved abroad. Thus, the Bulgarian society is rather slow to join global modernisation tendencies. This is also clearly seen in the DESI (2018) figures.

Bulgaria was rather underdeveloped country compared to other socialist countries before the transition process. Forced industrialisation created important metallurgical capacities and also some other manufacturing activities were launched (e.g. in machinery industry: fork lifts production, electrical industry: types of personal computers and radio transmission devices), but the bulk of the country's industry was still specialised in garment and footwear, as well as food industries. All these industries became crisis industries already during the 1980s, before the transition process was started. Therefore, due to the lack of competitive activities quick liberalisation (70% of prices were liberalised in 1989) produced serious transformational recession in the country. This also created high inflation, that peaked by 330% in 1991 (Bitizenis 2003).

The Bulgarian governments could not avoid massive unemployment and impoverishment through other means than the subsidisation of loss-making industrial firms. The state-owned banks also continued lending and accumulated huge amounts of non-performing debt portfolio. This policy could not be maintained any longer than 1996/7, when the Bulgarian economy collapsed and inflation started to soar again (900%). The macroeconomic stability was restored with the introduction of currency board to stabilise the Bulgarian currency and tightening of the prudential regulations of commercial banks (Bitzenis 2003; Barlemann *et al.* 2002). The stabilisation program was also supported by the International Monetary Fund. IMF extended conditional loans to Bulgaria. Financial sector privatisation was to be accelerated (Pop-Eleches 2009).

As far as privatisation policy is concerned, only slow efforts were made by the 1992 funded Privatisation Agency (PA) and the responsible branch ministries. The otherwise also rather unattractive Bulgarian firms were not foreseen to be sold on open tenders. PA rather wanted to consolidate them before deciding how to privatise. The consolidation of firms was not successful since economic policy did not have any credible device during the 1990s to enforce corporate restructuring. Instead, continuous subsidisation of the loss-making companies occurred with no serious restructuring efforts. When this expensive way of maintaining jobs could not be financed any more, firms went bankrupt on a mass scale in 1997. Up till then, practically only a kind of mass privatisation effort was effectively carried out in late 1995, but this action did not change the situation of the state sector (Bitzenis 2003).

The development of the private sector did not root in privatisation but rather in misusing incompetent banks loose crediting activity. Inadequate levels of banking skills and loose prudential regulation topped by high level corruption enabled some Bulgarian would-be oligarchs to take huge loans under fraudulent conditions from the commercial banks. Similarly to the establishment of Russian oligarchy, many Bulgarian tycoons also started their capital accumulation process using illegal or at least fraudulent transactions. Although Bulgaria made some efforts to limit corruption and organised crime, and also to stabilise the economy, the most important measure of these efforts, the EU accession, was postponed to 2007 (Appel and Orenstein 2018). Even then Bulgaria had to set up appropriate agencies under the EU control to curb corruption and organised crime. Property

rights are still not well protected. The judiciary in Bulgaria's "flawed democracy" relies on legal and institutional reforms demanded by the EU accession process, but effective gains in efficiency and accountability continue to be lacking (Krastev 2002). The court system is not trusted by citizens that gives rise to "alternative dispute management practices" and criminal activities. The government's half-hearted efforts to combat corruption remained with moderate success. The policy of political conditionality pursued by the EU and the IMF negatively affected the governments' domestic power base (Simmelfenning and Sedelmeier 2005). Organised crime is heavily involved in human and narcotics trafficking and smuggling (Racovita 2011).

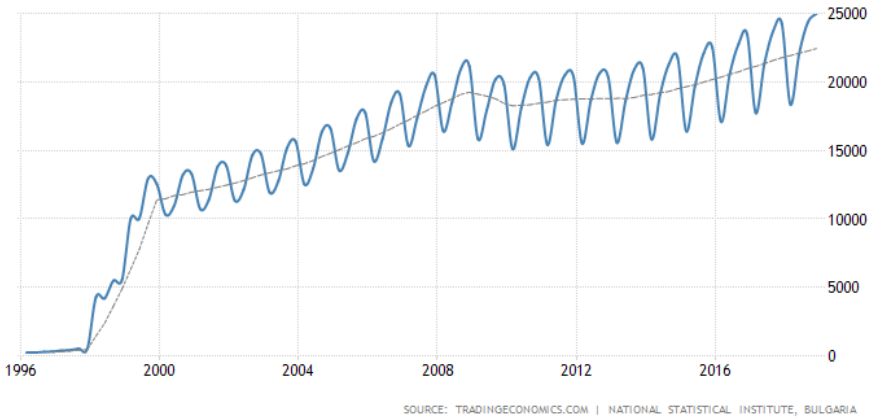
World Bank (2018) governance indicators shows mixed development tendencies in the case of Bulgaria. The country could significantly improve its position in two important indicator groups between 2007-2018. In political stability and absence of violation its ranking increased from 56 to 60. Government effectiveness improved even more significantly: from 54 to 64. Regulatory quality improved from the relatively high 71st to 73rd position. The rule of law indicator and control of corruption remained unchanged (around 50). This is bad news, because these areas have always been important bottlenecks of Bulgarian development that was criticised by global institutions and the European Union as well. Unfortunately, the voice and accountability indicator declined from 68 to 59 after 2007. This means an important decline in the perceptions of the extent to which citizens are able to participate in selecting their government, as well as freedom expression, association, and a free media.

## 2. General economic outlook

The growth performance of the country has been rather whimsical. The World Bank (2017) database shows that during the transformational crisis that started in 1989 and lasted until 1993, GDP declined by over 25.6% only to recover rather slightly between 1993-1998 by 10%, when the Russian currency crisis pushed back the economy again by 8% (EBRD 2000). The early 2000s showed rather vivid economic growth with 4-7% annual rates, thus by the year of the country's accession to the European Union (2007) economy finally recovered to the pre-transition level of output. The 2008 global financial crisis hit the Bulgarian economy again producing 3.6% decline, which was then recovered in the following two

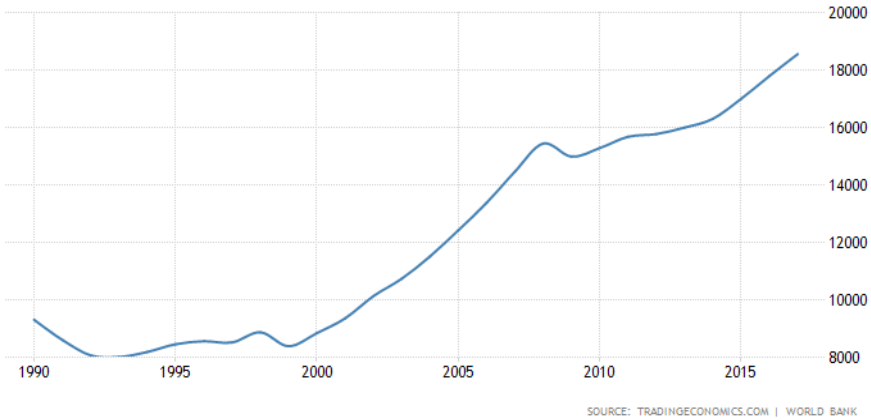
years. The Bulgarian economy showed more stable and significant growth in the years 2015-18 with rates between 3-4%. The 10 year average growth rate was 1.9% in 2018. GDP per capita at purchasing power parity was 49% of the EU average in 2017, up from 37% in 2006. Taking into account the relatively modest GDP growth performance of the country, the increase could be traced back to the massive decline of the denominator (declining population).

**GDP of Bulgaria (BGN Million, constant prices).**




**GDP Annual Growth Rates (%).**

**Per Capita GDP in USD, PPP (1990-2018).**




Bulgaria used to be a mostly agrarian land. As a member of the Soviet bloc, forced industrialisation took place also in this country producing important facilities in mining and metallurgy, engineering and food industry. Much of the heavy industry collapsed during the years of transformational recession. Instead services gained importance also through the entry of multinational firms in trade, telecommunication and banking. Agricultural employment still maintained much importance employing 17.7% of the total labour force in 2018. Industrial employment remained relatively stable with 25.4% (manufacturing 19.6%). Services (including community services) employed 56.9%.

Fiscal and monetary stability have not always been primary targets of economic policy in Bulgaria. The governments during the 1990s repeatedly accumulated high state debt in their fruitless effort to consolidate ailing big business and loss-making banks. Instead of tightening fiscal discipline, paternalistic linkages have survived in a new political manner. This conflict avoiding behaviour and the accumulated high debt and hyperinflation of course strongly limited the country's chances to successfully complete the EU accession requirements. In fact, accession occurred without the full implementation of the acquis (Racovita 2011). The systemic weaknesses of the country required continuous monitoring, especially in the field of corruption and organised crime. Fiscal stability, on the other hand, was successfully restored and maintained throughout the 2010s.

Fiscal discipline of Bulgaria is clearly shown by the country's most recent macroeconomic data. In 2017, Bulgaria run fiscal sufficit (+1.1%), and the debt burden was also well beyond the Maastricht criteria representing 25.6% of the GDP. With these figures Bulgaria has become one of the macroeconomically most stable countries of the European Union. As it was already shown by the relatively low social expenditure, Bulgaria moderately centralises the spending of GDP, and state redistribution is not particularly high. Total government expenditure was 35.1% in 2017. Not surprisingly, inflation was also very low in the same year: 1.2%.

Bulgarian social protection system is built up in line with the acquis of the European Union. Fine tuning of the systems may of course create substantial differences in many aspects. The rather generous Scandinavian model being an extreme and the rather self-reliant Anglo-Saxon model being the other. The Bulgarian system is only moderately generous. This may also be a consequence of more cautious fiscal policy after having learnt the lesson of excessive paternalism during the 1990s. In 2017, the level of total benefits was 11.3% of the GDP. The total government expenditure directed to families as a share of total government expenditure was only 5.8%. Pension expenditure reached 8.6% (2015) and the government spent 8.2% of the GDP on health care in the same year. Inequality in Bulgaria is fairly high, higher than in other countries in the region. The Gini coefficient on incomes was 43.4 in 2018. After corrections with social transfers it declined to 40.2. This means that social solidarity cannot significantly improve living conditions of the poor.

## 3. Quality of entrepreneurship

Entrepreneurship has little tradition in Bulgaria. Traditionally, in this mostly agrarian land much of the economic activity has been carried out in families or in unincorporated small business. Also, the centuries long foreign dominance discouraged Bulgarian citizens to launch business ventures. After the 1990 transition this situation changed and entrepreneurship was encouraged. However, high level of criminalisation paralysed business development also in this more recent period. Therefore, the level of entrepreneurship is very low in the country. Unfortunately,

criminalisation has affected government activities also very badly. All this is reflected by the entrepreneurship surveys.

The Global Entrepreneurship Monitor's spider shows adequate levels of physical infrastructure in the country. Unfortunately, this is the only measure where Bulgaria got a 4 score. Nevertheless, the country exceeded the regional average levels with scores around 3 in three aspects: entrepreneurial finance, taxes and bureaucracy (government policies) and commercial and legal infrastructure. Bulgaria lagged behind the regional average of the entrepreneurial framework conditions with regards to internal market dynamics, entrepreneurial education at post school age and also school age, government entrepreneurship programs and internal market burdens, entry regulations. These factors reflect handicaps in social institution systems (education and business support). All these barriers contribute to the very low level (2) of support, and relevance measure of government policies, as well as the similarly underdeveloped cultural and social norms. In all these aspects Bulgaria naturally also lags behind the regional average. Inadequate business support by social institutions and government policies, as well as low level of STI system both determine a rather low profile development path for the country.

The 2018 edition of WEF's Global Competitiveness Report evaluated Bulgaria to rank 51 out of 140 countries worldwide. This is a very impressive improvement from the 2009 low of ranking 76. The improvement was mainly achieved in the area of institutions (from rank 116 to 70, and infrastructure from rank 102 to 58). The country's overall performance became more balanced scoring in the range 30 to 70 (mostly around 50) in the various competitiveness pillars. Bulgaria lags behind the Europe-North America average most significantly still in the area of institutions, moreover in ICT adaptation, health, product market, financial system, business dynamism and innovation capacity; the main drivers of business dynamism. A closer look at the components of the individual pillars shows however, that the country has clear advantages in some fields and long lasting problems in some others. Efficiency of legal framework in challenging regulations (rank 134), conflict of interest regulation (121), property right enforcement (108), and judicial independence (103) show

serious weaknesses of market economic institutions, especially in the area of property rights and social control over public regulations. Another problem area is human skills and education. Ease of finding skilled employees is especially low ranked (138). This is due not only to the relatively modest level of education but even more importantly intensive outmigration. Most of the estimated 1-1.2 million migrants are young active adults. As mentioned, the cultural heritage is not favourable for entrepreneurship. Attitudes toward entrepreneurial risk (134), low level of internal labour mobility (136), as well as diversity of workforce (139) all show low level of incentives to take risks, which may be to some extent a general phenomenon in East-Central Europe.

An important feature of the social heritage in Bulgaria is risk aversion. This is also reflected in relatively low acceptance of competition. Therefore, on the one hand the Bulgarian firms have difficulties with competition, and they will rather settle market conflicts than fight back. The low interest in business participation is reflected by the relatively low number of SMEs per 1000 inhabitants (336). The OECD's product market regulation measure (2013) was 1.57 in 2013 (the only figure provided for the non-member country) that is somewhat higher than the OECD average. More developed countries' figures were in the range of 1.2-1.4. Barriers to entry related to administration is regarded high in the Institutional Profile Database (ranked 3). This gives an impression of having significant bureaucratic corruption in the country. The share of large scale distribution in the retail sector is also evaluated relatively high, meanwhile the role of foreign firms in this was most significant (4). Large national firms role is negligible or non-existent. Practices of competitors have moderate impact, competition regulation is not very strong.

The 2019 Heritage Foundation Economic Freedom ranking placed Bulgaria 37$^{th}$ with 69 points to the top of the moderately free countries (before other East-Central European countries). The country improved performance in monetary freedom, and fiscal health. The Foundation appreciated Bulgarian efforts at the improvement of free market conditions: "The institutional and structural reform process, although somewhat hindered by political conflicts, is gradually being implemented to complete

the transition from the centralised, planned economy to a more liberal, market-driven one. Reforms include privatisation of state-owned enterprises, adoption of favourable investment regime, liberalisation of trade, and strengthening of the tax system. Public debt has been well managed. However, corruption in public administration, a weak judiciary, low productivity, and organised crime continue to hamper Bulgaria's investment climate and economic prospects". Weak points are still property rights enforcement, government integrity and judicial effectiveness. The measure intensity of local competition in the 2017 Global Competitiveness Report was 4.8 or 91st position, which is well below the average. The number of newly registered firms per 1000 active persons was 10.69 in 2016.

## 4. Modernisation based on FDI

Bulgaria has never been a primary target of foreign direct investments. Its accumulated FDI stock is rather modest. The country followed cautious privatisation policy and did not sell big business and major banks to foreign investors. The Bulgarian governments maintained the subsidisation of loss-making firms rather in the hope that they would sooner or later consolidate their activity. In most of the cases this did not happen. The continuous financial unattractiveness of Bulgarian big business and the expiration of first movers' advantage (massive investment in other countries of the region) dramatically reduced Bulgaria's attractiveness as an FDI target country. Mostly market seeking investment projects were carried out in trade, communication banking and other services. The main investors were Greek and Turkish companies. The fairly weak FDI activity and the weak industrial potential delivers the message that FDI did not contribute to a massive restructuring and modernisation of the country. Unfortunately, no other (internal) sources were found to do this job. Therefore, the lack of modernisation investments in value adding activities limited the development potential of the economy.

The banking sector became dominated by foreign firms after the consolidation and sale of bankrupted state-owned banks in the late 1990s. By the year 2000, foreign share reached 74%. After some further increase it remained at 66% level by the year 2012. Parallel with this process the

role of state ownership was reduced from 70% in 1995 to 3% in 2010. Among the 500 largest companies of the CEE region only 10 operated in Bulgaria. This low figure also shows the relative underdevelopment of the country with very modest activity of big business. Out of this rather small stock there were 2 state-owned, 3 multinational companies (not from CEE), two multinationals from CEE countries, and 3 local companies. Clearly, there are not many foreign firms in Bulgaria, but the country also lacks sizeable local companies. The total inward stock of FDI in Bulgaria was 47.838 million of USD in 2017, up from only 2.704 USD in 2000. Total outward FDI stock of Bulgaria was 2.817 million USD in 2017 (UNCTAD 2018).

Investment in general remained moderate with 18.5% of the GDP in 2018, while the European average was 20.5%. Sluggish investment activity does not provide strong thrust to modernisation and reconstruction of the Bulgarian economy. Bulgaria runs a trade surplus and has therefore a higher share of exports in percentage of the GDP than imports. The 67.4% of exports and 63.7% of imports represents moderate openness. It reflects the importance of the production of basic commodities consumed domestically (high share of agriculture in the GDP). Also, the role of multinational companies' GVCs is less developed than in the Visegrad countries, let alone core Europe. Domestic consumption has an important role, therefore Bulgaria is perhaps less dependent on its foreign trade performance than the Visegrad countries.

Labour market processes in Bulgaria are determined by declining labour supply. Both quantitatively and qualitatively seen, Bulgarian labour market is shrinking due to massive migration. Excess demand and relatively weak regulation (higher flexibility) are the two important features. Due to the lack of larger scale industrial investments productivity has not increased sufficiently, therefore incomes have not yet increase significantly despite of the labour shortage. The share of wages in total GDP was 36.7% in 2017, total compensations of employees plus employers' social contributions – 49.5%. Trade unions played marginal role in Bulgaria. The trade union density rate was 18% in 2012. Due to labour market flexibility and also the massive reduction of active population excess demand curbed the

participation rate to relatively high 71.3% level (2017). It is not surprising under the given labour market circumstances that unemployment is low with 5.2% in 2018. This is a fairly low rate especially in comparison with the years 2010-2014, when it was double digit peaking in 2013 with 13%. Collective bargaining affects 29% of the employees, somewhat higher that the trade union rate, most probably because collective bargaining in the public sector with only 3.8% temporary employees rate is rather negligible. Most probably temporary employment is badly recorded thus contributing to the grey economy. Labour productivity increased by 22.9% in the period 2010-2018, very significant increase, third after Romania and Poland in the European Union. Estimations of migration vary between 1 and 1.2 million people, mostly active persons, roughly 25-30% of total active population, which constitutes a tremendous loss to the Bulgarian economy.

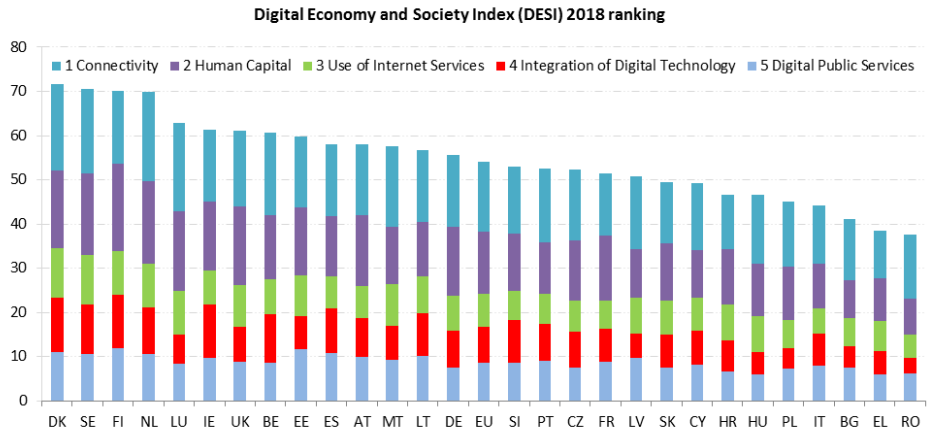
## 5. Knowledge sector

In the traditional Euro-Atlantic capitalist model innovation is a main driver of economic development. In the Byzantine heritage of Bulgaria this driver has always been very weak. Therefore, Bulgaria is a moderately innovating country with fairly weak traditions in its STI system. Historic tradition of being part of the Ottoman empire did not create strong social institutions, and the Bulgarian governments had to make rather serious efforts to create a modern school system. Government efforts to improve education are still relatively strong. The government expenditure on education was 11.44% of the GDP (2013), a fairly high share in the region. Higher education rate was even more impressive with 36.4%. These figures of course do not tell much about the quality of education but we can expect that it is not better or worse than in other countries in the region, and then the high share of higher education enrolment could be an advantage of the country. The other sub-system of the STI sector, innovation, on the other hand is still very weak. Total R& D expenditure as percentage of the GDP was merely 0.78% in 2016. Very clearly, there is not much private (corporate) spending, and also state spending is inadequate. Bulgarian plans to increase this share to 1.5% do not seem very ambitious but given the fact that the country lacks appropriate big business this ambition still seems unrealistic. The relative

weakness of big business is also reflected in the modest share of high tech products in total exports, which was 7.44% in 2017.

Economic growth and prosperity is fuelled in the long run through technological development and innovations. The role of STI is far reaching and is not restricted to the application of modern products and technologies in the factories. It crucially determines also entrepreneurship and the level of usage of new technologies (productivity). Therefore, an adequate development level of the national innovation system can strongly support long term development of the economy and society. Unfortunately, Bulgaria seems to lag behind the European average in this regard. The 27 STI measures used by the European Innovation Scoreboard clearly reflect this situation. Bulgaria is modest innovator: only 27$^{th}$ among the EU member states. R&D expenditure was only 0.63% of the GDP in 2013. Both public and private spending on R&D is very low. The summary innovation index deteriorated between 2010 and 2017. This was mainly due to massive declines in the fields of finance and support, firm investments, SME innovation outputs, linkage development and the sales impact of knowledge intensive and high-tech products. Some improvement was achieved in intellectual assets and broadband penetration. Bulgaria seems to lack important institutional legs of innovation in the area of higher education and industry.

Bulgaria scores rather weak in the European Union's Digital Economy and Society Index as well. The country was 26$^{th}$ in 2018. The DESI country profile reported only slight improvements over the year 2017. The country lags behind the EU average in all of the covered aspects. It is relatively closest to the average with 35% level in the field of connectivity and digital public services. The use of internet services is still somewhat over 30%. Worse is the country's situation in human capital (enabling knowledge), and the integration of digital technology. The overall DESI indicator shows an increasing gap with the EU28 average. A few areas where Bulgaria was closest to the EU average were mobile broadband takeup, video calls (perhaps because of the large number of dissidents), and social networks. Significant improvements were reported in the area of digital public services for business (obligatory electronic tax declarations).




## 6. Public opinion attitude towards transformations

The EU accession process has always been a political issue. This is clearly seen in most enlargement programs. The accession of Bulgaria and Romania was not an exception either. The European Union admitted two relatively poor new member countries that did not belong to the Euro-Atlantic historical and cultural heritage, and could not transform their societies to that pattern even after several years of accession. This is clearly seen in their continuous fight with corruption and crime, very low level of legal security especially in the field of property right enforcement, the survival of the traditional crony ties between business and polity. In Bulgaria these linkages are controlled by the private business, the state is captured. This model lacks the adequate drivers for economic development. No ambition is present to excel with entrepreneurship. Career opportunities in competitive business are rather limited since property right enforcement is loose, the judiciary is weak and not independent. Also high level of corruption thwarts business development. These conditions together with economic policy mistakes reduced the growth potential of the country. Therefore it could not narrow its development gap with more developed member states of the EU. This is the main reason of very large scale outmigration, a process that deprives the Bulgarian economy form vital human resources for future development as well.

Dissatisfaction with the economy is very strong (72% in 2018 according to Eurobarometer 90). Economic problems are in the foreground of citizens' concerns: inflation/cost of living 48%, health and social security 32%, general economic situation 26%. Concerning European problems Bulgaria too sees immigration and terrorism more serious than the European average, maybe also because the country is heavily involved in smuggling. The general public clearly sees the weakness of the governments and an outstanding high share of the population does not trust the government (67%). In contrast, most people still support the European Union (53%). Public support declined from 63% in 2004 (Eurobarometer 62).

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### 3.3.2 Croatia

Fruzsina Sigér

**Introduction / general information / latest data**

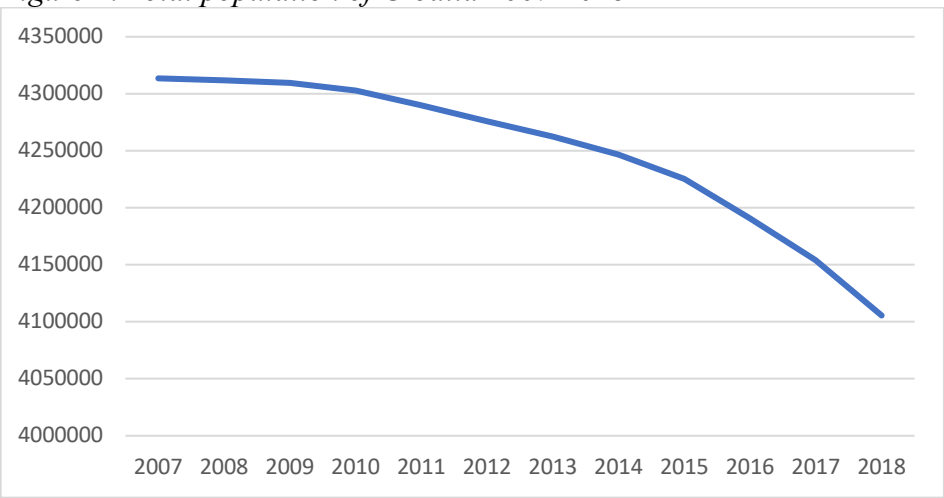
a) Area

Croatia is in Southeastern Europe, bordering the Adriatic Sea, Bosnia and Herzegovina, Hungary, Montenegro, Serbia and Slovenia. Its area is 56,594 square kilometes, including 55.974 sq km land and 620 sq km inland water. The country possesses some 1.200 islands, islets, ridges, and rocks, with 4.058 km of coastline (CIA 2018).

b) Population

Croatia has a total population of 4.105,493 as of 1 January 2018. The country's population is decreasing and ageing. The proportion of the youth (0-14 years) population is 14.5% while the proportion of population aged 65 and over is 20.1% (Eurostat 2018a).

*Figure 1: Total population of Croatia 2007-2018*




Source: Eurostat population statistics

c) The capital and the next two cities

The capital of Croatia is Zagreb with 686.000 inhabitants in 2018 (CIA 2018). The second and third cities are Split and Rijeka with 173.109 and 121.975 inhabitants in 2016 (Eurostat 2018b).

d), Urban population per 1.000 pop.

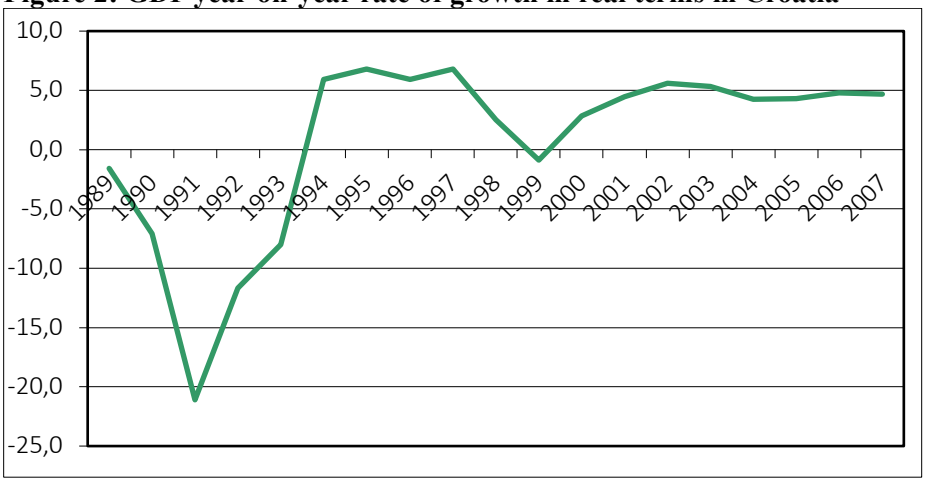
The rate of urban population is 56.9% (CIA 2018).

1.1 Basic economic data

a) GDP growth rates, average annually growth GDP (from the 90's)

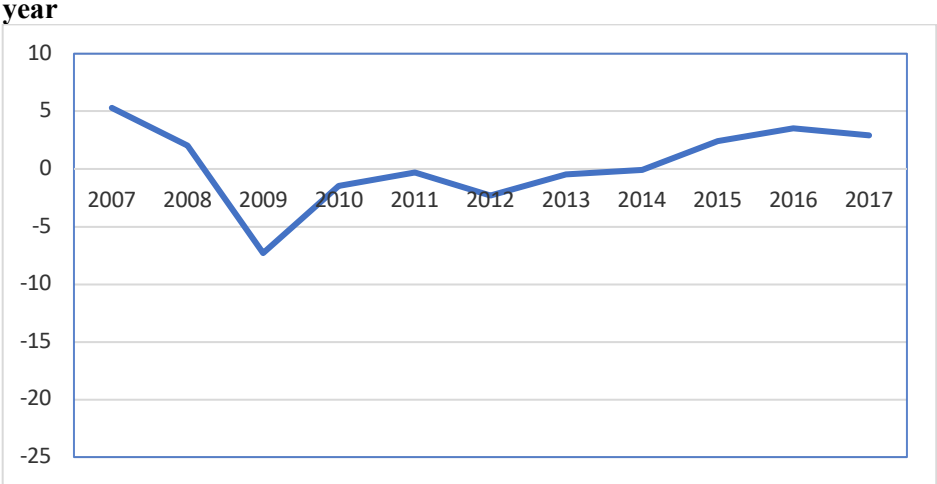
The decline of the GDP in the early 1990s was deeper in Croatia than in the Central and Eastern or South-eastern European countries. The transformational recession of Croatia was exacerbated by the break-up of the Yugoslav market and by the Yugoslav war. In 1991, partly due to the explosion of the war, the GDP fell with 21.1%, and by 1994 it reduced to two-third of the pre-war level. The economy went into recession in mid-1998. The reason of the downturn was the 1998-1999 bank crisis, during which 14 banks went bankrupt. After a costly consolidation, Croatia emerged from the recession in the final quarter of 1999, and the growth picked up in 2000. Until 2003, the Croatian economic growth increased or even exceeded the average trend in the Central and Eastern or South-eastern European region. The global financial and economic crisis reached the Croatian economy in 2008. It led to a significant economic downturn in 2009, the GDP declined by 7.4%, which was among the worst in Europe that time. In 2015, the six-years-long recession finally ended. The economy grew on the back of a good tourist season, a strengthening of external demand and reductions in oil prices.

**Figure 2: GDP year-on-year rate of growth in real terms in Croatia**




Source: EBRD Economic statistics & forecasts

**Figure 3: Real GDP growth rate – volume, percentage change on previous year**

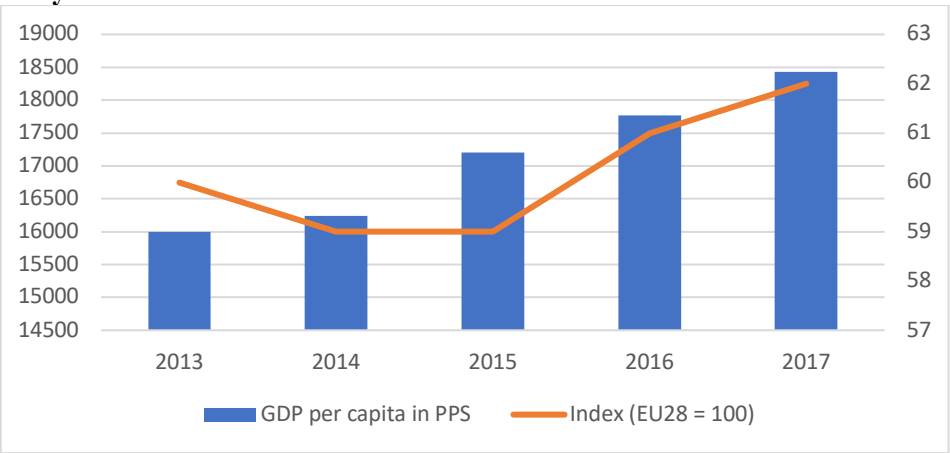



Source: Eurostat database

b) GDP per capita at purchasing power parity (PPP)

Croatia entered the EU in 2013. It is not a euro area member yet. In 2017, the GDP per capita in purchasing power standards was 18.434 euro that was 62% of the EU28 average (Eurostat 2018c).

**Figure 4: GDP per capita at purchasing power parity (PPP) since the EU entry**




Source: Eurostat database

1.2. Structure of employment

The structure of employment is characterised by a small share of agriculture (1.9%), 27.3% of industry and a major role of services: (70.8%) according to 2017 estimates (CIA 2018).

1.3. Components of GDP, percentage of total

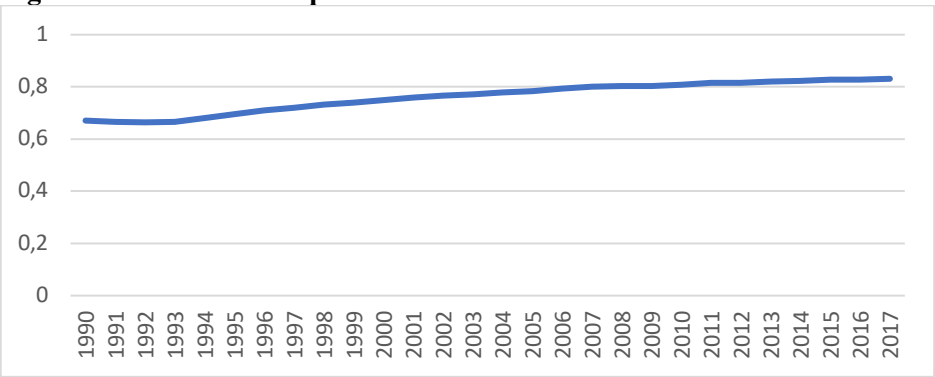
In 2018, the household consumption consisted of 57.5% of the GDP while government consumption consistsed of 19.7%. The investments in terms of gross fixed capital formation reached 20,1% of the GDP. The value of exports of goods and services made up 51.2% of the GDP, at the same time the imports of goods and services reached 49.9% of the GDP (Eurostat 2018c).

1.4 Synthetic rankings of business environment

a) The overall level of development

In 2017, Croatia's Human Development Index was 0.831 which meant rank 46 in the world. With this result Croatia is well above the world average. Since the end of the war in the early 1990s, the country's position has been continuously improving (UNDP 2019).

**Figure 5: Human Development Index in Croatia 1990-2017**




Source: UNDP

b) Innovation Union Scoreboard

Considering the European Innovation Scoreboard, which assesses the relative strengths and weaknesses of national innovation systems, Croatia belongs to the moderate innovators. With its score 0.25832, the country's innovative capacity is well below the EU average (0.50438) and ranks the country as 26th out of 28 (EIS 2019).

c) Global Entrepreneurship Monitor

In Global Entrepreneurship Monitor two elements are taken into consideration: on the one hand the entrepreneurial behaviour and attitudes of individuals, and on the other hand the national context and how that impacts entrepreneurship.

Entrepreneurial behaviour and attitudes in Croatia: Croatia is at the top of the EU by expressed entrepreneurial intentions, but this is more the result of necessity rather than of perceived opportunities. Entrepreneurial activity of Croatia measured through early activity and activity of "established" entrepreneurs (more than 42 months of activity) has two worrying patterns: low motivational index and low share of "established" businesses. Croatia has a small number of growing businesses, that are characterised with innovation in the use of new technologies and innovation in the development of new products. At the same entrepreneurial employee Croatia is above the EU average throughout the observed 2015-2018 period. This form of entrepreneurship represents hidden entrepreneurial

capacity in Croatia, which would be beneficial to take into account both by businesses, and national policies in the field of innovation, education or tax relief. Entrepreneurial demographics show relatively stable relations in distribution of entrepreneurial activity both by gender and age, but Croatia is still more "male" country by entrepreneurial activity. Social values do not really support entrepreneurial activity.

The national context: In terms of physical infrastructure and internal market dynamics Croatia provides sufficient conditions for entrepreneurs. However, in fields of entrepreneurial finance, government entrepreneurship programs, entrepreneurial education at post school stage, and commercial and legal infrastructure, Croatia's performance is modest compared to both regional and global average scores. In several other dimensions the Croatian environment is highly insufficient. Governmental policies regarding support, relevance, and government policies on taxes and bureaucracy, the entrepreneurial education at school stage, and the internal market entry regulations are unfavourable compared to both the regional and global level. The R&D transfer capacity and the cultural and social norms that enclose entrepreneurship may also burden the entrepreneurship-friendly environment of Croatia. Altogether entrepreneurial environment in Croatia is still more limiting than stimulating for entrepreneurial activity (GEM 2018).

d) Global Competitiveness Index (GCI)

In World Economic Forum's Global Competitiveness Index Croatia possessed the 68$^{th}$ place out of 140 economies in 2017-2018 (WEF 2018). Regarding the Institutions pillar, Croatia's rank is 74$^{th}$ out of 140, the worse in the EU, and it decreased from 2017 to 2018. *Judicial independence* seems to be a huge weakness in Croatia's institutional environment, the value it reached is 2.5 out of 7, that puts the country to the 120$^{th}$ place out of 140. While the process of the EU accession was instrumental in advancing judicial reforms, and in 2010 the constitution was amended to strengthen judicial independence and reduce political interference in the State Judicial Council (IMF 2017: 53), a lot needs to be done. The efficiency of legal framework in challenging regulations and in settling disputes is also relatively weak in comparison with the peer countries. The

*protection of property rights* has been deemed by the European Commission to be generally assured since 2008, but with its value of 3.5 from 7, enforcement seems still to be weak. While the legal system in general puts heavy emphasis on the rule of law, in practice, legal certainty has been often limited (IMF 2017:55). Government regulation very often burdens the business environment. Its value of 1.9 from 7 ranks Croatia to the 138th place out of 140. Auditing and reporting standards partly comply with International Financial Reporting Standards (IFRS), since it is only mandatory for big companies and for those that have their bonds on the stock exchange. The strength of auditing and reporting standards reaches 3.9 points from 7. A research shows that modified audit opinions are expressed in 29% of audit reports of listed companies in Croatia. The manipulations are principally oriented towards creditors, tax authorities and suppliers with the intention to hide bad performance, get better terms of crediting and minimise fiscal and political costs (Aljinovic Barac 2017).

e) Worldwide Government Indicators

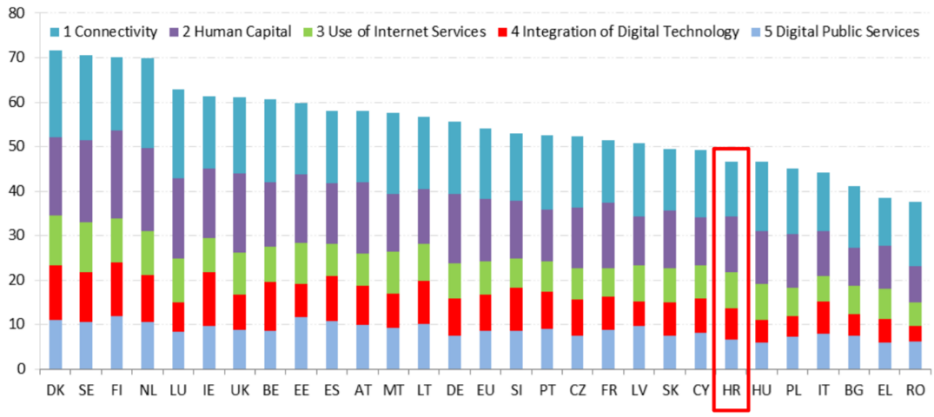
The Worldwide Governance Indicators (WGI) report aggregate and individual governance indicators published by the World Bank, in six dimensions of governance: Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. Similar to the previous set of indicators, a lack of institutional development is visible. As Petak and Kotarski (2019: 9) highlight, in case of Croatia this is also combined with an increased government expenditure that creates excellent conditions for clientelism and state capture.

f) Digital Economy and Society Index (DESI)

The Digital Economy and Society Index (DESI) is a composite index published by the European Commission. It summarises relevant indicators on digital performance and tracks the evolution of the EU member states in digital competitiveness. Croatia ranks 22nd out of the EU28 Member States. Overall, it made good progress over the last year, when it was 23rd. Croatian citizens are above average internet users and enterprises are also keen to employ digital technologies. Croatia's greatest challenge in digital remains its low performance in connectivity: rural broadband connectivity and fast broadband coverage are limited, while prices for fixed broadband remain

the highest in Europe. In terms of e-Government, Croatia is progressing slowly (DESI 2018).

*Figure 6: Digital Economy and Society Index ranking, 2018*




Source: European Commission

## 2. Milestones of the transformation of the Croatian economy

The *privatisation* procedure started with the federal privatisation plan in July 1990. It relied on spontaneous privatisation and allowed the subsistence of social ownership, while it reintroduced state ownership in any sector chosen by the government. Croatia inherited this Yugoslav path of privatisation with all of its consequences. The individual Croatian privatisation was first set out in a law of April 1991 that completely replaced the inherited Yugoslav laws. The social ownership was converted into state ownership. The primary form of the Croatian privatisation process was the management and employee buyouts, while the secondary form was voucher privatisation. By end of 1999, the state still kept stakes in 1610 enterprises: the state kept many firms out of privatisation, other firms could not find buyers. The Croatian Competition Agency was established in early 1997, but state aid control only became one of its tasks in 2003. After a costly consolidation, the restructuring of the banking sector was carried out successfully. Large banks were privatised mainly to foreign investors. The constitution of the Republic of Croatia, adopted on 21 December 1990, determined the Croatian National Bank as the central bank of the Republic of Croatia as independent in its work, and held responsible

to the Croatian Parliament. The Zagreb Stock Exchange was established in 1991 by 25 banks and two insurance companies as the central place of securities trading in the Republic of Croatia. Altogether, even if in a slower pace than in the "benchmark" Central and Eastern European countries, the pressure from the EU (and from other international organisations) have always had remarkable impact on the Croatian transformation process, policy making and structural reforms.

## 3. The essential features of the economy

### 3.1 The Croatian variant of capitalism

The Yugoslavian type of market socialism seemed to be a third-way system between capitalism and the strict Soviet type of central planning. The Croatian type of crony capitalism, which emerged in the 1990s, was a consequence of the Yugoslav legacy, on the one hand. The relatively large private sector meant large space for unofficial activities. The social capital that developed under these circumstances had little respect for the rule of law but showed large inclination to work in informal networks. On the other hand, the war and the economic and social structures that emerged as a consequence of the war contributed further to the shape of the crony capitalism. The war reshaped the priorities in the country, and created opportunities for free-riding and rent-seeking. These structures continued to exist after the war. The system of crony capitalism was not abolished with the changes of the foreign policy orientation. The size of the state remained huge, and the role of the state in the economy remained dominant (Sigér 2010).

Lane (2007) identifies a continental type of capitalist countries, containing some of the new EU members from Central Eastern Europe, and a subgroup within, including Croatia, with higher role of state in coordination and lower levels of privatisation.

### 3.2 Main institutional segments of the economy

a) Product market competition

1. According to the OECD's product market regulation tool, Croatia belongs to the "less competition-friendly" group, as only one in the European Union. State control is around the

OECD average, barriers to entrepreneurship is also around OECD average, except for administrative burdens on start-ups, which is worse than the average. Barriers to trade and investment indicate the biggest burden in the Croatian Economy (OECD 2013).

2. Considering the Institutional Profile Database, *barriers to market entry* in Croatia reaches 2.5, where 0 means major barriers and 4 means no barriers (DG Tresor 2016).
3. In Heritage Foundation's *business freedom* index Croatia earned 61.4 points in 2019, which is a slight (0.4) improvement since the previous year with a spike in fiscal health offsetting a precipitous drop in judicial effectiveness. Croatia was ranked as the 86th freest economies in the world out of 180, and the 38th among 44 countries in Europe. Its overall score is below the regional average but above the world average (HF 2019).
4. In 2018 Global Competitiveness Report, Croatia's *intensity of local competition* score is 4.7 (from 7), making its economy the 102nd best out of 137 in the 2017-2018 Index.
5. The *number of enterprises* in Croatia was 147.481 in 2016, which was 35.198 per million inhabitants (Eurostat 2016).
6. The *number of newly registered firms* per 1000 persons aged 15-64 was 13.618 in 2016 (World Bank 2017).

b) Labour market and industrial relations

1. The share of wages in GDP in Croatia was 36.9% in 2017, which was below the EU average of 40.7% (Eurostat 2018d).
2. The trade union density rate was around 32% in Croatia in 2013, indicating a decreasing trend from 40% in the 1990s. The Croatian value has been above the EU average (ETUI 2019: 59).
3. The total activity rate in the labour market is around 66% in 2018. For males, it is slightly above 70%, while for females it is little more than 61% (Eurostat 2018e).
4. The total unemployment rate was 11% of the active population in 2017, permanently decreasing from 17.4% in 2013 (Eurostat 2018e).

5. The collective bargaining coverage rate is 53% of workforce in Croatia, indicating a slightly decrease compared to the pre-crisis period. (ETUI 2019:56).
6. The temporary employees' rate (as percentage of the total number of employees) was 20.7% in 2017, which was well above the EU average (14.3%) (Eurostat 2018e).
7. The labour productivity per person employed increased by 9.9% from 2010 to 2017 (Eurostat 2018e).
8. Croatian population staying temporarily abroad is among the highest in the EU, 14% in 2017, while on average 4% of EU citizens of working age live in another EU member state (Eurostat 2018f).

c) Social protection system

1. The social total benefits to GDP ratio in Croatia was 20.9% in 2016, while the average stood at 27.1% (Eurostat 2019a).
2. The share of government expenditure directed to families to total government expenditures was 8,4% in 2016, which just went by the EU average (Eurostat 2019a).
3. The pension expenditure to GDP in Croatia reached 10.4% in 2016. The average expenditure on pensions was equivalent to 12.8% of the EU's GDP in 2015 (Eurostat 2019a).
4. The Croatian expenditure on health care made 6.9% of GDP in 2016 (Eurostat 2019a).
5. The Gini coefficient of equivalised disposable income in Croatia was 29.9 in 2017, while the EU average was slightly higher at 30.7 (Eurostat 2019b).
6. The total fertility rate in Croatia was 1.41870 in 2017 compared to the little bit higher EU average of 1.58571 (Eurostat 2018a).
7. Healthy Life Years (HLY) at age 65 indicator counts 4.9 years for females and 5.2 for males (Eurostat 2018g).

d) Knowledge sector

1. The R&D expenditure as a percentage of GDP in Croatia was 0.856% in 2016, less than half of the EU28 average (2.032) (World Bank 2019a).
2. The share of high-tech exports, as percentage of manufactured exports, was 7.45% in 2017, compared to the EU28 average of 14.22% (World Bank 2019b). While most of the new member states succeeded in increasing their exports mainly in higher-end technology sectors, Croatia mostly specialised in exporting lower-end technology products (EC 2015b:29).
3. The share of public expenditure on education, as percentage of GDP, in Croatia (4.7%) is in line with the EU28 average (4.6%) (Eurostat 2019c).
4. The turnover of enterprises from innovation was 10.1% in from of new or significantly improved products that were only new to the firm, and 6.4% in from of new or significantly improved products that were new to the market (Eurostat 2019d).
5. The rate of students in tertiary education, as percentage of 20-24 years old in the population, was 38.4% in 2016 (Eurostat 2019e).

e) Financial system

1. The balance of the general government was +0.9% of GDP in 2017, while -0.9% of GDP in 2016 (Eurostat 2019f)
2. The general government gross debt in Croatia was 77.5% of GDP in 2017 (Eurostat 2019f).
3. The general government expenditure in Croatia was 45% of GDP in 2017 (Eurostat 2019f).
4. The HICP inflation rate in Croatia was 1.6% in 2018 and 1.3% in 2017 (Eurostat 2019g).
5. The market capitalisation of listed domestic companies in Croatia was 41.2% of GDP in 2017 (World Bank 2019c).
6. The level of domestic savings in Croatia was 23.1% in relations to GDP in 2017 (World Bank 2019d).
7. Domestic credit to private sector in Croatia was 57.3% of GDP in 2017 (World Bank 2019e).

8. Investments in form of gross fixed capital formation made up to 20% of GDP in 2017 (World Bank 2019f).
9. The ratio of bank concentration (assets of three largest commercial banks to assets of all commercial bank) in Croatia reached 60.3% in 2016 (World Bank 2019g).

f) Modernisation based on FDI

1. The market share of different types of banks: foreign ownership in banking sector is prevailing with 90% of assets, while 6% assets are still state-owned. The rest is owned by domestic private banks (EFB 2019).
2. Considering the 500 largest enterprises in Central Europe in 2016, 13 companies were coming from Croatia. The ownership structure of these 13 enterprises indicated 4 foreign (2 Central European and 2 multinational companies), 5 domestic private (1 local company and 4 local individuals), and 4 state-owned companies (Deloitte 2016).
3. Foreign direct investment inflow in Croatia as a percentage of gross fixed capital formation was 20.7%, while inward FDI stock as a percentage of gross fixed capital formation was 66.8% in 2017 (WIR 2018).
4. In the EU we find 420 state-owned multinational enterprises from which 10 are headquartered in Croatia (WIR 2017). State-owned enterprises are still an important part of the Croatian economy and they are more prominently present in many sectors compared to Central European peers. Their presence includes not only transport, energy, post and communication, forestry and utilities where public participation may be explained by public interest or market failure, but also in agribusiness, manufacturing or even tourism (EBRD 2018a). The list of companies of special interest was reduced to 39 in 2018, signalling potentially intensified privatisation efforts (EBRD 2018b). Foreign ownership is far the largest in the financial

service sector, while it is notable also in wholesale trade, in real estate activities and in telecommunications (HNB 2016)[38].

5. Foreign direct investment inflow in Croatia was 3.69% of GDP in 2017 (World Bank 2019h).

## 4. Summary

### 4.1. Market economy – the Croatian Way (socio-economic model)

The Croatian type of crony capitalism, which emerged in the 1990s, was a consequence of the Yugoslav legacy, on the one hand. The social capital that developed under these circumstances had little respect for the rule of law but showed large inclination to work in informal networks. On the other hand, the war and the economic and social structures that emerged as a consequence of the war contributed further to the shape of this crony capitalism. The war reshaped the priorities in the country and created opportunities for free-riding and rent-seeking. After the war, these structures, however, continued to exist. The inability for structural change has been the continuous feature of the Croatian economy since the beginning of the transformation process (Sigér 2010). The role of the state in the economy is still huge and reducing it is a continuous task. Still, even if in a slower pace than in the "benchmark" Central and Eastern European countries, the pressure from the EU (and from other international organisations) have had remarkable impact on the Croatian policy making and appeared to be important anchors for essential structural reforms in Croatia. The geographical proximity of the EU market has always had strong impact on the Croatian economy, and Croatia has clearly benefited from the trade and capital flows from EU members, already before the EU membership.

### 4.2. The most important achievements

After a long and meandrous road Croatia joined the European Union on 1 July 2013, more than nine years after the first round of Eastern enlargement. Beside all the already mentioned obstacles, altogether we see a gradually improving business environment (see Table 1) that benefits a lot from the EU membership. In 2015, the six-years-long recession finally

[38] The OECD data are not available for Croatia.

ended. The economy grew on the back of a good tourist season, a strengthening of external demand and reductions in oil prices (Sigér 2018). Croatia may be seen as a late-comer Central and Eastern (or South-eastern) European country, or a forerunner Western Balkan state. Most of the studies, and also the markets represent the first comparison, and interpret Croatia in relation to Central and Eastern, and South-eastern European context, which means that Croatia has to compete with these peer countries.

***Table 1: Doing business in Croatia, measured in DTF (distance to frontier)***

| year | overall DTF (DB17-19 methodology) | overall DTF (DB16 methodology) | overall DTF (DB15 methodology) | overall DTF (DB10-14 methodology) |
|---|---|---|---|---|
| 2019 | 71.40 | | | |
| 2018 | 71.06 | | | |
| 2017 | 70.92 | | | |
| 2016 | 70.8 | 71.15 | | |
| 2015 | | 71.02 | 67.14 | |
| 2014 | | | 64.90 | 63.12 |
| 2013 | | | | 62.20 |
| 2012 | | | | 62.58 |
| 2011 | | | | 61.36 |
| 2010 | | | | 61.24 |

*Source: Doing Business Custom Query*

### 4.3. The main development challenges

Croatia was hit by the crisis severely and entered the EU when its economy contracted for its fifth year in a row which reflected both spill-overs from adverse external factors and the persistence of deep structural problems. In the light of this deteriorating economic environment, signing the accession treaty and becoming the 28th member of the EU promised vital opportunities for Croatia to manage its economic challenges and become a competitive economy. As the Commission highlights, restrained growth, delayed restructuring of firms and the limited performance of employment have common roots: inefficiencies in the allocation of resources. The unfavourable business environment is a major obstacle on the adjustment capacity of the economy (EC 2015b:1). Croatian National Bank Governor Boris Vujčić said in January 2017 that Croatia was planning to introduce the euro. Croatia is not a member of the Schengen zone yet, but becoming

a member is certainly a priority for the country, largely because tourism in Croatia is mainly focused on guests from the EU.

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### 3.3.3 Romania

Miklós Szanyi

## Introduction

Romania is a medium-sized country in the North-Eastern part of the Balkan Peninsula. It's Central and North-Eastern parts belong to East-Central Europe (Transylvania in the Carpathian Basin). The country faces the Black Sea in the East with the important harbour city Constanta. The area of Romania is 230.080 square kilometres and contains very colourful terrains. The Carpathian Mountains occupy the central part of the country with various natural resources (wood, natural oil, salt, gold and iron ore and coal). The mountains are surrounded by fertile arable land producing various types of crops. The largest river is the Danube, the main European sweet water shipping line connecting the Black Sea region with heartland Europe (Germany). Total population of the country was 19.530.631 inhabitants in 2018, down from the pre-transition period high of over 23 million. Part of the decline in population was natural shrinkage (mortality rates exceeding birth rates), but the bulk of the population loss was due to significant outmigration. This is estimated to some 2.5-3 million people taking job and living opportunities mainly in Western Europe. The consistence of age cohorts reflects mostly the aging process, albeit it does not seem to have worsened by migration. Children below 15 consisted 18% of the population, citizens over the pension age (65 years) 15.6%. The share of urban population is fairly low only 53.94% (2017).

### 1. Political context and quality of institutions

Historically, the Romanian economy has evolved in three different entities. Moldova and Walachia were provinces under Turkish rule with partial internal autonomy until 1877. Modern Romania was established after the 1877 Turkish-Russian war that ended the rule of Turkey over the two provinces that merged and established a joint kingdom. The newly established state gained new territories after World War I, when its size was more than doubled with the annexation of Bessarabia in the East (today's Republic of Moldova), Transylvania and Eastern Hungary in the West. These newly acquired territories had historically different

development patterns being parts of the other two main Central European empires (Russia and Austria-Hungary). Thus, current day Romania also shows significant ethnic, cultural and also material development differences and diversity in its different regions. Despite of vigorous social mobility in the country the overall relative development level did not change much in the years of communist rule either. Romania tried to maintain some distance from superpower Soviet Union. This was most obvious in politics, especially under the rule of Nicolae Ceausescu, but also in the economy. Romania did not participate in the close cooperation network of the communist bloc. High degree of self-reliance was however a dead end street already in the years of communism. Hence, Romanian economic and social development lagged behind even its communist counterparts.

Romania's transition to a free-market economy began with its new constitution in 1991. The country became a member of NATO in 2004. EU membership negotiations were finished after long delays due to the high level of corruption and slow progress of liberalisation and privatisation of the economy and the country became member in 2007 (Appel and Orenstein, 2018). The road of transition has been rather turbulent in Romania. The inception of the Romanian Republic was bloody and hard-won: some 2000 people were killed in the late 1989 "revolution" and the consequent street fighting. The Romanian dictator and his wife were caught in flight and executed by revolutionary officers of the army on 25 December. Violence continued also in the successive years. Heated political debates emerged partly because of the leading role of former communist party leaders in the political landscape of the transition process. For example, Ion Iliescu, the first President of modern Romania (1990-1996; 2000-2004) used to be a member of the Central Committee of the Romanian Communist Party before the systemic change. He had decisive influence on politics not only in his social democratic party but also in general in the early stage of Romanian development. His political heritage remained rather strong also after his death.

Despite of the violent, revolutionary overturn of the communist regime in 1989 incumbent politicians could maintain leading positions in Romanian politics. This was also reflected in the very cautious introduction of reform measures and the postponement of privatisation process (Appel and Orenstein 2018). Surviving paternalism served as continuous hotbed of

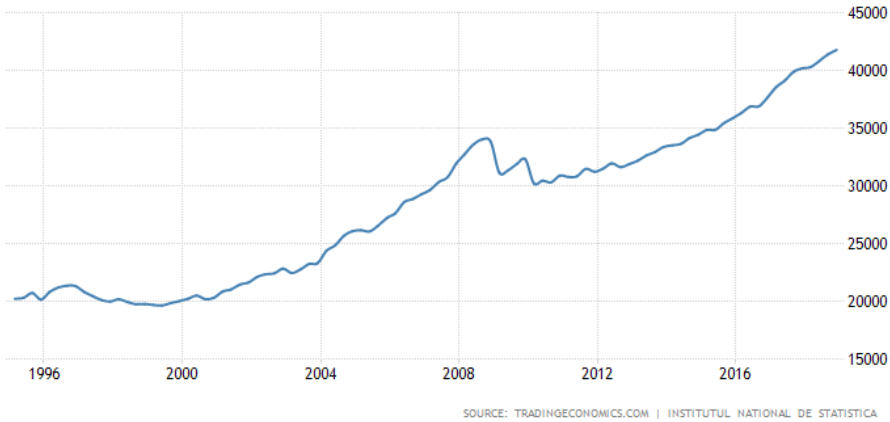
corruption (Hellman *et al*. 2000; Innes 2013). Socially important big business remained intact despite of lack of competitiveness. Politicians soon used dependent company communities for their political support even in form of organised violent counter-demonstrations against their political opposition. The state captured business, Romanian transition was earmarked by strong politicians and weak business sphere (Schoenman 2014). Since the economy became a prey of polity, economic development was rather slow during the 1990s. The development was reinforced by international institutions and the European Union, but the Romanian governments tried to avoid or water down the impacts of newly established market institutions (Simmelfenning and Sedelmeier 2005; Racovita 2011; Appel and Orenstein 2018).

Consequently, the World Bank (2018) governance indicators show permanently low indices for Romania. The measure voice and accountability measure (the public perception of freedom in various areas) was relatively highest ranked around 60. This level is in fact not better than the regional modus. Moreover, it did not change much over the 1996-2017 period. The measure of political stability and absence of violence was fluctuating despite of the fact that the very frightening events of the 1990s (e.g. visits of militant Jiu-Valley miners to the anti-government demonstrations in 1991) were not repeated in the 2000s. This measure evolved below 50% level low. Government effectiveness was ranked even lower between 40 and 50%, with a small peak in 2014. Interestingly, EU accession made no change in this measure either. Regulatory quality was perhaps highest among the indicators, and steadily improving after 2000, reaching a plateau around 65% in 2011. The rule of law measure also climbed from below 50% to around 60%, especially in the years after the EU accession (2007) showing the beneficial effects of acquis application. Control of corruption has always been the most serious problem in Romanian economic policy. The strikingly low value of 30% in 1998 improved steadily parallel with the establishment of various anti-corruption offices (on demand of the European Union). However, the relatively stable position on 50% by far does not mean that the control would be effective. But as repeated political scandals show many corrupt cases are discovered and there has been some institutional and social control over the problem (especially in DNA anti-corruption office). Yet, sentences against affected politicians were usually very meager.

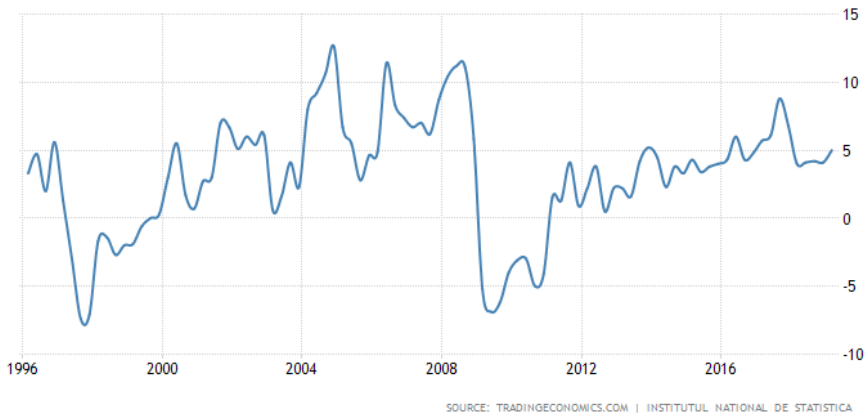
## 2. General economic outlook

Romania underwent a rather long and difficult transition process, which was also reflected in the macroeconomic performance of the country. Economic growth was rather sluggish during the 1990s reflecting the lack of competitiveness of most segments of the economy (including unproductive agriculture and weak manufacturing industry). Liberalisation, lack of capital investments and modernisation brought deep transformational recession to the country during the first phase of the transition process with 25% GDP decline between 1990 and 1992 (EBRD 2000). During the 2000s, the Romanian economy performed much better and reached very high growth rates (6.9% in 2007; 9.3% in 2008). The 2008/9 crisis hit also the Romanian economy rather badly (over 10% decline in two years), but the economy recovered after that and grew at accelerating speed again (7.0% in 2017). The quick economic growth of the country is very remarkable especially in regional comparison: highest in most years. Three main factors can be observed in the background. FDI penetrated the country and successfully modernised a few strategic industries (automotive, electronics, personal services). The country became a net recipient of EU transfers that also stimulated economic growth. Thirdly, the country has successfully restored macroeconomic stability after the rather troubled years in the 1990s (Pop-Eleches 2009). The annual average growth was 5.9%. Consequently, Romania successfully increased its per capita GDP development level from 39% of EU average in 2006 to 63% in 2017. The very impressive improvement might deliver the necessary material resources for the overall modernisation of the country's main infrastructure systems (linear infrastructures, health, education). Due to the inherited relatively low level of development these systems still show the signs of underdevelopment.

