Economics in Transition in Eastern Europe and the Function of the Bruxelles Consensus

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DECLARATION

"I certify that this work has not been accepted in substance for any degree, and is not concurrently being submitted for any degree other than that of PhD by Published Work being studied at the University of Greenwich. I also declare that this work is the result of my own investigations except where otherwise identified by references and that I have not plagiarised another's work".

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ACKNOWLEDGMENTS

This thesis represents an economic interpretation over developments in Central-East Europe after 1990. It has the challenging purpose to serving as a coherent source of examples and realities concerning economic transformation. My methodological coverage ranges from the theory of economics of transformation to banking, investment on information technology to the 'Bruxelles Consensus', issues presented in a unique perspective when interpreting this part of Europe. We strive to interpret the realities as they have been and are currently playing out in Central-East Europe, not least their interrelationship with the European Union context.

In completing this work, I am obliged to Prof. Željko Šević who carefully read several draft of this thesis, helped me to clarify all arguments and pointed to several parts in the chapters needed to clarification by giving me excellent suggestions concerning the manuscript's development, logic and point making.

ABSTRACT

In today's fast evolving Central and Eastern Europe, economic perspectives, especially European Union perspectives are indispensable to the success of the transformation process initiated in the late 1980s and early 1990s. Based on our research output, this thesis offers many such perspectives that can help understand the logic of the transformation and the subsequent business done by national and international enterprises. We have interwoven many information-rich threads of transformation principles with banking, dynamic cultural factors and tax policy that influence these new market-economy countries. We observe the role and the process of financial institutions and also consider the impact that information technology exerts on these economies and thus concluding that the significance of culture development and the betterment of the population are the central driving force within a wider Europe.

This thesis offers fundamental notions that influence cross-cultural interactions also, providing a concrete basis for understanding the influence of Central and Eastern European countries on the European Union's political choices and vice versa. We examine the transformation and its significance, paradoxes and the interplay of economic approaches and entrepreneurship. In the specific, we look at how the European Union policy towards these countries evolved, suggesting that a trend towards a *Bruxelles Consensus* is the specific outcome of the European Union's attitudes towards Central and Eastern Europe. An extended evaluation of the consequences for all of us will also emerge as our approach has been that to present all these aspects in a way that inspire understanding of basic governing issues and expectations concerning the future on Central and Eastern Europe in the ever-growing European Union.

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Chapter 1

Introduction

1.1 Economic and Political Direction of Central-East European Countries

New economic and political direction in Central-East Europe and the role played by the European Union in the process of economic convergence and the overall catch up process has emerged as a major focus of interest in economics and politics over the last decade. At the beginning of the transformation, international economic organisations and some economists believed this process would last only a few years and market economy prescriptions would become reality almost overnight (Kornai, 1990; World Bank, 2005). Unfortunately, this did not occur and the transformation has proved painful and socially unsustainable, and scholars such as Kornai (2000) felt that he had been too optimistic in his previous predictions of economic growth. In fact, it was not easy to expose the new economic reality without a precise logic of arguments. Indeed, it was difficult when concerning transitional economies in Central-East Europe that neglected previous procedures and took up liberalism and market impulses in an open context almost hastily. In moving towards a market setting, there was one main issue being addressed: to what extent would liberal thinking be accepted leading to complete market reform in a new society. Therefore, privatisation policy and the need to complete restructuring, while offering minimum social protection by the state, combined to create a situation both favourable for the state and the people. We may interpret economic reforms in terms of 'institutional reforms', 'political business cycles' and vast 'write-offs of knowledge'. The early 1990s were driven by the dismantling of previous communist practice and the initiation of market reforms with the aim to carry the process of transformation forward favouring the economic growth and a reduction in the overall gap with the most advanced economies in the West. However, due to the acceptance of neoclassical paradigms, experts on the region have partially neglected the role of institutions and overlooked the role of an overall strategic state policy towards the passage to a market economy and the achievement of a wider economic consensus (see e.g. Kornai, 2007; Fischer and Sahay, 2004; Ofer and Pomfret, 2004; De Melo *et al.*, 2001; Rodrik, 2006; Sergi, 2003a).

