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guest edited by
Christian Schweiger
&
Ruth Wittlinger

The Internal Dynamics of the Enlarged Single European Market

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research articles

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Special Issue Editorial Foreword

The Internal Dynamics of the Enlarged Single European Market

Ruth Wittlinger
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IN CONTRAST TO POLITICAL INTEGRATION, ECONOMIC INTEGRATION HAS LARGELY BEEN considered to be one of the big success stories of the European Union (EU). Successive waves of EU enlargement to include countries from Central and Eastern Europe (CEE) in 2004 and 2007 have not only opened up new markets, they have also been considered as a highly effective tool to overcome the Cold War division of the continent and ensure stability and security in Europe. Further enlargement to this region and beyond is also on the cards with Croatia, FYR Macedonia and Turkey as official candidates for membership and Albania, Bosnia and Herzegovina, Montenegro, Serbia, Kosovo and Iceland all recognised as potential candidates for membership of the Union.

In view of the fact that a positive assessment is very often made from a Western European perspective, Christian Schweiger – co-editor and one of the contributors to this Special Issue – organised a number of seminars which paid particular attention to the recent internal dynamics of the enlarged Single European Market. Sponsored by the ESRC, the seminars were held at Durham University, the Centre for European Reform in London, the Institute of Social Policy at Warsaw University and the Centre of EU Enlargement Studies at Central European University in Budapest throughout 2008. What distinguished the series from other initiatives in the field was the fact that much emphasis was placed on ensuring that the participants consisted not only of academics but also included political elites and practitioners and representatives from business and other interest groups and that the key focus of the analysis were primarily, though not exclusively, the new member states in Central and Eastern Europe. In this respect the series particularly examined what impact the new member state economies are likely to have on the future shape of the Single Market.

This Special Issue consists of a small selection of the wide range of papers which were delivered at the seminars. It can thus only provide a snapshot. We have, however, tried to ensure that the choice of the papers included in this volume also reflects the fact that it was academics AND practitioners who contributed to the overall success of the series. Whereas the first five contributors (Schweiger, de la Porte, Funk, Allen and Aldred, Pogátsa) examine their various topics from an academic perspective, the last two papers (Galgóczi and Medhurst/Tortolano) provide assessments of the impact of the Single European

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Market on Central and Eastern European and wider EU member state economies and societies from a trade union perspective.

The article by **Christian Schweiger** examines the internal mechanisms of the Single Market arguing that the ongoing revision of the Commission's Single Market legislative framework indicates an inherent dilemma in the process of economic integration. Although in principle, member states agree with the ethos of free market competition in the Single European Market, he argues that in practice they continue to defend national economic monopolies and oppose a harmonisation of social policy standards. Schweiger comes to the conclusion that the review of the policy framework with its emphasis on a social agenda and the fact that the supervisory powers have been extended in the financial services sector is to be welcomed but in his view this does not add up to the change that is required in order to radically overhaul the ideology or internal dynamics of the Single Market. In his view the European Union should move beyond the Lisbon Strategy's emphasis on growth and jobs and focus on preserving the core common values which exist in the various economic and social models of the EU-27. Schweiger calls for a model which sees an active state facilitating open and dynamic market competition thus providing the backbone for a new European success story.

Caroline de la Porte looks at the specific example of the Czech Republic in order to establish the similarities and differences in the policy prescriptions of the OECD and the EU. In particular, she analyses the role that the OECD has played through its "Jobs Strategy" and the role the EU has played through its "European Employment Strategy". She examines how each of the two actors has assessed performance and adopted specific solutions. Furthermore, she examines how influential the policy models of the two actors have been. De la Porte comes to the conclusion that the OECD's approach has been characterised by clarity and consistency in meditative regulation with its de-contextualised inquisitive approach strengthening the message. Due to the continuing tension between strong economic versus weaker social interests and actors, the EU's method on the other hand has been unclear, ambiguous and even contradictory, according to de la Porte.

Lothar Funk's paper examines to what extent "flexicurity" provides an answer to the labour market trends and problems in the European Union's Central and Eastern European member states. According to Funk, "flexicurity" is a popular concept since it suggests a consensual approach which combines generous unemployment benefits and spending on active labour market policies with a flexible, employment-friendly labour market thus balancing the employers' needs for flexibility with the workers' needs for security. Funk's assessment is cautious. He concludes that it would be a risky strategy to promote only flexicurity in the new member states in Eastern and Central Europe. In his view, it would be much safer to embed it in the broader context of structural reforms.

The contribution of **Matthew Allen** and **Maria Aldred** to this Special Issue has two main aims. Firstly, it examines the key claim of the varieties of capitalism framework – that socio-economic institutions can help to shape comparative advantage – by applying it to some of the CEE countries. Secondly, it aims to add to existing assessments which have mainly relied on qualitative data and have focused predominantly on a small number of economic sectors. Allen and Aldred suggest that the evidence is inconclusive. Whereas some of the evidence supports the varieties of capitalism framework, much of it does not. This, they argue, raises important conceptual and methodological issues that need to be on the agenda of future research in this area.

Zoltán Pogátsa provides the second country case study in this volume. He examines the transition that Hungary has recently made from being the ideal type of a liberal transition

economy to being one of the laggards in the region. Acknowledging that factors such as the mismanagement by the political elites, policy inadequacy and populist policies have played a considerable part in this negative development, Pogátsa casts doubt on the sustainability of foreign direct investment based transition. In his view, the economic crisis has also highlighted the weaknesses of the foreign direct investment based dependent competitiveness model in other CEE countries. Optimistic assessments of the European Union's Eastern enlargement might thus yet prove to have been premature, according to Pogátsa.

As mentioned above, it was the explicit aim of the seminar series to establish a dialogue between academia and practitioners. **Béla Galgóczi** from the European Trade Union Research Institute for Research, Education, Health and Safety in Brussels therefore also looks at the issue of external financing such as bank loans, trade-related lending, foreign direct investment and portfolio investment and suggests that growth thus achieved has resulted in 'boom and bust' in the CEE member states rather than having created sustainable national economies. In his view the global economic crisis has made it particularly obvious how fragile the integration model, which prior to the economic crisis had helped the CEE to achieve a considerable degree of convergence towards the West, actually is. At the same time Galgóczi argues that economic integration has not been matched by deeper social, political and institutional integration and hence the crisis is being more painfully felt in the new member states.

The assessment of **John Medhurst** and **Enrico Tortolano** from the Public and Commercial Services Union is equally bleak. Arguing explicitly from a trade union perspective, they fundamentally question the current framework of economic policy within the European Union and discuss its negative effects on social cohesion. The two authors assert that the undemocratic nature of European policy-making institutions provides a key obstacle to progressive reform. Furthermore, they criticise the economic philosophy that guides the Lisbon Agenda as well as recent European Court of Justice decisions that have cemented this agenda even further. The paper goes beyond merely criticising existing arrangements, however, and ends with suggestions that would ensure a more strongly developed social dimension to European integration in the opinion of the two authors.

Finally, we would like to thank the ESRC for awarding us the funds which made it possible to establish the research network between academics and practitioners that became the basis for establishing the seminar series. In this respect we are extremely grateful to everyone who participated in the series and helped to organise individual events, particularly Simon Tilford at the Centre for European Reform in London, Maciej Dusczyk at the Institute of Social Policy at Warsaw University and Peter Balazs, Anna Reich and Zselyke Tofalvi at the Centre for European Enlargement Studies at the Central European University in Budapest.

Many thanks also to Eamonn Butler, Christian Kaunert, Sarah Leonard and the rest of the editorial team at JCER for all their help and support in compiling this special issue. The seminar series network will continue its research on the future of the Single Market and is currently preparing an application for UACES collaborative research network status.

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Beyond Growth & Jobs? Perspectives for the EU Single Market Policy Framework

Christian Schweiger
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Abstract
This article provides a critical analysis of the scope and the internal dynamics of the EU-27 Single European Market (SEM) policy framework, which is characterised by the intrinsic tension between application of a hard deregulatory strategy in the area of market liberalisation and the soft approach of the Open Method of Co-ordination (OMC). The latter acknowledges the diversity of national socio-economic models and reluctance of member states to transfer key areas of economic and social policy-making to the EU level. It instead concentrates on promoting best practice on the basis of policy exchange and learning and the overall framework targets set out in the Lisbon Strategy. The lack of commitment amongst member states towards applying the OMC and the Lisbon targets as a basis for national policy development illustrates that the Commission has yet to achieve a consensus amongst the EU-27 member states on common economic and social policy priorities. In the wake of the global economic crisis the SEM policy agenda therefore risks being reduced to a market liberalisation programme with waning levels of support from citizens and national administrations.

Keywords
European Union; Single Market; Open Method of Coordination; Lisbon Strategy

ECONOMIC INTEGRATION HAS ALWAYS BEEN AT THE HEART OF THE EUROPEAN PROJECT. However, in recent years the European Union (EU) has increasingly concentrated on the deepening of the Single European Market (SEM) due to the difficulties in reaching agreement amongst member states in the area of political integration. The SEM is now presented as the centrepiece of the EU integration process and is actively promoted by the European Commission. The increasing liberalisation drive which the Commission has adopted since the creation of the Common Market in the Treaty of Rome in 1957, particularly on the way towards the Single Market in the aftermath of the Single European Act in 1987, has repeatedly clashed with national resistance on the part of the member states. The tendency of member state governments to try to defend the competitive economic advantage of their domestic economies against Commission attempts to create a level playing field for trade and economic competition has been a constant feature of the Single Market. The Commission tried to solve this dilemma by developing a distinguished dual strategy, in which it combines the acceleration of market liberalisation with the acknowledgement of national competences in the area of social policies. This approach was represented in the original Lisbon Agenda which the EU adopted in March 2000 in response to the lack of progress in the completion of key areas of Single Market

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integration and noticeable weaknesses in the economic performance of individual member states. Lisbon was hence aimed at turning the EU into the "most competitive and dynamic knowledge-based based economy" by boosting economic growth through quicker market liberalisation and a focus on national job creation on the basis of setting overall employment targets (European Council 2000).

Due to the lack of progress on the part of the member states in pursuing these targets, the newly appointed Barroso Commission relaunched Lisbon in 2005 as a strategy on the basis of the recommendations made in the report issued by the High Level Group under former Dutch Prime Minister Wim Kok. The Kok report called on the EU Commission to concentrate on accelerating economic growth and job creation in the member states by monitoring their performance more rigidly. It also recommended the acceleration of the removal of national barriers towards market liberalisation in order to enhance competition and business activity (European Commission, 2004a: 17 and 24). The Commission subsequently intensified the monitoring of individual member state performances, both in the area of Single Market legislation and in the pursuit of the Lisbon goals. In the former area the Commission has strengthened its "hard" approach of implementing Community legislation and removing national legislative barriers on the basis of compulsory EU directives. Here the Commission has implemented a tight monitoring regime on the basis of scoreboards and a "naming and shaming" strategy, which ultimately results in penalising attempts of member states to delay or water down Single Market legislation. In 'soft' policy areas which affect the domestic welfare state tradition of member states, like employment and education, the Commission is avoiding attempts to force member states into a one-size-fits all approach of forced harmonisation. Instead, it has adopted the rather loose "open method of coordination", which encourages member states to develop their own domestic policy solutions by adopting elements of best practice from other member states through information exchange and policy learning (Büchs 2008: 25).

This article examines the internal mechanisms of the Single Market and argues that the ongoing revision of the Commission's Single Market legislative framework reflects an inherent dilemma in the process of economic integration. While member states have, in principle, signed up to the ethos of free market competition in the SEM, in practice, they continue to defend national economic monopolies and remain hostile towards attempts to harmonise social policy standards across the EU. This dilemma of trying to achieve consensus amongst an increasing variety of socio-economic models in the enlarged Single Market of 27 member states forces the Commission to pursue a rather complex and contradictory policy framework. The Single Market is thus dominated by a strategy of "negative" integration, where the Commission has successfully established its position as an enforcer of pro-competition framework legislation which ultimately removes national regulatory barriers. This increasingly affects core elements of domestic economic models, particularly in the crucial area of services, where national opposition against removing former public service monopolies remains substantial. While the Commission's role in developing SEM framework legislation and monitoring its implementation on the micro-level of national governance has grown substantially in recent years, it has not managed to weaken the role of the member states in safeguarding their veto power over the macro-level of strategic economic and social policy-making. The adoption of the OMC in the latter area therefore represents an approach which tries to achieve a workable compromise between the ambition to achieve at least a basic level of policy convergence between member states, who have shown little enthusiasm to pool their national sovereignty in this area (Wallace, 2005: 487). This consensual approach restricts the role of the Commission in the field of economic and social policy to the determination of the overall Lisbon targets in cooperation with the member states in the Council. The targets are aimed at promoting job creation through welfare reform and investment in research and education. Member states are subsequently encouraged to pursue these targets in their national policy

strategies. This policy mode has been described as a “two-level game” (Büchs 2007: 19). It adopts a variation of the concept originally put forward by Putnam (1988) and subsequently adopted by Moravcsik (1993) for his liberal intergovernmentalist analysis of the European integration process. Moravcsik argued that member state governments attempt to influence the policy agenda on the supranational EU level on the basis of a set national preferences which previously emerged on the domestic level in a process of liberal preference formation. With regard to the OMC, member state governments are thus pursuing a twofold strategy, in which, in the first instance, they attempt to influence the Commission in developing the OMC policy agenda by “uploading” their national priorities (Büchs, 2007: 26). In the second instance, member states tend to introduce those OMC policy recommendations which correspond with their domestic policy agenda and to ignore or water down those that do not (Meyer *et al.* 2007: 213). This leads to a “commitment-implementation” gap between the EU and the national level. It explains why the Commission has to repeatedly point the finger at the lack of collective member state commitment towards the OMC policy agenda under Lisbon. As the OMC is a clear departure from the classic integration method of gradually transferring national sovereignty to the EU level, it accepts differences in the domestic institutional constraints and national preferences amongst member states rather than trying to harmonise them (Borrás and Jacobsson 2004a: 202). The practice of “benchmarking” best performance and trying to encourage member states to achieve policy consensus on the basis of information exchange and learning is frequently hampered by the prevailing differences in the national institutional cultures in the economic, social and legal sphere (Arrowsmith *et al.* 2004: 323). The “soft” coordinative approach has thus failed to lead even to a gradual emergence of a common economic and social policy agenda in the Single Market which goes beyond pure market liberalisation (Meyer and Umbach, 2007: 115). As a result the SEM policy agenda is increasingly facing the risk to be perceived as a rather narrow deregulatory framework, which attempts to undermine existing pillars of national economic and welfare state traditions. This has lead the Commission to undertake a review of the Single Market policy agenda in 2007, in which it included reflections from national and supranational stakeholders and also from citizens across the EU (European Commission 2006a). The global economic crisis, following the credit crunch in the United States, has caused member states to push the Commission to focus more on the development of policy solutions beyond the core ‘hard’ deregulatory framework of the internal market mechanisms.

Jobs and growth centre stage: A critical assessment of the 2005 revised Lisbon Strategy

The original Lisbon Agenda, passed at the Lisbon European Council in 2000, had emerged on the basis of the realisation amongst member states that a consensus on further steps towards policy harmonisation in the social area, particularly employment, could not be reached. At the major intergovernmental conference in Amsterdam in 1997 the newly elected government of French prime minister Jospin had promoted the harmonisation of European employment policies but met the opposition of the German and the British governments, who preferred to strengthen coordination in this area. Jospin threatened to veto the treaty if it did not contain a commitment to joint efforts on the employment front (Umbach 2009: 182). This lead to the inclusion of an employment title in the Amsterdam Treaty and the development of a European employment strategy, based on the principle that the future of the social policy in the Single Market should develop on the basis of a loose intergovernmental coordination of best practices. This gave birth to the open method of co-ordination approach of Lisbon, under which member states are expected to follow overall targets developed by the Commission, while the individual implementation in the domestic context remains in the hands of their national administrations. The lack of

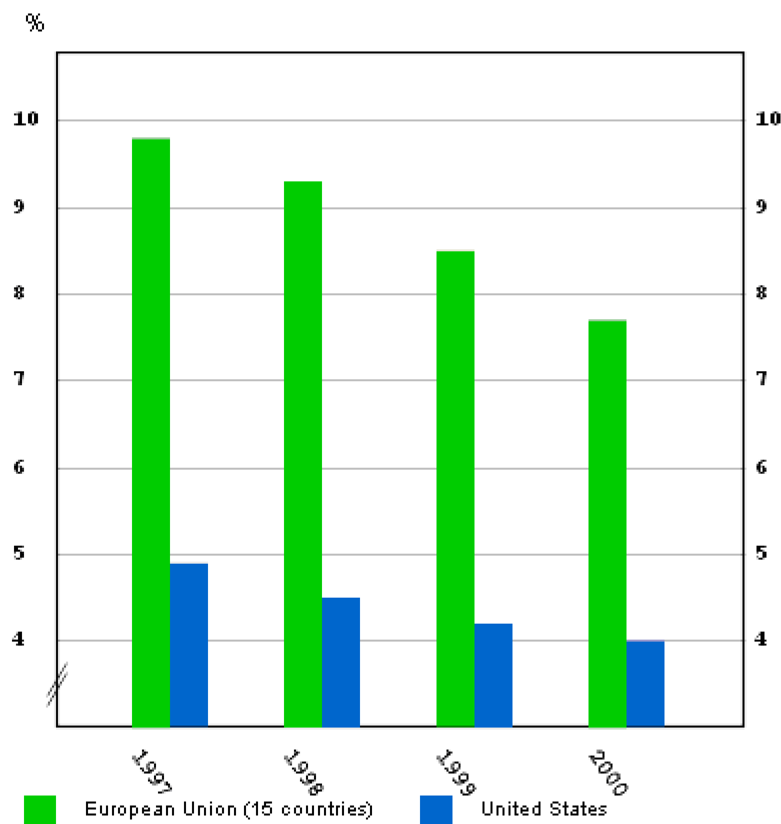
willingness to agree to the pooling of national economic and social policies, in spite of the common global economic challenges which all member states are confronted with, shows that the national level remains the main point of reference for policy development in the EU for both citizens and policy-makers. Member states therefore continue to be adamant to defend their "comparative institutional advantage", on the basis of the national institutional framework surrounding their economies. This leads to a variety of levels of economic success of individual countries in different contexts and at different points in time, most prominently outlined in the "varieties of capitalism" approach (Hall and Soskice 2001: 37). The absence of binding positive harmonisation of EU-wide labour market regulations and welfare standards contrasts unfavourably with the predominance of negative integration in the area of market liberalisation (Scharpf 1999). In contrast to the assumptions of neofunctionalists in the early days of the integration process that the Community would enter into a quasi-automatic spillover drive towards ever deeper economic, political and social integration (Haas 1968), the EU has witnessed a rather limited pooling of economic sovereignty in the Single Market area. This results from the fact that the aftermath of the Treaty of Rome was characterised by the failure of member states to substantiate the aim of accompanying the establishement of an integrated market with the harmonisation of national economic and social policies. In particular the disagreement over the extent of social integration was also one of the main reasons why the integration process as a whole slowed down considerably in the 1960s and 1970s (Leibfried 2005: 246). The issue of social integration was subsequently mainly considered to be "in a supporting role" for the hard economic considerations targeted at deepening market integration (Hantrais 2007: p. 21). The fundamental changes to the Community's *acquis communautaire* following the Treaty of Rome were characterised by the priority of accelerating the completing of the Common Market on the basis of a renewed impetus towards the deregulation of domestic legislative restrictions. In the mid-1980s the three largest member states the UK, France and Germany showed a clear correspondence in their interests to achieve rapid economic liberalisation in the European Community as a means to counter rising unemployment in their domestic economies (Moravcsik 1991: 51). The policy framework designed under the Single European Act consequently limited the Community's ambition in the area of social policy to the expansion of qualified majority voting in areas concerning the Common Market, with an intention to expand supranational powers on social issues in the future (European Community 1987). The SEA set the background for the most fundamental step in the integration process since Rome, the Treaty of Maastricht signed in 1992. Even Maastricht was nevertheless disappointing with regard to its achievement on the social front. The fact that the Social Protocol, which mainly gave the EU soft coordinating powers in promoting social protection and improved living and working conditions, was put in the annex of the treaty on the insistence of the British government, showed that this continued to remain a low priority area for member states. The Delors Commission was therefore forced to abandon any attempts to harmonise social policies and focused on the coordination of national policies through cooperation and policy exchange instead (Leibfried 2005: 249; Hantrais 2007: 30-31).

Those who had hoped that the tyding-up exercise at the Amsterdam IGC in 1997 would lead to a correction of the imbalance between market integration and the lack of social integration were bitterly disappointed. French initiatives to strengthen the harmonisation of employment policies in the EU were rejected by the British and German governments, and the compromise that was reached concentrated on loose policy co-ordination in the form of an EU employment committee. The purpose of the employment committee to encourage member states to adopt a method of mutual policy-learning on labour market reform and welfare reform (European Union 1997: article 137, paragraph 2) set the way for the best-practice benchmarking approach of the open method of coordination which was subsequently applied for the European employment strategy.

Maastricht had intensified the efforts towards the deepening of economic and monetary integration, with the decision to achieve Economic and Monetary Union by 1999 and the goal to develop a fully integrated Single European Market. The desire of member states to rapidly move towards the completion of Single Market integration was subsequently put into concrete form in the Internal Market Strategy of 1999. The basis for the IMS is a *hard* liberalisation strategy of national economies, based on directives which member states need to implement correctly and within an allocated timeframe if they want to avoid infringement cases against them at the European Court of Justice. Apart from the risk to be "named and shamed" in the regular implementation reports published by the Commission, member states hence face substantial financial penalties if they delay the opening of certain sectors of their domestic market to full internal and external competition.

As a result of the persistently high unemployment figures in many European countries throughout the 1990s, when the EU-15 average total unemployment rate fluctuated between seven and 10 per cent compared with less than five per cent in the United States **(Figure 1)**, the EU decided to combine the process of market liberalisation under the IMS with the policy framework passed at the March 2000 Lisbon summit.

Figure 1: *Average unemployment rate EU-15 and US (%)*



Source: EUROSTAT (2009)

The Lisbon process follows a logic which is build on the premise that rapid market liberalisation and enhanced open competition will ensure persistently high GDP growth

and employment rates across the Single Market. Lisbon promotes a social model for the SEM, which considers employment to be a precondition for the achievement of social cohesion in the societies of the member states (European Council 2000). The problem of this approach lies in the combination of a "hard" Single Market liberalisation programme, which is accompanied by a "soft" best practice benchmarking procedure in the area of employment policies, welfare state reform and also education and training. The Lisbon goal of creating a "knowledge economy", which is supposed to enable Europe to compete successfully with the rising economic powers in Asia (particularly China and India) in an increasingly fierce global economic environment, has been left under the mechanism of the open method of coordination. Member states are encouraged to exchange good practice in education and training based on the overall targets set by the Commission. One of its more prominent features is the "Bologna" process, which is aimed at gradually converging higher education qualifications between member states and to create a "European Higher Education Area (EHEA)" (European Union 1999).

The target-driven approach of the OMC grants member states a relatively large amount of flexibility with regard to the development of their domestic policies. As outlined at the beginning of this article, the lack of binding policy harmonisation in this area and the emphasis on policy development and implementation on the domestic level leads to a generally slow process of policy coordination with rather fragmented outcomes. At the same time, the various target-driven strategies under the OMC are often excessively ambitious in their timeframe and scope. Member state governments consequently rarely consider them as a framework for their national policy agenda. The relatively weak threat of being "named and shamed" in the case of non-compliance in one of the various progress reports which are issued by the Commission on a regular basis, is thus no substitute for compulsory common standards (particularly in the areas of job quality and welfare provision) as long as the internal dynamics of the SEM remain characterised by "a lack of 'ownership' of the Lisbon strategy by politicians, whose political support is mainly determined by their actions at national level" (Dierx and Ilzkovitz 2006: 41).

It is important to note in this respect that the EU applies the OMC in a number of different ways depending on the policy area. This ranges from the very clearly defined stability and growth criteria for the members of the eurozone to softer approaches towards the co-ordination of employment, welfare and education standards (Borrás and Jacobsson 2004: 192). It is frequently argued that due to the diversity of socio-economic models in Europe, the OMC offers the freedom for member states to pick and choose which measures they consider to be suitable for their own domestic reform strategies and "therefore make political action more practicable" (Borrás and Greve 2004: 333). Although the OMC gives member states a large amount of flexibility, it has yet to prove that it is a mechanism which is efficient in embedding market liberalisation with noticeable socially cohesive effects across the different societies of the currently 27 member states. The process of best practice benchmarking too frequently remains at the level of a display of vanity between member states with regard to best performance, which then leads to "an obsession with placings in 'league tables" to the detriment of the quality of outcomes" (Arrowsmith, Sisson and Marginson 2004: 321).

This explains why the EU considered it to be necessary to relaunch the whole Lisbon project in 2005. The lack of member state progress on achieving the Lisbon targets, particularly in the area of job creation (70 per cent employment rate by 2010 and 60 per cent for women) was highlighted in the 2004 Kok report, which provided an assessment of the efficiency of the Lisbon Strategy. The report warned member states that it was mainly due to their lack of "determined political action" that the targets of the original 2000 Lisbon Agenda had not been sufficiently met. The report yet also criticised Lisbon's

"overloaded agenda" and "conflicting priorities", which would make it harder to find support and consensus amongst member states (European Commission 2004a: 6).

This set the tone for the relaunch of Lisbon under the newly appointed Barroso Commission in 2005. The relaunch of Lisbon was based on the criticism made in the Kok report of an overburdened list of policy objectives in the 2000 Council agenda. The new strategy intended to set this right by concentrating on the priorities of "growth and jobs centre stage". It was noticeable that the revised strategy adopted a far less balanced tone than the original agenda and clearly referred to a neo-liberal economic viewpoint. This could be seen in its emphasis on the need to develop the Single Market into a "knowledge economy" where the everyone would have to take on greater individual responsibilities by accepting the need for lifelong education and training to be able to "climb up the productivity ladder and guarantee that overall our productivity grows quickly" (European Commission 2005: 13).

The neo-liberal trend of the Lisbon relaunch could be seen in the prioritisation of market liberalisation and the deregulation of national practices, particularly in the three areas of services, corporate governance and financial markets. The 2005 document underlines even more clearly that market liberalisation and unlimited competition must be the top priority for the EU in its pursuit of the Lisbon goals:

> Competition is of fundamental importance for the whole partnership for growth and jobs (...) Cutting unnecessary costs, removing obstacles to adaptability and innovation and more competition and employment friendly legislation will help create more conductive conditions for economic growth and improved productivity. (European Commission 2005: 19)

In the area of corporate governance, the new emphasis on deregulation was most obvious in the recommendations of the 2002 Winter Group report, which substantially influenced the direction of the EU corporate governance liberalisation strategy. The report proposed to drastically reduce the regulatory burden for businesses within the Single European Market modelled along the lines of US corporate governance. The report argued that the existing low-level regulatory environment in the US had shown that a laisser-faire and self-regulatory approach towards business operations across member state boundaries would be the best mechanism for a dynamic corporate environment. The Winter Group consequently proposed to implement the principle of the freedom of movement for companies and businesses across the SEM, with a minimum of interference from national or supranational regulations on the internal structure and the operation of companies (European Commission 2002). In the area of capital and financial markets, the Commission's Financial Services Action Plan adopted the principles set out in the 2000 Lamfalussy report on the regulation of European Security Markets, which recommended steps towards the elimination of "administrative, regulatory or other types of obstacles which in practice impede cross-border securities transactions" (European Commission 2000: 5).

The most controversial area of market integration in terms of its impact on national economic and social models is the integration of the services sector. Here the Commission had originally initiated a rather radical approach. The widely debated draft services directive that was developed under the leadership of the former Single Market Commissioner Fritz Bolkestein in 2004, intended to substantially weaken the control of member state authorities over the operation of foreign service providers in their country. The inherent "country of origin" principle of the draft directive intended to allow the operation of services in any member state on the basis of the legal background of the service provider's country of origin and the supervision by the national authorities in the

country of origin (European Commission 2004b: 9). The directive was widely considered as a legal framework that would undermine national service quality standards and the protection of individual consumer rights for the sake of a swift removal of all restrictions to the free movement of services. The general definition of a service as an "economic activity" and of public services as "services of general interests" (European Commission 2004b: 14) reflected an approach which fundamentally contradicted the traditional public service ethos of many member states. This was reflected in the level of opposition that emerged from the European Parliament and national governments, particularly France and Germany, whose leaders Schröder and Chirac warned that that the directive would "terrify" the people of Europe.

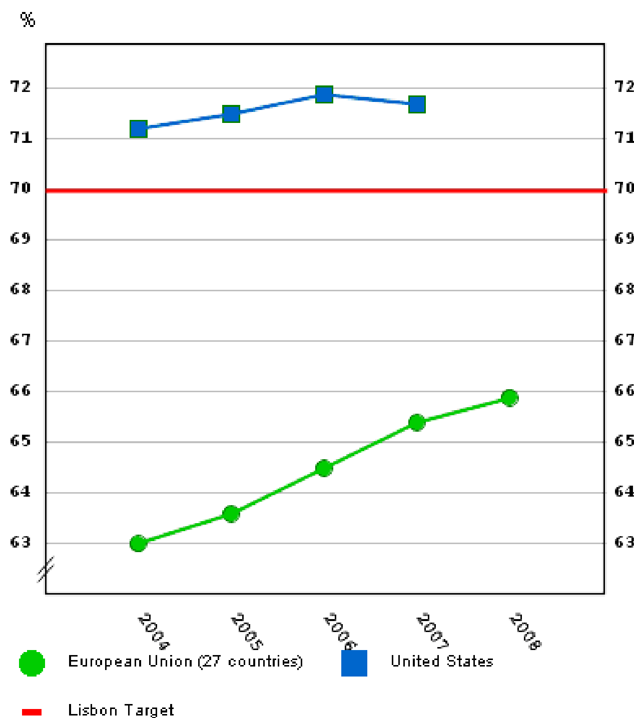
The compromise directive which emerged from these discussions was subsequently adopted by the Council and the European Parliament in December 2006, and should now gradually be implemented in the member states until the end of 2009. It was substantially toned down in terms of its scope and controversial content. Public services as "services of general interest" are generally excluded from the directive (Paragraph 17, preamble, Directive 2006/123/EC), and also the directive specifically does not apply to a number of services which are classified as "services of general economic interest", such as transport, postal services, healthcare, and also social services, such as housing and childcare (Paragraph 21-27, preamble, Directive 2006/123/EC). The directive also gives member states the right to initiate legislation which protects "the public interest, in particular in relation to social policy objectives" (Paragraph 71, preamble, Directive 2006/123/EC). This provision has proven to be a relatively powerful tool in the hands of member states which allows them to slow down and obstruct the liberalisation of individual service sectors. As Badinger and Maydell's study of the legal and economic impact of the services directive highlights, "member states keep a high degree of obstructive legislation, both in quantitative as well as qualitative terms, and tend to abuse their margin of discretion" (Badinger and Maydell 2009: 703). In this respect the study highlights that the European Court of Justice has been quite liberal in accepting member state justifications for overriding the general rule of non-discrimination against foreign service providers on the basis of the protection of public interests (Badinger and Maydell 2009: 699).

While the 2006 watered-down services directive seems to have found a compromise between a deregulatory liberalisation approach and the need to protect consumers (Barnard 2008: 323), it has nevertheless become clear that the Commission considers to work towards the removal of current restrictions to the full liberalisation of the services in the Single Market. The Commission continues to pursue the goal of integrating those service areas which are currently still exempt at a later stage. The recent high-level conference on the future of services in the Single Market, organised by the Commission and the Czech Council presidency, highlighted the need for member states to consider "the possibility of applying innovative tools (...) to sectors or aspects not covered by the Services Directive" (European Council 2009b: 4). The Commission drive towards full competition in the area of services is problematic because it affects the core of national social models in member states. The concept of *public space* is an integral part of European societies, and is embedded to a greater or lesser extent in all national economies, most noticeably in continental Europe and Scandinavia. Here the concept of an active state as a provider of high quality public services which are accessible to all citizens is based on the principle that "all citizens should have an equal right to participate in economic and social life" (Hutton 2002: 63). This is connected with the notion of the state as a protector against market forces by granting citizens essential social rights, such as good standards in the provision of healthcare, education and welfare. If the Commission continues to push towards the inclusion of the core public services which are currently excluded from the services directive, it risks provoking growing hostility towards the Single Market policy framework in many member states. This would occur against a background where

national governments are already slowing down the compulsory implementation of Single Market directives, particularly in the area of services, where the Commission had to introduce 18 per cent of all infringement proceedings in 2009 (European Commission 2009a: 21). It remains to be seen if the application of a "single regulatory model" can be effectively applied to the diversity of services that exist within the varieties of economies and social systems in the EU-27 (Badinger and Maydell 2009: 710).

The combination of the pro-competition and privatisation drive in the Internal Market Strategy with the loose coordinative framework of the OMC in the area of employment, welfare and education poses a long-term strategic dilemma in terms of efficiency and level of support in the member states. As Figure 2 shows, the European employment strategy did not manage to initiate a substantial boost to the average employment rate in the enlarged EU-27. Before the current global economic crisis, the average EU-27 employment rate rose from 63 to 66 per cent between 2004 and 2008 and still remains under the Lisbon target of 70 per cent. In contrast, the United States exceeded this permanently before the downturn of 2007/08.

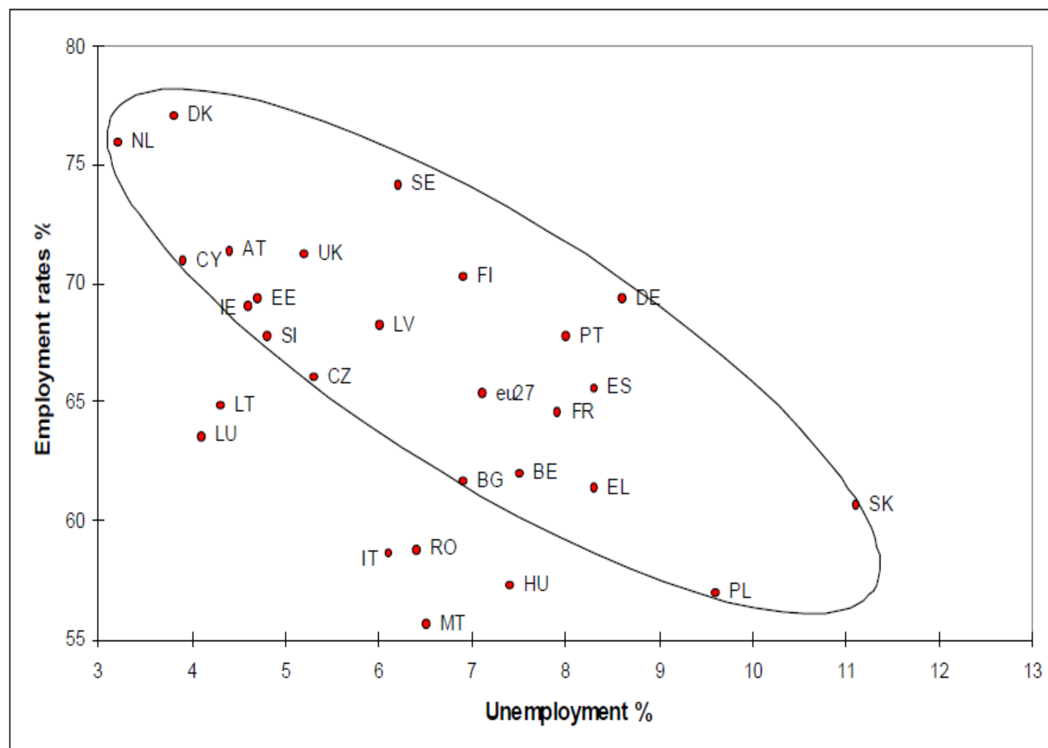
Figure 2: *Total Employment Rate EU-27 and US (%)*



Source: EUROSTAT (2009)

The latest Joint Employment Report for 2008/09 illustrates that the global economic crisis has made it even harder for most member states to meet the 70 per cent target. The diverse levels of success on the job front amongst individual member states is shown in Figure 3, which reflects national employment and unemployment rates in the EU-27 in 2007. It shows that only a small number of member states (the UK, Austria, Cyprus, Sweden, the Netherlands, Denmark and Finland) managed to reach or exceed the Lisbon target.