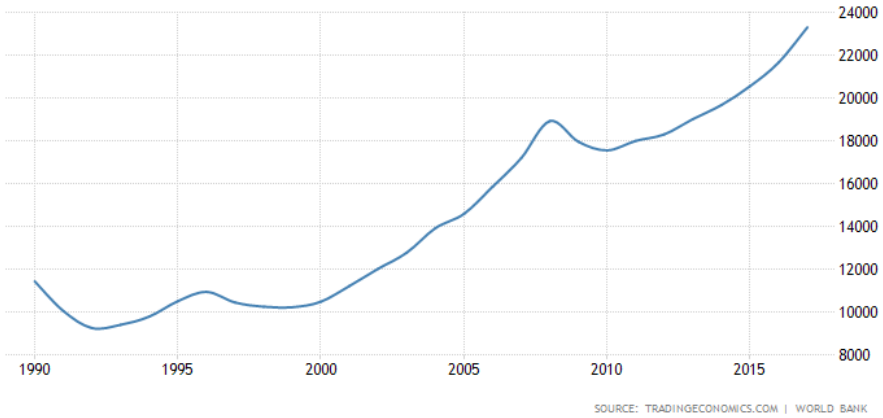
**GDP at constant prices (million RON).**




**GDP growth rates (1996-2018)**



**Per capita GDP (USD, PPP constant prices)**




Historically Romania has been a mostly agrarian land with a few important industrial centres that based their activity mainly in natural resource based industries (oil extraction and refinery in Ploesti, iron ore mining and metallurgy in Hunedoara, etc.). This profile changed only slowly during the years of socialist industrialisation, since Romania did not take part in the complex industrialisation programs of the Soviet Bloc. Important engineering industry centres were added in Brasov, Pitesti and Galati already in the interwar period (with strong military equipment profiles). This tradition is reflected in the slow changes of the transition period. Agriculture still employed 23 % of the labour force in 2018. Industry's share was also relatively large (29.9%). The services sector on the other hand remained at the relatively low 47% level. Unfortunately, agriculture is not modern, this is also reflected in the high share of agrarian population. Low levels of productivity in the sector yield low income, hence the mostly agrarian regions suffer of deep poverty. The overall level of per capita GDP increased due to significant economic growth in the 2000s and peaked with 63% of the EU average in 2017. The relatively larger size of the Romanian economy, as well as the still modest FDI penetration produce lower levels of openness of the country. Exports reached 41.2% of the GDP, meanwhile imports accounted to 42.1%. Excess import means a moderate deficit in Romanian trade balance.

The Romanian economy fought with serious macroeconomic imbalances in the first phase of the transition process like many other EEC countries. Macroeconomic stabilisation was not an easy job, due to several social and political factors. On the one hand, the high influence of organised labour always threatened governments with open political pressure especially when austerity measures were to be introduced. But they were also successfully manipulated to block government policies in other domains as well. On the other hand, the high social cost of systemic corruption could not be eliminated in the country despite all efforts and pressure from especially the European Union. Weak tax collection, expensive functioning of institutions, and widespread bribing has always limited the budgetary reserves of the governments. Moreover favouritism in public spending also deteriorated the efficiency of the usage of the centralised part of the GDP (Kaufman and Vicente 2011). All this resulted in relatively expensive and fairly low quality of social services. This also increased the danger of emerging macroeconomic imbalances. The problem of budget deficit has always been a key macroeconomic problem of the country. The level of deficits ranged from 3-11% per year in 2006-2013. Latest figures are more promising. Starting with year 2013, the Romanian budget deficit did not exceed the 3% Maastricht criteria level (2.9% in 2017). The accumulated state debt was only 35.1%, well below the Maastricht conditions.

The share of wages amounted to 29.9% of the 2017 GDP, a relatively low level. Romania has remained a country of cheap labour force. The more recent increase of the minimum wage started perhaps a longer-term acceleration of real wage increases. This may cause problems if not paralleled by matching increase in labour productivity, because then unit labour costs would increase too. The country would lose its hard-won FDI attraction potential. Low wages prevailed despite of considerably high level of trade union density. In 2014, 35% of the labour force was organised. Also, the collective bargaining share was considerable (36% of all employed in 2012). This is most probably the outcome of the inherited industry structure, the survival of large industrial complexes in major industrial cities. With the high share of agriculture as usual rates of activity remain lower. In Romania the activity rate was 67.3% in 2017, which is higher than in some more traditional rather agrarian countries, but less than other EEC countries' figure. Total unemployment was rather low, 4.2% in 2018, as a result of the impressive economic growth figures of the country

in the 2000s. Temporary employment is almost nil, statistically. Most probably, short term employment is not reported at all, due to the weak operation of state control in this area too.

State spending on social protection is relatively low in Romania. The total benefits to GDP ratio is only 10.8% in 2017. Self-reliance is relatively high, but also perhaps the size of available services that the state can afford is relatively low. This may be a reason why many individuals who have both Romanian and Hungarian citizenship choose to participate in the Hungarian social service system (mainly in health care), that puts rather serious burden on the Hungarian system, since these recipients of the services do not contribute to the Hungarian system. The total government expenditure directed to families in percentage of total government is very low: only 5.4% (2017). Pensions' share in GDP was 8.1% in 2015. Total expenditure on health care: 5.0%. Inequality in the society is moderate, only slightly higher than for example in Hungary and lower than in Bulgaria (another country with byzantine heritage). The Gini coefficient was 36.5 (yet, it was 40.4 in 2015), only slightly exceeding the EU28 average (36.0). After correction by social transfers it still remains 33.1, which is a clear evidence of relatively modest efforts of social security systems in Romania.

## 3. Quality of entrepreneurship

Entrepreneurship in Romania has no long tradition. Political control was especially tight during the communist regimes, citizens were regarded as sole contributors of ambitious government plans. No effective work incentives were used and entrepreneurship flourished only on the black market. Since the transition process did not change much the ruling elite, the old type of state and political control together with flourishing corruption survived. Since the international advising community set modernisation requirements in order to change the Romanian system into a compatible one, market economic institutions were set up. Nevertheless, their functioning has always been marred by the impacts of the "old traditions". This is clearly shown in most evaluations.

The country profile in Global Entrepreneurship Monitor mirrors entrepreneurial behaviour and attitudes. Romania's scores are rather mixed. From the self-perception measures the country scored above the global and

regional average in “fear of failure rate” and in “entrepreneurial intentions rate”. This shows strong entrepreneurial attitudes of the Romanian population (see also the high share of agricultural employment which is most importantly self-employed small holders). Entrepreneurial employee activity rate was also very high. However, many entrepreneurs are quasi or forced entrepreneurs, people who have no alternative job opportunities, which is clearly shown by the extremely low motivational index. The GEM spider shows in the case of Romania above average level of commercial and legal infrastructure. However, this is the only good news: in all other aspects the country scores rather badly, usually below rank 3, and mostly below the international average too. Worse grades were achieved in the 2015 ranking in entrepreneurial finance, governmental policies both in support and relevance and in taxes and bureaucracy, as well as in government entrepreneurship programs.

Despite of impressive economic growth figures Romania was only 68$^{th}$ in the 2018 edition of the Global Competitiveness report. Worse performance was achieved in business sophistication pillar (116) and innovation (96). Far below average was the record in pillars institutions, health and primary education, goods market efficiency, labour market efficiency and financial market development. Not surprisingly, the score was improved by pillars market size and macroeconomic environment, and to some extent technological readiness. Individual indicators can reflect more nuanced problem areas and also advantages.

Unfortunately, Romania has had very many indicators with ranking below 100. This means that the problem pillars all need massive improvements. Pillar 1 is about institutions. The transition period and the EU accession process was thwarted by continuous problems with political as well as low level (bureaucratic) corruption. There has been a widespread consensus among political forces about the treatment of political power as a prey. Despite of continuous efforts at tightening control over corruption virtually all political parties defended the affected politicians and maintained systemic corruption intact. The political consequence of this policy was frequent political crises and also low level of public trust in politicians (113), due to frequent favouritism in decisions of government officials (116), low efficiency of government spending (115), and the burden of government regulation (124) or transparency of government policy making (113). Due to the lack of judicial independence efficiency of the legal

framework in settling disputes was the worst measure of all (131). Similar aggregation of bad scores is observed in labour market efficiency pillar. These measures show the reasons of high outmigration from Romania. Pillars financial market development and business sophistication also received repeatedly bad grading. For example, availability of financial services was 121, venture capital availability 126, local supplier quantity 122. All these indicators show serious institutional and cultural weaknesses of the Romanian economy that could be improved on the long run through steady deliberate government efforts to cure the roots of the problems. Unfortunately however, most indicators of the public administration and structural policies of the government show the opposite, a deliberate maintenance of the current situation.

The Heritage Foundation's research on business freedom ranks Romania 42nd on the list, which is ahead of many countries from the CEE region. The score was 68.6 in 2019. Judicial effectiveness and investment freedom deteriorated (e.g. the president of the anticorruption office DNA was successfully forced to resign), but there were improvements in the area of property rights, tax burden and government spending. Romania's score matches the regional average and is above the world average. Despite of the relatively advantageous ranking and score, the explanations in the text call the attention to some of the same unsolved problems (mainly corruption) that have plagued Romania transition for the past 30 years. More recently also some relaxation on tight fiscal policies were introduced putting macroeconomic stability at risk once again. Also, courts are still subject to political influence and suffer from a lack of expertise. On the other hand, efforts to fight both petty and high level corruption have become more credible. Yet, judicial corruption still remained a problem.

## 4. Modernisation based on FDI

Romania has delayed privatisation rather long and did not provide strong incentives for foreign investments either. Thus, the 1990s passed by with virtually no important FDI inflows (except Hungarian petty entrepreneurs' small scale investments, and a few larger Hungarian firms presence). The investment climate changed in the 2000s, but it has never been as supportive as in Hungary. Privatisation also proceeded and some of the Romanian flagship companies were sold to foreign firms (Petrom to Austrian OMV in 2004, Dacia, the Romanian car manufacturer to Renault

in 1999). Also some new greenfield investments took place. Nevertheless, in terms of total FDI stock Romania still lags behind the Visegrad countries. According to UNCTAD (2018) database the total inward FDI stock was a mere 6.9 billion USD in 2000. It increased to 68.7 billion USD in 2010, and 88.2 billion USD in 2017. This was approximately 50% of the Romanian GDP. Romania could enjoy significant investor interest in this late phase of the transition process because of the country's relatively big size (market seeking motive of investments) and also the inexpensive labour force. This later factor is however not always decisive. What really matters is unit labour cost: labour charges should be adjusted by productivity level. Labour productivity has been lower in Romania than in Visegrad countries, hence, access to cheap labour motivated investments in only a few specific labour intensive sectors (leather, shoe, and textile). Unfortunately, also some Romanian investments suffered from the 2008 crisis. The then still relatively new (2008) Cluj facility of Nokia was closed down in 2011 (parallel with the closure of the company's cellular production facility in Hungary).

The penetration of multinational business in Romania has been similar to the Visegrad countries, however it has not been so widespread due to the time delay of the process and the relatively few privatisation opportunities. The market share of foreign owned banks was large already in 2010 (84%). On the list of the 500 largest business ventures in ECE we can find 46 situated in Romania (a fair number but smaller than what could be expected given the size of the country). Out of this number the majority was foreign owned (37 entities). There were still 5 state-owned firms, only two owned by local individuals, and two in the possession of investors of other ECE countries.

Booming economy produced very significant increases in labour productivity in the 2010s. The 2010 level was exceeded by 42.7% in 2018, the highest level increase among the EU member states. This development in fact gave an opportunity to take measures to increase real wages even if during the preceding period labour productivity actually declined by 7%, thus the increment was lower if treated on longer time horizon. Labour attractiveness of the country was regarded insufficient by the Global Competitiveness Report. But it can potentially improve if economic development continues, labour shortage intensify in the country, and real wages are pushed up. However, if high level outmigration ( some 3- 3.5

million people) had other reasons than insufficient employment opportunities and migrants turn out to be refugees, than real wage increases would seriously deteriorate the country's very fragile international competitiveness position with FDIs just having started to explore the country.

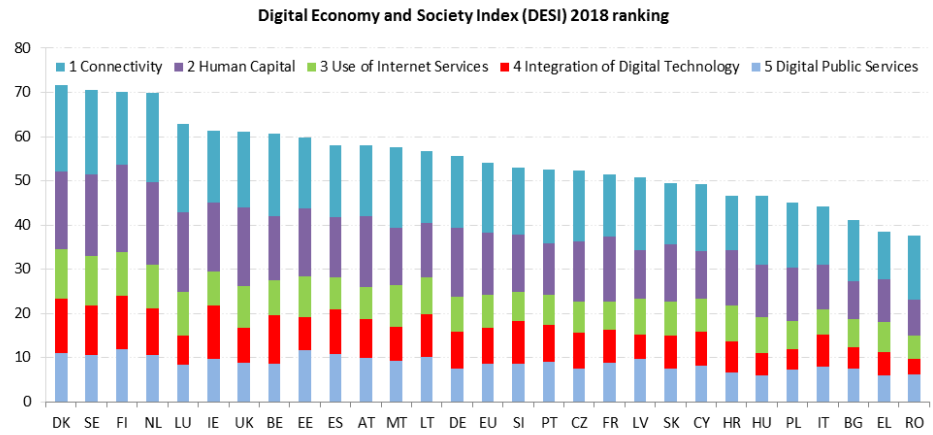
## 5. Knowledge sector

As seen also in many other already mentioned indicators the knowledge sector does not belong to the country's strengths. Inherited low level of development of institutions plagued the performance of the education and innovation system. Especially bad was the situation under the communist regime of Nicolae Ceausescu, who exercised strong political pressure on the system instead of providing it the necessary level of self-governance. The situation improved substantially in the Romanian transition process, but especially after the EU accession. Yet, the low profile heritage is still depressing the sector which is reflected in the performance measures.

R&D expenditure was a mere 0.48% of the Romanian GDP in 2016. This reflects huge hiatus both in public and private spending. Although the high-tech export seems relatively considerable, this is due to the export-oriented activity of a handful of multinational companies. Moreover, their effective activity in Romania is most probably not especially knowledge demanding but rather some simple labour intensive transformation or assembly phases of the production in the GVCs. Just as R&D public spending on education is also fairly low with 9.08% of the GDP (2015). The higher education rate was 28.6 % below the 30-40 % rate of most developed countries of the European Union.

The economic structure of the country with high share of agriculture and heavy industry does not seem advantageous for science and technology development and innovation (STI). This is reflected by the poor performance measures of the country in the European Innovation Scoreboard. Unfortunately, the country could not improve its ranking and still takes the last position of the 28 member countries, moreover, its gap is widening. Meanwhile in 2010 the country stood at 47% level of the EU-average in the synthetic STI measure (Summary Innovation Index), this position sunk to 33% level by the year 2017. Situation improved only in broadband penetration and slightly in medium and high-tech product

exports (this later was due to new export capacities of multinational firms in car and electronics industry). The country's position is extraordinarily bad and deteriorating in human resources (down from 41% of the EU-average in 2010 to 22.5% in 2017), finance and support measure (from 48% to 22%), firm investments (from 65% to 13%).




The digital economy as part of STI world is not yet highly developed in Romania. In 2018, the country was on last position among the 28 European Union member countries. The good news is that the country could improve its performance over the past year, so the gap did not widen. The most important problem is that digitalisation of the economy and digital skills in the population is low. This hinders progress in most other dimensions as well. Broadband connectivity is on the other hand relatively high: 44% of the homes subscribe to ultrafast broadband. ICT contributes 6-7% to Romania's GDP and the digital sector is growing with two major hubs in Bucharest and Cluj-Napoca. All this achievements were at least partially due to the 2015 Romanian Digital Agenda 2020. But despite of the technical opportunities the degree of ICT affectedness is still below other countries' levels, in terms of internet usage, basic digital skills or the supply of ICT specialists. Because of inadequate human background various types of internet uses are also underdeveloped except video calls and social networks. These services are widespread cheap communication devices between dissidents and relatives left back in Romania. Digital public

services is another very weak point of the Romanian digital economy and society system.

### 6. Public opinion attitude towards transformations

The byzantine heritage of Romania has influenced economic and social development also most recently, during the EU-accession process and with full membership. High level of corruption both in politics and in bureaucracy plagued the economy with little social control. This led to continuous poverty in most backward regions and a fairly ineffective use of the country's endowments. The EU accession process enforced the establishment and strengthening of some liberal structures in Romania. However, these efforts brought only very limited results when implemented by the "one step forward two steps back" approach of the Romanian governments that made all efforts to reduce outside or internal social control over their policies and practices. Therefore, a long term progress and catching up of the country requires the steady presence of (not very effective) Europeanisation anchors. Europeanisation has always been supported by the urban population and regarded as the main driver of gaining stronger control over inherited and transformed paternalistic linkages in polity and economy. Election campaigns always featured anti-corruption slogans, but most governments were then flawed in corruption scandals.

The most important field of debate has always been systemic (elite) corruption (Racovita 2011). Under pressure of the European Union Romania established not less than 6 anti-corruption authorities. Their activity area and licenses largely overlapped, and their control was rather chaotic. Their licenses were frequently changed. As a consequence, no effective control over corruption was carried out for many years. The European Union even froze negotiations about the last chapters of membership negotiations until results were delivered by the country in anti-corruption fight. During the mid-2000s this was done by the Anti-Corruption Office (DNA) and Romania was admitted to become EU member. Yet, the problem of corruption was not solved at all. On the contrary, the government forced President of DNA to resign. Continuous conflicts between Romania and the EU over issues of corruption are demonstrated by the fact that the recently dismissed DNA president became the strongest candidate for the President's post in the newly established

European Persecution Office. The task of the office would be among others to detect fraudulent usage of the EU funds in the member states.

While Romanian governments were not really interested in fundamentally changing the political and societal profile of the country, and successfully paralysed the effective functioning of institutions of the competition state, large part of the population desired getting rid of the traditional byzantine heritage. This is clearly expressed by mass demonstrations against corruption and some government measures recalling past routines. Also, opinion surveys show a surprisingly large support of western values. The ruling elite's clever policies could however dampen social pressures. Concerning opinion poll results we see for example that the social support and appreciation of the European Union is very strong in the country. According to the last survey (Eurobarometer 88) 76% of the citizens was dissatisfied with the economic situation of the country. Consequently trust in the government was very low (21% of the citizens). In contrast, 51% of the Romanians trusted the European Union. The most important problems for the Romanians were inflation and the cost of living, economic situation in general, and the low level of health and social security services. Support for the EU declined somewhat from the pre-accession peaks (e.g. 74% appreciation rate in 2004, then highest among the surveyed countries: Eurobarometer 62). There were high social expectations towards EU membership concerning solving important problems in various areas (foreign affairs, crime, economic problems, environmental protection, health and education, etc.). Unfortunately, these expectations were not fulfilled.

## Conclusions

Romania is a country with great economic potential, but the usage of the opportunities is rather weak due to several historic, cultural and most recent political problems. The inherited weaknesses of social and economic institution systems could not be significantly improved up till the late 2000s. After 2010 however, we see a strong economic revival, partly based on the increasing role of FDI that can create the necessary conditions for the improvement of the underdeveloped infrastructure items. Unfortunately, systemic corruption still plagues all spheres of the economy and society that makes every reform step most difficult. Romanian governments do not rush to support effective market economic institutions

that could potentially deprive them from their easy rents. Growing foreign owned sector can substantially improve the country's macroeconomic performance and thus create more stable environment. The modernisation process of the country and the expansion of its economy would badly need more efficient use of the resources. This is a task that cannot be solved without curbing historically embedded corruption and paternalism.

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### 3.3.4 Slovenia

Miklós Somai

## Introduction

The Republic of Slovenia is a small country with an area of just 20.271 square kilometres and one of the few on the Continent with a growing population (2.066.880 inhabitants, of which 15.0% under 15, and 19.4% over 65, on 1st January 2018). It lies at the heart of Europe, at the crossroad of four major European geographic regions, the Alps, the Dinarides, the Pannonian Plain, and the Mediterranean. Its immediate neighbours are Austria to the north is, Hungary to the east Hungary, Croatia to the south, and Italy to the west. The coastline is only 46.6 kilometres long, but there are 26,000 kilometres of rivers and streams, and around 7,500 fresh water springs, several hundred of them being first class therapeutic mineral springs. While the territory is relatively poor of mineral and energy resources (with some lignite, lead, zinc, building stone, and hydropower), forests cover half the territory which makes Slovenia the third most forested country in Europe, right after Finland and Sweden. This mostly hilly and mountainous country, with some 90% of the surface 200 metres or more above sea level, is rather unsuitable for agriculture, but an excellent place for tourism.

The country has a fairly evenly distributed population. The rate of urbanisation (54.27%) is rather low by European standards. The capital city, Ljubljana, has got 280.000 inhabitants (2015). The next most populous city is Maribor (95.000), but the following ones, Celje and Krajn (each with 38.000 inhabitants), are much less important.

The main economic and political process in the country after 1990 was Slovenia's threefold transition: "from socialism to a market economy, from a regional to a national economy, and from a part of SFR Yugoslavia to an independent state and member of the European Union" (Mrak *et al.* 2004: ix). This process, together with the three waves of privatisation which have been its essential element, fundamentally influenced business environment,

macroeconomic performance, as well as the quality of institutions and living conditions in the country.

## 1. Political context and quality of institutions

At the very beginning of transition, because of the inherited macroeconomic situation (of former Yugoslavia), characterized with a huge debt, hyperinflation and high level of imbalances in the economy, the tasks of macroeconomic stabilisation (and further internal and external liberalisation) mixed with the tasks of structural and institutional reforms (also the establishment of the missing institutions, such as a central bank and a national currency, customs systems, and a worldwide diplomatic network), privatisation of state-owned assets, reform of the enterprise and the financial sector, the public utilities, the pension and tax system, the social welfare system, and the public administration.

The introduction of the new currency (tolár) in October 1991, happened at a time when the new central bank (Bank of Slovenia) faced a double-digit monthly inflation, a highly indexed economy, with no international reserves, and a huge legacy of nonperforming loans in large commercial banks. The central bank's primary concern could not be but price stability. As annual inflation was reduced to single-digit levels by mid-1995, and foreign reserves increased from almost zero to the equivalent of 7.1 months of imports by the end of August 2003, the Slovenian central bank established itself as a credible institution. International respect for the country's economic governance was further strengthened by a roughly balanced general budget and a fiscal environment conducive to foster growth.

Ljubljana declared independence on 25th June 1991. Following a war against the Yugoslav army which lasted 10 days, the European Community acknowledged Slovenia as a sovereign state on 15th January 1992. Once the independence had been achieved, and following a two-year long transitional recession (aggravated by the rapid disintegration of Yugoslavia), Slovenia experienced an unprecedented period of unbroken economic growth that ran from 1993 until the outbreak of the 2008 crisis. These 16 years were marked by a gradual transformation from socialism to a market economy, also integration into western structures through gaining

membership in all important international institutions (World Bank, IMF, UN, GATT, WTO, and OECD). Here, it is to be noted that the apportionment of the former Yugoslavia's external debt served as a precondition for Slovenia's full integration into the international financial system. The country entered both the EU and NATO in 2004.

What were the fundamental causes behind these achievements? First, the legacy of the former SFR Yugoslavia. Slovenia inherited a strong tradition of a quasi-market system with relatively independent enterprise management structures running their firms which, in contrast to those in other planned economies, were directly exposed to some degree of competition. Second, Slovenia was by far the most developed and industrialised part of the SFR Yugoslavia. In 1990, its share in population, GDP and exports accounted for 8, 20 and 29% of the federation respectively. Its contribution to the federal budget amounted to 16.8%. Following independence, in terms of GDP, its deliveries to the federal budget declined from 7.2 in 1990 to 0.9 in 1991 (and then to zero) which meant an even greater relief than when the Czechs separated themselves from the less developed Slovakia in 1993 (Žídek 2016: 164).

Finally and surely, what was the main driver behind the success story is gradualism. Just like the Yugoslav self-management system had been a sort of moderate version of socialist planned economy, with the business sector enjoying ample freedom in their investment, production and pricing decisions, similarly the independent Slovenia adopted the mildest possible version of capitalism, a Nordic-type market economy, with high degree of social cohesion and low levels of income inequality (the Gini coefficients, both before and after social transfers, are amongst the lowest in EU28.). The success of this socio-economic model, built on gradualism has largely contributed for this small country to become the fastest growing economy and the first new EU member to introduce the euro in the former Eastern Bloc. This strategy, which enabled it to build up the region's most stable and efficient state institutions, made Slovenia the most Westernised post-socialist country. In the early years of transition, it exhibited all the attributes of Western European small states mirrored in its economic openness, capitalist accumulation (of which high level outward FDI), "protective and efficiency-enhancing compensatory policies,

macroeconomic stability, and governance by established democratic and neocorporatist institutions" (Böhle and Greskovits 2012: 182).

The success story is well reflected in Slovenia's Human Development Index (HDI) value which, for 2017, was 0.896 placing the country 25th out of 189 countries and territories, following France, but ahead of Spain, Czechia or Italy. In the period of 1990-2017, Slovenia's HDI value increased by 16.8%. Life expectancy at birth increased by 7.9 years, mean years of schooling by 1.3 years, and expected years of schooling by 5.2 years. The country's GNI per capita improved by about 61.8% between 1990 and 2017. Since 2010, an approved indicator (IHDI) takes into account inequality in all three dimensions of the HDI by "discounting" each dimension's average value according to its level of inequality. For this improved indicator (IHDI) Slovenia ranks even better than for HDI, and stood at 14th position (out of 151) in 2017, ahead of countries like Belgium, the UK, Austria, but also Singapore, Hong Kong, France, and the USA.

It has to be noted, however, there are traditionally sharp dividing lines in this small country's society between left and right, religious and irreligious, urban and rural, public and private (Szilágyiné 2019). Ever since the beginning of the transformation there has been a struggle between the new and the old elites. As long as the latter held their position firmly, the transition was gradual. From 2004 on, however, political power relations changed, and gradualism was halted. The result: severe banking crisis and double-dip recession in the economy. Although the country could avoid to be bailed out, but, under extreme pressure from both international markets and the EU institutions, it had to accept a growing interference by the latter in Slovenian post-crisis bank restructuring and economic governance, which resulted in decreasing democratic oversight of national banking policy: by "the hollowing out of democratic institutions, and strengthening of the executive, rule-based policy-making" the process narrowed fiscal democracy in Slovenian banking policy formation (Piroska and Podvršič 2018: 32).

The impact of the above processes has also been reflected in the quality of the institutions, which has not been very flattering for Slovenia. The Worldwide Governance Indicators (WGI) project constructs aggregate

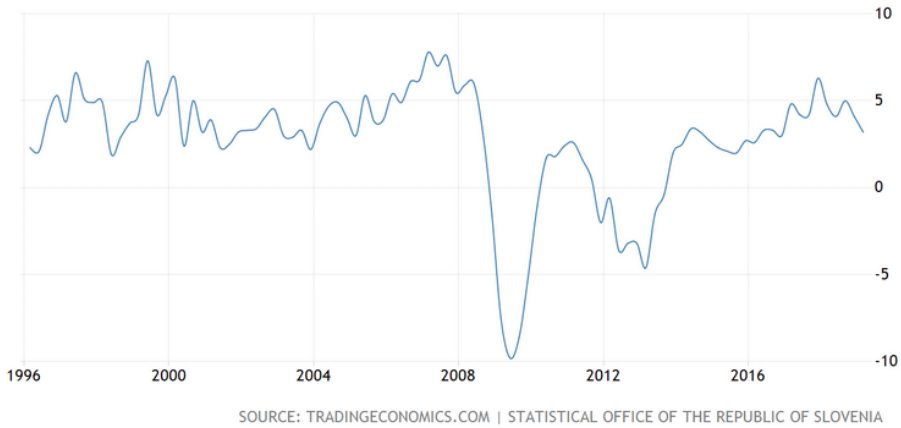
indicators of six broad dimensions of governance, based on over 30 underlying data sources reporting the perceptions of governance of a large number of survey respondents and expert assessments worldwide. Indicators for Slovenia tend to show a rather disappointing picture. Three out of the six aggregate indicators have, throughout the whole period 1996-2017, been continuously deteriorating: in 1996, 2004 and 2017 Slovenia ranked 26th, 33rd and 44th for "Voice and Accountability", 15th, 35th and 49th for "Political Stability and Absence of Violence/Terrorism", and 31st, 47th and 59th for "Regulatory Quality". In the case of "Control of Corruption", the country's position (35th, 35th and 44th) declined following the EU accession. It is to be added that, since 2013/2014, there was some recovery in ranking, save for "Regulatory Quality". The picture is different for both "Government Effectiveness" (39th, 42nd and 33rd position) and "Rule of Law" (31st, 43rd, 37th), as following a declining period until 2004, indicators improved afterwards. These improvements were probably due to the external pressure coming from both financial markets and the European Commission, especially from the early 2010s on, when Slovenia went through a very difficult period, and was almost in a position of having to ask for being bailed out by international institutions like some other Mediterranean countries did beforehand.

## 2. General economic outlook

After a two-year recession in 1991/1992 caused by the rapid disintegration of Yugoslavia, the independent Slovenia enjoyed a remarkably long era of uninterrupted economic growth between 1993 and 2008. In spite of having been one of the most advanced countries of Central East Europe at the beginning of the transition, Slovenia did better than any other fast-growing country of the region in catching up with the old EU member states. In the period of 1988-1990/2006-2008, it reduced its development gap vis-à-vis the EU15 by 13.9% in terms of real GDP per capita, more than Estonia (10.0 pp.), Poland (7.5 pp.) or Slovakia (4.8 pp.) did, all of them starting from much lower levels of development than Slovenia (ERS 2015). In the following period, the economy suffered a double-dip recession: in 2009, real GDP fell by 7.8%, which means that within the eurozone, Slovenia was the country most severely hit by the first wave of the global crisis. After a small recovery in 2010 and 2011, negative growth returned in 2012

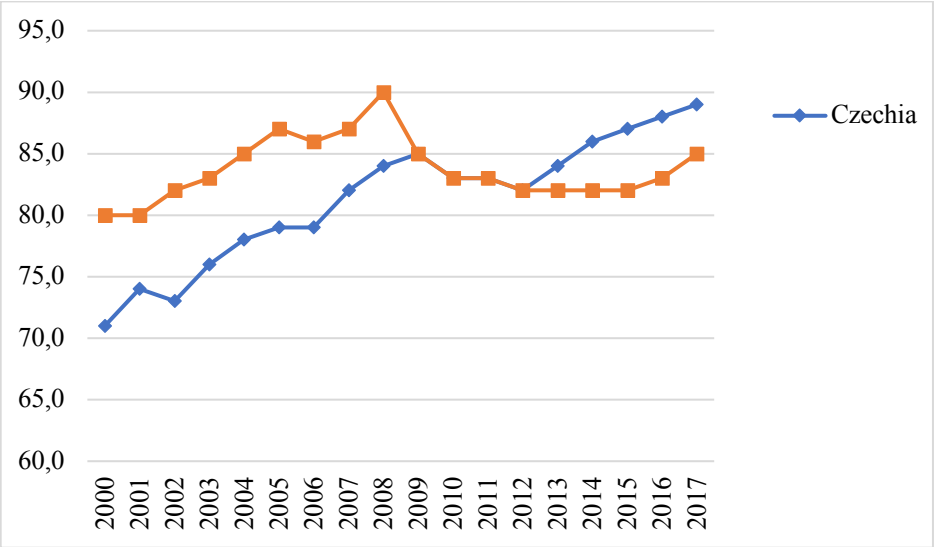
(-2.5%) and 2013 (-1.0%). From 2014 on, however, the country has returned to steady growth. It took until early 2017 before GDP reached its pre-crisis level.

**GDP growth rates.**



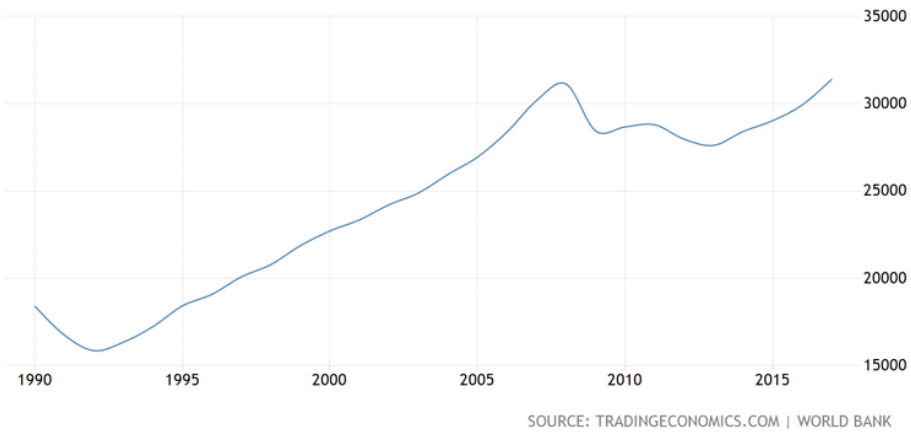

Purchasing power adjusted GDP per capita in Slovenia stood at 79.8% of the EU28 average in 2000. In the year of the EU accession (2004) it was up to 85.8%, and the year of Slovenia's entry into the eurozone (2007) 87.0%. Things started to go wrong afterwards. At the height of the crisis (2013), the indicator deteriorated to 81.7%. Even if, by 2017, it climbed up to 85%, it was not only well below the level the country introduced the euro, but also below the level Slovenia entered the EU. Using Czechia, a country which have not introduced the euro yet, as a control panel, we can find the following data: 71.7% (2000), 78.2% (2004), 82.4% (2007), 83.6 (2013), and 89.3% (2017).

**Purchasing power adjusted GDP per capita (EU28 = 100).**




Source: Eurostat

**GDP/capita, (USD, PPP)**




As already mentioned, the economic situation has been improving since 2014. The main driver behind this recovery was foreign demand, coupled with improved competitiveness of Slovenian exporters and their favourable sectoral structure which facilitated rapid growth in exports. Domestically,

due to the restructuring of the banking system and the gradual fulfilment of fiscal commitments, which improved the country's standing on financial markets, economic growth has become more broad-based. So, apart exports, remaining the most dynamic component of economic growth, domestic consumption has increased as well. Household consumption has been growing since the last quarter of 2013, stimulated by favourable labour market trends and high consumer confidence. Since 2017, gross fixed capital formation has also increased at a steadier pace, becoming the third main driving force of GDP growth. Investments in equipment and machinery have been growing since 2014, while from 2016 on, housing investments started to speed up as well, after having seriously (by circa 60%) declined during the crisis.

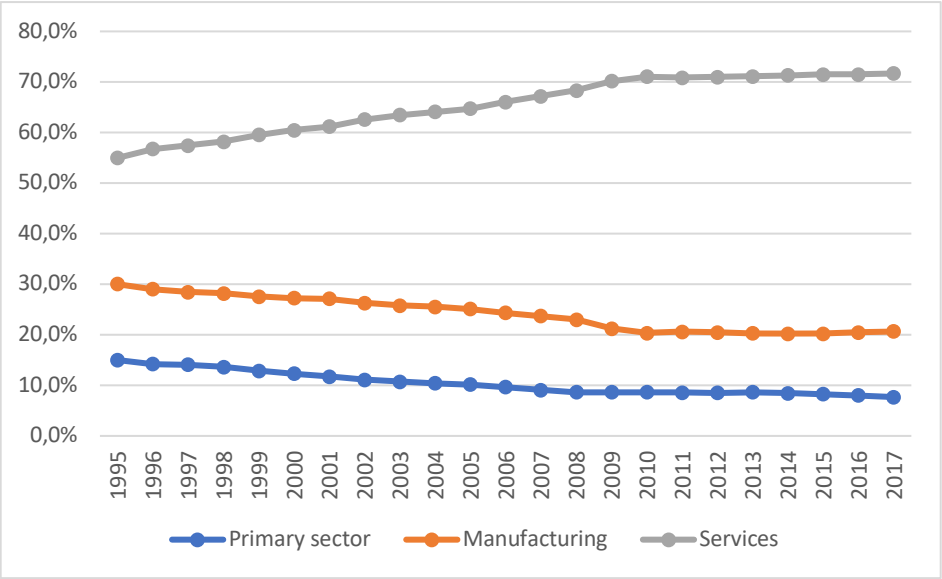
As a consequence, and as for the basic structure of GDP, Slovenia performs a relatively low share of public consumption (17.8 % in 2018, the EU28 average being 20.0 %). This indicator started from comparatively low level before crisis, went up a bit over 20 % during the first years of the crisis, and is declining since 2012. The same holds true for private consumption, with a share of 50.8 % of GDP in 2018 (EU28 average being 55.5%), 51.1% in 2007, over 55% from 2010 to 2013, and declining since then. Investments topped just before the global crisis (29.6% in 2008), fell sharply during the next two years, slightly decreased/stagnated until 2016, and gained momentum since then. In 2018, GFCF stood at 19.7%, not much below the European average (20.5%). The ratio of both exports and imports (of goods and services) to GDP has traditionally been very high, one of the highest in the EU. Leaving out 2009, a year when international trade dropped worldwide, both indicators have continuously been increasing throughout the whole period of 2007-2018. In 2018, imports stood at 75.7, while exports at 82.5% of GDP.

The robust economic growth of recent years has also boosted the labour market. Despite positive developments (e.g. growing employment, falling unemployment, increasing activity rate), structural challenges remain. The working-age population is shrinking as a result of demographic change. This could hamper economic growth in the future. It also poses challenges to the sustainability and adequacy of the pension, health care and long-term care systems. In addition, labour-market participation remains low for older

workers, in particular those with lower levels of education. The tightening labour market is putting some upward pressure on wages, although wage growth remains somewhat lower than expected. In short, Slovenia faces some structural labour market weaknesses, notably a weak employment situation of low-skilled and older workers, as well as a mismatch of labour market needs and skills.

In 2017, 7.7% of the Slovenian workforce was employed in the primary sector (agriculture, fishing, mining, forestry), 20.6 % in manufacturing, and the remaining 71.7 % in services. In 1995, the distribution of workforce displayed a different pattern: the above data were at a level of 15, 30 and 55 % respectively. The decline in the share of both the primary and secondary sector, as well as the increase in the share of the tertiary sector have been gradual. But, it should be noted that the major part of this move was completed by the outbreak of the global financial crisis, and there has been very few changes since then.

**National accounts employment data by industry.**




Source: Eurostat

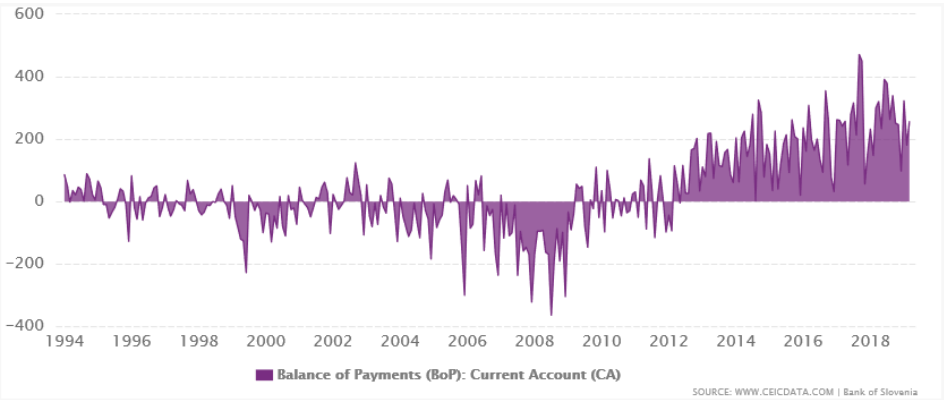
Two other notable changes can also be observed in the structure of employment. First, both young and older workers saw their employment shares decline, especially in the early years of transition. The young ones faced more difficult access to jobs because of the tightened labour market, so making schooling at the college level became more attractive for them; while the old ones escaped unemployment through government-sponsored early retirement programs. Second, the educational structure of the employed improved greatly: the share of those unable to complete elementary school fell sharply, while the share of those with a high school education increased considerably.

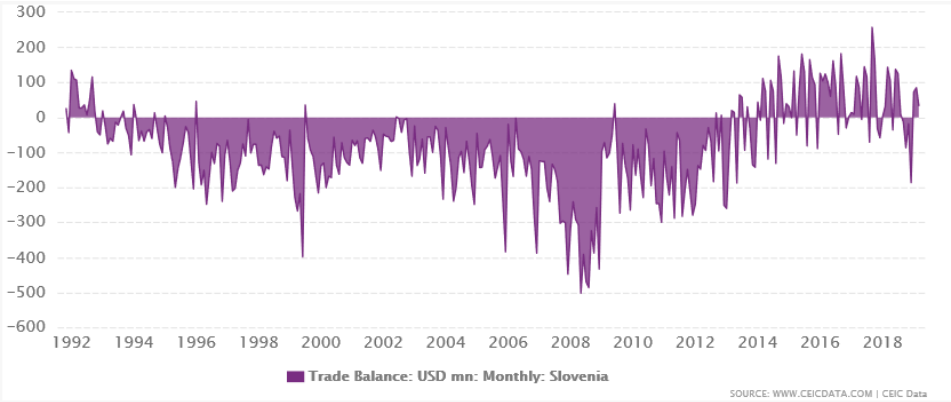
In 2017, the share of wages stood at 41.9% of GDP. Although it was a net (2.6%) decline vis-à-vis 1997, Slovenia ranked third (together with Germany) in the EU28, behind Denmark, and Luxembourg, but well above the European average. Trade union density tended to decrease throughout the 2013-2016 period, but remained relatively high in Slovenia, somewhere between 25 and 30 %. The union structure is fragmented, with seven separate union confederations, although one of them, ZSSS (Zveza svobodnih sindikatov Slovenije, Association of Free Trade Unions of Slovenia), being clearly dominant. In Slovenia, the activity rate has traditionally been higher than in Italy or Croatia, but lower than in Austria. In 2017, it was 74.2%, the best data since 2008, higher than both the EU28 and EU15 average.

Following a 5-year declining trend, Slovenia's total unemployment rate decreased to 4.4% by March 2019, i.e. back to before crisis level, after having climbed to over 10% in 2013. In Slovenia, collective bargaining takes place at industry-level negotiations, setting pay and conditions for the vast majority of employees covered by bargaining. The ending of compulsory membership of the Chamber of Commerce and Industry for employers, and the 2006 Collective Agreements Act, which stated that only employers or employers' associations with voluntary membership could sign collective agreements resulted in that many employers have chosen to withdraw from collective bargaining. The proportion of employees covered by collective bargaining has fallen from 96% in 2005 to an estimated 65% by ten years later. Temporary contracts have always been very common in Slovenia, due to high share of students combining study and work.

Temporary employees' rate for people aged 15 to 64 was 14.6% in 2017, of which young people aged 15 to 24 accounted for 71.6% of the contracts. Labour productivity progressed by 9% from 2010 to 2018, somewhat slower than in the V4 countries (except Hungary) or the Baltics, but much faster than most of the EU15, let along Italy. A comparison of global overall productivity in 2014 presented Slovenia as, by far, the most productive of the EU13 new countries. The share of Slovenian citizens of working age (20-64) living in another Member State increased from 2.4 to 3%, in the period of 2007-2017. While Slovenians are amongst the less mobile nations in the EU28, they rank first when it comes to the rate of employed of those living abroad (more than 80%).

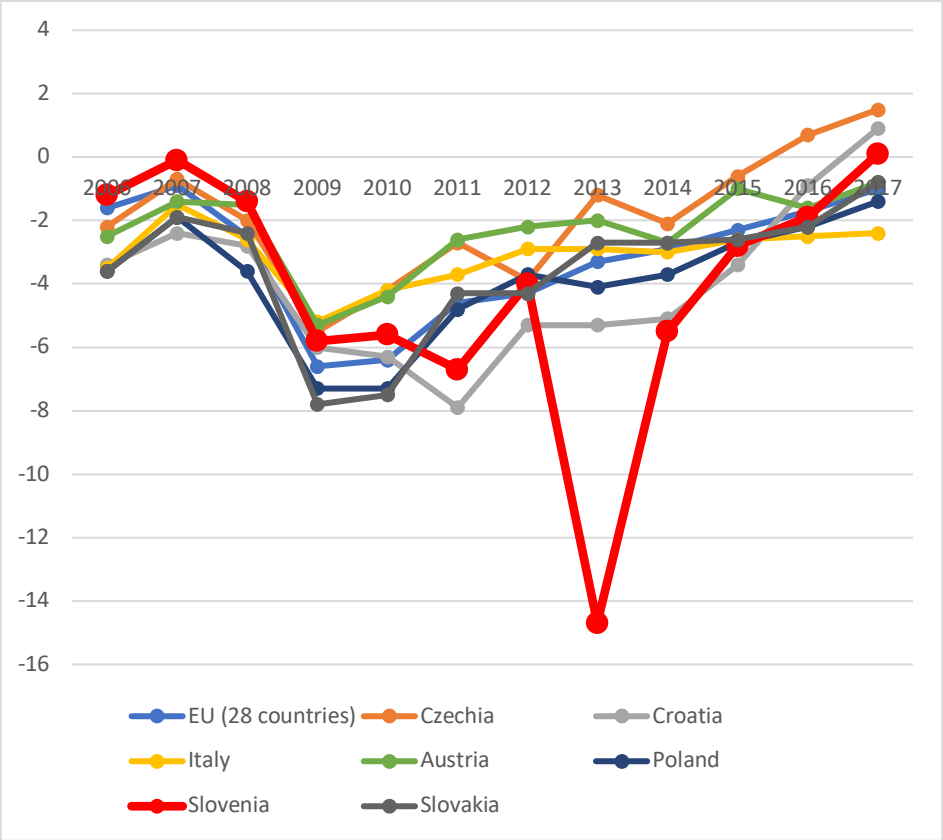
As far as the macro equilibria are concerned, both trade and current account balances are mostly positive since 2013/2014. A turning point in trend can, however, be observed lately, as a 300 million euro wage increase for the public sector, decided upon in December 2018, started to have an impact on the economy.






The general government balance has improved spectacularly in recent years. Deficit declined steadily after peaking in 2013 (at -14.7% of GDP). In 2017, Slovenia reached a slightly positive fiscal position (+0.1) due to improved macroeconomic circumstances following the stabilisation of the banking sector, the recovery of domestic and foreign confidence, and the measures implemented to increase revenue and restrain spending. Except for 2013, and to a lesser extent 2014, the years of bailing out banks, general deficit has always been in harmony with that of its neighbours (as well as Poland and Czechia).

General government deficit (-) and surplus (+).




Source: Eurostat

Following brisk growth until 2015, general government debt as a share of GDP did not start declining until 2016 and remains at a high level. General government debt surged from 2008 to 2015 (from 21.8 to 82.6% of GDP), but dropped since then to reach 73.6% in 2017. Factors behind this improvement include sustained economic growth, as well as an active debt management in favourable borrowing conditions. Nevertheless, debt remains high and restricts the fiscal space to cope with possible shocks, or ease austerity measures. General government expenditure has been declining since 2014, and in 2017 reached a level (43.2% of GDP) which was clearly lower than that of any of its neighbours. Inflation was gaining momentum, but remained low. After a two-year period of deflation in 2015

(-0.5%) and 2016 (-0.1), it rose to 1.4% in 2017, and reached close to 2 % in 2018, especially due to higher oil prices.

Despite the reforms of 2010-2014, stemming from austerity type crisis management, and the need for rescaling of Slovenian state regulations in line with the EU single market and eurozone constraints, social protection system remained complex, and consists of rights and services derived from various compulsory social insurance systems (old-age, disability, health, unemployment, professional disease) and a system of rights (benefits and services) which are tax-financed and categorical or mostly means-tested (protection of persons with disabilities, social assistance, child and family care). Reforms, starting in 2010, introduced means tested social transfers and subsidies, whereby allowances are attributed on the basis of income and wealth, in line with new welfare principles, meaning that benefits moved from being universal to targeted and conditional.

### 3. Quality of entrepreneurship

In former Yugoslavia, under the system of workers' self-management, companies were operating in a quasi-market environment in relatively independent managerial structure, and had, to a certain degree, been exposed to competition. After the 1965 reform, which further liberalised the system, managers could feel themselves like quasi owners of the companies they managed. Despite inherent inefficiencies of the system (in the form of forced equalisation at both micro and macro level), the country progressed towards becoming a market economy: by the end of the 1980s, all prices and imports were liberalised.

The process of privatisation of the corporate sector – at least at the level of principle – started already in the Yugoslav era. Amendments to the federal constitution, as well as some laws on economic and labour relations at the end of the 1980s (the Enterprise Act, the Law on the Circulation and Disposal of Social Capital, the Law on Social Property) (Mencinger 2006: 5) – while limiting workers' self-management rights and allowing socially owned firms to transform into mixed companies – tried to find a solution to the problem of insolvency: bankruptcy rules were put in place, and companies in distress were allowed to include private capital to carry out the necessary restructuring (Pleskovič and Sachs 1994:210).

The first wave of privatisation still bore the imprint of the socio-economic heritage of the preceding communist regime, the old elite having taken prominent part in it. This ensured a degree of continuity and resulted in balanced macroeconomic development. It was a mixture of free distribution, internal buyouts with discount and the possibility of deferred payment to employees, and commercial privatisation. In profitable small and medium-sized labour intensive firms (i.e. in more than 60% of the cases), workers and managers obtained majority ownership. The second most popular method for privatisation (in over 10% of the cases) was applied in profitable large firms – in fact too large for insiders to acquire a majority stake – where managers tried to maintain their influence by combining internal distribution of shares with public auction, thus opting for dispersed shareholder structure rather than strategic and/or institutional owners. At the end of the first wave of privatisation, which was followed by a non-transparent domestic consolidation of ownership, managers, domestic companies, and state and private funds were the key economic players. This model enabled the state to maintain significant ownership in privatised firms through state-controlled (pension and restitution) funds. Foreign and/or strategic investors played a much smaller (also less than desirable) role.

Things began to go wrong during the second wave of privatisation. Due to political inexperience and internal division, the new elite lost the 1992 election and the old elite governed the country for the following 12 years. When the new elite came back into power in 2004, the centre-right forces tried to take control of the economy and even large parts of the national media. In less than a year, they managed to put their faithful men into the managerial and supervisory boards in both government-related companies and state-owned banks, and, by forcing the latter to finance MBOs in the former, they exposed both banks and companies to extreme risks. By doing so, they also overheated the economy, especially in cyclically sensitive sectors like construction, real estate and financial mediation.

Credit expansion was bolstered, first, by the country entering the European Exchange Rate Mechanism (ERM-II) at the end of June 2004, whereby the Bank of Slovenia practically lost control of the amount of money in circulation; second, by the introduction of the International Financial

Reporting Standards (IFRS) in early 2005, replacing the previous conservative regulations with much more permissive ones; third, by growing competition among the banks, pushed especially by foreign banks who proved to be very aggressive in their efforts to expand their market share. Among factors on the supply side, undoubtedly the most important was the fourth one, i.e. the large supply of assets available on the international financial markets. In the period of 2004 to 2008, Slovenian banks borrowed massively from the interbank markets, and provided domestic companies with cheap loans.

It was at the intersection of supply side (more financing) and demand side (more investment) that the problems leading all but to sovereign crisis concentrated:

- the Slovenian banks faced increasing exposure to risks arising from a maturity mismatch (i.e. short-term liabilities outweighing short-term assets), as interbank credit had historically been short-term, whereas loans issued to the private sector were typically long-term;

- a substantial part of the above mentioned loans financed the corrupt insider privatisations (i.e. consisted of soft funding for buyouts by politically connected managers);

- the most dangerous was the very way in which the banks provided loans for this "conquest" (i.e. totally inconsistently with the principle of risk minimisation). On the one side, companies actively invested beyond their core business, and whereby created a real estate boom. On the other side, the banks, by letting an exceptionally high proportion of loans be tied to the value of properties which were pledged as collateral, exposed themselves to excessive risks. Also, they committed similar errors by financing companies carrying out leveraged buy-outs (LBOs) (Bank of Slovenia 2015: 20).

This "conquest" attempted by the new elite came in the worst moment and played a crucial role in Slovenian economy having, since the outbreak of the global crisis, to suffer the Eurozone's deepest slump. It was only after years of hesitation over the seriousness of the crisis, and several changes in governing power, under the pressure coming from both financial markets,

in the form of encouraging speculation over a possible bailout, and the European institutions to introduce austerity policy, and comprehensive bank recovery measures, that the Slovenian economy came back from the brink.

Here two remarks need to be made. First, although the economy has been put back on track in terms of growth, the recovery is still fragile, mostly driven by exports which in turn are fuelled by internal devaluation. This means that important strata of the population are far from enjoying any of the blessings of this recovery. Poverty is gaining ground especially in the countryside. The gradual weakening of labour bargaining power and its institutional capacities to impact on policy-making over major macroeconomic decisions accelerated in the post-2008 period. Second, although the country could avoid a direct intervention of the troika, the price to be paid was huge: the Slovenes were forced to give up their traditionally cautious attitude about privatisation and agreed to start a new program involving the sale of several of their nationally important entities.

The third wave of privatisation included fifteen corporation from various sectors (of which some strategic such as banks, the national airways and airport). The process can be followed and checked on at the Slovenian Sovereign Holding (SSH) website. What immediately strikes the observer is that all closed transactions involved companies that passed into foreign hands. As far as the financial sector is concerned, in exchange for the ECB's approval to recapitalise the banks, the Slovenian government was forced to promise to privatise them: to fully privatise the second and third biggest banks (NKBM and Abanka), and partially privatise the first one (NLB). NKBM has already been sold to the US equity funds Apollo Management (80%) and EBRD (20%). Abanka has to be privatised by the end of 2019. As for NLB, 65% of its shares were sold at the end of 2018, in an initial public offering (IPO) process on Ljubljana and London Stock Exchange; the rest of the shares of up to 75% minus one share were to be sold by the end of 2019. The flip side of this process is that, apart from its already mentioned contribution to democracy deficit, the growing influence of the EU institutions on Slovenian banking policy "prolonged and deepened the banking crisis in Slovenia, contributed to a costly state rescue that boosted state debt and led to the privatisation of the key systemic bank which will

have a negative long-term effect on Slovenian fiscal balance" (Piroska and Podvršič 2018: 30).

The Global Entrepreneurship Monitor (GEM) was established in order to measure the differences regarding the relationship towards entrepreneurship, uncover factors that encourage or hinder entrepreneurial activities, provide a platform for assessing the extent to which entrepreneurial activity influences economic growth, and reveal policy measures for the purpose of enhancing entrepreneurial capacity in an economy. In 2017, 34.6% of Slovenian adult population saw the possibility of future business opportunity, which ranked the country 40$^{th}$ globally and 12$^{th}$ in Europe. The percentage has been on the rise during the last couple of years: in 2015 it only amounted to 20.5%. As for the self-perception potential, 53.3% of the population believed they had the required skills and knowledge for entrepreneurship, which ranked Slovenia 18$^{th}$ globally and 1$^{st}$ among the European countries that participated in the survey. Successful entrepreneurs were also of great respect by Slovenian society, an opinion is shared by 73.4% of adults, which ranks Slovenia 5$^{th}$ in Europe. But, the percentage of people believing that entrepreneurship represents a good career choice (55.1%) ranked Slovenia in the middle of the European scale. Total early-stage entrepreneurial indicator (TEA) is one of the basic measures of GEM research, which measures the percentage of the adult population aged between 18 and 64 that are in the process of starting or who have just started a business venture. In 2017, Slovenian TEA reached 6.85%, which was below the European average (8.07%). The next phase in the development of enterprises is the so-called established entrepreneurship, consisting of entrepreneurs who own businesses and have paid salaries for more than 42 months. In European context, Slovenia ranked 10$^{th}$ among 20 countries in 2017. Business discontinuation is the final stage of entrepreneurial process. In Slovenia, 17.2% of entrepreneurs discontinued a business, mostly due to lack of profitability, but also due to government/taxation policies or bureaucracy. Reflecting all the above, Slovenia's 2017 GEM spider chart shows that expert ratings of the national entrepreneurial framework were in line with the European average, the level of physical infrastructure ranking highest, while entrepreneurial education at school stage and government policies/taxes and bureaucracy

the lowest. The latter indicator, together with cultural and social norms were below European average.

On the list of WEF's Global Competitiveness Index (GCI) Slovenia scored 35th out of 140 countries in 2018. This means a clear improvement from the 42nd position in 2008, mainly because of improved macroeconomic indicators (of which inflation and debt dynamics). The other main pillars of the GCI did not change spectacularly, and most of them were close to the level of the high income group average or the Europe-North-America average. Exceptions were the "market size" and the "financial system" indicators for which Slovenia ranked well below the control groups, and macroeconomic stability for which the opposite was true. Slovenia ranked among the best for the "cost of starting a business", "macroeconomic stability", "internal security" ("terrorism" and "homicide"), "railroad density", "electrification rate", "R&D expenditure", "competition in services", and some aspects of Pillar 6 ("skills").

## 4. Modernisation based on FDI

In 2017/2018, according to statistics derived from the OECD database comparing inward foreign direct investment (IFDI) to GDP, there has been a clear difference between Slovenia (31%) and the other new member states of the EU, like the Visegrad (Poland 45%, Slovakia 54%, Hungary 57%, Czechia 64%) or the Baltic countries (Lithuania 37%, Latvia 50%, Estonia 80%). It is, however, to be noted that Slovenia's performance in this field is far from being unique either in the region – take e.g. Italy (21%) – or within the group of small European OECD countries, like Finland (35%), Iceland (34%) and Greece (16%)[39]. Nevertheless, the relatively low stock of IFDI indicates that the country could, at least until very recently, avoid to become a dependent market economy in the sense of TNCs controlling sectors of strategic importance. At the beginning of transition, the Slovenian economy was both more market-oriented and more internationally competitive – i.e. less in need of foreign capital to develop – than the V4 or the Baltics. Add to that the fresh new independence of a nation after centuries of subjection within ancient (Roman, Holly Roman, and Habsburg) empires or in Yugoslavia, and small wonder that the main

[39] https://data.oecd.org/fdi/fdi-stocks.htm#indicator-chart

methods chosen for the first two waves of the privatisation process clearly benefited local managers and investment funds rather than foreign ones. For the latter, it was quasi a signal they were non-welcome in Slovenia (Vaupot 2018:9).

Foreign direct investment (FDI), although traditionally low, has been increasing at a faster pace since 2014. FDI inflow as a percentage of GDP was 2.2 in 2017, fluctuating between 2 and 4% of GDP since 2014, up from between 0 and 1.7% for the previous 4 years. The favourable economic conditions in the international environment were not the only driver of this improvement. There were multiple domestic factors as well: the acceleration of privatisation; the improvement of the economic situation and business expectations; friendlier government attitude towards FDI; favourable labour market and cost trends compared to some competitors facing with labour shortage and rapidly growing labour costs. However, Slovenia is yet to improve certain key elements of the business environment, such as taxes and tax legislation, the length of administrative procedures, and labour legislation.

At the end of 2017, there were twelve commercial banks, three savings banks and three branches of foreign banks (two from Austria, and one from France) operating in the Slovenian banking sector. Three out of five largest banks were partially state-owned: NLB with 25.6%, Abanka with 10.5%, and SID (a development bank) with 7.1% market share as measured by total assets. NLB and Abanka are under the state aid restructuring programme, and the government was committed to privatising them by the end of 2019.

In 2016, on the list of Deloitte's Central Europe (CE) Top 500 companies, there were 17 operating in Slovenia, so two more vis-à-vis 2015. As for their ownership situation, 6 out of them were in foreign hands, 2 belonged to the Slovenian state, while 9 were local companies.

Measured by development indicators, the financial system still falls far short of the EU average. Banks' total assets (as a percentage of GDP) are well below the EU average. The gap is narrowest in insurance, least affected by the financial crisis. The capital market remains poorly developed: treasury bonds account for the bulk of the market capitalisation of issues traded on the Ljubljana Stock Exchange, with the number of listed

stocks and their market capitalisation modest and lower than before the crisis. Stock market capitalisation amounted to 12.0% of GDP in 2017, on a stagnating/declining trend since 2009, very far away from the peak year of 2008 (39.1%). The level of domestic savings in relations to GDP started to increase after having reached the bottom at 22.9% of GDP in 2012. Their level of 28.9% (in 2017) was above those of its neighbours (except for Hungary).

The situation in the banking system has improved significantly for the last few years, largely due to a sizeable bank recapitalisation at the end of 2013, and the transfer of a large share of non-performing loans from banks to the bad bank (BAMC). The quality of bank assets has improved strongly relative to 2013, and the favourable economic circumstances have contributed to an improvement in creditors' ratings. Lending activity, however, is beginning to grow very slowly. Only in 2017 could it increase for the first time since 2010. Although loans to households grew for the third year in a row, but corporate loans increased for the first time in six years. Domestic credit to private sector was at 44.8% of GDP in 2017 (cp. 85.3 in 2010), a much lower level than any of the V4 or its neighbours, except for Hungary (33.4), whose indicator performed a parallel path to that of Slovenia. Gross fixed capital formation, in terms of percentage of GDP, having felt from 27.3 (in 2000) or 24.3 (in 2009), then fluctuated significantly due to the dynamics of the drawing on the EU funds, started to increase in 2017 (18.5%). This level is very low compared to Slovenia's neighbours or the V4 partners, with only Poland and Italy performing poorer. Bank concentration, measured in percentage of bank assets held by top 3 commercial banks, stood at 59.7%, with a minimum of 51.4% in 2013 and a maximum of 65.2% in 2003 during the period of 1996-2016, and climbing again since 2013.

## 5. Knowledge sector

Education has always been high priority in Slovenia. Already in 1921, the rate of illiteracy was below 10% when no other region of the Kingdom of Serbs, Croats and Slovenes had it below 20, and the country average was above 50% (Gulyás 2009a: 6). Despite intense redistribution efforts, differences in development have not decreased in Tito's Yugoslavia; in

1971, tiny Slovenia, with a mere 8% (but the highest-skilled and best-educated people) of the population of Yugoslavia, produced 20% of the Federation's GDP and accounted for 18.4% of its exports (Gulyás 2009b: 163).