As a matter of fact, the transition lasted longer than expected and it continues in some parts of the post-Soviet block and the Balkan Peninsula. In this context, a specific objective of international observers is to understand the ways in which governments and international financial institutions have effectively done in the past and what they should achieve in the future regarding ethical accomplishment. Especially the ethical perspective (Sergi, 2004b) could serve to interpret main issues, trigger debates, and further lines of thinking along the European context characterised by the so-called *Bruxelles Consensus*.

1.2. The Washington Consensus and the International Economic Institutions

The starting point of interpretation introduced by Sergi (2003a, 2004b, 1999b, 1998a, 1997b, 1996) was the analysis of the Washington Consensus as developed by Williamson in 1990 and also rethink its application to the case of Central-East Europe when the countries from this region were trying to join the European Union.

The concept of the Washington Consensus served the purpose to reflect a perceived economic belief among governmental and international organisations in Washington D.C. and it became a widely used notion regarding global economic issues. Although little has changed since the term was coined and the book by Kolodko (2000) or the recent paper by Dani Rodrik's (2006) 'Goodbye Washington Consensus, Hello Washington Confusion?' are two examples of why the consensus has not produced its desired results due to its internal inconsistencies, much has changed regarding the global economic realities, especially in Central-East Europe. Despite proponents and critics agree on the fact that the Washington Consensus has not produced the desired results, the question we must answer is whether regional and global realities mark the Washington Consensus with consistency at both the policy level and in terms of successful outcomes. An analysis of the historical record will tell as much, perhaps too much to allow us to continue to ignore an ever-growing reality confronting the application of ethics to everyday life for everyday people globally. The implications for decision-makers are enormous. The Washington Consensus essentially concerned the ability of the US government, through its Treasury Department, to influence and coordinate the IMF and the World Bank regarding agenda specific economic issues used for many countries throughout the so-called Third World.[1] In Latin America, Africa or Asia, a pattern emerged, especially noticeable after the 1980s and continuing to the present. Meanwhile, the expanded reform agenda emphasizing second-generation reforms and policies able to address inequalities and social issues was launched (see e.g. Kuczynski and Williamson, 2003).

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[1] The World Bank broadened its role by 1960s. Robert McNamara (1968-1981) steered the World Bank to deal with poverty issue and direct policy intervention. In McNamara's fresh view, managerial competence proved more important than private entrepreneurship, and loans had to induce reforms the same as the IMF's approach. In this new setting, the IMF should care about short-term stabilisation programmes and the World Bank on long-term structural adjustment lending. Macroeconomic policy stabilisation and balance of payments adjustments followed a strong rightist market oriented approach after 1981. The debt crisis in the 1980s and increasing World Bank loans contingently on policy reforms led to conditionality more extensive (often to fifty or more measures) with respect to the ten or even fewer policy measures requested by the IMF. Therefore, a change in the World Bank's attitude and a renewed emphasis on poverty issues spurred from within its own management and by the appointment of Barber Conable as president in 1986. Furthermore, it has been under James Wolfensohn (1997-2005) that the World Bank supported an integrated approach to development in closer relationship with other institutions (Sergi, 2005b). In addition, the IMF recognised that the conditionality policy needed to be revised and the Executive Board revised guidelines in September 2002. Even before that, the IMF had set up a permanent Independent Evaluation Office in 2001, and its new focal point shifted to distinguishing between what is relevant but not critical to the objectives of a programme, and also to improving the division of operations between the IMF and World Bank in ways that both would share conditionality policy when possible with the number of structural benchmarks decreased and put comes under coordination between the two institutions (Sergi, 2005b).