Figure 3: *Employment vs. Unemployment rates in the EU-27*



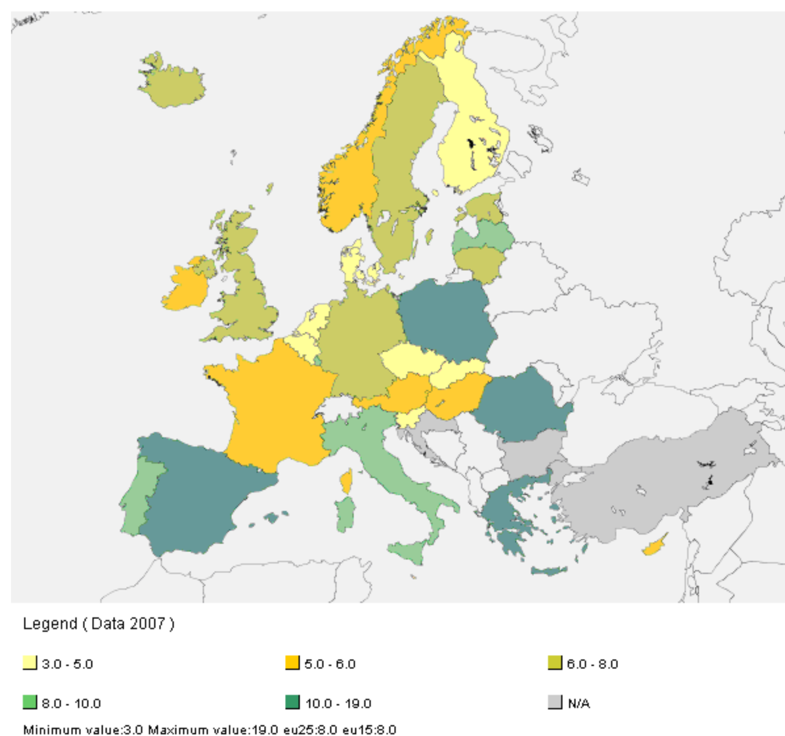
Source: European Council (2009)

This is significant because the employment figures for 2009/10 are likely to be substantially worse and they will occur on the basis of ongoing structural unemployment problems amongst young people and the lack of access to lifelong education and training opportunities in many member states (European Council 2009b: 6). The success of the OMC to coordinate national policy responses to the common challenge of unemployment therefore remains limited. This is acknowledged in the report and underlined by calls for the swift adoption of a new "flexicurity" approach in national employment and welfare state policies to counter the effects of the instability in the global economy. The concept of "flexicurity" is modelled along the lines of the "third way" welfare-to-work strategies which emerged in the late 1990s in the US under President Bill Clinton and the UK under New Labour. The European Commission defined it as a combination between 'flexibility and security on the labour market' in its 2006 report 'Employment in Europe', with a particular focus on the flexible employment contracts, active labour market policies and the reform of education, training and welfare policies (European Commission 2006b). Modelled along the lines the Danish employment model it is aimed at reintegrating people into the labour market who have previously been registered as long-term unemployed through welfare activation strategies and investment in education and training:

> The current economic context reinforces the need for efficient and effective, but especially integrated, flexicurity approaches in all Member States (...) Active inclusion policies and activation policies including labour market training will become more essential to avoid the long-term and persistent unemployment that may otherwise follow. (European Council 2009b: 3)

Under the harsh economic conditions of the global credit crunch, the combination of the deregulatory drive of the Single Market legislation and the promotion of employment as the ultimate strategy against poverty and social exclusion under Lisbon risks losing the support of the citizens in the member states, who seem to view the EU policy agenda as an destructive rather than protective intrusion into the national economic and social policy domain. The view of growing sections of the European public of the EU as a force that "has sufficient political muscle to destabilize existing national systems without the strength, in the employment sphere at least, to build alternative EU-wide systems of regulation" (Arrowsmith *et al* 2004: 6) played a major role in the rejection of the Lisbon Treaty (the former Constitutional Treaty) in public referenda in formerly pro-integrationist countries like France, the Netherlands in 2005 and the Republic of Ireland in 2008. The Irish also initially rejected the Nice Treaty in 2001, but this was mainly due to justified concerns that the impending enlargement towards new member states in Central and Eastern Europe would marginalise smaller EU-15 member states and cut them off from existing structural funds (*Daily Telegraph* 2001). The EU is hence confronted with a new debate on the need to enhance the drive towards economic competition and high levels of employment with a more coherent common social agenda which includes wider set of EU-wide legislative standards for workers in an increasingly integrated borderless labour market in the SEM. The increasing numbers of working poor in the SEM justify doubts about the Commission's assumption that high levels of employment will quasi-automatically result in high levels of social cohesion in European societies. The latest Eurostat figures (Figure 4) on the levels of people who are in work but are classified to be at risk of falling into poverty because they receive less than 60 per cent of the median income show that in 2007 only seven member states (Belgium, Czech Republic, Denmark, Finland, Slovakia, Slovenia and the Netherlands) had less than five per cent of people who fell into this category. The rest of the EU-27 countries had more than five per cent of their population in work, but at risk of falling into poverty, with seven member states showing levels above eight (Italy, Portugal, Latvia) or even 10 per cent (Spain, Greece, Romania, Poland).

Figure 4: *In work-at-risk-of-poverty rate (%)*



Source: EUROSTAT (2009)

The Single Market Review: A new direction for the SEM after the credit crunch?

The Commission responded to the controversy on the services directive and the growing unease about the direction of the Single Market in the member states by initiating a review of the policy framework in 2006. The review was based on the acknowledgement of concerns regarding "the social and environmental implications of market opening" (European Commission 2007a: 3). The review took place in the context of a public consultation which consisted of survey of the opinions of citizens, stakeholders and interest groups, particularly trade unions. Especially the latter had in previous years criticised the Commission for tailoring Single Market policies too much towards business interests, at the expense of ordinary citizens (European Commission, 2006: 10). In the wake of the review, the Commission has tried to move away from the narrow focus on growth and jobs and highlighted the need to encompass the Single Market into a "renewed social agenda for the 21st century", which takes into account the pressures on individuals as a result of the global economic crisis. Although the policy solutions and mechanisms the Commission proposes as part of the new social agenda are strongly based on Lisbon ("flexicurity" and OMC), a stronger focus on a formerly neglected aspects of the Single Market are noticeable. The 2008 Social Agenda explicitly takes up the concern of many trade unions that work on its own is, in many cases, not a sufficient means to lift people out of poverty:

> Even employment is not a guarantee against poverty: in-work poverty is on the increase with some eight per cent of employed people at risk of poverty. There are barriers and financial disincentives preventing or discouraging certain groups from gaining full access to employment, training, education, housing and health-care. (European Commission 2008a: 12)

The Commission has also started to address the issue of the quality of employment and work-life-balance more explicitly (European Commission 2008b), in response to the realisation that "citizens and stakeholders expect the EU to bring added value to social development" (European Commission 2008b: 15). It nevertheless remains hesitant to adopt a binding legislative approach in these areas and emphasises the continuing focus on the OMC which it claims has "helped Member States to develop a shared vision of social challenges" (European Commission 2008b: 16). The Commission yet plans to adopt a more streamlined "partnership approach" in this area, which focuses on "establishing and maintaining closer cooperation within and between the Member States, and with the Commission, in all areas that are relevant for the single market" (European Commission, 2009b: 3).

Under this approach, the Commission continues to respect the responsibility of the member states for the implementation of Single Market directives and OMC targets at the domestic level. At the same time, it intends to liaise more closely with national administrations in order to ensure that all member states work towards the effective implementation of Single Market goals (European Commission, 2009b: 3). As part of this, the Commission has recently become more active in proposing framework legislation in the employment area. It has proposed the establishment of a "European Works Council", which is aimed at "ensuring the effectiveness of employees' transnational information and consultation rights" and "increasing the proportion of European Works Councils" (European Parliament and Council 2009, preamble, paragraph 7) to ensure the improvement of job quality across the Single Market. The directive, which has now been adopted by the European Parliament and the Council, takes into account that in the increasingly integrated Single European Market "procedures for informing and consulting employees as embodied in legislation or practice in the Member States are often not geared to the transnational structure of the entity which takes the decisions affecting those employees" (European Parliament and Council 2009, preamble, paragraph 11). The

directive consequently determines that companies which operate in two or more member states, with at least 1,000 employees in total and at least 150 employees in each member state (Article 2, paragraph 1a and 1c), need to set up European Work Councils or at least "create other suitable procedures for the transnational information and consultation of employees" (preamble, paragraph 14). However, the directive also emphasises that the responsibilities of a European Work Council will be strictly limited to "transnational" issues (Article 1, paragraph 3) and is supposed to promote a "dialogue and exchange of views between employee's representatives and central management" (Article 2, paragraph 1g) between employer's organisations and trade unions in transnational business operations. The directive also highlights the subsidiarity principle, under which member states will be able to adapt any provisions made in the directive to the arrangements of their own national industrial relations systems, particularly in relation to the selection of employee representatives (Preamble, article 20). Part of the new concern for the quality of work and the protection of employees in the increasingly borderless labour market of the SEM-27 are attempts to protect new forms of work. The Commission has thus been more active in engaging with member states in preventing the social dumping of workers. It has issued a common position with the Council and the European Parliament on a directive on temporary agency work. The Commission proposal on this issue is aimed at achieving the equal treatment of all agency workers across the EU-27 on the basis of a flexible framework which would still allow "differing national practices as regards labour market conditions and industrial relations practice" (European Commission 2008d: 7). The Commission has also tried to strengthen the application of the directive on the protection of posted workers, particularly in the area of services. Here the Commission aspires to find a middle way between promoting the spirit of the free movement of services set out in the new services directive and the need to protect workers who are posted in service provider branches in other member states. The directive does not, therefore, go beyond the determination of a core set of minimum standards for posted workers, and puts its emphasis on creating "a level playing field as well as a legal certainty" for the free competition between service providers in the Single Market (European Commission 2007b: 3).

Apart from the showing greater concern for the social aspects of the Single Market as part of the renewed social agenda, the Commission was forced to take swift action in the area of financial services regulation. Here its strong support for a deregulatory *laisser-faire* approach was overtaken by the events of the global credit crunch, which revealed the fatal consequences of the application of low levels of regulation in the financial industries in the United States. The Commission responded to the crisis by introducing a new agenda of what it calls "regulatory repair" (European Commission 2009c: 5). Based on the recommendations put forward in the report issued by the High Level Group of financial experts (Larosière group) in October 2008, the Commission has developed proposals for a new regulatory framework for financial supervision in the Single Market. The Commission accepts that previous arrangements were not suitable to prevent the emergence of the financial crisis, but, at the same time, blames "serious failings in the cooperation, coordination, consistency and trust between national supervisors", rather than its own deregulatory agenda, as the main reason behind the events that occurred in the financial sector (European Commission 2009d: 2). It has consequently proposed a new regulatory framework for financial industries in the Single Market, which, although it strengthens the level of supranational supervision, mainly concentrates on ensuring the greater efficiency of national regulators. The new "macro-micro" financial supervision architecture consists of a supranational pillar represented by the European Systemic Risk Council (ESRC) and a network of national financial supervisors, the European System of Financial Supervisors (ESFS). The strong interaction between these two bodies is supposed to ensure the emergence of a "common supervisory culture" (European Commission 2009d: 5). The main burden of supervision in this framework falls on the ESFS, which will consist of the

Commission and three new supervisory bodies, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and a European Securities Authority (ESA). While national supervisors will remain in charge of the bulk of the supervision of domestic financial industries, the bodies of the ESFS will monitor these activities on the basis of a set of common supervisory standards. They will also have the right to interfere in case of a disagreement between national supervisory authorities. The ESFS authorities have an ultimate right to override national regulators if they the latter fail to settle their dispute (European Commission 2009d: 9-10). The main task of the ESRC, which will be headed by a president and contain the governors of all national central banks as members, is the supervision of the financial services industries on the macro-level with regard to their stability and efficient interaction with the global financial system. The ESRC will provide an early warning system for national regulators and the ESFS authorities of potential risky developments on the basis of reports and collective or individual recommendations for particular member states. The Commission does not envisage to give the ESRC powers to introduce legally binding recommendations (European Commission 2009d: 6:). The emphasis of the new framework rather lies on "binding cooperation and information sharing procedures between the 'micro' and the 'macro' levels" (European Commission 2009d: 14), which illustrates the similarity to the rather soft approach of the OMC in the social area.

Conclusion

The review of the policy framework, with the new emphasis on a social agenda and the rather limited extension of supervisory powers in the financial services sector, marks a slight change of emphasis in the overall direction of Single Market, but does not represent a radical overhaul of its ideology or its internal dynamics. The Commission neglects the promotion of binding standards in the social area, and the parallel deregulatory drive towards market liberalisation has lead to a situation where the scepticism about the pooling of further powers on the EU regulatory level has grown substantially amongst member state governments and citizens. Therefore, the Commission currently has a rather limited set of options available which it applies to overhaul the direction of the Single Market. The SEM review shows that the Commission now acknowledges that regulation is not necessarily always an efficient mechanism to ensure effective market integration:

> Regulation remains important in some areas, but it many not always be necessary or adequate, for instance where obstacles to the functioning of the single market are not primary legal, but mainly behavioural or institutional. (European Commission 2007a: 12)

Due to the lack of consensus between member states on the elements of a common European social agenda, the Commission also seems to be determined to widen the OMC approach to further areas, and to deepen its remit by enhancing the input of citizens and stakeholders through better information and dialogue with the aim "to help build consensus on single market issues" (European Commission 2009b: 4). It remains to be seen if this softer, and more inclusive, approach can indeed create a new consensus between citizens, national policy-makers and the Commission on the future shape of the Single Market, and its role in the global economy. Such a consensus will inevitably depend on the establishment of a shared set of values and integrated standards in the social area, which prevents the SEM from remaining on the level of a borderless free trade area with an increasing diversity of national regulations in the area of employment, welfare, education and training. The current economic crisis shows that the Single Market is hardly likely to function efficiently on the basis of "race to the bottom" competition for low regulatory standards between member states. As national policy-makers and citizens are struggling

to come to terms with the knock-on effects of the global economic crisis on their domestic economies, they have become more defensive over their national regulatory powers and are unlikely to support further intrusion of Single Market legislation in this area. This is mainly the result of the fact that the European integration process has made the inefficiencies of domestic employment and welfare systems to fulfil their traditional functions of preventing mass unemployment and providing citizens with essential welfare provision in the face of globalisation and demographic change more obvious (Esping Andersen 1999; Sapir 2004). As a result, national policy-makers and citizens show a tendency to, at least partially, blame the EU for the increasing lack of employment and welfare security.

The latest Eurobarometer issued in December 2008 shows that citizens across the EU-27 remain sceptical about the role of the EU in protecting them from the negative effects of globalisation (European Commission 2008e). Only 43 per cent consider the EU to fulfil this role, while 37 per cent consider it not to be a safeguard against globalisation. Support for the greater involvement of the EU level in the process of domestic policy-making in the area of social welfare (32 per cent), education (33 per cent) and pensions (26 per cent) also remains low. Overall, a slim majority of citizens in the member states support a greater input of the EU institutions on national economic policy development (51 per cent). The Commission will thus have to make a new positive case for the coordination of national standards on the basis of the "best practice", which will be particularly important for the new member states in Central and Eastern Europe, who continue to struggle with the tensions between integration into the legal EU *acquis* of the SEM, the stability and growth pact of the Eurozone, and domestic calls for the development of higher standards of welfare and education (Goetz 2005: 274). The capacity of national governments to maintain welfare systems which offer high levels of protection for citizens are coming particularly under pressure from the tendency of Single Market to encourage competition for foreign direct investment on the basis of low domestic corporation and capital tax rates. In addition, the principle of the free movement of workers, which is at the heart of the Single Market, has lead to a certain degree of "welfare shopping" amongst migrant workers, which poses an addition burden on already overstretched national welfare systems (De Giorgi and Pellizzari 2006; Andersen et al. 2000)

The EU thus needs to move beyond the fixation on growth and jobs in the Lisbon Strategy and concentrate on the preservation of core common values in the various economic and social models that exist in the SEM-27. The recent global financial crisis showed that the deregulation of markets does not automatically lead to increasing wellbeing for citizens. On the contrary, the resulting global economic crisis has highlighted the importance of regulatory intervention at both the national and the supranational institutional level. The ambition to create a level-playing field for competition in the EU-27 Single Market must therefore be accompanied by a more efficient coordination of social policies. As Bertola points out "the EU can hardly continue to strive for one market and one money as long as it features a considerable number of labo(u)r markets, and economic integration will stall if it is perceived to conflict with social policy objectives" (Bertola 2006: 27). In this respect, the combination of the role of an active state, as a promoter and guarantor of *public* space, manifested in public service quality, employment standards, equality, social cohesion and environmental sustainability, with the facilitation of open and dynamic market competition, has the potential to be the backbone for a new European success story in the global economy of the 21st century.

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The Role of the OECD and the EU in the Development of Labour Market Policy in the Czech Republic

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Abstract
This article analyses the role of the OECD through its "Jobs Strategy" and the European Union (EU) through the "European Employment Strategy" in the development of macro-economic, employment and labour market policy in the Czech Republic. As a full member of the two organisations, the Czech Republic has been subject to their soft non-binding policy advice in the area of labour market reform. The OECD and EU policy models are similar, both insisting on growth-oriented macro-economic policy, supported by active labour market policies, an active and effective public employment service (PES) and the de-regulation of labour markets. However, the OECD actively advocates private actor involvement in labour markets, while the EU insists on the role of the public sector. The inquisitive styles of the two organisations differ: the OECD has a decontextualised and quantified analysis of performance accompanied by a supportive in-depth qualitative analysis, while the EU has a more contextualised analysis, which is also more politicised. However, the EU's policy is partially supported by European structural funds, while the OECD has no comparable instrument. Despite some differences in policy model and inquisitive style, both the OECD and the EU have given the same major policy recommendations over time to the Czech Republic, although the OECD has insisted more on de-regulation, whereas the EU has also emphasised worker security and anti-discrimination. In macro-economic policy, de-regulation and increasing flexibility on the labour market, the Czech Republic conforms with OECD and EU policy models and recommendations. The PES has been developed institutionally to fit both models. However, activation, shifts in expenditure from passive to active labour market policy, training and placement of the PES have not changed substantially since the Czech Republic became member of the EU, suggesting that the real impact of the OECD and the EU has been weak.

Keywords
OECD; Jobs Strategy; EU; Lisbon Strategy; European Employment Strategy, policy coordination; labour market policy; employment policy.

BOTH THE OECD, VIA ITS 'JOBS STRATEGY' AND THE EUROPEAN UNION (EU), THROUGH the European Employment Strategy (EES) advocate high labour market participation as an important part of the solution to achieve economic growth and well-being. This article contributes to understanding the similarities and differences in policy prescription of the two actors, how the actors assess performance in the Central and Eastern European

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countries (CEE), which types of solutions have been adopted and ultimately, how influential the policy models of the OECD and the EU have been. The Communist system left an important institutional heritage in labour market policies and institutions in the CEE in their transition to democratic capitalism. Under communism, the countries were officially full employment societies, with no unemployment problems. The systems were paternalist and all individuals had rights to comprehensive social protection (education, health care, housing) via their job status' (Offe 2009). The post-1989 development has involved (sometimes very extensive) re-calibration of the former social and labour market policies and institutions, driven by the new elites in these countries, but in a context where external actors, including international organisations and the European Union (EU), have had an important impact on institutional change and policy development (Offe 2009; Ornestein 2008). The World Bank (WB) and other international organisations have been effective in directing pension reform in the CEE, promoting liberal policies based on individually funded solutions (World Bank 1994; Deacon *et al.* 1997; Deacon 2007). Ornestein (2008) argues that it was due to liberal pre-disposition in the CEE during the 1990s, that the WB and other international actors were able to persuade many of the CEE to adopt liberal policy solutions (Ornestein 2008). Ornestein (2008: 911) also claims that the governments in the CEE wanted to "out-liberalise" the EU and to become policy leaders in economic liberalisation.

The EU has been influential in the CEE through membership conditionality (Grabbe 2006) across a wide array of policy areas governed by the hard *acquis communautaire*, including the development of the Single Market. Strikingly, the new member states show a better track-record than the old member states in compliance with EU law (Sedelmeier 2008). On the other hand, compliance with convergence criteria of the Maastricht Treaty for full membership of the Economic and Monetary Union (EMU) has been partial and is still lagging behind (Johnson 2008), whilst the EU's influence in social policy has been weak due to the virtual absence of hard law in this area (de la Porte 2001; Ornestein 2008). In this context, what have been the (external) driving forces of reform in labour market and employment policy? What policies do the OECD and the EU promote and how do they do that? With a few exceptions, analyses of the impact of the OECD's Jobs Strategy and how the policy advice compares to reforms undertaken is quantitative (Armingeon and Beyeler 2004). Casey (2004) compares the OECD and the EES, but does not go into detail about the differentiated policy recommendations in the individual countries, measured against reform efforts. The analyses of the impact of the EES[1] are more detailed and in-depth, but focus mostly on old, rather than new EU member states (Zeitlin 2009; Buechs 2007). This article analyses the policy model of both actors, the specific recommendations they make to one country, and compares this with the reform outcome in that country.

To analyse the role of the OECD and the EU in this process, I draw on literature that analyses the role of international organisations in policy reform. Bengt Jacobsson (2010) has identified two means of non-traditional means of regulation used by international organisations: 'meditative' and 'inquisitive' modes of regulation (Jacobsson 2010; Mahon and McBride 2009). Meditative regulation refers to the development of a policy model that is advocated as the best solution to respond to a policy challenge; it involves the diffusion of norms that may embody a broad policy paradigm (Hall 1993). Inquisitive regulation, which often accompanies the meditative regulation of international organisations, involves surveillance, monitoring and benchmarking, used to support target countries in the achievement of the aims of the advocated policy model (Jacobsson 2010). It is these two modes of regulation that capture the means of influence of international organisations and that will be used in this article to analyse the OECD and the EU. More

[1] See Kröger (2009) for a comprehensive analysis of the Open Method of Coordination (OMC) and the EES.

specifically, what is the content of the advice for labour market reform and employment policy – meditative regulation - directed at the CEE by the OECD and the EU? To which extent is their meditative regulation consensual and on which points do they diverge? What are the characteristics of the inquisitive dimension of the OECD and of the EU and to which extent are they successful in coercing the countries to reach the policy aims that they prescribe? On the basis of their inquisitive regulation, what is the assessment of labour market reform by these two external actors? What kinds of policy solutions have the CEE developed, how do they compare to the blueprint of the international actors and to which extent do they deviate from these models, developing their own policy solutions, driven by domestic reform processes? This article provides answers to these questions on the basis of an analysis of one country, the Czech Republic, selected as a 'critical case', that can provide an answer to the main research question: to which extent are the international organisations influential and to which extent do they adapt their advice to the context of a particular country? (Flyvbjerg 2007).

Table 1 below summarizes key statistical data for the Czech Republic in 2000, 2005 and 2007/8, which shows that GDP per capita has increased incrementally and steadily, starting at 68.4% in 2000, increasing to 75.9% in 2005 and finally reaching 80.1% in 2008. Regarding the overall employment rates, the employment rate in the Czech Republic was already high in 2000 at 65%, increasing to 66.1% in 2007 (in fact it is the highest among the EU-8).[2] However, the Czech labour market is (still) dual, where Foreign Direct Investment has created employment in new areas and is flourishing, while the former industrial sector is costly and unproductive. The Czech Republic has had a low unemployment rate since EU membership, but the financial crisis in the autumn of 2008 has changed this. The unemployment rate was 4.5% in November 2008, increasing to 7.1% in November 2009 (Eurostat 2009a).

Table 1: *General economic and employment indicators for the Czech Republic*

Indicator (%)	Czech Republic 2000	Czech Republic 2005	Czech Republic 2007*	EU average/ targets
GDP per capita in PPS**	68.4	75.9	80.1	100
Overall employment rate	65.0	64.8	66.1	70
Female employment rate	56.9	56.3	57.3	60
Employment rate older workers	36.3	44.5	46.0	50

Notes: * The GDP per capita in PPS is for 2008; for employment rates the latest data is from 2007; ** The average EU GDP per capita in PPS is 100.

Source: Eurostat (2009b)

As mentioned above, the Czech Republic is a 'critical case' (Flyvbjerg 2007): it is successful in terms of GDP growth, employment rates and until recently, unemployment rates, but there are structural problems to be confronted in the ineffective domestic industries. Have

[2] EU-8 refers to the 8 eastern European countries (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia) and Slovenia, formerly part of Yugoslavia, that became full EU members in 2004. Malta and Cyprus also became full EU members at this time.

the OECD and/or the EU played a role in reforms adopted in macro-economic policy, employment and labour market policy? And if so, to what extent and how have they addressed the dualism of the labour market? If the OECD and the EU tailor advice to this particular case, it can be expected that they do so for other countries as well. If not, then it can be expected that their advice is driven mostly by their blue-print. Reform advice should be informed by circumstances, rather than the pretention of the existence of a one-size fits all policy model. The remainder of this article is organised as follows. First of all, the OECD and the EU are compared along the meditative dimension and inquisitive dimensions, the former referring to their policy model in the area of labour market and employment policy and the latter to their means of analysis and surveillance. To support the analysis, I develop indicators for detecting the robustness of the meditative and inquisitive regulation of the OECD and the EU. Secondly, I undertake an analysis of labour market and employment policy development in the Czech Republic in the view of the policy models of the OECD and the EU and their assessments of policy reform. I analyse when reforms were undertaken in order to be able to assess whether the OECD and the EU, respectively, have had an influence. Finally, I draw conclusions about the relative influence of the OECD and the EU in the Czech Republic and point to some possible explanatory factors.

Meditative and inquisitive regulation of the OECD and the Lisbon Strategy

Meditative regulation refers to a consensual policy discourse or model, which includes the framing of a policy problem and then the drawing up of a specific policy solution, which is developed by experts in international organisations (Jacobsson 2010). A frame "provides conceptual coherence, a direction for action, a basis for persuasion, and a framework for the collection and analysis of data – order, action, rhetoric, and action" (Rein and Schon 1993: 153, in Fischer, 2003: 144).[3] The development of a policy model is accompanied by the inquisitive dimension of regulation, which refers to the means of 'inquiry' (peer review, benchmarking, visits of country experts, recommendations) used by international organisations to monitor and to assess policy development with regard to a policy template that they seek to uphold and to diffuse among their member countries. The literature on the policy advice of international actors and the EU has focused on their development of normative models (meditative regulation) together with their capacity to diffuse those norms to target countries (mainly through inquisitive regulation, or 'learning capabilities') (Deacon *et al.* 1997; Hartlapp 2009). However, the literature does not clearly define indicators to locate the robustness of a meditative discourse or of the inquisitive regulation of a particular organisation. In this article, four indicators are developed to compare the potential leverage of the OECD and EU in policy reform. The first is the *temporal dimension*, since the time at which an issue is put on a policy agenda affects its likelihood of being adopted (Kingdon 1994): when there is ideological congruence of a policy model promoted by external actors with national political priorities, this may enhance the adoption of the features of that policy model. The second is *competition*: were there other models of policy solutions proposed by domestic or international actors at the same time? The more alternative solutions were present during the process of restructuring labour market institutions, the less the likelihood of adoption of one specific solution. Conversely, if the policy advice of one actor is repeated by another actor, then that strengthens the potential influence of both actors. The third is *clarity*, as the clearer the objectives are, the more likely they are to appear feasible, and hence, to be adopted as intended by the international organisations. Here, it is not only the policy model that should be clear but equally, the assessments of member countries' performance by the

[3] See Daviter (2007) for a more detailed overview of the different strands of policy framing literature in the European Union.

international organisations and the policy recommendations to member countries, in the sense that they should be targeted, contextualised and realistic. The fourth is *consistency*: has the policy model of the international organisation changed over time or has it remained the same? As shown in public policy literature, it takes about a decade for policy learning to take place (Sabatier and Jenkins-Smith 1993). The longer the model is the same, the more likely it is to be influential; conversely, if the model changes, then it is less likely to be influential in the long-term.

What, then, is the policy model of the OECD in labour market policy and how robust is it? How does this compare with the policy model of the EU in labour market policy? The aim of the OECD's 'Jobs strategy' developed in 1994 was to liberalise labour markets in order to enhance economic well-being[4]. The strategy consisted of 10 recommendations[5], unambiguously based on liberal policy and that remained stable for over a decade (Casey 2004; Mahon and McBride 2009). The aims were clearly stated, leaving little room for interpretation. As a policy model, then, it was very robust. It was not until 2006 that the recommendations (and policy model) were altered, involving more of a social dimension to complement the negative effects of liberalisation (Jacobsson and Noaksson 2010). The first component of the strategy recommended stable (non-inflationary) macro-economic growth, involving the reduction of budget deficits and public debt levels. The second aspect prescribed policies that should reduce unemployment and increase labour market participation, mainly via increasing flexibility on the labour market. This included the reduction of employment protection[6], the facilitation of enterprise start-up, the facilitation of dismissal, the development of different types of contracts (part-time, fixed term, partial retirement)[7] and making wage and labor costs more flexible (through a reduction in wage and non-wage labor costs). Third, the OECD advocated a shift in expenditure on labor market policy, from passive to active labor market policy (ALMP). In that process, the OECD identified the public employment service (PES) as an important (but not sole) actor that should be responsible for placement, counseling services, delivery of labor market programmes. The OECD especially highlighted the importance of targeting job creation at long-term unemployed youth and long-term unemployed. Fourth, the OECD's policy model also advocated the development of a (continuously) trained workforce, to be achieved by enhancing the quality of school (and pre-school) programmes but also by increasing the role of the private sector in the provision of educational services. Finally, regarding social partners, the OECD considered trade unions and worker protection a hindrance for the development of labor market flexibility and thus advocated the development of framework agreements that would leave enterprises free to respond flexibly to market trends.

To diffuse this model, the OECD has developed 'inquisitive regulation' extensively in the absence of other instruments, such as short-term loans, used by actors like the International Monetary Fund and the WB (Mahon and McBride 2009) or membership conditionality, as used by the EU. Its inquisitive regulation has been identified in the literature as decontextualised, explicitly assessing progress with the Jobs Strategy template as the benchmark, independently of the conditions in the country (Armingeon and Beyeler 2004; Jacobsson and Noaksson 2010; Casey 2004). The approach is also

[4] Here I only analyse the OECD Jobs Strategy and no other policy models that were developed subsequently (see Mahon and McBride 2009; Jacobsson and Noaksson 2010 for more details about other more socially oriented policy dimensions developed in the OECD after 2000).
[5] This article summarises only the main types of policies in labour market policy, in order to be able to compare the meditative regulation of the OECD and the EU.
[6] The OECD recommended decreasing the replacement rate and the duration of the unemployment benefit and increasing conditionality for access to the unemployment benefit.
[7] To meet this objective, the OECD recommended the development of contracts with lower degrees of protection, and test periods.

quantified, whereby each country receives a quantified 'score', expressed as a percentage, for each of the ten objectives of the Jobs Strategy. These ten scores are then added up and the average, expressed as a simple index, represents the overall 'performance' of the country. It is the econometric analysis and ranking that is intended to put pressure on the countries to comply with a particular policy template. This econometric approach makes it possible to 'rank' the OECD countries in terms of compliance with a policy model. However, this quantification of performance can be problematic, since increasing a minimum wage from a very low level, in all cases is assessed by the OECD as going *against* its recommendations, regardless of whether the minimum wage is above or below the poverty level (see analysis in Brandt *et al.* 2005). This is not to say, however, that the OECD does not undertake other qualitative analyses about reform measures. On the contrary, its research capacity is enormous and it comprehensively analyses development in different policy sectors for its 30 member countries over time. In addition to quantified ranking, the OECD also makes individual country recommendations, identifying the main challenges in priority policy areas. The OECD country assessments that include specific policy recommendations to each country must be approved by the country reviewed and by its peer reviewers. It is notable that the European Commission is also present in the Economic and Development Review Committee that prepares the assessments and recommendations.

How does the EU policy solution to high unemployment and low growth compare to that of the OECD and how does its inquisitive regulation compare to that of the OECD? While the OECD had a fully developed policy model about labour market reform already in 1994, the EU's labour market and employment policy was not fully institutionalised until 1997. The main objective and inquisitive mode of regulation of the European Employment Strategy (EES) is defined in the Employment Title of the Amsterdam Treaty (articles 125 EC – 130 EC), agreed in June 1997 (de la Porte 2007). Specific policy objectives were agreed at the European Council in November 1997, but have been adapted on a yearly basis since then, potentially rendering the policy model less robust, but perhaps more receptive to political priorities and economic and social realities, than that of the OECD. Nevertheless, there are some core features of the model that have been permanent from the outset. Foremost, in the area of macro-economic policy, the EU upholds, like the OECD, low budget deficits (theoretically allowing only 3% budget deficit for its member states) and controlled public expenditure (with a ceiling rate of 60% public debt). Secondly, the EU seeks, like the OECD, to maximise the participation of the active population in paid employment, which should in turn contribute to improving the economic growth rate. To reflect this aim, the EU agreed on quantitative employment rate targets (70% overall employment rate, 60% female employment rate, 50% older worker) in 2000 and 2001 (European Council, 2000; European Council, 2001). To reach this aim, various policies have been proposed. Many of these seem to be an emulation of OECD policies – reduction of very strict employment protection, development of different types of contractual arrangements, reduction of wage and non-wage labor costs.[8] However, for the OECD, flexibility was not accompanied by any complementary measures in its Jobs Strategy, and the role of social partners in the development of collective agreements was seen as an obstacle to the development of flexible labour markets. For the EU, flexibility is to be enhanced (particularly in countries with high regulation), but the importance of contractual arrangements and worker security is also emphasised and is embodied in the 'flexicurity' concept (European Commission, 2007). Worker security has been singled out as a particular problem for the CEE (Interview Commission 2, July 2009). The EU also has legal requirements in the area of labour law, requiring a lawful work contract, where labour inspectorates play a role in ensuring that this is enforced. This was even part of the *acquis*

[8] In the Commission Communication on flexicurity, the knowledge and data developed by the OECD is referred to explicitly (European Commission 2007).

communautaire in the social policy area for the CEE. The EU, like the OECD, has underlined that Member States should shift expenditure from passive labour market policies (PLMP) to active labour market policies (ALMP).[9] While the OECD has highlighted 'activation' as a core component of its strategy, the main political emphasis of the EU has been on 'employability', which refers not only to 'activating' individuals through employment, but also in ensuring that they are trained continuously throughout their working lives. Similar to the OECD, the EU identifies the PES as the key actor that should be responsible for placing individuals in various types of employment schemes. However, contrary to the OECD that explicitly advocated the involvement of other private actors in the announcement and administration of vacancies and training, the EU (at least theoretically) promoted only the PES. This is an important point of difference with the OECD policy template developed in the 'Jobs Strategy'. Like the OECD, the EU has emphasised the need to focus on 'activation' and the increase of labour market participation. The EES explicitly refers to more target groups than the OECD – young people, women, older workers, immigrants, long-term unemployed – although the emphasis on which groups of individuals should be 'activated' has changed over time (de la Porte 2007). Like the OECD, the EU insists on the upgrading of skills and training, under the term 'life-long learning'. It is not only the PES but various actors that should be involved in this activity, but contrary to the OECD approach, there is no explicit reference to the private sector[10]. Another point of difference is that the EU advocates that social partners take on an important responsibility in the development of norms in the area of labour law, including contractual conditions and working time, while the OECD identifies social partners as an obstacle to deregulation of the labour market. Finally, although the EU, particularly the Economic and Financial Affairs Council and the DG for Economic and Financial Affairs in the European Commission, upholds the importance of controlling public expenditure, the Social Affairs Council and DG for Employment and Social Affairs in the European Commission upholds that it is important to develop modern social security systems, which can ensure equity and access to high quality health care and pensions (European Commission 2007).

Concerning the inquisitive regulation, there are important differences between the OECD and the EU. First, the Council of Ministers sets the political agenda of the EU, which influences and indeed, politicises the policy objectives of the EES, which is different from the OECD that is not affected by the political tendencies within the European Council. The policy cycle of the strategy, repeated iteratively is as follows: first, the policy objectives (employment guidelines) of the EES are agreed at the level of the Council; second, member states show compliance with policy aims in regular[11] national reports (compiled by governmental actors with the involvement of different ministries), which are peer reviewed by two countries, and third, the European Commission[12] prepares comparative information and statistical analyses on member state performance, together with

[9] Eurostat and the OECD collaborate in the development of statistics, namely the EU's labour force survey and the OECD's statistics on passive and active labour market policies.

[10] With the EES the EU has from the very beginning promoted policies to reconcile work and family life, in particular the development of high quality care for the 0 to 3 year olds and for the 3 to 6 year olds. The EU here explicitly refers to the role of the public sector in the development of (and/or subsidising of) child-care institutions. The OECD, in its 1994 Jobs Strategy, excluded family policy altogether, but it has been developed subsequently in "Babies and Bosses" and even in the revised Jobs Strategy in 2006 (Jacobsson and Noaksson 2010). However, family policy will not be analysed here, since the scope of the article is limited.

[11] The reports were yearly until 2005. Since 2005, the reports have become tri-annual.