Independent Slovenia started, in the 1990s, to establish a host of new institutions to promote innovation in the business sector: national agencies (TIA, ARRS, JAPTI)[40], regional development agencies, new technology parks, and university incubators in Ljubljana, Maribor and Primorska (Breitfuss-Stanovnik 2007:6). Slovenia's still highly diversified manufacturing sector accounted for more than 88% of BERD (Business Expenditures for Research and Development) in 2007. Best performer was the pharma industry (37%), whose much-appreciated brands (LEK, Krka) have got strong links with the universities of Ljubljana and Maribor, as well as the National Institute of Chemistry. Pharmaceutical and chemistry, car and car components, electrical industry and electronics, ICT, metal and machinery – which together with transport and logistics make the competitive backbone of the Slovenian industry – may all attribute their success to their close cooperation with the relevant faculties of universities, and other public research organisations of the country (OECD 2012: 110,111).

The annual European Innovation Scoreboard (EIS) provides a comparative assessment of member states' research and innovation performance, highlighting their relative strengths and weaknesses, and helping them to concentrate their efforts to boost innovation performance. In 2017, Slovenia, together with Austria, Belgium, France, Germany, Ireland, belonged to the group of the so-called "strong innovators" with performance above or close to the EU average. The country stood 12$^{th}$ in the EU28, the same position as in 2010. Its performance relative to the EU28 average was 92.2%, a slight deterioration vis-à-vis 2010 (96.2%). Human resources and firm investments were the strongest innovation dimensions, finance and support, sales and employment impacts being the weakest.

[40] Slovenian Technology Agency, Slovenian Research Agency, and Public Agency for Entrepreneurship and Foreign Investment

Slovenia ranked 15th out of the EU28 Member States in the European Commission's Digital Economy and Society Index (DESI) in 2018. Since 2015, it gained three places, leaving behind countries like Czechia, France and Portugal. Slovenia now belongs to the medium-performing cluster of countries consisting of, apart those mentioned, Spain, Austria, Malta, Lithuania, Germany, and Latvia. Although digital content is included in the formal education from elementary school to university level, and lifelong learning programs target parts of the population not covered by the formal education process (45+ years old, low-skilled and rural population), companies cannot find enough digitally skilled labour. Slovenes increasingly engage in online banking (50%), online shopping (57%), and read news online (77%). Slovenian SMEs are increasingly taking advantage of the possibilities offered by online commerce, 17.7% of them selling online, and 11.6% cross-border. Slovenia has considerably improved its performance in "Digital Public Services", especially due to improvements in the re-use of public sector data, and in e-Health services. Digitisation contributes to transparency, as almost all documents for meetings of the government and parliament are available online, and several applications make it possible to monitor public procurement expenses, as well as the use of public funds. The high ranking in e-Health is explained by a generalised roll-out of e-prescriptions, enabling physicians to prescribe medicines to patients electronically.

It is not for nothing that the country belongs to the group of strong innovator countries. People of research/innovation and education have always been highly appreciated members of Slovenian society. First scientific organisation (Academia Operosorum Labacensium) was founded in 1693 in Ljubljana. R&D expenditure as a percentage of GDP was 1.85% in 2017, following stagnation from the late 1990s to 2007 (approximately 1.3-1.5%), a steep growth from 2008 to 2013 (2.58%), and a decline since then. Since 1995, Slovenia's R&D to GDP ratio has always been higher than that of its main regional partners (except for Austria), higher than the EU28 average in 2010-2016, and higher than the OECD average in 2011-2014. In 2015, most of the R&D budget was spent on natural research (29.1%), engineering and technology (48.3), medical and health sciences (14.0), while much smaller part of them was devoted to social sciences

(3.7), or humanities and the arts (2.8). In 2017, and by sector of performance, 74.7% of the R&D expenditure was carried out in private businesses, 13.8% in government, 11.2% in higher education, and 0.3% in private non-profit institutions.

The effects of the global economic crisis have largely been reflected in the adjustments of public budgets, also across all levels of education. Slovenia was among the countries with the largest negative adjustments: in 2015, public expenditure on educational institutions as a percentage of was 4.3 (4.1 without R&D), a 15% decrease vis-à-vis 2010, and 19% vis-à-vis 2005. The higher education rate, i.e. the share of students in the 20-24 year-old population, was 46.7% in 2016.

## 6. Public opinion attitude towards transformations

When we examine public opinion about transformation, we follow two main lines: first, one's attitude to the change of regime, and primarily to change in ownership (i.e. privatisation); second, people's attitudes to their country's membership in the EU, as one of the most important factors in their daily lives.

Slovenians are hard-working, economical peoples who worked also for the people of the other, poorer republics of Yugoslavia. Once independent, they sought security, i.e. their primary aim was to become member of the EU and NATO. But, they also wanted to maintain their control over their own country. Hence a certain degree of aversion to private capital, especially if it originates from abroad. It is generally believed that a particular area is best under government control. Entrepreneurs who move their capital abroad are treated as traitors. Unless they invest into the former Yugoslav republics, because these latter are being exploited by the Slovenians the same way as the West does with them: they export their capital and repatriate the profit, and also import the best manpower and employ at half price at home (Szilágyiné 2019). It is, therefore, no wonder that privatisation has always progressed slowly, and the privatisation of the most important (largest insurance and telecom) companies (Triglav and Telekom) was stopped for reasons of national security. Also, in the largest bank, the state must, by law, remain the largest shareholder.

Regarding the public opinion about the country's EU membership, there is a significant change in it since the time of gaining this membership. Support for the EU membership, which peaked at 57% in 2003, turned into 52% of Slovenian respondents expressing distrust towards the European integration in 2015 (Kukovič and Haček 2016). We can add that the introduction of the euro, which seemed to be a good idea at the time, proved to be a rather bad idea: first, because, being much more appreciated than the tolar would be, it penalises the Slovenian exports; second, the Slovenian government had to borrow 250 million euro so as to pay its due part in the Greek rescue packages. And the risk that a similar event may happen in the future is not negligible.

## Conclusions

Slovenia's economic transformation from a socialist to a market economy went parallel with two other transitions: from a regional to a national economy, and from being a part of Yugoslavia to becoming an independent state. When observing the Slovenian way, we have to take into consideration some important facts: first, this new independent country was the most developed region not only in SFR Yugoslavia, but in the whole of Central and Eastern Europe; second, reforms started already under the former regime, and enterprises, operating in a quasi-market system, were exposed to some degree of competition; third, Slovenia inherited a unique enterprise ownership structure based on self-management, where workers exercised management functions; and finally, all three transition processes were undergoing in a period of intense social conflict. Having in mind all the above, we can identify three characteristic features: trade unions were very strong and organised labour shaped the trajectory of new Slovenian capitalism in many ways; gradualism had to prevail in all aspects of transition; foreign capital and intervention of any kind was not welcomed.

Among the most important achievements, we can observe that Slovenia was able to distinguish itself as a new independent nation with a relatively stable economy and high living standard, also maintaining good quality public services available for the majority of people. This small country, contrary to most of the other transformation countries, has never had to ask for financial help from international institutions, introduced the euro first

among the new EU member states, and is among the strong innovator nations of the EU. Despite the changes related to EU and eurozone membership (e.g. the giving away of monetary policy), despite structural reforms and the partial downscaling of the welfare system, despite a restrictive fiscal policy gaining (also constitutional) grounds since mid-2013, Slovenian neo-corporatist structures did in fact remain in place and social dialogue has not vanished.

Short-term challenges facing the new government (in office since September 2018) include the need to finalise or get through with bank privatisation, and reform the public health and pension systems. Its plans for higher taxes and spending threaten to undo the fiscal consolidation measures taken by the previous government to ensure the long-term stability of public finances. Institutional weaknesses continue to undermine prospects for long-term economic development. In particular, the judicial system remains inefficient and vulnerable to political interference. Corruption continues to be perceived as widespread.

Key long-term challenges are related to relatively low productivity growth, and as yet only slow adjustment to demographic change. High level of labour market segmentation of young people, and the relatively low economic and social inclusion of older people can also prove to be problematic. From the environmental point of view, high and rising GHG emissions from transport, the interrupted increase in the share of renewable energy sources and unsustainable use of land should be mentioned.

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## 3.4 The Western Balkans

### 3.4.1 Albania

Mihailo Gajić

### Introduction

Albania is a small country on the Balkan peninsula, on the Adriatic coast. Its area is just 28.750 square kilometers, with lowlands by the coast line, while the interior is mostly mountainous. Although its mining industry is not well developed, mineral resources are abundant (such as coal, boxite, natural gas, copper, including the largest oil filed in continental Europe) as well as water resources for power generation. Total population of Albania stood at 2.87 million in 2018, with 17.8% inhabitants younger than 15, and 12.2% older than 65. Majority of people lives in urban areas (60.1% in 2018), but the capital of Tirana is by far the biggest urban center with almost 900 thousand people, due to significant migration in the previous two decades. Fertility rate in the country is very low (TFR being 1.54), resulting in shrinking population, which further exacerbated by high emigration from the country, mostly to Western Europe. The main economic and political process in the country after 1989 was transition from a centrally planned to a market economy. This process included creation of market institutions, macroeconomic stabilisation, privatisation of state-owned enterprises, improvements in business regulation and establishment of the functioning state institutions and basic rule of law.

1. **Political context and quality of institutions**

The process of transition in Albania took place in a very different environment compared to the other CEE countries. The Albanian society was the most closed one in the former Eastern Bloc: the regime of Enver Hoxha had bad relations not only with the West, but also with the Soviet Union, other countries from the Eastern Bloc, and even with China, due to ideological rigidity of the Albanian leadership which insisted on their own interpretation of Marxism-Leninism. This self-made isolation increased the autarchy in economic field, and repression in political field compared to

other European communist regimes of the era, making Albanian starting point for transformation much more difficult.

The political transformation from a one party to a multi-party system started with mass demonstrations and chaos, including violent conflicts, and was completed with 1992 general elections, in which new political forces took the lead. The new government ushered in an era of reforms, but this did not lead to increased political stability, due to high political, economic and social turbulences, which erupted in another series of mass violent conflicts, after the collapse of several financial institutions that were operating as pyramid schemes in which many Albanian lost their savings. This state collapse similar to an open civil war claimed 2000 lives and had deep economic and social effects on the whole country (Yusifi 2017).

Since 1997, the political stability significantly increased, which had a positive impact on the building of state institutions, which can be described by the governance indicators (World Bank, WGI). However, the administrative capacities of Albanian civil service remain a challenge. Employment in civil service is reserved as a pool of job placements for partisans of the political party in power, and members of their family, and career advancement is more connected to clientelist networks than abilities and skills. Consequently, the administrative results of Albania have only incrementally increased since 1996, although some limited improvements were achieved in the absence of political violence and regulatory quality.

These reforms were closely connected to the political reforms. Albanian political system rests on two main parties, that were both connected to the previous authoritarian communist regime: the Socialist Party is seen as its main successor, but the staunch anti-communist rhetoric of the Democrat Party hides the fact that its 1992-2013 leader had very strong political connection with the regime. Due to the weak rule of law and state institutions, democratic procedures in the country, although mostly respected, are not fully followed. The prevailing political culture and party cohesion has led to a wide national political divide due to the ''winner takes it all'' mode of governance and clientelist networks operating in the society, which leads to political tensions (BTI 2018). The most important reform in the country was the adoption of constitutional amendments in

2016 intended to strengthen institutional check and balances on executive power, and thus confirm the rule of law; although this process was initiated by the support of both political parties and under strong international supervision and backing, its implementation is rather slow and inconclusive.

One of important political issues in Albania is the status of Albanians living in neighbouring countries. For the time being, the strongest focus is put on Kosovo, and its disputed status – some nationalist political circles across both sides of the border would like to unite Albania and Kosovo in a single political entity, but this is neither fully supported by the Albanian citizens not the international community, since it would raise the argument of inviolability of current borders. The country is Western oriented, being a NATO member since 2009, and on the EU accession path. Although the EU accession has been one of the main political commitments of all governments in the previous two decades, the reforms necessary to join the EU are very slow and superficial, since they would disturb the current equilibria of social power and powerful vested interests.

## 2. General economic outlook

The economic transformation in Albania started only after the second elections held in 1992, with the new government. The beginning of the economic transformation was characterised by macro-stabilisation policies: combatting high inflation and fiscal deficit policies were complemented with liberalisation of prices and foreign trade. Privatisation of agriculture land and small companies took place rapidly, already in 1991, often spontaneously and without any plan. Privatisation of housing was also an important step, since state housing made up majority or urban dwelling, and was finalised by 1994 (Muco 1997). The privatisation of small companies was considered mostly finished by 1994, but privatisation of medium and large companies was slower, and started only in 1995 through privatisation vouchers. This and other reforms, however, were put to a halt in 1997 due to the massive internal conflicts that took place after several financial institutions went bankrupt.

The model of capitalism in Albania combines different institutions: it is based on market economy, but with a significant government involvement in economic activities directly (through SOEs) and indirectly (through regulation). Other important traits are a relatively rudimentary welfare state with low government expenditures in the European or even regional sense (below 30% of GDP in 2018), and thus lower level of government services provided; significant importance of the shadow economy and remittances of workers residing abroad; and the importance of imported capital (through foreign owned banks and FDI) for technology transfer and investments. When different criteria are taken into account, the economic system in Albania can be described as "dependent market economy" (Nolke, Vliegenhart 2009), "hybrid economy" (Schneider, Paunescu 2012), "weekly coordinated market economy" (Mykhnenko 2007) or "embedded capitalism" (Bohle, Greskovits 2012).

There are, however, some differences from these models. First, the stock of FDI in Albania is smaller than in the CEE countries in transition. The second very important characteristic is the inability of the economy to provide the necessary number of job placements for the working age population, or the adequate level of salaries due to its low productivity. Therefore, many Albanians migrated in the previous two decades (mostly to countries in vicinity, such as Greece and Italy, but also to the other European countries). The labour market is also dual, divided in two: on one side is the new productive sector of the economy that employs younger and more educated people with modern work skills, and on the other side are more seasoned workers with old or obsolete work skills that are more suited for the economy before the transition.

The Albanian economy was able to reach significant growth rates, after the deep transition recession that was recorded in the beginning of the transition. This recession was deeper than in other transition countries since the system of economic dirigisme and centrally planned economy was more readily implemented in Albania than in some other countries, such as Yugoslavia or Hungary, which had some experience with price mechanisms and international competition. Prior to socialist development policies, the industrial base of Albania was almost non-existent, small scale

private sector was not tolerated, and the regime implemented the policy of import substitution and autarchy. All this led to a deeper recession at the beginning of the transition, but this was offset by high growth rates. Albania was able to surpass its 1991 GDP per capita level already in 1996, and keep significant growth pace after the 1997 recession that took place due to political factors and following civil unrest. Albania was one of rare European economies (alongside Poland) that did not experience a recession in 2009 due to the financial crisis, although its growth rates after that period moderated.

Total investments in the country are moderate; standing at 22% of GDP in 2018, slightly below the average of transition countries reaches 25% of GDP (IMF, WEO). This gap is mostly attributed to low domestic private investments caused by the low quality of business environment, and low government effectiveness in infrastructure project realisation.

Unemployment remains one of the structural problems of the economy, standing at 13.8% in 2018, and being on a similar level almost since 1996. Activity rates are low, especially for the young people and women, standing at 65% of the total labour force. One of the causes for this fact is the high level of remittances, which artificially increases the reservation price of wages, especially for the young people with college education.

Although there is a tripartite mechanism of social dialogue (between the government, employer associations and trade unions), this mechanism is weak since majority of the employees in private sector are not member of trade unions, which are present only in large companies with a tradition of union organisation. Furthermore, almost a fifth of the total labour force is active in the shadow economy, without formal contracts, which naturally excludes them from union organisation. Therefore, only 13% of the workers are union members (ILO database) and collective bargaining and agreements are mostly restricted to the employees in the public sector. However, there is a nationally mandated minimum wage.

Albania has a moderately high level of HDI, which increased significantly from 0.609 in 1990 to 0.785 in 2017. Bearing in mind the relatively low level of economic development, this is mostly attributed to good results in

the areas of health and education, which are attributed to the healthcare and education system that were introduced in socialism.

Since the beginning of the transformation process, the Albanian economy has significantly changed. The industrial output share in GDP generation fell significantly, from almost 60% in 1990 to just below 10% in 2010, while the share of services increased significantly. The biggest loser industries were the textile and heavy industry, and the biggest winners – the construction sector (Muco *et al.* 2015).

## 3. Quality of entrepreneurship

Weak state institutions, especially the judiciary, do not create a business environment conducive to entrepreneurial activities which would enable businesses to thrive. This is visible in low domestic investments which have for years made just two thirds of total investments, which is significantly below the CEE average. The quality of business regulation was improving since the beginning of transition up to 2012, after which a decline was attested (Heritage Foundation, Index of Economic Freedom – Business Freedom). However, corruption in the country remains on a very high level, and is considered to be a very significant obstacle to developing business in the country (Global Competitiveness Report). Political connections and favours are often also used to evade regulatory requirements, and the capacity of inspectorate is often limited.

As in other transition countries with weak rule of law, the main problem is not the quality of regulations, but their implementation in practice. High level of corruption within the civil service, but also political clientelism and conflicting regulations, laws and other regulations are not applied consistently to all entities, which can be used to gain competitive advantage and increase the level of unpredictability in doing business in the country.

The privatisation that took place in the 1990s created a group of new entrepreneurs that used their good political connections to create, maintain and expand their business operations. This process was also fuelled by international sanctions imposed on Yugoslavia, since it created many lucrative opportunities for organised crime groups for smuggling of fuels and other goods across the border to Kosovo and Montenegro. These

groups also relied on their good political connections they used to organise this business. The area of public procurements is prone to corruption, which again enable businessmen that are part of the clientelist network to gain competitive advantage through getting government contracts. This system is often described as "crony capitalism" where the rule of the game are not same for everyone, and in which political connections can lead to business success, while lack of it – to failure. Also, competition in the country is considered to be constrained by the influence of big companies or cartelisation: GCR 2018 ranks Albania as125$^{th}$ regarding the extent of the market dominance, while according to the Institutional Profile Database 2016 edition, the market barriers reach intermediate levels (with 2 points; on a scale where 0 means high barriers and 4 no barriers).

However, the number of new businesses that open annually is quite high, reaching 11.9 in 2015 per 1.000 inhabitants of working age (World Bank, WDI) which is significantly higher than in other Western Balkan or most European counties. Most of new companies that open are concentrated in traditional sectors, such as retail, tourism and similar services. The number of technological and innovative companies in the country is limited, and the adequate ecosystem for their development is lacking. However, the ICT sector in the country is thriving, mostly due to numerous small local companies – these, however, are often involved only as subcontractors for international companies and often do not innovative services on the global scale, nor are active on the small domestic market. Capital in Albania is still scarce, and rely on international sources – such as foreign owned banks, since local savings are inadequate. Very high transfers from abroad in the forms of remittances of Albanian workers residing and working abroad have still not become a potential source of investments, fuelling domestic consumption only. Also, their level has been decreasing since the onset of the economic crisis in 2008.

## 4. Modernisation based on FDI

During the first decade of transition, FDI were scarce due to high political instability and internal conflicts. Only when the political situation stabilised after the 1997 unrest did FDI inflow increase, and it markedly increased after 2001. FDI were mostly concentrated in energy generation,

telecommunications, cement production, mining, oil and industrial parks. However, major obstacles, such as: insecure property rights, weak rule of law and high corruption, lack of developed infrastructure and reliable energy supply significantly impede the proliferation of FDI in Albania (Dragusha 2013).

Low inflow of FDI during the first transition reform means that the FDI stock in the country is below the level attained in the CEE countries, especially those that were more active in obtaining FDI, such as Hungary and Slovakia. Lower FDI level means that Albania was not able to find its place in global supply chains, which makes its economy less open to the world when total volume of trade to GDP is taken into account. Main FDI origins are the EU countries, most notably Italy, Greece and Germany.

Even so, FDI had a significant impact on the level of growth of the Albanian economy, but of secondary importance to increases in public spending especially on infrastructure projects financed through increases in public debt (Muco *et al.* 2015). This is clearly visible in exports: the data show that in 1995 main Albanian export products were textiles and footwear, which made up almost a third of the total exports of just 328 million USD. In 2017, total Albanian exports reached 5.7 billion USD, out of which services made almost a half (mostly tourism, transport and ICT). On the other hand, the structure of imports has not significantly changed, but its volume increased sevenfold in this period, from 1 to 7.3 billion USD.

Banking is clearly the most dominated sector by foreign affiliates, since 14 out of 16 banks are foreign owned; there are no state owned banks and foreign bank assets are dominating the sector, being above 90% in 2009 (EBRD 2012). This is one of the legacies of the inflation that swept the country during the 1990s, and destroyed domestic banks since their loans lost most of their value. The high share of foreign banks, however, did not have a negative impact on the economy – it actually enabled much needed foreign capital inflow since domestic savings were low, just 8.6% of GDP in 2017 (World Bank, WDI), which was significantly lower than the investment rate.

There is no clear data on ownership in industries, but state remains a significant market player only in some sectors that are considered sensitive or natural monopolies, such as transport, postal services, energy and utilities. Therefore, the privatisation process can be considered finished, and was as almost as thorough as in more successful transition countries, bearing in mind that GDP generation in private sector constituted 75%, which is just shy of the CEE average of 80% (EBRD, Structural and institutional change indicators).

## 5. Knowledge sector

Albania is a modest innovator. The data (GCR 2018) show that R&D expenditures are just 0.2% of GDP, which is not only far behind the EU average of 2%, but also makes Albania at the bottom of the Western Balkans region, alongside Bosnia and Herzegovina. The total government spending on education is 3.9% of GDP (World Bank, WDI), which a moderate increase compared to the previous decade. After two decades of transition, education remains publicly funded and accessible to the broadest population, but its quality has decreased due to poor investments, corruption, and other problems arising from the weak governance (BTI 2018). This low quality of education is visible in weak PISA results of Albanian students, who on average score just 415 points compared to the OECD average of 492 (OECD 2015); but also in the fact that there is a high unemployment among people with tertiary education, which implies lack of acquired skills through education but also low level of cooperation between universities and companies operating on the local market. Tertiary gross enrolment rate was 57% in 2017 (World Bank, WDI), which is a significant rise compared to the previous decade – almost double the 2006 level.

## 6. Public opinion attitude towards transformations

Life in Transition Survey (LTS) of the EBRD shows that only 20% of the respondents in Albania do not have preferences regarding the economic system they live in, which is significantly below the transition region average of 30%. Support for the planned economy is recorded among 30% of respondents, somewhat below the transition region average, while

market economy is supported by a rather high 50% of respondents (compared to 35% in transition region). The situation is identical in the political section: half of the respondents support democracy, one third – authoritarian government, almost 20% of the respondents are indifferent. These results are strongly in line with other transition economies, but deviate from Western Europe, where respondents hold a significantly higher support for democracy.

However, there is a widespread sentiment that the privatisation process that took place was neither fair nor effective, and that people with good political connections were able to use them to their advantage during this process. This is also reflected in the fact that more people think that political connections are more important for success (40%) than hard work (30%), while it is completely the opposite in Western Europe (LTS 2016).

The support for EU integration in Albania is very high, reaching 93% of respondents in a recent survey (European Commission 2019) which is the highest in the whole Western Balkans region. According to this survey, there is a widespread positive opinion of the European Union, and the main reasons for support are economic: people associate the possible EU accession with new employment and economic development. Albania, however has not yet been able to open the accession negotiations, and the main prerequisite for this is the strengthening of the rule of law, which is supposedly under implementation through the recent judiciary reform. Albania has been a member of the NATO since 2009.

## Conclusion

Unlike the other Western Balkan countries, Albanian transition path from a planned to a market economy, and from an authoritarian to a democratic government took place peacefully. The country did not face the challenge of the collapse of a federate state, or a civil war, which to some extend resembled the situation in the majority of CEE countries. Consequently, Albania could devote most of its political attention to economic problems, mainly the macroeconomic stabilisation and creation of the basic market institutions. However, Albania did suffer from different setbacks, the most important being the most authoritarian and rigidly run planned economy in

Europe, with almost no economic cooperation and trade with other countries due to the propagation of import substitution and self-sufficiency. Albania was also the country on the lowest level of economic development in the region. Although it did not experience major episodes of violence outbreaks, it did experience severe political instability on several occasions, leading even to the complete breakdown of state institutions during the beginning of the transition.

Weak political institutions, the political influence of political parties, the former security apparatus over the state owned enterprises, and organised crime groups active in international smuggling led to the creation of a whole class of "political entrepreneurs" both through the privatisation process and the political patronage system. These business people profited from political connections and rent seeking activities that often included a quasi-monopoly status in the market through market entry barriers, but also advantages over competition through government contracts and inconsistent application of regulation. This group had vested interests that would be hit by deeper reforms through the imposition of the rule of law, liberalisation of the economy, and relaxation of political tensions. Other significant insider groups that could lose their rent were the SOE employees, since they enjoyed higher level of salaries and better working conditions than their private sector counterparts. These strong pressure groups had a significant effect on the political economy of reforms in Albania, which also shaped the way in which the local economy evolved.

Weak rule of law and political pressure on courts was one of the drawbacks that had a significant effect on the privatisation, since many companies were sold below their estimated asset value, and were used for asset stripping and tunnelling by the buyers, many of whom had good political connections though the system of political patronage. Therefore, a significant number of privatised companies that otherwise would have been successful after the privatisation, actually became defunct or stopped their operations: the main role of some privatisations was not to continue the business but to launder money from illegal activities, or to reach valuable land for real estate development. Although this was common to some extent to all privatisation processes in CEE, it had a deeper effect in Balkan

countries due to the weaker state institutions. However, while in the CEE countries new sectors and industries developed after privatisation, either through FDI or local innovative companies, this did not fully materialise in Albania due to the low quality of business environment, which discouraged investments and growth.

Debates among academic economists in Albania during this time mostly concerned the role of the state, the extent of privatisation in the economy, and a possible industrial policy. Other important topics, such as institutional quality and its impact on economic development were mostly overlooked. Majority of academic economists in the country favoured a stronger government involvement in the economy, championing the role of state owned enterprises and an industrial policy that would lead export growth, but also focus on the role of FDI in economic development due to low domestic savings and investments. Therefore, a more thorough analysis of the economic system that evolved after 1989 in the country or the transition path that was taken has not been yet conducted.

Future challenges in Albania are the demographic changes, institutional development and the EU accession. According to the UN population estimates, the population of Albania is expected to shrink significantly in the future, from the current 2.9 million to 2.2 million in 2060. Furthermore, the overall population will continue to age, which will put a significant additional pressure on the state funded pension and healthcare system, and will raise public expenditures, while these costs will be directed to the shrinking working age population. High emigration rate, however, pose a more pressing problems than the low fertility rates in the short run. Some industries are already facing shortages of skilled labour. This tendency poses a significant obstacle to future growth. The state of economic and political institutions in the country is currently one of the most important obstacles to ensuring long-term economic growth. Albania is slowly advancing towards the middle-income trap. In order to overcome it, it needs to transform from a resource driven economy with cheap labour to an economy based on rising productivity and innovation. Institutions that would galvanise this transition are those that would secure private property rights (which would boost investment in physical capital) and intellectual

property (which would boost investments in innovation and technology). However, this would meet a strong resistance of the vested interest groups since it would undermine the current political patronage system that have been a part of the institutional development in the country for decades. The EU accession could serve as a catalyst for institutional transformation, since it requires a strong rule of law and implementation of the common legal heritage (the aquis) but due to significant deficiency in the rule of law Albania has not yet begun its accession negotiation process, although it has been a candidate country since 2014.

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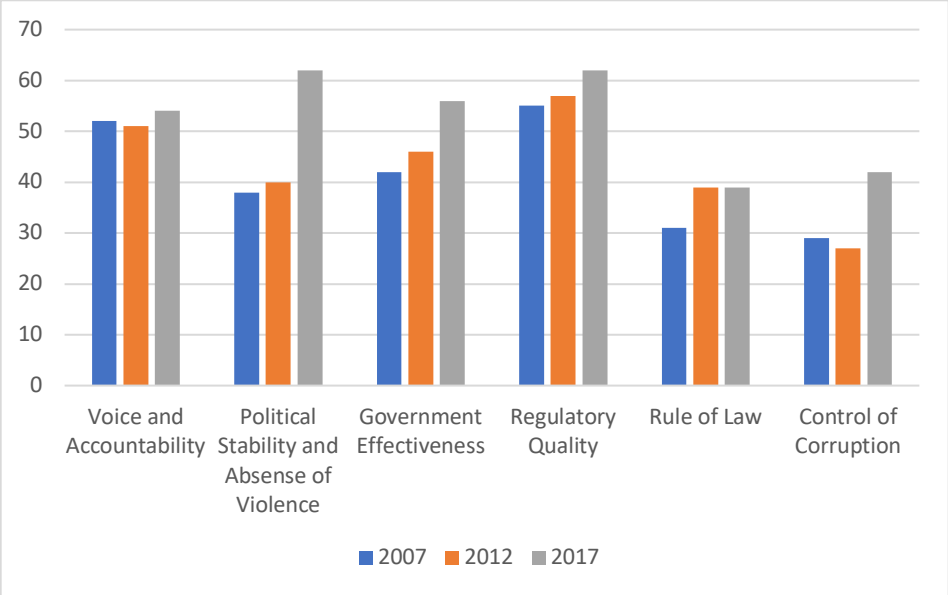
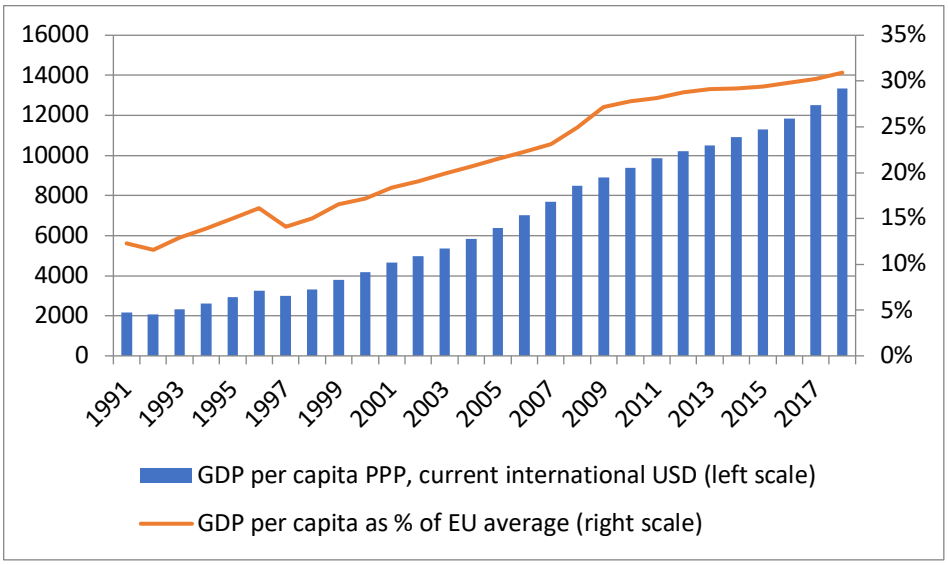
**Institutional capacities of Albania.**



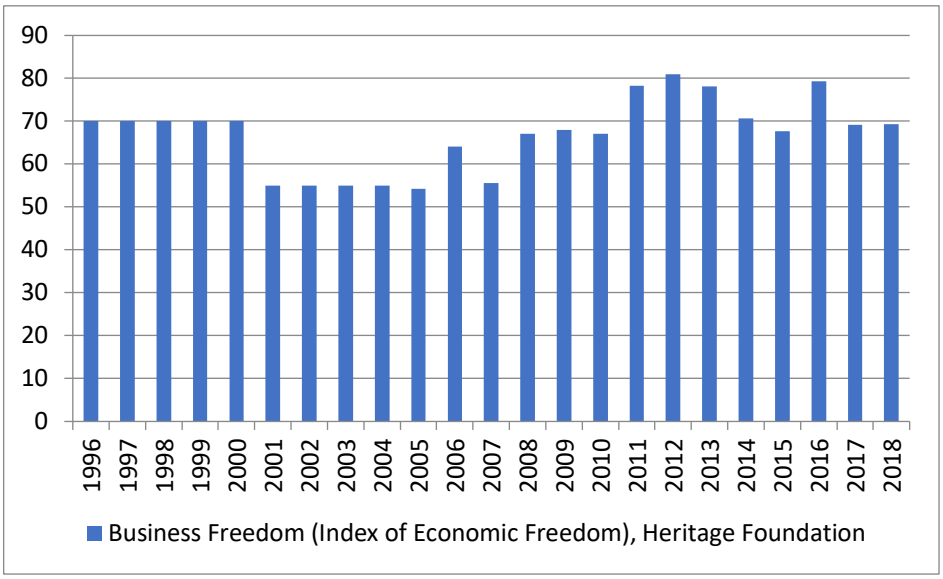

Source: World Governance Indicators, World Bank.

## GDP per capita in Albania 2000-2018



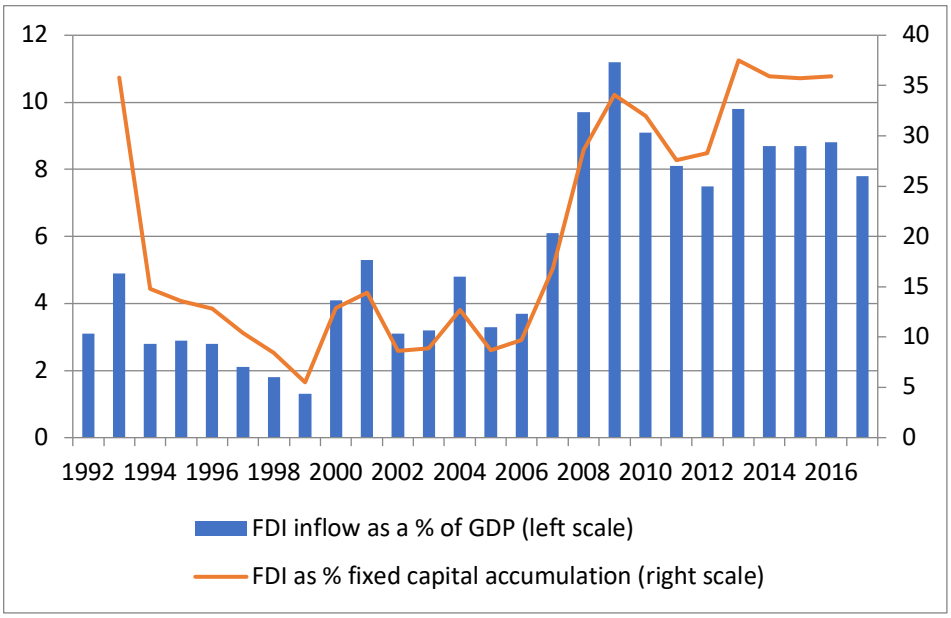

Source: IMF, World Economic Outlook April 2019.

## Quality of business environment in Albania




Source: Index of Economic Freedom (Business Freedom), Heritage Foundation.

**FDI inflow to Albania**




Source: World Bank, World Governance Indicators.

### 3.4.2 Bosnia and Herzegovina

Mihailo Gajić

## Introduction

Bosnia and Herzegovina (B&H) is a small country on the Balkan peninsula. Its area just 51.210 square kilometers, with lowlands in the north by valley of the Sava river, while the rest of the country is mostly mountainous. The country has a small exit to the Adriatic Sea of just several miles in length. Although its mining industry is not well developed, mineral resources are abundant (such as coal, iron, lead and zinc) as well as water resources for power generation. Only 20% of the land is arable, so B&H remains a large net importer of food and agriculture products. Total population of Bosnia and Herzegovina stood at 3.5 million in 2018, with 13.2% inhabitants younger than 15, and 15% older than 65. Urbanisation is below European average, since only 48% of people live in urban areas, and the capital of Sarajevo with 550 thousand residents is the largest city in the country. Fertility rate in the country is among the lowest in Europe (TFR being 1.36), resulting in shrinking population, which was further exacerbated by high emigration from the country, mostly to Western Europe. The process of economic and political transformation in the country after 1989 was stopped with the 1992-1995 civil war. Apart from creation of market institutions, macroeconomic stabilisation, privatisation of state owned enterprises and improvements in business regulation, Bosnia and Herzegovina had to rebuild the war-torn country, and navigate through a very complex bureaucratic network put in place during the peace agreements in order to set up a functioning government.

### 1. Political context and quality of institutions

The transition process in Bosnia and Herzegovina is inextricably tied to the national question. The transformation that took place after 1989 was of very short breath since the civil war between the three ethnic groups within the country (Bosnians, Serbians, and Croatians) erupted already in 1992. This bloody conflict that lasted until 1995 and claimed more than 100.000 lives

also led to great migration of the pre-war population due to large scale violence, economic devastation, ethnic cleansing, and even genocide (Srebrenica). Although the peace agreement that was signed in 1995 stopped the hostilities, it did not make Bosnia and Herzegovina a politically stable and functional state. The division into two entities (Bosnian and Croat majority Federation of Bosnia and Herzegovina; and Serbian majority Republika Srpska) made entities more powerful than the politically weak central authority. The patronage of the international community through the Office of the High Representative (OHR) did facilitate peaceful political transition and establishment of political institutions after the war, but the achieved political stability failed to materialise since the political elites in the country were mostly not satisfied with all provisions of the Dayton agreement (Iličić&Smeriga 2019). The centralisation process to a more unitary state at the expense of the entities, supported by Bosnian parties, created a counter-initiative within the Serbian entity for self-determination and even possible secession. At the same time, the Croat elite sought formation of a separate entity with Croatian majority at the expense of the Federation. The question of war crimes still remains as a divisive issue since few of the perpetrators were convinced in front of the local courts (BTI 2018).

Therefore, the process of economic transformation in Bosnia and Herzegovina apart from moving away from a centrally planned to a market based economy also included the alleviation of immediate war destruction. Due to the years of war and wide scale infrastructure destruction, the Bosnian economy virtually collapsed: immediately after the war GDP per capita was only 500 USD, down from 1900 USD just before the war (Efendic *et al.* 2015). Also, total population in the country decreased for almost a quarter due to war casualties and mass emigration to neighbouring countries, as well as developed nations in Europe and the US.

The territorial and administrative composition of the country envisaged during the peace negotiations was negotiated with the aim of ending hostilities by organising subnational political entities that would encompass ethnic groups and make them as much independent from the national level of government as feasible. However, then the first two

entities, the Federation and Republika Srpska (RS), were accompanied by a third one – the Brcko district, which was removed from RS authority. Furthermore, the Federation was divided into 10 mid-level self-government units called cantons to which numerous important responsibilities were allocated. Finally, the country was divided into 143 towns and municipalities. This complex administrative web of competing authorities, often with overlapping responsibilities and jurisdictions, does not provide a stable environment conducive to business, since already small territory is economically divided to even smaller areas.

Furthermore, Bosnian administrative capacities and the lack of the rule of law raise serious concerns, which are clearly visible in international benchmarks, such as the World Governance Indicators of the World Bank, where Bosnia ranks in the second half in all categories.

Although rankings on the Rule of law, Political stability and Government effectiveness increased over time, they are still very low, even when compared to neighbouring countries such as Serbia or Croatia. A worrisome trend is visible in the Control of corruption and Voice and accountability variables since their values actually decreased over time. Even so, the biggest problems are visible in the Political stability and the Rule of law section.

The bleak situation regarding institutional development is also clearly depicted by the GCR, which ranks Bosnia very low in some key variables of institutional quality. Bosnia is ranked 124$^{th}$ in Judicial independence, 130$^{th}$ in protection of property rights and 135$^{th}$ in burden of government regulation.

Political and economic reforms after the war went hand in hand, with the aim of establishing a functional market economy, as well as a democratic regime in order to foster economic and political development that would decrease internal ethnic tensions. However, the country is still strongly divided alongside ethnic lines. This is clearly depicted in the fact that although there were several attempts to establish non-ethnic parties that would cover all of Bosnian population, these attempts have not been politically successful and ethnic divisions continue to define the political

situation in the country: Serbians vote predominantly for Serbian parties, Bosnians for Bosnian parties and Croats for Croat parties, and political tensions within the country follow ethnic or entity lines.

Although political culture that emphasises the role of the leader over the party ideology and institutions is very similar among all ethnic groups, election system, and more importantly, the decentralisation of executive power in the Federation entity led to differing political evolution in the country. In the Serbian entity, which is centralised, the SNSD party was able to dismantle weak institutional checks and balances once it gained power, through control over the SOEs and employment opportunities in the civil service, and exert significant influence over media. This development stopped the progress of political pluralism and liberalisation in that entity. However, in the Federation entity, which is further divided to 10 cantons with their own wide responsibilities, it was impossible to achieve this informal centralisation of power, so institutional checks and balances, although not always successful, do exert some influence over political entities since they face political competition.

## 2. Economic outlook

The economic transformation in Bosnia and Herzegovina really started only after the end of the war that was brought by the Dayton agreement in 1995. The beginning of the economic transformation was characterised by macro-stabilisation policies, rebuilding the destroyed infrastructure, and returning to the peace-time economy. The first transition reforms that were undertaken after the end of the war in 1995 were supported by the multilateral financial institutions and international aid community, providing substantial foreign aid, debt restructuring, and preferential loans.

Macro-stabilisation policies were implemented through adoption of the currency board system: the new national currency, the Bosnian convertible mark (BAM), was introduced in 1998 with 1:1 exchange rate towards the German mark. This modified fixed exchange rate meant that Bosnian central bank did not lead an independent monetary policy but simply operated a big monetary exchange bureau, with total quantity of money in circulation depending on the quantity of foreign currency available. When

euro was introduced in 2002, the BAM was pegged to euro with the same rate as the German mark. This monetary regime was introduced since it was impossible to reach political agreement between two entities on the common monetary policy, but it achieved great results in maintaining stability of prices, since the CPI was above 5% in only one year since its introduction.

Although the privatisation process started with the Yugoslav federal law in 1990, since the war erupted already in 1992, this insider privatisation had almost no effects, as did the privatisation in the Serbian entity that adopted a law regarding privatisation during the war. The privatisation process had to wait for the hostilities to end, and the first privatisation laws were adopted already in 1997 in both entities, but only with the Law on privatisation of companies and banks adopted by the OHR in 1998 could privatisation commence: this law stipulated that property would be privatised by using the privatisation law of the entity in which it is located. While the privatisation in Republika Srpska was a mix of voucher privatisation (most of companies) and sale of capital through auctions (only for strategic companies in certain industries), the privatisation process in the Federation was based on sale of capital either through initial public offering of shares or tender procedures. The privatisation process was very slow and not thorough (for example, in Republika Srpska only 2/3 of the state capital was privatised), and the state retained a significant minority shares in privatised companies – on average 15% in the Federation, and 30% in the Republika Srpska (Transparency International B&H 2009).

The model of capitalism in Bosnia and Herzegovina is based on market economy, but with a significant government involvement in economic activities directly (through SOEs), and indirectly (through regulation). When different criteria are taken into account, the economic system in Bosnia and Herzegovina can be described as "dependent market economy" (Nolke, Vliegenhart 2009), "hybrid economy" (Schneider, Paunescu 2012) or "embedded capitalism" (Bohle, Greskovits 2012).

The welfare state system in Bosnia can be regarded as a "premature welfare state" (Kornai 1997). The state funds and operates educational and healthcare systems, with redistributive policies towards the poor, as well as

PAYG pension system, but redistribution rate is smaller than in the EU countries, mostly because there is little to redistribute, having in mind the low level of economic development. But Bosnia and Herzegovina enjoys a significantly higher level of public expenditures standing at 42% of GDP in 2018 (IMF 2019) compared to countries with the similar level of GDP.

There are, however, some differences from these models. First, the stock of FDI in Bosnia is significantly smaller than in the CEE countries in transition. Due to ineffective governance, weak rule of law and protection of property rights, as well as widespread devastation during the war, but most notably due to the high political instability, Bosnia did not receive almost any FDI during the whole first transition decade. The import of capital was therefore mostly done through foreign owned banks that transfered funds from abroad in form of loans instead of foreign direct or equity investments. The level of FDI attracted to the country was rather limited in scope, and was significant only during the boom cycle 2004-2008, while after the 2009 recession their level remained very low. Secondly, the privatisation was less thorough than in other transition countries so the state (most notably the entities) still had a significant hold over the economy, mostly through strategic sectors (such as banking, telecommunication, transportation, energy generation and transmission). While private sector GDP generation for the CEE countries in transition was close to 80% in 2010, this figure was only 60% for Bosnia (EBRD, Structural and institutional change indicators).

The economic development since 2000 was uneven. In the beginning, the country experienced unusually high growth rates, which were the consequence of abandoning the war time economy, and shifting towards peace-time production. Between 2000-2008 growth rates moderated, but were still significant, and the economy created many new jobs and allowed rising wages. After the recession that took place in 2009, growth was low, mostly due to low capital inflow and FDIs.

Total investments remained low, with just 17.2% of GDP in 2018, while the average of transition countries reached 25% of GDP (IMF, WEO). All three investment components (private domestic investments, foreign investments and public investments) are low. This is mostly attributed to

the low quality of business environment and low government effectiveness in infrastructure project realisation.

Unemployment almost halved to 18.4% in 2018 from its 2012 peak of 28%. However, most significant contributor to this positive factor is high emigration rate since the number of the people that are leaving the country has been high. The labour market is also dual, divided in two: on one side is the new productive sector of the economy that employs younger and more educated people with modern work skills, and on the other side there are more seasoned workers with old or obsolete work skills that are more suited for the economy before the transition. Almost 20% of the people employed are active in the shadow economy with no labour contract or social rights stemming from it. They are mostly concentrated in low productivity industries, such as agriculture, and have low education level. Activity rate in the country is just 57% – mostly because of low activation among the young cohorts due to prolonged education and little opportunities for part-time work, and the old cohorts due to low retirement age and long-term unemployment that discouraged people from looking for work.

The social dialogue is done on a tripartite basis (between the state, trade unions and employers' associations); it is conducted on the entity level, and also on canton level in the entity of Federation of Bosnia and Herzegovina. This lack of a national social bargaining in a small country such as Bosnia and Herzegovina in fact leads to the situation in which there is only one trade union and one association of employers active in the dialogue, which further complicates industrial relations for companies active in more than one canton or entity. Trade unions in the country are mostly represented in state sector, since their activities in private sector are mostly weakened due to the high unemployment rate and job insecurity, which put employers in a stronger bargaining position, and makes union activities more difficult. The latest ILO data from 2012 show that only 30% of Bosnian workers at the time were trade union members.

The high emigration rate during, but also, after the war has led to a situation in which a significant number of Bosnian citizens are residing abroad. For example, Bosnia had a population of 4.37 million before the war in 1991,

while 2013 census showed just 3.6 million, or a decrease of almost 20%. UN estimates that a quarter of the total population in 2017 resided abroad. Therefore, there is a high inflow of remittances of workers residing abroad which are mostly directed to private spending. These funds alleviate many social and poverty problems that would have been more pronounced in the case of their decrease, and also are a significant factor that alleviates pressure on the balance of payments.

Bosnia and Herzegovina has a high level of HDI, which increased from 0.716 in 2005 to 0.768 in 2017. Bearing in mind the relatively low level of economic development, this is mostly attributed to the results in the areas of health and education. These results are residuals of the healthcare and education system that were introduced in socialism.

## 3. Quality of entrepreneurship

Weak state institutions that do not guarantee rule of law, do not create a business environment conducive to entrepreneurial activities which would enable businesses to thrive. This is visible in low domestic investments, which were near 10% of GDP in 2018, significantly below the CEE average. The low quality of business regulation is also a significant obstacle to developing entrepreneurial activities in the country. According to the business freedom variable of the Index of Economic Freedom, Bosnia initially increased its low score, but this trend was reversed in 2009, after which the score actually started to decline. Furthermore, there is also a significant difference between the situation in two entities – the centralised Serbian entity was able to implement wider reforms and guarantee their more or less equal implementation in all regions of the entity, while this was impossible in the Federation entity, due to its administrative divisions into cantons. Some of cantons were able to emulate the example of the Serbian entity, but the administrative burden of regulation in most of them is more pronounced.

However, the main problem is not the quality of regulations, but their actual implementation in practice. Due to corruption and political clientelism, but also conflicting regulation, laws and other regulations are not applied consistently to all entities. This can be used by entities with good political

connections to gain competitive advantage, and it also increases the level of unpredictability in doing business in the country.

The civil war created ample opportunities for a new business elite to emerge, which was useful to one or all warring parties during the conflict, in order to procure weapons, ammunition, food, medicine, and all other needed materials, through smuggling and other illegal activities. When the conflict was resolved through peace negotiations, these new businessmen were able to take advantage of the wide amnesty that was adopted after the war (which besides targeting people who deserted the army, also included illegal traders, thieves of humanitarian aid, etc). The new business elite then had an important role in the upcoming privatisation, also using their political connections, which made them respectable members of the business community.

Low level of opening up of new businesses is the logical consequence of the bad business environment, corruption and clientelism. The number of newly registered companies is just 1.13 per 1.000 working age inhabitants (World Bank, WDI), which is the lowest among all Western Balkan countries. Also, competition in the country is considered weak, pointing out to possible cartelisation of the small market and high barriers to entry in some industries (GCR ranks Bosnia as 117$^{th}$ country in the world in this area). However, according to the Institutional Profile Database (2016 edition), the market barriers are estimated as low with the score of 4 (0 means high barriers, and 4 no barriers).

## 4. Modernisation based on FDI

During the first decade of transition, FDI were scarce due to high political instability and seclusion from the world economy through military conflict. The inflow of FDI started only after 2000, after the political situation stabilised, and when most important infrastructure was rebuilt or under reconstruction. Although FDI did increase, the wasted first decade of transition means that the total FDI stock is lower than in more successful CEE countries, reaching only 49.4% of GDP in 2017 (FIPA 2018). Furthermore, a significant proportion of FDI was oriented towards non-tradable sectors, such banking, insurance, trade and telecommunications.

Main FDI origins are countries from the region, such as Austria, Croatia, Serbia and Slovenia, but also Russia in the energy sector.

FDIs did have a modernising effect on the Bosnian economy, but their influence was limited: low total FDI and significant proportion of it was located in non-tradable sectors such as services. Total exports have increase from 1.2 billion USD to over 8 billion in 1998-2017 period. Although traditional sectors such as agriculture and textile continue to dominate Bosnian exports, completely new sectors have emerged, such as electronics (350 million USD in 2017), machinery (548 million), vehicles (206 million) and chemicals (724 million). The rise in export of services, most notably the ICT and tourism, was also quite high, from 460 million in 1998 to 1.88 billion in 2017 (Atlas of Economic Complexity, 2017).

This change resulted mostly from the influence of foreign companies active in these new industries, but their impact on the rest of the economy was limited. Bosnia has not been able to attract significant FDI in manufacturing, which would include it in global supply chains, and create opportunities for local producers to be included in production as subcontractors.

Banking in B&H is, as in the other countries in the region, strongly dominated by foreign affiliates. This is again a legacy of the civil war, since it destroyed almost all existing domestic banks. After the war, banks that were not solvent lost their license to operate, making space for new market entrants. Due to regulatory differences, banks operate on entity, rather than the national level. There are currently 16 banks operating in the Federation, and 8 banks in Republika Srpska (3 of these operate in both entities). More than 80% of the banking assets is owned by foreign banks, while only one bank – the Development bank – is in majority state ownership through Federation entity. Domestic credit to private sector has been stable at 53-54% of GDP since 2008, while it was strongly growing in 2001-2008 period (World Bank, WDI). Foreign bank affiliates provided an important source of fresh capital to the local economy, bearing in mind that the local savings is very low, standing at 1.2% of GDP in 2017.

There is no clear data on ownership in industries, but state remains a significant market player only in transport and postal services, energy generation and transmission, and partially telecommunications, since it owns the biggest telecom operator.

## 5. Knowledge sector

Expenditures for R&D in Bosnia and Herzegovina are estimated to stand at just 0.2% of GDP, according to the GCR, which is extremely low compared to the EU average of 2%. But these expenses are probably underreported due to the lack of tax breaks, insufficient accounting practices, and knowledge.

Due to 14 different ministries of education (1 national, 2 entity, 10 canton and 1 for special Brcko district) with overlapping competences, and weak coordination, there are no data on total government expenses on education in the country. The joint ministries of Bosnia and Herzegovina and the UN report on Millennium Development Goals state total expenses in 2011 to be 4.9% of GDP, which is comparable to the countries in the region.

Tertiary gross enrolment rate was just 38% in 2017 (World Bank), and the quality of education provided in most universities is substandard compared to the European average. The number of expected years of schooling according to the UN HDI is 14.2 years.

## 6. Public opinion attitude towards transformations

Harsh economic reality in Bosnia and Herzegovina, with high unemployment and low wages, is the environment in which people judge the political and economic transformation that took place since 1989. However, most attention is still given to the national question i.e. unresolved ethnic-based disputes within the country. The media and intellectual circles mostly look at the economic transformation through the lenses of post-war reforms, mostly privatisation, which is considered to have been unfair and used by people with good political connection to gain massive wealth at the expense of the population as a whole. There is also a conviction that market economy did not fulfil its promise in providing a decent standard of living. These claims may be true, but they disregard the

very problematic starting point: the long and bloody civil war, which tore apart the economic fabric of the country, and led to high political instability, which is never a suitable environment for economic development.

Life in Transition Survey (LTS) of the EBRD demonstrates that approximately a third of the respondents in B&H does not have preferences regarding the economic system they live in. The support for the planned economy is rising, standing at 30% in 2016, while positive view of the market economy is fixed at 35% (in line with the Transition region, but far behind Western Europe with 65%). The situation in the political field is very similar: there is a high number of people with no preferences between an authoritarian or democratic regime, and support for democracy is incrementally stronger (45%) than for authoritarian style of leadership (35%), in line with other transition countries and diverging from Western European countries.

Research form the B&H institutions regarding the EU showed that a significant majority of 76% of respondents support Bosnia's EU accession. The proportion is significantly higher in the Federation entity (91%) compared to the Republika Srpska (51%). People in favour of joining support the idea in hope for opening of new and more quality job placements, and as a guarantee of peace and stability, while the opponents cite increased taxes and centralisation as negative features of this action (Direction for European integration 2016).

**Conclusions**

Bosnian transition path from a planned to a market economy and from an authoritarian to a democratic government was shaped by the context in which it took place. While all other countries from other areas of the CEE region (to some extent excluding Czechia and Slovakia) had to tackle first the macroeconomic stabilisation, the dissolution of their main export partners, the Soviet Union, as well as establish basic market institutions, Bosnia and Herzegovina first had to deal with political issues and nation building, while the internal imbalances and ethnic disagreements finally led to the brutal civil war which lasted for more than 3 years and claimed more

than 100.000 casualties, as well as destroyed infrastructure and markets. In this kind of environment, transition reforms were not only stalled, but were put into second plan since the initial goals was to establish a lasting peace, and deal with the war time consequences, including infrastructure destructions and institution building. The political foundation of the Dayton peace agreement basically created a malfunctioning state, divided by ethnic lines, and the two entities (the Serbian and the Bosnian-Croat) having a high level of autonomy from the central government. This structure was further complicated by 10 cantons in the Federation entity, with additional significant self-government, and the special status of the Brcko district in the Republika Srpska entity. This multi-layered governance is very complicated and ineffective, with competing authorities and differing regulations, which inhibits entrepreneurial activities. Political instability still plagues the country, among ethnic lines and with calls for further centralisation from Sarajevo, and the status quo or even secession from Banjaluka.

Weak political institutions, utilisation of criminal groups as paramilitary in the war conflicts which increased their political importance, the sway of political parties over the state-owned enterprises, and their later privatisation led to the creation of a whole class of "political entrepreneurs" – people whose economic success was based on political connections and rent-seeking activities that often included a quasi-monopoly status in the market through official licensing and other market entry barriers, but also advantages over competition through government contracts, inconsistent application of regulation, and subsidies and tax waivers, exchanged for political support. This group had vested interests that would be hit by deeper reforms through the imposition of the rule of law, the liberalisation of the economy, and the relaxation of political tensions. Other significant insider groups that could lose their rent were the SOE employees, since they enjoyed higher level of salaries and better working conditions than their private sector counterparts. These strong pressure groups had a significant effect on the political economy of reforms in Bosnia and Herzegovina, which also shaped the way in which the local economy evolved.

Infirm rule of law and political pressure on courts was one of the weak spots that had a significant effect on the privatisation, since many companies were sold below their estimated asset value, and were used for asset stripping and tunnelling by the buyers, many of whom were politically well-connected, which enabled that kind of behaviour. Therefore, a significant number of privatised companies that otherwise would have been successful after the privatisation, actually were dismembered and sold in pieces: the privatisation was not conducted to continue the business but to launder money from illegal activities or to reach valuable land for real estate development. Although this was common in all privatisation processes in CEE to some extent, it had a deeper effect in the Balkan countries due to the weaker state institutions. However, while in the CEE countries after privatisation new sectors and industries developed either through FDI or local innovative companies, this did not fully materialise in Bosnia and Herzegovina due to the low quality of business environment which discouraged investments and growth.

Debates among academic economists in Bosnia and Herzegovina during this time were mostly concerning the role of the state, the extent of privatisation in the economy and a possible industrial policy. Other important topics, such as institutional quality and trade liberalisation and their impact on economic development were mostly overlooked. Majority of academic economists in the country favour a stronger government involvement in the economy, championing the role of state owned enterprises, and an industrial policy that would lead export growth, and abstain from further privatisation. After the 2008 financial crisis, a new important discussion topic was the state of public finances and the growing public debt, and the quality of infrastructure, especially connectivity with the region. On the other hand, bank sector reforms and the introduction of the currency board is often hailed as one of the most successful economic reforms in the country. However, a deeper analysis on the economic system that evolved after the 1989 in the country has not been yet conducted.

Future challenges in Bosnia and Herzegovina are the demographic changes, institutional development, and EU accession. According to the UN population estimates, the population of Bosnia and Herzegovina is

expected to shrink significantly in the future, from the current 3.3 million to 2.4 million in 2060. Furthermore, the overall population will continue to age, which will put a significant additional pressure on the state funded pension and healthcare system, and will raise public expenditures, while these costs will be directed to the shrinking working age population. In the short run, the most pressing problem is the high emigration rate, rather than the low fertility rates: some industries are already facing shortages of skilled labour, which would pose a significant obstacle to future growth. The state of economic and political institutions in the country is currently the most important obstacle for ensuring long-term economic growth. Bosnia and Herzegovina is slowly advancing towards the middle income trap. In order to overcome it, it needs to transform from an resource driven economy with cheap labour to an economy based on rising productivity and innovation. Institutions that would galvanise this transition are those that would secure private property rights (which would boost investment in physical capital) and intellectual property (which would boost investments in innovation and technology). EU accession could serve as a catalyst for institutional transformation, since it requires a strong rule of law and implementation of the common legal heritage, the aquis, but Bosnia is still the most laggard country in the region regarding the EU accession, since it is the only Western Balkan country that has not yet obtained a candidate country status, but is still considered as a potential candidate. Societal divisions along ethnic lines still pose a significant threat to political stability and government capacities to tackle important issues.

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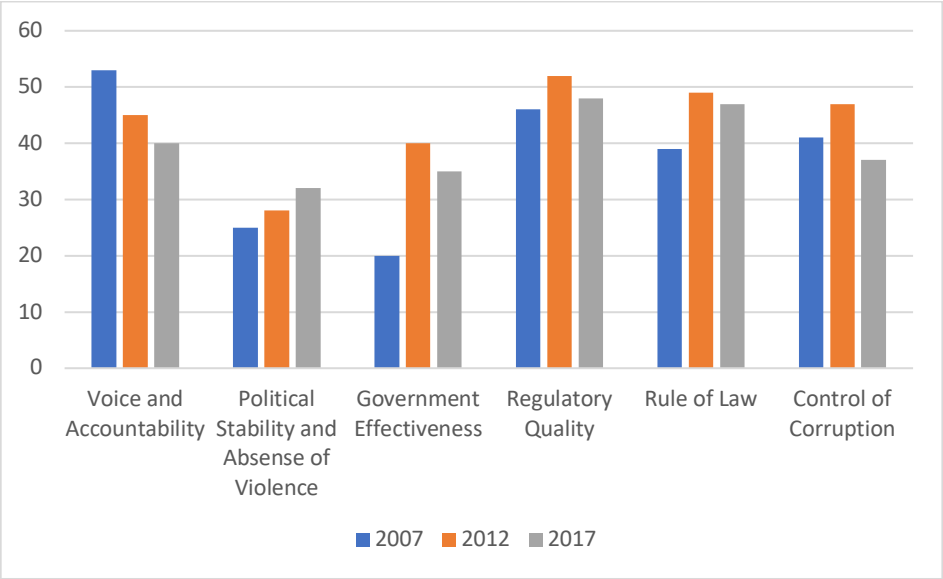
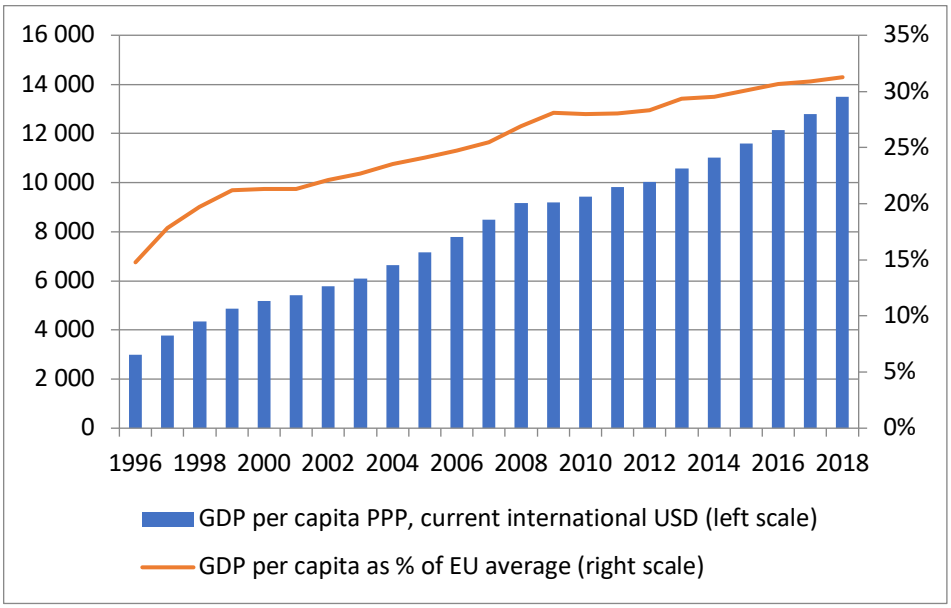
**Institutional capacities of Bosnia and Herzegovina.**



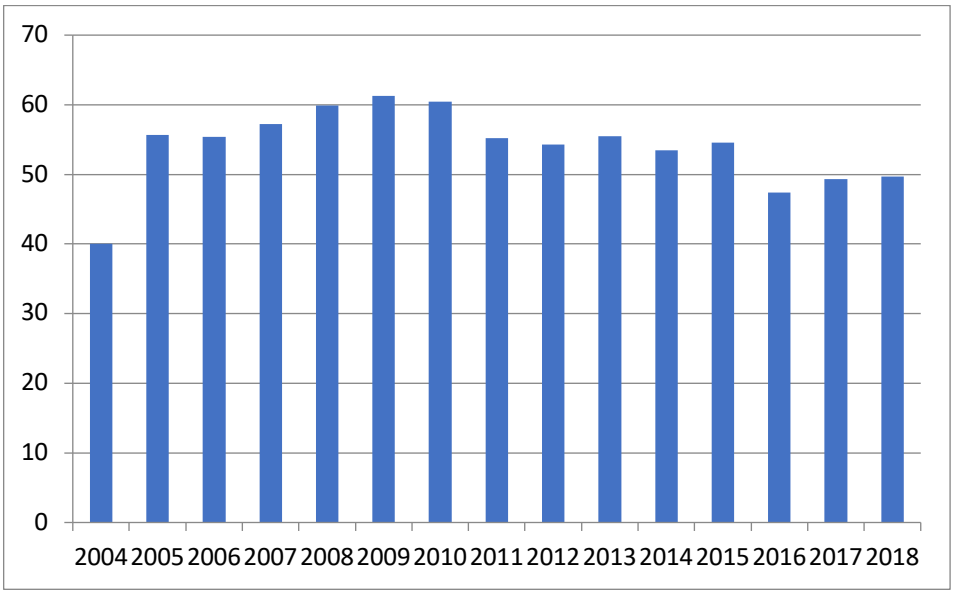

Source: World Bank, World Development Indicators.