[12] The European Parliament was initially side-lined from the Lisbon Strategy. Since 2005, its role – which it conducts through its Economic and Monetary Affairs Committee and its Employment and Social Affairs Committee - has been strengthened somewhat. It is consulted, but it is not a core actor in the Lisbon strategy. Its role has recently, at least on paper, been strengthened in the Strategy in the recently adopted Lisbon Treaty.

individual country recommendations. These three aspects of surveillance carried out by the European Commission must all be endorsed by the Labour and Social Affairs Council to be officially published.[13] The inquisitive dimension of the EU is similar to, but more frequent than that of the OECD. Perhaps more important, the assessments of country performance and country recommendations are more contextualised, i.e. they take more account of the diverse challenges faced by the member states and of their economic and social conditions than the econometric approach by the OECD. The EU, like the OECD, issues individual country recommendations, which highlight the most important challenges faced by that country. However, EU recommendations are more politicised than the recommendations of the OECD, as are the country assessments.[14] As expressed by a Commission official, "[in] a sense, recommendations can be considered to set priorities for each member state…The instruments do not focus on economic or other policy issues in neutral ground, but involve political actors. From a political perspective, it is not possible to issue 8 to 9 recommendations for Bulgaria, Poland or other new member states and then to issue fewer recommendations to some of the more successful old member states. The governments simply would not accept that. That is why we have a few broad-ranging recommendations within which there may be some sub-recommendations" (Interview Commission official 3, August 2009).

Aside from higher frequency and more politicisation of the EU inquisitive regulation, there are other particular features that distinguish the EU employment strategy from the OECD's 'Jobs strategy'. One is that there is funding – European structural funds – associated with the EES. When there is funding, it can and does act as a carrot to implement a particular policy, particularly if that policy is costly (Interview commission official 2; interview commission official 3).[15] An independent expert has stated that: "the EU's soft coordination system is associated with another policy instrument, i.e. the Structural Funds (European Social Fund and European Regional Development Fund). In many cases, these funds act like a carrot (some other instruments may also act like sticks, whilst soft coordination is rather a matter of sermons). The instruments reinforce one another. That is something we have seen in many countries, of course in member states benefiting most from structural funds (new member states and old Mediterranean member states)" (Interview Independent Expert, August 2009). Second, in some areas, such as anti-discrimination and labour law, the EU has a body of EU hard law that backs up the policy objectives of the EES.[16] In particular, three EC directives in the area of labour law have provisions for equal treatment, the prohibition of discrimination, and labour contracts concluded for a definite

[13] Since 2005, the Economic and Financial Council has more weight in the EES as the economic and employment policy coordination cycles have been synchronized.

[14] There are different assessments in the literature on the EES about its inquisitive dimension. Hartlapp (2009) argues that the inquisitive dimension of the EES, or its potential for learning, is not particularly strong, despite the various EES instruments that have the potential to induce policy change (guidelines and recommendations, national reform programmes, benchmarking, peer review and indicators). Others, such as Zeitlin (2005 and 2009), have argued that the EES has induced learning and led to policy change through several of its inquisitive tools.

[15] In 2005, an EU programme to support the reform process associated with the aims of the Lisbon strategy (the Community Lisbon Programme) was launched. While many of the measures launched through the programme represent a re-grouping of former programmes and measures, notably the Structural Funds, the programme provides EU support only when it is connected to the implementation of the Lisbon strategy (Begg 2007: i).

[16] There is also a third dimension: in 2005, national Lisbon "coordinators" have been appointed in order to enhance the integration of the EU policy aims into national policy. The existing academic analyses about the role of Lisbon coordinators show mixed results. In some cases, they have led to more integration, in others they have acted as gate-keepers for presentation of national policy to the EU, whereas in still others, they have spurred a national debate along different dimensions (Borras and Peters 2009; Poulsen 2009). As it is a recent development, it will not be included in the scope of this article.

period of time. These provisions must be integrated into legislation in all member states, and must be implemented. In addition, a Labour Inspectorate must be established to ensure that labour law is enacted lawfully. The EU-8 member states have been obliged to comply with EU legislation and have also been involved in the EES policy cycle since they became full EU members in 2004.[17]

Policy advice of the OECD and the EU and the reform outcome in the Czech Republic

The OECD and the EU, then, share a diagnosis of policy challenges in industrialised/EU economies (low economic growth, high unemployment, low employment rates) and in essence, propose similar solutions in their policy models in terms of labour market flexibilisation and activation, although there are also important differences. The case analysis below presents the country-specific recommendations made by each organisation to the Czech Republic (focusing mainly on the 2004-2009 period when it was subject simultaneously to OECD and EU pressure), which casts light on whether and if so, how, the two organisations actually differ in terms of the policy advice they give. It also analyses the reforms undertaken in the Czech Republic, which shows the real leverage of the OECD and the EU for policy reform in employment and labor market policy. Table 2 below summarises the main policy recommendations to the Czech Republic in the key areas of macro-economic and labour market policy and reforms in the Czech Republic

In macro-economic policy, the Czech Republic has been recommended by both the OECD and the EU throughout the 2000s to reduce its public deficit and its public debt, in particular by making fundamental reforms in pensions and health care. The OECD recommended that the pension system should be reformed to make it financially sustainable, by channeling contributions to private pension funds and by enhancing the voluntary pillar of the pension system. Like the OECD, the EU has iteratively recommended that the Czech Republic undertake fundamental reforms in the pensions system to reduce the public deficit. The Czech Republic has undertaken several reforms, in line with these recommendations. It has incrementally adapted the existing PAYG system (increasing the required contribution period for being able to receive a full pension, increasing the mandatory retirement age and decreasing the replacement rate). In 2008, yet another change in this direction was taken: the retirement age was increased to 65 (by 2030) and the minimum contribution period required for a full pension changed from 25 to 35 years (also to be achieved by 2030). The OECD states that the parametric changes to make the existing system more sustainable should be accompanied by the development of a second pillar, to counteract the decline of replacement rates in the PAYG system. The EU does not make this recommendation but states that the reforms should contribute to maintaining sustainability in the pensions system (OECD 2008; European Commission 2008).

The OECD also recommended that the Czech Republic should make fundamental changes in health care reform, by increasing the privately funded share of health care services and by facilitating the emergence of a private health care market (OECD 2003, 2008). The EU has also consistently recommended the reform of the health care system in the Czech Republic, in line with the OECD advice. Reforms have been introduced recently by the Czech Republic in this area: user fees were introduced for some health care services in

[17] Prior to EU membership, the "accession countries" participated in the EES by preparing national reports to the European Commission. However, as shown by Jacobsson and West (2006), the pre-accession action plans were passive and reactive documents (Jacobsson and West 2006: 120). Also, their statistics were harmonised and integrated with EU statistics prior to EU membership. This has had an impact on the capacity to analyse and then quantify policy problems (Interview statistical expert Czech Republic, November 2009).

2008 and reforms will be pursued in this direction. In addition, the Czech Republic plans to open up the health care market to private actors, which has been highlighted as a positive development in the country assessments by both the OECD and the EU (OECD 2008; European Commission, 2007a, 2009). The result of incremental changes to the health care and pensions systems in the Czech Republic is that the budget deficit has been reduced over several years, from 5% of the GDP in 2001 to 1.2% of the GDP in 2008.

Table 2: *Policy Advice of the OECD and the EU for the Czech Republic (2004-2009)*

Policy area/ organisation-reform	OECD	EU	Reforms Czech Republic
Macro-economic policy	reduce public deficits via sustainable expenditure cuts (health care and pensions); strengthen bankruptcy conditions(targeted at ineffective domestic industries)	Achieve fiscal stabilization and improve the long-term sustainability of public finances (health care and pensions)	Incremental changes to existing systems in health care and pensions; Recently plans to introduce private agents in health care, and to undertake more substantial pension reform
Flexibility/security, minimum wage, employment protection, Public employment service and Activation	Reduce non-wage labour costs, reduce regulation to be able to start-up businesses, enable the development of different types of contractual arrangements (part-time, temporary employment); Increase conditionality for the reception of unemployment benefit; decrease the length of reception of unemployment benefit; decrease the income replacement rates; Increase the retirement age and adjust early and late retirement regulation.	"modernise" employment protection: facilitate the development of labour contracts, mainly by de-regulation; Security should be enhanced for workers; Invest in training for older workers and the low-skilled, increase activation.	Possibility to conclude different types of labour market contracts enabled; Unemployment benefit has been changed, hardening conditions and decreasing the benefit; Social assistance has been reformed to make access conditional; A lower "minimum survival" rate has been introduced; Minimum wage has incrementally increased; Programme for activating older people has been adopted; pensionable age increased, total years of contribution to receive full pension changed from 25 to 35 years.
Education and Training*	Education systems should be improved, especially to facilitate the transition from secondary to tertiary education and to render the skills provided in the education system relevant for the labour market; Introduce tuition fees in tertiary education	The efficiency and equity of education and training should be improved, and rendered more responsive to the labour market needs	National progarmme has been adopted for improving education, with the support of the ESF
Social Partner Involvement	Decrease collective agreements to over-protect some sectors: construction, textiles and metal-working	No recommendation	Trade unions did not approve of the last national reform programme (reflecting reforms planned in economic and employment policy).
"Score"**	The OECD "score" was 22.5% for following through on more specific recommendations (rank 18 out of 30 countries); the "reform intensity"*** indicator is 6.2, whereby the Czech Republic is ranked 28 out of 30		

Notes: * Due to lack of space, education and training will not be discussed in detail in the text. But it is shown here to reflect the difference in OECD and EU policy advice; ** It is only the OECD that quantifies progress. This data is derived from the 2005 comparative assessment of country reforms, after 10 years of implementation of the Jobs Strategy. The EU has no corresponding quantified benchmarking and ranking system; *** For each area an assessment was made on a basis of reforms scoring positively being in line with OECD policy and negatively when against OECD recommendations. In the quantification process, if reforms go in opposite directions, the two reform initiatives cancel each other out, so that reform effort is "0". The reform intensity indicator represents the average reform efforts in the 10 areas covered by the OECD recommendations

Source: OECD (2003, 2005); European Commission (2007a, 2009)

Despite these reforms, the OECD re-enforced these recommendations in 2008, calling for "more ambitious" deficit targeting, further health care reform, in particular the reduction of public expenditure and the decrease of coverage of "ever expanding treatment possibilities", as well as the creation of conditions favourable to private actors in the health care sector (OECD 2008). The EU is more positive and does not press for more change, assessing that reforms undertaken should improve the prospect of ensuring long-term sustainability of public finances. Indeed, the budget deficit is lower than the requirement in the Stability and Growth Pact of 3% of the budget deficit. In this area, then, the two organisations are strongly driven by their respective blue-prints, which are widely similar. However, the OECD is more stringent than the EU, which is satisfied once the criteria for the Stability and Growth Pact have been met (OECD 2008, European Commission 2009). It is the agenda of the economic actors in the OECD and the EU.

Compared to the area of macro-economic policy, where the OECD and the EU have the same position, the core of the OECD and EU models in labour market policy are the same, as are their policy recommendations, but there are also some differences. When the Czech Republic became member of the EU in 2004, it had to revise its Employment Act to conform to EU legislation, in particular with regard to the issues of equal treatment and non-discrimination, but also that of protection against repeated extension of temporary contracts. In this sense, and unsurprisingly, the Czech legal framework has directly been affected by the EU membership conditionality (British Chamber of Commerce 2004). Since then, the Employment Act has been altered several times, not only to implement legal EU membership requirements but also to implement political decisions, regarding the development of flexibility in labour market contracts and changes to the minimum wage, to employment protection and to the provision of employment services.

In 2009, alterations were made in the Employment Act regarding the changes in conditions for concluding employment contracts. In line with OECD and EU recommendations, possibilities to conclude labour contracts have been facilitated, as have the possibilities to create part-time jobs. Financial incentives for employers to employ people on a part-time basis (lower social security contributions) have been enhanced. The assessment of the recent reforms by the OECD and the EU differ: the EU has noted that, while the Czech Republic has successfully facilitated the development of flexible working arrangements, it has failed to ensure that more security is incorporated in contract law for those with full-time contracts. The OECD, on the other hand, considers that the changes are going in the right direction, but that more deregulation needs to be introduced, in particular for jobs with short job tenure (OECD 2008). Here, the OECD and the EU differ. Whilst the OECD more blatantly follows its blue-print, the EU insists more on lawful employment and security, backed up by legislation. This agenda is pushed forward mainly by socially-oriented actors (Social Affairs ministries and DG Social Affairs in the European Commission).

The minimum wage in the Czech Republic was initially very low, in the mid-1990s, but it has progressively been adapted upwards, and has from 2000 onwards increased relative to average gross wage. Table 3 below summarises the developments from 1995 to 2007. This change was against OECD recommendations and the OECD has highlighted this as a negative development, despite the fact that the minimum wage has been increasing from a very low initial level. These developments took place well before EU membership and the EU has not made recommendations in this area. In essence, the reforms were domestically driven and the minimum wage has been increased in order to make work pay and to ensure minimum living standards. In the Czech Republic, it is estimated that 2-3% of the population receive the minimum wage (EIRO-online 2005). Another point is that there has been an increase in the payroll tax on low-wage earners in 2004, which is against both the OECD and EU policy models (Brandt *et al.* 2005). The OECD and the EU, then, have had no leverage in this area.

Table 3: *Development of the minimum wage in the Czech Republic*

	1995	1998	2001	2002	2003	2004	2007
Average wage (euros)	2,200	2,650	5,000	5,700	6,200	6,700	7,000
% of average gross wage	27	23	34	36	37	37	-

Source: EIRO-online (2005); NRP (2008).

In the unemployment scheme, the changes have gone the opposite way than that of the minimum wage, towards a decrease in the benefit level and increase of conditionality. In 1991, unemployment support was codified in the Employment Act. Initially, it could be obtained for one year, the first six months at a 60% replacement rate (65% for those that were unemployed due to restructuring) and the following six months at a 50% replacement rate, with no upper benefit levels. Since then, it has been downsized incrementally. Already in 1992, the benefit period was reduced to six months, and the higher rates of replacement for those that lost jobs due to restructuring was removed. After a fiscal crisis in 1997, the replacement ratio in the unemployment benefit was decreased in 1998 to 50% of the last wage for 3 months, and 40% of the last wage the remaining 3 months. In 1999, conditionality was increased and a ceiling rate was introduced: the upper limit of the unemployment benefit was agreed to be 250% of the minimum living standard and to 280% when in training. In 2004, the benefit became dependent on the age of the beneficiary. The benefit level for the latter 3 months of unemployment was increased from 40% to 45% of the replacement rate. This last change was criticised by the OECD (Brandt *et al.* 2005). The OECD, once again, sticks systematically to its blue-print. In 2004, partial unemployment was introduced (Kaluzna 2008: 33). In 2009, conditionality was further enhanced and the total duration of the period for receiving the benefit decreased from 6 to 5 months (NRP 2008). The result of these reforms in the unemployment scheme are that the average unemployment benefit level as a percentage of the gross average wage has decreased over time, and the share of jobseekers receiving the unemployment benefit has also decreased. This effect can be seen in the data in table 4 below.

Table 4: *Share of unemployed receiving benefits and average unemployment benefit level in the Czech Republic*

	1991	1994	1997	2000	2003	2006
% share of jobseekers receiving unemployment benefit	65	47.5	50.7	37.5	35	28.1
Benefit level (% of gross average wage)	-	26.2	23.7	20.6	19.8	22.4
Social assistance expenditure (% GDP)	-	-	0.16	0.39	0.40	0.27

Souce: Kaluzna (2008: 33 and 42)

Due to the fact that conditions have been made more stringent for receiving unemployment benefits and that the social assistance system has received more beneficiaries, different levels of benefits and increased conditionality have been introduced. In 2007, it was re-organised substantially, as there had previously been no central management of the social assistance system. The 2007 system developed different types of benefits, including a ‘subsistence benefit’, that is equivalent to the living minimum, considered necessary for minimal survival. A second even lower rate called ‘existence minimum’ was also introduced as a final safety net. In 2007, the subsistence benefit was CZK 3126 (€120.33) per month and the ‘existence minimum’ was CZK 2020 (€77.76) per month. This system is punitive, in the sense that individuals who fail to be

active (i.e. actively seeking for job or performing voluntary work) are eligible only for social benefits on the level of the existence minimum (Kaluzna 2006: 43). As part of the overall macro-economic policy, expenditure in social assistance has decreased over time (see table 4 above). Once again, the OECD assesses performance exclusively on the basis of its policy model, but taking little heed to the implications for the material conditions of existence of the beneficiaries. The EU, on the other hand, is elusive about commentary in this area.

Another major area where the OECD and the EU have provided policy advice is in the development of employment services. In that area, the OECD insists more on competition in the provision of services, with the PES as the central agent, whereas the EU recommends that the PES be the sole agent in the administration of unemployment, retraining and placement (OECD, 2003, 2008; European Commission, 2007, 2009). In the Czech Republic, the PES has been established as the key agent in the management of unemployment vacancies, the monitoring of compliance of employers with employment legislation and activation. Regarding unemployment vacancies, employers are required to notify job vacancies to the PES, and since 2006, employers can be fined if they fail to comply with this requirement (0.5 million CZK – 19,369.77 euros). Indeed, the role of the PES has developed considerably following EU membership, which the OECD, like the EU, sees as a positive development. Furthermore, in line with EU anti-discriminatory legislation, employers are required to indicate whether the job is suitable for school leavers or people with disabilities. In addition, if requested by a labour office, employers should identify vacancies suitable for disadvantaged jobseekers. In this sense, all jobs are announced in the PES. The role of the PES in placement, however, has been decreasing over time. Table 5 below summarizes the rate of placements assisted by the PES between 1999 and 2006.

Table 5: *Placement with the assistance of the PES in the Czech Republic (1999 – 2006)*

	Number of registered job seekers	Placed with assistance of PES	Rate of placements assisted by PES
1999	443171	120104	27.1
2000	469967	146217	31.1
2001	443826	137044	30.9
2002	477466	116900	24.5
2003	521583	109732	21.0
2004	537426	115414	21.5
2005	514310	103372	20.1
2006	474790	106759	22.5

Source: Kaluzna (2008: 31)

Concerning activation, there has been a change from virtually no systematic planning about how to organise and to implement activation schemes in 2002, to detailed yearly planning about how to target ALMP in 2007. This is in line with both the OECD and EU policy models. The planning component is implemented at municipal level and is part of a general policy of evaluating performance of the individual labour offices according to their activities, including how they fare in activation and how successful they are in the management of the ESF. The ESF has made a significant contribution to the development of services by the PES: almost 80% of the ESF Funds earmarked for skills improvement were used by the PES for this purpose (Kaluzna 2008: 20).The ESF has especially been used for the development and implementation of counselling services to advise jobseekers in

their search for employment. In its National reform programme, the Czech Republic notes that some initiatives have been developed, notably a programme to activate older people and to integrate Roma on the labour market (National Reform Programme of the Czech Republic 2008). However, the EU has stated that ALMP are still small scale and not sufficiently targeted towards disadvantaged groups (European Commission 2009). Indeed, the overall expenditure on employment services (running the PES and activation measures) is still low, and has not increased substantially over time. The ratio of expenditure of active to passive labour market expenditure has increased only slightly (see table 6 below).

Table 6: *Expenditure on employment services, active labour market policies and passive labour market policies (millions of euro)*

Labour market policy	2002	2003	2004	2005	2006	2007
Total LMP	36884	40463	44425	49290	55539	58277
ALMP	93.47	94.22	115.17	122.16	143.68	153.28
PLMP	221.76	249.14	221.55	241.57	264.31	259.73
ALMP/PLMP	0.425	0.378	0.520	0.505	0.544	0.590
Notes: Total expenditure on labour market policy (Total LMP) refers to expenditure on labour market services (including running the public employment services), active labour market policies (ALMP), and passive labour market policies (PLMP) (unemployment benefits and early retirement)						

Source: Eurostat (2009) and own calculations (ALMP/PLMP)

This development suggests that one of the core elements of the OECD Jobs strategy and the EES – to shift from passive to active expenditure on labour market policy – has not taken place. This shows that the leverage of both organisations in this area has been weak.

Finally, regarding the development of wage structures and wage-setting, social partners are very weak in the Czech Republic. Collective bargains apply to half the total number of employees. Furthermore, obligatory sectoral and regional tariff agreements are absent (National Reform Programme of the Czech Republic 2008). Employers practise independent wage policy within the framework of existing legal regulations. Despite their weak position in wage negotiations and norm-setting in labour market policy, the OECD would like the leverage of social partners to further decrease (OECD 2003, 2008). The EU model calls for EU social partner involvement, but no country specific recommendations have been made to the Czech Republic in this regard. It is notable that the social partners in the Czech Republic did not approve of the National Reform Programme that outlines economic and employment policy, because worker security was not addressed (National Reform Programme of the Czech Republic 2008).

Conclusion

In macro-economic policy, the Czech Republic has generally conformed with the recommendations of both the OECD and the EU, cutting expenditure in pensions and health care, but without major institutional changes. In employment protection, the reforms have followed OECD policy prescriptions, which have been supported by the EU: increasing conditionality, decreasing the duration and the replacement rate of the unemployment benefit. However, the major changes were enacted incrementally, particularly during economic instability and were not due to the pressure of the EU or the

OECD. Labour market flexibility has been enhanced, but worker security has not improved, which is more in line with the OECD than the EU policy model. Regarding the minimum wage, it has incrementally been increased over time (from a very low level), which has nevertheless been criticised by the OECD, while the EU has silently supported this change. Concerning the management of employment services, the results are mixed. The institutional set-up of the PES has been developed in line with OECD and EU policy, but placement, activation and re-training remain underdeveloped, whereas control over employers and jobseekers has been enhanced. Some activities of the PES have been developed with the support of the ESF, but the relevance of these activities for confronting the dualism on the Czech labour market (in particular re-training of the workforce in the industrial sector) is questionable. There has been no genuine domestic will (or policy advice by the OECD or the EU) to develop the PES into a service that retrains and up-skills workers, rather than a service that focuses mainly on monitoring compliance of employers and employees with the rules and procedures in labour market policy and administration of unemployment schemes. Altogether, the OECD has unconditionally assessed performance on the basis of its Jobs Strategy blue-print. The EU has developed the same policy advice in macro-economic policy, but in labour market policy, EU policy advice differs since it emphasises that flexibility should be combined with security. However, its voice is not as loud in this area because the EU Finance ministers, with their emphasis on the economic and financial criteria of the Stability and Growth Pact, ultimately, are decisive, rather than the EU Social ministers, who are in a weaker position. The OECD has been clear, concise and consistent over time in meditative regulation, while its de-contextualised inquisitive approach has reconfirmed its message. The EU has been unclear, ambiguous and contradictory in its meditative regulation due to the underlying and permanent battle of strong economic versus weaker social interests and actors in the EU. In addition, the EU has been driven by a diplomatic approach in its inquisitive approach in macro-economic and employment policy, where no hard critique to any member state is permitted. The reform outcome in the Czech Republic has taken place incrementally, where domestic actors have incrementally introduced changes, particularly in the aftermath of economic crises.

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Labour Market Trends and Problems in the EU's Central and Eastern European Member States: Is Flexicurity the Answer?

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Abstract
Throughout the 1990s, international organisations, such as the International Monetary Fund mainly based their policy proposals for transition economies and the high unemployment, low growth countries in Western Europe, on economic "orthodoxy". This approach predominantly followed neoclassical economics in which market liberal solutions predominate. These suggestions were controversial; the early results of these policies appeared to be disappointing. Policymakers sought alternative reform proposals and the idea of "flexicurity" has gradually emerged to the political buzzword. Flexicurity combines flexibility with security and suggests that rather generous unemployment benefits and spending on active labour market policies can be aligned with a flexible, employment-friendly labour market. Originating in Denmark, the European Commission and the International Labour Organisation have promoted flexicurity more or less independent of specific single country cases, and based their approach on more abstract, generalised relationships between flexibility and security. These bodies argue for an alternative policy to pure orthodox deregulation and liberalisation for the member states of the European Union (EU) and the former transition economies that joined the EU since 2004. After a review of common labour market-related characteristics and problems of the EU's central and eastern European members, the article summarises and critically evaluates the main elements of flexicurity suggestions. It further compares them to the relevant policy proposals based primarily on more orthodox economic analysis. The analysis shows that several preconditions for a successful flexicurity strategy are still lacking across the new member states. Moreover, the article demonstrates that current proposals by the critics of a single-minded flexicurity approach by no means always disregard potentially positive effects of improving the supposed trade-offs between flexibility and security. At least a limited convergence between flexicurity and a renewed orthodoxy in the economic mainstream can be detected.

Keywords
Central and Eastern Europe; Convergence; Employment; Flexicurity; Labour market- related institutions; Transition; Welfare regimes

"FLEXICURITY" HAS BECOME A BUZZWORD AMONG POLICYMAKERS IN EUROPE BECAUSE it suggests that rather generous unemployment benefits and spending on active labour market policies can be aligned with a flexible, employment-friendly labour market. In other words, the idea is to balance employers' needs for flexibility in an environment where companies face the challenges of increased competition – for example, due to

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globalisation – with workers' need for security and (working-time) flexibility in a way that allows high economic growth and good labour market performance.

The approach originates from Denmark's successful combination of relaxed hiring and firing rules (flexibility), comparatively generous wage replacement rates (income security) and extensive support for the unemployed to return to work (employment security). The European Commission views Denmark's success as an example of best practice and encourages all European Union (EU) member states to move towards such a pathway in their labour market policies. Flexicurity has often been set broadly in contrast to flexibility-enhancing approaches advocated by the International Monetary Fund's (IMF), the World Bank or the Organisation for Economic Co-operation and Development (OECD). These institutions regard more flexibility as the panacea to reinvigorate regulated labour markets with persistently high unemployment and to bring about more growth through increased employment. The analytical framework of flexicurity is also said to have proved to be "an extremely powerful and relevant concept for transition economies of Central and Eastern Europe, offering an alternative to the 'pure' flexibility policy prescription promoted in that region" (Cazes 2008: 10).

Against this background the question may be posed whether the flexicurity approach is adequate for the EU's Central and Eastern European member states (CEECs) that joined the European Union (EU) since 2004 (i.e. Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovakia, Slovenia (May 2004), Bulgaria and Romania (January 2007). After a thorough review of the most important, common labour market-related characteristics and problems of the CEECs, the article summarises and critically evaluates the main elements of the flexicurity argument. It further compares flexicurity to the relevant policy proposals based primarily on more orthodox economic analysis, which have been suggested by certain international organisation such as the IMF, World Bank and OECD. On the one hand, the analysis shows that several preconditions for a successful flexicurity strategy are still lacking across the CEECs. This may explain why, until recently, empirical evidence has found little substance and convergence among reform pathways that are said to be based, at least in parts, on flexicurity in the CEECs. On the other hand, current proposals by the critics of a single-minded flexicurity approach do not always disregard the potentially positive effects of improving the (apparent) trade-offs between flexibility and security. Furthermore, a limited convergence between flexicurity and a renewed orthodoxy in the economic mainstream can be detected.

Common labour market characteristics in the CEECS

In the former centrally planned economies of 'real socialism', prices and wages were not determined by market forces or bargaining between employers and employees and their representatives; rather they were determined directly or indirectly by government directives. In this system, workers enjoyed a high degree of employment protection (Kohl 2008: 1). In fact, the labour code did not allow laying off redundant workers for economic reasons. Full-employment was guaranteed by the state despite its negative effect on productivity and low efficiency of production. The economic problems that emerged during times of increased structural change, due to globalization and new information and communication opportunities, led to the collapse of the communist regimes across Eastern Europe during late 1989. This resulted in a process of triple transition (political, economic and social) which saw the CEECs restructure their economies along market lines. The need for rapid structural adjustment of the CEECs was particularly reflected in profound amendments to national employment protection laws immediately after the collapse of the former communist regimes. "The objective was to facilitate workforce adjustment for firms in order to make enterprises more flexible and economically

competitive while guaranteeing solid employment protection for workers comparable with that prevailing in developed market economies. In reality it meant substantial moderation of workers' protection in general, which was also made possible due to the weakening of trade union power" (Cazes and Nesporova: 2003: 7). As a result of all these changes, it is undisputed that after the market-oriented restructuring accompanied by negative economic growth and strong turbulence in labour markets, as well as "much hardship and disillusion" (McAleese 2004: 339), the economies' average production has outperformed the former system. Real Gross Domestic Product (GDP) between 1989 and 2007 increased across all CEECs, ranging from 7% in Bulgaria to 69% in Poland (Wagener *et al.* 2009: 299).[1] It has to be acknowledged that "relative to the dramatically different starting conditions there has been substantial convergence towards continental European labour market outcomes and institutions" (Huber 2003: 155), despite some remaining differences particular until the EU accession process started. The following facts describe the main common contemporary characteristics of the CEECs with regard to outcomes, institutions and remaining problems. Since 2000 the following patterns can be detected:

Unemployment: In the four years prior to the accession of eight CEECs, the average unemployment rates of these countries were roughly three to four percentage points higher than in the EU-15. The average unemployment rate of the CEECs decreased by 1-2 percentage points per year between 2004 and 2007. At the same time the average unemployment rate in the EU-15 decreased more slowly (see table 1). The matching of the average unemployment rates is one element of a convergence of labour market conditions between the CEECs and the EU-15.

Table 1: *Comparison of average unemployment rates in EU-15 and CEECs between 2000 and 2007*

	Years							
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Average unemployment rates in EU-15	7.7	7.2	7.6	7.9	8.0	8.1	7.7	7.0
Average unemployment rates in CEECs	10.8	11.6	12.4	11.6	11.5	10.6	8.9	6.9*
Notes: * without Romania, where data were missing for this computation.								

Source: Brücker *et al.* (2009: 15).

Such a comparison of averages conceals a picture that is more mixed when analysing the CEECs individually. In all countries, apart from Hungary, unemployment decreased in 2007, compared to 2000 and 2004. This trend continued into 2008, when unemployment was lower than in 2007 across half of the CEECs, despite the global economic downturn that affected countries to different degrees depending on their integration into trade and financial markets. In table 2 (below) the final two columns provide information for 2007 on the difference between the actual unemployment rate and the non-accelerating wage rate of unemployment (NAWRU) which is a measure for the tightness of labour markets as well as the long-term unemployment as a percentage of the labour force. Official unemployment was below the estimated NAWRU, except Hungary. This indicates overheating in the labour markets which is confirmed by high inflation rates of close to or

[1] Other GDP increases between 1989 and 2007 were; Czech Republic = 39%; Estonia = 50%; Hungary = 35%; Latvia = 24%; Lithuania = 16%; Romania = 20%; Slovenia = 51%; Slovakia = 54%

above 5% in 2007 across the majority of the CEECs, as well as strong wage increases between 8.1% in Poland and 33.2% in Latvia (Kamps *et al.* 2009: 28). With the development of the economic downturn in 2009 the resulting negative growth rates and rising unemployment in the region affected the high inflation rates and wage increases (Johnson and Turner 2009: 263). The high shares of long term unemployment – in spite of the overheating in the labour markets in four countries, especially in Slovakia, where unemployment that lasts longer than one year is larger than the EU-15 average of 2.8 per cent – meant that this unemployment can be described as structural. In other words, long-term unemployment remains high even as the overall unemployment rate has been substantially reduced. This shows problems of mismatch that need to be addressed in order to avoid overheating during the next upswing in the economy.

Table 2: *Different rates of unemployment in %*

Country	Unemployment rate (UR) in year				UR minus NAWRU** in 2007	Long-term UR in 2007 (% labour force)
	2000	2004	2007	2008*		
Bulgaria	16.4	12.0	6.9	6.0	-0.8	4.0
Czech Rep.	8.7	8.3	5.3	5.0	-0.8	2.8
Estonia	12.8	9.7	4.9	5.1	-1.7	2.3
Hungary	6.4	6.1	7.2	7.7	0.1	3.4
Lithuania	16.4	11.4	4.3	5.4	-1.9	1.4
Latvia	13.4	10.4	5.9	6.5	-1.1	1.6
Poland	16.1	19.0	9.6	7.4	-1.9	4.9
Romania	7.2	7.0	6.4	6.2	-0.2	3.2
Slovakia	18.8	18.2	11.3	9.8	-0.9	8.3
Slovenia	6.7	6.3	4.7	n.a.	n.a.	2.2

Notes: n.a. = not available; NAWRU = non-accelerating wage rate of unemployment; * = WIIW estimate, ** = estimate by Kamps *et al.* (2009)

Sources: Brücker *et al.* (2009: 15), European Commission (2008), Kamps *et al.* (2009: 28) and estimates of unemployment rates for 2008 by European Commission in Johnson and Turner (2009: 262).

Several issues have to be kept in mind when interpreting the data in both tables 1 and 2. Much less generous systems of unemployment assistance than in the EU-15 may lead to underreporting of unemployment in the CEECs. This issue and other factors like higher wages abroad can result in migration from CEECs to other EU countries. A comparison of average unemployment and wage rates between the EU-15 and the CEECs can, therefore, be misleading. For example, if large scale migration occurs and if migrants from CEECs cluster in those EU-15 countries and regions which have high wage levels and low unemployment rates, then this would potentially result in lower wage growth and rising unemployment rates in these 'receiving' EU-15 countries.

Migration has played a role in recent years in some sectors (e.g. health sector in Estonia and Latvia, skilled labour in the industrial and construction sectors more generally) and contributed to a shortage of (adequately skilled) labour. Migration is not the only challenge to labour requirements. Demographic changes including increased life expectancy and falling birth rates mean that populations across the CEE region are aging even faster than those in the old EU (Barysch 2005: 11 and for details FAES 2009: 58-62). According to Kohl (2008: 15-16), this shortage of labour, in part, triggered significant pay increases after EU accession. However, Brücker *et al.* (2009: 169) maintain that labour and

skill shortages should not be attributed solely to international migration or an aging population. Other contributing factors to labour shortages include business cycle effects, younger people staying longer in education, or insufficient regional mobility within countries. Based on the most recent evidence, a consensus appears to be emerging with regard to the labour market effects of immigration in Europe "that such effects are small to negligible" (Brücker *et al.* 2009: 169).

Employment: The unemployment indicators are to some extent flawed, as shown above. Therefore, additional information is useful. It is particularly important, at least in middle- or high-income market economies, to see what percentage of the population is in gainful employment and, therefore, earns its own income and contributes to wage tax and social security payments towards the state and social security institutions. The employment-to-population ratio, or employment rate, measures the number of employees, both the self-employed and those employed by someone else (though not the unemployed), as a ratio of those of employable age amongst the whole population, or amongst a certain age group (Funk 2004: 23). This relationship is particularly appropriate if high employment rates do not hide significant factual problems in labour markets. This is often the case in low-income economies, where jobs of low productivity in the informal sector dominate and social protection systems are lacking, such as the transition countries of the Commonwealth of Independent States (Rutkowski 2006: 38). This indicator is especially useful if average hours of work are high, as is the case in the CEECs. This is due to the dominant role of the full-time unfixed standard employment relationship in the official labour market, which stems, to a large extent, from low hourly wages and a comparatively high payroll tax burden and the resulting low popularity of part-time jobs in the CEE region. Across the region, with the exception of Poland and Slovenia, levels of fixed-term contracts are below the EU-15 average. In addition, part-time employment was always less than half the rate of the EU-15 on average, and in some cases much lower (see table 3). Indeed, partly in order to earn sufficient net-incomes, hours worked in the CEECS "tend to be substantially higher – by up to 30 percent – than in EU-15" (IMF 2008: 6). The rather low average figure for fixed-term contracts masks the fact that this result often does not hold true for younger persons. In Poland and Slovenia, for example, more than half of all young workers are on limited duration contracts, but many of them would prefer a permanent employment relationship (Barysch *et al.* 2008: 86).

Table 3: *The role of the classic more flexible non-standard employment relationships in the CEECs compared to the EU-15 average.*

Country	Part-time employment		Fixed-term contracts	
	2000	**2007**	**2000**	**2007**
Bulgaria	3.2*	1.7	6.3*	5.2
Czech Rep.	5.3	5.0	8.1	8.6
Estonia	8.1	8.2	3.0	2.1
Hungary	3.5	4.1	7.1	7.3
Lithuania	10.2	8.6	4.4	3.5
Latvia	11.3	6.4	6.7	4.2
Poland	10.5	9.2	5.8	28.2
Romania	16.5	9.7	2.8	1.6
Slovakia	2.1	2.6	4.8	5.1
Slovenia	6.5	9.3	13.7	18.5
EU-15	**17.7**	**20.9**	**13.5**	**14.8**
*2001				

Source: European Commission (2008)

Regarding different forms of dependent work (i.e. differing from the unlimited standard employment relationship (from 9 to 5, 5 days a week)), one must not forget the differences to the EU-15 with respect to self-employment before taking a closer look at the statistics of total employment. Across the CEE region self-employment ranges from less than 10% in countries like Estonia to more than 30% in Romania (with slight decreases in most countries, apart from Slovakia recently). This is by several percentage points higher than in EU-15 countries. In the latter countries it accounted for about 15% of total employment between the years 2000 and 2007 (table 4). On the one hand, the higher percentage rate reflects people having been pushed or pulled into self-employment by lack of work opportunities under difficult labour market conditions or higher expected earnings than if they were dependent workers. The push-factor appears to be more important, however. This means that self-employment figures include a large group of subsistence workers, often in the agricultural sector, with low value-added activities, for whom unemployment is not a viable alternative. On the other hand, the number of self-employed is also inflated, as in quite a few cases there is little difference between dependent wage employment and self-employment, although there is no corresponding difference in the nature of jobs. Bulgaria and Poland are countries where, for example, some categories of health care sector employees were turned into independent, self-employed contractors (see Rutkowski 2006: 13-14).