**GDP per capita in Bosnia and Herzegovina 2000-2018.**



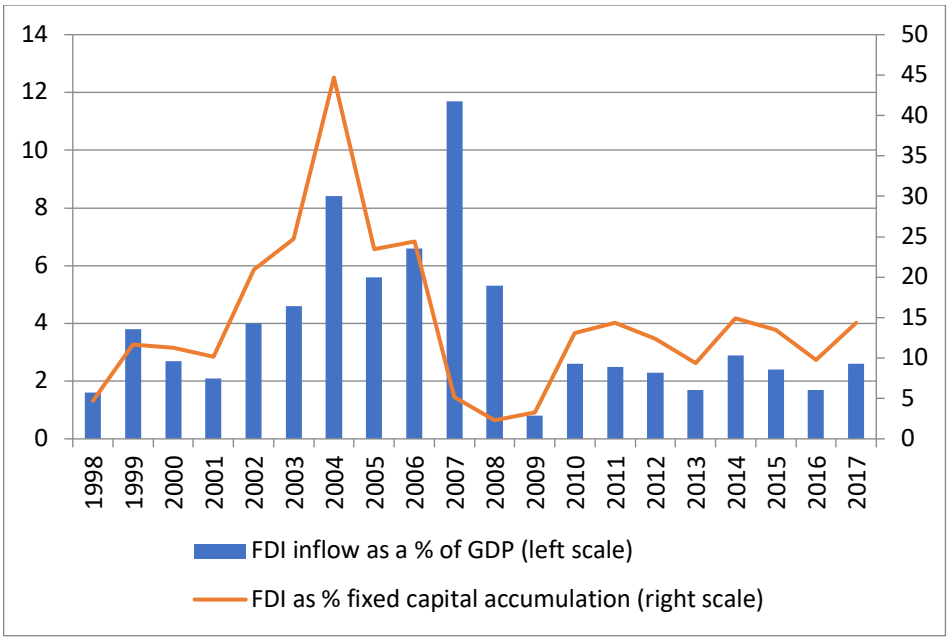

Source: IMF, World Economic Outlook April 2019.

**Quality of business environment in Bosnia and Herzegovina.**




Source: Index of Economic Freedom (Business Freedom), Heritage Foundation.

**FDI inflow to Bosnia and Herzegovina.**




Source: World Bank, World Governance Indicators.

### 3.4.3 North Macedonia

Mihailo Gajić

## Introduction

North Macedonia is a small land-locked country located in centre of the Balkan peninsula. Its area is 25.710 square kilometres, making it one of the smallest countries in the region. The country is relatively abundant in mineral resources, such as iron, copper, lead and zinc, but on the other hand it is not well suited for agriculture, since only 16% of its land is arable. Its population was 2.08 million inhabitants in 2018, out of which 16.2 % was aged less than 15 years, and 13.4 % – over 65. Total population is currently slowly increasing, but soon it would experience a decrease, due to the low birth rates (TFR is just 1.45, well below replacement rate). Majority of people live in towns (58% in 2017), but the country has only one real urban centre, the capital city of Skopje with 550 thousand inhabitants. The main economic and political process in the country after the 1990 was transition from centrally planned economy to market economy, and state building – although Macedonia enjoyed a wide autonomy within the socialist Yugoslavia, this was the first Macedonian state in history. This process fundamentally influenced macroeconomic performance, business conditions and political institutions.

## 1. Political context and quality of institutions

The process of transition in North Macedonia took place in a slightly different environment compared to the other CEE countries. First of all, the process of economic and political transformation coincided with the establishment of the first independent Macedonian state. The process of state and nation building was one of the first political goals of several governments which gave little room for other priorities. Also, the ethnic dimension, most importantly the ethnic divisions between Macedonians and Albanians, as the largest minority in the country, also had a key part in the political dimension of the new state, somewhat fuelled by the military conflicts in the vicinity (most notably, the war in Kosovo). These ethnic

divisions even led to a short military conflict within the country in 2001, followed by the Ohrid agreement, which provided more cultural and linguistic rights to the Albanian community, and increased their presence in the ranks of the civil service and government. Another differing starting point was the international isolation of Macedonia due to the unresolved issues with the neighbouring Greece, mostly regarding its identity politics and the nation's name. In the process of nation building, the Macedonian politicians claimed no connections to the other neighbouring Slavic populations, such as Serbs and Bulgarians, but insisted on the alleged connection to the ancient Macedonia, a Greek kingdom in the antiquity, which is widely considered a part of the Greek heritage, alongside its name. The name disputes between Greece and Macedonia were settled first by the UN-backed interim agreement in 1993, where Macedonia agreed to use for international purposes the name of Former Yugoslav Republic of Macedonia (FYRM). With this, Macedonia was able to enter the UN in 1993, and become an EU candidate in 2005. However, its further EU and NATO accession was blocked until the resolution of this dispute, eventually settled in June 2018 with the Prespa agreement, after which Macedonia changed its constitutional name to North Macedonia.

Bearing in mind these environmental factors, it is not surprising that administrative results of North Macedonia have in recent decades increased only in the areas of Absence of Political Violence and Regulatory Quality, while in other areas results were not significantly improved, or were even reversed, as in the case of Voice and Accountability (World Bank, WGI).

The political transformation from an authoritarian to a more open democratic regime is not yet fully finished. National policies of both Macedonians and Albanians play a significant role in the domestic policy, and there was a significant backslide in the rule of law in the country in the previous decade, so that the EU declared North Macedonia as a country with strong elements of state capture, due to the significant influence of the political parties in power over judiciary, civil service and police, with very little (if any) remaining constitutional checks and balances on the executive government. This political regime is centred on a wide-spread system of political clientelism and patronage, in which the executive government

provides public resources in exchange for political support (BTI 2018). After the parliamentary elections in December 2016, and the change in the dominant coalition, the regime of Gruevski that governed the country for more than a decade was toppled, but only after massive civil unrest, including the storming the house of parliament by political supporters of the previous regime. The new regime is more open to the Western political agenda, and its main goals are swift NATO and EU accession.

## 2. General economic outlook

The economic transformation in Macedonia took place alongside the nation building process. Although Macedonia did enjoy a significant autonomy from the central government as one of the 6 constituent republics of Yugoslavia, this was the first time in history that Macedonia was an independent state, which fuelled much of political energy towards political and identity questions instead towards economic reorganisation and transformation. The beginning of the economic transformation was characterised by introduction of market institutions – such as price and foreign trade liberalisations, introduction of the new legal tender in 1992 that replaced the previously used Yugoslav dinar etc. However, the dissolution of the common Yugoslav market had a significant impact on the Macedonian economy, which experienced a significant recession in several consecutive years; the GDP of the country was 20% lower in 1995 compared to its pre-transition level (Radovanovik-Angjelkovska 2014). Furthermore, a strict macroeconomic stabilisation program had to be introduced in 1993 to put a stop to the hyperinflation that took place in Macedonia. The process of privatisation in the country started with the Yugoslav law on social transformation from 1989, through which equity shares were gained by workers through internal buyouts. This privatisation wave was more significant in Macedonia than in other Yugoslav countries, since in 2.5 years of its initial implementation private equity capital in Macedonia stood at 17.7%, while it was only 5.7% in Yugoslavia on average (Arsov 2005). The second wave of privatisation was initiated in 1993, with the new law on social transformation, which made the privatisation mandatory but which enabled companies to choose the preferred privatisation process. Small companies were to be privatised

either by employees buyouts or through sales of the part of the enterprise, while the medium and large companies could also employ capitalisation through additional shares, management buyouts and debt/equity swap. Management buyout method was responsible for 34% of equity, followed by enterprise buyout with 23% of the total privatised equity (Jovanovska *et al*. 2002). The privatisation process, as in other transition countries, led to different problems in the absence of the rule of law, and the internal buyout by managers was used to gain significant resources and created a group of powerful local business people, at the detriment of workers and other small shareholders, leading to a wide sentiment that privatisation was unfair or legalised robbery (Shajnovski 2006).

The model of capitalism in North Macedonia combines different institutions: it is based on market economy, but with a significant government involvement in economic activities directly (through SOEs) and indirectly (through regulation), to a certain extent more so than in other countries in transition. Other important traits are: a relatively rudimentary welfare state with low government expenditures in the European or even regional sense (just above 30% of GDP in 2018 according to the IMF), and thus lower level of government services provided; significant importance of the shadow economy which encompasses almost a third of GDP; high remittances of workers residing abroad; imported capital (through foreign-owned banks and FDI) being the main channel of technology transfer and investments. When different criteria are taken into account, the economic system in North Macedonia can be described as "dependent market economy" (Nolke, Vliegenhart 2009), "hybrid economy" (Schneider, Paunescu 2012) or "embedded capitalism" (Bohle, Greskovits 2012).

There are, however, some differences from these models. First, the stock of FDI in Macedonia is smaller than in the CEE countries in transition, especially when shown per capita. The second very important characteristic is the inability of the economy to provide the necessary number of job placements for the working age population, or the adequate level of salaries due to its low productivity. Unemployment levels are persistently high, standing at 19.4% in the end of 2018, which is still a better result compared to the 33% recoded in 2010. The labour market is also dual, divided in two:

on one side is the new productive sector of the economy that employs younger and more educated people with modern work skills, and on the other side there are more seasoned workers with old or obsolete work skills that are more suited for the economy before the transition.

The economy of North Macedonia has not been able to fully use its advantages of cheap but skilled labour. Economic development was volatile, with deep recession in the beginning of the transition, but sluggish growth rates which began to rise only after 2003. However, the financial crisis took a toll on the Macedonian economy through decline in exports and capital inflows, and in the previous decade the country was not able to reach its high pre-crisis growth rates. Macedonia remains one of the poorest countries in Europe, measured by the income per capita, standing at one third of the EU average level.

Total investments in the country are somewhat higher than in comparable countries from the region, mostly in line with the CEE average that reaches 25% of GDP (IMF, WEO). Unemployment remains one of the structural problems of the economy, standing at 19.4% in 2018, although on a lower level than during its peak of 35% in 2007. Activity rates are low, especially for the young people and women, standing at 65% of the total labour force. One of the causes for this fact is the high level of remittances, which artificially increases the reservation price of wages, especially for the young people with college education.

Although there is a tripartite mechanism of social dialogue (between the government, employer associations and trade unions), this mechanism is weak since majority of the employees in private sector are not member of trade unions, which are present only in large companies with a tradition of union organisation. Furthermore, almost a fifth of the total labour force is active in the shadow economy, without formal contracts, which naturally excludes them from union organisation. Therefore, collective bargaining and agreements are mostly restricted to the employees in the public sector, but there is a nationally mandated minimum wage.

Although economic emigration from the country continues, the number of Macedonian citizens residing abroad is rather restricted compared to other

countries in the region (most notably Albania, and Bosnia and Herzegovina), being estimated by the UN to be just 6,7% in 2017.

North Macedonia has a moderately high level of HDI, which increased from 0.699 in 2005 to 0.757 in 2017. Bearing in mind the relatively low level of economic development, this is mostly attributed to good results in the areas of health and education, which are attributed to the healthcare and education systems that were introduced in socialism.

The Macedonian economy has a relatively moderate economic complexity, which remained unchanged in the previous decade followed even by a fall in diversification of exports. However, the total value of Macedonian exports increased from just 1.6 billion USD in 1995 to 8.1 billion in 2017; while major export sectors in 1995 were clothing and footwear followed by agriculture, in 2017 these were replaced by chemical products, electronics and vehicle parts (Atlas of Economic Complexity 2018).

## 3. Quality of entrepreneurship

Weak rule of law, with serious deficiencies within the judiciary, as well as high level of corruption, do not make the business environment in Macedonia conducive to entrepreneurial activities. Instead of improving this situation, several governments opted for easier answers to these problems, such as lowering statutory tax rates, providing incentives for foreign investors (subsidies and tax waivers), and streamlining the existing business procedures. This regulatory streamlining had a significant impact on North Macedonia's ranking in the Doing Business report of the World Bank, where it was placed ahead of Germany, but its rank in other international regulatory benchmarks (such as Economic Freedom in the World or the Global Competitiveness Report of World Economic Forum) has not increased as significantly. Corruption and political interference in the work of state institutions is still a matter of great concern, with strong links between politicians in power and strong private companies (Bertelsmann Transformation Index 2018). The quality of business regulation has indeed improved since 2010, after which it stagnated, as attested by the Index of Economic Freedom, but policy instability remained a matter of concern for companies conducting business in the country.

The privatisation that took place in the 1990s created a group of new entrepreneurs that used their existing political connections to create, maintain and expand their business operations. These close connections between politicians and business people who exchange favours and influence for electoral and financial support, is often described as "crony capitalism", instead of providing an even playing field for all competitors. Public procurements, as well as state-owned enterprises are considered to be under a significant political control, in order to finance political activities and reward party members and political allies.

Competition in the country is considered to be under some constraints due to the influence of big companies or cartelisation (Global Competitiveness Report 2018 ranks N. Macedonia as 41st regarding the extent of the market dominance, with the score of 5.4 out of 7; while the Institutional Profile Database 2016 describes market barriers as medium, with the score of 2 points on a 0-4 scale). The Competition for Protection of Competition has been set up and is active in this field, but it lacks resources and expertise to exert its influence, as well as stronger political commitment, since state aid remains unaccounted for (Bertelsmann Transformation Index, 2018).

The number of new businesses that open annually although low by European standards, is higher than in the rest of the Western Balkan region, reaching 3.88 per 1 000 inhabitants of working age in 2016 (World Bank, WDI). Most of new companies that open are concentrated in traditional sectors, such as retail, tourism and similar services. The number of technological and innovative companies in the country is limited, and the adequate ecosystem for their development is lacking. Capital in Macedonia is still scarce, with domestic savings of just 19.2% of GDP (World Bank, WDI) so a significant portion of new investments come from international sources – such as foreign owned banks, which operate with international savings, or through FDI. High transfers from abroad in the form of remittances of Macedonian workers residing and working abroad have been on the decline in recent years – from more than 4% to less than 3% of GDP annually – and they have not become a potential source of investments, being transferred mostly to domestic consumption.

## 4. Modernisation based on FDI

FDI inflows to Macedonia have not been high compared to other countries in transition. The main reasons lie in the high political instability and internal conflicts, but also the quality of business environment. But even when these characteristics are taken into account, Macedonia (as well as the other Western Balkan countries) experienced a significantly lower FDI inflow compared to the other countries in transition (Estrin and Uvalic 2014)

Although Macedonia was able to avoid conflicts during the 1990s Yugoslav wars, it did receive a significant influx of refugees during the Kosovo crisis 1998-1999, and the inter-ethnic rivalry between Albanians and Macedonians erupted in 2001 in an armed conflict. Problems in the quality of business environment stemming from the deficiencies of the rule of law further exacerbated these problems, and Macedonia was not perceived as business-friendly destination, until political stability took root and some reforms in business regulation were enacted, that improved Macedonia's ranking in international benchmarks, most importantly the Doing Business.

The FDI inflow was rather volatile since the beginning of transition, following not only international economic cycles of expansion and recessions, but also local political and economic developments. The FDI inflow level significantly increased after 1997, and then fell after 2001 political crisis, and rose again in 2004-2008. In the wake of European financial crisis, FDIs once again shrank, even though they were supported by generous incentive programs and tax breaks.

Low inflow of FDI during the first transition reform means that the FDI stock in the country is below the level attained in the CEE countries, especially those that were more active in obtaining FDI, such as Hungary and Slovakia. Due to lower FDI stock, Macedonia has not been able to take advantage of inclusion to global supply chains, which makes its economy less open to the world when total volume of trade to GDP is taken into account. Main FDI origins are the EU countries, most notably Austria, Slovenia, and Germany.

In order to attract foreign investors and technology transfer, Macedonian governments established special economic zones with significant tax breaks and other incentives, but the positive effects of this policy still need to be materialised, since the total number of companies operating in these zones is limited. Moreover, in 2016 these companies employed only 7 thousand employees. Most of them are active in low end technological industries – for example, automobile industry is presented by car seats production companies. However, high productivity of these international companies means that they account for one third of the total Macedonian export (DG NEAR, 2017).

Banking is clearly the most dominated sector by foreign affiliates, since almost all banks are in predominantly foreign ownership, apart from the state owned Development Bank. Therefore, foreign bank assets are dominating the sector, being well above 90% in 2009 (EBRD, Structural and institutional change indicators). High and unstable inflation rates during the first decade of transition significantly weakened domestic banks, which were later privatised, ending up in the hands of foreign owners. The high share of foreign banks, however, did not have a negative impact on the economy, since it enabled much needed foreign capital inflow. Domestic savings are relatively stable, standing at 19.2% of GDP in 2017 (World Bank, WDI) which is significantly lower than the investment rate.

There is no clear data regarding ownership in industries, but state remains a significant market player only in some sectors that are considered sensitive or natural monopolies, such as transport, postal services, energy and utilities. Therefore, the privatisation process can be mostly considered finished, as in more successful transition countries, but state involvement in the economy remains somewhat more pronounced since private sector constituted 70% of the GDP generation in 2010, which is below the CEE average of 80% (EBRD, Structural and institutional change indicators).

## 5. Knowledge sector

North Macedonia is a modest innovator. The data (GCR 2018) show that R&D expenditures are just 0.4% of GDP, which is far behind the EU average of 2%, and near the regional average (behind Serbia, but ahead of

the rest of the Western Balkans). The total government spending on education is approximately 4% of GDP (EU Progress Report), which is comparable to the regional and EU standards. After two decades of transition, education remains publicly funded and accessible to the broadest population, with modestly rising education attainment and student enrolment, which was also triggered by making secondary education compulsory. However, low investments and low quality of teaching staff lead to low quality of education in the country. This is visible in weak PISA (Programme for International Student Assessment) results of Macedonian students, who on average score just 384 points compared to the OECD average of 493 (OECD 2015) and behind all the other CEE countries. There is a high unemployment rate among the young university graduates who lack skills acquired through the formal education process. Tertiary gross enrolment rate was 41% in 2015 (World Bank, WDI), which is almost double in comparison to two decades earlier.

## 6. Public opinion attitude towards transformations

Life in Transition Survey (LTS) of the EBRD showed that half of the respondents in North Macedonia prefer market economy as the economic system of their choice, which is behind the Western Europe (65%) but significantly above the transition region average (35%). Planned economy was preferred by almost 30% of the respondents, while the rest did not show any preferences at all. When compared to the previous results from 2010, Macedonian citizens showed an increase in support for market economy of 10%, at the detriment of the undecided. In the political section, a vast majority of respondents (70%) preferred democratic to an authoritarian government (10%), similarly to the 2010 results, with a growing support for democratic governance, and falling number of people undecided on this matter. Support for democracy in North Macedonia is significantly above the transition regional average (50%), and almost reaching the same level as in Western Europe. However, it must be noted that the democratic governance may be understood differently in transition countries, and countries with established democracy, therefore some practices considered democratic by citizens in North Macedonia would probably not be perceived like that in Western Europe.

However, there is a widespread sentiment that the privatisation process that took place was neither fair nor effective, and that people with good political connections were able to use them to their advantage during this process. This is also reflected in the fact that more people think that political connections are more important for success (40%) than hard work (30%) or intelligence and skills (20%), while in Western Europe only 10% of respondents gives weight to political connections, giving priority to intelligence, skills, and hard work (LTS 2016).

The support for the EU integration in North Macedonia is very high, reaching 72% of respondents in a recent survey (KAS 2019). Trends in public opinion in recent years show that Macedonians mostly consider utilitarian stances when considering benefits and costs of the EU membership, which is seen as a tool for economic development and higher standards of living. On the other hand, the number of respondents stating that Macedonia is ready for the EU accession significantly decreased from 51% in 2014 to just 36% in 2018, which demonstrates public opinion regarding the capacities of the state to fulfil the accession criteria. While the other candidate countries in the region have already opened accession negotiations (Montenegro, Albania, and Serbia), North Macedonian EU negotiation process has not yet been open, due to political issues arising from the name dispute with the neighbouring Greece. However, since this dispute has been recently resolved through constitutional changes on the Macedonian side, it is expected that negotiations could be opened in the near future, although the accession process will take years to finish. After the name dispute resolution, North Macedonia was invited to join NATO, and in February 2019 the accession protocol was signed, but some more time is necessary for all the country members to ratify the treaty, which would allow to make this country the newest full-fledged NATO member.

## Conclusion

As in case of the other Western Balkan countries, Macedonian transition path from a planned to a market economy and from an authoritarian to a democratic government was done in a context of a dissolution of the confederate Yugoslav state, high political instability and ethnic divisions, which all had a strong impact on the reforms that were implemented, as

well as their results. While all other countries from other areas of the CEE region (to some extent excluding Czechia and Slovakia) had to tackle first the macroeconomic stabilisation, the dissolution of their main export partner: the Soviet Union, as well as establish basic market institutions, Macedonia first had to deal with political issues stemming from the question of nation building, the political instability and violence that erupted in former Yugoslavia. In this kind of environment, transition reforms were stalled and not as decisive as was the case in CEE.

Weak political institutions, ethnic divisions within the country between the two main groups (Macedonians and Albanians) and the armed conflict that led to constitutional changes in 2001, the political influence of political parties over the state owned enterprises, and their later privatisation led to the creation of a whole class of "political entrepreneurs". These business people profited from political connections and rent seeking activities that often included a quasi-monopoly status in the market through market entry barriers, but also advantages over competition through government contracts and inconsistent application of regulation, subsidies and tax waivers, exchanged for political support and patronage. This group had vested interests that would be hit by deeper reforms through the imposition of the rule of law, liberalisation of the economy, and relaxation of political tensions. Other significant insider groups that could lose their rent were the SOE employees, since they enjoyed higher level of salaries and better working conditions than their private sector counterparts. These strong pressure groups had a significant effect on the political economy of reforms in North Macedonia, which also shaped the way in which the local economy evolved, especially the newly created "ethnic entrepreneurs" which benefitted from frictions between the Macedonian and the Albanian populations, presenting their business interests as national ones.

Weak rule of law and political pressure on courts was one of the problems that had a significant effect on the privatisation, since many companies were sold below their estimated asset value, and were used for asset stripping and tunnelling by the buyers, many of whom had good political connections thought the system of political patronage. Therefore, a significant number of privatised companies that otherwise would have been

successful after the privatisation, actually were dismembered and sold in pieces, or stopped in their operations: the main role of some privatisations was not to continue the business but to launder money from illegal activities or to reach the valuable land for real estate development. Although this was common to some extent to all privatisation processes in CEE, it had a deeper effect in the Balkan countries due to the weaker state institutions. However, while in the CEE countries new sectors and industries developed after privatisation, either through FDI or local innovative companies, this did not fully materialise in Macedonia due to the low quality of business environment which discouraged investments and growth.

Debates among academic economists in North Macedonia during this time were mostly concerning the role of the state, the extent of privatisation in the economy and a possible industrial policy. Other important topics, such as institutional quality, trade liberalisation and their impact on institutions on economic development were mostly overlooked. Majority of academic economists in the country favour a stronger government involvement in the economy, championing the role of state owned enterprises and an industrial policy that would lead export growth, but also focus on the role of FDI in economic development. However, political instability and the creation of an ossified economic structure in which businesses connected to the ruling party thrived at the expense of the rest of the economy during the last decade has shifted focus from economic to political situation in the country. Therefore, a deeper analysis on the economic system that evolved after 1989 in the country or the transition path that was taken has not been yet conducted.

Future challenges in North Macedonia are the demographic changes, institutional development and the EU accession. According to the UN population estimates, the population of North Macedonia is expected to shrink significantly in the future, from the current 2.1 million to 1.7 million in 2060. Furthermore, the overall population will continue to age, which will put a significant additional pressure on the state funded pension and healthcare system, and will raise public expenditures, while these cost will be directed to the shrinking working age population. In the short run, the more pressing problem is the high emigration rate rather than the low

fertility rates, since some industries are already facing shortages of skilled labour, which poses a significant obstacle to future growth. The state of economic and political institutions in the country is currently one of the most important obstacles for ensuring long-term economic growth. North Macedonia is slowly advancing towards the middle income trap; in order to overcome it, it needs to transform from and resource driven economy with cheap labour to an economy based on rising productivity and innovation. Institutions that would galvanise this transition are those that would secure private property rights (which would boost investment in physical capital) and intellectual property (which would boost investments in innovation and technology). However, this would meet a strong resistance of the vested interest groups since it would undermine the current political patronage system, and ethnic politics that have been a part of the institutional development in the country for decades. The EU accession could serve as a catalyst for institutional transformation, since it requires a strong rule of law and implementation of the common legal heritage, the acquis, and since the political obstacles stemming from the Greek veto due to the questions of national identity and cultural heritage have finally been resolved through the Prespa agreement, Macedonia could reap benefits from accelerating this process. At the same time, societal divisions along ethnic lines still pose a significant threat to political stability, and government capacities to tackle important issues.

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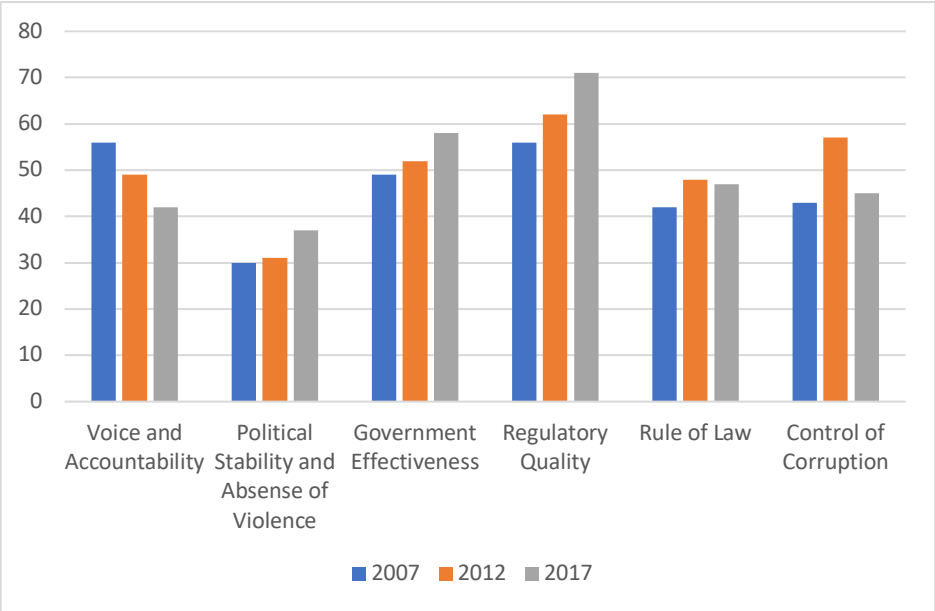
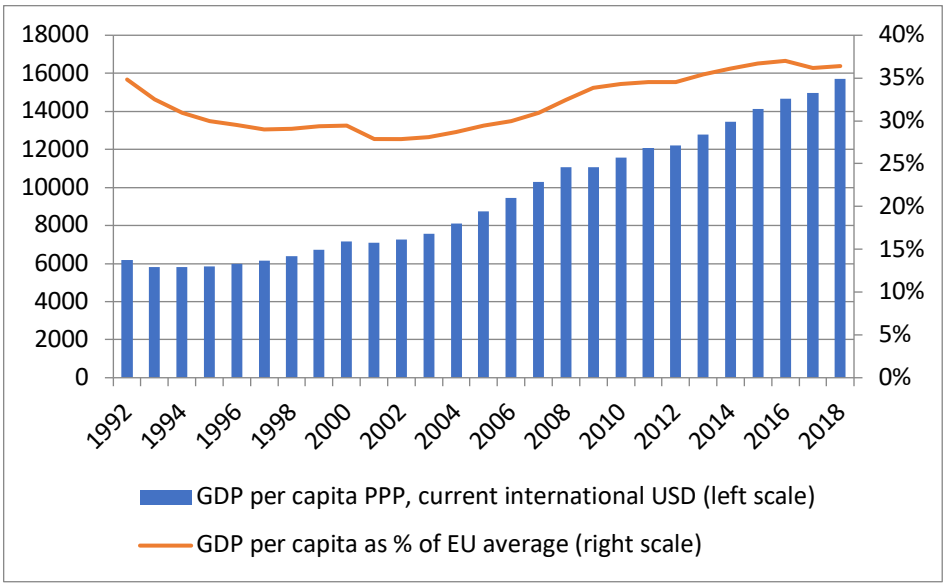
**Institutional capacities of North Macedonia.**



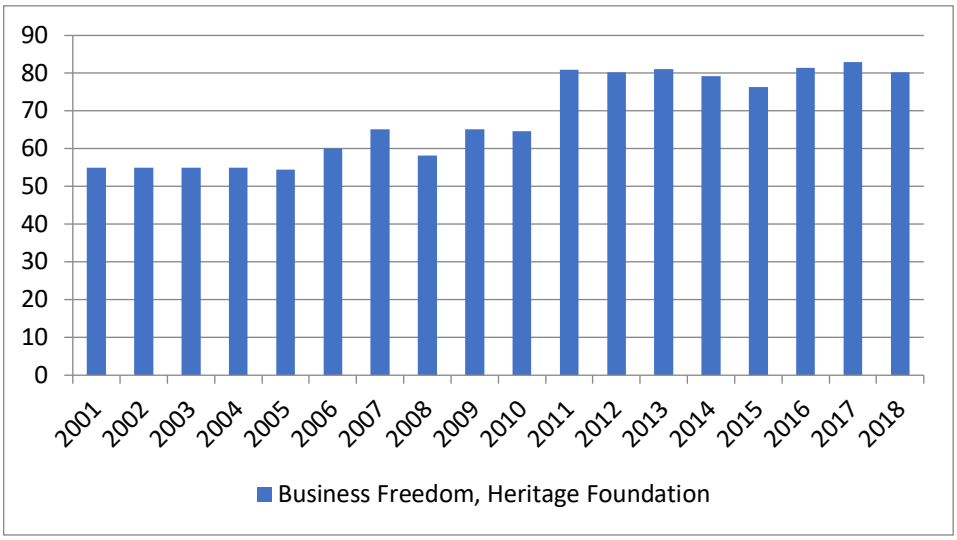

Source: World Governance Indicators, World Bank.

**GDP per capita in North Macedonia 2000-2018.**



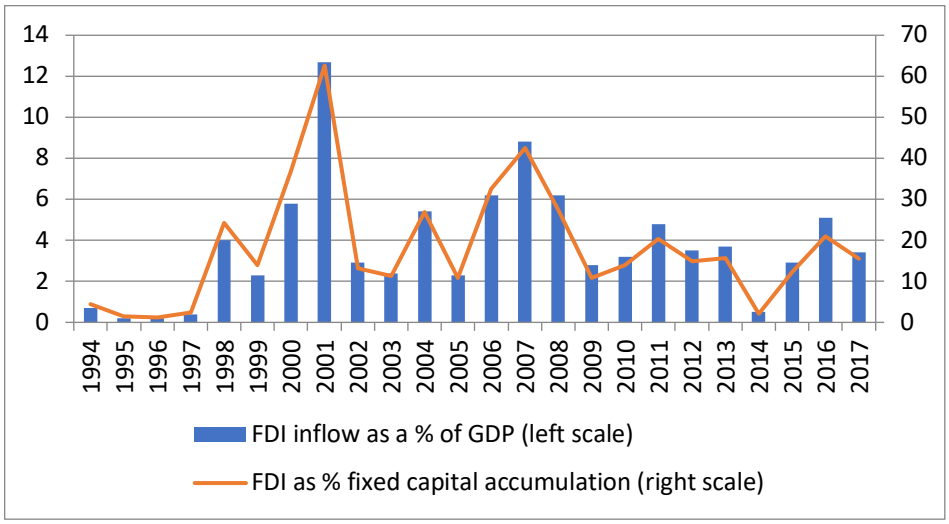

Source: IMF, World Economic Outlook April 2019.

**Quality of business environment in North Macedonia.**




Source: Index of Economic Freedom (Business Freedom), Heritage Foundation.

**FDI inflow to North Macedonia**




Source: World Bank, World Governance Indicators.

### 3.4.4 Montenegro

Mihailo Gajić

## Introduction

Montenegro is the smallest country on the Balkan peninsula, since its geographical area covers just 13.810 square kilometres. It mostly mountanious area, with an acess to the Adriatic, and some low lands near the Skadar lake. Mineral resources in the country consist of red boxite, lead and zinc, and different types of stone. Due to its geographical characteristics, more than a half of the land is forested, while only 12% – arable, so Montenegro remains a significant net importer of food and agriculture products. Total population of Montenegro stood at 0.62 million in 2018, with 18.2% inhabitants younger than 15, and 15.1% older than 65. Two thirds of the population lives in urban centres, while the capital of Podgorica with its wider area gather almost a third of the total population, with 180 thousands inhabitants. Fertility rate in the country is low, with the TFR standing at 1.67, although somewhat higher than in the other countries in the region. The process of economic and political transformation in the country after 1989 went hand in hand. Apart from creation of market institutions, macroeconomic stabilisation, privatisation of state owned enterprises, and improvements in business regulation, Montenegro had to involve itself into late nation building process, determining would it once again be a fully independent country or stay in some kind of union with Serbia, and foster new political and economic ties with the neighbouring countries after the end of the dissolution of Yugoslavia. Montenegro has been a candidate EU member since 2010, and a full NATO member since June 2017.

## 1. Political context and quality of institutions

Montenegro enjoyed a high level of autonomy in Yugoslavia as one of the 6 federal states, but when the dissolution of Yugoslavia started in 1991, it did not follow suite to independence but decided to join Serbia in forming a new entity, Federal Republic of Yugoslavia, in 1992. Although

Montenegro retained a high level of autonomy, this was an uneven union since Montenegro had approximately only 6% of the total population of the federal country. Internal struggle for power in Montenegro together with disagreements with Serbia, the more potent partner in the federal union, regarding the international situation and future alignment, created an internal demand for full political independence that created a deep rift in the society. After the regime change in Belgrade in 2000, relations with Serbia were renegotiated through a new constitutional charter adopted in 2003, transforming the Federal Republic of Yugoslavia to a more loose entity with elements of a confederate state: the Union of Serbia and Montenegro. Following a successful referendum in 2006, Montenegro finally regained its full international independence (ICG 2006).

A small state with just above 600.000 people, Montenegro has a clientelist system of widespread political patronage, based on political affiliation but also on wider family and even tribal connections. The current regime is the only one in Eastern Europe which remained in power after the 1989 transition, and uses the state resources and patronage system to remain in authority, even though the elections are relative free (Dzankic 2014). This does not provide a suitable environment for the rule of law and independence of state institutions, which is clearly visible in the international benchmarks. Also, there is a strong tendency for political power to lie outside of formal institutions, and concentrate in a small group of political oligarchy.

Out of 6 governance variables gathered by the World Bank in its World Governance Indicators, only Government Effectiveness and Regulatory Quality have seen a significant increase. The biggest challenges, however, remain in the areas of corruption control and the rule of law, where no significant improvement has been made. The problems in the rule of law area are also attested in the GCR, which depict judicial independence and respect for property rights in rather bleak terms, ranking Montenegro as 68$^{th}$ and 75$^{th}$ country respectively, well below the EU countries.

## 2. General economic outlook

Although Montenegro was significantly less affected by the civil war in Yugoslavia than countries on whose territories military actions were conducted (Serbia, Croatia, or Bosnia and Herzegovina), the dissolution of the common state and its internal market had a strong negative effect on the economy. International sanctions during the war also badly impacted the economy as a whole, and led to widespread smuggling operations across the Adriatic Sea, which created strong business cartels close to high ranking politicians (Hodzic 2004). In order to shield itself from monetary instability, Montenegro decided to unilaterally adopt the German mark as a legal tender in 1999, and discard the previously used Yugoslav dinar. When the euro was adopted in 2002, Montenegro switched to this currency, again unilaterally.

The privatisation took place in two phases. During the first phase which lasted between 1992-1998, 27% of total capital in the country was privatised, mostly through share discount sales to employees. The second phase lasted between 1998-2007, when three main privatisation techniques were used: a mass voucher privatisation through which additional 27% of capital was privatised, accompanied by privatisation through strategic investors and open tenders (Cerovic *et al.* 2008). As was the case in many other countries in transition, the privatisation process was not considered fair, and people with good political connections were able to gain privileged status.

The model of capitalism in Montengro is based on market economy, but with a significant government involvement in economic activities directly (through SOEs) and indirectly (through regulation). When different criteria are taken into account, the economic system in Montenegro can be described as "dependent market economy" (Nolke, Vliegenhart 2009), "hybrid economy" (Schneider, Paunescu 2012) or "embedded capitalism" (Bohle, Greskovits 2012).

The welfare state system in Montenegro can be regarded as a "premature welfare state" (Kornai 1997). The state funds and operates educational and healthcare systems, with redistributive policies towards the poor, as well as

PAYG pension system, but redistribution rate is smaller than in the EU countries, mostly because there is little to redistribute having in mind the low level of economic development. But Montenegro enjoys a significantly higher level of public expenditures standing at 48% of GDP in 2018 (IMF, 2019) compared to neighbouring comparable countries, as well as countries with the similar level of GDP. Even though mountainous area of the country or a small number of inhabitants do not allow for economies of scale in provision of public services, and there are recently high expenses on the construction of Podgorica highway, these variables cannot fully explain the difference.

First, the stock of FDI in Montenegro is significantly smaller than in the CEE countries in transition. As is the case of the whole region, weak governance, low quality of infrastructure, and high political instability and wars, prevented Montenegro from attracting significant FDIs during the whole first decade of transition. Stabilisation of the political situation in the country, and adoption of the euro during the second decade of transition did increase its potential for FDI inflow, but this was somewhat curbed due to the massive privatisation through vouchers. Secondly, while FDI in the transition countries was mostly directed towards manufacturing in order to utilise skilled cheap labour that was abundant in these countries compared to the EU core, the main FDI areas in Montenegro were services, most significantly real estate development and tourism. Thirdly, the privatisation was less thorough than in the other transition countries, so the state still holds a significant grip over the economy, mostly through strategic sectors (such as banking, energy generation and transmission, railway and airlines). While private sector GDP generation in transition countries was close to 80% in 2010, this figure in Montenegro was only 65% (EBRD, Structural and institutional change indicators).

Montenegro has started to record economic growth since 2001, with two recessions in 2009 and 2012. However, high growth rates between 2004-2008 were fuelled by high capital inflow and investments in real estate and tourism, which was not sustainable. Since the 2009 financial crisis, growth rates were significantly lower, and picked up only in recent years with low interest rates in Europe and high spending on infrastructure (Podgovrica

highway). The economy is service oriented – this sector employs 75% of the total workforce, mostly in tourism and related industries.

Total investments increased to 34% of GDP in 2018, from as low as 20% in 2016, while the average of transition countries reacheed 25% of GDP (IMF, WEO). This was due to high public investments in infrastructure on Podgorica highway, a project that is envisaged to cost approximately a quarter of annual GDP, putting a significant strain on public finances due to the rising public debt. Low quality of business environment, low quality of infrastructure, and lack of educated workforce pose significant constraints on the private sector investments.

Unemployment remains significant, standing at 15.2% in 2018 after its 2011 peak of 19.7%. The high unemployment rate is the effect of labour market duality in Montenegro – in which people with low qualifications living in the north of the country do not have the same economic opportunities as younger people with high qualifications living in the south. Shadow employment without contracts or payment of taxes and social contributions is also high, reaching 20% of the workforce. Activity rate in the country is very low by European standards, standing at just 58.5% – mostly because of low activation among the young due to prolonged education and little opportunities for part-time work, as well as the old – due to low retirement age and long-term unemployment that discouraged people from looking for work (Eurostat).

Industrial relations in the country are organised on a tripartite basis, with the representatives of the government, trade unions and employer's associations. However, social dialogue is marginalised, because in a social system of clientelism predominant in Montenegro, big businesses have an open communication link to the government; furthermore, as in the other countries in transition, trade union density is rather low, with trade unions mostly functioning in the state sector. According to the ILO latest data from 2012, only 25,9% of Montenegrin workers were trade union members.

Unlikely the other countries in the region (such as Albania, Bosnia and Herzegovina, and to some extent Serbia), Montenegro has a moderate

diaspora, with the UN estimation from 2017 that 12.7% of the population was residing abroad.

Montenegro has a high level of HDI, which increased from 0.750 in 2000 to 0.814 in 2017. Bearing in mind the relatively low level of economic development, this is mostly attributed to good results in the areas of health and education, which are mostly residues of comprehensive healthcare and education systems introduced during socialism.

## 3. Quality of entrepreneurship

Weak state institutions and widespread political clientelism do not create a business environment conducive to entrepreneurial activities. However, regulations in the country seem to be business-friendly on paper, comparable to the other CEE countries. However, protection of property rights remains a concern, because rules and regulations can be bent through informal political pressure.

However, the main problem is not the quality of regulations, but their implementation in practice. Due to corruption and political clientelism, but also conflicting regulation, laws and other regulations are not applied consistently and equally to all entities (BTI 2018). This can be used to gain competitive advantage over competitors in the market, and this increases the level of unpredictability which has influence on entrepreneurial calculation.

The insider privatisation that took place in the 1990s created a group of new entrepreneurs that used their good political connections to create and maintain their business operations. This process was also helped by the international sanctions, since there were well organised business groups that took place in large-scale international smuggling operations, with tacit or active support from the government. There is a clear symbiosis between the political and business elite, and this system is often described as "crony capitalism" where parties with strong political connections can exploit them for business purposes. This system of political patronage among the domestic business elite continues to the present day.

Montenegro has a higher level of new business density than the other countries in the region. The number of newly registered companies is 6.7 per 1.000 working-age inhabitants (World Bank, WDI), which is significantly higher than in the other Western Balkan countries, and at par with the more entrepreneurial European countries such as Sweden. However, competition in the country is considered weak, pointing out to possible cartelisation of the small market and high barriers to entry (GCR ranks Montenegro as 122nd country in the world in this area).

Most of newly-opened companies are concentrated in traditional fields such as retail, real estate and tourism. There is no developed ecosystem that would foster opening up of new technological and innovative companies, such as technology hubs, industry-university cooperation, or venture capital.

## 4. Modernisation based on FDI

During the first decade of transition, FDI were scarce due to high political instability and seclusion from the world economy because of military conflicts and international sanctions. Only when the political situation stabilised did the FDI inflow commence, which was supported through the second privatisation program. It envisaged auctions and tenders for big strategic companies, which favoured multinational companies since they would bring new capital and technologies. The sharp increase in FDI was recorded in 2005, and lasted to 2011 after which is subsided, and took off again only recently. Since Montenegro is a small country, one or two bigger projects can have a substantial statistical effect. Consequently, high volatility shown by the data would be more expected than in bigger economies.

Since the first decade of transition was lost for FDI, this means that the total FDI stock in Montenegro is lower than in more successful CEE countries. Furthermore, the majority of FDI was oriented towards non-tradable sectors, such as real estate, tourism, banking, insurance and telecommunications: only 10% of all FDI was directed towards manufacturing. The main FDI origin country is Serbia, with 33% of all FDI

(Monstat 2018) but almost 40% of all investment came from small island countries and tax heavens.

Even so, FDI had a modernisation effect on the Montenegrin economy, at least in the fields where FDI were significant, such as tourism, real estate development and banking. This can be traced through exports: while in 2007 tourism reached exports of 630 million USD (40% of the total exports), in 2016 this was 940 million USD (50% of the total exports). However, not all FDI were successful, since the biggest investment in manufacturing in Montenegro, the aluminium factory KAP in Podgorica, went bankrupt. Once the biggest exporter in the country, KAP decreased its exports from 340 in 2007 to 87 million USD in 2016.

Banking is clearly the most dominated sector by foreign affiliates, since foreign banks operate 73% of the total bank assets in the country. These banks come from Austria, France, Hungary, Slovenia, but also Serbia. This is again a legacy of the Yugoslav crisis, since the hyperinflation in the 1990s destroyed domestic banks after their loans had lost all value. In 2003, most of domestic banks went bankrupt and entered liquidation procedures, which opened up the field for foreign-owned banks to enter the market. Total bank assets in the country are in line with most CEE countries, but well below the eurozone, with 100% of GDP (CBCG 2018). There are currently 15 banks operating in the country, 12 of which are foreign-owned. This has had a beneficial impact on the Montenegrin economy since it enabled much needed foreign capital inflow: domestic saving was just 7.1% of GDP, while domestic credit to private sector is almost 50% of GDP (World Bank, WDI).

There is no clear data on ownership in industry, but state remains a significant market player only in transport and postal services, energy generation (where it enjoys a quasi-monopoly) and agriculture.

## 5. Knowledge sector

Expenditures for R&D in Montenegro are low compared to the European countries (the EU average being 2%), reaching just 0.4% in 2018, according to the GCR. However, due to the lack of tax breaks and insufficient accounting practices and knowledge, the data on R&D

activities, especially in new innovative sectors such as ICT, are probably underreported.

Tertiary gross enrolment rate was 58.2% in 2017 (World Bank), but the quality of education provided in most universities is substandard compared to the European average, and a significant number of students study abroad, especially in Serbia, due to the lack of language barriers. Although primary and secondary school enrolment rate is high and resembling the OECD average, the quality of sub-tertiary education is significantly lower, which is depicted by PISA results. Montenegro participated for the first time in PISA testing in 2015, and Montenegrin students scored 411 points in science, compared to the OECD average of 493 points. Similar situation is also present in mathematics and reading.

## 6. Public opinion attitude towards transformations

Deep divisions within the population are present in the field of nation building, which is still an important topic for the Montenegrin public, to a bigger extend than the topic of transition. This national rift was somewhat healed with the passing of time, so few people question Montenegrin independence per se. But there are heated political debates regarding the status of the official language (is it a new Slavic language, or just an offshoot of Serbian), or else the role of the Serbian Orthodox Church in the society versus uncanonised Montenegrin Orthodox Church. The new current political rift is dealing with Montenegro's NATO accession – in June 2017 Montenegro became the 29$^{th}$ member of this organisation, but the number of NATO supporters has been very close to NATO opponents. Although these numbers varied, the data show a certain pattern: in 2008-2011, NATO support increased while opposition decreased; in 2012-2015 opposition erupted due to the conflict in Ukraine, while since 2015 these numbers have been almost equal. Even today, only 40% of the inhabitants support NATO, while 42% is opposing it (CEDEM 2018).

The public opinion is more favourable towards the EU, but there is also a negative trend. The high point of the EU accession's support was

recorded in 2007, with 72.4%, after which a decade of decrease in support started until only 56.1% in 2017. This rose again to 63.3% in 2018.

According to the Life in Transition survey, support for market economy in Montenegro stood at 40% in 2016, similar to its level a decade before, higher than in the transition region (35%) but lower than in Western Europe (65%). Support for democracy is much higher, but on a downward spiral – it decreased from 70% in 2006 to 60% in 2017, putting Montenegro again between the transition region (50%) and Western Europe (80%). Support for authoritarian government increased, but is still well below 20%, just above its support for Western Europe.

## Conclusion

Montenegrin transition path from a planned to a market economy and from an authoritarian to a democratic government was done in a context that had strong impact on the reforms that were implemented and their results. While all the other countries from the other areas of the CEE region (to some extent excluding Czechia and Slovakia) had to tackle first the macroeconomic stabilisation, the dissolution of their main export partner: the Soviet Union, as well as establish basic market institutions, Montenegro first had to deal with political issues and nation building, together with the stemming political instability and violence that erupted in former Yugoslavia. Although Montenegro was able to avoid direct conflict on its territory, the political situation in the region had a significant impact on domestic politics and the political economy of reforms.

Weak political institutions, strong state connection to organised criminal groups that used international trade embargo for state sponsored smuggling activities of excise goods, and the strength of the unreformed secret service and the old "nomenklatura" led to the creation of economic elites whose entrepreneurial activities were closely connected to the political influence rent-seeking activities. State owned enterprises, government contracts, and public sector job placements are used as political spoils and rewards for political backing. Therefore, the creation of strong economic institutions such as the rule of law and efficient government bureaucracy would clash

with these vested interests, which had a significant effect on the political economy in the country. In the political arena, ossification of these structures explains how Montenegro has become the only CEE country in which there has not yet been change of regime after the fall of the Berlin wall in 1989.

Weak rule of law and political pressure on courts was one of the challenges that had a significant effect on the privatisation, since many companies were sold below their estimated asset value and were used for asset stripping and tunnelling by the buyers, many of whom were well politically connected, which enabled that kind of behaviour. This means that a significant number of privatised companies that otherwise would have been successful after the privatisation, were not used in order to continue their business operations, but to launder money from illegal activities or to take over the valuable land for real estate development. Although to some extent this was common for all privatisation processes in CEE, it had a deeper effect in the Balkan countries due to the weaker state institutions. However, while after privatisation new sectors and industries developed in the CEE countries, either through FDI or local innovative companies, in Montenegro this did not materialise due to the low quality of business environment which discouraged local investments and hindered growth of existing companies, and most of investments were transmitted to services (mostly tourism).

Debates among academic economists in Montenegro during this time were mostly concerning the role of the state and the extent of privatisation in the economy, FDI attraction and diversification of the economy away from tourism and connected services through some sort of an industrial policy that would promote specific industry sectors. A point that majority consensus has been reached is the positive effects of the introduction of the German mark and later the euro, as a legal tender in order to rein in inflation and maintain macroeconomic stability. A deeper analysis on the economic system that evolved after the 1989 in the country has not been conducted yet.

Future challenges in Montenegro are institutional development, economy diversification and the EU accession. Population change is one of the areas

in which Montenegro fares much better than countries in the region, owing to lower emigration and higher birth rates. According to the UN population estimates, this will help avoid negative population change in the next several decades. Institutional development in the country is currently the most important step for ensuring long-term economic growth. Montenegro is slowly getting closer to the middle income trap; in order to overcome it, it needs to transform from a resource-driven economy with cheap labour to an economy based on rising productivity and innovation. Institutions that would galvanise this transition are those that would secure private property rights (which would boost investment in physical capital) and intellectual property (which would boost investments in innovation and technology). This is also connected to the goal of economy diversification, since tourism remains the most important sector. The process of the EU accession could serve as a catalyst for institutional transformation, since it requires a strong rule of law and implementation of the common legal heritage, the acquis. Montenegro is currently the forerunner among the Western Balkan countries, as it started its negotiation in June 2012, but the necessary reforms would endanger strong local political and economic interests that have been pervasive in recent decades.

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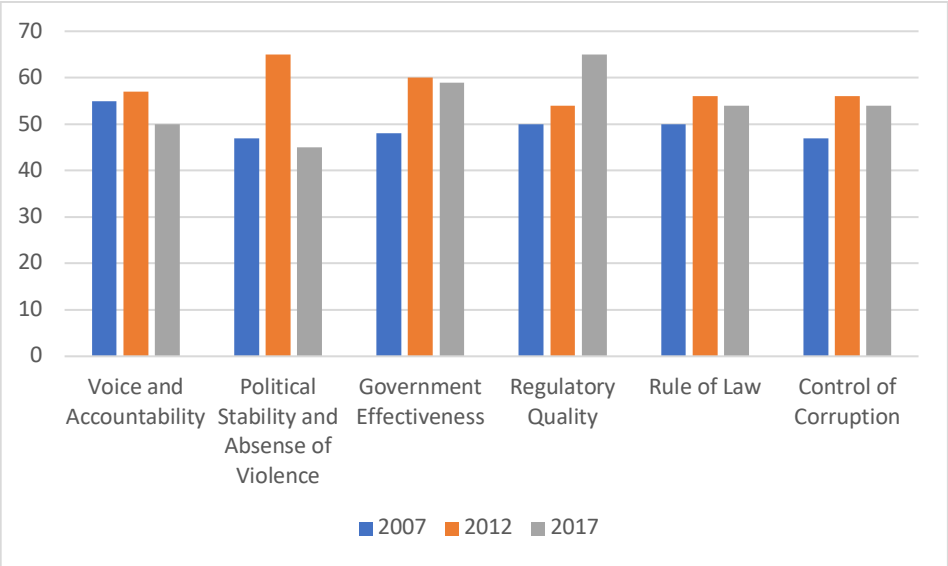
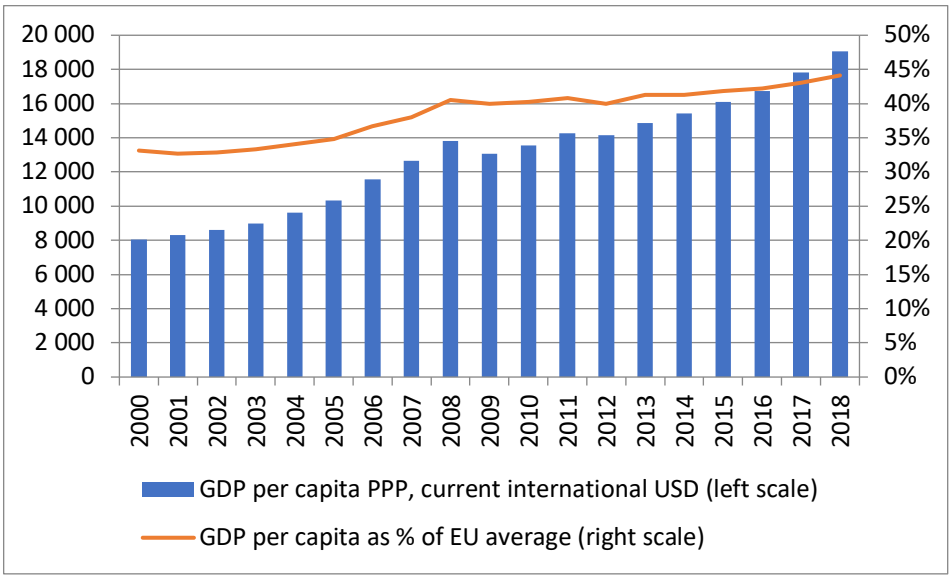
**Institutional capacities of Montenegro.**



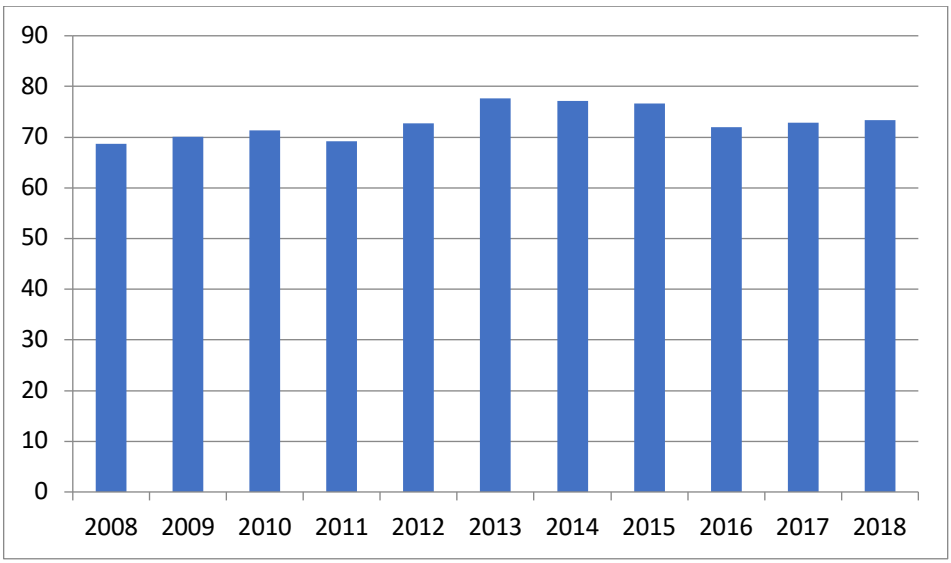

Source: World Governance Indicators, World Bank.

**GDP per capita in Montenegro 2000-2018.**



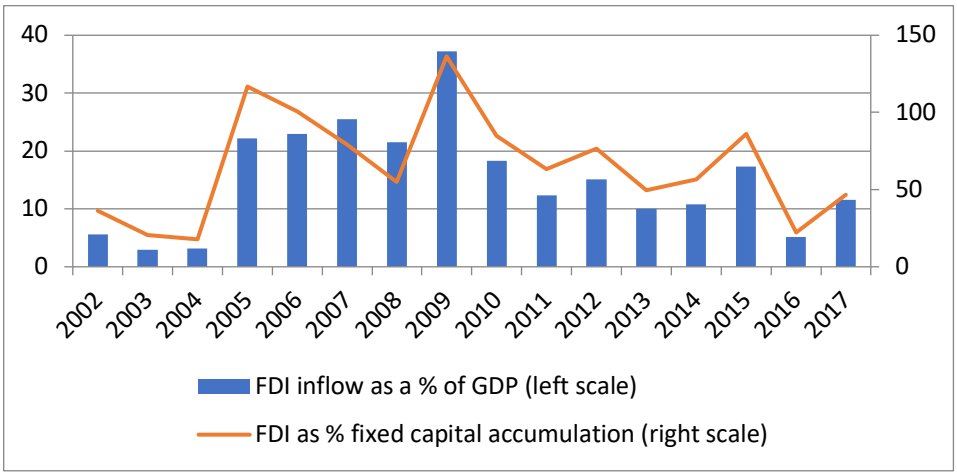

Source: IMF, World Economic Outlook April 2019.

**Quality of business environment in Montenegro.**




Source: Index of Economic Freedom (Business Freedom), Heritage Foundation.

**FDI inflow to Montenegro.**




Source: World Bank, World Governance Indicators.

### 3.4.5 Serbia

Mihailo Gajić

## Introduction

Serbia is a small land-locked country in the central area of the Balkan Peninsula. Its area is just 88.360 square kilometres, with flat lowlands in the north that are a part of the Pannonian plain, hilly region with river plains in the middle, and highlands in the southern part of the country. It is rich in natural resources, including lignite coal, bauxite, and copper. The country also has oil fields that they are mostly exhausted, generating less than one half of total annual consumption. However, the most important mining sites are located in the southern province of Kosovo, which unilaterally declared independence in 2008, which Serbia does not officially recognise, together with majority of the UN members, including the PRC. Total population of Serbia stood at 6.99 million in 2018, with 14.4% inhabitants younger than 15, and 19% older than 65. Majority of people lives in urban areas (56.1% in 2018), but the capital of Belgrade is by far the only metropolis with almost 1.7 million inhabitants, due to significant migration in the previous two decades. Fertility rate in the country is very low (TFR being 1.46), resulting in shrinking population, which further exacerbated by high emigration, mostly to Western Europe. The main economic and political process in the country after 1989 was transition from a centrally planned to a market economy, which included creation of market institutions, macroeconomic stabilisation, privatisation of state owned enterprises, improvements in business regulation, and establishment of the functioning state institutions and basic rule of law, but also – overcoming the legacy of the wars in Yugoslavia, which took a heavy toll on the economy. Political relations with other ex-Yugoslav countries remain strained with many unsolved issues, but the biggest political issues Serbia faces is the status of the Kosovo province, and its unilaterally declared independence, followed by the awaited EU accession, which has been among the top political priorities for years.

## 1. Political context and quality of institutions

The transition process in Serbia after 1989 was not only connected to the economic transformation from a centrally planned to a market economy, and from an authoritarian to a more open democratic regime, but also with the resolving the national question arising from the different aspiration of Yugoslavian constituent republics. The complex political situation in Yugoslavia led to a series of military conflicts in Croatia (1991-1995) and Bosnia and Herzegovina (1992-1995), in which Serbia was involved to a certain extent, and later even Serbia itself (the conflict in Kosovo and the subsequent NATO military intervention in 1999). During this decade (1990-2000) the international political situation and the nation building were the political priority, which had devastating effects on the economy. The Serbian economy entered a deep recession due to the dissolution of the internal Yugoslav market, which discontinued the existing supply chains, while the transition recession in the USSR, an important international trade partner, also curbed economic activity. However, it was the 1993/4 hyperinflation (one of the most devastating hyperinflation episodes in the recorded economic history) and the UN-sanctioned international embargo on imports and exports that crippled the economy the most. Therefore, when the democratic regime took over in 2000, the Serbian economy was approximately just third of its 1990 level, with GDP per capita falling from 5.000 to just 1,500 USD (Pinteric 2017).

A decade of "extraordinary politics" (dissolution of the federal country, military conflicts, international sanctions, and internal power struggle) had a devastating effect on the rule of law and the quality of public administration. Corruption became a widespread phenomenon among all levels of the civil service, while the rule of law decreased. Not only the physical capital was depleted during this year, but human capital as well due to deterioration in health and education services, mass exodus of young and educated people from the country to avoid economic hardship, but also due to political appointment in state sector that preferred party allegiance to expertise (Palairet 2001). Since early 2000, there has been a wave of reforms that managed to somewhat curb the level of corruption, mostly through market liberalisation (opening the economy to international

competition, elimination of licenses etc.) but the overall rule of law level was not significantly altered.

Low institutional capacities of the Serbian civil service are also attested on international indices, such as the widely recognised World Governance Indicators of the World Bank. The strength of this measure relies on its nature: it is a composite indicator, using several different sources (up to 8) in order to reach the final score.

The WGI depicts Serbia's internal institutional capacities as bleak, compared to the other more successful European countries (the EU15 or more successful transition economies such as Estonia or Czechia). The rule of law and control of corruption are depicted as areas that lag behind the EU countries to the greatest extend, while the situation is considered a bit better in other areas. The value of variables, such as Government Effectiveness, Regulatory Quality and Political Stability, and Absence of Violence have significantly increased through time, but Voice and Accountability decreased, while Rule of Law, as well as Control of Corruption remained on a level similar to their initial scores.

These reforms were closely connected to the political ones. The new regime that took over in 2000 was more open and inclusive, creating a space for bridging the societal division, and led to liberalisation of politics through decentralisation of political power, following electoral results in which there was no clear dominant player was strengthened via the adoption of the new constitution in 2006, which created a set of institutional checks and balances through adoption of new administrative bodies and further derogation of the role of the president and strengthening the roles of government. This process of political modernisation was supported by the ongoing EU accession inclination, which was one of the most important political goals of all post-2000 governments. However, the dominant political culture that emphasises personal leadership and the proportional election system in which party oligarchy (and not the voters) determines who the member of the national parliament would be, created a fertile ground for non-institutional centralisation of power that started after 2008. This trend towards a rule of centralised party oligarchy and disregard for established procedures can be traced to the centralisation of political power

that came in 2008 election, when a single political party controlled the president and the government of the country at the same time. In 2008-2012, the leader of the strongest party (Democrat Party) was elected president of the country, grabbing the executive political power through his control over the party and appointing a weak prime minister. When the regime changed in 2012, the new party in power (Serbian Progressive Party) at first was within its constitutional role with a weak president and strong government, but after power consolidation it again used the same method of a strong president and weak prime minister when in 2016 the leader of the party was elected president. Executive power was increasingly centralised to a small entourage of the party leadership, and dislocated from formal institutions. For example, the main policy influence in the field of agriculture is not located within the Ministry of agriculture, but within the cabinet of the president among its councillors on agriculture.

A very important political issue in Serbia is the status of Kosovo, which unilaterally declared independence in 2008, after a period of international supervision when the armed conflict had been resolved in 1999. This independence has been recognised by the majority of the EU countries (all but Slovakia, Romania, Greece, Cyprus and Spain), the US, etc. but not by the PRC or Russia. This has intertwined with the EU integration process, since Serbia would have to make a legally binding treaty with Kosovo before its accession (which may or may not be recognition of its secession and independence).

## 2. General economic outlook

The economic transformation in Serbia started already within the Yugoslav federation with the property transformation, and macro-stabilisation policies aimed at curbing inflation and relieving balance of payments' deficits. However, since the political situation quickly worsened, the whole process of economic transformation was delayed, and macro imbalances grew, peaking with one of the worst hyperinflation episodes in recorded history in 1993. International trade sanctions had a significant impact on the Serbian economy, since both imports and exports were made impossible, and the destruction of physical capital during the 1999 NATO intervention had also a negative effect on economic activities. This

environment was not conducive to economic reforms, and most of them were implemented only after 2000, with the democratisation and regime change that led to waiving of international embargo, significant foreign debt restructuring, and foreign aid inflows.

The economic development since 2000 was volatile. The first period (2001-2008) was characterised by high growth rates stimulated through high privatisation receipts, which were used to raise salaries in public sector and pensions, and high capital inflow though loans and investments. After the recession that took place in 2009, growth was low, and has only recently picked up.

Total investments remain low, with just 20.5% of GDP, while the average of transition countries reaches 25% of GDP (IMF, WEO). This is due to low public investments which are just 3%, and very low domestic private investments which are below 10% of GDP. This is mostly attributed to the low quality of business environment, and low government effectiveness in infrastructure project realisation, while FDIs have significantly increased since 2011 owing to lavish subsidies and facilitation programs that help these businesses deal with administrative obstacles that are set before them.

Unemployment has almost halved to 13.8% from its 2012 peak of 24.6%. However, most significant contributor to this positive factor is the high emigration rate, since the number of people who left the country is high and increasing. Another problem is the duality of the labour market – there is little overlap between high productivity industries, which demand new marketable work skills and specialised knowledge, and old low productivity industries that rely on cheap manual labour with low or obsolete skills. Therefore, people with old skills set cannot be absorbed by the new rising industries, and they often remain long-term unemployed, or work in the shadow economy. Activity rate in the country is just 65% – mostly because of low activation among young people due to prolonged education and little opportunities for part-time work, and among old people – due to low retirement age and long-term unemployment that discouraged people from looking for work (Eurostat).

Within this working environment, trade unions do not play a significant role, since they remain prevalent only in public sector and state owned enterprises. A significant number of workers are active in the SME sector, where worker organisation are underdeveloped, while the situation is even worse in big foreign companies since trade union activities are actively discouraged, even with tacit government approval. The latest ILO data (from 2011) show that only 27.9% of workers are members of trade unions. Furthermore, trade unions have a history of political connections to the political parties and ruling governments, which significantly undermines their possibility to be established as non-partisan organisations. Therefore, although the tripartite social dialogue between representatives of government, trade unions and employer's associations is active, its real reach is rather limited. This situation is further exacerbated by the fact that the only employers' association included in the social dialogue is of dubious representation (since members of this association do not employ the minimum required number of workers), and that the two representative trade unions have been successful in barring other trade union in joining the social dialogue.

Serbia has a numerous diaspora, mostly in advanced countries in Europe and North America, due to high emigration rate. The total number of people residing abroad, according to the UN estimates was 10,1% in 2017, putting Serbia ahead of Macedonia and Montenegro, but behind Albania and Bosnia and Herzegovina in this regard. At the same time, Serbia served as a temporary or final destination for almost 700.000 war refugees from Croatia and Bosnia and Herzegovina during the 1990s, not including 220.00 internally displaced people from Kosovo after 1999.

Serbia has a high level of HDI, which increased from 0.713 in 2000 to 0.787 in 2017. Bearing in mind the relatively low level of economic development, this is mostly attributed to good results in the areas of health and education. These results are residues of the healthcare and education systems that were introduced in socialism.

The model of capitalism in Serbia combines different institutions: it is based on market economy, but with a significant government involvement in economic activities directly (through SOEs) and indirectly (through

regulation). Another important trait is a relatively developed welfare state with government expenditures nearing the level of the more advanced European countries. The level of shadow economy is also significant, reaching almost 30% of GDP, while 20% of people employed are active in the shadow employment. Remittances of workers residing abroad are high, and the importance of imported capital (through foreign owned banks and FDI) for technology transfer and investments.

This relatively high state consumption does not translate into high quality government services, and the welfare state system can be regarded as a "premature welfare state" (Kornai 1997). The state funds and operates well-established educational and healthcare system, with redistributive policies towards the poor, as well as PAYG pension system, but redistribution rate is lower than in the EU countries, mostly because there is little to redistribute having in mind the low level of economic development. But Serbia does have a significantly higher level of public expenditures standing at 41% of GDP in 2018 (IMF 2019) compared to neighbouring comparable countries.

When different criteria are taken into account, the economic system in Serbia can be described as "dependent market economy" (Nolke, Vliegenhart 2009), "hybrid economy" (Schneider, Paunescu 2012), "weekly coordinated market economy" (Mykhnenko 2007) or "embedded capitalism" (Bohle, Greskovits 2012). However, the Serbian economy also shows significant characteristics which differentiate it to a certain degree from these models. These traits are not unique only to Serbia, but they are also present in the other Western Balkan countries.

First, the stock of FDI in Serbia is smaller than in the CEE countries in transition. Due to weak governance, low quality of infrastructure, but mostly due to the high political instability and wars, Serbia remained almost with no FDI for the whole first transition decade. FDI attraction increased since the political changes and stabilisation in 2001, but again ceased with the spill-over of the financial crisis to Europe in 2008, picking up again after 2010. Secondly, the privatisation was less thorough than in other transition countries so the state still holds a significant grip over the economy, mostly through strategic sectors (such as banking,

telecommunication, transportation, energy generation and transmission). While private sector GDP generation in CEE countries was close to 80% in 2010, this figure was only 60% for Serbia (EBRD, Structural and institutional change indicators).

## 3. Quality of entrepreneurship

Weak state institutions, especially the judiciary, do not create a business environment conducive to entrepreneurial activities which would enable businesses to thrive. This is visible in low domestic investments, which were near 10% of GDP in 2018, which is significantly below the CEE average. However, the quality of business regulation has somewhat improved in recent years. The biggest improvements have been made in the area of construction licenses, ease of opening up a new business, and increasing the level of flexibility in the labour legislation, some improvements are also visible in the area of digitalisation of administrative procedures, and use of ICT by the civil service in their dealings with the businesses.

However, the main problem is not the quality of regulations, but their implementation in practice. Due to corruption and political clientelism, but also conflicting regulation and high level of discretionary power for their implementation by civil servants, laws and other regulations are not applied consistently to all entities, which can be used to gain competitive advantage and increases the level of unpredictability in doing business in the country.

The insider privatisation that took place in the 1990s created a group of new entrepreneurs that used their good political connections to create and maintain their business operations. This process was also helped by the international sanctions, since only a privileged few had the possibility to access important goods and technology (Vujačić *et al.* 2011). This system of political patronage among the domestic business elite continued even after trade liberalisation in 2000, but it changed form to include public procurements as its main vehicle. Even though public procurements are conducted by the rules that are mostly in line with the EU regulations, they are often disregarded in practice. This system is often described as "crony capitalism", where the rules of the game are not same for everyone, and in

which political connections can lead to business success, while lack of them – to failure.

Low level of opening up of new businesses is the logical consequence of this system in practice. The number of newly-registered companies is just 1.76 per 1.000 working age inhabitants (World Bank, WDI) which is significantly lower than in any other Western Balkan country apart from Bosnia. Also, competition in the country is considered weak pointing out to possible cartelisation of the small market and high barriers to entry (GCR ranks Serbia as 115th country in the world in this area, while according to the Institutional Profile Database 2016 edition, the market barriers reach relatively high level of 1.5; where 0 means high barriers and 4 no barriers).

Most of newly-registered companies are concentrated in traditional fields such as retail. Although technological and innovative companies continue to experience growth, supported through technology hubs and cooperation with universities, start-up ecosystem is not developed, and venture capital is hardly present. Capital in Serbia is still scarce, and therefore investments are made mostly locally, thanks to which they can provide a high rate of return. When local capital is employed in investing internationally, it is mostly directed to countries in the region such as Bosnia and Herzegovina or Montenegro, due to the prevailing economic, linguistic and cultural ties.

## 4. Modernisation based on FDI

During the first decade of transition, FDI were scarce due to high political instability and seclusion from the world economy through military conflicts and international sanctions. Only when the political situation stabilised after 2001 did the FDI inflow really start. This was encouraged through the new privatisation law that envisaged external purchase of companies, favouring big international companies that would, apart from capital, bring new technologies. A program of subsidising big FDI programs was started in 2006 in order to facilitate their inflows, with direct cash payments of 0.2-0.3% of GDP per year, not including high tax waivers. Although FDI did increase, the lost first decade of transition means that the total FDI stock is lower than in more successful CEE countries. Furthermore, a significant proportion of FDI was oriented towards non-tradable sectors, such as real

estate, banking and insurance. and telecommunications (Estrin *et al*. 2014). Main FDI origins are the EU countries, most notably Germany, Austria, Italy, and Norway.

Even so, FDI had a propounding modernisation effect on the Serbian economy. This is especially visible in exports: the 2006 data show that Serbian main export products were raw materials (flat rolled iron and copper) and agriculture products (corn, fruits and sugar) and rubber products. A decade after, in 2016, the situation was much different: manufactured cars and car parts, insulated electrical wire, cigarettes and machinery have taken the lead, even though total exports increased three fold, from 6.4 billion USD to 20.8 billion. This was mostly due to the influence of foreign companies, but their impact on the rest of the economy was limited since there was little spill-over effect in terms of wider inclusion of local producers, and their integration into existing global supply chains. This is one of the many reasons why the Serbian economy is less open in terms of trade to GDP ratio than other countries from CEE (Estrin *et al*. 2016).

Apart from manufacturing, banking is clearly the most dominated sector by foreign affiliates. This is again a legacy of the Yugoslav crisis, since the hyperinflation in the 1990s destroyed domestic banks after their loans had lost all value. In 2003, most of domestic banks were bankrupt and entered liquidation procedures, which opened up the field for foreign-owned banks to enter the market. Domestic banking experienced another hit when in 2012 almost all remaining state-owned banks became insolvent since their loan policy was influenced by political factors and the bulk of their loans could not be repaid. Currently there are 28 banks in the country, and domestic banks have just a 16% in total banking assets (NBS 2018). This has had a beneficial impact on the Serbian economy since it enabled much needed foreign capital inflow: domestic saving was just 12.2% of GDP (World Bank, WDI) which is significantly lower than the investment rate.

There is no clear data regarding ownership in industries, but the state remains a significant market player only in transport and postal services, energy generation (where it enjoys a quasi-monopoly) and telecommunications (it owns the biggest telecom operator). The process of

privatisation in manufacturing has not yet been finished, since the state is still the owner of a group of companies that were nationalised after the initial privatisation after their owners and not fulfilled their part of the contract. These companies still employ almost 45.000 people (approximately 2% of total employment), but their number is slowly diminishing through privatisation or bankruptcy.

## 5. Knowledge sector

Expenditures for R&D in Serbia are low compared to the EU average of 2% of GDP, reaching just 0.9% in 2018, according to the GCR. However, due to the lack of tax breaks and insufficient accounting practices and knowledge, the data on R&D activities, especially in new innovative sectors such as ICT, are probably underreported.

The total public spending on education is 3.9% of GDP (World Bank, WDI), a significant reduction from the all-time high of 4.8% in 2010, mostly due to streamlining the wage bill through decreasing the number of ancillary staff in schools and cutting the wages by 10% in late 2014. Since the wage cut has recently been reversed, these expenditures are expected to rise in near future. Tertiary gross enrolment rate was 66.5% in 2017 (World Bank), but the quality of education provided in most universities is substandard compared to the European average. There were several high level cases of academic fraud – from PhD thesis plagiarism (including the previous mayor of Belgrade and current minister of finance; minister of police) and to a widespread selling of degrees, but none of them led to a satisfactory judiciary or social closure. There is little cooperation between universities and companies, and little incentives to make education more in line with market needs.

The Serbian economy is considered to be a moderate innovator (EU Innovatation Scorecard 2017). Although its overall performance, when compared to the EU average, has increased from 66 to 70 points since 2010, it is still lagging behind comparable countries that are the EU members. The strongest innovation dimensions are Firm Investments, Linkages and Employment Impacts, while innovation-friendly environment and intellectual assets are the weakest innovation dimensions.

## 6. Public opinion attitude towards transformations

A very popular sentiment regarding the economic and political transformation in the country is that it failed the common man. The privatisation process is widely considered as rigged and corrupt, in which politically connected people and politicians tunnelled assets to increase their wealth. This narrative has increased in recent years, since it is supported by the mass media, as a part of internal political struggle between parties for election votes. Parties now in power feed on this narrative since it enables them to discredit their competitors, and facilitate further control over the economy so as to create opportunities to support their clientelist network.

Life in Transition Survey (LTS) of the EBRD demonstrates that almost 45% of the respondents in Serbia do not have preferences regarding the economic system they live in. Although the support for the planned economy is small and shrinking, it does not mean that support for market economy is high and rising. The support for planned economy in 2010 stood at 30% of respondents and it decreased to 25% in 2016 (compared to 20% in Western Europe, and almost 40% in the whole transition region). However, the support for market economy was almost on the same level of 30% in 2016 and 2006 (compared to 35% in transition region, and 65% in Western Europe).

The situation is very similar when political attitudes are taken into account. The inhabitants of Serbia show significant lack of preferences for any of the two political systems offered – 40% of respondents in both 2006 and 2016 declared that the system of government did not matter, compared to 25% of people in transition region, and 10% in Western Europe. Although the support for democracy (40%) is lower than in transition region (50%) of Western Europe (80%), it is still higher than for the alternative, since only 20% of people support an authoritarian government (lower than 30% in transition region, but higher than 10% in Western Europe).

The support for the EU integration among the population is still dominant, but it experienced a significant fall in the previous decade, from all-time high of 73% in November 2009 to 55% in December 2018, while the

number of people against the EU membership doubled from 12% to 25% in the same time (Ministry for EU integration 2018). Support for NATO is rudimentary, with 8% of respondents, mostly due to NATO's bombing of Serbia in 1999, and majority of respondents are favouring military neutrality and cooperation with all countries.

## Conclusions

Serbian transition path from a planned to a market economy and from an authoritarian to a democratic government was done in a context that had strong impact on the reforms that were implemented and their results. While all other countries from the other areas of the CEE region (to some extent excluding Czechia and Slovakia) had to tackle first the macroeconomic stabilisation and the dissolution of their main export partner: the Soviet Union, and establish basic market institutions, Serbia first had to deal with political issues and nation building, and the stemming political instability and violence that erupted in former Yugoslavia, including wars and ethnic cleansing. In this kind of environment, transition reforms were stalled, and were implemented only after a regime change, almost a decade after the start of similar reforms in the CEE region.

This environment led to significant economic turmoil and problems, including a hyperinflation in 1993/1994, cutting off international trade flows through the UN sanctioned embargo, leading to a rapid deindustrialisation, mass unemployment, and a significant fall in GDP. Weak political institutions, utilisation of criminal groups as paramilitary in the war conflicts which increased their political importance, the impact of secret service and the old "nomenklatura" on state-owned enterprises, as well as their later privatisation led to the creation of a whole class of "political entrepreneurs", people whose economic success was based on political connections and rent-seeking activities that often included a quasi-monopoly status in the market through official licensing and other market entry barriers, but also advantages over competition through government contracts and inconsistent application of regulation, subsidies and tax waivers. This group had vested interests that would be hit by deeper reforms through the imposition of rule of law and liberalisation of the economy. Other significant insider groups that could lose their rent were

the SOE employees, since they enjoyed higher level of salaries and better working conditions than their private sector counterparts. These strong pressure groups had a significant effect on the political economy of reforms in Serbia, which also shaped the way in which the local economy evolved.

Weak rule of law and political pressure on courts was one of the challenges that had a significant effect on the privatisation, since many companies were sold below their estimated asset value, and were used for asset stripping and tunnelling by the buyers, many of whom were politically well-connected, which enabled that kind of behaviour. This means that a significant number of privatised companies that otherwise would have been successful after the privatisation, actually were dismembered and sold in pieces in order to get the invested resources out of the company as soon as possible. The privatisation was used to launder money from illegal activities, which also did not incentivise business development of companies at stake, or to reach the valuable land for real estate development. Although this was common in all privatisation processes in CEE to some extent, it had a deeper effect in the Balkan countries due to the weaker state institutions. However, while in the CEE countries after privatisation new sectors and industries developed, either through FDI or local innovative companies, in Serbia this did not materialise due to the quality of business environment which discourages local investments and growth of existing companies.

Debates among academic economists in Serbia during this time were mostly concerning the role of the state and the extent of privatisation in the economy, and the trade liberalisation and industrial policy. Two groups of economist evolved, connected to state universities and research institutes, one supporting free trade/globalisation, privatisation, and curtailing the government involvement in the economy, while the other advocated import substitution policy, and stronger state involvement in the economy through greater role of SOEs, curtailed privatisation, and a strict industrial policy to direct investment to champion industries. At the same time, other topics such as strong exchange rate appreciation and its effect on the rise of non-tradable sectors at the expense of the tradable ones, or market institution development, did not receive enough spotlight. After the 2008 financial

crisis, the most important topic in discussion was the state of public finances, and the growing public debt. Therefore, deeper analysis on the economic system that evolved after the 1989 in the country has not been conducted yet, while there has been one international edition on this topic (Uvalic 2010).

Future challenges in Serbia are the population changes, institutional development and the EU accession. According to the UN population estimates, the population of Serbia is expected to shrink significantly in the future, from the current 7 million to 4.9 million in 2060. Furthermore, the overall population will continue to age, with more than 25% being older than 65 already in 2040. This will put a significant additional pressure on the state-funded pension and healthcare system, and will raise public expenditures, while these cost will be directed to the shrinking working age population. However, the more pressing problem is the high emigration rate rather than the low fertility rates: some industries are already facing shortages of skilled labour which can pose a significant obstacle to future growth. Institutional development in the country is currently the most important step for ensuring long-term economic growth. Bearing in mind Serbia's level of development, it is slowly advancing towards the middle income trap; in order to overcome it, the country needs to transform from an resource driven economy with cheap labour to an economy based on rising productivity and innovation. Institutions that would galvanise this transition are those that would secure private property rights (which would boost investment in physical capital) and intellectual property (which would boost investments in innovation and technology). EU accession could serve as a catalyst for institutional transformation, since it requires a strong rule of law and implementation of the common legal heritage, the acquis, but its prerequisite is the resolution of the status of the Kosovo, the south Serbian province which unilaterally declared independence in 2008, which is very hard to be achieved.

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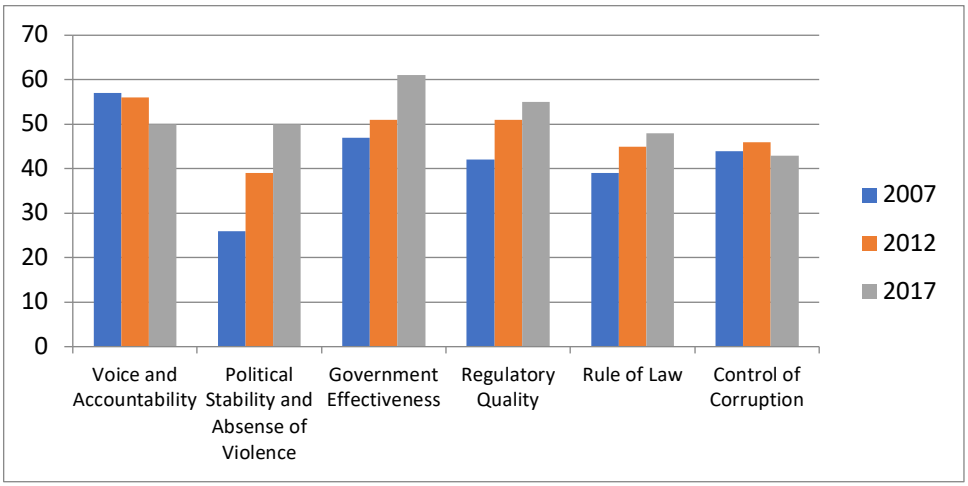
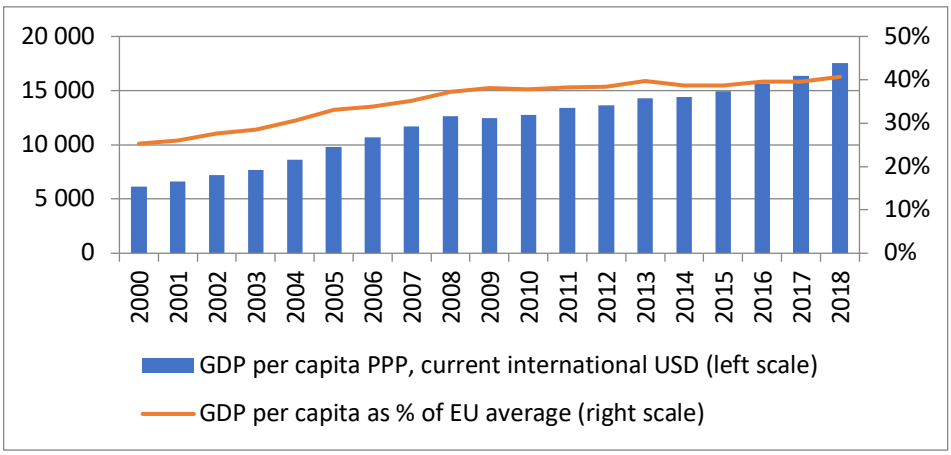
**Institutional capacities of Serbia.**



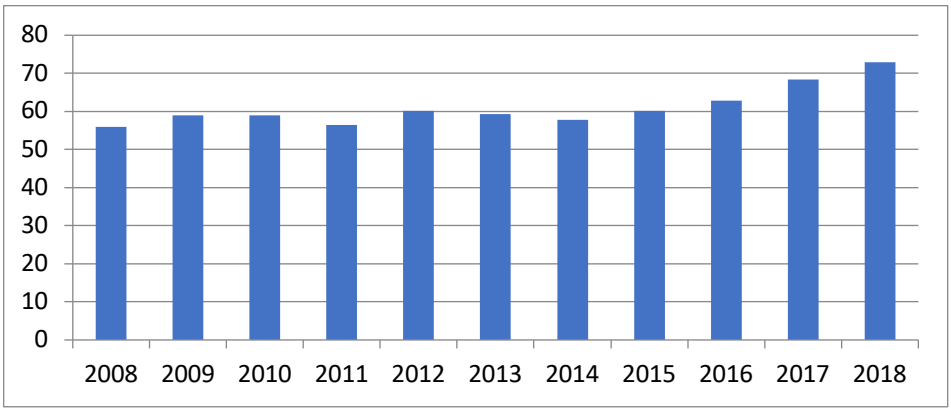

Source: World Governance Indicators, World Bank.

**GDP per capita in Serbia 2000-2018.**



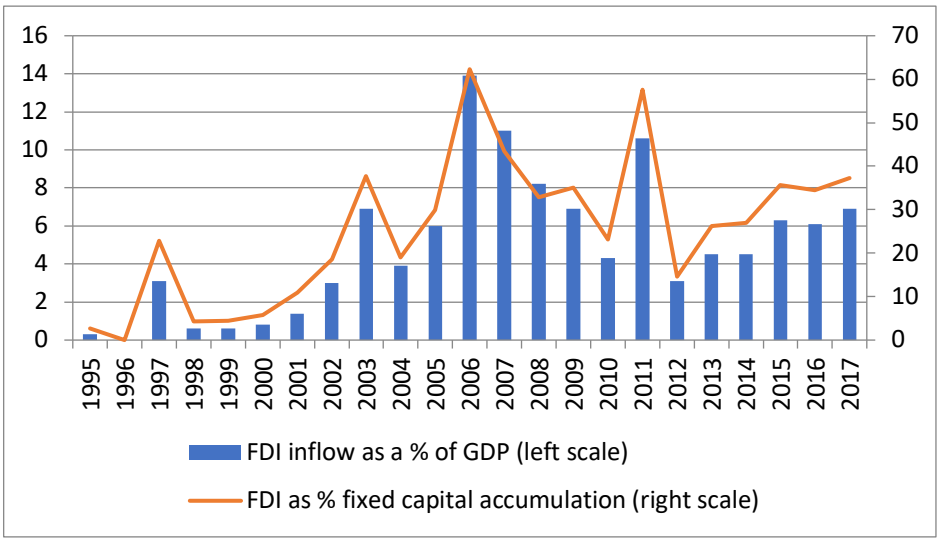

Source: IMF, World Economic Outlook April 2019.

**Quality of business environment in Serbia.**




Source: Index of Economic Freedom (Business Freedom), Heritage Foundation.

**FDI inflow to Serbia.**




Source: World Bank, World Governance Indicators.

# Chapter 4 Findings and concluding remarks

Krzysztof Jasiecki

## 4.1 Conclusions from analyses groups of countries

### 4.1.1 The Visegrad Countries

#### Historical Introduction

Poland is the largest country in the post-socialist CEE countries. In terms of GDP, it ranks sixth in the EU28. Geographically, the V4 countries belong to Central Europe and are directly adjacent to two EU countries – Germany (Poland and the Czech Republic) and Austria (the Czech Republic, Hungary, Slovakia). Since the Middle Ages, they have been strongly connected politically, economically and culturally with German-speaking countries. During the dynamic development of capitalism in Western Europe in the 19th century Hungary, the Czech Republic, Slovakia and part of Poland belonged to the Austrian Habsburg monarchy.

The political and economic situation of the countries of the region remained significantly different. After the First World War Poles and Hungarians rebuilt their independence lost in the 18th century. The Czechs and Slovaks created a new federal state – Czechoslovakia – which belonged to the most economically developed in Europe. Poland and Hungary, due to war damage, territorial changes and a large share of agriculture, were at a much lower level of development. Politically, only Czechoslovakia was a stable democracy between 1918 and1939; Poland and Hungary had short periods of operation of democratic institutions in the 1920s, which was soon replaced by semi-dictatorial governments (Marshal Piłsudski, Admiral Horthy). In 1939, under the Munich Agreement, Czechoslovakia was divided. The first Slovak state in history was established – authoritarian, dependent on Germany, and the Czech Republic became the protectorate of the Third Reich. After the war, the Czech Republic and Slovakia formed Czechoslovakia again.

At the end of the 1940s, communist parties took power in Central Europe. They carried out profound changes in the economic and social structures, including rapid industrialisation based on heavy industry, nationalisation of enterprises and banking, collectivisation of agriculture and urbanisation. All the states of the region belonged to the Council for Mutual Economic Assistance (Comecon) and to the political and military Warsaw Pact – both organisations were entirely subordinated to the Soviet Union. The low efficiency of command and distribution economies led to stagnation and later – a development regression compared to Western Europe. For example, Poland's GDP after World War II exceeded the level of Greece, Spain or Portugal, and in the late 1980s these countries had a national income at least twice as high (Farkas 2016: 184). As a result of social dissatisfaction in Hungary, Poland and Czechoslovakia, there were mass political demonstrations in favour of political reforms and a departure from the economic model shaped on the USSR (the Hungarian uprising 1956; protests in Poland in 1956, 1968, 1970, 1976, 1980-1981; the "Prague spring" in Czechoslovakia in 1968).

Since 1968, Hungary has carried out the deepest market reforms in the Comecon countries. It introduced the highest number of liberal and free market elements. Governments experimented with economic reform initiatives in order to introduce performing price system, partial freedom of enterprise, collective and personal incentives and more direct links to the non-communist world economy (Hungary has been a member of the World Bank and of the IMF since 1982). However, these reform steps did not change the basic character of the economy. The dissimilarity of the Polish economy was determined by maintaining private ownership in agriculture and in small trade, services and crafts. From 1956, the authorities undertook reforms that tried to combine the command and distribution system with decentralisation of management and economic accounting. However, the changes were selective, and their failures led to social discontent. As a result, in 1980 "Solidarity", led by Lech Wałęsa, was established and it was the first trade union and social movement in CEE, independent of state authorities. The introduction of martial law in 1981 stopped political

changes and economic reforms[41]. At the end of the 1980s, the government returned to them, but failed to introduce market elements while maintaining a centrally planned economy. (Poland, in preparation for the reforms, became again a member of the World Bank and of the IMF in 1986). Due to the economic crisis and the belief in the need for deeper changes, the autonomy of enterprises and the scope of market activity were increased. At the end of the 1980s, there were restored, among other things, pre-war commercial codes and company law as well as the possibility of creating mixed-capital enterprises (state, private, foreign, joint ventures, etc.), business-friendly tax reforms, as well as reform of state-owned banks preparing their division and ownership changes. On the other hand, Czechoslovakia, after a short period of liberalisation followed by the intervention of the Warsaw Pact military forces, which resulted in suppressing the reforms undertaken in the late 1960s, returned to the centralised command and distribution system. Market economic changes were initiated only on the wave of political transformation in CEE. However, after 1989, different, partly competitive, ideas of economic transformation crystallised in the power elites of the Czech and Slovak federation. In the Czech Republic, supporters of economic liberalism took over, and Slovakia was ruled by proponents of the greater role of the state and protectionism. Along with increasing nationalism and separatism (as in Yugoslavia and in the USSR), such differences led to the collapse of the federal state. In 1993, two independent states emerged from Czechoslovakia: the Czech Republic and Slovakia.

After three decades of transformation, there are still significant economic differences in the region. The Czech Republic is the most developed in the entire CEE region, reaching 90% of GDP per capita of the EU average (EU28 = 100). For Slovakia this ratio is 78%, for Poland 71%, and for Hungary 70% (Eurostat 2019).

[41] In 1979-1982, Poland's accumulated GDP fell by 25% due to the economic crisis, political conflicts and isolation from the West after the imposition of martial law in 1981 (Farkas 2016: 184).

## 1. The political context and the quality of institutions

Reforms introduced earlier in Hungary and Poland reinforced the belief there that the strengthening of market mechanisms, including the development of the private sector and individual entrepreneurship, opens up greater development opportunities than the centralised command and distribution economy. Also, the political and institutional environment in these countries was diverse and, in some respects, different from most CEE countries. Hungary and Poland entered the transformation in the early 1990s with a significant private sector (25-30% share in GDP), while in Czechoslovakia it existed only marginally. At the same time, Hungary and Poland were distinguished by a very large share of foreign debt in GDP (64% and 63.4%, respectively), which affected their relations with international economic organisations, and with Western governments. However, the relatively small foreign debt of the Czech Republic (12.2% of GDP) and that of Slovakia (6.8% of GDP) gave them greater opportunities to independently determine the directions of systemic changes in the economy.

In the 1990s, the political transformations of Hungary, Poland, the Czech Republic and Slovakia became an inspiration and reference system for the other CEE countries. The Visegrad states (and Romania) have not only relatively the largest economies and demographic potential among the 16 characterised countries, but also strategic locations in Europe. They are often treated as exemplifications of economic trends occurring throughout the region. At the beginning of the 1990s, the following factors were particularly important in this aspect: political conditions (neoliberal turnover, orientation towards NATO and the EU), ideological motivations (attractiveness of Western capitalism, no systemic alternatives), economic factors (belief in market efficiency), location (proximity to Germany), historical premises (common legal and business traditions) and cultural and social identifications (sense of belonging to Europe, preferences for a different lifestyle, connections with diasporas in Western countries) (Bandelj 2008). In CEE, similar circumstances appeared together and comparatively strongly only in Slovenia and in the Nordic-oriented Estonia.

The most important common denominator of the V4 countries (apart from Slovakia between 1993 and 1998) was the dynamics of political systems based on liberal-democratic consensus and the desire for rapid rapprochement with the West. This consensus translated into trends in reforming the financial system, industrial relations, labour relations, social protection and education (Farkas 2016: 419-420). Regardless of the type of initial political transformation – radical ones (Poland, Czech Republic, Slovakia) or gradual ones (Hungary), their effects soon led to the domination of the private sector in the economy. The pace of change is illustrated by the growing share of this sector in GDP – in 1997 it reached 75% in the Czech Republic, Hungary and Slovakia, and 65% in Poland (Schoenman 2014: 16). For economies, the key catalyst for system transformation was the prospect of integration with the EU, which also forced changes in the area of the rule of law, regulatory quality, property rights, trade openness, competition policy, or FDI inward. At the same time, because of that, in many aspects (e.g. protection of the internal market), the V4 countries became more neoliberal than Great Britain under Thatcher or the US under Reagan (Szelenyi, Wilk 2010: 569). The transformation began the earliest in Hungary and Poland. The institutional infrastructure of the economy was quickly created – an independent central bank, a stock exchange, regulatory agencies, etc.

In Hungary, the shape of the state's economy was considered relatively better than in the other countries of the region and it was decided to implement the strategy of gradualism. A "premature welfare state" with a growing budget deficit (Kornai 1997) was consolidated. This deficit was reduced mainly through foreign debt and proceeds from privatisation dominated by MNCs, and since the second half of the 1990s, by a dynamic growth in GDP. However, this did not stop the deepening macroeconomic budget imbalance, which later became the premise for the systemic crisis. Initially, Poland was in a much worse economic situation than Hungary: hyperinflation, market shortages, a large budget deficit, as well as the breakdown of production and trade links with the USSR and the Comecon, which were of much greater importance than in Hungary. As a result of the agreement between the ruling elites and the opposition centred around "Solidarity", parliamentary elections were held on 4 June 1989, followed

by profound political changes. The "Balcerowicz plan", a shock therapy, was key to the economy and included macroeconomic stabilisation (suppressing hyperinflation, limiting the budget deficit), deregulation (liquidation of price subsidies, de-monopolisation), privatisation, trade liberalisation, strengthening social security, currency convertibility, and opening towards foreign countries. The Polish reforms, recognised as exemplary, were recommended by international economic organisations to the other CEE countries (Aslund 2008; Laar 2006). An expression of their support by Western countries was rescheduling the defaulted repayments and the cancellation of half of Poland's debts.

In January 1991, the Czech Republic and Slovakia, still within the common state of Czechoslovakia, began implementing their shock therapy, which started with macro-stabilisation, voucher privatisation, liberalisation and trade openness policies. Since 1993, due to the breakup of the federation, they focused on reconstructing state institutions, introducing the national currency, property settlements, etc. In the more developed Czech Republic, with its long recognised industrial traditions, the Vaclav Klaus government continued its neoliberal economic policy with strong ties with the West. Slovakia had a larger share of heavy industry and suffered bankruptcy of some enterprises formerly exporting to the USSR, which adversely affected the social situation in the form of the emergence of unemployment, significant deterioration in the material situation of the society, followed by an increase in the influence of politicians advocating protectionism and social security at the expense of market economic reforms. The political trajectories for the development of the Czech Republic and that of Slovakia soon also became different. Initially, the authorities of both states wanted to build "national capitalism", preferring national business circles and middle classes through insider privatisation.

In the Czech Republic, however, systemic changes were made in accordance with the rule of law and the constitutional separation of powers, as well as with other criteria determining the conditions of EU membership. The government was implementing voucher privatisation. Investment funds set up by state-owned banks were to stimulate the development of entrepreneurship and the market without favouring managers of companies (often coming from the previous system) and without foreign investors

(able to quickly take control of the market of a small country). However, state-owned banks and investment funds exerted little pressure on enterprise restructuring. The competitiveness of Czech exports was falling. Banks were accrued bad loans and found themselves in crisis; the government introduced austerity measures. The privatisation process and related corruption scandals led to the parliamentary elections in 1998. The new government sold most of the banking sector and restructuring agencies to foreign investors.

Since its re-establishment, Slovakia has been inclined towards nationalism, populism and radicalism. Prime Minister Meciar's paternalistic methods of governing led to the weakening of democratic institutions, through breaking the constitution and the law, or by appropriating the judiciary system and the public media. The government administration created a system of patronage and clientelism in access to privatisation, taxes and loans. This period is described as the stage of unsustainable economic development and implementation of "own way of transition" (Sikulowa, Frank 2013). In addition, the country's economy was hit by the Russian crisis (1998), aversion towards foreign capital, and conflicts with the Hungarian minority (10% of the country's population) contributed to blocking its OECD and NATO memberships[42]. As a result, Slovakia was initially excluded from accession negotiations with the EU (1997) as a country that failed to meet the Copenhagen criteria, since 1993 determining the conditions of EU membership (including the requirement to respect the principles of the rule of law, the separation of powers, and the supremacy of the EU law over national law) (Gould, Szomolanyi 2000). The political situation in Slovakia changed radically in 1998. After the parliamentary elections that removed Meciar from power, the new government announced a "return to Europe" program and resumed cooperation with the EU. A neoliberal turn in economic policy followed. Due to high GDP growth, Slovakia was referred to in the West as the "Tatra Tiger" (the name derives from the local Tatra mountain range). In 2000, the country became a member of the OECD. In 2004, Slovakia joined the EU with the other V4

[42] Among the Visegrad countries, three states had already become members of the OECD: the Czech Republic (1995), Hungary (1996) and Poland (1996). These three countries joined NATO in 1999.

countries, and was also admitted to NATO. Slovakia took advantage of the high economic growth rate, and was the only one of the group to become a member of the euro area (2009).

The effects of the global crisis meant that the other V4 countries did not follow the example of Slovakia (Orłowski 2018). In 2008 Hungary, most affected by the recession, was forced to turn for help to the IMF, to the World Bank and to the EU. Even in Poland, which was the only state in the European Union to avoid recession, distrust towards instituting the euro was evoked by the dire situation of Southern Europe. Doubts were reinforced by the consequences of the austerity policy in eurozone, fears of reducing the public sector, as well as burdening the euro area countries (including Slovenia and Slovakia) with the costs of the Greek crisis. Although accession to the EU increased political and institutional convergence, the crisis of 2008-2009 strengthened the opposite tendencies, and launched the processes of economic destabilisation, social disintegration and systemic de-legitimisation. Liberal-democratic consensus was collapsing in many countries. The political scene became more divided, as well as susceptible to authoritarian and anti-elitist tendencies – control of the media, violation of the rule of law, and of constitutionalism. Influences of radical anti-system movements (populist, nationalist etc.) increased. In Europe, their extreme manifestation is Brexit, as well as tensions arising from security threats, e.g. terrorism, the Russian annexation of Crimea or the migration crisis. After accession to the EU and following its crises, assertiveness of CEE increased, including the V4 consolidation built on their opposition to EU migration policy, and the Three Seas Initiative to strengthen the economic interests of CEE[43]. The countries of the region are re-defining the goals and forms of cooperation resulting from changes in the EU and in its external environment. Such tendencies had emerged previously – after the 2004 and 2007 enlargements – in the form of backsliding symptoms of some CEE countries from the strategy of neoliberal transformation of the economy, and from standards of Western democracies. This can be seen as a response to economic and

[43] This initiative, commenced by Poland and Croatia at the summit in Dubrovnik (2016), consists of 12 countries from CEE. The project received official support from US President D. Trump during the Warsaw Summit (2017).

social costs of alignment with the EU or as negation of liberal political culture models that are poorly embedded in the region (Bohle, Greskovits 2012; Jasiecki 2008; Ost 2005).

In many CEE countries, the EU is no longer seen only as a modernisation opportunity, but also as a source of problems, including dependence on western EU states or Muslim migration. The effects of the global crisis triggered political trends in the V4, which also partly reverse the direction of transformation. Their special manifestation has been changes in Hungary since 2010, and those in Poland, following a similar course since 2015. The nature of these changes proves the fragility of institutions formed in the region. In Hungary, under the slogan of rebuilding a strong nation-state, systemic changes are implemented, including amendments to the constitution in 2012. They enabled the concentration of powers in the hands of the prime minister and introduced a majoritarian system of power in the state. The check and balance system became dismantled, the independence of the judiciary system, control institutions and the media was reduced, along with the guarantee of individual rights, including property rights. According to the authorities' declarations, this is a transition from liberal democracy to "illiberal democracy", and from a market economy to a state-led economy. This direction of systemic changes is conducive to building a patronage state with reduced governance efficiency and lower regulatory quality. It also leads to an increase in corruption, a deterioration of the investment climate, and a decrease in competitiveness (Martin 2017; Lengyel, Ilonszki 2016; Szanyi 2016).

The political changes introduced in Hungary have been an important inspiration for the Polish authorities. The 2015 takeover of power by the united right camp took place under the slogan "Budapest will be in Warsaw". The current character of changes is depreciating, and a new economic policy is being introduced, accompanied by changes in the institutional environment, including the reverse of privatisation. The most important distinguishing features are the centralisation and concentration of the executive power, relying economic development on the state, generous social policy programs, tightening the tax system, as well as limiting the competence of local governments (Jasiecki 2019). In recent years, both Hungary and Poland have been in conflict with the key EU

bodies regarding the observance of European values provided by the Treaty, such as separation of powers, the rule of law, independence of judges, freedom of the media, and minority rights. Hungary is additionally accused of systemic corruption.

Although the Czech Republic and Slovakia implement other development scenarios, they are also burdened with issues that deteriorate the quality of political and economic institutions. However, while in Hungary and Poland the problems are of a more systemic nature, in Slovakia and in the Czech Republic they concern narrower issues, mainly the behaviour of persons in key positions accused of corruption and conflicts of interest (Prime Minister Babis in the Czech Republic, former Prime Minister Fico in Slovakia). These issues are less transferred onto economic institutions, e.g. in the form of an increase in statist tendencies. One of the problems of the Czech Republic and Slovakia is the crisis of the authority of state leaders and that of political parties, which translates into low confidence in national institutions of power and democracy. Slovakia is categorised as weakly institutionalised unconsolidated democracy with key favourable structural conditions, difficult historical legacies, and with nationalist political elite (Malova 2017).

Divergences between the EU and the V4 governments are also increasing on issues such as migration or interpretation of the EU law, Euroscepticism (also in the other CEE countries) is rising. New political tensions create controversies in assessing the directions of system changes, and the extent of further participation in the development of European integration. However, Slovakia and the Czech Republic are not conducting any objectionable legal or institutional changes comparable to those in Hungary and in Poland.

## 2. The general economic outlook

Compared with the other CEE countries, the Visegrad countries are considered a subregion, and have similar systemic features (Aslund 2008; Nolke, Vliegenhart 2009; Myant, Drahokoupil 2011; Bohle, Greskovits 2012; Farkas 2016; Ahlbornat al. 2016; Rapacki 2019). The main

distinguishing feature of the variants of capitalism taking shape there became the building of democratic market economies. The average GDP growth rate has hitherto been around 4% per year, with relatively low inflation, a large share of the private sector, along with high taxes and high public expenditure, significant social transfers, serious budget deficits and corruption slightly higher than in the Baltic Republics (Aslund 2008). Other features also point to the extensive and formalised rules of bureaucracy inherited from the previous system, accumulation based primarily on importing capital from abroad, economic development based on exporting modernised industrial production, financial fragility related to capital deficit, the dominance of MNCs in the economy, and the weakness of domestic business (King, Szelenyi 2005). Hungary experienced the largest inflow of foreign capital in CEE in the 1990s. The FDI entry helped strengthen the quality of market institutions and the competitive structure of exports, and initiated the reindustrialisation of the country. Poland as well, due to its relatively high GDP growth and its largest in CEE internal market, a few years later experienced a growing inflow of FDI, and began to restructure its economy based on exports to EU countries.

In connection with the accession to the EU and strong links with the German economy, the countries of the region began to be considered in the categories of dependent market economies – a new variant of capitalism, whose institutional shape differs from both the liberal and the coordination models. In this version of capitalism, coordination mechanisms, as well as investment financing, corporate governance and innovation transfer, were subordinated to the interests of MNCs, which took control of strategic sectors of the economy, and of the largest companies providing financial and telecommunications services as well as of export industries (especially the automotive sector). At the same time, from the economic perspective, the V4 states were considered examples of particularly successful transformations (Nolke, Vliegentart 2009: 692). A confirmation of this success was, among other things, a gradual reduction of the development gap compared to Western Europe. There were hopes in the region that it was entering the path of economic advancement that had previously been shared by Spain and Ireland.

The Visegrad countries have been collectively defined as a model of "embedded neoliberalism". They implement an economic strategy in the style of the Washington Consensus, partly modified by state regulations and social protection (Bohle, Greskovits 2012). In building the foundations of the market economy, the main organizer of the transformation were state institutions that played a key role in economic transformations and public sector management (much larger than in Western Europe), as well as in the areas of labour markets, industrial relations and welfare state. They also organise tripartite dialogue between the government, trade unions and business associations. Tripartite institutions in the V4 were formed in the 1990s in reference to the EU standards, among other things. This important position of state institutions resulted from the competences of the state apparatus (regulatory, financial, etc.), as well as from the implementation of many tasks requiring large resources, including restructuring the economy and the challenges of the labour market, that other segments of the society were unable to provide. This role is still being reproduced due to the relatively limited development of civil society institutions.

However, in the V4, social participants usually have limited opportunities to exert influence – they can do this mainly through consultations, which is referred to as hybrid "transformative corporatism" (Iankova 2002) or "illusory corporatism" (Ost 2000). In most of the tripartite institutions, the strength of social partners is limited to being acquiescent to government decisions. Trade unions are losing importance, their influence remains significant mainly in the public sector, and sometimes in former large state-owned enterprises acquired by foreign investors. De-industrialisation, the collapse of large state-owned enterprises, the expansion of small and medium-sized enterprises and that of the service sector, as well as the use of new technologies and the progressing individualisation of work in CEE have made companies the main level of bargaining. Employee representation in the private sector has been marginalised, the key indicators of which are low membership in trade unions (union density) and the decreasing share of collective bargaining. With the exception of the Czech Republic, there were no active labour market policies in the V4. On the other hand, the labour market was characterised as markets with regulated flexibility, high work-related migration from Poland and

Slovakia, lower from Hungary, and marginal from the Czech Republic. As a result, traditional forms of employee representation (such as trade unions, crew representations on supervisory boards or employee self-governments) have eroded, and have been fragmented and politicised, which has led to a significant reduction in membership base[44]. However, there have been certain differences in this respect among the countries of the region.

In Hungary, trade unions and social dialogue initially played an important role. In Poland, the Solidarity trade union supported market reforms in the early implementation phase. In both countries there was a limited institutionalisation of social dialogue and tripartite principles (Farkas 2016; Gardawski *et al.*). In the Czech Republic, however, compromise arrangements with social partners – "low-wage and low-unemployment" were adopted at the beginning of the transformation, thus avoiding high unemployment. Trade unions have also kept a greater distance from politics. In Slovakia, on the other hand, authoritarian tendencies blocked the institutionalisation of social dialogue. It was only after 1998 that subsequent governments changed this approach, which, however, did not significantly affect the position of trade unions.

In the area of welfare state, capitalism in the Visegrad states is distinguished by generous but strict conditions, targeting the population outside of employment (mostly pensioners). Pensions constituted a buffer against unemployment and an instrument for alleviating social conflicts. In addition to the institutional solutions inherited from the socialist system (especially free education, health care and the pension system), governments introduced new social concessions for employees, e.g. minimum wages or unemployment benefits. Since the 1990s, this model of a welfare state has been creating dilemmas for the coexistence of large budget spending with relatively low state efficiency (Avdagic 2005; Industrial Relations in Europe 2012; Bohle, Greskovits 2012). As a result, in the V4 countries there is an inconsistency of the coexistence of neo-liberal economic institutions with outdated, malfunctioning distributive

[44] The weakening of employee representation has been a widespread phenomenon in Western states since the 1990s; only the Scandinavian countries are an exception to this rule in Europe (Eurofound 2018).

institutions, which are fundamentally state socialist in nature (Szelenyi, Wilk 2010: 583). Higher status groups (administration, army, judiciary, some industries) and middle-class groups (tax deductions, free education, etc.) are the main beneficiaries of this situation. The global financial crisis became a catalyst for significant changes. However, the different trajectories of political development resulted in the fact that they assumed a different character in Slovakia and the Czech Republic than in Hungary and Poland.

In Slovakia after 1998, on the wave of pro-European sentiments, the previously abandoned structural reforms were undertaken, leading to meeting the EU standards. The implementation of neoliberal reforms has accelerated since 2002: they focused on macroeconomic stability, public finance reform, in particular that of the tax system, which later became a "symbol" of economic reforms (flat tax rate with 19% on personal income, as well as corporate income taxes) liberalisation of the labour market, and reducing welfare transfers. At the same time, Slovakia opened onto FDI (which became the driving force of the economy). These reforms, together with the accession to the EU and the operation of new industries (mainly automobiles), created a precondition for fast economic growth of the 2000s, which reached its peak at 10.7% in 2007. Good economic results enabled Slovakia to enter the euro area. Although this was adversely affected by the global financial crisis (collapse in exports, falling GDP, rising unemployment and budget deficits), Slovakia quickly returned onto the path of growth. The Czech Republic experienced a significant recession in 2009, and then its minor recurrence in 2012-2013; in the following year, however, the Czech Republic regained stable growth, strengthening its position of economic leader in CEE. Both countries are still the most developed in the V4. They have coalition governments, without the dominance of a hegemonic party, which limits the possibility of centralising and monopolising power that could favour statist concepts. A different situation took shape in Hungary, and later in Poland, where power was taken over by strong leaders at the head of the largest political parties.

After joining the EU, Hungary benefited from the favourable economic conditions much less than the other V4 countries. During the period of left-liberal rule (2002-2010), the country's debt increased sharply. The global

financial crisis overlapped the internal economic and political crisis, and there was a massive outflow of foreign capital. The state found itself on the verge of insolvency, fell into a deep recession (-6.8% of GDP in 2009). The threat of bankruptcy was averted thanks to a loan granted by the IMF and by other financial institutions in 2008 (20 billion euro). A wave of criticism and social protests became the source of the rise to power of Viktor Orban in 2010, and of the hegemony of the right-wing Fidesz Party. The new block of power gained a constitutional majority in parliament, which enabled the implementation of reforms transforming the system of the state. A change in economic policy followed – from neoliberal to heterodox and towards selective "economic nationalism".

Hungary's main economic reforms focus on several aspects; firstly, on combining the protection and promotion of domestic companies with the establishment of a "workfare regime" – job creation policies even if they are of low efficacy. Secondly, on strong statism and recentralisation, meaning, among other things, limiting the role of regulatory offices, privatisation reversal (e.g. building state champions, increasing state interference in prices, especially those of energy and municipal services). Thirdly, on the consolidation of public finances and changes in the tax system (a flat tax on individuals, imposing high taxes on sectors dominated by foreign investors, family support policy and, at the same time, reduction of certain social spending, changes in the pension system, including the takeover of public-private resources in open pension funds). As a result, the government led to a permanent reduction of the financial deficit below 3%; in 2013, the EU completed the excessive deficit procedure since the country's accession to the European Union (in relation to Poland, this procedure was conducted between 2009 and 2015). Hungary has returned to the path of economic growth and in this respect has remained at the forefront of the EU for the past two years. Such an economic policy which internally enjoys social support has an ambivalent image on the international stage. Despite the development shown, Hungary's position in various competitiveness rankings is decreasing (Farkas 2016: 416). It has become the avantgarde of heterodox economic policies and a new archetype of change in CEE.

Poland is implementing a similar direction of political changes. Here, too, the power system is dominated by one party – the Law and Justice, led by Jarosław Kaczyński, the actual (though informal) head of state. Since 2015, the government has been pursuing a policy of radical economic changes. The country is moving towards a model of state capitalism, combining economic interventionism based on state-owned enterprises with a paternalistic policy of material and social redistribution (inter alia, through the exchange of elites). The new government has made the largest social transfers since 1989, intended mainly for "losers" in the transformation (including large families), raised minimum wages and (unlike Hungary) restored the earlier retirement age. State energy companies finance seed money for start-ups, which extends government control over the economy. Poland, like the other CEE countries after the global crisis, also took effective measures to tighten the tax system, which allowed to increase the financing of social policy. Like in Hungary, this policy has a positive impact on economic development in the medium to short term. In both countries, such a policy meets with significant public support, confirmed by, among other things, the results of the 2019 elections to the European Parliament` and to the national parliaments. The actions taken confirm the thesis that right-wing governments in CEE allocate more funds to social policy than left-wing and liberal parties do (Tavits, Letki 2009).

Questioning the existing development model in Hungary and in Poland has revealed the limitations of the strategy of economic changes implemented since the 1990s. The two countries that initiated the neoliberal transformation have become leaders of anti-liberal system changes. This turn contrasts with the continuation that is still taking place in the Czech Republic and Slovakia. Different development paths may result from different political and social situations. In Hungary and Poland power is exercised by nationalist-populist, conservative and economically statist groups. Parties with stronger centre-left and liberal preferences rule in the Czech Republic; in Slovakia conservative social democratic and nationalist parties do. Hungary and Poland, and on the other hand the Czech Republic and Slovakia, are also different in terms of social differences (measured by the Gini coefficient and exclusion) – much larger in Hungary and Poland.

The Czech Republic and Slovakia are closer to the Scandinavian countries in this respect.

Regardless of the differences among the Visegrad countries, some common problems can be identified. What is reducing the efficiency of the economy is the deteriorating quality of institutions, particularly the public administration, as well as corruption. The increasingly difficult demographic situation, including the aging of societies, low fertility rate of women and large emigration (with the exception of the Czech Republic) to Western Europe are all of significant importance. There is a growing shortage of employees, especially skilled ones, which increases labour costs and threatens the region's competitiveness. As a result, the share of social transfers (family, health, retirement, etc.) in the state budgets keeps increasing. Education systems are poorly adapted to the needs of the economy and the costs of reorientation and vocational training are rising (to varying degrees). Hiring employees from the outside of the V4 countries has become a new challenge amid resentment towards immigrants and lack of migration policy.

Forecasts of economic slowdown in the EU and on a global scale reinforce fears of the middle-income trap[45]. Counteracting this phenomenon must allow for the departure from the current model of economic development, based largely on the low costs of relatively well-educated employees. Further increase in labour productivity is also necessary (e.g. in Poland it is 50% of the EU15) through, among other things, increasing technological advancement and automation – to the level of Western Europe. Discussions are taking place in the countries of the region about methods to strengthen endogenous development, including in particular domestic sources of financing in the light of the low importance of the stock exchange and the capital market (at the end of 2017, the share of banks from the entire EMS (*European Stability Mechanism)* was less than 1.5% in the structure of the EU banking sector's assets) (Orłowski 2018: 52). The low level of investment is also a problem, especially in Poland, where in recent years it

[45] After reaching approximately 60% (+/- 10%) of American prosperity, many states cease to catch up with the USA. This happened, among others, in Greece, Portugal and in some Latin American or Middle East countries. South Korea and Finland are opposite examples.

has been at the level of 8.5% of GDP annually instead of the envisaged 25%.

### 3. The quality of entrepreneurship

Since the beginning of the post-socialist transformation, the Visegrad countries have faced a double challenge. The first one concerns the reconstruction of a competitive market economy after a period of central planning, the second one is due to the rapid development of technology in the global economy. The course of changes was different in individual states, due to, among other things, the diversity of starting conditions for doing business. In Hungary and in Poland they were more favourable due to the prior significant participation of the private sector and the related political and institutional transformations. The Czech Republic and Slovakia joined the analogous process a little later, in the early 1990s. All the V4 countries were distinguished by the high dynamics and expansiveness of private entrepreneurship stemming from the crisis of state-owned enterprises, and partly motivated by the opening of new perspectives resulting from market reforms. Initially, some of the undertaken actions were forced by the inability to find a job or the fear of losing one. Gradually the motivations changed. What usually increases along with the increase in GDP per capita is the share of projects undertaken by those who take advantage of market opportunities, knowledge and skills, those who have capital, and are more innovative (GEM 2004: 63).

At the same time, since the second half of the 1990s, there was a change in the business development environment, accelerated by the participation of the countries in the EU accession process. The manifestation of this trend was, inter alia, improving their position in the Doing Business rankings. The relatively stable situation in this respect reflects the effectiveness of reforms that were successively implemented in the last decade. In the latest edition of the ranking, the V4 states are in the top forty (Poland, the Czech Republic, Slovakia) and fifty (Hungary) out of 190 states, and therefore are among the countries with relatively good business conditions. However, the decline in these positions in recent years can serve as a certain warning signal. The analysed indicators, as well as those taken into account by,

among others, the Global Competitiveness Report, the Index of Economic Freedom or the Digital Economy and Society Index (DESI) confirm the tendency, present already during the accession period, that in CEE the leaders of pro-business changes are the Baltic States. However, the distance to EU15 countries in this respect is not decreasing.

The countries of the region are characterised by a relatively high level of entrepreneurship development, as evidenced by the development of SMEs – over 40 companies per 1000 inhabitants. But although it is 30-50% more than in Western Europe, the scale of their participation in the economy remains significantly smaller. Small entities dominate (over 95% of them belong to the group of micro-enterprises); they are dispersed, less organised and managed, weaker in the system of interest representation. Without consolidation, this business segment will not increase its competitiveness. On the other hand, small companies are relatively young compared to those operating in the EU15, and the ongoing processes of generational change create additional opportunities to boost entrepreneurship, including by introducing new technologies and increasing innovation.

A considerable hindrance impeding the development of SMEs in the V4 countries is the economic structure inherited from the command and distribution system – the biggest employers in the region are companies with a large share of the treasury, which are characterised by greater risk aversion, a conservative approach, and short-term development strategies. In response to the global crisis, first in Hungary (2010), and then in Poland (2015), power was taken over by groups that promote the policy of statism, and economic development based on the leading role of state-owned enterprises. These activities arise controversy and significantly differentiate the states of the group – they have no equivalent in the Czech Republic or in Slovakia. They also create a new kind of dilemma. Those states that declare the national nature of economic policy concentrate political and economic resources at the governmental level. For example, in Hungary this is pursued by introducing sectoral taxes (in banking and trade), buying up domestic enterprises from foreign owners, or building a dominant position of domestic capital in strategic sectors. In Poland, similar concepts are implemented under the slogan of re-polonisation, i.e. restoring the national character of enterprises. What raises anxiety, among

other things, is the possibility of renationalising large enterprises (e.g. from the 500 List), or even the media (Chapmann 2017).

Directing support to the so-called new economy champions runs the risk of poor resource allocation. It also limits the development opportunities for small businesses and private entrepreneurs who have not yet accumulated enough capital. SMEs also do not have management competences comparable to those of Western countries, and the skills of building corporate chains and cooperation networks are now being shaped (source 2017 report, Borys PARP). Contrary to OECD recommendations, ownership, regulatory and management functions are mixed up, which promotes new forms of monopolisation and politicisation of the economy, as well as lowering institutional standards in the public sphere and corruption. The occurrence of such threats is also associated with lower efficiency of state-owned enterprises in CEE compared to companies with foreign capital, and to those with private domestic capital (IMF 2019; Bałtowski, Kwiatkowski 2018; Pula 2017; Błaszczyk 2016; Mihalyi 2016; Somai 2016; Szanyi 2016; Jasiecki 2013). The crises of state-owned banks in the Czech Republic in the 1990s (and later also in Slovenia) confirmed the negative consequences of similar actions.

Dynamic economic development in recent years has caused a significant increase in the cost of labour. For political reasons, this is supported by the Polish and the Hungarian authorities, as well as discussed in the Czech Republic, where it has become a conflict area between employers' organizations, trade unions and the parties forming the ruling coalition. Economic environments are concerned that rising labour costs and, at the same time, increased social outlays will reduce resources for investment, including R&D necessary to strengthen the competitiveness of the countries of the region. Increasing labour market deficits in the V4 are also opening in a new way the issue of hiring employees from countries with cheaper labour, mainly from Ukraine. Generally, governments in the Visegrad countries (often supported by trade unions) officially oppose this; however, employers are effectively pushing for the opening of the labour market.