Table 4: *Self-employed as a percentage of total employment.*

Country	Year		
	2000	**2004**	**2007**
Bulgaria	28.2	28.5	26.6
Czech Rep	17.4	18.8	18.2
Estonia	9.0	9.6	9.1
Hungary	15.1	14.2	12.4
Lithuania	19.7	18.7	14.0
Latvia	15.0	13.2	10.8
Poland	27.4	26.7	25.0
Romania	n.a.*	31.9	31.8
Slovakia	8.3	12.3	13.2
Slovenia	18.5	17.8	17.0
EU-15	**14.5**	**14.3**	**14.3**
Notes: *n.a. = not available			

Source: European Commission (2008)

The following employment figures contain the above mentioned specific forms of employment if they are not offered in the shadow economy. As a result of the transformation process, we saw a long and persistent reduction in regular employment rates in the CEECs to levels which were, on average, lower than those of the EU-15 member states. In the year 2000, for example, the total employment rate amounted to 63% in the EU-15. Across the CEECs, with the exception of the Czech Republic, this rate was lower (see table 5). Comparing the developments since 2000 demonstrates, however, a general improvement in total regular employment. This is also reflected in the statistics for specific groups, women and older workers. The EU set targets for these groups will actually be obsolete for some time due to the widely unexpected downturn in 2008/2009. They will, however, most likely play a vital role again once the recession ends. Nonetheless, the figures for 2008 (not in table 5) demonstrated that the total employment rate in the CEE countries ranged from 57.8% in Hungary to 69.8% in Estonia. This was just below the target rate of 70%. Lithuania (53.1%), Latvia (59.4%) and Estonia (62.4%) all reached the Lisbon

strategy target with respect to the employment rate of older workers. This latter rate is 50% and is related to workers aged between 55 and 64 years (Massarelli 2009: 1).

Table 5: *Total employment rate, employment of women and of older workers in 2007 and their percentage point changes since 2000.*

Country	Total employment rate (%)		Female employment rate (%)		Older workers* (%)	
	2007	**Δ 2007-2000**	**2007**	**Δ 2007-2000**	**2007**	**Δ 2007-2000**
Bulgaria	61.7	+11.3	57.6	+11.3	42.6	+21.8
Czech Rep	66.1	+1.1	57.3	+0.4	46.0	+9.7
Estonia	69.4	+9.0	65.9	+9.0	60.0	+13.7
Hungary	57.3	+1.0	50.9	+1.2	33.1	+10.9
Latvia	68.3	+10.8	64.4	+10.6	57.7	+21.7
Lithuania	64.9	+5.8	62.2	+4.5	53.4	+13.0
Poland	57.0	+2.0	50.6	+1.7	29.7	+1.3
Romania	58.8	+1.2	52.8	+1.0	41.4	+4.1
Slovakia	60.7	+3.9	53.0	+1.5	35.6	+14.3
Slovenia	67.8	+5.0	62.6	+4.2	33.5	+10.8
EU-15	66.9	+3.9	59.7	+5.6	46.6	+8.8
EU-targets	**70%**		**more than 60%**		**50%**	
Notes: Δ 2007-2000: percentage change between 2007 and 2000; * Workers aged 55-64.						

Source: European Commission (2008: 30).

These figures also show that the CEE market economies were similar with respect to employment, and the problems of certain groups more or less resembled those of the medium to low performing ones in the EU-15 in 2007. This is despite the above mentioned fact that informal work, jobs in the production of and commercialisation of legal goods and services that are not registered or protected by the state, is still much more important in several of CEECs than in the EU-15 (OECD 2009b: 1-2; Offe and Fuchs 2007: 13). In addition, even if the very high regular employment rates (with often inefficiently low labour productivity due to disincentives and inefficient organisation of work) in the former socialist states are out of reach and remain so in the future, the average material living standards are higher than ever before, as shown above. The general improvement of employment masks different dynamics and shows unequal changes of employment rates between 2000 and 2007 as a rough comparison (table 5). Starting from a high level of employment, it is generally more difficult to achieve a similar percentage point increase than from a low level. In this respect the situation regarding women often improved less than the one for men. In spite of the above mentioned successes with respect to older workers, countries like Poland and Hungary are still very far away from reaching the employment goal of 50 per cent for this age group. The region's countries differ, however, in their achievements. While Poland's old age employment was almost stagnant, it increased in Hungary between 2000 and 2007 by 10.9% points.

A pervasive problem in the CEE region is still the particularly low employment rate of young people aged 15 to 24 years compared to the EU-15 average of just above 40% since the year 2000. The rates are only similar in Estonia, Latvia and Slovenia to the EU-15. Here we see only about 2.5-6 percentage points lower rates in 2007. In the other countries the rates were on average between 13-20 percentage points lower than in the EU-15 (table 6). They are among the lowest in the EU-27 in Hungary, Poland, Bulgaria and Romania. It is

also possible to highlight the special problem of young people by drawing attention to those young people who are not in employment, education or training (NEET). This may capture the problem of inadequate skills formation and education, and the difficulty in moving from education to work. The EU average for this age group stands at 18% of the population aged 15 to 24 years. According to the European Commission (2009: 58) "this hides considerable variation across Member States, with the lowest NEET rates in Denmark and Netherlands and the highest in France, Italy, Poland, Romania and Slovakia". Moreover, Bulgaria and Romania exhibit particularly high NEET rates among teenagers, "indicating problems of school dropout, lack of training and joblessness" (European Commission 2009: 58).

Table 6: *Employment rates of age group 15-24 years.*

Country	Year		
	2000	**2004**	**2007**
Bulgaria	19.7	21.5	24.5
Czech Rep.	36.4	27.8	28.5
Estonia	28.3	27.2	34.5
Hungary	33.5	23.6	21.0
Lithuania	25.9	20.3	25.2
Latvia	29.6	30.5	38.4
Poland	24.5	21.7	25.8
Romania	33.1	27.9	24.4
Slovakia	29.0	26.3	27.6
Slovenia	32.8	33.8	37.6
EU-15	**40.5**	**40.0**	**40.8**

Source: European Commission 2008.

It is also revealing to take a closer look at the relationship between economic growth and employment in different periods of transition (table 7). The end of the 1990s were characterised by a mixed economic growth experience with rather large fluctuations in single countries. Between 1997 and 2000 six countries showed a higher economic growth rate than the EU-15 countries. Due to the ongoing economic restructuring, employment growth was negative, except Hungary and Slovenia. This can be explained by the necessary adjustment during a restructuring period which regularly leads to a period of low labour market performance in spite of flexible labour markets.

The "pre-accession" and immediate "post-accession" phases of the 2004 eastern enlargement saw a higher economic growth rate in all countries, except Hungary, Poland and Slovenia. Employment growth was no longer negative, with the exception of Poland and Romania and it stagnated in the Czech Republic. Half of the countries displayed lower employment growth rates than the EU-15, despite higher unemployment rates in these economies. Though experiencing high catch-up growth of real GDP in the CEECs, the low, stagnant or declining employment growth in the period mirrored the rather bleak labour market performance in terms of solving the macroeconomic (un)employment problems of that time.

The period 2001 to 2004 was characterised by low growth of real GDP of, on average, 1.6% in the EU-15; the exceptions being Ireland, Spain and the United Kingdom (UK) which experienced more than double this average. During that period, employment grew by only 0.8% per annum in the EU-15, with Germany and Denmark being the worst

performers in this regard displaying negative figures, while only Ireland and Spain experienced noticeable employment growth.

Table 7: *Relationship between economic growth and employment growth.*

	Average annual economic growth 1997-2000	**Average annual employment growth 1997-2000**	**Average annual economic growth 2001-2004**	**Average annual employment growth 2001-2004**	**Average annual economic growth 2005-2007**	**Average annual employment growth 2005-2007**	**Economic growth in 2008**
BL	1.5	-0.4	5.1	1.2	6.2	2.9	6.0
CZ	0.9	-1.2	3.1	0.0	6.4	1.6	6.0
EE	6.4	-2.0	7.8	0.9	9.5	2.7	-3.6
HU	4.7	1.7	4.4	0.2	3.1	0.2	0.5
LT	4.7	-1.6	7.8	0.5	8.1	2.0	3.0
LV	5.8	-0.2	7.6	1.6	11.0	3.3	-4.6
PL	5.2	-0.7	3.0	-1.3	5.4	3.3	4.8
RO	-2.5	-2.0	6.1	-4.2	4.5	0.8	7.1
SK	2.5	-1.5	4.6	0.4	8.5	1.9	6.4
SL	4.5	0.3	3.5	0.5	5.3	1.4	3.5
EU-15	**3.1**	**1.7**	**1.6**	**0.8**	**2.4**	**1.3**	**n.a.**

Source: European Commission (2008), own calculations.

The post accession period was characterised by an upswing in the business cycle in the EU-15. This period also saw real GDP growth for most CEECs. Employment growth became more robust than in the earlier periods. Simultaneously, unemployment decreased significantly. "This drop was largely attributable to the strong GDP growth and, to a lesser extent, to labour migration, e.g. in Latvia, Poland and, probably so, in Romania" (Brücker *et al.* 2009: 168). Economic and labour market prospects for the years to come are uncertain due to the severe recession in the industrial countries especially in 2009 and partly in 2008. Poland, in particular, has been less severely affected by the global downturn as it is integrated into the financial markets to a lower degree and depends less on foreign trade (Brücker *et al.* 2009: 168).

With regard to (un)employment outcomes, it has to be recognised that, in the years immediately prior to accession, after more than a decade of transition, the labour markets of the CEECs were still displaying very poor outcomes with, low and, sometimes, still declining employment rates (Cazes 2008: 4). This situation changed decisively after accession to the EU, at least until the downturn of 2008/2009. Overall, in 2007, just prior to the recession, the labour markets in the CEECs compared much better with the EU-15 average than before accession. Explanations for these patterns will be given below. Nonetheless, the region was still lagging behind the best performers in the EU (and the leading OECD countries) with regard to (un)employment. This was particularly so with respect to the Nordic countries and the UK. The main reason for this was because low employment rates for young people and the older generation, women and a relatively high and persistent incidence of long-term unemployment has continued across the CEECs.

Common institutional problems and related trends in the CEE region

The fact that transition has led to a large fall in the number of jobs and a longer-term under-utilisation of labour than was expected, means that quite a few issues and their

interactions have to be taken into account. Initially social income support was generous. Accelerating unemployment due to the deep transition crisis that was associated with the pace of enterprise restructuring and the rate of job creation, however, changed policy-makers minds as experts of the World Bank and the International Monetary Fund as well as the OECD proposed liberal labour market policies. Against this background, politicians decreased unemployment benefits hoping that this would contribute towards faster re-employment of jobless persons. Since then, relatively restrictive unemployment benefit systems compared to western European countries with rather low replacement rates and a constrained duration have become characteristic of the region. In other words, the initially generous eligibility conditions have been strictly tightened since the mid-1990s.

The above mentioned restrictive contemporary unemployment benefit system and the "limited job opportunities have also led to discouragement and massive labour force withdrawals, especially among younger and older cohorts as well as women" (Rutkowski 2006: 38). Additionally, the oft-used early exit strategies meant effectively an enduring burden on systems of social security and employment, as this policy led to high payroll taxes. The reason for this is the fact that social security systems and expenditures in the region are financed similarly to continental European countries like Germany, predominantly through contributions levied on wages, which results in high supplementary labour cost (Barysch 2005: 8 and Buttler 2008: 1, Żukowski 2009: 29). The majority of the CEE region's countries "stick to the Bismarckian model regarding the mode of financing the welfare state, which relies on social security contributions shared between employers and employees, and levied against wages, with general tax revenues playing only a marginal role" (Offe and Fuchs 2007: 16). Even low labour incomes have to bear regularly high social contributions in the CEE region which explains the high salience of the shadow economy in the region, apart from the Czech Republic and Slovakia (Rutkowski and Scarpetta 2005: 94; Buttler 2008: 5). Effectively, the CEE economies "also suffer from poor labor market performance which is due, in part, to the high non-wage costs of employment. […] High non-wage labor costs weaken the already imbalanced labor market and shrink the contribution base as a result of increasing incentives to participate in the shadow economy. Therefore, there seems to be at best, only very limited room to increase revenues by increasing contribution rates" (Offe and Fuchs 2007: 16).

Some evidence suggests that early exit strategies still play a certain role in several CEE countries and can contribute to explaining rather low labour force participation rates compared to the best performers in the EU-15. It is obvious, and in line with well-known tendencies for welfare budgets in catching-up countries (Offe and Fuchs 2007: 12), that social protection-related expenditures as a share of GDP, which ranged from 12.4% in Estonia and seven other countries below 20% to 22.3% in Hungary and 22.8% in Slovenia, were considerably lower than the average of 27.5% in the EU-15 in 2006 (Puglia 2009: 4). However, expenditure on social protection benefits in certain areas that are, as a share of total social benefits, much higher than the average in the EU-15, may signal only to some extent real demographic or sickness and disability trends (Puglia 2009: 6). Several examples serve to show this: in eight CEE countries, old age expenditure was similar to the EU-15 average of 45.9% of total social welfare payments, while they amounted to 52.9% in Bulgaria and 61.25% in Poland in 2006. Similarly, the spending on sickness/health care as a per cent of total social benefits was more than 5 percentage points higher than the EU-15 average of 29.3% in the Czech Republic and in Romania in 2006. Additionally, the relative spending on disability was, apart from Latvia, by one to 3.3 percentage points higher than in the EU-15, with 7.4% of GDP in 2006. Therefore, these figures rather hint at the use of these social protection expenditures to some extent to pay for alternative routes into factual early retirement to decrease registered unemployment. The figures above also imply that with respect to some parts of the CEE region it is probably true that "the Central and East Europeans spend too much on social security, given their rather low level of

income and economic development" (Barysch 2005: 8), at least if this spending is connected to a poor labour market performance. Simultaneously, the relative spending on unemployment benefits was almost always 2 to 3 percentage points lower than the EU-15 average of 5.7% and reached just 0.9% in Estonia.

Furthermore, labour mobility in CEE was "relatively low, *inter alia* due to an underdeveloped housing market. Although regional wages tend to respond to regional unemployment, this is not enough to entice entry of new firms and investment which are a prerequisite for job creation" (Rutkowski 2006: 39). A further problem is insufficient availability and affordability of (public) transport to increase labour mobility. At the same time "activation measures" have been comparatively unimportant in the CEE region. Such measures refer to the use of active labour market policies (ALMP) to help unemployed persons and others experiencing difficulty to a job by themselves. One in ten of the total population wanting to work across the EU took part in some form of labour market policy training, one of the most important measures of ALMP, at any time during 2006. In terms of methodology, this figure shows the average number of people activated at any point during the year 2006 (and not the number of different individuals activated through training during this year). According to the definition by the International Labour Organisation (ILO), persons wanting to work include unemployed individuals without work that are currently available for work, or actively seeking work, as well as the other inactive persons wanting to work but not actively seeking employment or not currently available for work (the so-called labour reserve). There were large differences between countries, however, with respect to labour market policy measures among the EU countries. While the highest activation rates through training were observed in some of the continental European countries (ranging from around 16 persons per 100 people wanting to work in France to 23.6 in Germany), the levels of activation were one person per 100 persons wanting to work in the UK. This low value was also witnessed in all CEE countries, apart from Slovenia which had about 8 in 100 persons wanting to work (Gagel 2009b: 6-7). In line with these facts, the implied low relevance of labour market policies in the CEE region shows up in particular in its low labour market policy expenditures in per cent of the respective GDP values which are often several times lower than the average in the EU (Gagel 2009a).

These developments were accompanied by sharply falling real wages during the early phase of transition, which have rebounded since the mid-1990s, following the resumption of economic growth (Rutkowski 2006: 38-39). Meanwhile, the income inequalities in the CEE region have become more pronounced than in the EU-15 on average (Buttler 2008: 5). "The income disparities correlate with low union density, small shares of firms bound by collective agreements and little centralisation and co-ordination of wage bargaining (Buttler, Schoof and Walwei 2006: 112). In such an environment, firm specific characteristics such as profitability, industry affiliation, ownership etc. increase wage inequality. Further driving forces behind the growth in income inequalities, particularly with regard to wages, have been the increases in returns to education and high white collar skills. This has resulted in rising income inequalities with respect to skills and regions. These inequalities are partly related to labour market segmentations in the CEECs. Such segmentations show up, for example, in unemployment rates in depressed regions of a country that are two to three times as high as in low unemployment regions. The losers comprise less skilled low-wage blue collar workers in declining industries and regions where unemployment is already high. The winners include well educated white collar workers who find employment mainly in the well-paying expanding services sector (Rutkowski 2006: 39). The final effects of these developments on, for example, inequalities are not entirely clear by now: "One way to counteract the income disparities in the prime distribution is by state redistribution. However, because of their developmental backlog the potential of the Central and Eastern economies for substantial social policy

intervention is exceptionally limited" (Buttler, Schoof and Walwei 2006: 112). Due to the recent recession, this problem has become worse. Governments now often have to choose between Draconian cuts in welfare and fiscal irresponsibility (that may prove unsustainable in the longer term).

Against this background, persistent unemployment existed until the first half of the 2000s. "In particular, outflows from unemployment to jobs have been low in many cases leading to build up of a large pool of long-term unemployed, with a negative effect on their employment prospects" (Rutkowski 2006: 39). A reasonable explanation for these patterns put forward by Buttler, Schoof and Walwei (2006: 110) suggested that the transformation crisis is ongoing because "unlike in western Europe, the still high level of employment insecurity in the new member states induces fewer workers to change their jobs even during especially good times". Such a poor and slow adjustment occurred in spite of the comparatively underdeveloped trade union power as demonstrated by the low and still rapidly declining average density of trade unions in the CEE countries – exceptions are only Slovenia and Romania – compared to the EU-15 as a whole (see table 8). This is further reflected in the low and ineffective collective bargaining coverage across the region; the only exception being Slovenia (see for details and background Funk and Lesch 2004 and Kohl 2009). Similar to the US and Japan, as well as the UK, the new CEE member states "limit themselves largely to fixing 'the rules of the game'. Minimum rules on employment conditions are laid down in law, the rest being left to the individual negotiating power and skills" (Gerstenberger 2009). These features are often portrayed as being in contrast to "the key elements of European Social models" that "clearly distinguish the EU from its global competitors" (Gerstenberger 2009); namely, Japan and the USA. More specifically, in the EU, around two third of workers have their pay and conditions set by collective bargaining, in contrast to the lower levels in Japan (20%) and the USA (12%) as well as in the CEE region (often considerably lower than 50%). Furthermore, as opposed to the often pursued practices in the eastern parts of the EU, employee involvement is mandatory and it is not up to companies to decide whether and how they wish to involve their employees with respect to many areas of industrial relations, employment conditions and workers rights.

The lack of union success in the CEE region with regard to job security, labour standards and wage-determination procedures may explain this situation. Several non-union sectors (often without employers' associations as well) and a large number of non-union companies, in the order of around 80%, prevail in the CEE region. In other words, essential conditions for bilateral wage settlements and wage bargaining as well as the involvement of workers via works councils are regularly missing. The exception is the special Slovenian case with amongst other things, a different tradition of self-government in a small comparatively rich nation in relation to the rest of the CEE region

It has to be seen what changes the implementation of the 1994 EU Directive on European works councils and of the 2002 EU Directive on Minimum Standards for Information and Consultation of Employees will finally bring to this situation of obviously weak trade unions in the future. An important reason for the weakness of the trade union movement appears to be its decentralised funding structure that leads to particular weak trade union centres hardly able to pay expert staff and national campaigns and projects (Kohl 2008). This background of weak actors in industrial relations can, at least partly, explain the often pretty low influence of debates triggered by the EU Commission. Given the increased heterogeneity of the EU-27 populations and economies, it is currently unclear if EU industrial relations and other labour market-related policies will evolve more towards those of other similarly heterogeneous countries like the US (Burkhauser 2008: 38) or if those CEE economies which conform less to the EU social model will face pressures to

change their industrial relations systems so as to conform better to the sometimes alleged "EU standards".

Additionally, employment protection legislation (EPL) appears to be rather moderate at first sight, as the average indicator of the CEECs which was 2.2 in 2003 – the latest year for which data for all CEE countries are available (see Knogler 2008) – is somewhat lower than in the old EU member states with 2.4 (see table 8). This is also closer to the OECD countries that have a lower average than the EU (Cazes and Nesporova: 2003: 25 and (Buttler, Schoof and Walwei 2006: 109-110). These figures should signal higher average labour market flexibility in the CEE region. It is also obvious, however, that notable cross-country differences existed (and still exist), as the overall indicator ranged in 2003 between 1.7 in Hungary and 3.1 in Romania. Comparative international studies often use this indicator developed by the OECD to measure EPL. It combines the regulations on individual dismissal protection, collective dismissals and forms of temporary employment such as temporary work via employment agencies and fixed-term employment. While employment protection rules differ across CEE economies, the combined overall EPL index has become on average more liberal compared to the EU.

Nonetheless, these figures also demonstrate that the equilibrating market forces have been weak to alleviate the imbalances in the CEE region with regard to labour market performance. This is all the more so when compared with the more successful EU-15 economies and their labour market performance over the last decade, for example Denmark or the United Kingdom, where the EPL indicator was lower. In the CEE region, the important reasons for insufficient labour market performance explained above, appeared to outweigh the causes often used in highly industrialised economies to explain high structural unemployment; for example, Germany, with strong trade unions, strict labour market regulations and job-protection laws and generous unemployment benefits (Bradley and Stephens 2006: 1).

It has to be noted that minimum wages, which tend to be rather uniform within nations across CEE, are generally not low in an international perspective, in spite of strong and persistent regional and occupational disparities and segmentations (Rutkowski 2006: 36-38; Funk/Lesch 2006: 81). In all CEECs, minimum wages as a percentage of average gross monthly earnings in industry and services were higher than in the USA (31.2%) in 2007, with the exception of Estonia and Romania, which are slightly below the USA-figure (often used as a benchmark). The other countries were below 40% apart from Slovenia (43.9%) and Slovakia (46.6%). The latter two countries' rates are, therefore, higher than in the United Kingdom (38.2%) (Czech 2009: 5). In several of the high-income older member states of the EU, including Denmark, no national minimum wage exists (table 8). Usually high labour taxes in the CEE region contribute to (un)employment problems especially due to interactions with these national minimum wages, as noted above (see for details Boeri/van Ours 2008: 81-98). The main sources of funding social protection expenditures in the CEE region were social contributions in 2006. In eight of the ten CEECs, the share of social protection receipts to fund social protection expenditures amount to 58% (similar to the EU-15 average of 58.9%), while in the Czech Republic and Estonia is higher at 80%. The figures were only significantly lower in Hungary and Poland, by around 5-10 percentage points respectively (table 8). Only these latter countries, since 2000, achieved a significant decrease of their often employment-unfriendly dependence of social contributions to fund social protection expenditure, when social protection receipts still amounted to 59% per cent in Hungary and 55.3% in Poland (Puglia 2009: 10).

The EPL comparison in table 8 (below) hides the fact that significant differences, other than the ones mentioned above, prevailed when taking into account several components of the indicator. Although collective dismissal protection was rather similar to the old EU

countries, this was not true for the other parts of the indicator (Knogler 2008). Apart from Latvia and Lithuania, regular employment relationships were much stronger regulated in the CEE countries, with an average indicator value of 2.7, than fixed-term and temporary jobs, with a value of 1.2. Similarly, regular jobs were better protected, on average, in the CEE countries, than in the EU-15 with a value of 2.3. The comparative figure for Denmark demonstrates that regular employment relationships (indicator value: 1.5) were less protected than in all single CEECs (though more than in the UK), whereas fixed term and temporary contracts in Denmark (1.4) were slightly better protected than on average in the CEE region.

Table 8: *Important selected indicators with respect to institutional incentives*

Country	Indicators			
	Trade union density around 2005[a]	**Employment protection legislation in 2003[b]**	**Minimum wages in 2007[d]**	**Social contributions[f]**
Bulgaria	20	2.0	42.1	58.0
Czech Rep.	20	1.9	38.1	80.3
Estonia	11	2.3	30.5[e]	80.4
Hungary	17	1.7	36.5	53.8
Lithuania	12	2.8	33.5	61.0
Latvia	16	2.5	31.5	63.9
Poland	14	2.1	32.4	48.0
Romania	35	3.1	29.1	69.5
Slovakia	22	2.0	46.6	65.6
Slovenia	44	2.3	43.9	67.9
in comparison:				
EU-15	26	2.4[c]	n.a.	58.9
Denmark	> 60	1.8	n.a.	30.8
UK	< 20	1.1	38.2	47.9

Notes: [a] Density of trade unions in per cent of total workforce (private sector); [b] Overall indicator of employment protection legislation: OECD indicator scores range from 0 to 6 (a high value represents heavy restriction, a very low score hardly any restrictions); [c] without Luxembourg [d] Minimum wages as a percentage of average gross monthly earnings in industry and services; [e] 2006; [f] as per cent of total receipts in 2006. n.a. = not available.

Source: Czech (2009); European Commission (2009); Knogler (2008); Kohl (2008); Puglia (2009).

Despite the asymmetric liberalisation of the CEE labour market and the persistence of strictly regulated regular employment relationships (Knogler 2007, 2008), the role of registered "irregular" jobs, particularly fixed-term or temporary ones, remains very small compared to the EU-15, apart from Poland and Slovenia (see table 3). The empirical evidence for OECD countries shows that the different treatment of fixed-term and permanent contracts encourages a two-tier regular labour market that is undesirable from a pure theoretical economic and equity point of view. This is because this approach shifts the burden of adjustment onto the margins of the labour market, such as youths, older workers and women (OECD 2006). An important reason why this adjustment is probably much less visible in the CEE region, apart from Poland and Slovenia, appears to be the larger role of the shadow economy compared to the EU-15 average. In other words, the larger informal sectors in the CEE region seem to be driven by the avoidance of labour market-related and other regulations, including evasion of taxes. Despite evidence supporting a relatively strong enforcement of labour market regulations, at least compared to the non-CEE transition states (Rutkowski 2006: 39), other empirical evidence appears to demonstrate that the effectiveness of regulation in several of the CEEC is smaller than international comparisons of EPL suggest (Knogler 2007, 2008).

Voluntary leaves, for example, are often only reported as voluntary due to illegal extra-agreements when signing a new labour contract that includes "a notice of dismissal (voluntary leave) signed by employee and left with the employer with open date" (Eamets/Masso 2004: 26). Similarly, in "Poland new recruits frequently negotiate their employment conditions directly with their boss, who may make it clear that notice periods or severance pay will not be available" (Barysch 2005: 12). Further examples for the lack of regulatory effectiveness are the apparently widespread habits of widespread tax evasion, despite low income taxes (Barysch 2005: 8), and of non-declared pay-components, above all for recipients of minimum wages, in several CEE countries. "This results in a considerable loss of taxes and social security contributions for the general public as well as lower revenues from union dues for the trade unions if dues are paid on the basis of the officially declared minimum rate only" (Kohl 2008: 12; see also Barysch 2005: 15). The comparatively high importance of the informal sector is associated with the increased incidence of casual jobs as well as with self-employment (table 6). On the whole, these factors can largely explain why atypical work appears to play a small role in the regular sector in spite of its comparatively low and decreasing regulation.

The EU accession negotiations, which began in 1997, saw the transposition of the *acquis communautaire* – the key laws of the EU – by the CEECs. This led the investment climate to improve considerably. As a result, CEECs, particularly those in central Europe (i.e. Poland, Hungary, Czech Republic), became prime targets for foreign direct investment (FDI) and outsourcing by European and non-European firms (Hölscher and Stephan 2009: 864). Barysch (2005: 2) notes:

> The process of accession has been important for FDI, for several reasons: first, as the East European countries took over EU rules and policies, their business environments started to resemble those in Western Europe. As a result, foreign investors started to feel more at home in the accession countries. Second, as the EU opened up its markets for goods from Poland, Estonia or Slovakia, these countries became more attractive locations for export-oriented production. And third, the prospect of EU membership acted as an "external anchor" for economic reforms, guaranteeing a certain amount of stability and insuring investors against policy reversals.

Additional reasons explaining why the (un)employment performance remained weak until external conditions improved, include the following factors: (1) world economic growth and trade expanded to a larger degree in the post-accession period than in the years before; (2) the EU-15 further expanded trade, which helped the catch-up CEE economies, as these countries became major export markets for the EU-15. Benefits arose from the abolition of the final remaining trade barriers after accession, allowing easier cross-border co-operation between the various new member states, thus boosting trade within the CEE region, as well as with destinations beyond the EU. Last but not least, transfers from the EU budget were higher after the accession process, these payments were, however, much too low to fully account for the improved performance (Richter 2007).

From a labour market perspective, all these factors shifted labour demand upwards and thus could have contributed to solving quite a few of the former labour market problems if the increased demand for labour had endured. However, the high demand for labour proved to be unrealistic in the light of the 2008-2009 economic crisis. This was due to the fact that, in part, the increased demand was cyclical and in some parts of the CEE region, particularly unbalanced (i.e. Latvia and Hungary). These countries were characterised by unsustainable consumption, growth of the construction sector or export-dependent booms (Tilford and Whyte 2009: 11 and 72-74). In other words, structural labour market problems in the CEE region will still have to be addressed in the next section. Before

moving to this, however, the analysis of further important structural indicators will be provided.

In order to highlight commonalities among the CEE nations, this article has thus far not fully addressed important cross country differences. These differences may go some way to explaining the divergence of future trajectories taken by the CEECs. Two social indicators that are often used in international comparisons are (1) income inequality and (2) the percentage of persons at risk of poverty (Tilford and Whyte 2009: 89). Income inequality can be defined as the ratio of total income earned by the top 20% of the population relative to the 20% at bottom. 'At risk of poverty after social transfers' is defined as the share of the population whose income is less than 60% the national median disposable income after social transfers. The poverty of risk, as well as income inequality indicators are very mixed in the CEE region. They are also highly correlated and range from those states with a high risk of poverty, i.e. UK with values of 19% and 5.4 in 2006 (similar to Estonia, Latvia, Lithuania and Romania) to those with a low risk, such as Denmark with values of 12% and 3.7 in 2007 reflecting similar values in the other CEE member states (Tilford and Whyte 2009: 89). However, the belief that freeing up markets always leads to more social inequality problems is not supported by the evidence (Tilford and Whyte 2009: 89). On the contrary, it has to be noted by Tilford and Whyte (2009: 90) that:

> the country with the lowest levels of long-term unemployment, income inequality and poverty in the EU is Denmark – a country with some of the most liberalised markets for goods, services and labour in the EU. Equally, many of the countries with the worst social outcomes in the EU (notably Greece, Italy and Portugal) have highly restrictive product and labour markets. So liberalisation does not threaten social justice and high levels of regulations do not guarantee it.

Hence, the worst outcome of the 2008-2009 economic crisis from a longer-term perspective for economic efficiency, employment as well as social equality will be fulfilling emerging demands to strengthen EPL and "that globalisation will be blamed for job losses, sparking demand for trade protection" (Tilford and Whyte 2009: 72).

A final important issue is the role of skills and education. Employment rates and productivity levels, as well as wages for people with university-level education, are, on average, markedly higher for people with university-level education than those for people who complete secondary education (let alone those who fail to do this). It has to be borne in mind that the Danish employment successes have to be seen also in light of its excellent education system. Probably, countries that adopt flexicurity measures without improving skills levels will not achieve Danish social outcomes (Tilford and Whyte 2009: 90). Stocktaking in this respect is mixed; the results of selected CEECs are respectable in terms of international performance rankings (e.g. Estonia) or at least with regard to improvements in this respect (e.g. Latvia and Poland). However, in the Czech Republic, Hungary or Slovakia, for example, the percentage of persons aged 25 to 34 who hold a university degree is at less than 20%; much lower than the EU average of around 30% and the one in Denmark which is still 10 percentage points higher (Tilford and Whyte 2009: 81-82).

Orthodoxy, flexicurity or a mix of both: which way forward?

This section examines the policy agendas impacting the CEE regions and informed by key economic institutions. A good starting point is to check the proposals by the experts of the international economic institutions which specialise in benchmarking countries. Institutional approaches differ considerably at first sight, and move in at least two alternative directions. On the one hand, the OECD, the IMF and the World Bank based their

early policy proposals, particularly in the 1990s, on commonly accepted economic theories and general "orthodoxy", that is "neoclassical economics in which market liberal solutions predominate" (Bradley and Stephens 2006: 2).

In contrast, the most important alternative agenda follows a flexicurity model and is based on more institutionalist scrutiny demands, more or less presents a turn-around of orthodox mainstream economic policies. The ILO and the EU are the main proponents of this flexicurity-agenda (Auer and Gazier 2008). Arguing independently of specific single country cases, the ILO and the EU approach is based on more abstract, generalised relationships between flexibility and security as an alternative policy to pure deregulation. These approaches included the flexicurity project by the ILO that was launched in 2002 and lasted until 2005. It dealt particularly with Bulgaria, Hungary, Lithuania and Poland. Later this has included the EU Commission's flexicurity project according to which "flexicurity strategies aim to combine employment and income security with flexibility in labour markets, work organisation and labour relations" (European Commission 2009: 54). This framework has directly addressed the CEE region since 2006, when the EU published its so-called pathways to flexicurity, of which one especially fits the situation in the CEE region.

According to representatives of ILO, "the 'pure flexibility' approach that was promoted through pressures from international financial institutions to amend the labour legislation, in the region as the main and sole alternative to best transform labour markets in this region did not work" (Cazes 2008: 4-5). They contend that rather adverse effects on employment and reallocation of labour were the result. "Many workers, for example, were hesitant to quit their jobs voluntary, even in periods of economic recovery, because of the weak labour market institutional and policy setting and the resulting perception of job insecurity" (Cazes 2008: 5). In other words, "the liberalization of the employment protection legislation in Central and Eastern Europe was not adequately compensated by social protection, since the unemployment insurance became as well less generous and active labour market policies were underdeveloped" (Cazes 2008: 5). In this view, it is acceptable that governmental measures increase labour market flexibility in order to combat their employment problems. However, this requires that employees do not experience the changes that are needed "as a threat but understand it to be an opportunity" (Buttler, Schoof and Walwei 2006: 110). According to the proponents of this approach, the chances of realisation and success of more external labour market flexibility would increase if it were accompanied by labour market and social policy aimed at activation (Cazes and Nesporova 2007: 242). In other words, proponents of flexicurity support, as a rule, a larger role for tax-financing of a more generous unemployment benefit system and an increased role of ALMP spending (see Buttler 2008: 9).

Critics doubt that it is uncertain as to whether the expected pay-off in terms of increased productivity in the economy can outweigh the increased cost of financing these measures (see Calmfors 2007; Funk 2008 and Zhou 2008). In other words, a net gain in terms of job creation, as well as average job quality, is not ensured. In the current situation of rising budget deficits, it remains unclear how to finance additional spending on passive and active labour market policy. In order to finance such measures for certain groups without rising budgets of government bodies both the flexibility and productivity of the beneficiaries need to increase, or less security spending will be available for other groups and measures. Taking into account the likely electoral consequences of decreasing the security of insiders in the labour market, it is uncertain that flexicurity is popular among the majority of the electorate or, for example, the representatives of trade unions. At the same time, it is unlikely that the flexicurity strategy will be popular among national politicians, despite the EU Commission's efforts to promote the approach.

A recent study, financed by the European Commission, on flexicurity in industrial relations, presents rather disappointing results and impact levels of the approach, despite of its prominence at the European level since 2006. The comprehensive study was based on questionnaires to industrial relations experts in all the EU member states by the European Foundation for the Improvement of Living and Working Conditions in Dublin. It demonstrates that although "flexicurity is now the overriding guideline for labour market reform in the EU" (Auer and Gazier 2008: 3), the break-through in industrial relations in the Union is still rather limited. The study finds a "relatively low relevance of flexicurity in the national debates" (Pedersini 2008: 6) with certain important exceptions including some new member states (NMS) that joined the EU since 2004. "In the case of the NMS, the reform of labour regulation has been a relevant part of the accession phase and the EU employment policies have been widely debated" (Pedersini 2008: 6). In these cases:

> reference to flexicurity tends to remain rather abstract and does not preclude the presence of harsh criticism, but in certain circumstances it can emerge as an important element of the shared objectives of the government and the social partners, like in Bulgaria. In many Member States, the integration of the flexicurity concept at national level is only in its early stages – as in the Baltic states of Estonia, Latvia and Lithuania, as well as…Hungary. (Pedersini 2008: 6)

However, "the effects of the debate on flexicurity on the policymaking process are rather weak", because "the concept still needs clarification and interventions follow the lines of traditional segmented policies – which is the case in many of the NMS" (Pedersini 2008: 7). The actors in wage bargaining are to a very large extent characterised by traditional attitudes, with employers demanding more flexibility and trade unions arguing for more security. Exceptions are traditional fields of training which are, for example, sponsored by the state. Contractual agreements often attract opposite demands from employers in the form of more flexibility and trade unions in the form of more security.

Moreover, it has to be noted that despite the fully justified criticisms against the use of economic orthodox explanations in terms of understanding what has happened in the CEE region, it still may have merits for wider analysis. Labour market developments may be explained according to the realists among the challenged economic orthodoxy in a plausible way. Their story starts with the extreme situation of transition countries which was often underestimated by the orthodox optimists. It was marked by severe shocks to their economies with simultaneously only very poor adjustment capacities, partly because of the urgent needs to keep budget deficits in line with sound macroeconomic policies. One of the potential explanations for the rather bad labour market record in the years after transition until around 2004 is as follows. Generous labour market institutions, and in particular, unemployment benefits, may have contributed to the initially high levels of unemployment in the CEE region by acting as a floor on wages. It is true that subsequent changes to benefits systems have not necessarily been associated with moving people back to employment. This may be perfectly in line with economic reasoning. For example, "if the least productive workers lost their jobs first, those with low skills have subsequently become locked into unemployment. When the generosity of benefits began to recede in the second half of the 1990s the human capital had effectively deteriorated to an extent that they were unable to find work" (Commander and Heitmueller 2007: 4-5). It is highly implausible to assume that such structural problems which were related to a much lower effective stock of profitable jobs compared to the existing (potential) supply of labour could have been resolved with, for example, increased expenditure on ALMP financed by governments with already very tight budgets, rather than with an enduringly improved investment climate that trigger investments into profitable employment relationships to increase the stock of jobs available in the economies (an alternative could be an adjustment mainly via emigration of labour to other countries to find a new long-term equilibrium). However, this hypothesis is difficult to test empirically. At least some

'anecdotal' evidence is available that supports it. For the CEE OECD member states, comparable data related to this hypothesis is available. It shows that in 2006 employment/population ratios of persons aged 25 to 64 with less than upper secondary education was at 23.5% (Slovak Republic), 38.2% (Hungary), 43.9% (Czech Republic) and 53.6% (Poland). This was below that of the EU-19 (this is the EU-15 plus the four CEE OECD member states) and total OECD averages of 55.5% and 58.4% (OECD 2009d). Moreover, this mainstream hypothesis of faster human capital depreciation of the job losers than profitable job creation in the real economies has not been rejected convincingly by other evidence. In other words, according to many mainstream economists the labour market performance in the CEE economies described above cannot be used as evidence that can reject the principal longer-term employment-effectiveness of the earlier implemented reform trajectories, though considerable adjustment in details may well prove welfare-enhancing.

Returning to flexicurity, one may, at least superficially, compare the conditions and indicators of flexicurity's role model, Denmark, with the situation in the CEE region. It is obvious that the structural indicators for Denmark in table 8 differ considerably from the ones in all CEE countries, apart from probably Slovenia, with regard to trade union membership. The EPL indicator even masks that, in contrast to the CEE region, the regulation between regular and non-standard jobs is much more symmetric. Taking account of further indicators mentioned above, as for example the expenditures on social protection as per cent of GDP in 2006, the spending of Denmark was even higher than the EU-15 average, which was not reached by any CEECs by far, by 1.6%. At the same time, the relative spending for old age and survivor benefits was at 37.9% (UK: 44.7%) which was much lower than in the CEE region, while the relative spending on unemployment benefits was considerably higher at 7.2% (UK: 2.4%).

More generally, with respect to most of these indicators, the UK, as the most important type of an European Anglo-Saxon regime, seems to mirror the average CEE economy much better than the currently most debated Nordic regime of Denmark (Puglia 2009: 6). Even accepting that the Danish model must not be regarded as a one-size-fits-all model (Cazes 2008: 5) and taking into account that such a direct comparison is limited, it is striking how far the indicators amongst Denmark (Nordic model) and the large majority of the mixed regimes of the CEECs are falling apart. This is partly because the CEECs still keep important elements like stricter product and labour market regulations that are characteristic for the traditionally employment-hampering continental employment and welfare regimes as, for example, Germany. Reforming these aspects could prove employment-enhancing, if the resulting gains are used to prop-up efficient spending on ALMP and unemployment benefits based on the flexicurity idea. However, it has to be kept in mind that, up until now, both the steering capacities of the industrial relations systems as explained above and of the state (in terms of, for example, to effectively formulate and implement sound policies) have to be regarded as relatively low compared to the Nordic countries, especially Denmark, and partly also to liberal regimes (with low steering capacity of the industrial relation system only) as evidence demonstrates (Kaufmann *et al.* 2008, Wagener and Jacobs 2009: 298-299). This is even more important, as the CEECs have to be regarded as "low-trust"-societies in contrast especially to Denmark (Hausner 2009: 216) which is characterised by a strong "public-spiritedness" (that is a low inclination to cheat with respect to public benefit systems). Table 9 (below) highlights such a broad-brushed stylised comparison.

Finally, it has to be acknowledged that, at least since the restatement of the OECD's Jobs Strategy in 2006, important convergence of the OECD's view towards the ILO position with respect to flexicurity can be easily detected. The OECD concedes now, for example, that well-designed unemployment benefits and activation policies can promote the re-

employment of jobseekers and that strong labour market flexibility combined with low welfare benefits may imply unwanted income gaps and labour market segmentation (Viebrock and Clasen 2009: 21). Furthermore, recent reform proposals for the CEECs contain important ingredients of flexicurity; for example, expansion of training measures and improved activation schemes (OECD 2008, 2009a). Additionally, the ILO admits simultaneously that her approach leaves some open questions that partially address issues raised by the OECD criticism and that countries with only moderate dismissal protection may perform better than the ones with very strict regulations (Abu Sharkh 2008).

Table 9: *Highlighting the differences between continental, liberal and mixed regimes of welfare and employment*

	Liberal regime (e.g. UK)	**Nordic regime / Flexicurity (e.g. DK)**	**Mixed regime (e.g. CEECs)**
Industrial relations system	weak unionisation and weak wage coordination	relatively centralised or at least strongly co-ordinated wage bargaining	weak unionisation and weak wage coordination as in liberal regime
Employment protection legislation (EPL)	minimal public regulation and very low EPL	low need for strict EPL; high coverage by welfare state and dual earner model	strong EPL of core workers in regular jobs as in Continental regime
Unemployment protection / active labour market policies (ALMP) / side effects	residual to alleviate poverty / activation and in-work benefits/ high poverty rates and inequality	uniformly high / ALMP to bring back people to jobs especially in Denmark / very costly, high taxes	movement from status-oriented towards residual / very low ALMP spending / rather high poverty and inequality similar to liberal regime
Product market regulation	Very light and very employment-friendly	light and employment-friendly	rather strict; hampers job creation as in continental regime
Social services provision	market-determined by strong wage differentiation	financed by high taxes and offered by jobs in public sector	often employment-hampering as in continental regime
Steering capacity of state / industrial relations system	strong / weak	strong / strong	weak / weak

Conclusions

An unequivocal answer to the question in the heading of this article proves difficult. The answer depends, amongst other things, on the expected likelihood of different scenarios and, in the final analysis, value judgements about the importance of alternative goals that are connected to often inevitable unwanted side-effects. An example for such a trade-off may be the societal decision between high employment and low structural unemployment but large wage differences and inequalities (liberal regime mainly found in Anglo-Saxon countries, i.e. UK) or a low employment rate with a compressed wage structure and potentially a persistently rather high unemployment rate (conservative regime mainly found in continental Europe; i.e. Germany particularly since the 1980s until the substantial recent reforms). Both 'models' may be connected with rather high poverty rates, either of the unemployed/non-working population or of persons in work on low-paid jobs. In practice, however, poverty rates are generally higher in Anglo-Saxon countries. Potentially, a superior approach is available that combines good labour market performance – similar to liberal regimes – with an improved record in terms of social outcomes – comparable to the traditional outcomes in western or northern Europe and based on the experience in Denmark and, to some extent, the Netherlands. The idea of

flexicurity has served as a blueprint for CEE economies by the ILO and the EU commission in the last years, albeit with few obvious effects up until now. What can be the future of this approach in the CEE region?

Flexicurity offers a vision of a fairer and, in terms of labour market performance economically, superior model compared to the current hybrid regimes of the emerging market economies in the CEE region with foremost conservative and liberal elements. A sudden and very likely inconsistent partial movement towards flexicurity may, however, lead to meagre results. This could even be counterproductive if unrealistic expectations are not fulfilled. In turn, markets might, after such a failure, be regulated by backwards-oriented new governments in a more employment-hampering way than existed before. Currently the awareness among bargaining partners in industrial relations about flexicurity remains low in practice. Despite of having been triggered as a debate more than half a decade ago, there are only few visible results in the CEECs. This is probably caused by the missing preconditions for the practical success of the flexicurity concept in large parts of the region.

It has to be kept in mind that mutual trust among employers and trade union representatives is still often missing to a large extent in the region. Until now, even the power of trade unions to implement collective bargaining systems as well as effective structures to control their use – if they are available – is often missing. Therefore, as long as employers and their associations as well as trade unions do not regard flexicurity as a rather secure "win-win"-situation, in such an environment its implementation appears to be rather doubtful. Additionally, empirical evidence suggests that industrial relations bargaining partners in CEE take decisions that, by no means, are always in the best interest of society as a whole, as proponents of a flexicurity strategy often assume. Instead, they appear to have a preference to shift adjustment burdens on outsiders if possible, for example the entrants into the labour market. Furthermore, it is not obvious that the governments in the CEE region with still rather low steering capacities can – or want to – counter such tendencies. Moreover, it may be in the narrow, short-term interest of governments to increase 'security' by spending more on ALMP under the heading of flexicurity without simultaneously increasing "flexibility". The result is very likely to be lower regular employment, particularly if ALMP is implemented inefficiently. Indeed, it is well known that the problem with ALMP is that it is a double-edged sword: it can improve the operation of markets as well as undermine them. It is by no means obvious if a large-scale increase of such measures without targeting them narrowly will be on net beneficial to CEECs.

It is also by no means confirmed that the existing combination of enterprise-level bargaining and the limited importance of collective agreements (which dominates the CEE regions' firms), will produce a worse labour market and economic growth performance than a move to collective bargaining at the sectoral level (often demanded by proponents of flexicurity) (see Funk and Lesch 2004). Moreover, it is not obvious that strengthening the role of social partners (if they are weak or missing) and their inclusion, which factually often means giving them veto-power, will always lead to better results for society or workers as a whole.

Taking all considerations into account, a strategy of only promoting flexicurity, may prove to be a rather risky strategy in the CEE economies. A more secure approach is probably to follow a strategy with many differing starting points that attack poor labour market performance very broadly, as suggested by the OECD. It is true, however, that since the restatement of the OECD Jobs Strategy and due to similar amendments of the suggestions by the IMF or the World Bank, the proposals by these institutions contain important elements of flexicurity. Therefore, we can sum up that embedding flexicurity in such a

broader context of structural reforms can avoid the main risks of a pure flexicurity strategy and may be worthwhile to follow in the CEE region.

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Varieties of Capitalism, Varieties of Innovation? A Comparison of Old and New EU Member States

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Abstract
This article seeks, firstly, to shed light on the main claim of the *Varieties of Capitalism* (VoC) framework that socio-economic institutions can help to shape comparative advantage, and, secondly, to complement existing assessments that have relied predominantly on qualitative data and that have tended to focus on a few economic sectors. It examines the distribution of export success in a number of economic sectors, in which competitiveness is said to be characterised by either radical or incremental innovation, as well as exports in knowledge-intensive service sectors. Unlike previous studies it applies the framework to some of the new member states of the European Union in Central and Eastern Europe. This is an important area to examine the contentions of the VoC framework, because, if those arguments are correct, they should be applicable to the new member states. Moreover, it draws on the latest available data; for indicators measuring export success this is done at the lowest level of aggregation. In contrast to previous studies, a more appropriate measure of trade specialisation, revealed symmetric comparative advantage, is used. Whilst some of the evidence supports the VoC framework, much of it does not. This raises important conceptual and methodological issues that should be addressed by future research.

Keywords
Comparative Business Systems; Varieties of Capitalism

IN RECENT YEARS, THERE HAS BEEN HEIGHTENED INTEREST INTO THE EFFECTS OF increased global competition (product-market de-regulation, technological advances, enhanced capital mobility, and the spread of the market system) on national public policies (Allen 2004; Allen *et al.* 2006; Berger and Dore 1996; Hall and Soskice 2001a; Whitley 1999). The mainstream view is that socio-economic frameworks that hinder the freedom of companies to adjust their strategies – for example, in terms of output or employment – will have to de-regulate their economies (Esping-Andersen and Regini 2000; Sapir *et al.* 2004; Scharpf and Schmidt 2000), so that firms operating there can

Allen, M.M.C. and Aldred, M.L. (2009). 'Varieties of Capitalism, Varieties of Innovation? A Comparison of Old and New EU Member States', *Journal of Contemporary European Research*. Volume 5, Issue 4. pp. 581-596. Available at: http://www.jcer.net/ojs/index.php/jcer/article/view/224/183

compete more effectively. The view that de-regulated economies perform better than those that hamper managers' prerogatives is especially prevalent in the public debate (Phelps, 2007). Such a view obviously assumes that there is one best way for countries – via the companies that operate in them – to achieve economic success. An important exception to this view is the recent volume on the *Varieties of Capitalism* (VoC) edited by Hall and Soskice (2001a; see also Hall 2001). It argued, in part at least, that 'non-market' socio-economic institutions, such as regulated labour markets, might offer distinct benefits to companies.

The main and innovative claim of the VoC framework is that different types of national institutional settings, which are categorised as either 'liberal market economies' (LMEs) or 'co-ordinated market economies' (CMEs) (or 'unclassified') (Hall and Soskice 2001b: 19-21), will favour contrasting innovation strategies (either, respectively, radical or incremental). These different innovation strategies are, in turn, likely to lead to success in different product markets. Indeed, as the subtitle of the volume makes clear, Hall and Soskice contend that nationally based socio-economic institutions lay the foundations for comparative advantage. They argue that these institutional differences will result in 'cross-national patterns of [product] specialization' Hall and Soskice (2001b: 38; see also Bartle 2002; Casper and Whitley 2004; Hall 2001; Soskice 1999). This article will seek to assess the validity of that main claim, from which two broad expectations can be drawn. Firstly, LMEs, compared to CMEs, will tend to have a higher number of sub-sectors in which they have a comparative advantage in sectors characterised by radical innovation, and, secondly, that CMEs should outperform LMEs in sectors characterised by incremental innovation.

Despite many empirical analyses within the *Varieties of Capitalism* volume edited by Hall and Soskice (2001a) and despite other studies that have, in broad terms, attempted to assess the paradigm (Casper and Matraves 2003; Casper and Whitley 2004; Hall and Gingerich 2001; Paunescu and Schneider 2004; Soskice 1999), the measure of trade specialisation used here, revealed symmetric comparative advantage (RSCA), has tended to be overlooked (Allen *et al.*, 2006), even though it is a more appropriate measure of comparative advantage than those used by other researchers. For instance, Hall and Soskice (2001b) use patent data for Germany and the US to assess their arguments. This measure, however, suffers from a number of drawbacks. Firstly, patents do not necessarily 'translate' into competitive advantages for firms and, hence, comparative advantages for countries. Secondly, comparing only Germany and the US ignores other countries that they apply their framework to. Finally, patents do not capture the full range of innovative activities that firms in both manufacturing and services may engage in to enhance their competitiveness.

This article uses a different measure, revealed symmetric comparative advantage, to include not only a broader range of countries in the analysis, but also to capture the competitive strengths of firms located within a country more directly. When this measure has been used before (Fioretos 2001), the data underpinning it come from 1990. Building on the work by Fioretos (2001), this article will classify economic sub-sectors according to whether they are characterised by incremental or radical innovation. It will then examine the distribution of comparative advantage at the sub-sectoral level for all of the new member states of the European Union (EU) in Central and Eastern Europe (CEE) for which international trade data exist as well as core 'co-ordinated' and 'liberal market economies', as identified by Hall and Soskice (2001b: 19-21). In addition, this article will also examine exports of knowledge-intensive services to explore the link, if any, between socio-economic institutions and firms' competitiveness.

This article, therefore, applies the arguments espoused within the VoC framework to selected countries in CEE as well as paradigmatic countries from Western Europe. If those

arguments are valid, then they should hold true not just for Western Europe, but for CEE, too. Although the VoC covered only a range of North American, West European countries along with Japan, the arguments within that framework are based upon an assessment of the difficulties that firms face on creating and developing certain competencies that are needed to compete in various economic sectors. Therefore, the generic problems that firms must overcome if they are to be successful in sub-sectors that are characterised by either radical or incremental innovation will be faced by all firms regardless of location. (For thorough discussions of the applicability of the VoC paradigm to the countries of CEE, see Drahokoupil, 2009; and Nölke and Vliegenthart, 2009.) It is, according to the VoC framework, the socio-economic institutions that will shape firms' ability to overcome these problems. As these, in broad terms, vary from country to country so, too, will patterns of comparative advantage. This is because some countries' institutions will be more suited to helping firms create the skills and competencies that are need to compete in sub-sectors that are characterised by radical innovation, whilst others will facilitate the provision of organisational capabilities that are needed by firms if they are to be successful in sub-sectors in which the ability to carry out incremental innovation is a key determinant of success.

A further contribution of this article is that the analysis of trade statistics relies on data at the lowest possible level of data aggregation of the standard international trade classification (SITC) system (revision 3). This means that, in manufacturing sectors, a total of 754 sub-sectors in seven branches have been included in the analysis. By adopting a quantitative approach, this article aims to complement those assessments of the VoC paradigm that have been carried out at the sectoral level and that have relied predominantly on qualitative data (Casper and Matraves 2003; Casper and Whitley 2004). By seeking to provide a thorough assessment of the VoC framework, this article will also outline how many of the arguments in the VoC literature are based on the concept of *necessity* and not *sufficiency*. This has important ramifications for the type of analytical techniques used and the interpretation of the evidence.

The structure of this article is as follows. The next section will outline the VoC approach. It will then discuss the concept of 'necessity', and the way it applies to the VoC framework. The socio-economic frameworks of the new EU member states are then outlined, and the expectations that can be derived from the VoC arguments for their patterns of comparative advantage are discussed. Previous studies in this area are then outlined. This is followed by a section on the data and methodology used in this article; it will, *inter alia*, outline why revealed symmetric comparative advantage (RSCA) is a more appropriate measure than that used by Soskice (1999) in a similar analysis. This will be followed by an examination, and then a discussion, of the distribution of sub-sectors in which Germany, the UK and new EU member states in CEE have a comparative advantage. The sub-sectors form part of seven broader economic sectors that are characterised by either incremental or radical innovation. Data on knowledge intensive business services are then discussed. Finally, the broader ramifications of the findings of this article both for the VoC approach and for its application in CEE are assessed.

The importance of socio-economic institutions in the 'Varieties of Capitalism' framework

The VoC framework focuses on many important socio-economic institutions. These can include the industrial-relations, corporate-governance systems, inter-firm relations, and vocational training systems. It will not be possible to go into the details of these different areas here. However, an overview of the main arguments espoused in the VoC paradigm as well as the ways in which different socio-economic institutions interlink within these broad arguments will be provided. In short, the VoC approach has two key stages. In the

first, it is argued that different national economic institutions offer distinct opportunities to companies. As companies are likely to be aware of these opportunities, they will, on the whole, adjust their production strategies to take advantages of these opportunities. This will be reflected in the types of organisational capabilities that firms develop and maintain. These differences will be apparent in, for example, firms' use of various forms of human capital (either general or firm specific). It is argued that these institutions and, hence, opportunities differ between countries or at least between groups of countries. Hall and Soskice (2001b) distinguish between CMEs, such as Germany and Sweden, and LMEs, such as the USA and the UK. To be sure significant sectoral and sub-national variations exist (see, for instance, Allen *et al.* 2007 and Crouch and Voelzkow 2009); however, such nuances are generally downplayed in the VoC paradigm.

In LMEs, labour-market institutions, such as works councils and industry-wide collective agreements, can promote the provision of firm-specific skills (Hall and Soskice 2001b: 24-25); this is also supported by the fact that many companies in these countries are financed by bank-based, and not equity, capital. This is said to facilitate a long-term outlook amongst companies (Casper and Matraves 2003: 1870). In the latter group of countries, by contrast, companies do not have to liaise with worker representatives; they are also freer to hire and fire workers as they please: "top management normally has unilateral control over the firm" (Hall and Soskice 2001b: 29). This will discourage firms from pursuing "production strategies based on promises of long-term employment" (Hall and Soskice 2001b: 30, see also 33). Such a strategy is also said to be discouraged by a financial system in which stock markets play a very prominent role. It is argued that financial markets place pressure on firms to post good financial results quarter after quarter (see Gospel and Pendleton 2004). This limits the long-term commitments firms can make to their employees as redundancies may have to be implemented to ensure good short-term profitability.

In the second key stage in the VoC framework, this reliance on, for example, different forms of human capital can help to facilitate success in certain product markets. Workers with firm-specific skills will be a prerequisite for, though not a guarantee of (Streeck 1992), success in product markets characterised by incremental innovation, which are said to be "marked by continuous small-scale improvements to existing product lines and production processes" (Hall and Soskice 2001b: 39). Workers with general skills, on the other hand, will be a *sine qua non* in markets in which radical innovation – "innovative design and rapid product development based on research" (Hall and Soskice 2001b: 39) – is the key to success. For instance, Soskice (1999: 113) has argued that products from firms in CMEs will "depend on skilled and experienced employees on whom responsibility can be devolved. By contrast, the United Kingdom and the United States have not been successful in these areas". In short, national economic frameworks lay the foundations for comparative advantage (Hall and Soskice 2001b: 41; see also Casper 2000; Whitley 1999). This differing success in various product markets will be reflected in comparative advantage or related data. Hall and Soskice (2001b: 37-38, 41) and Soskice (1999) have, indeed, used such data to bolster their arguments (see below).

Are certain socio-economic institutions *necessary* for success in some product markets?

In many of their arguments, Hall and Soskice (2001b) either explicitly or implicitly argue that, in order to overcome the problems associated with a strategy of incremental innovation (opportunism by autonomous workers as well as by managers who have the potential to be exploitative), it is *necessary* to have institutional settings similar to those found in CMEs, paradigmatic examples of which are Germany and Sweden (Thelen 1993;

Pontusson and Swenson 1996). (For more on Germany's institutional framework regarding innovation and the attractiveness of that model, see Allen 2010; Funk and Plünnecke 2009; and Schweiger 2005). A *necessary* cause, as Ragin (2000: 91) has noted, is one that 'must be present for the outcome in question to occur'. Its presence does not, however, 'automatically' lead to the outcome. If a factor, in Ragin's words (2000: 92), "always [produces] the outcome in question", it is viewed as a *sufficient* cause.

In other words, within the VoC approach, it is not argued that CME-type institutions will always lead to production strategies based on incremental innovation. (For a more in-depth look at the assumptions underpinning the VoC approach, see Allen 2004.) For instance, Soskice (1999: 115, emphasis added) has argued that "efficiency [when pursuing a strategy of incremental innovation] *requires* a more consensus-based approach to decision making." He does not argue that a consensus-based approach to decision making is *sufficient* to lead to efficiency in this area. In a similar vein, Soskice (1999: 115, emphasis in the original) has also spoken of the 'need', or necessity, of having '*skilled employees* with industry-technology skills as well as company-specific product knowledge skills', if companies are to pursue a product strategy of incremental innovation successfully.

The fact that the concept of necessity lies behind many of the arguments within the VoC approach that relate to public policies has ramifications for the statistical technique used to assess such arguments. Many conventional statistical techniques, such as multivariate regressions, conflate the concepts of *sufficiency* and *necessity* (Ragin 2000: 96). Therefore, multivariate regressions are an inappropriate means to assess the VoC paradigm (Allen, 2005). The nature of the arguments within the VoC framework, therefore, militates against their use. This article, building on previous quantitative analyses of the VoC approach (see below), will, therefore, examine the number of sub-sectors in which a selection of the new EU member states in CEE as well as the UK and Germany have a comparative advantage in economic areas that are characterised by incremental or radical innovation. This means that the VoC framework, which can be interpreted as being applicable to all firms that seek to engage in either radical or incremental innovation, will be assessed using a far greater range of countries than has previously been the case. It should, of course, be noted that, given the nature of the VoC arguments, there is unlikely to be a clear dichotomy in the pattern of comparative advantage in the countries of CEE and the sub-sectors in which they have a comparative advantage. Despite this, there should still be a tendency for firms in LME-type systems to outperform those in countries with settings akin to a CME in sub-sectors characterized by radical innovation if the institutions found in those economies are *necessary* supports for the development of new technologies.

Socio-economic institutions in the new member states of the European Union in Central and Eastern Europe

The new EU member states in CEE appear, at first sight, to have much in common with the CME model outlined by Hall and Soskice (2001b). For instance, corporate governance structures, in some respects, echo those found in Germany, and the education and vocational training systems in many CEE countries are structured along similar lines to Germany's. However, there are significant differences between the new EU member states in CEE and Germany's socio-economic framework to argue that they bear a closer resemblance to the LME type than they do to the CME model. (For detailed studies of some of the various elements that the VoC framework focuses on, see Feldmann 2006; Funk and Lesch 2004; Iankova 2002; Schulten 2005; Vaughan-Whitehead 2004; and Visser 2004.)

In terms of the differences, for instance, between the new EU member states and the 'typical' co-ordinated market economy, much collective bargaining occurs not at the

sectoral level, but at the company level with the possible exception of Slovakia (Schulten 2005). In addition, although agreements in some CEE states may be termed collective agreements, they do not always cover areas that would be deemed by many to be a central part of any collective agreement; that is, wages. This is, for instance, the case in Czech Republic (Pollert 2001). Similarly, in a survey of collective agreements in Hungary, 37% did not specify the wages that were to be paid (Neumann 2002). In addition to sectoral collective agreements functioning very differently in CEE countries to the expected manner in a co-ordinated market economy, worker representation is also much lower there compared to Germany. Therefore, in terms of employee representation at the workplace level, the new EU member states in CEE resemble more closely LMEs than they do CMEs.

Other important areas within the VoC framework are the related issues of corporate finance and corporate governance. Here, too, there are marked differences both between the countries in CEE and between them, on the one hand, and Germany and the UK, on the other. As Table 1 shows, the percentage of shares owned by foreign investors in Hungary, and Slovakia is much higher than it is in Germany and the UK. Poland has foreign-ownership levels that are comparable to the UK's. (Unfortunately, comparable data do not exist for the Czech Republic.) There may be many types of foreign investors. The largest two groups amongst them are likely to be, firstly, foreign firms that have bought shares in indigenous CEE firms, and, secondly, foreign institutional investors. As many firms from outside CEE have undertaken green-field FDI – that is, they have established new, wholly owned subsidiaries rather than joint ventures in the region that are may be listed on local stock exchanges – the largest group is likely to be the latter.

Table 1: *Share ownership in selected European countries (2005)*

Country	Foreign Investors	Private Financial Enterprises	Private Non-Financial Companies	Individual Investors	Public Sector	Not identified
Germany*	21	15	42	15	7	0
UK*	33	51	2	14	0	0
Hungary	77	6	5	4	8	0
Poland	38	17	8	17	20	0
Slovak Republic	60	5	19	5	1	10
Notes: * data are for 2004; data for the Czech Republic are not available.						

Source: FESE (2007)

Therefore, in the cases of Hungarian and Slovakian, it may be sensible to combine those percentages with those for ownership by domestic private financial enterprises, as both groups will exert pressures on companies to increase their short-term profitability ratios. This may take place even though it is detrimental to the firm's long-term profitability. The pressures of short-term financial goals are, therefore, likely to be greatest in Hungary and Slovakia. By contrast, these groups play a relatively minor role in Germany and Poland. In these latter two countries, pressures to increase short-term profits may be attenuated by the relatively large percentages of shares that are owned by either domestic private non-financial companies, in Germany's case, or the public sector, in Poland's case. The patterns of comparative advantage for Hungary and Slovakia may, therefore, resemble that for the UK than Germany's. By contrast, companies in Poland may be able to emulate the success of their counterparts in Germany.
In CEE, according to data from UNCTAD, FDI as a percentage of GDP is, in comparison to the old member states, high in the Czech Republic, Hungary and Slovakia. This has

important implications, too, for corporate governance. As noted above, if much of the FDI is in the form of green-field investment, this means that the subsidiary in CEE will not, usually, be listed on the stock exchanges there and, hence, subject to the corporate governance regulations in the relevant country. Instead, it will be part of a larger firm that is listed in say, the US or the UK. The head office of the multinational corporation would be required to conform to the corporate governance regulations in that country. Therefore, the dominant corporate governance regulations of the subsidiary in CEE are those of the investing firm's home country. This implies that major strategic decisions in such subsidiaries will be constrained less by the host-country's corporate governance regulations than they will by intra-firm bargaining within the multinational (Drahokoupil 2009; Nölke and Vliegenthart 2009).

The prevalence of foreign institutional investors and the reliance on foreign direct investment in CEE is likely to mean that the patterns of comparative advantage there may be more similar to the areas of specialisation found amongst LMEs than they are to those found in CMEs. In other words, the ability of firms to shift production and, potentially, employment within divisions in a company are likely to be less constrained by a variety of factors, including employee representation and labour mobility that is influenced by sectoral collective bargaining, in the new EU member states in CEE than they are in Germany or other CMEs. This is likely to be especially true if much direct and portfolio investment has come from LMEs.

Previous quantitative tests of the VoC paradigm

The measure used in Hall and Soskice (2001b) to bolster their arguments is patent data. They classify different industries into either incremental or radical innovators. Examples, according to Hall and Soskice (2001b), of sectors characterised by incremental innovation are mechanical engineering, product handling, transport, consumer durables, and machine tools. Germany, they argue, is strong in these sectors. Hall and Soskice (2001b: 41-44) juxtapose these German strengths next to relative American weakness. The US is, however, seen as being strong in sectors that are characterised by radical innovation. It is in these sectors, such as medical engineering, and biotechnology, that Germany is seen as being weak. It should, however, be noted that patent data are an inappropriate measure of comparative advantage, as patents might only 'translate' very poorly into comparative advantage. For example, the fax machine, though patented in Europe, proved to be a great commercial success for many Japanese companies (Schröder 2002). Secondly, patents do not capture the full range of innovation activities in firms. For instance, in the engineering sector, firms may prefer to use secrecy to protect their innovations rather than patents that can be vitiated by 'work arounds'.

Researchers who have propounded the VoC approach have not just relied on patent data, however. They have also tried to bolster their arguments with comparative empirical evidence on export success in different industrial sectors. For instance, adducing data from Michael Porter (1990), Soskice (1999: 113) notes that, in 1985, Germany had 46 industries in the 'machine industry' sectors of the economy that were 'internationally competitive'. In the 'machine industry' sectors of the economy, Soskice (1999: 113) noted that the UK had just 18 industries that were internationally competitive. The contrast with Germany is, therefore, stark. Soskice's analysis does not stop there. He goes on to note that the UK, a good example of an LME (King and Wood 1999), has a strong export record in 'service industries', whilst Germany fares relatively badly. Soskice (1999: 114) notes that in these industries, Germany had seven sectors that were internationally competitive, whereas the UK had 27, and the US 44. Soskice argues that these industries rely on the individual skills of highly trained and mobile professionals. They include, amongst other things, management consultancy, advertising and related media services, and investment

banking. These data would, therefore, appear to support Hall and Soskice's (2001b: 38) arguments that there are 'cross-national patterns of specialization'. This article extends the analysis by examining patterns of revealed symmetric comparative advantage amongst the new EU member states in CEE.

A useful and rigorous way of classifying sectors as being characterised by either radical or incremental innovation has been drawn upon in the VoC literature by Fioretos (2001: 222). This latter classification was devised by the OECD to assign different economic sectors to one of five categories. The two categories that are of interest here are the 'specialised supplier' and 'science-based' ones, as they conform closely to industries characterised by incremental and radical innovation respectively. (The other three categories are 'resource intensive', 'labour intensive' and 'scale intensive'.) The benefits of using this classification are twofold. Firstly, it enables the research undertaken here to be replicated. Secondly, and most importantly, it enables comprehensive data to be drawn upon that are not only available for all OECD countries, but that are also available at a very low level of aggregation. This is especially relevant given the fact that the VoC applies to the competitiveness of firms within specific industries (Hall and Soskice 2001b; see also Allen *et al.* 2006).

Data and methodology

The data used in the first part of the analysis in this article are drawn from the OECD's database on international trade by commodities statistics (revision 3) for Germany, the UK and all of the new member states in CEE for which data exist. Data at the lowest possible level of aggregation are used; this is usually the five-digit level, but, where this level does not exist, the four-digit level has been drawn upon. This means that 754 sub-sectors in seven branches have been included in the analysis. Data for 2004 are used as they are the latest year for which export data are available for all 32 OECD member states and territories. For the second part of the analysis, data that have been compiled by the EU (European Commission 2009) on exports of knowledge-intensive services are used.

Comparative advantages and disadvantages are based on the measure of revealed symmetric comparative advantage (RSCA), which, in turn, builds upon Balassa's (1965) index of revealed comparative advantage. The revealed comparative advantage (RCA) of sector j in country i is calculated as follows:

$$\text{RCA} = \frac{(\text{country i exports in sector j / total exports from country i})}{(\text{OECD exports in sector j / total OECD exports})}$$

The numerator in the above term represents the ratio between a country's exports in a given sector and the country's total exports; this ratio is then compared to the ratio for the same sector for the OECD as a whole (including country i's exports). If the RCA equals 1 for a sector, the country's exports in that sector as a share of the country's total exports is the same as the 'average' for that sector for the OECD as a whole. When the RCA is greater than 1, the country under consideration has a revealed comparative advantage in that sector. When the RCA is less than 1, the country has a revealed comparative disadvantage in that sector. The RCA could take any value between 0 and infinity, and, thus, is difficult to use in cross-country comparisons. In order to overcome this problem, Laursen (1998) has suggested transforming the RCA as follows:

$$\text{RSCA} = (\text{RCA} - 1) / (\text{RCA} + 1)$$

This makes the index symmetrical about zero: values above zero indicate a comparative advantage; figures below zero indicate a comparative disadvantage. It can range from -1 to 1.

It should, of course, be noted that wage rates vary significantly between the old and new member states. This has implications for comparative advantage, as the strengths of any particular country may reflect favourable wage costs rather than the institutional contexts within which firms operate. However, within the group of new member states, such considerations are likely to be less marked. Therefore, the differences between those countries, which form an important part of the analysis, are likely to stem from the institutional differences between them rather than variations in labour cost. This is an important point as it suggests that, contrary to some analyses (see, for example, Nölke and Vliegenthart 2009), the new member states should be viewed as a collection of distinct countries rather than as a group whose similarities outweigh their differences. The data on RSCA do not, unfortunately, enable intra-firm trade to be identified. Whilst this, because of the prevalence of FDI in many CEE countries, would be interesting to know, the data that would enable this distinction to be made do not exist.

Success in sectors characterised by incremental innovation

The next two sections set out the comparative advantages of the various OECD countries in sectors characterised by incremental and radical innovation. They are followed by an in-depth discussion of the data. Table 2 shows the number of sub-sectors, within the three broader economic sectors characterised by incremental innovation, in which the countries have a comparative advantage. The Table also ranks the countries. All of the rankings are based solely on the absolute number of sub-sectors in which the countries have a comparative advantage. They do not take into consideration the values of the actual exports or the magnitude of the RSCA scores. In situations in which two or more countries have the same number of sub-sectors with a comparative advantage, they are ranked in equal place.

Table 2: *Comparative advantage in sectors characterised by incremental innovation (2004)*

Country	Non-electrical machinery		Electrical machinery		Communications equipment & semiconductors	
	Rank	*No. Sub-sectors*	*Rank*	*No. Sub-sectors*	*Rank*	*No. Sub-sectors*
	i	ii	iii	iv	v	vi
Czech Republic	2	132	2	54	4	3
Hungary	5	62	1	55	1	14
Poland	4	68	4	37	5=	2
Slovak Republic	6	61	6	21	5=	2
Germany	1	228	3	53	3	4
United Kingdom	3	111	5	32	2	13
Total no. sub-sectors in analysis	-	**377**	-	**127**		**36**

Source: OECD International Trade by Commodities Statistics database; own calculations.

In the sectors shown in Table 2, CMEs should tend to do well, whereas LMEs should perform less well, if the VoC framework is correct. The evidence offers some support for

the contention that the new EU member states in CEE resemble LMEs than they do CMEs. For instance, in the 'non-electrical machinery' sector, Germany has a comparative advantage in a far greater number of sub-sectors within that broader sector than any other country. As might be expected from the VoC framework, the countries from CEE shown in the Table have a much lower number of sub-sectors in which they have a comparative advantage. The situation in the 'electrical machinery' sector is, however, somewhat different. The Czech Republic and Hungary have a higher number of sub-sectors in which they have a comparative advantage than Germany does. This suggests that those socio-economic institutions that do exist in those two countries may be able to help firms overcome the typical problems that are faced by firms in that sector. Evidence from the final sector, the 'communication equipment and semi-conductors' sector, suggests that the VoC framework is less suited to explaining competitiveness amongst firms in this sector than it is in the previous two. This is because, in contrast to theoretical expectations, Germany performs poorly in this sector. In addition, the UK has a strong record in this sector. Moreover, with the exception of Hungary, the CEE countries exhibit low levels of comparative advantage within this broad sector.