## 4. Modernisation based of FDI

The high level of penetration by the inflow of foreign capital and its type have become one of the main features of the post-socialist transformation, as well as a factor in differentiating variants of capitalism throughout CEE. The previously characterised combination of circumstances meant that the V4 countries sooner than other European post-socialist countries began to implement development strategies based on links with transnational corporations (TNCs), known as FDI-led growth or FDI-driven growth. Such strategies were considered a catalyst for reforms modernising economies, as well as an important dimension of integration with the EU (Pula 2018; Bohle, Greskovits 2012; Bandelj 2008). FDI-based V4 successes are compared to Southern Europe. There, however, economies have long ceased to grow dynamically, and investment transfers are of a different nature; it is mainly portfolio capital (Farkas 2016: 207; Bruszt, Vukov 2015). The Visegrad countries also compare more favourably against most of the Balkan states and the former Soviet Union, where there was no comparable inflow of foreign investment (Okafor, Webster 2016). FDI in Central Europe became a substitute for small domestic savings and came to be the main capital stream in the privatisation and restructuring of enterprises. It became the basic premise for increasing the productivity of work necessary for the success of economic transformation and modernisation in the V4 countries.

The unprecedented rate of increasing the share of foreign investors in this region meant that before accession to the EU the most profitable or systemically important enterprises and sectors – financial intermediation, telecommunications, export industries and retail became dominated by Western TNCs (although to different extents). As a result, in the second half of the 1990s there was a transition from the "national capitalism" phase, in which economies were controlled by domestic capital, to the "foreign-led development" phase dominated by TNCs (Farkas 2016; Bohle, Greskovits 2012). In discussions on Comparative Capitalism, such a transition was reflected in the definitions of the V4 countries as "liberal capitalism from without" (King, Szelenyi 2005), "transnational capitalism" (Bohle, Greskovits 2007), "dependent market economies" (Nolke, Vliegenthart 2009) or " capitalist transformation based on FDI "(Farkas

2016). The common denominator of these terms is the multidimensional dependence of the region on foreign capital coming mainly from Western Europe.

Considering the location in international trade provides grounds for considering the V4 countries as FDI-based second rank market economies. Their institutions, modelled on those of the EU, quickly integrated with international markets. Foreign investors dominate the economies, and the development is based on exports with a growing share of highly processed goods, produced mainly by local subsidiaries of TNCs (Myant, Drahokoupil 2011). There was a system created that was a combination of export-oriented economic development with dependent financialisation determined by the weakness of domestic capital accumulation. In this perspective, the progressing "Europeanisation" of the V4 economies may mean their further "peripheralisation" in the form of dependence on import markets in the EU15 (especially Germany), as well as on foreign credits and technologies. However, such trends are gradual, historically variable and occur in various forms. They result from, among other things, different links between states, their role in the international division of labour and the relations between representations of foreign capital and domestic capital, which together determine the scope of economic autonomy (Podvrsic, Schmidt 2018). The inflow of FDI to the Visegrad states has been diversified.

The most indebted Hungary opened on FDI the most expeditiously. At the end of the 1980s, the authorities decided to repay foreign loans by increasing exports combined with privatisation with the participation of MNCs. Hungary attracted FDI also because of its well-developed business services resulting from the large share of foreign trade in the economy. In the 1990s, the country was a leader in acquiring FDI among all post-socialist countries (Bandelj 2008; Bohle, Greskovits 2012; Farkas 2016; Szabo 2019). At the same time, Hungarian rapid and mass privatisation with foreign investors largely shaped the patterns of FDI inflow to the other V4 states in terms of sectoral distribution of investment. The collapse of the already over-expanded, uncompetitive industry led to the bankruptcy of many enterprises and to the rising unemployment. The deficit of investment capital in Hungary – not unlike in most CEE countries – meant

that MNCs became the main driving force of change through re-industrialising the economy by means of integration with transnational corporations[46]. Soon similar scenarios were implemented by the other V4 countries. The substantial inflow of FDI was conducive to modernisation, which was indicated by the significant increase in exports strengthened by EU accession. For example, the value of Polish exports between 1990 and 2018 increased 14-fold (Arak *et al.* 2019: 22). Such tendencies strengthened the view that the Visegrad countries were close to transition from the semi-peripheral countries group to the semi-core countries category in the European Union (Bohle, Greskovits 2007)[47].

However, in the late 1990s, the FDI-driven growth strategy began to arise criticism. Its integration with international markets reduced the regulatory autonomy of the V4 countries, strengthening the position of TNCs from Western Europe. Due to the resources at their disposal, TNCs largely control financial, production and export relations that play a key role in the economy. Their position gives the opportunity to monopolise or oligopolise various market segments and marginalise domestic business. TNCs also take advantage of the political and regulatory weaknesses of the states of the region, including their rivalry for obtaining FDI through taxes, investor subsidies etc. (Bohle, Greskovits 2012: 169). As a result, in line with the concept of the "trilemma", in the V4 the entities of market hyper-globalisation, largely eroding the institutions of the state and democracy (Rodrik 2011) acquired considerable influences. Their most significant organisational form are corporate governance structures in which key decisions are mainly agreed among managers of the local subsidiary and TNCs Western headquarters. New governance rules have been formed in strategic sectors. This creates legitimacy tensions related to fears of a threat to national sovereignty, including the poor representation of FDI host countries in their relations with foreign capital, other EU countries or international organisations. This is how the perception of German capital

[46] The importance of foreign investment for the entire CEE is illustrated by the fact that at the end of 2017, the share of banks of all the countries of the region in the structure of the EU banking sector assets was less than 1.5% (Orłowski 2018: 52).

[47] Among the V4 countries, the Czech Republic and Hungary have the highest FDI stocks as a share of GDP (Szabo 2019: 2).

dependence began in the V4. The duality of development of more profitable companies with the participation of foreign investors and less effective domestic enterprises, as well as geographical and sectoral concentration of FDI is noteworthy. These tendencies deepen regional, economic and social differences significantly increased by the inflow of foreign capital. In the sphere of consequences, they resemble in a new way the problems known from the theory of dependence and the theory of the world system that characterised island development and semi-peripheral countries. A manifestation of similar phenomena is the emergence of a new "metropolitan class", wealth elite and middle classes concentrated in the capitals – Budapest, Prague, Bratislava or in several major agglomerations – in Poland (Jasiecki 2013).

The crisis in the EU revealed many other limitations and negative aspects of FDI-based V4 development, including a sharp decline in the export of companies with foreign capital, a radical reduction in the lending activity of banks controlled by transnational capital, as well as exchange rate risks shifted onto enterprises and households that took out loans in foreign currencies, especially in Swiss francs (Bartlett, Prica 2011 ). Amassing such phenomena resulted in increasing the budget deficit and, in the case of some of the countries of the region, in entering the procedures of excessive indebtedness in the EU (Hungary, Poland). Part of the response of the countries of the region to the ambivalent aspects of FDI became a discussion about the costs of their service, including tax optimisation and the balance of inflows and outflows (inward/outward). This is part of a wider debate about TNCs, pointing out that international investment is difficult to monitor and classify due to their frequently non-transparent origin. It is estimated that about 1/3 of global financial flows are multiple transactions carried out by third countries, which leads to tax revenue welfare losses, as well as distorted competition in the host country. TNCs make such transfers, which take advantage of tax preferences in some countries (in Europe, this includes Cyprus, Luxembourg, the Netherlands and the United Kingdom) (Aykutat al. 2017). Another problem in the V4 is, included in GDP, repatriated profits abroad by foreign owners, whose share is the largest in the Czech Republic – hovering at around 5% since

2010, slightly smaller in Slovakia and Hungary, and the smallest (about 2% per year) in Poland (Szabo 2019)[48].

In recent years, there have been different reactions in the region's countries to new development challenges, including the consequences of a large share of foreign capital in the economy. The role of Hungary and Poland is particularly important, unlike in the Czech Republic and Slovakia, where there are no tendencies to increase the state's share in the ownership of enterprises. In these countries, there is a shift towards the model of state capitalism, including privatisation reversal. In the conditions of weakness of domestic capital, an essential part of this return is to increase the share of the state treasury in the ownership of enterprises. In Hungary between 2010 and 2013, the value of state shareholdings doubled (Farkas 2016: 414). Between 2010 and 2016, over 80% of renationalisation transactions concerned foreign entities (Mihalyi 2016: 588). Similar tendencies have been observed in Poland since 2015, where state ownership has also continued to increase, especially in financial services and in the energy sector (e.g. in banking, the share of domestic capital controlled mainly by the state exceeded 52%, in the energy sector – 60%). Treasury companies are also often used in order to purchase other business entities (Jasiecki 2019). These activities are primarily aimed at overcoming the risks associated with consolidating the position of dependent market economies and at reducing the threat of the "middle income trap". Compared to the other EU countries, such a policy raises great controversy, as exemplified by the highest position of Hungary and Poland in the Expropriation risk in the EU ranking.[49]

Despite introducing diverse variants of re-industrialisation and promoting export of domestic companies and of modern technologies in Hungary and Poland, there is no data suggesting that these countries are now able to effectively deviate from the FDI driven growth strategy (Pula 2018: 208-2012). However, the view is being formulated that for their future it is not crucial to focus on the renationalisation of enterprises (their

[48] Such indicators show the growing need to compare the GNI to GDP ratio in the CEE countries.

[49] www.theglobaleconomy.com/rankings/Expropriation_risk/European-union (access 01 November 2019)

‘hungarisation’, ‘repolonisation’ etc.). Although this is an important issue for creating tools for autonomous economic policy and for reducing the scale of risk during periods of external shocks, in the area of FDI it is more important to eliminate the performance gap between domestic labour productivity and that of the leading world economies. It involves significant strengthening the of the spill-over effect in domestic enterprises and increasing their competitiveness (Farkas 2016: 209; Myant 2018: 302).

## 5. The knowledge sector

The development of the knowledge sector depends on many contextual factors (e.g. the level of economic development, R&D expenditure, cultural patterns) and on systemic ones (including public policies and the institutional model of capitalism). The role and functions of this sector are discussed within Comparative Capitalism. Its effectiveness, expressed in its ability to create radical innovations or incremental innovations, is seen as one of the main criteria differentiating capitalism models (Hall, Soskice 2001; Amable 2003). However, in the transformation of the political system in CEE, the importance of the knowledge sector was initially underestimated. Especially since governments were usually struggling with the crisis of public finances, the domestic private sector was just emerging, and the transfer of knowledge and technology was treated as a spontaneous process, in line with the neoclassical approach. It was assumed that it would occur automatically as modernisation there approached the Western levels. Openness onto cooperation with highly developed countries and accession to the EU were seen as the main factors conducive to the development of the knowledge sector.

In its reports summarising the effects of the EU enlargement to the East in terms of innovation and competitiveness, measured by labour productivity, the European Commission emphasised the significant economic success of CEE, in particular of the V4. Since the accession, they have achieved (with the exception of the global financial crisis period) economic growth on average twice as high as the “old” member states. To a large extent, this is due to the opening of new investment channels, increased productivity, technology transfer and sales markets in the EU15. The relative economic success achieved without substantial investment in the knowledge sector

long consolidated among the V4 decision makers little interest in this issue. Before 2008, the assumption prevailed that the adopted development model created good premises for convergence and integration of the region with capitalist centres in the EU. Such expectations strengthened the opinion that the countries of the region had significant potential in terms of innovation in the form of a growing R&D base, a large number of students and low-cost employees. TNCs also took note of this while opening research and development centres in the region.

However, development based on external capital, knowledge and technologies in the long run leads to selective and dual development. In the V4 states, productivity in companies with foreign capital is increasing, while at the same time national innovation capabilities necessary for long-term growth and competitiveness are developing more slowly. Simultaneously, the technological activity of branches of foreign corporations is often implemented without significant links with the domestic innovation system (Pula 2018: 194-195; Jasiecki 2013). In line with the market trend of accumulating innovations, research and development centres are located more often in the most developed countries, where the headquarters of dominant companies are usually sited (Porter 2001, Florida 2005). The profitability of TNCs is greatly affected by maintaining those parts of the supply chain that create the greatest added value: R&D and end sales. TNCs selectively provide their local partners with the latest technologies. Local research centres specialise in accordance with the interests of TNCs; industrial assembly or logistics are most often located in the V4 countries. The transformation process and later the 2008-2009 crisis negatively verified the expectations of the V4 elite regarding knowledge transfers. The analysis of changes in the categories of diversity of capitalism began to point out the shaping of its new variants in the region, modelled on developed EU countries. Their common feature in the area of innovation transfer and in the development of the knowledge sector is the dominant role of TNCs and FDI in the economy. The distinguishing feature of this variant is the growing share of highly processed products in the exports of goods, prepared mainly by local subsidiaries of transnational corporations. However, the innovation created in this way is, above all, imitative in nature through the imports of new technologies, and not

increasing the quality of domestic R&D activities. Therefore, in the region fears began to increase that the benefits of such a development pattern may prove to be temporary and that without one's own knowledge sector it is difficult to permanently improve the competitiveness of domestic enterprises. The knowledge sector is necessary to improve the innovation of production and services, as well as to transfer the spill-over effect into companies, industries and the economy. The global financial crisis and the economic crisis in the euro area partly confirmed such fears. Protectionist tendencies are rising, and the growing competition associated with the transition to a "knowledge-based society" is increasingly shifting onto the knowledge sector.

The relatively low standards of this sector in the V4 countries result primarily from the asymmetry of potentials in this respect in comparison with the highly developed countries of Western and Northern Europe. This asymmetry has structural premises in the capital and institutional resources of the "old" EU countries, in the distribution of benefits corresponding to ownership relations and the proportion of R&D expenditure, as well as in the subordinate role of the countries of the region in the international division of labour. In addition, during the economic boom after their accession to the EU, the V4 countries began to be affected by restrictions on human resources resulting from the aging of their societies, and, in the case of Poland, also mass labour emigration. Employee shortages and labour costs are growing, due to insufficient adjustment of education systems to the market, among other things. The 2008 crisis undermined the optimistic scenarios of rapid development convergence. There was doubt as to whether the innovation capacity of the V4 was sufficient to create its own strategic economic resources. In the countries where companies and households do not have significant funds at their disposal, the demand of the economy for products of science is low. Economic development is mainly stimulated by the inflow of foreign capital, and this limits the demand for domestic innovations. From the V4 perspective, this issue is of particular importance due to the threat of so-called "middle income trap". The imitative development model based on the use of cheap labour and high investment returns due to low capital saturation is running out.

The countries of the region, relying on the import of technology and innovation, have increasing problems with maintaining competitive advantages. They face the necessity of finding new sources of development, which requires, above all, increasing innovation and investment in high tech (Bukowski et al. 2012: 5-7). In the area of the knowledge sector, they have come closer to the model of Mediterranean capitalism. Substantial institutional changes are necessary. In response to such challenges, the need to increase the role of endogenous investments associated with changes of a more systemic nature is emphasised. Strengthening development-friendly mechanisms requires creating structural and institutional conditions and reinforcing the role of internal factors – both local and regional, which encourage companies (especially small and medium-sized ones) to go beyond imitative solutions. The European funds did not bring about the expected results in this respect because they were invested mostly in road and rail infrastructure, etc. On the other hand, the post-crisis changes in the EU budgetary priorities tend towards greater competitiveness rather than cohesion. This may translate into favouring leading European centres and at the same time limiting support for CEE countries catching up the West as far as their development gap is concerned.

Production in the V4 is not going to become more technologically advanced without a boost to the knowledge sector. There are two approaches in this respect. Statist strategies are being implemented in Hungary and Poland, relying on increasing the role of the public sector and of domestic capital. In 2010 Hungary started to implement a model which through centralisation was to lead to the increased activity of domestic enterprises in financing development and innovation. Similarly, in Poland, since 2016 actions have been taken to increase coordination in the sphere of innovation based on state-owned companies and on support for start-ups. In the Czech Republic and Slovakia, modernised neoliberal strategies are continued, based on changes in the system of investment incentives, mainly of a regulatory nature, which is primarily about moving away from concessions for companies creating low-paid jobs towards attracting companies that develop modern technologies.

The V4 states are diversified in terms of development and efficiency of the knowledge sector. In general, however, they are distinguished by innovation below the EU average. This tendency is confirmed by the results of the European Innovation Scoreboards (EIS) ranking. From the perspective of the diversity of capitalism, innovations leaders are coordinated economies in the Scandinavian and continental versions, or countries of the liberal model. Among the Visegrad countries only the Czech Republic placed in the strong innovators' category in the ranking between 2011 and 2017. Hungary and Slovakia placed in the next one – moderate innovators. Poland, on the other hand, is systematically classified among Modest innovations – the least innovative EU countries. The results of other rankings, such as the Digital Economy and Society Index (DESI), or the Global Innovation Index (GII) also lead to similar conclusions.

In the Visegrad countries, the Czech Republic is the clear leader in increasing the effectiveness of the knowledge sector in the economy. Poland is the weakest of the four in this respect.

## 6. The public opinion and attitudes towards transformation

The differences in the starting point and the course of the political transformation in the V4 countries were also reflected in the sphere of social awareness of their citizens. In a relatively short time, transformational changes began to be influenced by different historical experiences and political aspirations. Although the implementation of reforms was seen slightly differently in individual countries, the reformist consensus on democracy and the market was common in the new political elites of the region. Hopes were also common that quick accessions to the EU and to NATO would strengthen the change processes and create new development opportunities as well as provide security guarantees.

Initially, the Hungarian elites were convinced that the institutions formed during the so-called "Goulash communism" was a good starting point for the transformation of the economy towards the market and capitalism. The standing of the state, however, turned out to be much worse than initially assumed and in the first decade the effects of change were painful for Hungarians. They were critical of the changes in their personal situations and in the sphere of security and rated them economically the worst. They

also the most adversely affected by the global financial crisis and by the economic slowdown. As a result, they reminisced socialism better than Poles and Czechs. After a decade of reforms, almost half of Hungarians thought it was not worthwhile to change the system. They more often saw the impact of the socioeconomic slowdown on jobs. They saw opportunities in their EU membership. To this day, trust in EU institutions has remained higher in Hungary than on average in the EU. Hungarians have similar confidence in their government.

In Czechoslovakia, as in Hungary, the socio-economic situation at the beginning of the transformation was not very bad. Admittedly, there were crisis phenomena typical of the command-and-order economy, but they were not as dramatic there as in Poland. The main problem turned out to be the growing internal national division within the federation. This led to its collapse, against the will of the majority of its society. The elites feared that due to the lower level of development of the other federal state, reforms might slow down and, as a consequence, the preparation and accession to the EU might be delayed. After the division of the federation, most Czech residents positively assessed the change of system (CBOS 1999) and relatively least often expressed negative opinions about changes in the economic sphere. What they point out is the increase in the costs of housing, transport, education and health services. Although they consider their EU membership a successful transformation, they are the most sceptical of the EU among the Visegrad group. Like Slovaks, they prefer preserving the separateness of the nation-state in the EU as the supreme value.

In the 1990s, Slovakia was a special case. Its economic structure, more difficult to reform, dominated by heavy industry and connections with the USSR, was reflected in a much larger decline in national income and the rate of unemployment several times as high as in the Czech Republic. This was exacerbated by the weakness of the elite due to historical heritage, unconsolidated democracy and weak civil society, as well as by nationalist-oriented leaders, especially in 1993-1998 (the Meciar government). In the new situation, most citizens considered their standards of living unsatisfactory. The collapse of the communist system was followed by a clear contrast to the public expectations. Today, only small groups,

concentrated mainly in Bratislava and in several other larger cities, consider themselves the beneficiaries of the transformation – they are primarily new entrepreneurs/owners, financial groups, people with high education. The result of this phenomenon is considerable migration to other EU countries. The lack of social balance triggers an increase in nationalism, radicalism, extremism, etc. Problems related to the Roma minority and, above all, to the Hungarian one, have emerged. The political elite has not effectively developed responses and solutions to challenges such as long-term unemployment, regional disparities and corruption. All these problems generate dissatisfaction with democracy, produce anti-EU attitudes and an increase in populist or radical tendencies. Regarding social expectations, the most important problem is the government's ability to provide short-term benefits, especially improving employment and transport infrastructure, as well as carrying out investments that could reduce regional disparities. Slovakia is one of those countries where trust in the EU institutions is still significant and, despite strong support for the nation-state, remains higher than for the national political institutions. This is mainly due to the belief in the existence of corruption among the elites, to low quality management, and clientelism of domestic political parties.

Poles started at the very bottom of the economic crisis, which was accompanied by a strong resentment of a large part of the society towards the malfunctioning system model. Compared to, for example, Hungary this situation gave a greater credit of trust of the governing elites. Opinions about the transformation articulated by Poles were less clear-cut than those of Czechs and Hungarians. On the one hand, they most often thought that it was worth the effort to reconstruct the system; on the other hand, almost half of them declared the deterioration of their financial situation. After the first decade of political changes, the view prevailed among Poles that their current lives looked worse than ten years earlier, which was associated with the simultaneous introduction of reforms in several areas of social life (Zagórski, Strzeszewski 2000). It is worth emphasising that although the attitude of Poles towards the transformation has been subject to significant fluctuations, depending on many circumstances, including the economic situation, political changes and the position of social groups or specific people, overall it remains very positive. Poles assess their EU accession as

one of the country's greatest successes in the last 100 years, and the balance of the effects of Poland's integration with the European Union is evaluated as definitely positive.

From among the Visegrad Group countries, Poles most frequently and most strongly support their country's membership in the EU, whereas the Czechs remain the most Eurosceptic. Notwithstanding these differences, the societies of the four countries all share support for EU membership and, at the same time, a sense of insufficient impact on the activities of the EU institutions (CBOS 2017), which is reflected in the relatively strong presence of right-wing V4 factions in the EP, whose representatives call for strengthening the European Council vis-à-vis the European Commission. This is confirmed by the results of the 2019 elections to the European Parliament, which in the V4 were successful for the right-wing parties, especially in Hungary and Poland (Groszkowski 2019). At the same time, the preservation of the national sovereignty of EU Member States is seen as a paramount value, even at the cost of limiting the capacity of the European Union as a whole. This is especially a priority for Czechs and Slovaks. In the the four societies, only among Poles advocates of closer integration with the EU are in majority. In Hungary, the groups of supporters and opponents of close integration are just about equal (CBOS 2017). It is worth noting that Slovakia emphasises its aspirations to be in the very core of the EU, regardless of the positions of the other Visegrad states.

The attitude of the V4 societies and their political elites towards their membership in the euro area is varied and subject to fluctuations. This is particularly illustrated in the case of Slovakia, which in 2006 had the highest number of opponents of the introduction of the single currency; simultaneously, for the Slovak political elite joining the euro area was basically a permanent priority around which a cross-party consensus was built. Soon after the adoption of the euro (2009), Slovakia had to participate in assistance offered to those states adversely affected by the crisis, which caused serious turbulence on the political scene (the collapse of the government in 2011). Currently, the Slovak public opinion values the euro far higher than the EU average (Eurobarometer March 2018). Despite the crisis in 2009-2011, the country gained 10% of GDP per capita thanks to

the introduction of the single currency. In the remaining countries, the crisis radically changed the positive attitude of the public opinion towards the membership of the euro area (although Hungarian politicians still allow this possibility).

Although all the V4 countries are members of NATO (with three countries since 1999, Slovakia only since 2004), during the long accession process there were doubts as to whether the candidate countries would become full members of this pact, or whether they would be second-class members. Hungarians expressed such fears more often because of the size of the country and historical experience (the bombing of Budapest by the Anglo-Saxon air forces at the end of World War II) (CBOS 1999). Most citizens in Poland and Hungary initially expressed the view that there was no need for other countries' troops to be stationed on their territories. There were also controversies regarding a possible new form of subordination to the next superpower. At the same time, both Poles and Hungarians treated NATO primarily as a guarantee of independence, although in both countries opinions on this issue were divided. Slovakia expressed opposition to plans to build a missile shield in Poland and in the Czech Republic, postulating that it should be part of a project to protect all the NATO member states (Kubisz 2008). The attitude towards NATO is also associated with the diversity in the approach of the V4 societies towards the USA and Russia. Poland is traditionally most positive towards the USA, and the Czech Republic shares this attitude to a slightly smaller extent. Generally, V4 citizens, except Slovakia, trust Americans more than they trust Russians (Gyarfasowa, Meseznikov 2016).

Although Central Europe was historically a multi-ethnic region, located at the crossroads of different nationalities, culturally and religiously diverse, World War II and real socialism significantly reduced this multiculturalism. Some minorities have been eliminated, others have, been more or less successfully, assimilated, and barriers to migration have been created. Many citizens never had contact with people brought up in different cultures, with a different skin colour and different religious beliefs. The political breakthrough and European integration meant lifting barriers to migration.

Compared to the V4 societies, Poles stood out before 2015 by being open to newcomers, which was expressed in greater acceptance of the principle that anyone can come to Poland and settle down. In the Czech Republic, Hungary and Slovakia, the prevailing belief was that immigrants did not contribute lasting benefits to the country (CBOS 2005). The common problem of these countries is also the exclusion of Roma (especially in Slovakia), which also has a negative impact on the attitude towards migrants. The migration crisis in the EU in 2015 conferred additional importance to this issue. The new standards were set by the position of the Hungarian government which, after 200,000 migrants passed through Hungary, heading towards Germany and Sweden, recognised them as a threat to the social order and to Hungarian national identity. The other V4 countries joined this position, including Poland after the change of its government in 2015. The proposal to accept the automatic mechanism of relocation to the EU countries of refugee status applicants, promoted by the European Commission, was rejected; this position was supported by the majority of the public opinion in the Visegrad countries. It had various consequences. On the one hand, in domestic politics it strengthened support for right-wing, nationalist and anti-immigrant factions that cited slogans in favour of defending traditional values and national identities. On the other hand, it ideologically integrated the V4 in a new way through expressing views widespread in CEE. In addition, the migration crisis opened a new divide between the V4 countries and the "old" European Union, especially southern European countries, which, like Greece and Italy, to the greatest extent are struggling with migration problems.

### 4.1.2 The Baltic States

#### Historical introduction

The Baltic states are among the smallest EU economies. Only Malta and Cyprus are smaller than Latvia and Estonia. The languages of the populace are distinctive on a European scale and dissimilar from each other, which hinders external contacts. In the Baltic states, the linguistic and cultural specificity remain a premise for maintaining strong national identities and distinctions, sometimes also of a nationalist nature. The complexity of social relations is illustrated by the co-occurrence and overlapping of different cultural, religious and national identifications: Estonians and Latvians are mostly Lutherans, with Lithuanians predominantly Catholic. The Russian-speaking minority is very significant in the entire region.

In the 19th century, all the three countries were within the Russian Empire. They existed as independent states between 1918 and 1940. At the time, Western states treated them as the "sanitary cordon" separating Western Europe from the Bolsheviks. Their political, economic and cultural experiences as well as their level of development were significantly different. Although agriculture prevailed in their economies, industry and maritime also played an important role in Estonia and Latvia. The structure of the economies was more competitive than complementary (Rothschild 1998). Under the Molotov-Ribbentrop Pact (1939), the countries of the region were first occupied by the Soviet Union, and later by the Third Reich. As a result of World War II, it was annexed by the USSR (1944). However, the societies maintained such a strong identity and national separateness that during 1986 and 1987 the first demonstrations against the dominance of Moscow took place in the Baltic states. They gained full sovereignty only following the collapse of the USSR in 1991.

The Baltic states are distinguished by high development dynamics. After three decades of political transformation, Estonia and Lithuania reached 81%, and Latvia 70% of GDP per capita compared to the EU average (EU 28 = 100).

## 1. The political context and the quality of institutions

The consequence of the annexation of Estonia, Lithuania and Latvia to the USSR was full economic integration with the Soviet command and distribution economy and significant isolation from any links with the capitalist world and international markets. The system began to liberalise at the end of the 1980s on the wave of perestroika and glasnost by Mikhail Gorbachev, which on the threshold of political changes enabled conducting economic reforms and rebuilding independent statehood. In this context, the start was associated more with the need to create new economic structures than with adapting the existing ones (as in Hungary or Slovenia). The first period of changes that began even under the USSR was particularly important. At that time, the situation in the Baltic states was characterised by hyperinflation, a cumulative decline in GDP (of over 36% in Estonia and of almost 53% in Latvia) and a severe deterioration in living standards. Unemployment and social inequalities occurred. Employment in the public sector dominated. However, the germs of market institutions, almost completely destroyed previously (e.g. private property, individual entrepreneurship, etc.) started to form. The collapse of the Soviet command and distribution economy and its components becoming independent at the turn of the 1980s and 1990s forced concentration on macroeconomic stability and brought about cutting back of Soviet subsidies for enterprises. The collapse of production and deindustrialisation progressed rapidly. Significant for the Baltic states industries (e.g. electronic and machine) began to decline due to lack of financing and credit guarantees as well as to losing markets in the USSR and other Comecon countries. There was a radical diversification of cooperative connections together with exiting the rouble zone and establishing national currencies. Market pricing mechanisms were introduced. New institutions, including central banks and market regulation agencies, were established. A small privatisation of shops, restaurants, small services etc. began (Aslund 2008).

The Baltic states shared common motivations for implementing reforms. The main goal was to build a new political system and the foundations of a market economy as well as sovereignty and state security. Systemic changes were treated as confirmation of regained sovereignty – de-Sovietisation and building democracy based on the national community

(Bohle, Greskovits 2012). Estonia, Lithuania and Latvia are distinguished by an extremely strong determination to quickly integrate with the West, resulting primarily from their historical experience in relations with Russia. Therefore, they decided to implement a strategy more radical than the V4, one that was close to the ideal type of liberal market economy based on macroeconomic stabilisation, liberalisation of foreign trade prices, elimination of subsidies and privatisation of state property. Their political elites treated the process of rebuilding the state in terms of decolonisation. They were aware that the separation with Russia had to be carried out quickly, because the "window" of change was narrow and if the processes were not given dynamics, they could be reversed. Particular emphasis was placed on the quality of public institutions.

For the entire region, the critical point was the exit from the rouble zone and the introduction of each state's own currency, which required quick measures to stabilise the monetary system. Fiscal discipline was strengthened, and new tax systems were introduced; the role of the state in the economy started to be limited. Due to the belief that the state apparatus inherited from the USSR could not at first be fully functional, the Baltic reformers rejected the concept of a "positive" state (high taxation, income redistribution, state ownership of enterprises, as well as production and services). They adopted the concept of socio-economic order promoted by the EU (Bohle, Greskovitz 2012: 132). In the approach to systemic changes, the analysed states had a similar political perspective, but in practice it was significantly modified by local conditions. Estonia became the leader in reforms and had the greatest impact on the image of the region in the world. The smallest of the group, Estonia was, already in the final period of the existence of the USSR, the most developed and the most Western of them. This was influenced by, among other things, its coastal location and commercial traditions, large Estonian emigration residing in Sweden, Finland and North America, as well as access to Finnish TV (Farkas 2016: 177).

Estonians, due to the belief in the imperfections of the post-Soviet state apparatus, decided to completely liberalise imports and to launch markets, leading to the elimination of shortages. They were pioneers in introducing a low corporate and personal flat income tax rate as well as a private

insurance model and initial pension capital. Aiming at fast macroeconomic stabilisation, they implemented a restrictive wage policy and budget cuts, recognising economic growth as more important than social programs. They introduced the Currency Board, characteristic for the Baltic states, as one of the forms of the fixed exchange rate system[50]. Estonia quickly built its reputation as a reliable borrower; especially since after the collapse of the USSR it was not burdened with foreign debt.

Estonia avoided Russian capital for fear of its political or criminal nature (Hunya 2004: 99). Latvia started in pro-market changes from scratch. Previously, it mainly served as a Soviet military base (especially Riga). Following the example of Estonia, the emphasis was put on building the state according to its ethnocultural criteria and the national origin opened up channels of promotion. The voucher privatisation car gave Latvians a preferential treatment, as a result of which no foreign capital initially participated in this process and which reduced the inflow of external financial resources. Foreign trade was liberalised more slowly. Latvia tried to achieve success through banking and commercial services rendered to Russia through ports and special economic zones (Farkas 2016: 183). This contributed to the emergence of oligarchs as local business leaders and increased corruption. In Lithuania, a softer path of economic reforms was chosen. It was only during the USSR times that industrialisation began in Lithuania. Compared to Estonia, access to Western capital was limited, due to, among other things, less regulated property rights. The Lithuanians initially assumed that the changes would be based to a higher degree on domestic resources.

The diversity of the trajectories of Lithuanian reforms was also influenced by its greater national and political homogeneity. The process of system changes was more peaceful and slower. The transformed left remained influential, trade unions also had a stronger position, which created a certain counterweight to right-wing parties. As a result, with similar goals,

[50] The purpose of currency board is to limit government influence on monetary policy. The Central Bank has been deprived of the right to increase the money supply by printing it or buying and selling treasury securities. The Bank of Estonia had no right to control interest rates and could not credit the activities of the government which was left with two options – borrowing from the private sector or balancing the budget.

the Baltic states had a different pace and extent of systemic changes. This was significantly influenced by, among other things, directions of economic cooperation. Estonia attracted investors from Sweden and Finland. Latvia and Lithuania continued their business with Russian capital and the countries of the former USSR. Lithuania initially showed limited interest in transnational integration with the West. However, due to their stronger economic links with Russia, Latvia and Lithuania felt the negative effects of the financial crisis in that country more strongly than the V4 did (1998), which increased their orientation towards economic relations with the EU.

Integration with the EU played the role of the major catalyst for the transformation of the countries of the region. They decided to quickly transpose EU directives into their legal systems and developed their capacity building (fiscal discipline, investment climate, innovation in public management, etc.) better than many other CEE countries. As a result, they obtained a high capacity to use European funds and effectively continued reforms also after their accession. They also carried out, especially Estonia and Lithuania, rapid institutional changes in the area of the rule of law, improving their business environment and reducing corruption. Like the V4, the Baltic states prioritised meeting the Copenhagen criteria. Estonia, as the state in the region implementing the reforms required by the EU in an exemplary fashion, was invited to the accession negotiations first – in 1998; Latvia and Lithuania followed a little later. As a result, in 2004 all these countries, together with the V4 and Slovenia, became EU members. In the same year, their accession to NATO was another important stage in the process of their integration with the West, which they treated as confirmation of security guarantees (as well as a positive impulse for FDI).

Estonia is still a leading example for the Baltic states in their quick integration with the West. Its role in the region was confirmed by its determination to meet the Maastricht criteria, which initiated the entry of the other states to the eurozone as well (Estonia 2011, Latvia 2014, Lithuania 2015), despite adverse circumstances after the global crisis. The euro is perceived by them as an additional soft factor guaranteeing the security of the state, closing the process of integration with Western

institutions. The Baltic countries have also strengthened their political position by joining the so-called Hanseatic League, which regularly presents its point of view on reforms of the euro area and on other areas of European and social integration (Orłowski 2018). The Baltic states are also still characterised by relatively high political stability. In this respect, they remain separate compared to many CEE countries. This involves, among other things, fears of excessive centralisation of power and authoritarian tendencies (as in Hungary and Poland), which is considered mainly through the prism of changes in the political situation in Russia, including in particular the escalation of this country's imperial aspirations revealed during the annexation of Crimea (2014). The elites of the Baltic states see this type of events as a warning for states entering the path of criticism of liberal democracy. They are more sensitive to such threats than the V4 countries (Paabo 2019).

## 2. The general economic outlook

In the Soviet Estonia and Latvia, the governance of the old regime was dominated by ethnic Russians who lost their positions within the political and economic elite after the fall of the Soviet Union. This allowed disregarding the vested interests and networks of the old Soviet state. This situation did not have an equivalent in the other post-socialist countries. At the beginning of the transition, parts of the industry (e.g. the automotive sector) in the independent CEE countries were already relatively well integrated into the supply chains of the capitalist world, a portion of the exports were directed at the Western markets, while some forms of proto-entrepreneurship were allowed. None of this was a feature of the economic reality under the Soviet rule.

Leaving the rouble zone and achieving monetary stability required the adoption of currency boards and fiscal discipline. Tight monetary policy and fiscal policy with little anti-cyclical features further strengthened the spirit of low government intervention in the Baltics. The key catalyst for market-friendly governance and product market reforms in the Baltics was the accession conditionality of the EU and the OECD. Developing a level playing field and a competition-friendly environment has also been important to foster the development of the SMEs, which produce a

comparatively large share of value added in the economy of the Baltic states. In fact, SMEs dominate the business landscape in the Baltics (e.g. in terms of turnover), much more so than in the other CEE countries (which still have large-scale industrial and manufacturing enterprises). The reasons for the development of SMEs, however, were not only economic in nature, but they also resulted from the specific political economy of the Baltic states. Deindustrialisation related to the issue of nationality and citizenship became its special feature. An example is Estonia, where the new authorities began a profound change in the economic and social structures by marginalising or tolerating the collapse of large industrial enterprises built during the USSR times. Their restructuring was suspended because they employed mainly Russian-speaking employees from the former Soviet republics. Therefore, the policy makers in the Baltics chose not to adapt the existing structures (in terms of industrial basis, production regimes, and even currency) but to develop new ones. This approach was at the root of extraordinary economic openness – by 1992 all export restrictions and almost all export duties had been lifted, which reoriented the country's economic links. Western countries quickly took the place of the USSR (Laar 2006). The Russian financial crisis also contributed to deindustrialisation, which made many production companies associated with Estonia cease operating in other Baltic states.

The political and social effect of deindustrialisation became a permanent weakening of collective forms of employee activity (especially of trade unions), as well as employers' associations who, in the SME sector, are generally poorly organised and have rather little influence on decision-makers. Flexible labour market and little employment protection could be complementary with generally small role of the state. In Estonia and Latvia, the weakness of interest groups associated with the Russian elite and large industry significantly facilitated the fast implementation of liberal economic reforms. In the conditions of the dominance of post-Soviet passivity in the public sphere, when civil society institutions were just emerging, the creation of a strong system of representation and mediation of interests with the participation of trade unions, NGOs, etc. was unsuccessful. The climate of high social acceptance for radical reforms was treated as the price of independence. The "new national contract" created

in this way between the elites and the society gave hope for success; especially in the conditions of high economic growth after the Russian crisis, when between 2000 and 2007 the countries of this region were collectively referred to as "the Baltic Tigers" in reference to "the East Asian Tigers" (Bohle, Greskovits 2012).

The special circumstances of the transformation in Estonia and in Latvia largely determined the specificity of the development of capitalism in the region. It is usually characterised as liberal market economies (Feldmannn 2008; Babos 2010; Knell, Srholec 2007; Aslund 2008), mixed type economies with tendency towards LME (Farkas 2016) or the Baltic Model LME type (Bohle, Greskovits 2012). Confirmations of the most liberal in the CEE nature of the Baltic states are provided by analyses carried out in the fundamental dimensions of market institutions: labour markets (flexible) and low salaries, welfare state (minimalist), employee representation (fragmented trade unions, low union density), employer representation (significant foreign ownership MNCs, low employer density, marginal interest in cooperation with labour), dominant bargaining level (fragmented, company level), bargaining coverage (low percent) and importance of tripartite institutions (only formal) (Industrial Relations in Europe 2012: 70). Further to the discussion on the diversity of capitalism in the CEE, the view is also formulated that the Baltic states are a separate type of market economy, different from the typological distinctions between liberal market economy (LME) and coordinated market economy (CME) in the concept of Hall and Soskice (2001). In this approach, the countries of this region can be described as flexible market economies (FME), which is synonymous with "Baltic capitalism". Its principal distinguishing features include: 1) coordination mechanisms based on competitive markets and formal contracts; 2) corporate governance characterised by high ownership concentration, predominance of SMEs and private limited liability companies; 3) industrial relations dominated by market rules and a very high degree of labour-market flexibility; 4) education and training system preferring general skills and low R + D expenditures; 5) transfer of innovations based on limited innovation capacity; 6) macroeconomic regime with very strict monetary arrangement and budgetary policy subordinated to exchange-rate support and 7) very

limited industrial policy (Kuokstis 2011). Although, in many respects, this model is definitely liberal, it is completely different in some key issues. This is manifested as the weakness of the capital market in the Baltic states, and in Lithuania and Latvia additionally as a small capacity to create innovation, which leads to dependence on external financing.

From the perspective of nearly three decades of transformation, we can observe a significant dynamic of change, which is manifested in the sinusoidal curve of several economic periods. The early period of reforms (1990-1995) was associated with recovery from the collapse after the fall of the USSR. It was followed by a period of dynamic growth (1996-2008), interrupted briefly by the Russian crisis. This increase was significantly strengthened by the accession to the EU but was again weakened by the global financial crisis (2009-2010)[51]. It was transferred from the euro area by cross-border banks limiting credits as well as by the collapse of foreign investment inflow and by the downfall of exports. Due to the adopted rules of public finance stability during the accession to the EU and to the euro area, budget cuts or the use of reserves were the main form of balancing the public finances in those countries. The dominance of foreign banks which had different priorities (e.g. extending consumer credit) and were less interested in financing potential competition contributed to the escalation of the crisis. Governments embarked on economic reforms, which, according to liberal economists, may serve as a model for the euro area countries (i.a. further liberalisation of the labour market, wage freeze, social benefits reduction, retirement age increase and the privatisation of pension funds). The reforms were carried out without devaluing their currencies (Aslund 2010). After 2010, the Baltic states entered the path of growth higher than the EU average.

A special feature of the transformation in those countries is the limited level of state intervention in the sphere of social policy. Very significant economic fluctuations lead to the exclusion of large social groups and the weakening of social cohesion in terms of income and area. The Baltic states

[51] Latvia was one of the countries most affected by the global crisis in CEE. GDP fell from 10% in 2007 to -4.6% in 2008 (EBRD 2009). The internal devaluation strategy was introduced. As the only one of the Baltic countries, it applied for financial assistance to the IMF, the EU and to certain EU Member States.

have the largest income disparities in the EU according to the Gini coefficient; the disproportions are evident especially in Lithuania (36.9), although Estonia has been able to reduce this indicator (30.6) in the last five years (Eurostat 2019). The specificity of the Baltic states in the regional dimension is special, even for CEE, concentration of wealth in their capitals and a very sharp division into internal development centres and peripheries. This is related not only to income, but also to different access to public services and consumption of other forms of in-kind benefits (Blanchet et al. 2019).

A social response to the systemic weaknesses of the Baltic version of capitalism are individual adjustment strategies in the form of exceptionally high economic migration from Latvia and Lithuania to Western Europe after 2004 (as a substitute for an ineffective system of representation of interests and social policy). This is one of the reasons (apart from the decrease in the fertility rate of women and the aging of the population) for a dramatic decrease in the population, not observed in other countries. According to the UN, the rate of depopulation in Latvia and Lithuania the highest in the world. It is estimated that over the three decades, Lithuania and Latvia lost each about a quarter of the population, with Estonia losing a slightly smaller part – approximately 18% – of its people. Only between 2000 and 2017 Latvia lost 18.22%, Lithuania 17.44% and in Estonia 6.4% of the population (Varpina 2018).

The long-term consequences of the global financial crisis and the euro area crisis hit the foundations of the transformational success of the Baltic states. As in the other CEE countries, the discussion about the middle-income trap returns. In the case of this region, it is associated with the risk of perpetuating the GDP of the countries at 70-80% of the EU average. Such a threat is reinforced primarily by the growing deficit of employees and hence forced wage increases. It is necessary to strengthen national sources of financing for economic development, also by increasing expenditure, especially on the knowledge sector. This, however, creates dilemmas as regards choosing between development goals and social ones. Demographic changes will force an increase in expenditure on pensions, health care and education. This in turn will reduce competitiveness.

## 3. The quality of entrepreneurship

The conditions that define conducting business activities were initially similar in Estonia, Latvia and Lithuania. In the sphere of entrepreneurship, however, they had a much more difficult starting point than those states where the private sector had existed in various forms (Yugoslavia, Hungary, Poland). Their economic structure was also different, including a much higher share of agriculture in GDP (Lithuania – 27%, Estonia – 20%, Latvia – 19%).

After almost half a century of full dependence on the USSR, creating conditions conducive to the development of private entrepreneurship became a priority, especially after the collapse of large companies that worked to supply the Soviet markets. In this context, first in Estonia, and then in the other Baltic states, particular importance was attached to law-making and enforcement, including the effectiveness of the judiciary and the reform of economic environment institutions, which was crucial for business. It was recognised that the elimination of corruption and of organised crime required a clear application of the rules, the highest possible degree of deregulation of the economy and curtailment of the power of officials. An important feature of reforms in the Baltic states has therefore become a model of the state oriented primarily at regulations rather than at economic interventions. Preferences have been given to the market-oriented competition policy and to minimising the state aid. The state was to be devoid of the competence to license private entrepreneurship. From the entrepreneurs' point of view, the Estonian tax reform was particularly important. The flat tax encouraged setting up own businesses. Estonia has also reformed its public administration. In 2001, it was the first country in the world where e-administration was created, i.e. a transparent system of paperless government (even tax declarations were submitted in an electronic version)[52]. Thus, Estonia became a state particularly conducive to entrepreneurship.

[52] In 2005 Estonia was the first country in the world to vote in local elections over the Internet. New technologies are rapidly developing there. An example of success was the invention of Skype – an electronic telephone system. Cyber security centres of NATO and the IT agency of the EU are located on its territory.

Despite the later start of their reforms, the radical way of implementing them made it possible for the Baltic states to quickly achieve a large share of the private sector in GDP and in this respect approached the level of the V4 states. The introduction of stabilisation programs and structural reforms enabled the emergence of a significant group of entrepreneurs. As a result, in the 2000s, until the global financial crisis, the three Baltic states had the fastest growing economy on the continent. After three decades of economic transformation, the situations of Estonia and of Lithuania are comparable, and that of Latvia is slightly different. Entrepreneurship conditions were rated best in Lithuania and in Estonia. Latvia was the group's best in starting business. These countries rank higher than the V4 in Doing Business. The high tax code scores, the best among the OECD countries, as well as model support for start-ups are all noteworthy.

## 4. Modernisation based of FDI

In the context of the Baltic states' economic relations reorientation towards the West, acquiring FDI was perceived as one of the main factors to facilitate modernisation, to strengthen economic growth and create a new institutional framework to maintain it. Due to the difficult political situation and very limited economic resources, the FDI inflow was seen there as a greater chance than in the other CEE countries to accelerate economic changes, increasing employment included. In those conditions, it was particularly important to find new technology and marketing transfer channels, to improve management and to increase employee competences, as well as to support and disseminate modern business culture patterns. The inflow of foreign investment had also significant institutional dimensions. It involved the creation of regulations that in the long run favoured the process of market reforms, investment growth, changes in the economic structure, etc. In the political dimension (like in the V4), FDI was treated as one of the engines of globalisation and European integration and of creating an infrastructure of links with leading EU economies. Openness to foreign investment was also associated with growing integration in international trade (e.g. real exports of the Baltic countries tripled between 1996 and the beginning of the great recession in 2008). There was a clear positive relation between economic growth and the massive inflow of FDI. Between 1998 and 2008 Estonia played a leading role in the region in terms

of FDI. Nordic capital, especially Swedish, is the most important one for all Baltic countries,

The following are usually indicated as the reasons for the initial success in acquiring foreign investment by the region: the prompt introduction of conductive to business macroeconomic reforms, attractive labour resources, geographical location and strong links with Western countries. One of the most important circumstances was the positive consequences of radically introduced market reforms. Already at an early stage, a clear perspective of accession of the countries of this region to the EU was created, combined integrally with the creation of an FDI-friendly environment (Hunya 2004: 112). As a result, although after the collapse of the Soviet Union, per capita income in the Baltic states was approximately 30% of the average income in the EU15 (in purchasing power standards, PPS), the Baltic states were distinguished by relatively good education and cheap labour, continuously improving institutional environment, political stability, reliable monetary policy and determination in pursuing to join the EU and, later, the euro area. The differences in the level of institutional development between the Baltic states began to decrease. The confirmation of the positive effects of such a direction of changes was the WB classification, which decided (2006) that Estonia had passed from the an upper-middle income economy to a high-income economy. Long considered one of the ten most liberal economies of the world, Estonia drew Latvia and Lithuania along.

The FDI dynamics reflected the structure of the Baltic economies. Investment in transport, telecommunications and, above all, in financial services and business support began to flow in. In contrast, FDI in the sphere of production went mainly to low technology industries (Hunya 2004: 112). To some extent, this was due to the legacy of the previous system. In planned economies, some sectors, such as banking and insurance services or property management, are by definition less developed than in market economies. Therefore, catching up with development was mainly due to the opening of the economy, associated with the launch of large privatisation programs, a very significant inflow of FDI and rapidly growing exports. Foreign investment increased along with the improvement of the regulatory environment due to adjustments to EU

standards. In addition, foreign banks have brought with them a competitive reputation in solvency.

The inflow of FDI to the Baltic states was varied. Estonia was able to attract investment that exceed the absorption capacity of its small market, serving as the headquarters of many Scandinavian international corporations. The other countries, despite their considerable progress, have remained less attractive. Their institutions are more prone to corruption and less efficient (Hunyi 2004: 96; Varpina 2018: 21). Lithuania and Latvia began to strengthen their economic growth thanks to regional and international integration but were particularly weakened by the Russian economic crisis. It was the cause of both a decline in exports and a decrease in their attractiveness for foreign investors. Once again, the global financial crisis drastically affected the Lithuanian and Latvian economies.

In the Baltic states FDI was mainly targeted at financial services (primarily banks and insurance companies), as a result which most were taken over by foreign capital. In line with the rationality of financialisation specific to emerging markets, the investment was neither productive nor enhancing competitiveness. After joining the EU (2004), inflows to the financial sector increased fourfold in Latvia and twofold in Lithuania; in Estonia the same increase in inflows took place a year later. As a result, between 1995 and 2006 the Balts took advantage of consumer loans by borrowing in banks taken over by foreign investors. In turn, from the perspective of integration with the world economy, predominantly with that of the EU, the Baltic states are an exemplification of peripheral market economies (Myant, Drahoukopil 2011) or dependent market economies (Nolke, Vliegenthart 2009). Their exports are largely based on low-processed industrial products and agri-food products susceptible to economic fluctuations, and the underdevelopment of the financial market and internal market restrictions lead to the dependence of economic growth on the availability of external markets. A relative success based on the use of cheap and well-qualified employees managed by TNCs is primarily conducive to imitation innovation based on importing new technologies (Myant, Drahokoupil 2011). The elites are aware of the limitations of such a model and are trying to break them. Estonia, the leader among the CEE countries in supporting the knowledge sector, has been most effective in

doing this. Estonia is also the only country in the region that has played the role of investor in the other two states. In Latvia, Cyprus also plays a significant role. However, a significant portion of investment formally originating in Cyprus are in fact Russian funds only supplemented with Latvian funds for tax optimisation (money laundering) (Bohle, Greskovits 2012: 130-131).

As a result of the global financial crisis, the inflow of FDI collapsed. Stagnation in the EU and general uncertainty in the global markets due to customs wars, Brexit, military conflicts, etc. are not conducive to a return to the pre-2008 situation, although signs of improvement periodically appear. The deterioration concerns, in particular, greenfield FDI projects that are most valuable for economic development. The economic weakening in the Baltic countries is therefore clearly linked to the adverse international environment. Another external source of uncertainty is Russia which since the annexation of Crimea and the conflict in the Donbass has played a smaller role as an economic partner of the Baltic states.

FDI is sensitive not only to current economic conditions, but also to future expectations. In the case of small open economies, market conditions of economic partners have a particularly significant impact on the prospects of local enterprises. In order to avoid the "middle income trap", both the EC and the Baltic governments recommend supporting investment in education, in intellectual capital and in improving the institutional and regulatory quality of the economic environment (Duran 2019; Eteris 2018; Varpina 2018). This may increase the attractiveness of these economies for foreign investors. Estonia, which continues to strengthen its leading position among the Baltic states, will demonstrate the extent to which this is possible. The chances of breaking structural economic dependencies by states with limited economic resources remain an open issue. Formed in the early phase of political transformation, they reproduce the advantage of the more developed Western countries in the division of labour. Thus, they confirm in a new way the peripheral or semi-peripheral nature of these economies. Reducing the development distance to the EU leaders indicates, however, an increase in the economic and institutional potential of the Baltic states, and this increases the possibilities of their autonomous development.

## 5. The knowledge sector

In the area of the knowledge sector, crucial for long-term competitiveness and building strategic resources of the state, the situation of the Baltic states is diverse. The top place belongs to Estonia which effectively implements the strategy of economic development based on the increase in competitiveness primarily through increasing expenditure and effectiveness in the sphere of new technologies. In international assessments, Estonia is included among the leaders in CEE in this respect. Estonia's programs supporting the innovation of research centres, universities and private companies in the information and communication technology (ICT) sector, with the growing share of financing by large exporting companies are a confirmation of the effectiveness of the state's activities in the knowledge sector.

Estonia, as the only Baltic state is included in the European Innovation Scoreboards (EIS) in the strong innovators category, and in the Global Entrepreneurship Monitor (GEM) in the category of innovation-driven economies (in the concept of Porter's economic development levels). In the latest Digital Economy and Society Index (DESI 2019) it is ahead of Belgium, Spain and Germany. Like in the case of the Czech Republic and Slovenia, this increases Estonia's chances of joining the most developed EU countries swiftly. Against this background, the development of the knowledge sector in other countries of the region is much less favourable – especially in Latvia which allocates scant funds for the development of this sector and has a fragmented and less effective system of education. The latest European Innovation Scoreboard (2019) places Latvia in the 'modest innovators' category, i.e. the least innovative countries in the EU. In recent years, however, a significant success of this country has become the increase in the share of high technology products in total exports – to 11.2% in 2018, higher than the corresponding indicators for Poland, Lithuania and Finland. In turn, Lithuania, despite some improvement in the situation of the knowledge sector, still allocates to this area lower budgetary resources than the EU average, and its position is aggravated by the shortages of engineers, technology designers, and other specialists for innovation activities.

Despite significant differences in the knowledge sector, there are also negative phenomena and tendencies in this field common to the Baltic states. Compared to EU countries, all the Baltic states export high-technology goods to a lesser extent. Rather, low-to medium complexity, resource or unskilled-labour-intensive products prevail in the export structure. The most important reasons for this include: 1) weakness of the financial market (especially of venture capital); 2) relatively low position of domestic industrial and service companies in the value chains of international trade and production; 3) still a small share of domestic business in financing innovation; 4) lack of large domestic enterprises supporting R&D; 5) the dependence of outlays in this area on the domestic public sector and EU funds mainly; 6) limited transfer of knowledge and the spill-over effect of high productivity from export-oriented firms to the rest of the economy; 7) weakness of innovation applications for the entire business sector and 8) difficulties in commercialising innovative products and services.

Explanations of such phenomena and tendencies are partly institutional in nature, resulting from a specific model of capitalism, and are also associated with a place in the international division of labour. In view of the diversity of capitalist models (VoC), the Baltic states are usually referred to as liberal market economies (Farkas 2016; Babos 2011; Feldman 2008; Crowley 2008; Knell, Srhorec 2007; Buchen 2007) or the Baltic Model LME type (Bohle, Greskovits 2012). However, unlike the Anglo-Saxon countries, they are liberal only selectively, mainly in the sphere of competitive markets and formal contracts, in industrial relations (high degree of labour-market flexibility) and in the education and training system (general skills, low research and development expenditures). However, they do not have their own significant capital capable of financing the knowledge sector. Therefore, it is difficult to treat them as a replica of LME. Unlike the Anglo-Saxon states, in this respect they are largely dependent on external financing (FDI, foreign banks, the EU). In the interpretation referring to the concept of dependent market economy by Nolke and Vliegenthart (2009), the development of these countries can be characterised as a separate variant of the emerging market economy. It is a

“Baltic capitalism”, in the knowledge sector referred to as capitalism with limited innovation capacity (Kuokstis 2011).

In this variant of capitalism, institutional complementarities create a comparative advantage in production based on efficiency rather than knowledge. For instance, flexible labour markets and a small welfare state have helped maintain low unit labour costs. This has created disincentives for the labour force to invest into sector-specific skills needed for incremental innovation. In the Baltic states, an example of such adjustments undertaken in response to the global crisis, the assumptions of the EU 2020 strategy and the OECD recommendations is the program of measures to strengthen innovation and the knowledge sector developed by the Latvian government, where the major issue is a significant change in the economic development model, including in particular institutional and social reinforcement of its internal sources and resources (Eteris 2018). However, correcting and limiting the rules of the dependent market economy and obtaining greater autonomy for domestic economic policy requires, among other things, strengthening the active role of the public sector in creating networks of cooperation with the private sector.

After three decades of transformation in the Baltic states, the knowledge sector has developed a predominance of rationality characteristic of capitalism which is dependent and imitative in the scientific and technical dimensions. This variant of capitalism is based on external development factors, with a very limited share of national resources, especially in R&D, education and higher education. It is not clear whether such a model can be broken or significantly modified. Although the example of Estonia as a state entering a higher level of economic development indicates that such a possibility exists.

## 6. The public opinion and attitudes towards transformation

During the three decades of political transformation in the Baltic states, social views regarding various dimensions of deep and radical changes have been subject to significant fluctuations. The public opinion has accorded special importance to the issue of national minorities. Their presence was associated with the influx of workers from the Soviet republics, which radically changed the ethnic structure in the region. For

example, in 1945, native Estonians accounted for 95% of the country's population, and in 1989 for only 61.5%. Similarly, the number of Latvians dropped from 89% to 52%. National minorities did not have such a significant share in the population of the country only in Lithuania.

Estonia and Latvia are inhabited by a large Russian minority, which resulted in the problem of political rights, participation in privatisation and reprivatisation. The elites treated Russian-speaking residents as a remnant of the Soviet occupation and colonisation of the region, as well as a threat to political sovereignty. In these states there was a radical exchange of elites for national ones. The building of a new society was to marginalise the Russians. Initially, the policy in this area resulted in the exclusion of 40% and 27% of the country's population, respectively, and as a result, the intentional weakening of the leftist[53] parties linked to them. However, this attitude towards national minorities aroused great controversy both in the Baltic states themselves, as well as in Russia and in the EU (as contrary to the EU standards). Consequently, the rules for granting citizenship were liberalised, albeit Russian-speaking minorities were "pushed" to lower levels of the social structure. The Balts and the Russian-speaking inhabitants of these countries form separate communities that have their own media, organisations and political preferences. Their attitudes towards the state authorities, the EU, NATO and towards Russia are different. Separate views of Russian-speaking minorities became particularly apparent after Russia's annexation of Crimea in 2014. Such a division tends to significantly weaken public support for the direction of political changes and foreign policy.

National and social divisions in the Baltic states overlapped with other dimensions of social diversity. The radicalism of the reforms had also a

[53] Obtaining citizenship was associated with complicated procedures (including demonstrating language skills). It was common for the entire region to deprive the Russian-speaking minority of the opportunity to participate in ownership transformations (return of assets, privatization of enterprises). In Lithuania, restrictions were imposed on Poles who had lived there for generations. Ethnic division has been generated as an important factor of political division. Inclusion policy has been exercised in Lithuania to a greater than elsewhere in the region extent. A nationalist social contract, not a welfarist social contract, has become the specificity of the Baltic countries (Bohle, Greskovits 2012).

generational dimension, especially in Estonia, where power was taken by a very young generation of politicians. They preferred to create from scratch a new economic and ownership structure resting on domestic companies, whose development was based on cooperation with foreign capital. They treated social policy as budgetary burdens limiting economic development. Therefore, although Estonia is considered a country of economic success, for a long-time the social assessment of its development model was ambivalent. Significant differences in the perception of the transformation represented by the ruling elite and those of the rest of the society were, among other things, a manifestation of this phenomenon. Initially, Estonians demonstrated also the lowest among the potential member states support for their EU accession. Most of them strongly support their NATO membership. Their perception of the Soviet past is another common problem of the Baltic states. Sentiments toward the USSR now mainly concerns the older generation and is primarily due to the growing material distance of those in the post-working ages (low pensions).

It is worth to point out Lithuania's specificity. On the one hand, it is characterised by the highest among all the Member States confidence in the EU, and on the other hand, low support for the single currency – the lowest in the euro area. The adoption of the euro disappointed Lithuanians. The single currency is seen as a price increase catalyst and since the crisis has also been associated with the critical perception of 'internal devaluation' and austerity policies. In turn, Latvia is distinguished by the relatively worst social moods in the region, indirectly reflecting the development distance to the other Baltic countries. This is associated with moderate, compared to Lithuania and Estonia, support for democracy and weak support for the market economy – well below the CEE average. Latvians place less than Lithuanians and Estonians trust in the EU and in the government, and are convinced that citizens have little influence on the decision-making process. One of the reasons for low public confidence in the authorities are frequent scandals related to capturing the state by local oligarchs.

Diversified public opinions on transformation in the Baltic states reflect broader convergent trends with Western and pan-European ones. Here, however, they are, in particular, the consequence of the ineffective

response of the ruling elite to the 2008-2009 crisis which in this region had exceptionally severe consequences. As in other EU countries, it resulted in weakening the consensus of major political parties and in the mobilisation of anti-immigrant, nationalist right-wing circles and of anti-globalisation leftist movements. The tendencies eroding the institutional order formed in the 1990s are, however, weaker than in the other CEE countries. In the situation of small states, a return to "national capitalism" proclaimed in Hungary and in Poland is not an attractive prospect (Myant 2019). Especially since anti-liberal policy in the region is considered mainly in terms of security and comparisons with Russia. In contrast to the countries that arose after the collapse of the USSR, the Baltic states have achieved the greatest success in terms of economic development, living standards and the quality of democracy. The threat from Russia increases the motivation to be active within the EU and the desire is higher than in the V4. At the same time, for historical reasons, the perception of Germany is much less negative than among the Visegrad countries, and the neighbourhood and political socialisation with the Nordic countries favours a more consensual approach to the EU (Paabo 2019).

However, there appear in the region political forces questioning or seeking to correct the political order. The April 2019 entry into the coalition government of Estonia of the anti-immigrant, nationalist Conservative People's Party, which also achieved some success in the elections to the European Parliament in May 2019 (13% support) can serve as a manifestation of this tendency. The new president, Gitanas Nasueda, elected by parliament in Lithuania in May 2019, has announced judicial reforms modelled on the Polish ones. In Lithuania and Latvia, the Green Parties are winning voters and, as the only ones from European post-socialist countries, joined the EP. This signals new trends that may prove significant in the future.

In general, the political situation in the Baltic states is more stable compared to the other CEE countries. Anti-systemic and nationalist groups and politicians referring to the government practices in Hungary after 2010 or those of the united right in Poland after 2015 so far do not play a dominant role in various political configurations although they are part of them.

### 4.1.3 Southeast European States

#### Historical introduction

Bulgaria, Romania, Slovenia and Croatia are much more internally diverse than the V4, or than the Baltic states. Slovenia is one of the most developed CEE countries. At the time of its accession to the EU, Slovenia exceeded the GDP of Portugal and that of Greece. Bulgaria and Romania occupy the last places in the EU development rankings. The states of the region form a very diverse mosaic of cultures, traditions and national and civilisational affiliations. For centuries, this has defined their political and economic connections, religious and national identities, as well as complex social divisions.

Between 1945 and 1992, Croatia and Slovenia belonged to the Socialist Federal Republic of Yugoslavia (SFRY). It was the only country in Europe to free itself from the fascist occupation without outside help. The conflict between Tito and Stalin in 1948 was followed by a departure from the Soviet style model of extremely centralised economy towards a decentralised local government system with elements of market mechanisms. The new constitution of the SFRY (1974) gave its republics relatively high autonomy, which was particularly beneficial for developed Slovenia. Due to its shared past within the Habsburg monarchy and direct borders with Italy and Austria, Slovenia had good relations with Western countries. Bulgaria and Romania were established as independent states in 1878 and 1881 respectively. From the beginning they were the poorest countries in Europe. After World War II, they entered the orbit of the Soviet influence, joined the Comecon and the Warsaw Pact. From the mid-1960s to 1989, Romania was ruled dictatorially by Nicolae Ceaușescu, promoting the ideology of a self-sufficient state (the so-called national communism). As a result of political disagreements with the USSR and other Comecon countries, Yugoslavia (since the late 1940s) and Romania, unlike Bulgaria, did not participate in establishing close economic relations with CEE. The SFRY was one of the founding states of the IMF and of the WB and actively participated in the work of the General Agreement on Tariffs and Trade (GATT). In 1963 the SFRY became an associate member of the OECD and

had privileged relations with Western Europe (from 1965 the state allowed its citizens to travel abroad to work). Romania also joined the WB and the IMF (Ceaușescu borrowed significant amounts of money from the West) and signed trade agreements with the EU. As a result, the share of links with the Comecon in the development of economic cooperation and the creation of GDP in the SFRY and in Romania was slight. The SFRY system created a much more advantageous starting point for transformation. The decentralised economy gave considerable autonomy to companies operating in a market environment; the macroeconomic management system used standard market policy tools, agriculture was mostly private, and industry (especially in Slovenia and in Croatia) was more developed and diversified. Until the end of Ceaușescu's rule, Romania remained an extremely etatised country with a weakly industrialised economy of command and distribution.

The events of the 1990s and political transformations verified the initial development opportunities of these countries and the way they were taken advantage of. After three decades of transformation, Slovenia is still the most developed state. The rankings of Romania, Croatia and Bulgaria are much lower, with GDP per capita in relation to the EU average (EU28 = 100): 87%, 64%, 63% and 50% respectively (Eurostat 2019).

## 1. The political context and the quality of institutions

The states of the region began to introduce major political changes at different times. Their character, determination of governance and consequences also varied. Slovenia and Croatia belonged to early reformers (they introduced stabilisation programs in early 1992 and in the autumn of 1993 respectively). They were undergoing transformation within the institutions formed in the final period of the SFRY existence, including decentralised workers' self-management, established participation in political and economic decision-making processes and in the system of negotiated industrial relations. Bulgaria and Romania also undertook reforms (respectively in 1991 and in 1993. However, due to the political situation until 1996, i.e. till the change of the ruling parties, the reforms were delayed, erratic or interrupted. Although both Slovenia and Croatia faced a triple transformation to nation-states, democracy, and capitalism,

this process continued in radically different circumstances. The last federal-level governments in the SFRY attempted to carry out market economic reforms in the late 1980s, including the abolition of workers' self-management and the introduction of various forms of ownership (social, cooperative, mixed, and private). However, the failure of reforms and the growing nationalism led in 1991to the collapse of the federation. As a result, the former SFRY republics experienced the collapse of both their common state and of their internal market (23 million consumers), a large decline in GDP, hyperinflation, unemployment and increasing imbalances in the economy due to the collapse of exports, a deficit in commercial demand, and, briefly, barter exchange. Slovenia was distinguished by a more favourable political and economic situation. After the collapse of the federation, the new state avoided direct participation in armed conflicts which caused devastation and regression of almost the entire Balkan Peninsula, including certain states closely associated with it, such as Bulgaria and Romania. Slovenia focused on economic reforms, including setting up new institutions, establishing diplomatic relations and concluding economic agreements. Unlike Croatia, Hungary or Poland, it did not have significant public debt or foreign debt.

Slovenia's uniqueness primarily resulted from the fact that it was the only post-socialist country that in the early 1990s introduced pragmatic and gradual economic reform, avoiding shock therapy. It implemented a transformation strategy bringing the institutional architecture of the economy closer to the continental European model in the style of small Western states (e.g. Austria). In theoretical categories of Comparative Capitalism, it can be said that in the sphere of economic coordination, it skilfully used the complementarity of inherited neo-corporate economic self-government institutions and of the dialogue between social partners and the government to achieve stability and macroeconomic independence (including the introduction of wage control, price indexation, and reduction of public consumption). The political choice of such a strategy was facilitated by unusual circumstances in this region: a relatively high level of development of the state and its economy, ethnic and social homogeneity of the country, support for leftist reformers and political support from the West. The authorities could more peacefully prepare limited privatisation,

as well as the reforms of the public administration and management, the tax system, social security etc. The state control over commercial banks was retained, and the privatisation of enterprises with the participation of foreign investors was selective as a result of which they did not gain a significant position in the sector of the largest enterprises (Mencinger 2004).

After the EU enlarged to the East (2004 and 2007) and following the global financial crisis, some processes of economic destabilisation and a crisis of the legitimacy of the new order were triggered in the region. In Slovenia, the harbinger of such systemic changes was the takeover of power by right-wing parties (2004-2008). The conservative government of Janez Jens, on a wave of criticism of the dominance of political parties arising from the previous system, began the most substantial change on the political scene since the creation of this state. He presented a package of neoliberal reforms envisaging radical tax reforms, increasing the flexibility of the labour market, reducing the role of trade unions and accelerating the privatisation of enterprises. The new program was also associated with compliance with the requirements of the membership in the EU and in the euro area, which included, inter alia, austerity measures. Although, as a result of trade union protests and subsequent government changes, it was only partially implemented (e.g. in the area of privatisation and trans nationalisation), it initiated the erosion of the significant role of the state in the economy and that of the neo-corporate system of representing collective interests. The political scene became more polarised than consensual. The relatively often changing coalition governments have remained under pressure from the European Commission and large euro area states which are pushing for further cuts in public spending and privatisation. Disappointment with the elites, blamed for the economic crisis, has been growing.

Croatia entered the path of political change later and has been implementing a different scenario. Due to its participation in the war with Serbia, it incurred high costs of military conflicts, as well as high instability in politics and the economy, which delayed the introduction of reforms. The circumstances of the war were conducive to the growing role of informal political and business connections that limited the development of a modern market economy based on the rule of law, observance of property

rights and transparency. This was supported by the long time in power of the charismatic and populist F. Tudman, who subordinated the economy to nationalist goals. The manifestation of this was generous issuance of the currency or the creation of a network of informal links of a political and business nature with the participation of the ruling party. The rules of crony capitalism were established which in the 1990s became rooted in a system of semi-authoritarian rule and aversion to the market economy. In terms of the quality of institutions, Croatia has had long-term structural weaknesses, especially in the areas of corruption, the rule of law, civil service reforms, and the improvement of the business environment. Croatia was censured by the EU for, among other things, lack of sufficient actions to reduce the budget deficit, too much government assistance for state-owned enterprises, significant state interference in the economy, lack of progress in restructuring large enterprises, inhibiting the development of the private sector and low efficiency of the public administration (e.g. in the area of tax collection and statistics). These were the main areas of doubt and criticism that appeared in the accession negotiations with the EU that started in 2005. Not until 2013 did Croatia become a member of the European Union. In July 2019 Croatia submitted a formal application to be admitted to the European Exchange Rate Mechanism (ERM II). In the case of Croatia, the application also involves a commitment to implement anti-money laundering reforms and to increase the efficiency of the public administration while reducing its costs. The EC considered that the country meets the economic convergence criteria of Maastricht. There are also ongoing activities towards the accession of Croatia to the Schengen area.

In Bulgaria and Romania, in the early 1990s some economic reforms, due to political conflicts, chaos in governing, corruption, and the scale of organised crime, were slowed down, others were discontinued. Compared to Slovenia and Croatia, both states were weak. The cultural, political and economic heritage characteristic of the Byzantine tradition (paternalism, cronyism, corruption) long limited any interest of foreign investors in Bulgaria and Romania. Because of its political instability, including frequent government changes and social protests, Bulgaria introduced reforms only in 1996 as a response to the crisis of macroeconomic stability, the collapse of the economy and a return to very high inflation. However,

economic policy remained inconsistent in many respects, e.g. deep restructuring of the public sector was avoided. Like in the Balkan countries, the privatisation process was based on 'insider contacts.' In practice, managers were affiliated with the party state. The growing trade deficit and budgetary needs meant that the country's foreign debt was growing rapidly. Following the negotiations restructuring its foreign debts, Bulgaria returned to international capital markets at the turn of the 1990s and 2000. Romania began system changes amid chaos after the overthrow of N. Ceausescu. The appropriation of the state by politicians and interest groups from the previous system continued. Although reforms were announced quickly, they were not introduced due to the weakness of the state, poor governance and public protests. In addition, the country was deprived of capital as a result of previous decisions regarding the full repayment of debts incurred in Western countries during the 1980s. In 1996 the right-wing coalition took power, which enabled the introduction of shock therapy in the form of market reforms supported by the IMF. The implemented changes were largely analogous to those carried out in Bulgaria.

As a result of the undertaken actions, the EU recognised that Bulgaria and Romania were ready for accession negotiations in 2000. However, the changes turned out to be more difficult than anticipated. These countries were not included in the Luxembourg Group (i.e. the countries best prepared to start accession negotiations) primarily due to the delay in combating corruption, in implementing judicial reforms, price control and in privatisation. In 2002, the European Council decided that neither state guaranteed proper implementing and/or functioning of European law. Therefore, Bulgaria and Romania joined the EU only in 2007 (not together with Slovenia in 2004). Both states are currently seeking membership in the euro area and the Schengen area. Similar, as in their case, doubts were raised in relation to Croatia which joined the EU even later (2013). In these countries (except Slovenia) the justice system and anti-corruption institutions still raise controversy and concern; in the case of Bulgaria, there is still a problem of organised crime.

## 2. The general economic outlook

From the beginning, political transformations in SEE were more national and local than in the V4 and Baltic states. The transformations in Bulgaria, Romania, Slovenia and Croatia exemplify the phenomenon of "inward orientation", with limited participation of the external environment (foreign experts, international economic organizations, foreign investors). However, due to the genesis and different trajectories of political and economic transformations in these countries, they did not form a single dominant institutional model. This diversity was not radically changed by the EU accession and the related convergence tendencies in the field of profiling economic policies and the shape of variants of capitalism. Against the backdrop of political chaos and ambiguities which initially became a feature of political changes in SEE, Slovenia was the only state that stood out positively; therefore, in some aspects of transformations, it is comparable to the V4 countries. Since the beginning it has been among the leaders of transformation in price liberalisation, small privatisation, competition policy, trade and foreign exchange system, governance and enterprise restructuring and large privatisation (see the EBRD Annex). Croatia, Bulgaria and Romania rank behind Slovenia in all these aspects. Due to their relatively low level of development and institutional ambiguity, in the 1990s relatively little attention was devoted to shaping new models of the economic system.

For Croatia, Bulgaria or Romania, the application of a standard perspective on the diversity of capitalism and categories such as liberal market economy (LME) or coordinated model of economy (CME) is questionable. Owing to the different configuration of institutions and the principal directions of systemic changes, the economies of these countries are hybrid, diverging from the "pure" models of capitalism. The standard categories of description applied towards the EU-15 can by no means refer to Croatia, Bulgaria or Romania. It is uncontroversial to apply the division between LME and CME only in the case of Slovenia which is considered the only neo-corporatist variant of the coordinated market economy in CEE. Bohle and Greskovitz (2012: 183) defined the three other countries as non-regime countries – economies with an unclear systemic profile, which in their initial period of transformation underwent chaotic change.

The alliance of post-communist parties and trade unions was strengthened in Bulgaria and Romania. The corporatist model was considered possible. However, depending on the variables considered, their variants of capitalism were described as mixed or liberal, with a tendency towards a coordinated market economy. It was a temporary situation that lasted until the mid-1990s[54]. As a result of the crisis, as well as of pressure from the IMF and the EU, after 1997 Bulgaria and Romania turned to the neoliberal model. The tripartite dialogue was limited to purely economic issues (Iankowa 2002: 181). The trend leading to a greater flexibility of the labour market became stronger. Following the political changes during the next decade, the institutional configurations in the sphere of industrial relations in Bulgaria and in Romania resemble those of the Baltic countries. Due to its much worse economic situation and the impact of the war, in a relatively short period in the 1990s, Croatia moved away from the local government system characteristic of former Yugoslavia towards political authoritarianism. It was distinguished by a limited respect for the rule of law and significant inclinations to expand informal rules, including a large range of informal economy. Reforms were implemented more slowly and were redirected onto a different track. The strong position of trade unions and the process of accession adjustments directed Croatia's system changes in the sphere of general government expenditure and social protection towards the model resembling the Visegrad solutions. Against this background, Slovenia differs the most and, due to a much higher level of development and the most expeditious entry into the processes of European integration, remains closest to neo-corporatism. Until the global financial crisis, it was characterised by a regulated labour market, with an extensive sphere of social security and a relatively large Labour Unions. The principles of tri-partism have been weakened since its accession to the EU and have recently lost their relevance. However, the formal industrial relations structures have not changed radically, even though the introduction of austerity policies during the euro area crisis undermined the

[54] In the case of Romania, the term cocktail capitalism (Cernat 2006) is used, due to frequent changes in this country, instability of institutions and low efficiency of economic coordination.

dominant consensus in the 1990s (social conflicts over pension reforms and new labour law).

Thus, three variants of the institutional development of capitalism developed in the SEE states. Slovenia has consistently remained closest to the neo-corporate model. Croatia is evolving towards the Visegrad solutions. Romania and Bulgaria resemble the Baltic states. All the countries, except Slovenia, remain at an early stage of rooting the market economy in social and institutional structures. Invariably, informal links play a special role there, and their hybrid nature continues to consolidate. From the previous system they retain important components of institutions and processes, such as a significant share of state ownership, as well as social assistance and education, in combination with mechanisms adopted from market economies: the development of the private sector, expansion of small companies, the inflow of FDI, etc. (Bartlet 2007). Paradoxically, the states that made the greatest progress in creating the institutional framework of the market economy and of the private sector and became more integrated with global European markets were more severely affected by the global crisis than, for example, the Western Balkans. This shows that progress in adopting market-friendly institutions to a greater extent exposed these countries to external shocks. In terms of economic policy, responses to the crisis varied in the region from state to state. For example, fiscal growth stimulus packages, such as tax cuts, tax breaks, and easing monetary policies were applied. Governments soon returned to austerity policies and restrictions on public finances, which were previously the main domestic source of economic growth. As a result, the region became more dependent on the support of international financial institutions. All the states are substantially dependent on the EU, both in terms of export markets and financing for growth. (Bartlett, Prica 2011: 31).

The post-crisis economic growth shows that the situation of the most developed Slovenia is the best in the region.

## 3. The quality of entrepreneurship

At the beginning of the transformation, the common denominator of Slovenia, Croatia, Romania and Bulgaria was the dominance of state-owned enterprises and the limited participation of the private sector.

Entrepreneurship, defined as taking up independent business activity in private companies, was of little importance. However, there were differences among these countries and some still persist. In the former republics of Yugoslavia, the self- government system created relatively autonomous executive and ownership management structures that operated in conditions of quasi-market competition. At the end of the 1980s, economic reforms introduced total liberalisation of prices and imports, and a little later also market regulation pertaining to insolvency, bankruptcy of enterprises, as well as to commercialisation and privatisation of smaller companies. Transformational changes opened new opportunities for entrepreneurs. However, while the rise of independent Slovenia liberated the potential of entrepreneurship to a greater extent, mainly due to stable development and reforms related to its EU accession, similar phenomena proceeded much more slowly in Croatia. Resulting from the military conflicts (including territorial changes and weaker economic results), communication and technical infrastructure, important for business activities, deteriorated significantly. Subsequent structural and institutional reforms as well as allowing access to foreign investors (including their acquisition of ownership of most banks) did not eliminate obstacles to entrepreneurship. The business environment in Croatia still limits more than stimulates the activity of entrepreneurs.

The business environment in Slovenia worsened as a result of the banking crisis during the accession to the EU and to the euro area, and because of the global financial crisis. The large inflow of capital from the EU stimulated by the package of neoliberal reforms in 2004-2008 and the investment expansion of enterprises during the boom led to growing financial imbalances in the economy. In addition, the central Bank of Slovenia overly liberalised the monetary regulations, and the aggressive entry of foreign banks led to excessive credit expansion. Amplified by the introduction of internal devaluation and the austerity package, the crisis phenomena were consolidated so much that Slovenia had not rebuilt its pre-crisis GDP level until 2017.

In Romania, the centralised economy reduced individual entrepreneurship to the black-market area until the end of Ceaușescu's rule. After the transformation of the system and the introduction of market economy rules,

there was a large increase in the activity of new entrepreneurs, partly forced by the restructuring of the economy, but also based on self-employment and the activity of individual farmers. There was also a significant improvement in the level of legal and commercial infrastructure. Changes supporting entrepreneurship occurred – as in other countries of the region – primarily due to the prospect of integration with the EU. They involved, among other things, the adaptation of rules favourable to FDI, the privatisation of state-owned enterprises and the new tax system. Such modifications, however, did not find enough support from subsequent governments. Various indicators show institutional and cultural weaknesses limiting the development of the economy. Systemic corruption is especially a big problem which also contributes to frequent political crises and low confidence in politicians.[55] It is worth noting that the more difficult, compared to the republics of former Yugoslavia, initial conditions for developing entrepreneurship did not prevent Romania from achieving in this respect better results than Croatia. In Bulgaria, agrarian traditions, the development of socialist industrialisation based on large state-owned enterprises, and a significant criminalisation of economic activity in the 1990s did not create a social climate of entrepreneurship. This climate is also aggravated by the country's cultural heritage, including in particular risk aversion and relatively low acceptance of competitiveness. In the sphere of social behaviour, such attitudes translate into, among other things, a small number of new enterprises compared to other countries in the region. Although the competitiveness of Bulgaria has significantly improved in recent years (according to the Global Competitiveness Report 2018 it is close to that of Romania), institutional solutions regarding limiting corruption in the public administration, standards of government activities, enforcement of property rights, effectiveness of the judiciary and of prevention of organised crime. This adversely affects the investment climate and the country's economic development prospects.

[55] The latest manifestation of this kind of phenomena has become, inter alia, controversies related to the functioning of the anti-corruption office (Direcţia Naţională Anticorupţie, DNA) and the dismissal of Laura Kövesi from the position of its head, as well as the government introduced legislative changes lowering sanctions against power abusing politicians. These activities are also of great concern at the level of EU institutions.

After three decades of transformation, ongoing also in the quality of entrepreneurship, Slovenia is the clear leader among the states of the region. The significant distance existing between Slovenia and Croatia, which after the break-up of the SFRY had a similar starting point, confirms the long-term impact on the economy of the development trajectory shaped in the 1990s. Similar interpretations can be applied to changes taking place in Bulgaria and Romania. Comparisons of various dimensions of entrepreneurship prove, however, that there is significant potential in Croatia, Bulgaria and Romania that can be launched together with the consistent implementation of institutional reforms improving the quality of the business environment.

## 4. Modernisation based on FDI

In this area, the situation in the region also varied. Slovenia, as the most developed state of the region could, from the beginning, arouse potential interest of foreign investors. However, the authorities preferred the implementation of market economic reforms in a more moderate version of gradual transformation, instead of shock therapy. Part of the transformation was treating foreign investment selectively, primarily due to fears of weakening the economic sovereignty of a small country. Successive governments were sceptical about the large share of FDI in the economy. The level of economic development meant that the country did not need foreign investment to such an extent as the other post-socialist CEE states. Croatia, on the other hand, was bypassed by external capital due to its involvement in regional conflicts. In addition to war destabilisation, the problems that prevailed were a deep recession, not very transparent relations between the government and local business, as well as nationalistic disputes which made ownership one of the most strategic areas in the economy. Due to the legacy of the ownership system of employee self-government and the emerging economic nationalism in the countries of former Yugoslavia, in the 1990s the legislation in the successor states gave priority to internal shareholders, managerial staff and employees (insider privatisation, selling to managers and other employees). In this way, governments did not encourage foreign capital to become active. The inflow of FDI was further limited by the small internal market and the lack of a developed capital market.

Also, in Bulgaria and Romania in the early transformation period, foreign investors were treated distrustfully by governments led by politicians from the previous system. The attitude began to change in the second half of the 1990s when, as a result of the collapse of economic policy, the new leadership of the state began to implement neoliberal economic reforms, part of which was the privatisation of enterprises and banks. However, due to the low level of development of these states, weak GDP growth and limited market potential, foreign investment did not pour in. The underdevelopment of infrastructure and business services, including the capital market, also had a discouraging effect. Economic reforms were not given priority (Croatia), were implemented inconsistently or, as a consequence of social protests or government changes, they were slowed down (Bulgaria, Romania).

Significant opening of economies to FDI took place in the second decade of the transformation. Proposals for trade preferences, association agreements and financial assistance programs were prepared to support and accelerate the political and economic integration of the region with the EU. The scale of privatisation and liberalisation of foreign trade were expanded, which spurred the inflow of FDI. Regardless of the general trend, individual countries had their own trajectories for the inflow of foreign capital. The countries with relatively the highest dynamics were Croatia (e.g. the government sold significant shares of Hrvatski Telekom – the telecommunications operator) and Bulgaria (the banking sector was subject to privatisation); Romania was slightly less active (flagship companies such as Petrom and Dacia were privatised). The growing share of foreign investors in key institutional dimensions at the microeconomic level is illustrated by changes in ownership in the banking sector and in the Top 500 group of companies. According to data from 2009, the participation of foreign investors in the assets of banks was the highest in Croatia (91.0%), followed by Romania (85.0%) and Bulgaria (79.0%), and the lowest in Slovenia, where foreign investors did not hold a majority stake[56]. In 2011 foreign capital controlled the largest part of the Top 500 companies in Bulgaria (81.8%) and in Romania (78.8%), significantly less in Croatia

[56] For comparison, in this period the average share of foreign investors in the banking sector assets of OECD countries was 15% (Claessens, van Hoven 2012).

(28.6%) and in Slovenia (27.8%) (CEE TOP 500 2011). These values fluctuate little.

The specificity of relations between the SEE countries and foreign investors was particularly visible in three areas: privatisation, deindustrialisation and sectoral distribution of FDI. After 1989, the mass expansion of various types of services occurred in parallel with deindustrialisation. Apart from Slovenia, the majority of FDI was in non-production sectors and to a limited extent participated in the restructuring of the region. Foreign capital, minor, flowed mainly to the services sectors – banking, telecommunications, tourism, retail trade, real estate. It had little effect on increasing productivity, creating an export base or well-paid jobs. There was no broader horizontal productivity spill-over that would significantly integrate local enterprises in global economic links networks. An example of a partial change is Croatia where, thanks to the inflow of FDI, the volume and structure of exports changed. Data from the Croatian manufacturing sector prove that FDI companies, when compared to domestic ones, are more successful in terms of capital growth, sales, employment and productivity growth. However, FDI did not significantly increase employment, export volume, productivity or competitiveness of the economy. Domestic companies still show a relatively low level of internationalisation. Significant growth in FDI also bypassed export-oriented sectors. Croatia specialises mainly in lower-class technologies (EC 2015: 29). As a result of the global financial crisis, investors limited the inflow of capital to the countries of the region. Problems of individual economies, especially the loss of budget stability, additionally fuelled by avoiding cuts, quickly became apparent. The exception is Slovenia which, as a result of joining the euro area was forced to use the crisis prevention measures compulsory for countries with the single currency.

The exhaustion of the current development model bidding to use foreign investment on a larger scale became apparent. The conditions to which economic growth is positively correlated with FDI were met to a too limited extent. In the SEE countries, the inflow of foreign investment did not bring about a significant increase in added value in production, in industry employment or in expansion of export production. There was no horizontal spill-over effect at the sectoral level, i.e. the spread of new technologies

and the development impulses in a large group of enterprises evoked by them. For such an effect to occur, certain conditions must be met. Potential benefits of FDI were limited by, among other things, the level of development of national infrastructure (damaged – in Croatia, underdeveloped – in Bulgaria and Romania), size of markets (Slovenia and Croatia are small countries) and the low quality of institutions (especially in Bulgaria and Romania, and recently deteriorating in Slovenia). However, regarding certain significant aspects, the position of individual states varies significantly. Asa member of the euro area, Slovenia definitely stands out. Foreign investors were accepted selectively. The current FDI structure, with the dominance of manufacturing, is a manifestation of the effectiveness of this policy, while financial services and trade are less important. In Croatia, ranking second in the level of development, the acquisition of FDI was managed in a different way; financial services predominate there, the share of production is lower by half and the real estate sector is much more significant.

The effects of the FDI inflow varied across the countries of the region. Slovenia, which for the first decade kept a distance from foreign investors, did not experience a slowdown in economic development because of this, as evidenced by its convergence to the level of EU development and accession to the European Union in the first group of post-socialist countries, followed by its swift membership in the euro area. Paradoxically, it was only the wider opening to foreign investors (especially in the banking sector), which coincided with the global financial crisis, contributed to the collapse of economic growth and to the slowdown in the country's development. In the case of Bulgaria, Romania and Croatia, the expansion of FDI forced and accelerated the raising of standards of economic and political institutions. However, this process ran in a different and more selective way than in Slovenia; it also continues to have negative consequences. In practice, it means, among other things, strengthening forms of integration with the global economy, characteristic of peripheral capitalism. In the export structure of these countries, the share of industrial processing and services based on modern technologies is relatively small. The underdevelopment of the internal market is changed to a small extent by FDI, which leads to the dependence of economic growth on the inflow

of external funds; especially since the banking sector in Bulgaria, Romania and Croatia is fully controlled by foreign capital[57]. Another dimension of the peripheral nature of the economy is the low share of exports in GDP (as in Romania and Croatia). This delays entry into the international economic cycle, including cooperation with TNCs. Elements of institutional convergence (the implementation of EU law) and the development of links with EU markets (increase in mutual turnover, FDI inflow), however, create impulses that positively affect the benefits of participation in international economic cooperation. The way they are taken advantage of depends primarily on the economic policy and institutional shape of capitalism, including the ability to invest in resources that increase the competitiveness of the economy and society.

## 5. The knowledge sector

In the development of the knowledge sector, the situation of the SEE countries varies significantly. Slovenia ranks best. Having established investment patterns in education and R&D, it created new institutions promoting innovation and modern technological solutions, such as Digital Public Services. Expenditures on R&D are definitely higher in Slovenia than in other SEE countries and differ only slightly from the EU average (2% of GDP). Slovenia, together with Estonia, the Czech Republic and Portugal, is included in the group of strong innovators by the European Innovation Scoreboard (EIS 2019). Other countries are much weaker in this aspect. Croatia, Bulgaria and Romania rank last in the EIS, which means increasing their distance to the European leaders – the Scandinavian countries and the Netherlands (EIS 2019). Bulgaria and Romania have not created their own strong knowledge sectors and, similarly to Croatia, show low capacity to absorb new technologies and knowledge. In these countries, during the transformation period, most technology companies went bankrupt or were taken over by foreign investors. When selling them, the consequences for the country's industrial policy, technological development or connections with the academic world were rarely taken into

[57] It is worth noting the special dimension of the dependence of peripheral economies on financial transfers conveyed by labour migrants. In Croatia, the share of remittances in GDP was 4.5% in 2017, and in Bulgaria 3.79% of GDP (The World Bank, TheGlobalEconomy.com).

account. The weakness of the science and technology policy and that of innovation also pose problems.

Due to the delayed accession to the EU, the SEE countries (except Slovenia) did not receive benefits comparable to those the V4 did from reindustrialisation based on FDI, business trans nationalisation or EU structural funds. The change is also disrupted by widespread principles of clientelism and political protection shielding companies associated with the power elite. Very modest expenditure on R&D can be considered as a warning forecast: the lack of own large corporations capable of generating significant innovations is conducive to a decrease in the competitiveness of domestic enterprises. Among the indicators confirming such a scenario are, among other things, low expenditures on education and training (except Bulgaria), relatively low share of high-tech in exports (mostly carried out by local TNCs), low profits of domestic companies from innovation, and weakness of academic institutions. The Global Entrepreneurship Monitor (GEM 2019) confirms that in the ranking of levels of economic development only Slovenia is in the group of innovation-driven economies – placed behind Sweden, but before Spain.

After three decades of transformation in the SEE countries, predominance of rationality typical of dependent, imitative capitalism (in terms of innovation and scientific and technical progress) was formed in the knowledge sector. This variant of capitalism is based on external development factors such as FDI and EU structural funds with a very limited share of national resources, especially financing R&D, education and higher education. The exception is Slovenia, which, like Estonia and the Czech Republic, swiftly integrates with development centres in Western Europe. It undertakes relatively effective actions to strengthen the knowledge sector and national competitiveness. Croatia, Romania and Bulgaria implement a scenario like that of Southern Europe, but at a much lower level of inputs and outputs. If the situation proves to be permanent, the likelihood of increasing the development distance of these countries to the EU and reproducing the status of "periphery on the periphery" will increase, similarly to the case of the Western Balkans.

## 6. The public opinion and attitudes towards transformation

The public opinions in the SEE countries are diverse, both in terms of assessing the transformation and EU membership. In Slovenia, which is most integrated with the West, the entry to Euro-Atlantic institutions was a strategic goal that did not raise controversy. It was to constitute a "natural" closure of the geopolitical change process and confirm the durability of its character. It was about creating guarantees of development protecting against conflicts and regress that occurred in the former SFRY. The relatively high level of development created strong grounds for optimistic perception of prospects in the EU. A confirmation of the position the country had already achieved, rather than profound systemic changes related to accession, was expected. Croats found themselves in a slightly different position. After the armed conflicts and authoritarian rule, the public expectations concerned primarily the completion of economic reforms and the democratisation of the state. Croatia's accession to the EU could have played the role of a catalyst and later also that of a stabiliser of post-transformation changes. The prospect of rapprochement with the West became a key factor in mobilising the society to rebuild the state.

The small sizes of the countries and the fact that elites from the previous system continued to hold on to power often caused in Croatia and in Slovenia an aversion to private capital, especially to foreign capital (e.g. in Slovenia, entrepreneurs transferring capital abroad were considered traitors). For many years, limiting privatisation was being justified by national security reasons. The public suffered from the negative effects of adaptation to the EU, which was overlapped by the global financial crisis. In Croatia, its "franc crisis" also became a severe symptom, weakening the legitimacy of transformation, even among the beneficiaries of reforms. As a result, public support for EU membership began to weaken. In Slovenia, participation in the euro area and related requirements (e.g. austerity, internal devaluation and unpopular transfer of aid to Greece) became an additional reason. Similarly, in Croatia, which had not become a member of the EU until 2013, support for membership is falling. However, hoping for a lasting recovery in Western Europe, in 2017 the country's authorities announced their plans to join the euro area.

Other social attitudes took shape in Romania and Bulgaria, where the possibility of the EU membership meant mainly hopes for improving their financial situation as well as a desire to overcome the political crisis. However, in this case, the prospect of accession also involved deeper cultural and civilization changes. Unlike Slovenia and Croatia, Romania and Bulgaria are not only at a much lower level of economic development. For historical reasons (including, among other things, the long-term Turkish occupation, the dominance of the Orthodox religion and more repressive governing after 1945), they are separated by a greater cultural and civilizational distance from Western standards. The societies of these countries had more extensive expectations related to their EU membership (e.g. FDI inflow, reduction of corruption). The unsatisfactory course of reforms, together with the negative consequences of the global financial crisis and the extension of accessing the EU, caused growing social disappointment. In Romania, however, the public support for the EU remains high, and trust in its institutions is greater than trust in its own government (which is partly due to the awareness of how slim the chances are for favourable changes without EU support). These views are also impacted by the conflict of the government with the EU over legal regulations and anti-corruption institutions. In Bulgaria, where support, although slightly weakening, also continues, new, and greater than average in the EU, fears have arisen about the migration crisis and Islamist terrorism. They are associated with, among other things, the supported by Turkey 13% Muslim minorities residing in Bulgaria. The migration crisis in the EU restored concerns about the resurgence of national and religious tensions.

Even in Slovenia, support for transformation and integration weakened, especially after the 2008 crisis. As a result, issues of national security and the scope of economic autonomy within the EU are being discussed again. In Bulgaria and in Romania there is growing awareness that taking advantage of new opportunities requires further reforms, which is confirmed by their governments' announcements of plans to enter the euro area. However, the experience of transformation has popularised the view that EU membership also involves new types of risk, such as the costs of asymmetrical system solutions (the euro area) or migration crises. This can

be observed in Croatia, where support for the EU is the lowest. Poor development indexes and delayed reform implementation, as well as lengthy accession negotiations concurrent with the euro area crisis, disappointed a significant proportion of the population. It recognises that the country has not benefited by entering the European integration process as much as was expected.

### 4.1.4 Western Balkans

#### Historical introduction

Albania, Bosnia and Herzegovina (B&H), Northern Macedonia, Montenegro and Serbia form a very diverse mosaic of different cultures, traditions and economies as well as nationalities. In addition to divisions rooted in Catholic, Byzantine and Protestant influences, the influence of Islam is particularly strong, especially in Albania and in B&H. In modern history, they were associated primarily with Turkey, Austria-Hungary, Great Britain, France, Germany, Russia and Italy. After three decades of political transformation, Montenegro is the most advanced state, followed by Serbia and Northern Macedonia, with Albania and B&H, as the least developed ones. However, the countries of the region, small or even very small in terms of the size of their economies, are still among the poorest in Europe. In terms of GDP per capita in relation to EU28 = 100, this ratio in 2018 was for Montenegro 45%, for Serbia 40%, for North Macedonia 38%, and for Albania and B&H 31% (Eurostat 2019).

#### 1. Political context and quality of institutions

In the 1990s, the break-up of the Yugoslav Federation, the accompanying military conflicts and the transition to the market economy had the greatest impact on the development of the countries of the region. All the states of the former Yugoslavia were involved in ethnic wars and conflicts for almost a decade (first in Bosnia and Herzegovina, in 1998-1999 with particular intensification in Serbia and in Montenegro, and in 2001 in Macedonia). The nationalist clashes of two nations – Serbian and Croatian – were linked to historical conflicts dating back to the pre-communist period. Serbs and Croats conducted war not only against each other, but also against Bosnian Muslims. Such conflicts also occurred in other areas of former Yugoslavia, including Slovenia (1991), which for six days was encompassed by hostilities.

Building separate statehood has become a priority for political elites. However, tensions among the new states had an adverse effect on the economy. There was, among other things, a discontinuation of links between production and finances, hyperinflation and the collapse of the

economy. This period of extraordinary policy ravaged the rule of law and the quality of public administration. The SFR of Yugoslavia, by the standards of other European post-socialist countries (similarly to Hungary and the Czech Republic), was a relatively developed country, with market economy institutions and good international relations, with Western countries as well. It had potentially greater chances than the other CEE countries to carry out a successful transformation towards pluralist democracy and the market. The fall of the federation meant that the rule of law in the region became at that time subordinated to the rules of politics and the needs of the war. This heritage has largely determined the trajectory of political change and local pathway of cause and effect dependencies, including the quality of the new institutions. It fundamentally distinguished negatively the transformation in the region from that in the Visegrad Group countries and the Baltic states. The new Yugoslavia, comprised of Serbia and Montenegro, was subject to the UN and EU sanctions, first in 1992-1996 and later in 1998-1999. Until 2019, Macedonia was additionally adversely affected by the Greek embargo and could not start accession negotiations with the EU due to the dispute over the name of the country. The dispute was finally resolved, and the name North Macedonia was agreed on.

Political events had a negative impact on Albania as well. The collapse of Yugoslavia's domestic market adversely affected any economic cooperation with this country, although Albania was not directly involved in the civil war and since 1992 had been implementing the shock therapy market reform program supported by the IMF. However, her starting point was very difficult and different from the other CEE countries. For decades it remained the hermetic state in the former bloc of socialist states. For political and ideological reasons, until the end of the 1960s, China was the only country that the Enver Hodża regime had good relations with. Due to its specific interpretation of Marxism-Leninism, Albania adopted a system of political self-isolation and extremely centralised economic autarchy, very repressive in comparison with other European socialist systems. Like Romania, it had the most centralised economy in the region. Political transformation began in Albania with mass demonstrations and chaos, including the use of violence. The new authorities took over the leadership

of the state in 1992, but the economic reforms that began, due to the high political and social turbulence, undermined stability for a long time.

Extremely volatile political conditions in the region had serious economic consequences. As in the other CEE countries, high inflation, a large decline in GDP and rising unemployment occurred. However, the problems were much more severe. The degree of regress can be illustrated by the example of Serbia, where in the early 2000s the level of economic development fell to half of that from before the collapse of the former SFR of Yugoslavia – as a result of, among other things, expansive monetary and fiscal policy causing one of the largest hyperinflation in history and a deep recession in 1990-1993, which caused the cumulative GDP reduction of almost 80% (Uvalic 2012: 3). It should be remembered that these developments affected the poorest region of Europe, referred to as the "periphery of the periphery" or the "super-periphery" (Barlett 2018). The conclusion of the peace agreement in Dayton in 1995 pertaining to B&H, the end of the Kosovo war, and later the departure of key nationalist leaders in Croatia (Franjo Tuđman in 1999) and Serbia (Slobodan Milosevic 2000), improved the political climate in the region. Economic and institutional reforms started to be introduced, particularly in Albania and Macedonia. In B&H and in Serbia and Montenegro, the less favourable socio-political situation hindered major changes. The reforms included the liberalisation trade and prices, privatisation of small enterprises and state-owned banks. However, privatisation often did not lead to the expected results. There was a lack of capital and skills to modernise enterprises. The competition policy, including the reduction of bureaucratic procedures hindering doing business, was just starting to be introduced, albeit not very effectively. There were substantial differences among the states of the region. In Macedonia, for example, business support reforms were implemented more effectively than in the other countries. The implementation was the poorest in B&H due to its complex administrative structure that hinders joint operations, reflecting the division of the state into three parts: Serbian, Croatian and Bosnian.

After 2001, however, there was some rapprochement among the countries of the region in the area of private sector participation, company management and foreign trade liberalisation. The differences between the

“early” reformers (Croatia, Slovenia) and the “late” reformers (Albania, Macedonia, Serbia) began to blur slightly. The introduction of institutional and economic reforms also opened the way for the Western Balkans to join the EU. In 1999, the EU initiated the Stabilisation and Association Process (SAP), which defined the political framework for relations with the states of the region. In 2008, this process was institutionalised by the establishment of the Regional Cooperation Council. After the ethnic conflict in 2001, the political situation in Macedonia was stabilised. The declaration of Montenegro’s (2006) and Kosovo’s (2008) independence from Serbia was conducted peacefully.

The positive effects of such activities, including economic reforms, were supported by the EU which offered trade preferences and structural financial aid. A breakthrough in this respect was the 2003 Thessalonica summit which announced the prospects of membership in the EU of the countries of the region and specified its conditions, similar to those of the CEE countries in the early 1990s. However, additional requirements were added to the Copenhagen criteria, reflecting the specifics of the post-war Balkans – regional cooperation, reconciliation and resolution of disputes (Szpala 2017:1). The countries declared that they would act within the framework of the basic principles in force in the EU, such as respect for democracy and human rights, independence of the judiciary, decentralisation of power, which was all to be accelerated by the EU funds. It was assumed that within several years they would all join the EU.

The progressive processes and tendencies in the reconstruction of the institutions and economies of the region were stopped by the global financial and economic crisis at the end of 2008. The methods applied by the EU no longer produce such results as in the case of Central Europe. There is a scarcity of strong and efficient state bodies that can implement them, and societies remain conflicted and politically divided. The authorities are often unable to translate general EU recommendations into specific legal solutions. Neither Kosovo nor B&H can function independently without foreign support. The long-term consequence of the crisis was questioning within the EU the idea of admitting new members. The EU states began to pay more attention to the costs of any enlargement.

Some used the accession negotiation process to settle their interests (like Greece in the conflict with Macedonia over the name of the state).

The Western Balkan countries confirm their will to join the EU. Montenegro and Serbia, the most economically developed states in the group, are the most advanced in the process of preparing for their membership. Montenegro started accession negotiations in 2012, and Serbia began them in 2015, after concluding its agreement with Kosovo. In 2018, the EC stated that Montenegro and Serbia could join the European Union in 2025. North Macedonia has been a candidate state since 2005, and Albania since 2014. At the end of May this year, the EC acknowledged that North Macedonia and Albania had carried out appropriate reforms and the EU Council should decide to start accession negotiations. (Especially since North Macedonia signed the NATO accession protocol in February 2019, which is interpreted as increasing the country's chances of gaining the EU membership). However, the EU Council postponed the final decision until October 2019 because there is no agreement in the Community in this respect. France, the Netherlands, Denmark, Spain and Germany have doubts. In turn, B&H has the lowest negotiating status: that of a potential candidate state. The Stabilisation and Association Agreement with the EU was signed as early as 2008. However, the accession was suspended by the country's failure to comply with the ruling of the European Court of Human Rights. Currently, B&H's application for its EU membership is being reviewed by the EC.

Despite almost two decades of transformation, the states of the region are not considered consolidated democracies. Institutional standards are deteriorating; improvement was recorded only in Montenegro. In the other countries, the situation is getting worse, especially as regards the freedom of the media controlled by the ruling elites or, propitious toward them, oligarchs. Corruption and judicial control are still significant issues there. Bosnia and Herzegovina, Albania, Macedonia, Serbia and Montenegro are included in the countries where the progress made in preventing corruption is insufficient (Karklins 2005; Barlet 2016). In most countries of the region, an oligarchic system has been created, in which each party, taking power, takes control of the economy, and the exchange of political elites becomes very difficult. In Serbia, some politicians are returning to the Kosovo issue,

and in Macedonia, the conflict with the Albanian minority is returning. In addition, the 2015 migration crisis highlighted the shortcomings of the so far cooperation in the region.

## 2. General economic outlook

In the Western Balkans, from the very beginning the systemic transformations were more local and national in nature than in the V4 countries and the Baltic states. Due to the delay in implementing reforms, this region did not attract interest of foreign investors during the decade of the 1990s. Relatively little attention was devoted to the evolution of market institutions and the shaping of new models of the economic system. Until peaceful stabilisation, it was difficult to refer directly to the Balkan countries the theoretical categories associated with the Comparative Capitalism approach. In this perspective, economic institutions in the region are hybrid, departing from "pure" models of capitalism. Standard categories of diversity of capitalism, such as the liberal market economy (LME) or the coordinated model of economy (CME), are completely out of tune with them. Due to the lack of consistency and frequent changes in institutional configurations as well as the use of a various exotic mixture of economic and social reforms, emerging forms of capitalism are difficult to identify clearly. The early stage of rooting the market economy in social and institutional structures and their unstable nature largely contribute to the fact that the states of the Western Balkans are still *in statu nascendi*.

Disintegration, political and economic fragmentation meant that state and market institutions initially were changed primarily from within. Strong external pressure concerned mainly political and military issues. Not until the late 1990s did significant change in the economy start to appear. The special role of informal connections is an additional complication, which means that countries in the region are often referred to as hybrids combining various forms of coordination in the economy. They include important components of institutions and processes from the previous system, such as a significant role of state ownership, social welfare and education, combined with mechanisms adopted from market economies – the development of the private sector, the expansion of small businesses, the inflow of foreign investment, etc. (Bartlett 2007). Therefore, regarding

this region, it seems more appropriate to apply non-standard approaches to models of diversity of capitalism, assuming that the unprecedented nature of the changes requires focusing on other factors determining the shape of the emerging variants of capitalism.

In this regard, one can recall the concepts of Bohle and Greskovitcs (2012: 183), which referred to such countries as Bulgaria, Romania and Croatia as non-regime countries – economies with an unclear institutional profile, often subject to significant transformations. This lack of clarity also occurs in the Western Balkans as a result of chaos after the breakup of the SFR of Yugoslavia. Due to different conditions and trajectories of political development, the Balkan countries are heading in different directions of institutional changes. Some oscillate towards the liberal variant in the economy (Albania), others towards the continental European one (Macedonia), and still others towards the Mediterranean one (Serbia, Montenegro). However, all of them have specific features that differ significantly from the contemporary market economy standards (Bartlett 2007)[58].

A typical distinguishing feature of "the Balkan capitalism" is filling the greatest number of public posts in the administration and in state-owned enterprises, relatively better paid than the private sector, with government supporters. Governments maintain a high level of aid for enterprises, including private ones, which is usually of little transparency. Like controlling the media and the courts, this is a useful instrument of patronage as the foundation for a clientelist system that also allows to win support of important groups of voters (retirees, war veterans) through social programs

[58] The concept of King and Szeleny is also useful for characterizing the genesis of the transition from a centrally planned economy to a market economy in the Western Balkans, especially the distinction of capitalism 'from below' and capitalism 'from above'. Capitalism from below, in a hybrid way, combines elements of command economy and state-owned enterprises with the activities of private businesses. Its distinguishing feature is a large state sector in the economy and high regulatory influence of the government. Capitalism from above, also referred to as personalised 'patrimonial capitalism', was initiated by party-state elites from the previous system, which maintained power using the rhetoric of national and state sovereignty. The domination of internal privatisation, giving the management and some employees with good connections with the leaders of the ruling parties the greatest opportunities to take over enterprises, along with the introduction of market reforms has created a specific oligarchic model of government.

targeted at them. In this way, for instance in Serbia, there have been mechanisms created limiting the implementation of structural reforms (especially privatisation) and conducive to the growth of the public finance sector deficit (Barlett 2018; Mujanović 2018; Stanojevic *et al.* 2016).

Such circumstances reinforce certain tendencies different in various respects from the direction of reforms in the more open to Western influences V4 countries and the Baltic states. Compared to CEE, the weakest path of development in the region turned out to be the one described as capitalism from abroad or "liberal capitalism".

Referring to another typology, it can be stated that due to the place of the Western Balkans in international economic trade, together with the large economic role of the state and its relations with the enterprise sector and a rather low quality of institutions, they are close to the authoritarian rule. However, they retain basic democratic institutions, such as a multi-party system and competitive parliamentary elections, although their role tends to be periodically diminished or marginalised. Some are also significantly dependent on the inflow of remittances and are aid-based economies (Myant, Drahokoupil 2011), so they are strongly dependent on labour force exports and the situation on the labour markets in more developed states. This group includes, first of all, B&H and Albania, and Serbia to some extent (the inflows remittance percent of GDP is 8% and 9% and 5%, respectively) (the World Bank 2019). The countries of this region are also distinguished by an exceptionally large informal sector. It was estimated that even in the period of improvement in the economic situation before the global financial crisis, the informal economy sector was very significant and included 45% of employees in Macedonia, 18-20% of employees in B&H and Serbia, and in Albania it provided as much as half of household income (Uvalic 2012: 20).

In the institutional aspect, capitalism in the Western Balkans variant manifests strong oligarchic tendencies, with a wide range of the phenomena of rent seeking, especially in the form of corruption. This is a consequence of the close links between the world of politics and the economy, mediated

by organised crime during the war, which gradually evolved into new networks of business and political connections.[59]

A noticeable change in the economic situation in the region was a consequence of the end of conflicts and the prospect of European integration. Between 2004 and 2008, the GDP growth was significantly higher than in the EU and reached the average annual level of 5%. At that time, there was a marked improvement in most other macroeconomic indicators, including an increase in financial stability and a reduction in the budget deficit to the level of below 60% of GDP. Due to the liberalisation of trade between the countries of the region and the EU, the turnover in imports and exports began to increase significantly (in some cases four- or fivefold), which was further strengthened by the CEFTA (the Central European Free Trade Agreement) of 2006. Before the global crisis, for all the countries of the region the EU became a major trading partner (55-80% of total exports and imports)[60]. FDI began to flow in, stimulated by the reduction of political risk, mass privatisation of banks and enterprises, as well as by relatively low wages and prospects of the EU membership. As a result, the development distance has been reduced in comparison with the EU15 average. In 2008, Montenegro neared 43% of this average, Serbia 36%, B&H 31%, and Albania 26%.

Positive changes occurred in the private sector, whose share in the region's economies increased to 60-70% with the highest in Albania and the lowest

[59] In the 1990s, such mediation was carried out especially in the form of illegal contraband via the Adriatic Sea, thus bypassing the international embargo against Serbia. The process of transformation in Serbia is also interestingly presented in the documentary on organised crime related to the world of politics in that country, "Arkan's legacy. The Serbian Mafia" (dir. by Jerome Pierrot, France, 2018). It reconstructs the connections of followers of political radicalism and nationalism – movements which took the form of organised crime cooperating with special services. These movements became the backbone of one of the most controversial paramilitary formations in recent European history – the Serbian Volunteer Guard (the so-called Arkana Tigers, from the nickname of the commander). It participated in armed hostilities in Croatia, Bosnia and Kosovo and is accused of war crimes. The killer of Serbian Prime Minister Zoran Đinđić, who was shot dead in 2003, originates from this organization. The documentary shows the dramatic circumstances of the birth of capitalism in the largest economy of the Western Balkans.

[60] However, it should be remembered that due to the relatively low competitive nature of the Western Balkan economies, the increase in trade turnover contributed simultaneously to the increase in the deficit in economic exchange with the EU.

in Serbia and B&H. However, unlike the V4 countries, the process of deindustrialisation is being continued. An inefficient corporate management system and a deficit of managerial skills remain a persistent problem as well. The financial sector and the infrastructure are relatively weak. The specificity of capitalism in the countries of the Western Balkans is also determined by labour relations, social dialogue, employment and unemployment issues, and the social policy. Institutions of social dialogue in almost all countries of the region are weak and inefficient, which was influenced by very little traditions of civil society and numerous political conflicts and ethnic divisions. Trade unions in the private sector hardly exist. What is left of them operates mainly in large enterprises and in the public sector, where the Yugoslav tradition of unionism has survived. Tripartite dialogue institutions have been established also in Albania, but there they remain mainly a consultative body.

With the exception of North Macedonia, expenditure on education is low and the competences sought after in the labour market are taught poorly. Apart from Serbia, the results measured by, among other things, the PISA test not only significantly vary from the EU average, but in Albania, North Macedonia and Montenegro they are lower than those achieved in countries with similar incomes (e.g. a large proportion of students, 30% -70%, show various forms of functional illiteracy). The health care system is also anachronistic, largely focused on hospital services, rather than on health promotion and prevention. Relations between social assistance and labour market activity programs are weak – people with better education benefit from them more often than those excluded from the labour market. Funds allocated to such programs are proportionately much smaller than in the OECD countries.

Considering the issues of private property, labour market protection and social policy together, it can be assumed that several variants of the specific Western Balkan model of capitalism are evolving. Their common denominator is the peripheral character, which in terms of quality is unfavourably different from the CEE countries. An important distinguishing feature are phenomena and tendencies not occurring, on such a scale, in other countries of political transformation. First of all, there is a large share of patrimonial capitalism with a weak society, fragmented

in terms of ethnicity and income, and with low employee participation, as well as with a systemically significant role of corruption, informal economy and organised crime. Due to the small sizes of domestic markets and limited economic potential, all the Western Balkan states are heavily dependent on external partners, especially from the EU. There are also some trends that differentiate their development. Albania exhibits stronger features of the liberal model, with a large share of private property (largely informal), weak institutions and low social benefits. North Macedonia, in turn, is closer to the continental model – with a slightly higher protection of the labour market and relatively higher outlays on health care and education. In the case of Serbia and Montenegro more elements of the Mediterranean model can be identified; they are distinguished by tendencies to clientelism and oligarchisation, by a relatively high state participation in the economy and social policy, by politically motivated support for enterprises, as well as by hidered access to the market.

The 2008 financial crisis reduced the inflow of foreign investment to the Western Balkans, including bank loans and migrant workers remittances and donors' assistance. There was also a decrease in exports to foreign markets. The IMF and the EU recommended fiscal consolidation and structural reforms to improve competitiveness. However, such indications met with resistance from politicians and interest groups for whom maintaining high budget expenditure was necessary for political reasons. As a result, structural reforms focused – for example in Serbia – on investment cuts rather than on reducing wages and employment in the public sector; other cuts, such as those in education, were questioned. This is a syndrome of behaviour typical of peripheral regions, especially characteristic where middle classes are relatively weak when confronted with ruling elites (Bartlett 2018: 17). However, such a balance of power and intertwining interests does not question certain positive macroeconomic trends which in this region are mainly due to the participation in the EU accession process.

## 3. Quality of entrepreneurship

At the beginning of the transformation, setting up private businesses, especially SMEs, became one of the important issues in building the

economic and social potential. However, in most countries, the decade of the 1990s favoured the development of productive entrepreneurship to a limited extent. This resulted from the economic and political crisis and the slow or inconsistent implementation of market reforms, especially deregulation, as well as the insider privatisation which preferred local managerial and ownership elites which were initially not confronted with foreign investors in this regard.

The development of entrepreneurship relies on many elements and circumstances. Institutional factors are particularly significant for the business environment. Despite positive changes, the standards in the Balkans remain relatively low in this respect, especially regarding corruption in the administration, the courts and in the justice system. The specificity of the Balkan version of capitalism also involves a significant range of destructive activities that benefit only selected communities (e.g. organised crime groups in Serbia and B&H, or the Albanian mafia in Kosovo). However, the common problem continues to be not so much the quality of economic regulations, which have generally improved, but their implementation, largely dependent on the direction of political changes and the evolution of institutions surrounding the economy. The revival of entrepreneurship occurred primarily as a result of the change in the economic situation after 2010, as well as due to the prospect of integration with the EU (changes in regulations are moving towards the EU standards). Yet, it is worth noting that in addition to the small sizes of the local markets and low levels of demand, the main problem is the persistence of links of corruption between entrepreneurs and politicians, which often take the form of "crony capitalism", which is a heritage and continuation of conflicts of the 1990s. Clientelist connections confer privilege in being awarded with government contracts, maintaining monopoly positions or introducing regulations hindering market access for other entrepreneurs.

Due to the increased opening of local markets and the progressing liberalisation of trade and the process of complying with the requirements of European integration, business environment institutions in the region are formally similar to those in the developed countries, but in practice they work differently. The continuous system of political patronage among business elites has adapted to the new conditions, and its driving force has

become, inter alia, the public procurement system. The condition of entrepreneurship was adversely affected by the consequences of the global financial crisis, conducive to corruption and to the informal economy. The main problem of the region is the relatively small number of high-growth companies in comparison to the CEE countries. It is an indicator of structural restrictions of small, indigent countries that should, to a greater extent, promote market competition to boost productivity in these regions (World Bank 2019: 7-8).

## 4. Modernisation based of FDI

The inflow of FDI played a key role in the transformation and modernisation of economies in the CEE countries. However, in the Western Balkan countries the situation was different in the 1990s. Inward-facing politics was a priority in the region, and nationalist rhetoric mobilised societies for the new political elites. Economic reforms were treated as secondary, which had long-term negative consequences. Investors avoided the region because of the high risks. As a result of the difficult situation of the countries, foreign financial assistance was directed primarily to food and humanitarian aid and to support for refugees (especially in B&H).

Not until the beginning of the decade of 2000 did the situation begin to change when political detente along with the opening of the countries of the region took place and their relations with the EU improved. The privatisation of state-owned enterprises and the liberalisation of foreign trade were initiated on a large scale, which stimulated the inflow of FDI. In addition to investors from the EU, economic partners also began to pour in from the USA, Turkey, Russia and from China. One of the significant manifestations of the new trend was, inter alia, the acquisition of the majority of the banking sector (75-95% of banking assets) by capital from the EU countries. Montenegro unilaterally announced the introduction of the Deutsche mark (1999) and, later, of the euro (2002) as its official currency. There was a long-awaited economic recovery. The specificity of relations between the countries of the region and foreign investors occurred in three areas: privatisation, deindustrialisation and sectoral distribution of FDI. Due to the fact that the popular in the society ownership system of employee self-government functioned for several decades in the former

Yugoslavia, the legislation in the successor countries preferred insider privatisation, which left little room for foreign investors. The majority of foreign investment was located in non-productive sectors and marginally participated in the restructuring of the states. FDI mainly flowed to the services sectors – banking, telecommunications, tourism, retail trade, and real estate. However, this had a slight impact on increasing productivity, creating an export base or well-paid jobs.

The phenomenon of growth without employment, "jobless" growth, also known earlier from CEE, emerged. A substantial inflow of FDI and an increase in competitiveness brought about the restructuring process, resulted in some companies collapsing and was one of the reasons for a sizeable increase in unemployment. In favourable economic conditions, there was an increase in the appreciation of the local currencies, which adversely affected the competitiveness of the Balkan exports onto the EU markets. Developmental imbalances started to increase (e.g. trade balance deficit with the EU countries). The conditions thanks to which economic growth is positively correlated with FDI were met in the region only to a limited extent. The inflow of foreign investment failed to result in a significant increase in the added value in production, higher employment in industry or expansion of export production. At the sectoral level, there was no spill-over effect, i.e. the spread in a large group of enterprises of new technologies and the development impulses they brought about. Local enterprises were not significantly integrated into global economic networks. In addition, as a result of the global financial crisis, investors limited the inflow of capital, which was then followed by problems such as the loss of fiscal stability driven by averting from accumulating savings, the rising public debt, unemployment, and excessive employment in the state sector. The exhaustion of the hitherto development model which made attempts to use foreign investment to a greater extent also became apparent.

Potential benefits of FDI were limited by, among other things, low level of infrastructure development, the market sizes, the level of education and vocational training, and the quality of institutions. Therefore, in all important aspects, the situation of these states was inferior to that in CEE, where investors had been attracted since the 1990s and the institutions were reformed in a more coherent and longer-term manner. The political climate

in the EU was also an important issue. In the 1990s, the inflow of investment to the Visegrad countries and to the Baltic states was stimulated by widespread enthusiasm and great support for new democracies after the fall of the Berlin Wall. At the time, the EU policy was active in promoting transformation by providing financial assistance, concluding association agreements and starting accession negotiations. The Western Balkans began to receive support from the EU much later, when the political climate changed to a less enthusiastic one. Various problems related to accession also surfaced, and the economic situation deteriorated in Western countries. As a result of the shift in the FDI inflow, the effect of "late arrivals" did not succeed in the region, as it had in the V4 countries and in the Baltic states.

In discussions about transformation, the FDI inflow and level of penetration is treated as an important source of diversity of capitalism in post-socialist countries (Bandelj 2008: 217). Supporters of system reforms emphasised that foreign capital became a catalyst and impulse for modernisation changes in the economies of the V4 countries and the Baltic states, significantly supported the development of the domestic private sector, entrepreneurship and an increase in productivity. FDI's ingress and expansion in this region also forced and accelerated raising the standards of economic and political institutions. In this sense, the inflow of FDI was also correlated with the processes of development of liberal democracy being strengthened further by the adjustments and requirements of the accession to the EU.

Both the World Bank and the EC pointed to the successes of the CEE model based on FDI, as opposed to the countries of Mediterranean capitalism based on portfolio investments and other low-production capital flows. Unlike the V4 countries and the Baltic states, due to its marginal scale in the 1990s, FDI did not play a comparable role in the Western Balkans. Although over the next decade, until the global crisis, investment began to flow, it was of a different significance, both in terms of size and structure. They did not play the role of a catalyst for economic changes, although they contributed to greater convergence with the EU standards. This meant strengthening some of the anachronistic, and even degressive, forms of integration with the world economy, characteristic of a peripheral market economy.

As a result, what followed was, among other things, dependence on the inflow of remittances and foreign assistance and a sluggish departure from the anachronistic structure of exports based on raw materials and agricultural products, instead of entering the international cycle of industrial processing and modern services provided in cooperation with TNCs. Elements of institutional convergence (including the implementation of the EU law), increasing, although slowly, links with the EU markets, did not significantly affect participation in the benefits of international economic cooperation. This is one of the reasons for social discontent and the growing political tensions in the region, which, in recent years, have taken the form of illiberal democracy and of a more authoritarian forms of governance.

## 5. The knowledge sector

Although the countries of the region continue to develop, the changes in the knowledge sector are still at an early stage – mainly due to the lack of clear political concepts of change, the weakness of internal resources, especially capital, as well as a low level of education, which are a prerequisite for overcoming weaknesses in this area. The economic manifestation of this situation is the structure of exports of Albania, B&H, Montenegro, North Macedonia and Serbia, where medium and low-technology products predominate. Innovation efforts mainly concern traditional sectors, which do not necessarily represent the optimal competitiveness path. If there is no improvement, one of the consequences will be the reproduction of low levels of wages (belonging to lower-wage countries) and, as a result, the emigration of young and most talented residents.

To illustrate this situation, it is useful to use the typology of Porter's competitiveness stages, who distinguished three types of economies: 1) factor-driven economies; 2) efficiency-driven economies and 3) innovation-driven economies. According to the Global Entrepreneurship Monitor (GEM 2014: 28), countries in the region such as B&H or Kosovo are at the stage of efficiency-driven economies. Its distinguishing feature is increasing industrialisation and economies of scale, as well as the domination of large enterprises with a supply chain open to small and

medium-sized enterprises. The task of the state is to improve the functioning of the capital market and of the labour market, to attract foreign investment and to create educational systems enabling the adoption of modern technologies. Among the close neighbourhood EU countries, Romania is at a similar stage of competitiveness.

Very low expenditure on R&D in the region and GDP significantly below the EU average of 2% indicate that it is currently difficult to count on a significant improvement in this respect. In Serbia, expenditure on the knowledge sector amounts to 0.9%, in Montenegro and Northern Macedonia 0.4% of GDP each, and in Albania and B&H they reach a symbolic value of 0.2%. The quality of education and training also remains low, according to PISA test results, among other things.