Success in sectors characterised by radical innovation

Table 3 presents evidence in sectors in which, if the VoC is correct, LMEs should tend to perform better than CMEs; success in these sectors is said to rely on the ability to carry out radical innovations. Columns i and ii of Table 3 show the rank and number of sectors in which the selected OECD countries have a comparative advantage in the 'aerospace' sector. Unfortunately, data for 2004 for the 'aerospace' sector are not available for the UK. In the 'computers' sector, the evidence suggests that firms in the new EU member states have similar levels of competitiveness to those firms in Germany rather than the UK.

Table 3: *Comparative advantage in sectors characterised by radical innovation (2004)*

Country	**Aerospace**		**Computers**		**Pharmaceutical**		**Scientific Instruments**	
	Rank	*No. Sub-sectors*	*Rank*	*No. Sub-sectors*	*Rank*	*No. Sub-sectors*	*Rank*	*No. Sub-sectors*
	i	ii	iii	iv	v	vi	vii	viii
Czech Republic	2	2	3	4	5	3	3	21
Hungary	4=	0	2	6	4	4	4	13
Poland	4=	0	6	1	6	2	5	11
Slovak Republic	3	1	4=	3	3	5	6	9
Germany	1	3	4=	3	2	16	1	60
United Kingdom	-	n.a.	1	15	1	22	2	50
Total no. sub-sectors in analysis	-	**13**	-	**30**	-	**45**		**126**

Notes: n.a. = no data available

Source: OECD International Trade by Commodities Statistics database; own calculations.

In the final two sectors shown in Table 3, the patterns of comparative advantage amongst the new member states in CEE resemble neither Germany nor the UK. This is, especially for the pharmaceutical sector, not surprising as the establishment of firms in many sub-

sectors – though not all – of the pharmaceutical industry will require large initial outlays. In addition, the risks associated with developing new medicines are substantial. These factors may, therefore, preclude the establishment of firms – and, *a fortiori*, competitive firms – in countries that are transition economies. Similarly, the development of scientific instruments may require firms to draw on a range of different areas of expertise. If one of these areas is absent from the 'innovation chain', the development of radically new products may be fundamentally weakened.

Table 4 shows the levels of employment in knowledge-intensive services. Although Hall and Soskice (2001b) and Soskice (1999) do not examine the service sector, their arguments have clear implications for them. In particular, firms that provide those services that require them to shift their resources – including skilled employees – quickly to respond to shifting market demands will be helped by the socio-economic framework found in LMEs compared to CMEs. This is because, in the latter group of countries, employment regulations and corporate governance codes will hinder firms' ability to hire and fire personnel to meet new market demands. In addition, the stratified education system in LMEs promotes the acquisition of general – rather than firm-specific – skills. From the perspective of employees, careers in sectors that enable them to increase their general skills and that do not tie them to one employer will be seen as advantageous. From the perspective of employers, a pool of skilled employees who are willing to move from one employer to another, whilst making the acquisition of firm-specific skills difficult, facilitates organisational capabilities that are based on employment flexibility. Therefore, the UK should have high levels of employment in knowledge-intensive service sectors compared to Germany. The expectations for the CEE countries are less clear.

As Table 4 shows, the UK does, indeed, have relatively high levels of employment in knowledge-intensive services; however, Germany outperforms all of the countries in CEE. There is a difference of at least a few percentage points between Germany and the individual CEE countries included in this study. Once again, this data reveal, firstly, potential weaknesses in the VoC framework and, secondly, the need to provide a more detailed assessment of the socio-economic institutions that are subsumed within the VoC paradigm. For instance, the low levels of employment in knowledge-intensive services may reflect the focus of education within universities and the general need for such services within the domestic economy.

Table 4: *Employment in knowledge-intensive services as percentage of the workforce (2007)*

Country	Percentage
Czech Republic	10.92
Hungary	11.35
Poland	10.33
Slovakia	9.86
Germany	15.58
United Kingdom	18.64

Source: European Commission (2009)

In terms of exports of knowledge-intensive services, the VoC theoretical framework would lead to expectations that the UK should outperform all other countries examined here. This is not, however, the case. As can be seen from Table 5, the UK's exports of knowledge-intensive services as a percentage of all service exports are the lowest of the countries examined here. This is a striking finding. It highlights the need for the VoC framework to be examined in greater detail for individual sub-sectors within this broad sector to reveal the

causes of this outcome. Unfortunately, the data are not available that would allow such an assessment to be made.

Table 5: *Exports of knowledge-intensive services as percentage of total service exports (2006)*

Country	Percentage
Czech Republic	35.47
Hungary	25.60
Poland	27.93
Slovakia	20.83
Germany	53.84
United Kingdom	8.88

Source: European Commission (2009)

Discussion and implications for future research

The evidence on comparative advantage for some of the new member states in CEE suggests that, in the 'non-electrical machinery' sector, firms' competitiveness in those countries resembles that of companies in LMEs. This is despite the fact that, in some respects, there may be superficial differences between the two groups of countries. In other respects, there are, not surprisingly, substantial differences in the comparative advantage patterns between, on the one hand, the new EU member states and, on the other, Germany and the UK. History, of course, is likely to play an important role. The traditional strength of countries, such as the Czech Republic and Hungary, in 'electrical machinery' is also a contributory factor to the greater competitiveness of firms in those two countries compared to those in the UK.

The importance of history – in particular, the collapse of Communism in the region two decades ago – has had a profound effect on the economies in CEE. One way in which this is apparent is the degree to which the socio-economic institutions that form the cardinal components of the VoC framework are embedded within those societies and economies in CEE is debatable. This means that there is likely to be more flexibility in the ways in which those institutions operate in CEE countries even though they, superficially, resemble those of Germany.

Another important distinction between CEE countries and those economies around which the VoC theoretical framework was developed is the level of foreign direct investment (FDI). In comparison to the UK and, in particular, Germany, those new EU member states in CEE have relatively high levels of FDI as a percentage of GDP. As a result, many foreign firms operate in these countries. Whilst they are highly likely to have firm-specific competitive advantages that they wish to maintain control over and that lead them to invest abroad – rather than, say, allow other firms to produce their goods under licence – they may be reluctant to establish strong links to local companies as that may risk knowledge spilling over to those local firms. Over time, this may undermine the foreign firm's competitive advantage (McDonald *et al.* 2008).

However, describing the new member states as representing 'dependent market economies' (DMEs) (see Nölke and Vliegenthart 2009) overlooks important differences between them. For instance, if the new member states are seen, as a group, as DMEs, the question arises as to which countries the investors, upon whom the firms in CEE depend, come from. If, for example, they are largely from CMEs, then it could be expected that, in

some respects, the new member states will resemble CMEs. However, it is unclear at present whether direct investors are more likely to come from CMEs or LMEs. In addition, the home countries of portfolio investors are also unknown. Therefore, future research should aim to clarify the extent to which various kinds of investors are important in the different EU member states in CEE. Indeed, as other research has shown (Keune *et al.* 2009; Tüselmann *et al.* 2007, 2008), the home-country setting of multinational corporations helps to explain their preferences and the workplaces practices that they adopt in their subsidiaries abroad.

Nölke and Vliegenthart (2009) also suggest that much investment in CEE has been undertaken to benefit from the lower wages there. This implies that the patterns of comparative advantage between the new member states are likely to be similar. As this article has shown, however, this is not the case. For instance, the Czech Republic is significantly more innovative than the other new member states in 'non-electrical machinery', and the Czech Republic and Hungary have more comparative advantages in 'electrical machinery' than Poland and Slovakia. Moreover, Nölke and Vliegenthart's (2009: 677-8) contention that the new member states will not have comparative advantages in either incremental or radical innovation compared to those countries from which the investing firms come is not borne out by the evidence presented here. In some sectors characterized by incremental innovation, both the Czech Republic and Hungary perform better either individually or collectively than Germany and/or the UK. This indicates that those CEE countries can provide the conditions to support the competitive advantages of firms operating there. They are not merely carrying out lower value-added tasks.

In addition, Nölke and Vliegenthart's (2009) arguments suggest that the comparative advantages of the new member states are likely to be concentrated in sectors characterized by incremental innovation, as the processes of improving existing technologies are likely to be better understood in these sectors than they are in economic branches marked by radical innovation. If this is the case, firms may well seek to gain an advantage by carrying out their incremental innovations in relatively low-wage countries. This is, once again, however, not the case. Some of the new member states have significant comparative advantages in sectors characterized by radical innovation, such as scientific instruments (Czech Republic) and computers (Hungary).

In general, however, the new member states have stronger records in sectors marked by incremental innovation. As this article has noted, the links between comparative advantage and institutions in the new member states is more difficult to trace than in the old member states. The situation is complicated by the high share of FDI as a percentage of GDP in many new member states, the role of foreign institutional investors, and the ways in which institutions, such as collective wage agreements, operate in CEE compared to some of the old member states. This means that more research should be carried out at both the macro and micro levels to reveal the complex interplay between the range of domestic and foreign strategic actors and patterns of commercial specialization (Drahokoupil, 2009). As the data here have revealed, the new member states are not DMEs (Nölke and Vliegenthart, 2009), and domestic institutions play an important role in shaping the competitive strengths of firms in the new member states. Indeed, firms operating in CEE are able to compete strongly in a range of sectors. These strengths vary from country to country. This, too, suggests that the individual institutional characteristics of the new member states should be analysed in greater detail.

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Hungary: From Star Transition Student to Backsliding Member State

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Abstract
This article investigates the reasons behind the recent backsliding of Hungary in terms of economic performance. Special focus is given to its membership of the European Union's common market, the introduction of the euro, and the reform steps taken by various government administrations in recent years. The article also makes statements about Hungary in relation to the 'varieties of capitalism' debate.

Keywords
Hungary; capitalism; economic performance; eurozone; reforms; dependent competition states; privatisation; transition; Central and Eastern Europe

HUNGARY WAS HERALDED THROUGHOUT THE 1990s AS THE STAR STUDENT OF transition and was widely expected to be one of the economies amongst the new European Union (EU) member states that would come out as a clear winner of the transition to a market economy and entry into the EU. Yet lately Hungary has become one of the laggards of the region, with the economy underperforming heavily. This paper argues that the apparent backslide of Hungary is important because it took place not only due to mismanagement by the political elite of the country. Policy inadequacy and populist politics naturally did play their part, but what Hungary's recent relapse really demonstrates is the limits of the long term sustainability of what was the *sui generis* ideal type of a liberal transition economy.

The liberal dependent competition state model of transition

The origins of the current crisis can be traced back into the dying decades of communism. Hungary was already a rather 'liberal' state prior to transition. In parallel with its relative political openness during the pre-transition communist period (famously dubbed 'goulash communism'), Hungary had already also introduced a fair degree of economic liberalism into the functioning of its essentially Soviet style economic system. After the halted New Economic Mechanism (NEM) (see Csaba 2005: pp. 273-276) of the 1970s came the loosening of economic control in the 1980s. Private enterprise was allowed in certain segments of the economy, and foreign investors were encouraged to enter into joint ventures with ailing Hungarian state owned firms. Thus by the beginning of transition Hungary was already the single economy in the region with most experience of involving outsiders in rejuvenating its industrial base (see Bruszt and Stark 1998: p. 54).

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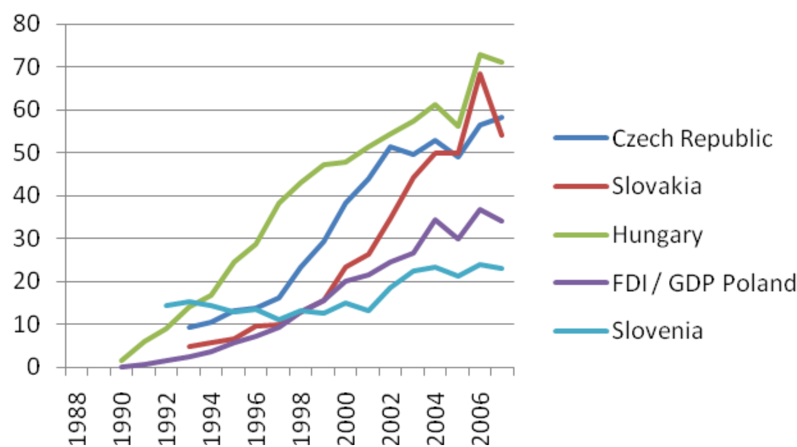
A second reason for the marked openness and strong outside orientation of Hungary was the enormous foreign debt it had accumulated in the last decades of the communist era. In contrast with some countries of the region that came out of transition with negligible foreign debt (Romania, the Baltic states, or Slovenia), and others that had a manageable foreign debt burden (Czech Republic, Poland, Slovakia), Hungary was very heavily indebted. Thus on top of the quasi bankruptcy of state owned firms in the late eighties there was also the issue of the crippling foreign debt.

These two reasons together led to Hungary become and early *de facto* model for outward oriented economic transition. While at the beginning of the nineties other states in the region were all experiencing with some inward oriented, coupon based scheme initially, Hungary never introduced such a design, and was well on its way to attracting significant amounts of foreign direct investment (FDI) through an FDI based direct privatisation strategy (Sass 2004). With the lack of domestic investment capital being the central justification, the state auctioned off assets to the highest bidder, who quickly turned out to be foreign investors. These transnational firms later went on to initiate greenfield investments in Hungary as well, which successive Hungarian governments welcomed as a reassuring sign of the attractiveness of the Hungarian economy, as well as proof of rapid, thorough and successful transition. Hungary used investment promotion systems such as heavy state subsidies (Sass 2003, 2004), tax exemptions and special industrial zones extensively to make itself more attractive, on top of its low wages and geographical proximity to the core of Europe. Trade union rights were also deliberately codified to be weak. In this light it is not surprising that by the middle of the decade ten million strong Hungary managed to attract as much foreign investments as all the other countries of the former Communist Bloc taken together – a fact much propagated by governments in Budapest.

Figure 1: *FDI stock accumulation in Hungary in contrast to other countries of the region*

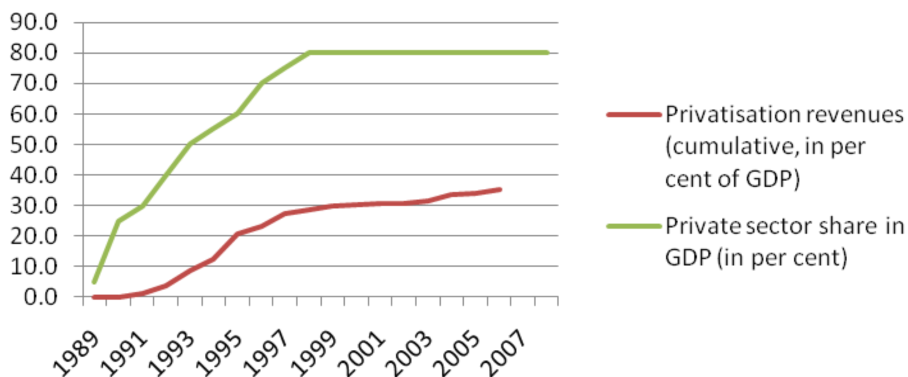


Source: UNCTAD (2008)

As Figure 2 (below) demonstrates, by 1998 Hungary had privatised 80 per cent of its economy, which is considerably higher than similar rates in Central and Eastern Europe, and even higher than the relevant rate in most Western European economies. Hungary was also unique in receiving steadily increasing revenues from privatisation right from the start of transition in 1991. Privatisation revenues only really began to trickle in from 1997 in most other transition economies. Hungary was successful in collecting an amount approximating one third of its GDP by the end of transition. (Much of this was used to pay

off some of the country's enormous foreign debt.) This rate is also considerably higher than similar rates in the region: approximately 25 per cent in the Czech Republic and Slovakia, 14 per cent in Poland, and 6 per cent in Slovenia.

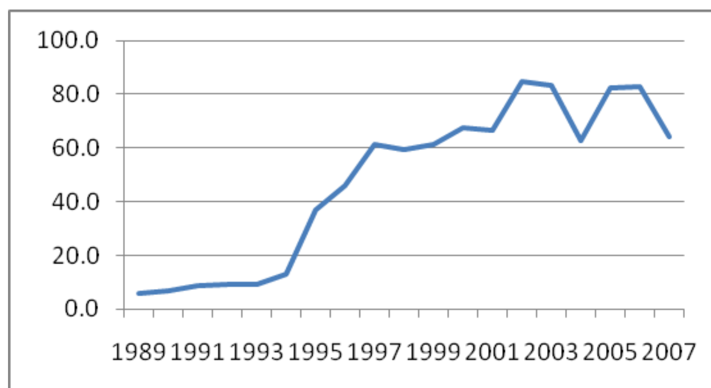
Figure 2: *Privatisation revenues and the share of the foreign sector in Hungary*



Source: EBRD (2009)

The banking sector was also quickly liberalised and made open for foreign investors, resulting in an extreme case of foreign domination in both Western and Eastern European terms. This was later emulated by other countries of the CEE region (Claessens *et al.* 1998).

Figure 3: *Asset share of foreign owned banks in the Hungarian economy, percentages*



Source: EBRD Structural Indicators (2009)

All these achievements were mirrored by institutions such as the International Monetary Fund (IMF) or the European Commission back to the region as a model case, a star student. It was being promoted (along with Poland initially) as the leading transition state by the 'Washington consensus' institutions, it was accepted to be in the first group of countries negotiating for membership by the European Commission. Even Hungary's own governmental administrations during this time period and the electorate were fully confident, based on all the positive Western feedback, that Hungary was the most daring former socialist state, fully embracing a private economy and opening up without second

thoughts to economic globalisation, while other states across the region appeared to be wasting time with domestically oriented alternatives that would not work. For example, when the Czech Republic was going through the crisis of the Klausian bank based privatisation scheme and Slovakia was struggling with the crippling political and economic conduct of Vladimir Mečiar, Hungary was proclaimed to be on a steady path to economic growth based on an almost completed transition. One glance at the so-called Transition Index of the European Bank for Reconstruction and Development (EBRD), a complex indicator of transition countries' performance in eleven key areas of transition reform, reveals how Hungary was the star student of the nineties:

Table 1: *Leading country in the EBRD's Transition Index*

Year	Leading country
1991	Poland
1992	Czechoslovakia
1993	Czech Republic
1994	Czech Republic
1995	Hungary
1996	Hungary
1997	Hungary
1998	Hungary
1999	Hungary
2000	Hungary
2001	Hungary

With the collapse of internally oriented privatisation schemes, essentially all other states (with the notable exception of Slovenia) began to follow the 'Hungarian way', the model that can retrospectively called the sui generis 'dependent competitive state'. This model does not fit any previously identified social or economic ideal type within the 'varieties of capitalism' debate (Shonfield 1965; Moerland 1995; Hall and Soskice 2001; Amable 2003), such as Liberal Market Economies (LMEs) and Coordinated Market Economies (CMEs) (Hall and Soskice 2001); Continental, Social Democratic or Mediterranean Models (Amable 2003); Market/Managed/State Capitalism (Schmidt 2002); or Germanic/Latinic/Asiatic subgroups (Moerland 1995). The defining features of dependent capitalism are twofold. Firstly, it is dependent upon capital and firms from other regions of the world, attempting to make use of foreign direct investment, multinational production chains, portfolio capital, and a foreign owned banking system to create economic growth for the domestic population. Secondly it is a competitive state, whose long term strategy is to create the conditions necessary for accommodating foreign investments (low wages, weak trade unions, direct state support, tax breaks, infrastructure), and is not interested in developing evidence based, monitored policies per se in employment services, education, RandD, social policy and inclusion, infrastructure, or elevating the domestic part of the economy. It perceives all these policies to be the resultant of investment promotion from abroad. As a consequence the decisive industrial relations are between managers of domestic subsidiaries with top level management of the firm abroad, as well as central government officials with the same group.

The concept of the 'competition state' was developed by Philip G. Cerny (2007), who used it to describe how former Western welfare states have attempted to react to what they perceived as the challenges and 'realities' of the globalised economy. The dependent form of the competition state is one where domestic economy had not gone through previous stages of capital accumulation and the formation of domestically based transnational firms. Instead, it has relied on foreign direct investment (Hunya 1998; Kalotay and Hunya

2000), portfolio capital and a foreign owned financial system for competing in the globalised world. In addition to access to financial development capital, they have taken advantage of the know-how, technology and network-type social capital of transnational production networks (Sturgeon 2001) and their value chains (Dicken 2004: 14-16). The aspect of this outside reliance makes them 'dependent' on outside resources.

Central European economies are not Liberal Market Economies, primarily because they lack the substantial autonomous domestic sectors that would make decisions based on market mechanisms. In addition, most subsidiaries are manufacturing and assembly bases for re-export to the parent company, who will sell the final products abroad. Therefore the key management decisions and functions do not take place within the economy, but abroad.

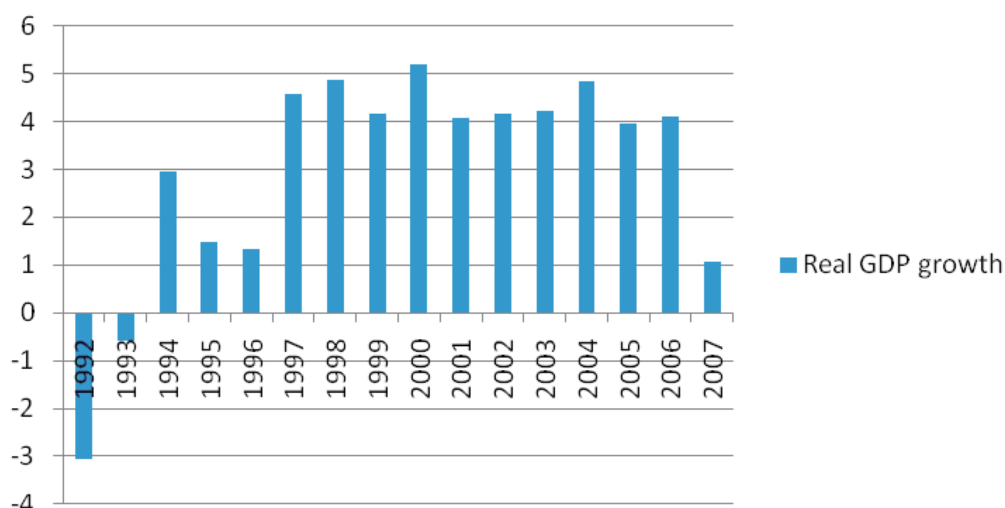
CEE economies are also not Co-ordinated Market Economies. In spite of the geographical and cultural proximity of Germany and Austria they have not established the distinctive institutional arrangements of a CME. Associations of both employees and employers are weak, trade unions are at a firm level, and there is no industry level bargaining or *mitbestimmung*. Groups of companies are not created, given their essentially foreign origin. Banks are also dominantly foreign owned, and therefore do not play a role as investors and stakeholders in company development. Central and subnational levels of government also do not think it should be their function to hold a stake in private enterprises.

Central European economies (with the single exception of tiny Slovenia) can best be described as dependent competition states, and Hungary was the early forerunner of this strategy from the middle of the 1990s, as a neoliberal transition state (Drahokoupil 2008: 36). After brief attempts at domestically oriented privatisation, based mostly on voucher schemes, all states of the region abandoned these alternatives and turned to towards the Hungarian model, which seemed to them to be outstandingly successful at the time. Central European reforms have always been understood by both the countries of the region themselves, as well as the international institutions as a sort of race. Which country will attract most FDI? Which one will complete its transition before all others? Which one will reach its 1989 GDP levels first? Who will be a European Union member state and who will be left out? Which countries will introduce the euro before everyone else, and which ones will lag behind and be symbolically shamed and exposed to the mistrust of the international financial markets? The Hungarian model offered a chance for rapid and efficient transition that many leaderships in the region have embraced in the region, perhaps most successfully Slovakia after 1998 and Bulgaria after 2007, but also for the Czech governments after Klaus and various others across the region. The model offered a chance for governments to demonstrate visible economic success, measured in terms of macroindicators such as GDP growth or FDI inflow itself (with other crucial indicators such as real wages or employment levels being represented as 'long term' ones). The model also represented a vindication of very goals that Washington consensus institutions promoted: privatisation, deregulation and opening up to free trade. While these institutions played a very positive role in serving as anchors of fiscal stability in a high debt country with a political elite bent on fiscal irresponsibility, some other economic issues were clearly ignored by them. The IMF and the World Bank have repeatedly declared that domestic economic structure (the weakness of the domestic part of the dual economy, low employment, the low value added presence of FDI) and integration into the global economy (as a low value added periphery) were matters of domestic policy that the international financial institutions will not be concerned with. They also made it clear that they will not be drivers of internal structural adjustment, and have tended to accept suboptimal proposals for this from governments, as long as their declared goals of fiscal stability, deregulation and privatisation were adhered to. Theoretically the European

Commission did have the mandate of assessing whether the new Eastern European entrants had a 'competitive economy that could withstand the pressures of the internal market' according to the Coppenhagen entry criteria, and was not simply to negotiate on the acquis communautaire of the EU. However, the Commission represented the governments of Western, Northern and Southern European states, whose corporate sectors were pressing for an opening up of Eastern Europe for free trade and the free movement of capital, seeing it as an opportunity to create a low wage re-export production platform. Therefore, the Commission never concerned itself with a more balanced economic development model, and accepted the FDI based model as the muster. And the muster was indeed implemented more or less everywhere, with the possible exceptions of Poland, which was simply too large geographically, with Western interest limited to its Western regions only, and Slovenia definitively, which deliberately opted for a different development model. As we shall attempt to demonstrate at the end of this paper, a possible failure of the Hungarian model must therefore serve as a warning sign for all of the other states in the central and Eastern European region.

The model produced tangible results at first. Enterprise restructuring was fast, as the theory suggested. Growth began to pick up, and there was some job creation as well in the late nineties. All in all, the model produced a certain degree of economic recovery, based on extensive exports mainly to the single internal market, chiefly by the local subsidiaries of the multinational firms. Hungary managed to achieve an 80 per cent exports to GDP ratio, making it a very export oriented country. In 2007, approximately 79 per cent of exports went to EU27 states.

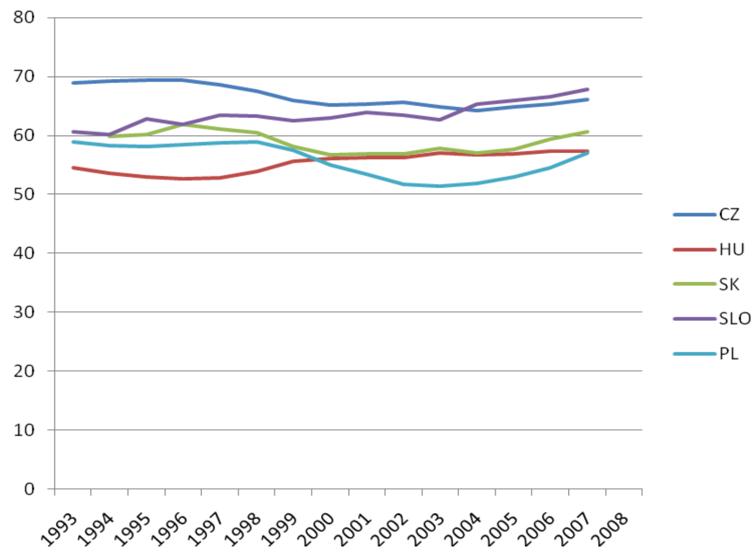
Figure 4: *Real GDP growth in Hungary*



Source: OECD (2009)

Employment in Hungary was at a lower level than elsewhere at the time of transition, but this particular feature of the Hungarian economy was not considered to be important and was rather overlooked. It was believed that statistical data collection in the first phase of the transition was inaccurate and unreliable, and that employment would eventually pick up with the inflow of FDI, as firms would resolve operation.

Figure 5: *Employment rates in Central and Eastern European countries after transition*



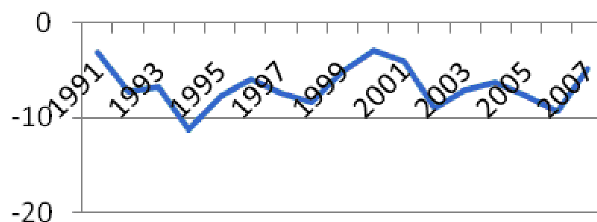
Source: OECD (2009)

These beliefs were initially confirmed, as the employment loss of the first few years was recovered in the following years. Incidentally, employment never really increased thereafter, and remained significantly lower than elsewhere in the region. This fact was once again overlooked, due mostly to the favourable unemployment rate of Hungary in this period at 5-6 per cent, much lower than the EU average. In terms of the complete picture on the labour market, the low unemployment rate of course concealed the very high ratio of dependent population. (It is also interesting to notice that the U-shaped shredding-reabsorption curve in employment was repeated elsewhere in the region at later stages, when the other countries eventually also opted for FDI based transition á la Hungary. Poland and Slovakia clearly illustrate this trend.)

The euro and the global financial crisis: The breakdown of the model

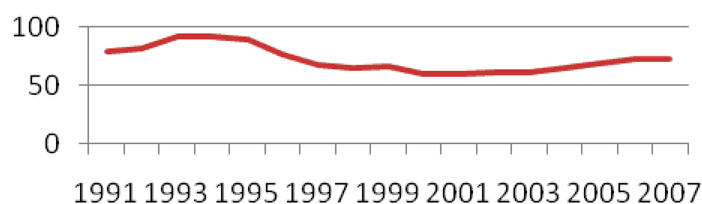
Hungary was feeling comfortable at the head of the pack around the turn of the millennia, with its prospects for high economic growth about to be enhanced by certain EU membership by 2004. Then suddenly something began to go wrong. The post accession commitment of entry into the eurozone made it obvious for the Hungarian elite that there are certain problems with the stability and the sustainability of the Hungarian model. The first target year specified for the adoption of the euro had been 2006. This would have meant immediate entry into ERM2 after accession in 2004. However, with the passage of time this target date began to be considered unrealistic. It was revised over and over, pushed back in time continuously as the country began to find itself in a continued state of macroeconomic instability. With the arrival of the global financial crisis Hungary was swept into such deep economic difficulties that the government (and market analysts) stopped speculating about possible target dates. Hungary, once the leader in economic reforms in the region, found itself very deep economic difficulties. The criteria of the stability pact seemed further and further:

Figure 6a: *Budget deficit in Hungary during the post-transition period (% of GDP)*



Source: OECD (2009)

Figure 6b: *Budget deficit in Hungary during the post-transition period (% of GDP)*



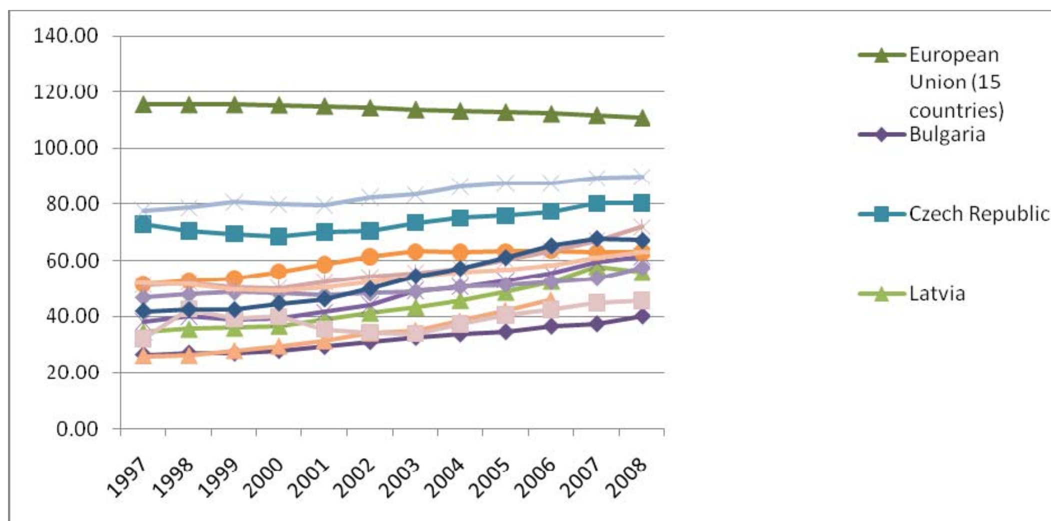
Source: OECD (2009)

As budget deficits began to reach outstandingly high levels in an EU comparison, the country began to accumulate foreign debt again. Having once decreased its exceptionally high levels of foreign debt in the transition period from privatisation revenues, the high budget deficits run by the governments after 2001 led to the re-accumulation of outside debt. Together with high inflation and interest rates, this led to Hungary becoming the only country in the region which did not fulfil any of the four criteria of the Stability Pact. While Slovenia and Slovakia were already introducing the euro in 2007 and 2009 respectively, and other states were well on their way, Hungary was left in the uncomfortable position of a laggard. In addition, the government was unable to meet even its own Convergence Plan for a number of years after EU accession. This left the European Commission in the difficult position of having to consider putting Cohesion Fund resources on hold for Hungary. The disciplinary measure was eventually never initiated, as the Commission went into extensive length to negotiate with the Hungarian government and to restore confidence in the member state on the markets. The Convergence Plan has therefore served as an important anchor to help facilitate fiscal stability in a new member state which otherwise is likely to have been even more imprudent. It is important to mention in this respect that the government was re-elected in 2006 after what The Economist called "...the worst mismanagement of public finances anywhere in post-communist Europe" (The Economist 2006). This indicated to the political elite that the electorate was not a hard constraint to fiscal imprudence. Another duress could have been a collapse of the national currency, however as long as there was an oversupply in global liquidity on the international financial markets, the Hungarian forint also remained strong. Thus the disciplinary stance of the European Commission remained the only significant force for member states politicians to reckon with.

The re-accumulation of outside debt was coupled with the slowdown of growth. While the initial years (1996-2003) after privatisation and restructuring had produced remarkable

economic growth, and therefore catch up, from 2003 on Hungary became the only country in the region not in the process of narrowing its GDP gap vis-á-vis the European Union average. In fact it has been drifting further and further away from it in recent years, with a number of countries such as Estonia and Slovakia overtaking Hungary in terms of GDP per capita. This has clearly been a disappointment for society in general, who voted overwhelmingly in favour of EU accession in the hope of rapid economic convergence. The slow economic growth also helped exacerbate problems with the 'debt to GDP ratio' criterion for eurozone accession, where the GDP level serves as the denominator.

Figure 6: *GDP per capita as a percentage of the EU average (=100%) in the new member states of the European Union, PPS, EU27*



Source: Eurostat (2009)

The leading intellectual elite found it difficult to believe that anything could be wrong with the eminent economy of the region that had so often been praised in the past. It was clear that the central budget was heavily out of balance. At first this was believed to be simply due to the populist bargaining of the two political parties that dominate the scene in the country. This was definitely a contributing factor. As can be observed in Figure , budget deficits rose to record high levels in and around election years (1998, 2002, 2006). This essentially means that the political elite has been attempting to buy the votes of the electorate in elections to the detriment of fiscal sustainability in a country where high indebtedness has been a defining feature of economic problems for decades. Perhaps the most glaring example of this high degree of irresponsibility can be found in the institution of the "13th month pension", introduced by Prime Minister Péter Medgyessy in 2002 before the local elections in the fall of that year. The pay as you go state pension system is in fact unable to finance even the 11th and the 12th months of pensions due to a low level of inward payments, and has to be complemented from the state budget. In spite of this, it took some seven years for the government to scrap this clearly unsustainable and politically motivated institution altogether. The leader of the leading opposition Fidesz Party, Viktor Orbán, even proposed the introduction of a 14th month pension in the 2006 parliamentary election[1], taking populism to new extremes. This competition in demagogy between the parliamentary parties lead to a continuation of high fiscal deficits throughout the period, dubbed by domestic economic commentators as "fiscal alcoholism". Naturally amidst conditions of fiscal irresponsibility the monetary side of economic policy was very

[1] "Orbán 14. Havi nyugdíjat ígér" Hungarian News Agency, 2006.01.20.

limited in its options. Since there was no agreement on the right fiscal-monetary mix between the government and the central bank, monetary policy was drawn into the political arena, with a protracted battle waged between the two sides that drew attention away from the more important issues of fiscal responsibility and structural reforms.

Later it had to be accepted that the problems went deeper. The entire functioning of the state needed a revision. Economists and business analysts began to talk about the need for a 'state reform'. It began to be acknowledged that the state was still functioning at the level of efficiency of the 1970s, while trying to meet the global challenges of the post-2000 era. Yet it was maintained that there was nothing wrong with 'the economy' itself. As if the functioning of the economy could be separated from that of the state. In the modern world, where half of GDP is redistributed by the state, and where governments essentially macromanage economic life through fiscal and monetary policy, the two domains have a relationship like milk and coffee in a latte. As an example, public procurement and large scale public investments are amongst the most problematic elements of the economies of new democracies in Eastern Europe from a public efficiency point of view. However, there were obviously serious problems with the non-state part of the Hungarian economy as well. The surest sign of this was the strikingly low unemployment rate, one of the lowest in the OECD. How could an economy be doing fine if it was not providing enough work for society?

What was impossible to swallow for the elite in Hungary was the fact that there was a fault with the entire economic model of transition. Hungary had embraced economic globalisation at such a speed that the reflexive capabilities of the state were unable to follow the developments. In fact there was even a high level of consensus that there was no need to develop such capabilities. After the collapse of communism, disillusioned intellectuals switched from believing in the omnipotence of the state to the omnipotence of the markets. There was, and still is, a very strong neoliberal underlying consensus in the political elite of Hungary. The logic was that Hungarian state owned firms had neither the capital, nor the know how to re-emerge in a Baron Münchausen fashion from the economic collapse of the eighties. Foreign ownership was seen as highly beneficial, resulting in a swift and thorough transition.

The Socialist-Liberal coalition led by Ferenc Gyurcsány (2004-2009) attempted to carry out certain reforms of the state. It is difficult to summarise these reforms, as there wasn't a single political or policy document summarising the steps to be taken during this period. As critics have observed (*HVG* 2008.), some eight different action programmes were compiled during Gyurcsány's two half terms as Prime Minister. These policy drafts ranged from neoliberal reformist through third way social democrat to purely populist. The period can best be characterised as governance through public relations. A well selected team of experts in the Prime Minister's Office monitored public opinion for possible policy steps, and the prime minister constantly went public claiming that reformist measures cannot be introduced due to "a lack of popular support". An institutional centre within the central government for the coordination of these reform programmes was also never found. Perhaps the best summary of the most important steps taken can be found in the Convergence Plan submitted to the European Commission, which became the de facto key policy document in a rather turbulent period of governance. The Plan is a rather incoherent document containing small scale and large scale reforms alike, without a real overarching narrative. Parametric changes included for instance the introduction of hospital visit fees (at roughly one euro per visit), as well as the school fee for university students. The most important of all paradigmatic changes was to take place in the health sector, which was to be partially privatised in the domain of insurance firms. It never became entirely clear why the governing coalition chose this particular sector of the operation of the state to initiate the first major, truly paradigmatic reforms. Unlike the tax

system, labour market institutions, or education, healthcare is a residual area of central budget expenditure that only very indirectly influences the competitiveness and the performance of an economy. Yet it was in this area where the coalition threw in its weight and passed an Act in Parliament. However, the main opposition party Fidesz ran a successful referendum campaign in the spring of 2008 against these changes and reform, and even the above mentioned steps had to be revoked.

The main problem with the reforms during the Gyurcsány period was that they never came together into a complete and coherent strategy. Secondly, they failed to touch upon the central weaknesses of the Hungarian model. The Hungarian economy can be characterised as a dual one, with a weak domestic sector and a strong and dynamic multinational one. The inflow of foreign direct investment had made Hungarian transition smoother than it would otherwise have been. However, this multinational sector has been providing overwhelmingly low value added jobs, forcing Hungary to compete with low wages in the global economy. With EU accession the country became a cheap re-export base for Western European multinationals. Thus we take an alternative view to Greskovits (2005) and Greskovits and Bohle (2006) who prefer to look at the sectors in which integration into global production chains took place. Greskovits for instance is then prompted to differentiate in the region between a Visegrád semi-core, and a Baltic and Balkans semi-periphery. Exports statistics can be misleading. It is much more the value added within the host economy that matters, rather than the final exports, and this can empirically be demonstrated (Németh *et al.* 2007) to be low in the case of Hungary.

Due mostly to the weak language skills, the deteriorating educational system, tragic health situation and low mobility, Hungary has not been able to upgrade itself and move into higher value added sectors. An additional problem has been the low employment potential of the Hungarian model. As can be observed from Figure 5, Hungary came out of communism already with a lower employment potential than the rest of the pack, and although the inflow of FDI helped create some additional jobs, the country has since never really managed to catch up even with the level of other economies in the region. It is also very far from the average level of employment in the EU, which is itself behind the considerably higher US level, as the analysis behind the Lisbon strategy outlines. Thus Hungary has been amongst those member states who have contributed the least to the success of the Lisbon strategy. In spite of spending roughly €1.5 million annually on job creation from the European Social Fund and domestic sources (on top of the educational budget), Hungary has not produced any significant result in job creation, and the situation has even deteriorated with the arrival of the financial crisis.

The low employment potential of the Hungarian economy means that the tax base for personal income tax (one of the key forms of taxation) is very narrow. Thus the tax wedge has had to be very high, reducing Hungary's price competitiveness abroad. Hungary also supports foreign multinationals through tax exemptions and direct government subsidies to an extent that is greater than the amount of corporate tax collected from foreign owned firms. This has placed extra burden on personal income tax payments.

Interestingly enough, economic reform programmes during the Gyurcsány period were initiated from outside the government. One was a much discussed document by the consultancy firm ORIENS (ORIENS 2008.), which correctly identified low employment as the key predicament of the Hungarian economy. The other major set of recommendations came from a civic organisation of reform minded researchers and public figures, known as the Reform Union (*Reformszövetség*) (Reform Union 2009.).

In the autumn of 2008 the global economic crisis hit Hungary on top of the already prevailing domestically manufactured economic hardships. As we have already

mentioned, Hungarian policymakers could continue their imprudent fiscal policy as long as there was enough liquidity in global financial markets for Hungary to borrow. The amounts thus raised were used to pay incurring interest on state debt, to renew the debt, and to finance open market intervention in defence of the Hungarian forint by the National Bank. As late as the 6 October session of the Hungarian Parliament, Prime Minister Gyurcsány was reaffirming that Hungary would only be affected by "side winds of the global crisis", and accused those more concerned of being "prophets of the crisis" (Gyurcsány 6 October 2008). However, only a few weeks later global liquidity did eventually dry up. It became more and more difficult to sell Hungarian state bonds to investors, with the interest rate on 12 month bonds rising to 12.76 per cent by the auction day of the 13 November 2008 (Hungarian National Bank 2008). Thus raising financing from the market became impossible, and Hungary had to turn to the International Monetary Fund (IMF) for help. The IMF, together with the World Bank and the EU, offered a 17 month stand-by loan of €20 billion, as part of its package to help states hurt by the global financial crises. The loan enables the rollover of debt in this period, but it is tied to strict criteria such as a sharp reduction of government expenditure, the restraint of wages and pensions, and a recapitalisation of eligible banks to ensure domestic liquidity. Hungary was the first European Union country to receive such assistance from the IMF and the EU, putting the country into same basket as economies such as Serbia and the Ukraine. Romania, another EU member state later also received such assistance. The IMF loan thus enabled Hungary to survive the immediate effects of the credibility crisis created by the Gyurcsány government, but at an enormous cost to taxpayers. The loan has increased Hungary's debt burden to well over the 60 per cent margin vis-á-vis its GDP required for eurozone entry, pushing the introduction date of the euro even further away. The European Commission and the Central Bank have repeatedly emphasised that an early entry of new member states under the security umbrella of the euro by relaxing the rules is out of the question.

Gyurcsány eventually stepped down in the spring of 2009 after a long and enduring government crisis, in which the liberal coalition partner, SZDSZ (Alliance of Free Democrats - *Szabad Demokraták Szövetsége – a Magyar Liberális Párt*) left the government, albeit continuing to support it from outside. The position of Prime Minister was taken over by former minister for the economy, Gordon Bajnai. He defined himself as the head of a quasi-caretaker government, and pledged not to run as a candidate in the upcoming 2010 parliamentary elections. Thus his term is limited to barely more than a year, in which he has set out to implement a stabilisation package. His leadership skills surpassed that of his predecessors, and he managed to pass a series of important changes through Parliament. These included the freezing of public sector wages for two years; the elimination of 13th month pensions and wages; a decrease in maternity leave from three years to two; a review of the personal income tax system; and the introduction of the long awaited real estate tax. These are just the most important measures taken in a long line of measures aimed at fiscal stabilisation and compliance with the conditions of the IMF loan.

By being able to push these reforms through a parliamentary majority composed essentially of the same MPs as Gyurcsány's, Bajnai has in fact provided proof of the immobility and the lack of leadership during the Gyurcsány era. It is important to note, however, that in the midst of sending mixed signals about the measures accepted, the opposition Fidesz party has in fact pledged itself to revoke most of the measures achieved by Bajnai. It is unclear what economic policy Fidesz would follow once in government, which, based on a constant and sizeable lead in polls, is extremely likely to happen after the 2010 elections. The official key policy document of the party, a text entitled 'Strong Hungary' is very poor guide to the future policy of the party, once in power. Its leader, Viktor Orbán simultaneously denounces neoliberal capitalism in his political speeches, and at the same time places a reduction of taxes on labour in the centre of his future economic policy for recovery in Hungary.

It is now well recognised by most that the two major political parties, the Socialists and Fidesz have been engaged in symbolic political struggles at a very low intellectual level in the past, preferring power to policy. The inability of the current mainstream political elite to confront real policy issues, and to engineer a major shift in the social and economic social and economic situation has lead to a very strong showing of the far right in the 2009 European parliamentary elections (15 per cent). On top of their racism and political radicalism, these extremists have successfully portrayed themselves as an anti-establishment party that is willing to face 'the real issues of the population'. Their arguments have been further strengthened by a clear and present prevalence of corruption at various levels of society. According to Transparency International, Hungary is in the middle range of countries in the world in terms of corruption. Its 2008 Corruption Perception Index (Transparency International, 2008) places Hungary in 47th position, down from 36th the previous year, with a grade of 5.1 on a scale of 10. Perceived corruption was increasing in the context of a perceived decrease in the Central and Eastern European context. The Global Corruption Barometer of the same organisation, which relies on representative opinion surveys (Transparency International, 2009), identifies the proximity of political parties, as well as public procurement as the key areas of corruption. 64 per cent of respondents have expressed scepticism about the efficiency of government in tackling corruption, cases of which dominate Hungarian printed and online media.

The sustainability of the 'dependent competition state' model

Even though many Hungarian intellectuals are still not quite ready to accept it, the crisis reveals more than merely the inadequacy and populism of the political elite. It is also a culmination of the weaknesses of the dependent competition state model of transition, of which Hungary has been the pioneering example. The Achilles heel of this model is its dependence on foreign investors, which creates a dual economy of foreign owned and domestically owned sectors. The foreign owned sectors are dynamic, efficient with an enormous export potential, but continue to compete with very low wages in the global economy. The domestic sector continues to be less efficient, and it has demonstrated a limited capacity to take advantage of the increased markets of the European Union's single internal market, the central advantage of membership in the organisation. The dependent competition state model has also demonstrated very limited employment potential beyond soaking up the unemployment created during the economic restructuring process. Hungary was unique in the region in having the lowest employment rate at the time of transition. This was partly due to the unfavourable demographics of the country, partly due to a deliberate strategy of shifting a large section of the population into early retirement and special unemployment benefits (Vanhuysse 2006). Part of the reason was to hide a sharp increase in unemployment due to economic breakdown and restructuring, and move it instead into the less visible and less scrutinised category of inactive, dependent population. Equally important was the desire to reduce the collective protest potential of labour in a very crucial period. This process went hand in hand with the weakening of trade union rights for those were left on the labour market. As a contrast, in the same period the domestically oriented Slovak and Czech governments provided soft credit and subsidies to state owned and privatised firms equally, in order to maintain employment (Drahokoupil 2008: 42.). This domestically oriented strategy failed conspicuously, but it did maintain a high level of employment, as well as the employability of large segments of society. Thus when later Czech and Slovak governments turned towards FDI oriented privatisation and restructuring, it was labour that was freshly shed that was being soaked up by the increase in output during the growth years following FDI based restructuring. As is clear from Figure 5, FDI based transition countries created almost no extra employment above those who had already been employed during the

domestically oriented period prior to opening up towards multinational production chains. Hungary, by contrast, remained unable to increase its employment rate after the end of the transition period. The main reason for this was the lack of employability amongst broad segments of the population who had been allowed to exit the labour market at the beginning and the middle of the 1990s. Unfortunately, most mainstream proposals to overcome the economic difficulties of the country in recent years have focused on tax cuts as their central prescription, referring to an oversized tax wedge on labour as the main reason behind what they correctly identified as being the central weakness of the Hungarian economy: low employment. They have refused to face the fact that an even more serious factor might lie behind this central weakness, namely the low employment potential of the dependent competition state model. The main lesson for the region, therefore, is that a tax race towards the bottom is a short term strategy with questionable effects in the longer run. With the single exception of the Czech Republic, the former Eastern Bloc continues to be a region of lower than average employment within the European Union.

The FDI based liberal transition model is often criticised by the political extreme left as 'selling out to capitalism' and the extreme right as the 'selling out of family silver'. In fact the failure of domestically oriented privatisation strategies ranging from Klaus's Czech Republic (Myant 2003) through Mečiar's Slovakia (Marcincin and Beblavy 2000; MESA10 1999, 1999; Pogatsa 2010) to Tudjman's Croatia, as well as coupon based privatisation elsewhere in the region demonstrate how there was a lack of a realistic alternative during transition. Inferior technology, overreliance on Soviet and Comecon markets, inadequate know how in management and marketing, as well as political reluctance to allow a thorough restructuring have all contributed to domestically oriented attempts to fail. Governments have tended to interfere in the affairs of domestically owned firms by securing them financing from state owned financial systems for restructuring and reorientation strategies that were not always viable. This in turn led to the accumulation of bad debt in the economy. There was also a temptation for clientalism. The only contrafactual, an economy where a domestically oriented privatisation strategy has proved to be sustainable and successful, has been two million strong Slovenia. There the economy has shown solid growth, amidst stable monetary and fiscal conditions, with relatively high wages in regional comparison, and a constantly increasing rate of employment. However, Slovenia is a very special case. It was not part of the Soviet Bloc. Economic transition started decades prior to 1989, with the establishment of a two tier banking system and quasi market conditions. Slovenian firms had been exporting heavily to the West even during Yugoslav times, and were not dependent on their Eastern markets (Piroska and Lindstrom 2007; see also: Damijan and Majcen 2000; Silva-Jáuregui 2004; Simoneti *et al.* 2004; Vodopivec 2004).

Most transition countries found that the involvement of foreign investors was a necessary element of successful transition. Thus privatisation to the outside can be considered a necessary first step. It ensured a more thorough transformation process, provided immediate technology, know-how and marketing by embedding East European firms in the global production networks of transnational corporations. It provided the capital needed for investment. It ensured the revival of collapsed production and provided some work in the economy. Therefore it enabled a much smoother transition to what it otherwise would have been, as many hardships as it caused for millions across the region.

However, the recent economic backsliding of Hungary (and elsewhere) has cast doubt sustainability of FDI based transition. The dependent competition state paradigm has focused on FDI promotion for economic development, and has relied on the same process for traditional roles of the welfare state, such as job creation, social policy and investment into technology. However, it has conspicuously failed in this strategy. With the onset of the

economic crisis, not only portfolio capital and the liquidity of international financial markets dried up, but also the inflow of FDI.

If we conceive of FDI based transition as a first step in transition, we can identify the need for a second one. Rather than reducing the size of the state (expressed in terms of the rate of redistribution within GDP), as is often proposed without any reference to its capabilities, there is a need to increase the efficiency of the state in Central and Eastern Europe. In some policy areas this might result in the withdrawal of the state, in others it might also necessitate a broader role, according to societal necessities as evidenced by policy data. Unfortunately, in contrast to legal harmonisation and capacity building specific to the application of the *aquis communautaire*, the European Union had not initiated efforts to increase the policy capacities of Central and Eastern European would be member states in the period of accession. This lack of transfer in know how related to state capacity was one of the great weaknesses of Eastern enlargement. Thus these states entered the EU with very weak states that are at present incapable of carrying out the great shift that would enable them to upgrade their economies. Such an effort would be targeted at shifting from a low employment / low vale added / low wage economy to a high employment / higher value added one with well paid jobs. In order to do this, the state needs to increase its capacity in areas such as employment creation, education, infrastructure and local governance. Such a strategic leap would therefore decidedly overlap with the Lisbon strategy of high employment competitiveness based on ICT society.

At the moment Hungary is the economic laggard of the region. From key economic data it might seem like it is an exceptional case in the region, which in terms of its fiscal alcoholism and the irresponsibility of its governing elite it probably is. However, the global economic crisis is beginning to highlight the weaknesses of the FDI based dependent competitiveness model elsewhere in the region as well. Among the states that have followed similar strategic and are experiencing serious economic difficulties arising from their exposed economic structure are Slovakia, Romania and the Baltic states. Would these states be unable to take the next step forward to a higher value added Western or Southern European style capitalist economy, recent optimistic posterior assessments of Eastern enlargements by European leaders and the Commission could easily prove to be premature.

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JCER Commentary

Boom and Bust in Central and Eastern Europe: Lessons on the Sustainability of an Externally Financed Growth Model

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Abstract
This commentary shows the patterns of a production model in Central Eastern Europe (CEE) that was based on a specific division of labour within the enlarged Europe. Its foundation was a newly emerged manufacturing base in Central Eastern Europe (CEE) and it was seen as a prerequisite for economic renewal in post-communist countries. This production model seems to be in danger now. The first section highlights the main elements of the process where CEE production locations became integrated into the value chains of western European manufacturing enterprises. The example of the automobile industry demonstrates the principles of this production model of with its particular pattern of division of labour between the East and west of Europe. The foundations of the past success have however proved to be fragile, as the dramatic effects of the economic crisis show us these days. The second part of the paper shows, how the particular pattern of the division of labour between East and West have become a risk factor and its sustainability is being questioned.

Keywords
European integration; CEE; FDI; Economic crisis; manufacturing industry

FOR THE EIGHT CENTRAL AND EAST EUROPEAN (CEE) COUNTRIES (CZECH REPUBLIC, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia), the fifth anniversary of EU accession on 1 May 2004 has since been marked by the devastating effect of the worldwide financial and economic crisis that has had a specific impact across Europe and particularly on the CEE region. Bulgaria and Romania, which joined the EU 1st January 2007, have been equally affected.

Over the past decade a convergence process of CEE transformation economies in terms of GDP per capita at Purchasing Power Standards (PPS) towards the standards and realities of developed Western Europe had taken place (figure 1). Their average growth rates over the last decade were characteristically between 4-5%, with Slovakia and the Baltic states attaining growth dynamics of up to 10% in certain years (European Commission 2008).

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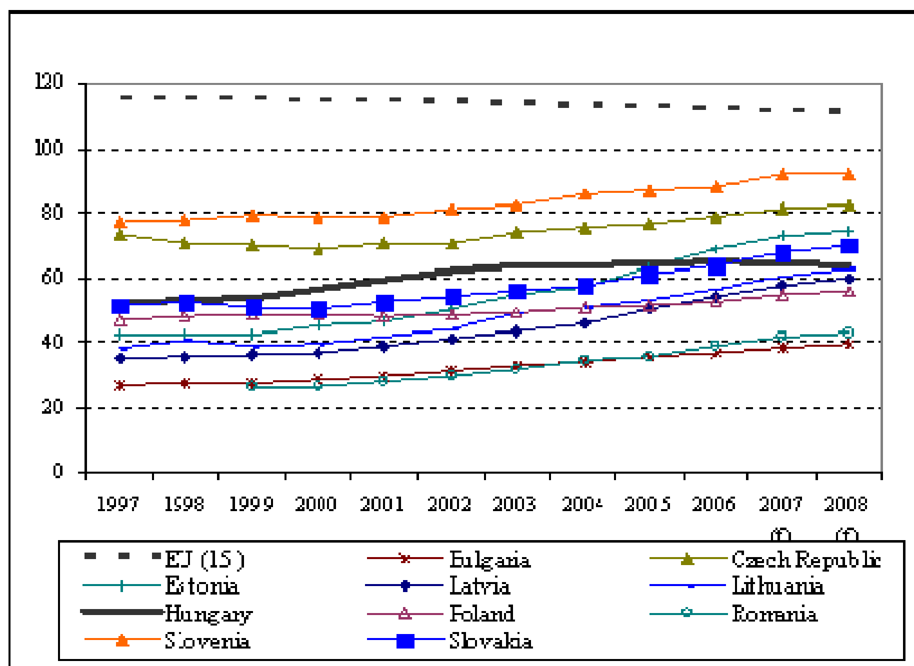
Productivity soared and national currencies, particularly those not pegged to the Euro, experienced real effective appreciation of exchange rates.

Figure 1: *Convergence of GDP/capita levels of CEE countries towards EU27 average at PPS*



Source: Eurostat Online Database (2009)

The growth of CEE economies was largely based on external financing. This took various forms and included, bank loans, trade-related lending, foreign direct investment (FDI) and portfolio investment. Taking a critical reflective overview of the CEE economies during this time helps to identify the central thesis of this article. This states that beside irresponsible fiscal policy or asset bubbles in individual cases, the fundamental vulnerability of the region, as a whole, can be found in the one-sided and unbalanced nature of its economic and financial integration with the EU15.[1]

The main characteristics of the FDI based production model, where CEE production locations became integrated into the value chains of Western European manufacturing enterprises, are examined in the first section of this article. FDI played a key role in the modernization and structural renewal of these economies and brought about a new division of labour in Europe on the foundations of a newly emerged manufacturing base in CEE. The particular form of this division of labour with its one-sided and concentrated specialisation has made the region vulnerable to external shocks, as the effects of the recent crisis have shown. The example of the automobile industry will demonstrate the model case for the new division of labour within the integrated Europe.

The second section of the article highlights the impact of the world economic crisis on CEE countries and identifies their high dependence on external financing and the resulting financial imbalances as the major factors behind their high exposure to the external shock posed by the crisis. The article shows the role of the different factors of vulnerability, one by one, and comes to the conclusion that the particular production model and the unbalanced financial integration with the EU15 were key factors of vulnerability for the

[1] EU15 refers to pre 2004 EU member states.

region. By this, the sustainability of past growth and the convergence model is questioned.

The new manufacturing base in Central and Eastern Europe

With liberalised trade and investment flows from the early 1990s the economic integration of CEE into the European economy had largely taken place before the political actuality of their accession to the EU in May 2004. Countries that had been isolated from western Europe for several decades not only offered new markets but also a huge labour force. CEE has a medium-to-high skilled labour force, generally available at much lower cost than the labour force in western Europe. The two European regions (east and west) have very different features, whether it be labour and capital, or commodity price ratios and cost structures.

The combination of large scale global capital and the additional labour supply from emerging countries has created a fundamental shift in comparative advantages worldwide. The arrival of multinational firms has helped to open up the emerging countries to foreign products. It has also quickened the vertical division of labour, which allows emerging countries to specialise in assembly and other labour-intensive activities, besides traditional sectors, such as textiles/apparel. This explains the growth in industrial-product trade between advanced countries and emerging countries at different stages of the value chain (Feenstra 1998; Sturgeon 2002).

The integration of low-wage countries into the world economy and that of CEE into the European economy deepened year by year and the pattern of global economic activity changed markedly, driven by extensive and fundamental changes in technology, production, investment and trade flows.

Several studies have shown an increase at the global level in the share of vertical FDI, lured by low production costs. New member states have experienced a rapid shift in international specialisation thanks to the establishment of facilities by multinational firms, particularly in the automotive and electronic components industries (Kaminski and Smarzynska 2001; Sachwald 2005). The European integration process has also brought about a new division of labour within Europe with a newly emerging industrial landscape in the CEE new member states during the late 1990s and early 2000s.

Manufacturing played a larger role in investment flows towards CEE than it did on the global level. On the other hand, it is a general trend for developed economies that manufacturing as a share of total employment shrinks over time. In Europe, the UK is the most telling example of this: manufacturing as a share of total employment shrank from 32% in 1970 through 23% in 1985 to 13% by 2003. This is the general pattern for the whole of western Europe, though less radically elsewhere. Germany had the highest share of manufacturing in total employment, at 20%, among the EU15 in 2003. CEE countries show quite a different picture. In the initial phase of their transformation in the early 1990s their former manufacturing base practically collapsed, but since the mid-1990s, primarily due to foreign direct investments (FDI), manufacturing output and exports soared and the share of manufacturing in GDP and employment continuously increased. By the mid-2000s they maintained higher shares of manufacturing in total employment than most European economies: Hungary 23%, Slovakia 25% and Czech Republic 31% (OECD 2006).

High levels of manufacturing trade within the same industry (intra-industry trade or intra-firm trade) are signs of cross-border integration of manufacturing activities throughout the value chain. Countries where intra-industry trade is above 70% of total manufacturing

trade can be seen as highly integrated in international value chains. In this case intra-industry trade intensity is a sign that a large part of the production is being carried out in these countries and the intermediate products are being re-exported to the home country, thereby substituting home labour. This is clearly the case in relation to the Czech Republic, Hungary and Slovakia. The share of intra-industry trade in total manufacturing trade was 81% for the Czech Republic, 79% for Hungary and 75% for Slovakia as an average value for the period 1996-2005, with an increasing trend (OECD 2006), in line with significant FDI flows into manufacturing.

Strong export expansion was also characteristic of these countries. In the period 1996-2005 the OECD countries that increased their manufacturing export market shares on OECD markets to the greatest extent were Hungary (by 116.2%), Slovakia (by 86.8%) and Poland (by 78.1%).

As a result, the EU-15's large trade surpluses with the CEE countries have shrunk and, in some cases, become deficits, as trade statistics show (Broadman 2005). Most indicative is the fact that the Czech Republic, Hungary and Slovakia have maintained a trade surplus with the 'export champion' Germany, especially in manufacturing, built up in the course of intensified production-sharing FDI (relocation).

Changing investment patterns have also played a role here. EU-15 countries have benefited considerably from the market opening of the CEE region, when they explored huge market shares, particularly in the first half of the 1990s. Since the late 1990s, investment patters have shifted from pure market exploring investments towards more complex forms, most notably production sharing networks. By this both the benefits and the challenges have become more complex.

Producer-driven supply chain networks are based on more complex forms of international division of labour. Such networks are mostly present in capital-intensive and more skilled labour-intensive industries such as the automobile industry and information-telecommunications. FDI plays a key role in establishing producer-driven networks.

Foreign trade data from the region clearly demonstrate a qualitative shift. By 2003 the share of clothing in manufacturing exports had fallen dramatically compared to the peak year in most of the CEE region. In the case of Hungary, the share of clothing exports in 2003 was 80% lower than in the peak year of 1992; in the Czech Republic the decrease was 75%, in Poland 73% (Broadman 2005). There is evidence of a strong correlation between FDI and the level of involvement in global IT and automobile production networks. In 2003 the share of network exports in total manufacturing exports reached 53.8% in Hungary, 40.5% in Slovakia and 34.4% in the Czech Republic. These figures clearly illustrate that producer-driven-network FDI has fundamentally transformed the economic and export structure of these countries and moved their activities up the value chain.

Export capacities in CEE locations were thus built up to a large extent through FDI and relocation and have been subject to subsequent upgrading. As a result, a shift from labour-intensive production towards technology- and capital-intensive forms of activity has taken place (OECD 2006).

Manufacturing FDI in CEE is mainly efficiency seeking and export expanding and is concentrated in the production of transport equipment and electrical components industries. While it had partially replaced production in the EU-15 and corresponding capacities were not downscaled there in parallel, an EU wide pool of surplus capacities appeared, especially in the automobile sector. The global car components industry has a significant concentration in the CEE, especially in Poland, the Czech Republic, Slovakia and

Hungary. It is thus worth having a look at the specific forms of the division of labour between the EU15 and CEE locations in the automobile industry.
The special dynamic of the automobile sector results from the fact that four key processes were taking place at the same time: internal company reorganisation, the redefinition of business strategies, the outsourcing of non-core activities and the restructuring of supply chains. A common denominator of these change processes is the increase of cross-border activities in the form of different outsourcing and off-shoring strategies.

It has often been argued that the initial reason why Western carmakers invested directly in CEE destinations was to gain access to new markets; but with the establishment of new capacities there, export platforms were created that might undermine the share of value added in the home countries and even threaten industrial manufacturing in high-wage countries (Sinn 2004; Dudenhöffer 2006).

The patterns of the division of labour among original equipment manufacturers (OEMs) and first-tier suppliers, with particular attention to the role of CEE locations cannot be characterised as exclusively market- or cost-driven and, in contrast to other industries, automobile production is not characterised by a clear East–West division of labour. CEE countries, therefore, cannot be said to have a clear specialisation in the value chain; for example, as regards labour-intensive or low-skill activities. Apart from design and core Research and Development (R&D) work almost all tasks are carried out at CEE locations. A clear division between winners and losers cannot be identified either. With the establishment of new plants in Central and Eastern Europe the existing sites in western Europe face actual or potential competition. This has led to the closure of production facilities to a limited extent, but a more widespread effect seems to have been stagnation and loss of growth opportunities in the West. Other company functions, such as R&D, and other industries, such as machinery production in the West, have profited from these developments. The loss of value added due to imported intermediate inputs has been more than compensated by the export of cars assembled from intermediate products, as prices on the world market have remained competitive and strong exports have created new jobs.

In the CEE countries the new automobile industry has created around half a million jobs and offers opportunities for the further upgrading of capacities established there. High intra-industrial trade (the share of which within total manufacturing trade grew from scratch to the level of the EU15 within a short period), a high share of FDI inflow into manufacturing (resulting in a strengthening of the manufacturing base in the CEE new member states, while manufacturing in the EU15 was shrinking) and soaring manufacturing exports were the main features that demonstrated a qualitative shift that took place in the European industry and led to a new division of labour between the West and the East of Europe. Even with this qualitative shift in trade and investment patterns EU15 countries continued to benefit from market expansion in the CEE region during the economic upswing until 2008. Within this framework, Western multinationals benefited from cheap sourcing from CEE locations and used this to strengthen their market positions and competitiveness at global level. The sustainability of this form of division of labour and the production model based on it in CEE has not been questioned previously. The huge impacts of the recent economic crisis on CEE are however raising questions about it now. The mono-industrial nature of the new industrial landscape in CEE that focuses on highly cyclical branches as automobile assembly and electronic components production had proven to be a risk factor at the time of a heavy downturn. High dependence on export demand that is concentrated on cyclical industries became a factor of vulnerability and added to the intensity of the downturn in CEE.

The impact of the economic crisis on CEE

The contagion generated by the US sub-prime mortgage market spread, via different channels of opaque financial instruments, around the whole world (see Watt 2008). The main effect was that ‘toxic assets’ have caused huge losses in the books of financial institutions and the previously abundant liquidity has turned into a credit crunch paralysing the entire banking system, not only in the USA and Europe, but worldwide. The contagion has engulfed the European banking system and the dramatic effects of the financial crisis on the European economy have surprised everybody.

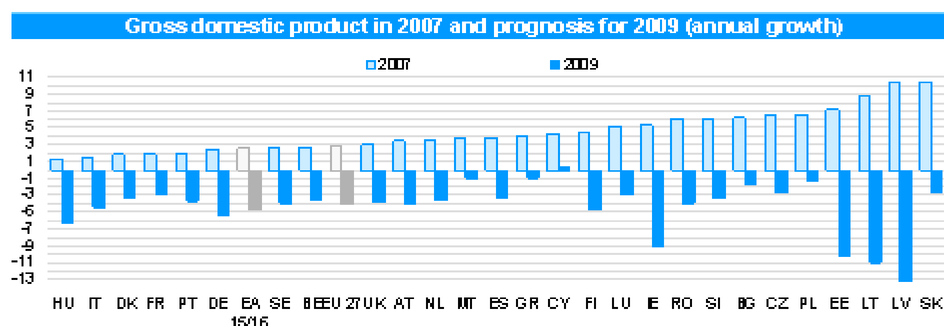
Governments of the region (e.g. of the Czech Republic and Slovakia, as of February 2009) and even the European Commission in its 2009 January Interim Forecast (European Commission 2009a) thought that CEE new member states would not be affected by the spreading financial turmoil as their financial institutions were not involved in the opaque financial transactions characteristic of the USA and most western European banks. This proved not to b the case; macroeconomic imbalances, chronic dependence on external financing were the primary reasons why CEE new member states suddenly found themselves deeply affected but the one-sided and unbalanced nature of their deep economic, trade and financial integration with the EU15 were the structural reasons of this vulnerability. They were hit hard within a short time due to a series of factors that highlighted how previous high growth became unsustainable once the external environment took a turn for the worse.

The next set of sections show the major effects of the crisis on the CEE new member states with an overview of the factors of their vulnerability as underlying reasons for the intensity of the downturn.

Economic growth and employment

The dramatic effects of the crisis on the CEE region now call into question the sustainability of the economic and social convergence process that was characteristic for the region in the past decade. The ‘hard landing’ of 2009 from high growth levels in 2007 is visible in Figure 2 based on the May 2009 Forecast of the Commission (European Commission 2009b).

Figure 2: *GDP growth 2007 vs Forecast 2009*



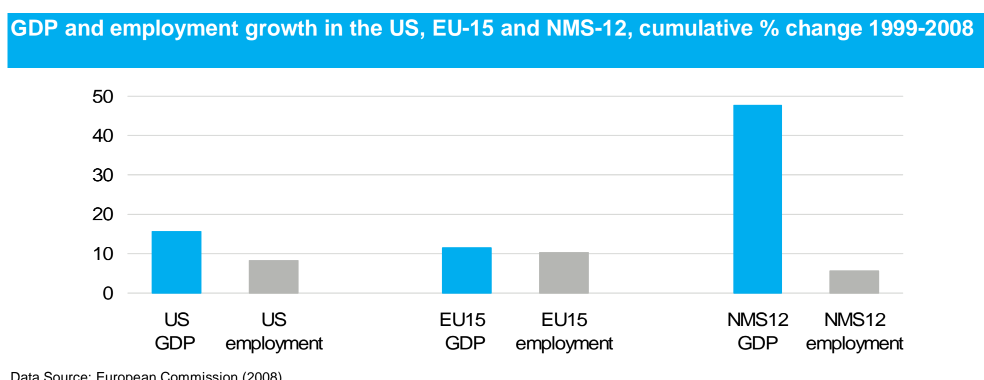
Source: European Commission (2009b)

Some of the CEE new member states have been particularly hard-hit. The most dramatic downturn has been in Latvia, where above 10% GDP growth in 2007 is likely to turn into a

decrease of 13.1% by the end of 2009. Previous high-growth economies, such as Estonia and Lithuania, are also expected to suffer, with a projected drop in GDP of 10.3% and 11% in 2009, while the 6.3% fall for Hungary is also substantial.

Employment creation had been very weak in Central Eastern Europe even in the boom years, as illustrated by Figure 3. Both the US and the EU15 have had higher increases of employment with a fraction of the growth found in the new member states.

Figure 3: *GDP and employment growth in the USA, EU-15 and NMS-12, cumulative % change 1999-2008*



Now jobs are disappearing on a massive scale. Unemployment in the Baltic States showed an alarming increase from low levels in May 2008 to around 15% by May 2009, the increase was most dramatic in Estonia from 3.9% to 15.6% (Eurostat 2009). The unemployment rate had also increased substantially in Hungary and Slovakia having reached double digit levels by May 2009 (10.2% and 11.1% respectively).

Factors of vulnerability of CEE economies

Soon after the crash of the Lehman Brothers in mid-September 2008, it turned out how vulnerable the CEE new member states indeed were and the figures on growth and employment have given an indication of this. The underlying reasons for these severe effects were rooted in these economies' vulnerability, the most important factors of which will be addressed in the next section.

Macroeconomic imbalances at times of financial turbulence

With the continuing paucity of domestic capital, 'catching-up economies' have been notoriously reliant on external capital throughout the whole transformation process. This included FDI, financial investments (into state bonds and diverse corporate assets), foreign bank and government loans and EU transfers. This high external financing need made these countries dependent on the available abundance of investment capital and high risk-taking attitudes of investors.
With a view to the links between international capital movements, economic wealth and economic growth, according to the neoclassical theory capital should flow from the capital-abundant rich countries to the capital-scarce recipient poorer countries, both in terms of flow (through the widening current account deficits) and a stock perspective

(through the deteriorating net foreign asset positions) and result in higher growth rates in the recipient countries (see Herrmann and Winkler 2009).

The dramatic increase of the financial and trade integration between the EU15 and the CEE transition economies during the late 1990s and early 2000s, with view to the widening current account deficits and deteriorating net foreign asset positions in the latter, has ignited considerable interest for external sustainability analysis. While the conventional wisdom suggested that current account deficits exceeding the level of 5% of GDP are potential danger for macroeconomic and financial stability, the payment balances on current account in most European transition economies were well above 10% of GDP. Given their impressive rates of economic growth during the 2000s, the theoretical and empirical guidance that the inevitable adjustment (in form of so called current account reversals) could have devastating macroeconomic implications seemed no longer important. The most striking example was Latvia, which was running current account deficits of 22.5% of GDP and real GDP growth of 10% in 2007 (IMF 2009). That is exactly the country that was severely hit by the global economic crisis with a projected negative real GDP growth of 18% in 2009.

In a number of countries consumption and private sector investments were largely financed by credit, while especially those countries with a pegged currency witnessed high price and wage inflation together with rising asset (i.e. house) prices.