### 6. Public opinion and attitudes towards transformation

In comparison to other European countries, opinion polls in the Western Balkan countries are at a greater risk of being over-interpreted. Nevertheless, they are worth looking at because they point out significant political, social and economic problems present in the public awareness. They also have some prognostic value signalling the possible evolution of views, e.g. the issue of support for European integration, which may affect the decisions of national authorities regarding the continuation of reforms or decisions of foreign investors making their presence dependent on the development prospects of the region.

The public opinion analysis in the Western Balkans offers several conclusions. First, it is not clear to what extent the concepts of democracy or market economy have connotations similar to those in other the European countries. Many years of chaos, armed hostilities and ethnic conflicts, inconsistent political reforms, criticised for, among other things, their ambivalent or negative effects, gave the processes involved distinctive meanings. For example, in countries that are distinguished by weak institutions, democracy is often associated with the authorities unable to act effectively while market reforms associated with pathologies of privatisation, appropriation of property by ruling elites, as well as with poverty and social exclusion (political opponents, ethnic minorities, etc.). Secondly, the pace of events overlapping with frequent political crises and

structural economic problems favours the verification of previous assessments, which largely reflects in the public awareness the specificity of the difficult period of transformation. These circumstances also strengthen the radicalism of views and the polarisation of public opinion.

Some categories of issues may also obscure other problems. For example, in B&H controversy persists around national and ethnic issues that for many years have not found an acceptable solution. In times of permanent political instability, declarations of support for various systemic solutions tend to fluctuate significantly, and a large proportion of citizens, as in North Macedonia, believe that political connections remain the best path to success. One can risk the assumption that without longer stabilisation and economic development it is difficult to expect any crystallisation in public opinion assessments.

However, there are issues where social views show some stability. The prospect of EU membership, perceived positively, although in different proportions, by the majority of respondents from the countries surveyed can serve as an example. Yet, the protracted accession negotiations with the EU are gradually weakening the public support for European integration. Balkan politicians hold the EU responsible for the lack of progress on the path to the EU membership, which dispirits supporters of further pro-Western reforms (Szpala 2017). At the same time, the economic slowdown, exacerbated by the austerity policy imposed by the IMF and the EU, continues to deepen the legitimacy crisis of weak institutions. These coincidences reinforce anti-EU rhetoric while generating further political conflicts, in Macedonia, Albania and Kosovo, and triggering nationalist and authoritarian tendencies, as in Serbia (Barlett 2018). Serbs also stand out due to their negative attitude towards NATO, which is the aftermath of Belgrade's western bombing in 1999, and also due to their particularly positive, historically and culturally conditioned, attitude towards Russia.

## 4.2 Summary of the study

The analysis covered three decades of economic development of the sixteen states established after the collapse of the socialist system in Central and Eastern Europe (CEE) at the turn of the 1980s and 1990s. Most of them emerged as a result of the collapse of the Soviet Union, the Socialist Federal Republic of Yugoslavia (SFRY) and the Czechoslovak Socialist Republic (CzRS). Diversified reactions to these processes in individual countries led to the emergence of three CEE subregions, distinguish by different cultures and political systems, as well as international links. They include: 1) the Visegrad Group countries (the Czech Republic, Hungary, Poland, Slovakia – the V4); 2) the Baltic Republics (Estonia, Lithuania, Latvia) and 3) Southeast European countries (SEE) which belong to the EU (Bulgaria, Croatia, Romania, Slovenia) and Western Balkan countries aspiring to acquire their EU membership (Albania, Bosnia and Herzegovina, Northern Macedonia , Montenegro, Serbia). The criteria for distinguishing these subregions result mainly from the historical distinctiveness of their political and economic development, their institutional and social specificity and of their geographical location. In this context, the main economic partners for the Baltic Republics are the Nordic states, the Russian Federation and post-Soviet states, for the Visegrad countries – Germany, and for the SEE countries – Germany, as well as Italy and neighbouring countries.

Owing to the lower than in Western Europe level of development and their mostly small scale in terms of size and population, external factors – the current balance of power, international policy and the economic conditions – play an important, and often decisive, role in systemic changes in CEE. Due to the fact that they entered political transformations during the height of globalization and European integration processes, the United States, international organizations (NATO, IMF, EU) and transnational corporations became, in addition to European powerful states, particularly significant for the region. In recent years, China has grown in importance (the 16 + 1 format, two Silk Roads project etc.); the Balkans (mainly Bosnia and Herzegovina) have been strongly influenced by Turkey, Russia and some Arab states as well.

Different definitions of security in international relations mean that close economic relations among the CEE countries do not always translate into their preferences in political and military relations. For example, Poland and Romania, strongly economically connected with Germany, in their security policy are entirely based on cooperation with the USA (not only within NATO), and Serbia, though distant from Russia, for historical and strategic reasons has particularly good political relations with this country, not unlike Hungary after 2010. By contrast, the Baltic Republics, although economically and culturally linked with the Nordic countries, due to their geographical location and small military security potential, are definitely pro-American.

At the beginning, Slovenia, the V4 countries and the Baltic Republics a little later were the leaders of political transformations in CEE. The common political platform for their actions was defined by the liberal democratic consensus of the power elite and the desire for rapid rapprochement with the West (with an intermittent exception of Slovakia). The process of EU integration supported by the US played the role of a key catalyst for transformation changes in most states. The membership of the countries of the region in the North Atlantic Treaty Organization and their accession to the EU became the most important manifestations of the institutionalization of such a direction of political transformation.

Most countries of Southeast Europe found themselves at the opposite pole of transformation. The breakup of the SFRY led to wars and ethnic conflicts in much of the Balkan Peninsula. Throughout the 1990s, these events had a regressive and destabilizing impact on the situation in the subregion, including neighbouring Bulgaria and Romania (where reforms were introduced erratically and with delay). Slovenia, which until 2007 remained the richest and most developed country in CEE, was a positive exception. It was also distinguished by the evolutionary introduction of market reforms and its specific version of capitalism.

Diverse links between internal and external factors meant that despite convergence trends resulting from integration with the EU, the CEE states create a mosaic of sometimes significantly different market economy variants. At the stage of accession preparations and early EU membership,

the following were distinguished: 1) the "Baltic capitalism" (close to the principles of neoliberal economics); 2) the welferistic model of the V4 countries (with greater social spending and trade-offs between market reforms and social cohesion); 3) the neo-corporate variant of Slovenia (multi-level rules of negotiation and dialogue, substantial social programs) and 4) the poorly crystallized, often changing SEE capitalism, such as "cocktail capitalism" of Romania.

The EU economic crisis, the diversity of the status of the CEE states (some of them belonged to the Union, others joined the euro area and still others are conducting accession negotiations) and different responses of governments to new political and economic challenges have modified the variants of capitalism in these four subregions. The most consistent reforms have been introduced in the Baltic Republics. They continue neoliberal economic policy with limited government intervention, tight monetary and fiscal policy, minor activities with little anti-cyclical features, austerity and internal devaluation by, among other things, reducing social benefits, employment and pay in the public administration. Part of this policy is creating a favourable regulatory environment for business, a flexible labour market and maintaining a small welfare state.

Changes in Hungary and Poland are evolving in another direction. For several years now, these countries have been implementing a partially opposite direction of political changes, which leads to disputes with the EU regarding, among other things, the separation of powers and the rule of law. They combine centralization of the economy with the "illiberal democracy" policy. Chosen in democratic elections populist leaders simultaneously run three policies: statist (development based on state-owned corporations), liberal (in the area of economic regulations and pensions) and paternalistic in the social sphere (with extensive social transfers and marginalization of social and civil dialogue). As the Czech Republic and Slovakia have not fundamentally changed their economic policy and approach to the political system, transformations in this field in Hungary and Poland have led to the diversity of capitalism also among the V4 countries.

Despite the development of different variants of capitalism, until the financial crisis of 2008-2009 in the EU and the Western world (including

the USA), some CEE countries were catching up with richer Western states relatively quickly. The dynamics of development stood out in the Baltic Republics (with Estonia at the forefront) and in the V4 countries, especially the Czech Republic, Slovakia and Poland. After the end of the wars in the former Yugoslavia and the introduction of market reforms, in most SEE countries there were positive prospects for economic development along with the possibility of accession to the EU (which, however, did not include the Western Balkans). The convergence between the member states motivated other CEE countries to enter into accession negotiations with the European Union, and then prompted some of them to seek accession to the euro area. This is considered as confirmation of institutional changes increasing the chances of dynamic economic development. Slovenia, Slovakia, Estonia, Latvia and Lithuania did this. Croatia and Bulgaria have applied to join the euro area, and Romania is preparing to do so. Hungary does not reject this possibility, at least not in the verbal sphere. At present, the Polish and the Czech authorities do not see the need for such actions. The economic crisis in the US and in Western Europe significantly slowed the rapprochement of the CEE countries with the level of development in the EU and questioned optimistic forecasts. Its aftermath became a catalyst for wider processes of economic destabilization and social disintegration, which led to the erosion of the liberal democratic consensus and to the widespread in the region belief in the neoliberal "market fundamentalism" under the Washington Consensus. The course of the crisis significantly reduced the legitimacy of liberal values and institutions, as well as changed the language of public discourse in the sphere of political and economic development, with a clear strengthening of currents and forces advocating centralization and a greater role of the state. In many Western countries (such as the USA, Great Britain, Austria or Italy) power was taken over by populist, radical and nationalist politicians. Some CEE states are ruled by leaders with authoritarian and Eurosceptic tendencies (Hungary, Poland, partly the Czech Republic), and the standards of democracy, attitudes to the rule of law and the faith in the strength of market mechanisms are eroding throughout region.

Approximately since 2010 (the Greek crisis), and especially since the middle of the second decade of the 21st century (Ukraine, Crimea and

Donbass, ISIS in 2014 and the great migration wave to Europe in 2015), CEE began to pay more attention to the negative aspects of political transformation and globalization. One of the dimensions of the discussion was reflection on the specificity of post-socialist capitalism. The EU crisis spread, inter alia, a critical look at the links between the countries of the region and transnational corporations and Western countries. What became visible, in addition to the benefits of approaching EU standards, were the negative effects of new economic dependencies, imitative innovation and the subordination of CEE to the more developed EU countries (in the sphere of division of labour, industrial relations, ownership of capital, distribution of profits, sales markets, employee migration, etc.) , especially in the V4 countries. The issue of Brexit also gave rise to such reflections (although it is too early for an adequate assessment of this process).

The conviction about the limitations and depletion of development strategies based mainly on cheap employees and foreign capital (as well as EU structural funds) became the common denominator of this reorientation. The dominant role of foreign investors has in many respects reduced the development autonomy of the CEE countries and has started to consolidate the model of a dependent market economy. Its continuation threatens to reproduce selective and dual development, in which highly productive companies controlled by foreign capital marginalize weaker domestic enterprises. As a result, even in those states that are economically successful, such as the V4 and the Baltic Republics, the crisis and the slowdown in growth have given raise to fears of the "middle income trap" and to the need to strengthen internal strategic, economic and social resources. Especially that further development in some CEE countries is limited by employee deficits, rising labour costs, economic emigration, aging of societies and the need to increase social outlays. These are circumstances that reduce the competitiveness of the economies in the region. The importance of new challenges and problems, such as climate neutrality, low-emission transformation or technological changes related to the transition to the next phase of civilization development is growing ("Digital Capitalism", Industry 4.0., etc.) Capital deficits and low innovativeness mean that in this respect CEE is significantly behind Western and Northern Europe.

The elaboration of new economic development strategies is also forced by geopolitical challenges in CEE. Russia's aggressive policy and the annexation of Crimea (partly a response to the growing influence of the USA and the West in that area) have made the security of the state a priority, especially in countries bordering Russia and Ukraine. Trade and technology wars between the US and China also extend the concept of security onto other areas of the economy, which gives the government policy a more national character and strengthens the role of the state.

The centrifugal tendencies in the EU interact in a similar way and are demonstrated in the form of protectionism, various concepts of "Europe of many speeds", with Brexit and other separatisms (in Catalonia, Corsica, Scotland etc.). The European Union is weakened by the growing differences of interest with the US which previously was a promoter of European integration, also in CEE. The weakening effectiveness of the EU is illustrated by the limited effects of the Eastern Partnership policy, especially the situation in Ukraine, as well as the freezing of accession negotiations in the Western Balkans. Post-crisis, and partly also post-transformation disappointment of societies in CEE has strengthened nationalist and Eurosceptic tendencies. This is reflected in the internal policies of some of the governments of the region, as well as in the controversy surrounding the policy of the V4 or of the Three Seas Initiative. They are a product of a departure from the liberal-democratic consensus, which has not been replaced by any other coherent development paradigm.

As a result, after three decades of political changes, the CEE countries face the dilemmas of redefining the rules of political and economic development. Although almost all of them approached the EU level of development after 2007, the Czech Republic, Slovenia and Estonia particularly stand out, reaching a threshold of between 80 and 90 per cent of the EU average of GDP per capita (they are also relatively most competitive and innovative). Slovakia, Lithuania, Latvia and Poland show high dynamics of development. The economic development strategy changes undertaken and implemented in the CEE have many common elements corresponding to the EU 2020 strategy and OECD recommendations. They emphasize the need to strengthen internal sources and resources of development (in particular, financial capital), to increase

the role of science and technology, to improve the quality of education, to increase the participation of industry in the economy and to provide greater inclusiveness of the labour market and social policy. The governments in the region are taking steps to optimize and seal tax systems, which increases their ability to support development through public policies. So far, however, there is no indication that any CEE country would be able to effectively depart from the strategy based on the key role of foreign investment in the economy and overcome the limitations of the dependent market economy model in relations with leading EU states.

This remark also applies to Hungary and Poland which implement to the greatest extent the policy of state interventionism – including reversing privatization – aimed at state capitalism and limiting the role of foreign capital in the economy. The multidimensional crisis of the EU, reaching the axiological layer, introduced political polarization in the Member States (in CEE as well). It also strengthened the tendency to institutional differentiation of countries, which results from different responses to new political, economic and civilization challenges. In the V4 such trends are manifested by system changes taking place in Hungary and Poland, which have a different direction from those implemented in the Czech Republic and in Slovakia, and even more so from those of the Baltic Republics. They make some countries of the former SFRY (Slovenia, Croatia) be considered similar to the V4 countries. Hence, the term "patchwork capitalism" tends to be used in reference to most CEE countries to describe the coexistence of institutions taken over from various Western economic orders (Anglo-Saxon, Mediterranean, continental) that overlap the heritage of a centrally planned economy and systemic transformation.

In addition, the latest technological changes are beginning to undermine the current competitive advantage model even of traditional industrial powers, such as Germany. These are circumstances that again pose the problem of both possible economic development strategies and the optimal model of capitalism in the CEE countries. The debate on this subject has already been conducted, both in the political, academic and expert dimensions. There is no new consensus yet, but one thing seems obvious: relying only on market forces, in a weak state, is inefficient and limits development. The basic problem and controversy are rather about the

proportions between the market and the state to be included in the new system.

**Table 1. Variations of capitalism in 16 countries of Central and Eastern Europe**

| The Visegrad Countries | | |
|---|---|---|
| | early transformation period | a system changing-landmark |
| Czech Republic | radical reform to neoliberal market economy combined with neo-corporatist institutions (like the tripartite consultation), social dialogue and egalitarian social policy | accession to the EU in 2004, continuation of earlier economic policy, weakening neo-corporate institutions and maintaining egalitarian social policy |
| Hungary | initial gradual approach changed in 1995 to neoliberal market economy, speedy institutional and economic development based on FDI, the highest share of exports and imports as % of GDP on CEE countries, premature welfare state with growing budget deficit was consolidated | accession to the EU in 2004, the 2008 crises, after the takeover of power by Viktor Orban in 2010, an increase in the centralization of power towards state capitalism and authoritarian rule ("illiberal democracy"), combines the priority of national capital accumulation with the crony model of capitalism and relative extensive social transfers |
| Poland | an immediate neoliberal "shock therapy" combined with neo-corporatist institutions, relatively generous welfare state, but strict conditions for social assistance | accession to the EU in 2004, since 2015 creation of autocratic a new variant of developmental state based on state-owned companies, centralization of power and great social transfers, with some signs of crony capitalism |
| Slovakia | radical program of reforms was unacceptable for the Slovaks, retention of neoliberal reforms after the collapse the of Czechoslovakia by the Meciar authoritarian and populist government, subsidizing | after the fall of Meciar autocratic government in 1998 with its low levels of unemployment and inflation and maintenance of social security net, a shift towards neoliberal economic policy, by |

| | | |
|---|---|---|
| | the public services sector and social transfers | liberalizing the labour market and limiting transfers of social care, accession to the EU in 2004, joining the euro area in 2009, generous but strict conditions welfare state |
| **The Baltic Republics** | | |
| Estonia | neoliberal market economy, in many respects similar to Anglo-Saxon capitalism (except for the capital market) with small welfare state | continuation of earlier economic policy, accession to the UE in 2004 and joining to the euro area in 2011, new priority for digitalization and business innovation ("Digital Republic"), with leadership role in this respect in the whole region |
| Lithuania | following the example of Estonia,<br>but slightly less economically neoliberal in economy | continuation of earlier economic policy, accession to the EU in 2004, joining the euro area in 2015 |
| Latvia | as above | continuation of earlier economic policy, accession to the EU in 2004, joining the euro area in 2014 |
| **The South East European States** | | |
| Bulgaria | Chaotic political situation and slow pace of economic transition, a stable government was not formed until 1996, paternalism, cronyism and organized crime destroyed this model of capitalism | in 1997 new government was committed to liberal reform, large state corporations were privatised to foreigners but the weakness of the state reduce level of welfare services, reforms enforced during the accession to the EU in 2007, gradual raising of standards of public administration, rule of law and economic management (anti-corruption programs) related to efforts to enter the euro area |
| Croatia | war after the collapse of Yugoslavia distorted the entire economic and | banking system crises in1998, death of president Tudman in |

| | | |
|---|---|---|
| | political transformation, the authoritarian regime of president Tudman used the economic transformation to built his political clientele, the welfare system and the structure of social expenditures were politicised but relatively extensive | 1999, neoliberal reforms enforced during the accession to the EU in 2013, continuation of reforms related to entry into the eurozone, as in Bulgaria and Romania |
| Romania | state's weak public policy and public administration without a clear concept of reforms have produced "cocktail capitalism", state-centered, paternalistic and corrupt system with minimalist welfare state | neoliberal "shock therapy" in 1997, reforms enforced during the accession to the EU in 2007, continuation of reforms related to entry into the eurozone, as in Bulgaria and Croatia |
| Slovenia | the most developed post-socialist country with the best overall starting conditions, was initially a gradual approach to market reforms, strong state involvement in economy, model coordinated market economy in the Austrian style with generous welfare state, relatively high social protection and social partnership | in 2004 new government introduced neoliberal reforms, started big privatization, accession to the EU in 2004, joining the euro area in 2007, erosion of neo-corporatism but social protection and social partnership still has a relatively great role than in the Visegrad countries and is the highest among the post-socialist states |
| **The Western Balkans Countries** | | |
| Albania | very different environment compared to other CEE countries, after self-made isolation, one of the most centralized command and autarchy economy, very high level of corruption, organized crime and clientelist networks, weak state institutions and relatively rudimentary welfare state | in 1997 several financial institutions went bankrupt, which forced government to initiate economic and institutional reforms, but they are very slow and superficial, reforms also strengthen and accelerate progress in accession negotiations with the EU (use of structural funds, common market, etc.) |
| Bosnia and Herzegovina | military conflicts in former Yugoslavia led to the extreme instability in the whole region and the pursue of nationalistic and inward-oriented policies, the | post-conflict reconstruction in early 2000, but rather mixtures of economic and social reforms have emerged in which institutional configurations are |

| | | |
|---|---|---|
| | political events of the 1990s have postponed many of the economic reforms of the transition to a market economy (the "lost decade" compared to other CEE countries) | often not complementary or compatible, such variants of capitalism are sometimes called "hybrid economic models", are still forming, they are in *statu nascendi* |
| North Macedonia | as above | as above |
| Montenegro | as above | as above |
| Serbia | as above, but the authoritarian regime of president Milosevic strengthened the informal economy as an important factor in economic development, including the shadow economy and criminal activity, which is sometimes qualified as the Balkan model of capitalism | as above, the end of the Milosevic regime in 2000 led to the implementation of important economic reform, but the economic crises 2008-2010 has pointed to some of the structural weaknesses of the model applied in CEE based on credit-driven growth and the resulting high dependence on foreign capital inflows, a new and more active role of the state will be necessary |

Note: Almost all CEE countries since the late 1990s are (with a partial exception for rich Slovenia), to a different extent, considered a dependent market economy due to the model based on FDI, also driven by low wages, a large share of foreign investors in enterprises ownership, relatively low position in value chains on the international market and exports mainly to EU-15 countries (starting from Germany).

# Appendix 1

## Annex 1. Some economic indicators of the CEE countries in the early period of post-socialist transformation.

### Table 1. GDP in selected CEE economies, 1989-1998.

| Country | Cumulative GDP decline to the lowest level (1989=100) | The year of the lowest GDP | Cumulative GDP growth since reaching the lowest level | Average growth rate since reaching the lowest level of GDP |
|---|---|---|---|---|
| Albania | 39.9 | 1992 | 43 | 6.3 |
| Bulgaria | 36.8 | 1997 | 4.0 | 4.0 |
| Croatia | 37.7 | 1993 | 30.8 | 3.1 |
| Czech Republic | 15.4 | 1992 | 12.8 | 2.0 |
| Estonia | 36.4 | 1994 | 25.7 | 4.3 |
| Lithuania | 40.8 | 1994 | 9.8 | 4.5 |
| Latvia | 52.8 | 1993 | 17.0 | 3.0 |
| North Macedonia | 46.6 | 1995 | 7.4 | 2.5 |
| Poland | 13.6 | 1991 | 42.6 | 5.2 |
| Romania | 26.7 | 1992 | 3.4 | 0.7 |
| Slovakia | 24.7 | 1993 | 32.9 | 5.7 |
| Slovenia | 20.4 | 1992 | 25.4 | 3.8 |
| Hungary | 18.1 | 1993 | 16.3 | 3.0 |

Source: Neneman 2000, pp. 24-25.

**Table 2. Stabilisation programs and inflation in selected CEE economies, 1989-1998.**

| Country | The stabilisation program starting date | Inflation before the stabilisation program | The largest annual inflation | The year of the largest inflation | Inflatio n in 1998 |
|---|---|---|---|---|---|
| Albania | August 1992 | 293 | 237 | 1992 | 8.7 |
| Bulgaria | February 1991 | 245 | 579 | 1997 | 1.0 |
| Croatia | October 1993 | 1903 | 2585 | 1989 | 5.3 |
| Czech Republic | January 1991 | 46 | 52 | 1991 | 6.8 |
| Estonia | June 1992 | 1086 | 947 | 1992 | 4.5 |
| Lithuania | June 1992 | 709 | 1162 | 1992 | 2.4 |
| Latvia | June 1992 | 818 | 1162 | 1992 | 2.8 |
| North Macedonia | August 1994 | 248 | 1780 | 1992 | -2.4 |
| Poland | January 1990 | 1096 | 640 | 1989 | 8.5 |
| Romania | October1993 | 314 | 295 | 1993 | 40.6 |
| Slovakia | January 1991 | 46 | 58 | 1990 | 5.6 |
| Slovenia | February 1992 | 288 | 247 | 1993 | 7.5 |
| Hungary | March 1990 | 26 | 35 | 1990 | 10.6 |

Source: Neneman 2000, pp. 28-29.

**Table 3. Initial conditions of transformations in selected CEE countries, 1989-1998.**

| Country | GDP *per capita* according to PPP (1989) | Contribution of the Comecon to GDP in 1990 | The share of agriculture in GDP | Share of GDP in foreign debt in the year preceding the transformation (%) |
|---|---|---|---|---|
| Albania | 629 | 102 | 26 | 36.9 |
| Bulgaria | 5740 | 15 | 11 | 50.6 |
| Croatia | 6919 | 6 | 10 | 74.7 |
| Czech Republic | 8207 | 10 | 7 | 12.2 |
| Estonia | 6475 | 27 | 20 | 0.0 |
| Lithuania | 1603 | 34 | 27 | 0.2 |
| Latvia | 5204 | 31 | 19 | 0.0 |
| North Macedonia | 3720 | 6 | 12 | 0.0 |
| Poland | 5687 | 17 | 13 | 63.4 |
| Romania | 3535 | 3 | 14 | 2.9 |
| Slovakia | 6969 | 10 | 7 | 6.8 |
| Slovenia | 11525 | 5 | 5 | 0.0 |
| Hungary | 6081 | 10 | 14 | 64.0 |

Source: Neneman 2000, pp. 36-37.

**Table 4: Structural indicators in selected CEE transformation economies.**

| Country | Year | Share of the private sector in GDP (%) | Unemployment rate (%) |
|---|---|---|---|
| Albania | 1989-1994 | 26.0 | 15.5 |
| | 1995-1997 | 67.5 | 13.5 |
| Bulgaria | 1989-1994 | 22.5 | 8.8 |
| | 1995-1997 | 37.5 | 12.1 |
| Croatia | 1989-1994 | 27.6 | 12.5 |
| | 1995-1997 | 49.5 | 16.1 |
| Czech Republic | 1989-1994 | 31.9 | 2.5 |
| | 1995-1997 | 72.5 | 3.5 |
| Estonia | 1989-1994 | 32.4 | 5.4 |
| | 1995-1997 | 65.0 | 10.0 |
| Lithuania | 1989-1994 | 30.6 | 2.0 |
| | 1995-1997 | 60.6 | 6.4 |
| Latvia | 1989-1994 | 32.8 | 4.5 |
| | 1995-1997 | 61.0 | 6.9 |
| North Macedonia | 1989-1994 | 22.0 | - |
| | 1995-1997 | 45.0 | 34.0 |
| Poland | 1989-1994 | 40.7 | 12.8 |
| | 1995-1997 | 59.0 | 13.0 |
| Romania | 1989-1994 | 26.6 | 6.0 |
| | 1995-1997 | 47.5 | 8.4 |
| Slovakia | 1989-1994 | 31.3 | 7.1 |
| | 1995-1997 | 64.5 | 13.1 |
| Slovenia | 1989-1994 | 20.2 | 9.7 |
| | 1995-1997 | 42.5 | 14.1 |
| Hungary | 1989-1994 | 38.4 | 8.5 |
| | 1995-1997 | 65.0 | 11.4 |

Source: Neneman 2000, pp. 47-49.

**Table 5: Average national incomes in Europe.**

| % of European average income (Europe = 100) | | | | |
|---|---|---|---|---|
| | **1990** | **2000** | **2007** | **2017** |
| **EU15 (West)** | 116 | 116 | 113 | 110 |
| **V4** | | | | |
| **Czech Republic** | 84 | 62 | 71 | 76 |
| **Poland** | 44 | 53 | 56 | 70 |
| **Slovakia** | 63 | 50 | 65 | 75 |
| **Hungary** | 63 | 53 | 61 | 65 |
| **Baltic states** | | | | |
| **Estonia** | 63 | 52 | 75 | 77 |
| **Lithuania** | 65 | 41 | 66 | 77 |
| **Latvia** | 64 | 32 | 56 | 61 |
| **Southeastern Europe** | | | | |
| **Bulgaria** | 43 | 32 | 41 | 53 |
| **Croatia** | 67 | 50 | 61 | 59 |
| **Romania** | 50 | 37 | 48 | 60 |
| **Slovenia** | 75 | 72 | 82 | |
| **Western Balkans** | | | | |
| **Albania** | 24 | 24 | 30 | 34 |
| **Bosnia and Herzegovina** | 9 | 28 | 30 | 33 |
| **Montenegro** | 63 | 39 | 44 | 49 |
| **North Macedonia** | 40 | 32 | 30 | 35 |
| **Serbia** | 48 | 24 | 32 | 35 |

Source: World Inequality Database, April 2019. p. 66.

# Appendix 2

Mihailo Gaijc

**Western Balkans: the reform laggards**[61]

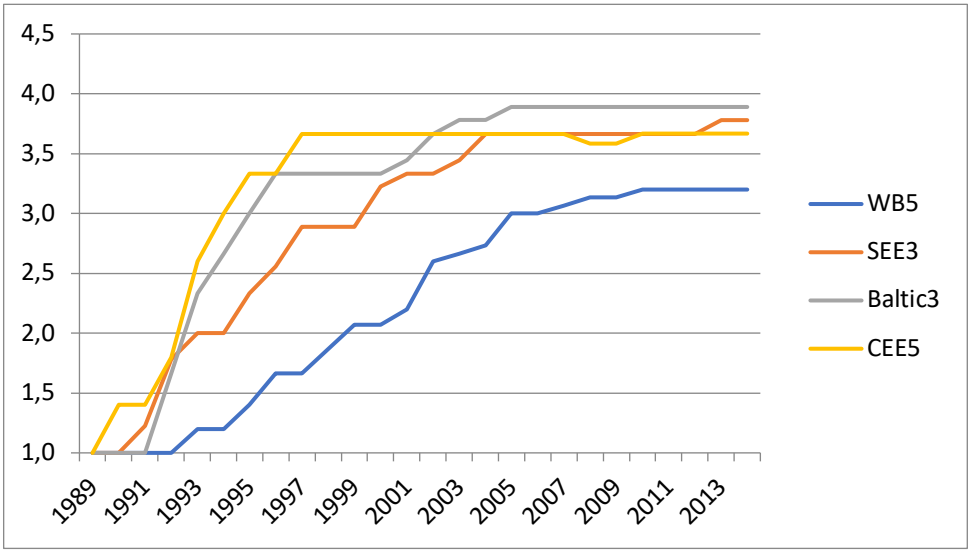
One of the most important characteristics of the Western Balkan economies (Serbia, Montenegro, North Macedonia, Bosnia and Herzegovina and Albania) is the relative slow process pace of reforms when compared to other CEE transition economies. WB countries were not significantly slower to undertake deep institutional reforms when compared to the most successful CEE or Baltics often championed as the forerunners in shock therapy type of reforms (such as, for example Poland, Czechia or Estonia) but also when less reform-oriented countries from the region (such as Bulgaria, Romania or Croatia) are taken into account.

When all the reform areas covered by the EBRD transition indicators are taken into account, Western Balkan countries, WB countries have been able to reach other CEE transition countries only in to areas: the price liberalization, and trade and foreign exchange. However, even in these two areas where a significant catching up process was recorded, the WB countries were able to improve their results only with a significant tardiness.

When EBRD transition score are taken into account, there is a clear trend which shows the Baltic and CEE countries as transition champions which implemented most reforms, and early in transition, followed by the SEE countries and with WB countries tailing at the end of the line.

[61] The data presented in this section joining together Slovenia and the countries of the Visegrad Group. The SEE3 in the tables denotes aggregate indicators for three countries (Bulgaria, Croatia, Romania).

**Large privatizations in transition economies**




Source: EBRD transition inidcators are estimated on a 1 – 4.33 scale.

1 Little private ownership.

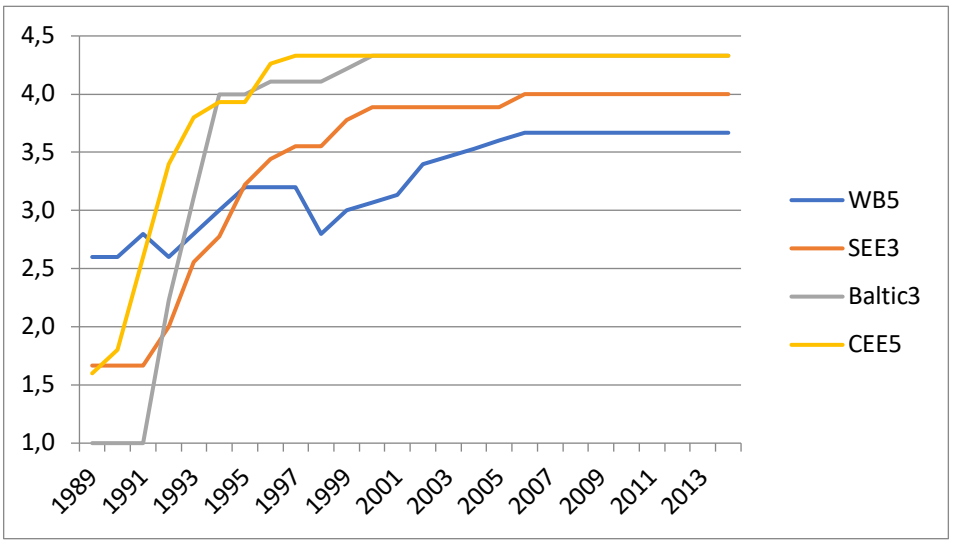
2 Comprehensive schemes almost ready for implementation; some sales completed.

3 More than 25 per cent of large-scale enterprise assets in private hands or in the process of being privatized (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possibly with major unresolved issues regarding corporate governance.

4 More than 50 per cent of state-owned enterprise and farm assets in private ownership and significant progress with corporate governance of these enterprises.

4+ Standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance.

**Small privatizations in transition economies**

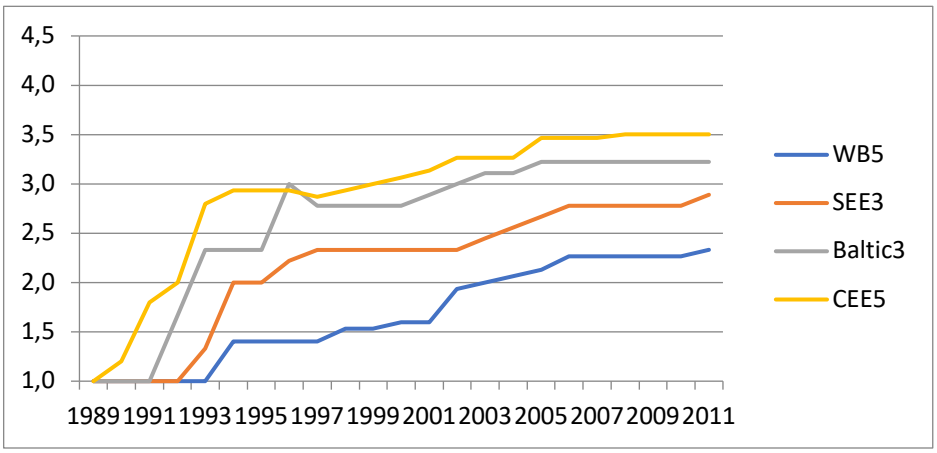



1 Little progress.
2 Substantial share privatised.
3 Comprehensive programme almost ready for implementation.
4 Complete privatisation of small companies with tradable ownership rights.
4+ Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.
Source: EBRD, Transition Indicators.

Privatization, both of small and large companies, has been less pronounced in WB countries than in other comparable economies. While small scale privatization in CEE and Baltic countries could have been considered mostly accomplished by 1995, WB countries had not reached that level of small scale privatization in 2014 (when the time series was interrupted due to EBRD methodology changes). In fact, WB countries in 2014 were in the same position regarding the small scale privatization as the Baltic were in 1994 or the CEE countries in 1993. This situation is even more pronounced having in mind the high score WB countries started – although this was all due to the high score of the Socialist Federative Republic of Yugoslavia, so it does not encompass Albania – Serbia, Montenegro, Northern

Macedonia and Bosnia and Herzegovina in the beginning of transition had the score of 3.0 in this segment, significantly above other countries (except for Slovenia and Croatia, who were also republics within Yugoslavia). The CEE countries surpassed this score only in 1992, and Baltics in 1993, taking them 3 or 4 transitional years more to reach this level; while their reached the maximum score of 4.3 (which put them in the same league with the other market economies in Europe) in 1996 and 2000 respectively, while not a single WB country reached that level in 2014. Similar situation is recorded in the large privatizations sector. Although here CEE and Baltics have a less stellar record, since did not attain the maximum score, they still managed to be significantly above WB countries during the whole observation period. While the first reform move in the WB region was initiated in Northern Macedonia in 1993, by that time the privatization of large enterprises in CEE and Baltics have already been initiated or even mostly conducted (as in Czechia, Slovakia and Hungary). Actually, WB countries were in 2014 on the same reforms place as the CEE countries were in 1995, Baltics in 1996 or SEE countries in 2000. This is a significant lag of almost two decades in this privatization aspect.

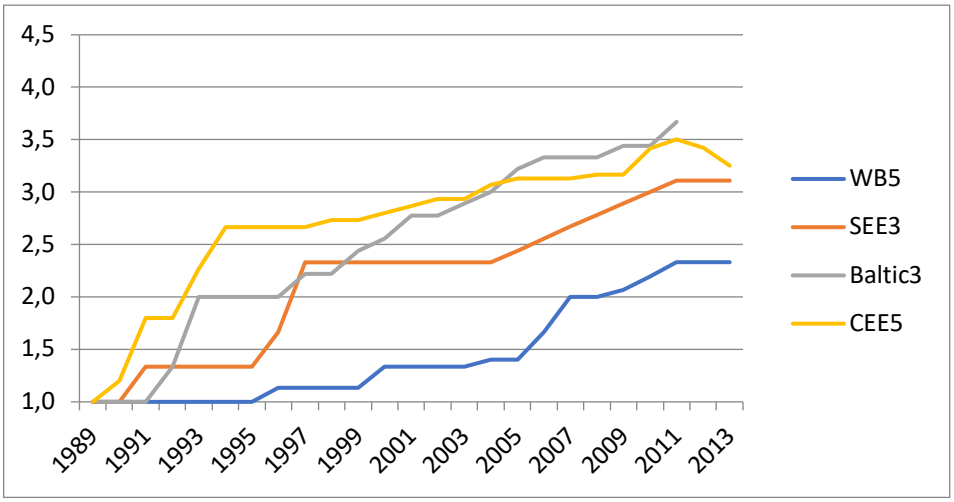
**Governance and enterprise restructuring in transition economies**




1 Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.
2 Moderately tight credit and subsidy policy, but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.
3 Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (for example, privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).
4 Substantial improvement in corporate governance and significant new investment at the enterprise level, including minority holdings by financial investors.
4+ Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring.
Source: EBRD, Transition Indicators.

Similar situation is also present in the governance restructuring. The WB countries in 2014 were on the same reform level that SEE countries are in 1997 and Baltics or CEE in 1993. Only somewhat smaller lag was recorded in the area of competition policy, since WB in 2014 were on the same reform level as SEE countries were in 2005, Baltics in 1999 and CEE in 1994.

**Competition policy in transition economies**

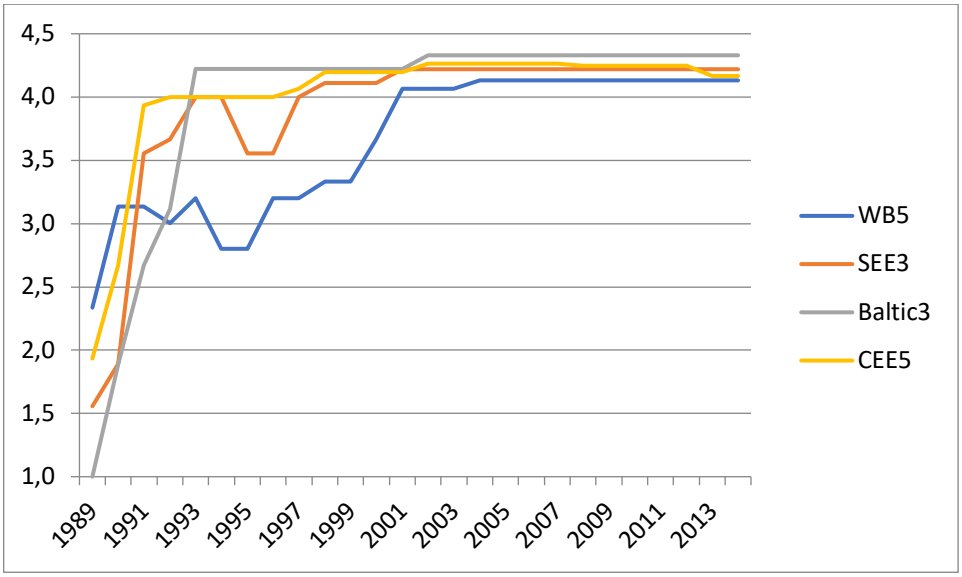



1 No competition legislation and institutions.
2 Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms.
3 Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions.
4 Significant enforcement actions to reduce abuse of market power and to promote a competitive environment.
4+ Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets.
Source: EBRD, Transition Indicators.

However, there are two areas in which transition indicators by the EBRD show that the WB were able to successfully close the gap between more advanced European transition countries. These are price liberalization and trade and foreign exchange, but even in these areas the closing of the gap came much later. Although starting from a better situation (Yugoslav score being 2.7 on a par with Hungary, while all other transition countries had much lower scores), price liberalization in the WB region halted after the initial reforms, and continued only after 2000. At the same time, almost full price liberalization in all other regions had already been achieved in 1993.

Only in 2001 did the WB countries reach the high level of price liberalization.

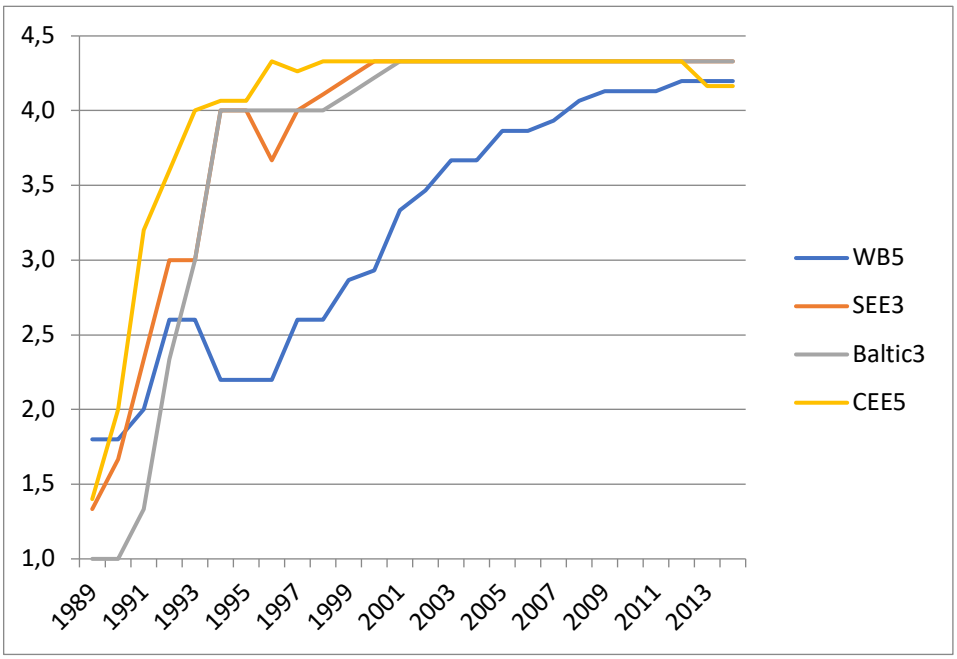
**Price liberalization in transition economies**




1 Most prices formally controlled by the government.
2 Some lifting of price administration; state procurement at non-market prices for the majority of product categories.
3 Significant progress on price liberalisation, but state procurement at non-market prices remains substantial.
4 Comprehensive price liberalisation; state procurement at non-market prices largely phased out; only a small number of administered prices remain.
4+ Standards and performance typical of advanced industrial economies: complete price liberalisation with no price control outside housing, transport and natural monopolies.
Source: EBRD, Transition Indicators.

Similar situation is present in trade and foreign exchange rate. While other transition economies took only a couple of years to reach the highest levels of reform score (within 3-4 years from the beginning of reforms), the WB countries put reforms to a halt for a couple of years, and when the reforms were continued it lasted longer than in other transition economies.

**Trade and foreign exchange system in transition economies**




1 Widespread import and/or export controls or very limited legitimate access to foreign exchange.
2 Some liberalisation of import and/or export controls; almost full current account convertibility in principle, but with a foreign exchange regime that is not fully transparent (possibly with multiple exchange rates).
3 Removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility.
4 Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services; full and current account convertibility.
4+ Standards and performance norms of advanced industrial economies: removal of most tariff barriers; membership in WTO.
Source: EBRD, Transition Indicators.

Yugoslavian countries a had probably the best possible starting point for a successful early transition, since their initial EBRD scores were the highest in CEE, meaning that it faced a significantly smaller set of reforms to be

implemented in order to establish a functioning market economy: small private companies were free to operate albeit with significant restrictions (they were mostly confined to services, and could not employ more than 10 people), trade with the Western bloc significantly more liberalized compared to the other socialist countries, agriculture was mostly relying on small private landholders etc. On the other hand, Albania was probably in the worst initial position, since the central planning system in that country was one of the most rigid in the whole sample of European transition countries, and the country was pursuing a self-imposed trade embargo, while other socialist countries could at least trade within the Comecon market and thus achieve some trade specialization.

However, political situation stalled the reforms in the Western Balkans. The dissolution of Yugoslavia through a civil and military conflicts, followed by wider civil unrest in the region, meant that economic reforms had to be postponed until some better time in the future. This is visible also in the fact that the countries in the WB region did not have the same pace of reforms: countries that did not take part in war conflicts with their neighbours in the early 1990-ies, such as Northern Macedonia and Albania, achieved a higher reform score and sooner, than Bosnia and Herzegovina or Serbia, countries which experienced the first-hand military destruction. Even when military conflicts in the region ceased, and reform impetus improved, the conducted reforms in many areas were slower than in more successful European transition economies or were more shallow, due to vested political and economic interests. On average, WB countries are one to two decades late in their reforms compared to their peers, which had a significant negative effect on the business environment in these countries and their economic development.

**FDI in the regional perspective: WB as a late destination**

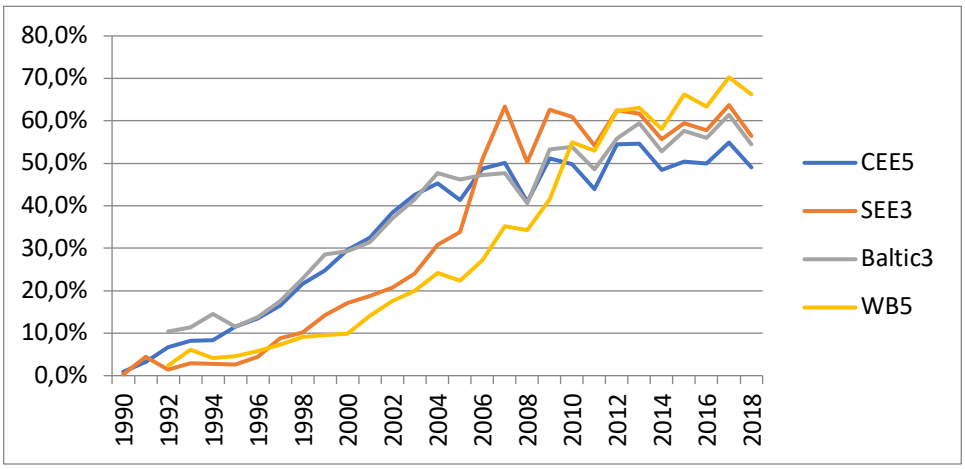
Foreign direct investments have been a major source of economic change and development in transition economies due to several factors. They introduced new technology and knowledge, which is very important having in mind the inability of socialist economies to innovate and implement new

technologies since the 1970-ies. Furthermore, the low level of local accumulation in socialist economies further strengthened the role FDIs had in investment and growth. On the other hand, this region proved to be a very interesting for FDIs due to several factors: new market penetration, acquisition of important local resources and above all, utilization of the significant pool of abundant skilled but cheap labour, compared to the western Europe. A metastudy on the connection of FDI and economic growth concluded not only that there is a statistically significant connection between FDI in transition economies and their level of economic growth, but also that the FDI impact was 1.86 times stronger in transition economies than in the rest of the world.[62]

The graph below shows that all transition economies in the CESEE (Central, Eastern and South-Eastern Europe (CESEE) region followed a similar path, increasing a growing stock of FDI. The countries that were slower in transition, due to political or economic circumstances, such as was, political instability or slow reforms, attracted FDIs more slowly than others: the SEE and WB countries were lagging behind the Baltics and CEE countries for a decade and a half after the initial transition, catching up only in 2005 (SEE) and 2010 (WB).

[62] Iwasaki, I., and M. Tokunaga. 2014. "Macroeconomic Impacts of FDI in Transition Economies: A Meta-Analysis." *World Development* 61: 53–69.

**FDI inward stock as % of GDP; unweighted regional average**




Source: UNCTAD database**.**

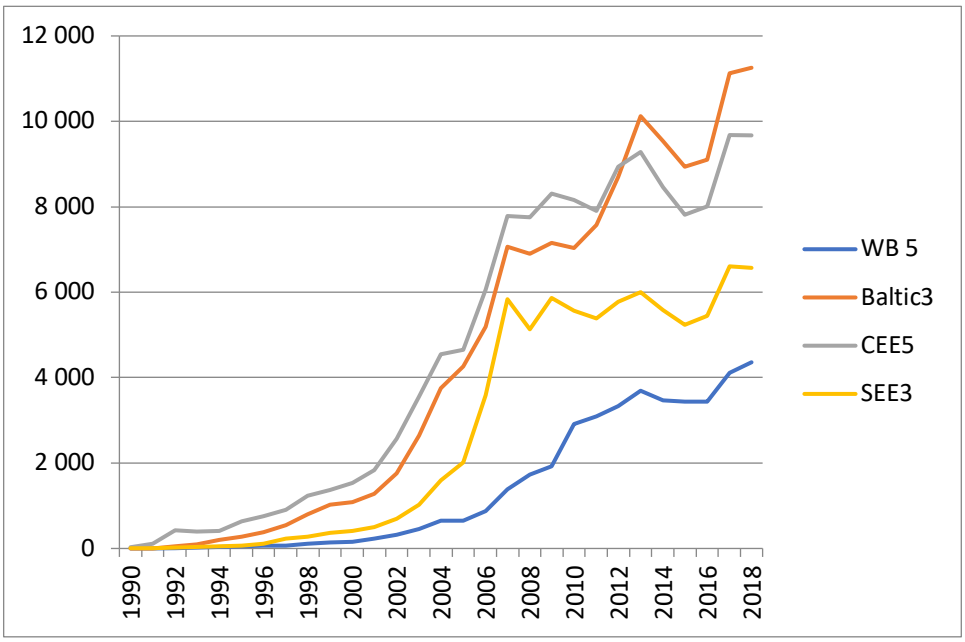
However, this somewhat artificial aggregation is covering up significant differences between countries in the same region. Montenegro, Serbia, Estonia, Bulgaria and Czechia host a significantly higher inward stock of FDI, than countries such as Lithuania, Romania, Poland or Slovenia. For example, Serbia alone host more than 60% of the total FDI stock in the WB region (44,1 billion USD of the total 72,3 billion). For the WB region, this means that FDI have not only been relatively late to come, the bulk of them coming in the years just before and after the financial crisis of 2008, but that they were also more concentrated than in other regions (the highest regional recipients such as Poland or Estonia attracted only 40%, only Romania surpassing this level reaching 50%). There is a large literature that estimated FDI determinants, and a significant section of this literature was dedicated to the transition economies.

Most important variables that impact FDI level were found to be the size of the source economy, the size of the recipient economy, geographical distance, institutional environment, quality of infrastructure etc. However, even when all these variables are taken into account, the WB countries are again showing a significant lower possibility to attract FDIs. This "Balkan

effect" has not yet been well explained (Estrin et al. 2014).[63] This is important to bear in mind, since the stock inward FDI as a % of GDP is not illustrating the low level of FDI inflows that were accommodated in the WB region. This problem is much better accentuated when GDP inflow FDI stock are presented per capita. With this metrics, the WB falls significantly behind other regions, even though the previous metrics showed them being on the same level.

[63] Estrin, S., and M. Uvalic. 2014. "FDI into Transition Economies." *Economics of Transition* 22 (2): 281–312.

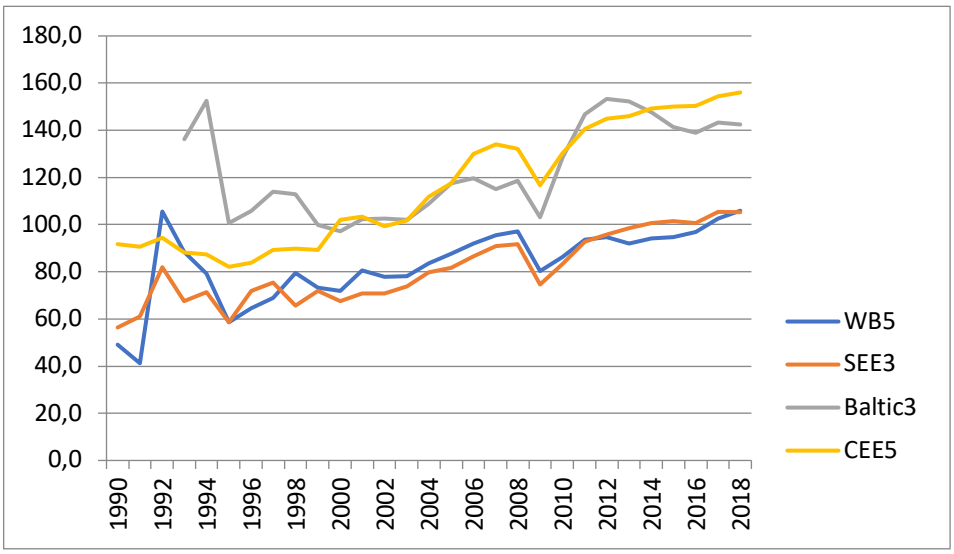
**Graph X: FDI inward stock in current USD per capita**




Source: UNCTAD database.

The WB region with this parameter show a decade and a half long lag behind CEE and Baltic regions, with the same level of per capita FDIs today as these regions had in 2004. In 2018, the WB5 regions had per capita foreign investments that were one half the CEE level, or just one third of the Baltic level.

**Graph X: Trade openness (exports and imports as % GDP).**




Source: World Bank, Word Development Indicators database.

This is also visible in the trade openness. Since the FDI are lower in WB countries, they have not been able to attract in great numbers multinational companies that for a part of global supply chains as other more successful countries have. For example, Slovakia has for years been the top per capita producer of automobiles, due to several international car manufacture companies operating in this country. Therefore, the WB and SEE regions remain less open to trade, compared to the Baltics and Central Europe.

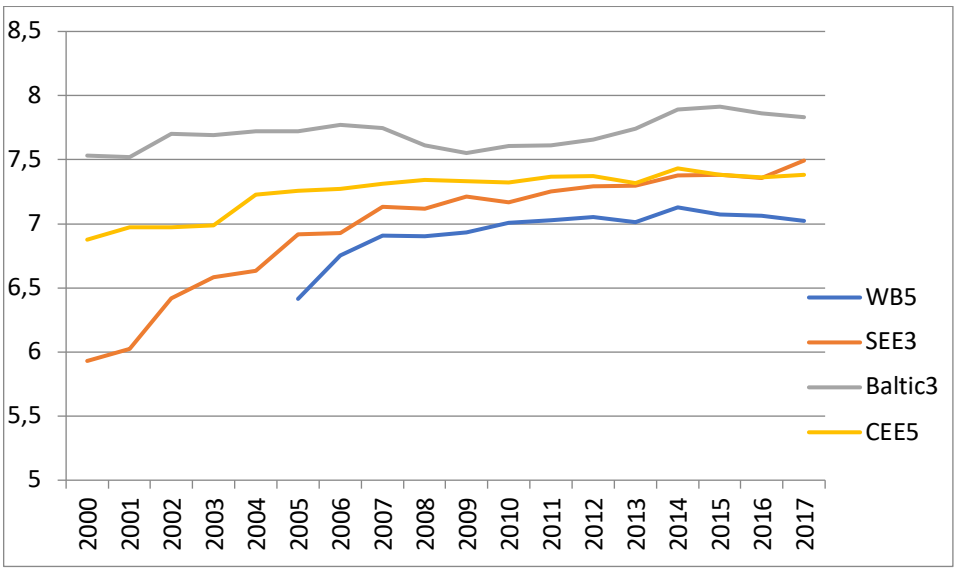
**Institutions in a regional perspective**

Although there are differences in institutional quality between countries in countries, a deeper analysis shows strong regional trends. There are many possible causes of regional particularities: shared culture and common beliefs, close political history, equal geographical distance from the European core and cross border knowledge sharing, all influence institutional development. All of this seem particularly important for European transition economies since they moved closer to their neighbors during the transition process in areas such as income levels, political and

economic institutions. As shown by Treisman[64], income level increased more in transition countries that had more economically advanced neighbors, their liberalism score of the EBRD would increase more if their European neighbors were more economically liberal at the off set of transition and democratic scores increased more if their close neighbors were more democratic.

These trends can be well discerned from the graphs below. The economic freedom – cornerstone of which are "personal choice, voluntary exchange, freedom to enter markets and compete, and security of the person and privately-owned property"[65] – are a good proxy for the open / close order dichotomy. It shows that B region is well below SEE and CEE countries that entered the EU, while the Baltics are on top.

**Economic Freedom in chosen regions, unweighted average**

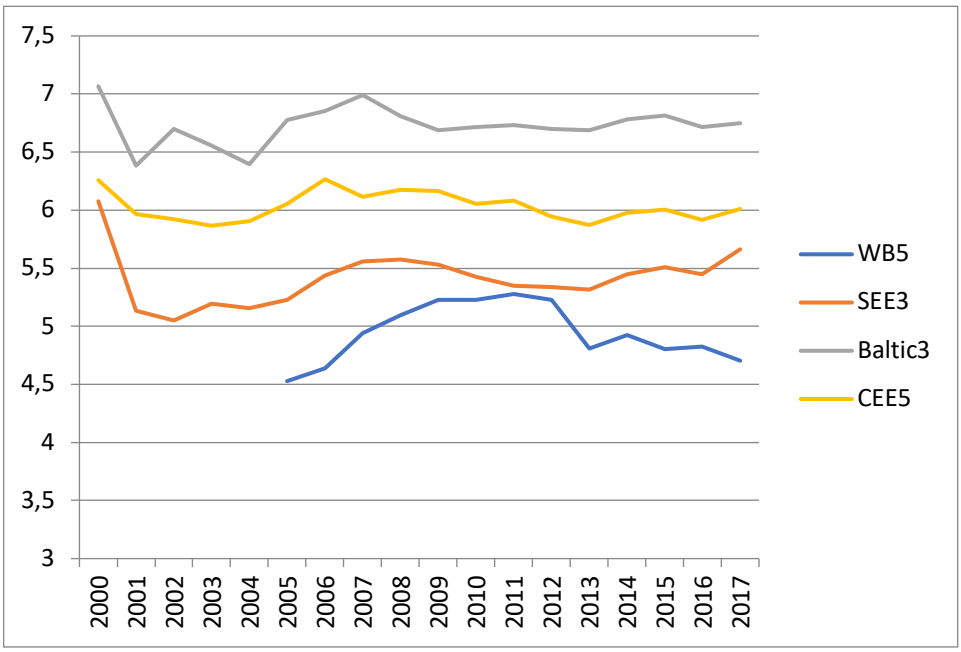



Source: Fraser Institute, Economic Freedom in the World.

[64] Daniel Treisman. *The Political Economy of Changes after Communism*. In: Aslund, A. Djankov, S. (eds). (2014). *The Great Rebirth: Lessons from the Victory of Capitalism over Communism*. Peterson Institute for International Economics.
[65] Fraser Institute, Economic Freedom in the World 2017.

The situation is even worse when just the segment of Legal System and Property Rights of the economic freedom is taken into account. While there is a trend that transition economies fare better than advanced countries in business regulation and size of government segments (more business-friendly legislation and lower taxes and social redistribution through state programs) they lag behind in the property rights segment. This is again attested, since transition countries show a lower score in the property rights segment than in the overall economic freedom score. But here, WB countries show even worse results since the gap between their and the Baltics, CEE or SEE countries actually increases.

**Legal System and Property Rights in chosen regions, unweighted average**




Source: Fraser Institute, Economic Freedom in the World.

## Summary

As EBRD transition data show, almost all transition countries followed a similar transition path: deep reforms in the first couple years of transition, followed by slower and weaker reforms steps taken afterwards. In most countries the transition path was liberalization (of prices and foreign trade) first, privatization second (beginning with small enterprises, followed by large ones) and establishment of market institutions third. The Western Balkan countries mirrored their counterparts form Central Europe, but the delayed transition and weaker reforms stemming for the complicated political economy of post-conflict societies resulted in a prolonged transition process, with transition in WB region lagging behind the CEE and Baltic states for almost two decades when EBRD transition scores are considered.

Institutional setting is one of the most important determinants of long-term growth, as shown by seminal studies of Douglass North, which was continued by Acemoglu and Robinson, whether it be described limited or open access order (North, 2009)[66] or as inclusive / exclusive institutions (Acemoglu & Robinson, 2012)[67]. In this light, having in mind the slow transition process and the limited scope of transition reforms, weak state institutions and strength of unconstitutional veto players (such as the veteran organizations, organized crime groups, hooligan football firms and Orthodox, Catholic and Islam religious organizations), it is not surprising that institutional environment in the Western Balkan regions is trailing behing that of the rest of the European transition countries. The long-lasting consequences of wars, political destabilization and inadequate conflict resolutions and the drain oo political energy resulting from it must also be mentioned as significant factor in the local political economy of reforms.

Due to all these issues, current political and economic problems are under stong influence of the institutional paths taken in the previous decades, both before and during transition. Political, economic and social problems remain widespread in the WB region due to high level of deindustrialization and jobless growth in the recent decades, coupled with low economic groth rates, making inequality and poverty rates high, while political instability in the domestic arena remains significant due to the poor history of solving conflicting social interests (including inter-ethnic), and the international arena due to many open diplomatic issues with countries from the region remain unsolved. The EU integration could provide a window of opportunity for reforms, and relieve many of these issues thorugh pressure for institutional development, and decrease in political instability, which would foster investments and growth, but current weak efforts on internal reforms of the WB countries and rising

[66] North, D., Wallis J., Weingast, B. 2009. *Violence and Social Orders*. Cambridge University Press.
[67] Acemoglu, D., Robinson, J. 2012. *Why Nations Fail*. Crown Business.

anti-enlargement bias in the EU institutions could make this process long or non-productive.

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