Lane and Milesi-Ferretti (2006) argue that the benefits of international financial integration are tied with the gross holdings of foreign assets and liabilities, rather than to capital flows. In essence, the stock adjustment approach to external disequilibrium analysis presumes that it is not the current account, but the net foreign asset position *per se* that matters). Net foreign assets are defined as the difference between the stock of foreign assets held by domestic residents and the stock of domestic liabilities held by foreign residents. The changes in net foreign asset positions reflect not only the current account balance, but also the changes in valuation in terms of asset prices and relative exchange rates.

Although government debt (that used previously to be the focus of attention) is substantially lower for most CEE countries than is usually the case for developed economies, their total external debt including enterprise and household debt has reached high levels in the most recent period. Table 1 (page 622) shows current account balances for 2008 and for 2009 and also indicates levels of total external financing need (see more on current account deficits in the region in Shelburne, 2008).

After the shockwaves of the credit crunch and the bankruptcies in the USA and the western European financial system, investors' confidence and appetite for risk suddenly evaporated. With growing risk aversion, foreign investors turned their backs on emerging market assets (including government securities) and retreated to their domestic markets. According to the Bank for International Settlements (BIS), American investors alone repatriated 750 billion USD in the last three quarters of 2008 (*Financial Times* 2009a). BIS data also reveal that cross-border lending by banks shrank by 4,800 billion USD in the first nine months of 2008. According to the IMF, the retreat from cross-border exposures was occurring more rapidly than the overall deleveraging process (*Financial Times* 2009b). The financing need of the stimulus packages of G7 economies might also add to the diversion of money flows from CEE financial markets, as the amount of state bond issues in the G7 economies is estimated to grow from US$1000 billion USD in 2008 to US$3000 billion in 2009.

As a result, financial markets in CEE Europe came under huge pressure and daily debt financing has suddenly become difficult. National currencies were shaken with

devaluations of up to 30%. Credit ratings of state bonds were downgraded and country risk indicators deteriorated sharply, resulting in high interest rate margins, making debt financing difficult or in certain cases impossible. Default risk of state bonds is indicated by 'credit default swap spreads' (CDS) which express the current risk judgement of financial markets on the probability of state insolvency that in case of the Ukraine was estimated at 39%, and in that of Latvia at 10% at the peak of the financial crisis in March 2009. State bonds of Latvia, Romania and Ukraine were correspondingly rated as 'junk bonds'. These developments triggered further devaluations of regional currencies (not only those of the affected countries) launching a vicious circle and spreading contagion across the region.

Table 1: *Financial indicators for selected CEE countries*

Country	GDP/capita 2008, USD PPS	Financing need, % GDP[1]	Current account balance, % GDP[2]		Export share in GDP (2008)
			2008	2009	
Bulgaria	12,372	29.4	-24	-12.9	61.0
Czech Rep	25,757	9.4	-3.5	-2.8	80.1
Estonia	20,754	20.0	-10	-6.3	72.0
Hungary	19,830	29.9	-6.5	-3.9	80.2
Latvia	17,801	24.3	-14	-6.7	46.6
Lithuania	18,855	27.1	-12	-4.8	59.0
Poland	17,560	13.2	-5	-4.9	42.3
Romania	12,698	20.2	-12	-7.5	34.4
Slovakia	22,242	12.5	-6		90.5
Slovenia	28,894	-	-6		70.5

Notes: [1] Total financing requirement, current account balance, principal due on public and private debts plus IMF debits, 2008 estimate; [2] IMF prognosis;

Source: *The Economist*, February 28th, 2009 based on IMF, Moody's and the *Financial Times*, 27th February 2009 based on Thomson Datastream

The role of western banks in the region

Over 80% of the banks of Central and Eastern European countries are affiliates of Western banks. These banks were eager to grant credits on a mass scale to the population and to enterprises in all countries of the region, often denominated in foreign currency (especially in countries where interest rates in local currency were substantially higher). According to a study by the Centre for European Policy Studies (Gros 2009), the residential mortgage debt in the so-called Visegrad Four (V4) countries – the Czech Republic, Hungary, Poland and Slovakia ranges between 11.7% of GDP in Poland and 15.3 in the Czech Republic, while levels in the Baltic states are over 30% (Latvia 33.7%; Estonia 36.3%).

Western banks made extraordinary profits in the region with profit levels more than twice as high as in their home countries and were expecting continued expansion in the region, even when the financial crisis was just around the corner. An analysis by the Deutsche Bank (Mühlberger 2007), dated December 2007, has seen huge growth perspectives for the central-east European banking sector with a credit expansion of 23% on yearly average until 2011. It also pointed to the underdeveloped nature of these banking systems, measured by the low levels of aggregated credit volumes (85%) compared to their GDP considering the usual levels in Western Europe (for the Eurozone: 230%).

The current situation is that, as a result of falling GDP, rising unemployment and weaker national currencies, the share of non-performing loans is rising and credit placements to CEE have become 'toxic assets' for Western banks. Austrian banks have outstanding credits at their branch offices in Eastern Europe equalling up to 80% of Austrian GDP. Eastern borrowers must repay $400 billion in debt owed to Western banks during 2009. Western headquarters (themselves in trouble) were reluctant to bail out their eastern affiliates and even to continue credit provision.

CEE Europe has thus been hit hard by global deleveraging and frozen cross-border bank lending. The impact has flowed through the same financial linkages with mature markets that previously allowed the region to build up a high degree of leverage through rapid foreign-financed credit growth. Cross-border bank funding is now being disrupted as the banking crisis in Western Europe intensifies. Growth in credit to the private sector is falling rapidly, intensifying the vicious circle between output declines and deteriorating asset quality (IMF 2009).

Although no western bank has withdrawn from the region as a result of the operations of its troubled CEE affiliates, the dramatic reduction of cross-border credit flows has had a huge impact on them. Through the activity of Western banks in the region, a large number of CEE enterprises and a substantial share of the population had become de facto integrated into the Eurozone without the safeguarding mechanisms applied for financial institutions of the Eurozone. By this, one-sided and unbalanced financial integration contributed largely not only to irresponsible lending practices by western banks prior to the crisis but also to the lack of guarantees, supervision and finally the absence of the lender of last resort during the crisis. This has largely contributed to the confidence crisis and the financial turbulences that swept through the region and ended up in the intervention of the IMF in a number of countries of the region.

With household debt in several new member states (such as Hungary and Romania) largely denominated in foreign exchange, as a consequence of currency devaluations of 20-25%, families face debt services that are up to 25% higher than originally planned. This is no longer just a problem of financial stability but a burning social issue.

Deep economic and trade integration with the West

In most of the region growth and modernisation were largely driven by FDI. Levels of FDI stock reached nearly 100% of GDP in certain CEE countries (e.g. Estonia, Hungary and the Czech Republic), while almost all have their FDI stock over 50% of GDP. According to recent estimates of the Institute of International Finance, FDI flows to the region are likely to be reduced from US$393 billion in 2007 to around US$220 billion in 2009.

Though FDI was, on the one hand, an indispensable modernisation lever, it resulted in a dependent economic position with strategic decisions made at Western company headquarters and profit repatriation practices having a negative impact on current account balances. This factor adds to their vulnerability under stormy conditions.

Moreover, the economies of the new member states are integrated with the European and wider world economy to a greater extent than most EU-15 economies and so are highly dependent on external demand. The particular pattern of their economic and trade integration with Western Europe with its sectoral concentration on the automobile industry had become a risk factor (as described in the previous section). The high dependence on exports of intermediary manufacturing products to Western Europe and other developed economies is, in particular, the major factor currently depressing growth

prospects (export shares of CEE countries are shown in Table 1). The new member states from Central Eastern Europe and specifically the so-called Visegrad Four (V4) countries (Czech Republic, Hungary, Poland, Slovakia) are particularly exposed to the breakdown of demand from the West, particularly from Germany.

The large automobile production capacities established in the Visegrad Four countries are highly dependent on the economic cycle, but also on their parent companies in Western Europe (in a few cases in Japan, Korea or the USA). The electronic components industry (an important part of manufacturing not only in V4 countries and Romania but also in the Baltic states), and especially contract manufacturers, are even more exposed to economic cycles. As these industries constitute a large part of the reshaped industrial landscape in the new member states, they are vulnerable to external shocks. Developments in Germany are crucially important for the CEE new member states as most industrial investments and most of their industrial exports involve Germany. The severe downturn in Germany estimated by the latest forecasts to -6% for 2009 has dramatic effects for most new member states.

The dependent position also appears on the micro-level, as a large part of CEE economies are dominated by foreign multinational enterprises with strategic decisions made at the Western company headquarters. The new member state affiliates of Western multinationals have adopted plant-level adjustment measures similar to those applied by their Western European parent companies, but with a heavier hand and less based on negotiation with social partners. The plant-level effects of the crisis in central and eastern Europe are also harder than in the West, as less cushioning tools for the shock – in terms of labour market policy and collective bargaining instruments – exist (see more on plant level effects in Glassner and Galgoczi 2009).

Conclusions

This commentary piece has shown some characteristics of the FDI based production model that marked the new division of labour in Europe and that was based on a newly emerged manufacturing base in CEE. This was seen as the foundation of economic renewal in post-communist countries leading to economic and social convergence to western European standards.

A number of factors that make CEE new member states particularly exposed to the current economic crisis were identified. One central factor, common for all countries in the region is the high reliance on external financing with a high level of economic and trade and financial integration with the West. This meant that the global shock was rapidly transmitted to the national economies of CEE.

The economic crisis has highlighted the fragility of the integration model that helped CEE countries manage a considerable degree of convergence towards western Europe in the previous period. Two factors that demonstrate the unbalanced and one-sided nature of this integration model are also identified. Economic and trade integration was based heavily on cyclical industries (in case of the automobile industry with a burden of Europe-wide overcapacities). One-sided financial integration that proceeded above all through bank takeovers and corresponding credit expansion was, on the other hand, not balanced by institutional risk management and supervision structures. Overall, this points markedly to a more fundamental shortcoming of the European integration process, where deep economic, trade and financial integration is matched with loose social, political and institutional integration that showed its limits during the crisis.

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JCER Commentary

The Future of the European Union: A Critical Trade Union View

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Abstract
This paper offers a radical critique of the current framework of economic policy within the European Union and its negative effect on social cohesion. It defends the aspirations of the "Social Europe" model but suggests this model is now withering on the vine, not least because employers and governments no longer support it and have withdrawn from genuine social partnership. The paper asserts that the undemocratic nature of European policy making institutions is a fundamental bloc to progressive reform of the EU, and criticises the economic philosophy inherent in the Lisbon Agenda and recent controversial European Court of Justice decisions that have expanded that agenda. Lastly, it sketches some alternatives to this direction of travel, drawn from successful models within and outside Europe.

Foreword

THIS PAPER WAS ORIGINALLY PREPARED FOR AN ECONOMIC AND SOCIAL RESEARCH Council (ESRC)/Durham University seminar "The European Social Model – Old vs New Europe" at the Central European University, Budapest, Hungary and delivered on 19 September 2008. The authors are researchers for the UK Public and Commercial Services Union (PCS). As such, the paper is a critical commentary and activist intervention in the European debate, driven by trade union concerns and the experiences of practitioners in the field.

Since the Budapest seminar the EU has plummeted into the deepest and most widespread economic recession in the post-war era. This has presented us with an opportunity to sharpen our critique with an updated foreword. In our view the causes and development of the current economic crisis, and the manner in which the Lisbon Treaty was eventually ratified, supports our original analysis. We do not claim any great prescience in criticising the Lisbon Agenda's commitment to deregulation and the liberalisation of public services, and its negative impact on European employment, trade union rights and social cohesion. Indeed, in May 2008 no less a group than former German Chancellor Helmut Schmidt, former French Prime Minister's Michel Rocard and Lionel Jospin, and former head of the European Commission Jacques Delors, issued a statement in which they said:

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> The current financial crisis is no accident. It was not, as some top people in finance and politics now claim, impossible to predict. This crisis is a failure of poorly or unregulated markets, and shows us, once more, that the financial market is not capable of self-regulation. (IPO 2008)

The statement was reported in the UK's *Daily Telegraph* (22 May 2008) under the headline "*EU-wide super regulator poses threat to City of London*". Months later the City begged the UK government to bail it out and save the British economy from the consequences of its own financial mismanagement and folly.

Proponents of the Lisbon Agenda are failing to face up to the new economic reality. In the UK former EU Trade Commissioner Peter Mandelson, (quoted within on the urgent need to make European capital markets even more flexible because "we are all Thatcherities now") has been rewarded for his regulation-lite approach to business by being promoted to Business Secretary and First Secretary of State. Yet the failure of the economic model voraciously championed by Mandelson and the political elite could hardly be more stark. The damage it has done to the wider European project is immense, and its extension into European employment law and social policy through the European Court of Justice (ECJ) rulings in the 'Viking' (2007), 'Laval' (2007) and 'Rüffert' (2008) cases has generated enormous opposition from the peoples of Europe, including the European trade union movement.

British unions have already been adversely affected by the ECJ's ruling in the 'Viking' case that created a potential liability for collective action, an historic step backward for progressive employment relations and a crushing blow to those who argued in the past that the EU had a strong social dimension. The ECJ's ruling in the 'Laval' case, that a Swedish trade union could not take collective action to require a Latvian contractor to observe the terms of Swedish collective agreements in the construction sector, also had negative implications for the right to bargain collectively. Hitherto that right had been safeguarded by the EU Charter of Fundamental Rights, which the ECJ ignored and in effect rescinded. As a result of this and other questionable rulings the "social partners" barely exist today in any meaningful sense.

Unfortunately, the current economic crisis has not prompted a fundamental policy shift within the EU. On the contrary, the May 2009 Prague European Employment Summit – hailed in advance as a golden opportunity to tackle the social and economic impact of the financial downturn across Europe – ended with the ETUC denouncing the summit's conclusions as "*inadequate*", not surprisingly as the summit limited itself to recommending a vague programme of retraining and enhanced "flexicurity" (which gives employers greater flexibility over employment contracts, in effect a reversion to unrestrained hire and fire).

For those who believe the ECT/Lisbon Treaty is an illiberal, anti-democratic instrument that has now encoded free market fundamentalism into the DNA of any future European Union, the final ratification of the Treaty in late 2009 was a disappointing, yet not entirely unexpected, development. In the only valid democratic tests to which the original European Constitutional Treaty (ECT) and the reformed Lisbon Treaty were exposed (in the first case the 2005 French and Dutch referenda, and the second case the 2008 Irish Referendum), their provisions were clearly rejected by those electorates privileged enough to be given a say. That the adoption of the reformed ECT/Lisbon Treaty hinged entirely on the second Irish referendum – in which every major political party, every business and trade union leader, and every major print and electronic media outlet supported the "Yes" vote – was by objective standards a rigged election, and would have been easily identified as such if conducted in, for example, Zimbabwe or North Korea.

There is a collective reluctance within EU policy circles to acknowledge the underlying economic causes of the recession coupled with a lack of political will to construct genuine alternatives. Successful working alternatives do exist – in our paper we only have space to sketch some possible approaches, ranging from Nordic social democracy to the growing Bolivarian Revolution in Latin America. In Venezuela, for example, the poor have seen their incomes soar by 130% since Hugo Chavez came to power and Venezuela's Millennium Development Goals for poverty reduction are years ahead of schedule (information from Datos Information Resources)[1], unlike the more affluent countries of western Europe.

If the structures and policies of the EU are not to further alienate Europe's workers and voters, we believe a similarly ambitious and redistributionist approach is now vital. The neo-liberal policy agenda built into the European Single Market and recent ECJ rulings has been discredited by events, and the evidence of success lies elsewhere. One does not even have to look outside Europe for viable alternatives. As the economist Stuart Holland (2009) explained:

> Social democracy succeeded in Scandinavia not only because it managed the level of demand, but because under the pressure of strong and highly political social and trade union movements, it redistributed it through progressive taxation and could fund high-class education, health and welfare services.

A co-ordinated cross-border approach that facilitates a programme of nationalisation and long-term planning for social welfare, within and between Member States, is now overdue. Our paper suggests that if the EU wishes to re-engage its citizens and initiate a progressive vision it needs to democratise its policy making institutions, implement a Europe-wide regulation of financial and capital markets, prioritise strengthening employment rights, and tighten regulation of employers in order to promote and protect social responsibilities and collective agreements. The financial meltdown and the consequent discrediting of fee market dogma requires a seismic shift in policy direction, not more of the same.

The following piece reflects our view and opinions as of September 2008, when the piece was first presented.

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November 2009

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[1] summarised at http://www.venezualanalysis.com

Introduction

This paper offers a critique of the current framework of economic policy within the European Union as defined by the Lisbon Agenda and emerging legal decisions that expand that agenda. It defends the past achievements of the "Social Europe" model and suggests a radical revitalisation of that model is necessary if a progressive European project is to have a future. Although it does not criticise the ultimate goal of greater social and political harmonisation of Member States to ensure pan-European affluence and peaceful co-existence, it argues that this goal is increasingly undermined by the EU itself, through the legal application of internal market legislation, and the unresolved issue of its own democratic deficit.

It traces these fault lines to the remit and power of the European Commission to initiate and propose legislation and the relative impotence of the European Parliament, a situation the original draft European Constitutional Treaty (ECT), subsequently the Lisbon Treaty, does little to address. In many respects this relationship completely inverts what is commonly accepted as a healthy democratic polity – i.e. elected representatives with a democratic mandate propose policy which is then refined into statutory law and enforced by an executive and a non-political civil service.

Brief History

The creation of the EU's forerunner, the European Economic Community (EEC), was a necessary and positive act. Following the creation in 1952 of the European Coal and Steel Community (ECSC), the Treaty of Rome (1957) created the EEC along with its core institutional structures. Thus emerged the European Commission, ultimately answerable to a Council of Heads of State, but still the creator and driver of European policy initiatives. The European Court of Justice (ECJ) would rule on the lawful application of those policies. In contrast, the European Parliament was a toothless focus group.

There were, then, two 'original sins' at the heart of the process. Firstly, the anti-democracy of the Commission/Parliament relationship was bound to incur the ire of excluded political groupings and national legislatures; secondly, the identification of trade liberalisation as the primary *'raison d'être'* of the EEC gave the project a negative rather than a positive thrust – the new institutions, for all their cross-European potential, were only really authorised to remove perceived obstacles to trade and competition. The prospect of the EEC developing new pan-European social and labour market policies had been considered and rejected at its inception.

The lineaments of what we now call the "Social Europe" model (e.g. formal information and consultation procedures, social partnership at work, progressive employment procedures and health & safety standards, and – occasionally - socially responsible financial institutions) emerged initially within the nation states of Scandinavia and Northern Europe (the UK excepted) and not through EEC institutions. It was not until 1996 that many of these elements were codified by Jacques Delors in the (revised) European Social Charter as fundamental social rights, which he saw as essential if European economic and monetary union was to have a progressive social dimension.

The Turn from Social Europe

Much of Delors' vision is now being eroded. Following the European Single Act (1986), the Maastricht Treaty (1992) and the signing of the Lisbon Agenda (2000), development of the

European Single Market (ESM) is an increasingly one-sided process. Partly this reflects a political shift within some Member States and the European Commission towards fundamentalist free-market doctrine. But this shift itself follows the rise of an aggressive neo-conservative Right in the USA and its influence on EU policy through bodies like the Transatlantic Business Dialogue (TABD), and the consequent mutation of the ESM into a vehicle for financial liberalisation, deregulation and privatisation. In *Forward with Europe: a democratic and progressive reform agenda after the Lisbon Strategy* (2008), Stefan Collignon, Professor for Economic Policy, at S. Anna School of Advanced Studies, Pisa, concluded that "The Barroso Commission took a significant turn to embrace a neo-liberal conservative interpretation of the Lisbon Strategy in 2005" (Collignon 2008).

As a result the essential social elements of European integration have been side-lined. Social dialogue is increasingly a charade. Social partnership is virtually non-existent. In its *A New Deal for Social Policy: the ETUC's contribution to the Preparation of the Renewed Social Agenda (*March 2008) the ETUC concludes "We have moved from a Social Action Programme, with clear objectives, clear measures, clear instruments, to a Social Policy Agenda and finally to a Social Agenda".

Yet we would argue that "Social Europe", for all its faults and regional variations, has proven itself a superior socio-economic model to that of American style capitalism. The latter's propagandists claim that the USA has achieved high employment with low social spending, but this is a narrow view. To make a relevant comparison, until recently the Nordic countries' combination of high employment and high social spending has on the whole avoided the low quality and lack of employee benefits of much US employment, and the social dislocation and high crime rates that has disfigured much of US society.

The justifications for introducing an American style deregulatory, non-unionised capitalism into the economies of Europe do not stand up to rigorous analysis. The OECD, in its *Employment Outlook* (July 2000), found that more comprehensive European employment protections had "little to no effect on overall unemployment" (OECD 2000: 50). Joseph E. Stiglitz (2000), former Chief Economist of the World Bank, contended that a financial system is "impaired rather than improved by deregulation", and that privatisations will fail in the absence of investment in the institutional framework of an economy

In this context, the economic analyst Will Hutton (2003: 320) believes that: "The lazy charge that European unemployment is the fault of unions, regulation and social charges does not bear serious scrutiny". He also concluded that the constituents of the European Social Model have "produced an array of social outcomes which on every important measure are significantly better than in the US" (Hutton 2003: 344). To take just one example, 18% of children in America live in poverty (U.S Bureau of the Census, Current Population Survey 2008), whilst child poverty in France and Germany is well below 10%, and virtually zero in Nordic countries.

The Single Market and the ECT

The development of the Single Market began with proposals for financial and labour market deregulation. As the neo-liberal agenda for Europe gathered pace, Article III-116 of the Nice Treaty (2000) specifically subjected European Public Services (or "Services of General Economic Interest") to competition, regardless of whether it would be more beneficial for such services to function for socially responsible and non-profit reasons. Member States were forbidden to pass or keep on the statutes laws contrary to the Treaty's intention.

It is the Commission (i.e. appointed commissioners and unelected civil servants) not the Parliament who decide the application of this article and adopt appropriate European Regulations and decisions. Susan George (2006: 1) summarised this process: "The European Commission is the executor of these policies, with the collusion of the great majority of European member states, all of which are influenced by business and financial elites whose lobbies are omnipresent in Brussels".

The appropriate regulations and decisions were forthcoming, most famously the proposed Directive on Services in the Internal Market, also known as the "Services Directive" with its controversial "country of origin" principle, which, had its initial text been adopted, would have guaranteed, at a stroke, a race to the bottom for labour regulation and employment law. Only a mass-based cross-European campaign led by the ETUC, the PES and others managed to remove the most socially damaging parts of the Directive at the last moment.

This was a welcome, though atypical, reversal of the march of free-market dogma over the protections of Social Europe. More telling has been the contortions necessary to impose the ECT/Lisbon Treaty on unwilling European electorates (to the extent that constituency can be measured, given its only outlet of opinion on the Lisbon Agenda's direction of travel was the French, Dutch and Irish referenda).

It is no co-incidence that the mantra "free and undistorted competition" occurs no less than 24 times in the original draft ECT, leading off in Article I-3 as one of the fundamental objectives of the EU. This would appear to be the first time a constitution of this type has mandated - as a principle in a founding document – not simply an abstract goal such as freedom or equality, but a specific economic model. Surveys of European Public Opinion towards the EU, such as the Commission's "Public Consultation on a Future Single Market Policy: summary of responses" (European Commission 2006) usually assume support for the principle of the Single Market, focusing instead on which specific policies will make it most effective. As such, the question of whether there should in fact *be* a Single Market guided by "free and undistorted competition" is carefully omitted and does not appear in the final text of the Lisbon Treaty.

Even thus presented, amongst the majority of respondents that broadly support a barrier-free market there is considerable scepticism as to whether the mooted benefits of that market have actually extended beyond the narrow interests of big business. The summary of the feedback, whilst no doubt accurate, tends to highlight this majority "agreement" with the assumed benefits of the Single Market whilst marginalising scepticism as lesser quibbles within a framework of broad endorsement. The overwhelmingly uniform responses of European Trade Unions that the Single Market lacks a social dimension is barely reported at all (see Section European Commission 2006: 13)

For example, in assessing Section II.2 of the "Public Consultation on a Future Single Market Policy" (Priorities for Future Single Market Policy) (European Commission 2006: 14), views on five possible areas of attention are given; these are: (1) fostering market dynamism, (2) better regulation, (3) better enforcement, (4) accounting for the global context, and (5) investing more in information and communication about the benefits of the Single Market. Given that area 2, better regulation, could be construed as less regulation, no respondent therefore has the opportunity to opt specifically for greater control of market mechanisms to ensure citizen and worker collective agreements, social protections etc. Significantly, *the concept of the Single Market itself* is never put to the question, and the extent to which the ECT absolutely precludes that it ever can be is never explained, justified or put out for consultation.

The potentially destructive effects of the Single Market and its instrument, the ECT/Lisbon Treaty, on European Public Services are not yet widely understood. As Susan George (2006: 6) concisely put it:

> [ECT] Articles III-166 to 168 literally organise the demise of public services and the right of member states to provide subsidies. These services are made explicitly subject to the rules of competition. If the Commission decides that the aid given by a member state to a public enterprise is incompatible with the rules of the internal market, it can order the guilty state to eliminate or modify the subsidy.

We would argue that any European Trade Union body that, despite this, supported the ECT has been hopelessly compromised by its integration into European "social partnership" and has lost all sense of its original mission.

A Renewed Social Agenda

In response to criticisms by the ETUC and others that the Social Agenda was withering on the vine, the Commission adopted a package of measures known as the "The Renewed Social Agenda" (*Renewed Social Agenda: Empowering and Enabling Europeans – Opportunities, Access and Solidarity in 21st Century Europe. July 2008*), an initiative that the ETUC was hoping would reassure sceptics that this aspect of the European project was still alive and relevant, despite admitting in its March 2008 Statement "A Single Market for the 21st Century" that "The recent Social Policy Agendas were characterized by their lack of political will and ambition", and rightly criticised those agendas as a list of "soft law" proposals.

The Renewed Social Agenda (RSA) follows this trend. For example, its central plank is a positive yet non-problematic proposal for a Directive on the application of patients' rights in cross-border healthcare (non-problematic in that it does not conflict with internal market legislation nor offend the employers' lobby). The Commission itself concedes that this is unlikely to require much application as all studies show that hardly anyone wishes to avail themselves of cross-border healthcare.

Other elements of the RSA are either proposals that many Member States will have already legislated for, or are exceedingly timid, e.g. a "Proposal to Review Legislation on European Works Councils", which even if actioned would offer minimal improvements. Neither are the RSA's Reports as significant as their titles imply – i.e. the "Annual Report on the European Globalisation Adjustment Fund" reports the provision of €18.6 million in support for over 5,000 redundant workers in France, Finland and Germany. Obviously helpful to the individuals concerned, it is a drop in the ocean in the context of Europe-wide recession. The 'Report on Social Services of General Interest' (see European Commission 2008) acknowledges in passing a shift from publicly controlled services towards 'more market based regulation', but otherwise is free of substance or proposals to address what many trade unions perceive as a major problem.

Even existing social legislation is being revised, delayed or undermined. Immediately after the Irish rejection of the Reform Treaty the ECJ ruled that Luxembourg's implementation of the Posting of Workers' Directive, designed to protect the rights of workers temporarily posted to another Member State, was an obstacle to the free provision of cross-border services. The UK's TUC (2009; see also Keoghan 2008) considers that this judgment "challenges the scope for Member States to secure decent wages for all workers on its territory, demand respect for collective agreements, and devise effective mechanisms for monitoring and enforcing workers rights in the Posting Directive".

Similarly, the Council of Ministers' agreement of June 10th 2008 on the Working Time Directive provides for continuing individual opt outs from the 48 hour limit, where a Member State wishes this to apply (as in the UK), and also introduced the concept of "active and inactive" on-call time, where previously the ECJ had classified on-call time (and therefore working time) as the time a worker was required to be on an employer's premises. ETUC General Secretary John Monks called these revisions "highly unsatisfactory and unacceptable to the ETUC", and MEP Alejandro Cercas, reporting on the Directive to the European Parliament, said the proposal was "a text more from the 19th than the 21st century".

Working Alternatives

The European Trade Commissioner Peter Mandelson (2002) has claimed "No serious challenge on the Left exists to Third Way thinking anywhere in the world. In the urgent need to remove rigidities and incorporate flexibilities in capital, product and labour markets, we are all Thatcherites now." Mandelson has been a Thatcherite for some time, but he speaks only for a small political and corporate elite who benefit from this model. Within Europe itself, and at the global level, his claim is demonstrably false as there are a plethora of successful working alternatives.

The most prominent European alternative to internal market neo-liberalism is that of Scandinavian Social Democracy, or the "Nordic Model". One of the strengths of this model, which has delivered the highest standard of living and quality of life in Europe for many decades, is that there is a genuine investment in social capital, as Stiglitz recognised was necessary for a whole society to prosper.

Although the effects of market deregulation are now being felt in the Nordic countries, until recently Bank finance of industry was much preferred to Stock Market finance because it provided less chance for irresponsible speculators to mount hostile takeovers and upset the pillars of the economy. Social and environmental regulation is extensive, yet flexible, efficient and socially responsible. None of this is unrelated to high trade union membership figures in the Scandinavian countries – 75% in Norway, 95% in Finland. The mainstreaming of the trade unions in both industry and welfare provision ensures a high degree of popular accountability and democratic legitimacy for these aspects of their societies. The biggest failure of the free-market financial system since the 1930s, and the need for the banking system to be rescued by the public sector demonstrates why the original 'Nordic model' is more durable and relevant to the economic needs of the 21st Century.

Globally, New Zealand was the first social democratic government to embrace a free-market programme of wholesale privatisation, liberalisation and deregulation. Named after New Zealand Labour Party's then finance minister Roger Douglas, "Rogernomics" finally imploded amidst a litany of social and economic failures: stagnation, unemployment, bankruptcies, rising crime and rampant inequality. Two decades on, another New Zealand government, this time a more progressive Labour coalition headed by Helen Clark, is again at the forefront of political change - leading the revival of public ownership.

Clark's government renationalised the country's railways and ferry services, privatised in the early 90s and subsequently run down and asset-stripped by the Australian owners. Launching the new, publicly owned KiwiRail, finance minister Michael Cullen declared that privatisation had "been a painful lesson for New Zealand" (AP 2008). Nor is this the first

renationalisation by the Clark government, which took over Air New Zealand after it nearly collapsed in 2001, and has also built up a successful state-owned retail bank.

Clark has championed the public takeover of rail as vital if New Zealand is to have a modern, environmentally sustainable transport network. Against a background of global warming and rising fuel prices, she believes that public rail is a "central part of 21st-century economic infrastructure" (Clark 2008). The UK's privatised railway system, by contrast, remains a byword for fragmentation, unreliability, overcrowding, delays and exorbitant cost - which has only now completed a high-speed link to the Channel Tunnel, 15 years after its state-owned French counterpart.

Although facing problems on a different scale to many European countries, Venezuela's experiments in local developmentalism, public ownership and popular participation also offer examples of what can be achieved when an economy frees itself from the rigidities of the "Washington Consensus".

The nationalization programme in Venezuela is comprehensive with the Chavez government's 2007 stated policy of "renationalising all that was privatised". The government renationalised one of Latin America's most significant steel companies in April 2008 and then nationalised a number of oil fields, electricity companies and a major telecommunications company. The drive to take key industries out of corporate hands is part of a strategy of promoting national development to overcome poverty and social exclusion: a policy designed to put the national resources of Venezuela at the service of Venezuelans and not transnational corporations (not incidentally providing cheap oil to developing nations, and in Haiti's case supplying oil for free).

Unfortunately EU policy making institutions (although not all European *governments*, as evidenced by Sweden's recent moratorium on future privatisations and France's re-nationalisation of the privatized Paris water utilities) are still in the grip of a discredited ideology that sees privatisation as the only way to 'reform' public services, and nationalisation as a throwback to be avoided at all costs - except, as we have seen with the ailing Northern Rock and RBS Banks in the UK, when the stability of the financial system itself is at risk. However, as global economic conditions increasingly undermine the credibility of free-market economics, other strategies are gaining traction. The revival of public ownership in countries as diverse as New Zealand, Belarus, Ecuador, Bolivia, Brazil, Sweden and Venezuela reflects a pervasive disillusionment with the top-down neo-liberal experience of the past three decades.

These are merely a snapshot of contemporary alternatives to the neo-liberal agenda. In our view they form the basis for serious, sustained criticism of that framework and arm the wide coalition of groups campaigning for rejection of the ECT with positive alternatives to draw upon.

Lessons To Be Learned

If democracy were the issue, the initial Irish rejection of the Lisbon Treaty would have meant the Treaty – in any form - was dead. It is possible that were other Member States given the choice, they would also have voted 'No'. Under the EU's own rules, non-ratification by one Member State should automatically derail the process. However, democracy is not the issue. Other Member States will not be given a vote, and we predict the EU's rules will be ignored. This will be a stark indication of the true nature of the neo-liberal project in Europe – an economic framework imposed by political elites without democratic legitimacy.

In this context, it is instructive to consider the history of the proposed Multi-lateral Agreement on Investment (MAI) in the 1990s. The MAI, in its original form, provided unprecedented power to international corporations, while restraining the right of national governments to regulate them, allowing foreign corporations to sue national governments for damages if they took any action – such as social and environmental regulation - to "restrain enjoyment" of an investment. It would have also banned new legislation that was "non-confirming" to the MAI, and mandated "rollback" of existing non-confirming legislation.

The MAI was ready for ratification (without the US Government informing the US Congress, as it was legally obliged to) when the full text got into the hands of NGOs and trade unions, and mass campaigns against it were organised. These popular protests seeped into the media and energised local political groupings to subject the text to fuller scrutiny. In the end, massive public opposition defeated a treaty that its proponents had initially assumed would be implemented under a veil of institutional obscurity and technical jargon. *The Economis*t (March 21st, 1998) noted with annoyance that it was becoming harder to ignore those who "want high standards written in for how foreign investors treat workers and protect the environment".

For those wishing to publicise the negative effects of EU Internal Market policy, and replace that policy with a more socially responsible alternative, the successful mass campaign against the MAI offers both inspiration and guidance.

A Future for the EU?

It will not be easy to offset the erosion of the Social Europe model. In the short term, the least that is necessary is the automatic inclusion of the so-called "Monti Clause" in all internal market legislation to ensure that implementing the four "fundamental freedoms" of the single market does not destroy collective bargaining rights and the right to strike as defined by national legislation. In the longer term, the European labour movement needs a more extensive and radical vision of European reform than tinkering at the edges of the dominant neo-liberal policy framework.

This must involve revising the powers of the European Parliament so that it can initiate legislation, and putting the European Central Bank back under democratic control. In tandem, the operating rules of the ESM would need to be radically reformed to allow a democratic European governing body to borrow and invest in Europe-wide public services, services which would be responsive to local and regional bodies of service users and trade unions. Clearly such a thorough overhaul of the ESM would require equally radical political change within Member States, to propel the process.

There is also an urgent need for greater oversight of the political activities of corporations, for tight corporate lobbyist registration systems, and mandatory transparency of financial donations to political groups. Currently there is scant transparency around these activities, and transnational companies are unlikely to voluntarily inform the public about their lobbying operations within EU institutions. Establishing genuine democratic control over finance and capital must be a central feature of a more progressive EU.

This would go some way to addressing the democratic deficit implicit in EU policy making institutions. Joana Cruz (2006) concludes that: "…it is difficult to deny the legitimizing impact of introducing an institutional structure into the European Union that allows for more political competition and direct participation by citizens". There are a number of

ways this could be achieved. Certainly the European Parliament should have legislative powers, and the key posts in the EU emerging from the ECT process should be subject to direct election by European electorates. Until these minimal democratic reforms are actioned, political, trade union and community campaigners for publicly owned and socially responsible public services should not concede the EU's authority to legislate on those services.

Catherine Needham and Alisdair Murray (2005: 3) of Catalyst and the Centre for European Reform assert in the Unison/Ver.di discussion document 'The Future of Public Services in Europe': "Public Services need to be understood in the broadest sense: as expressions of collective purpose, governed by shared principles such as equality of access and social solidarity, and oriented towards a common good". This is the basis of our own analysis, but we must recognise that such a vision is a frontal challenge to the economic philosophy espoused by free-market advocates such as the TABD and Peter Mandelson.

This vision of public services advocates, for example, that free universal health care is not provided to make or to save money but to treat illness and extend life; that the maintenance of a national network of Post Offices should be driven by social, not commercial considerations; that free high quality education to post-graduate level should be valued because it is fundamental to a civilised society, not because it may add to a nation's GDP; and that collective bargaining agreements are a vital social good, raising the quality of life for the vast majority of ordinary citizens.

We believe these policies could form the basis of an alternative to the current economic paradigm within the EU, and re-animate the concept of Social Europe. It may still be possible to chart a course towards a future EU with more democratised institutions and sustainable societies, underpinned by high social and environmental standards. We hope this paper aids the development of that alternative.

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