These second-generation reforms based on policies emphasizing both inequalities and social issues together with institutional reforms and selected investment is growing consensus in Europe. The *Bruxelles Consensus* is a term first used by Sergi (2003a) – in fact it developed since the late 1990s (see also Sergi, 1996, 1997b, 1999a, 1999b) – to address growing concerns globally with what passes for the Washington Consensus. The historical record of the Washington Consensus as it had been applied in the Latin America region might provide with revealing information and push us in a direction. Whether or not the European policy and society are prepared to accept and benefit from that sort of policymaking (World Bank, 2005).

In this light, we must ask whether more people are better off now than before the Washington Consensus became a perceived and noticeable reality at a global level. The emergence of a pattern is completely consistent with deteriorating economic realities for most of the world's population in the 1970s. High inflation in the US caused by the financing of the Vietnam War[2] and OPEC's oil price increases[3], certainly were not limited to the US. In fact, the US could export much of its inflation throughout the world. Obviously, the Bretton Woods fixed exchange rate system, in existence since the end of World War II, was the exporter of such inflation and its ultimate casualty. It is interesting as this fixed exchange rate system collapses, global poverty increases. From an ethical point of view, we clearly have a problem, and it is appropriate that global economic policies during the 1980s and 1990s be addressed in the light of current criticisms, being focussed on the policies of the IMF (Sergi, 2004b and 2005c). Washington's economic policies during the 1980s distinctively offered an economic model and patterns based among others on privatisations, free trade, deregulation, lower taxes on wealth.

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[2] The US combat troops were committed from 1965 to 1973, even though it is not easy to identify the exact beginning of the Vietnam War.

[3] The oil crisis began on October 1973, when Arab members of the OPEC during the Yom Kippur War announced that they would no longer supply oil to Western Europe and the US because they had supported Israel in its conflict with Egypt.

Overall, it is believed that a 'triad' formed by the IMF, the World Bank and the World Trade Organisation would set economic policies worldwide (e.g. Peet, 2003). Said 'triad' would be 'unholy' because it serves to introduce neoliberal corporate capitalism in order to control the global economy, for the well-being of the American political-economic power and do good to transnational corporations (Peet, 2003). However, the IMF's policies or the Washington Consensus, by which the IMF is more accurately portrayed as a relater of information from the US Treasury than as the internationally prominent financial institution which (with the World Bank) was established in the post World War II framework to directly address issues afflicting third world countries, comes from Joseph Stiglitz (2002). Professor Stiglitz has been the World Bank's chief economist, and then was Chairman of the US Council for Economic Advisors under former President Clinton. Professor Stiglitz offers the following commentary:

'It is understandable then why the IMF [Washington Consensus] and the strategies it foists [forces] on countries around the world are greeted with such hostility. The billions of dollars which it [IMF] provides are used to maintain exchange rates at unsustainable levels for a short period, during which the foreigners and the rich are able to get their money out of the country at more favorable terms (through the open capital markets that the IMF has pushed on the countries). For each ruble, for each rupiah, for each cruzeiro, those in the country get more dollars as long as the exchange rates are sustained' (Stiglitz, 2002, p. 209).

Stiglitz was in an unusually credible position to offer commentary concerning the effectiveness of the IMF through the Washington Consensus. His comments are offered in more regional and global terms than perhaps others would care to admit, therefore, they might be more revealing. As concerns Stiglitz's view of a Washington Consensus:

'In the Asian Financial crisis, this was great for American and European creditors, who were glad to get back the money they had lent to Thai or Korean banks and businesses or at least more of it than they otherwise would have. However, it was not so great for the workers and other taxpayers of Thailand and Korea, whose tax money is used to repay the

IMF loans, whether or not they got much benefit from the money. But adding insult to injury, after the billions are spent to maintain the exchange rate at an unsustainable level and to bail out the foreign creditors, after their governments have knuckled under to the pressure of the IMF to cut back on expenditures, so that the countries face a recession in which millions of workers lose their jobs, there seems to be no money around when it comes to finding the far more modest sums to pay subsidies for food or fuel for the poor. No wonder that there is such anger against the IMF' (Stiglitz, 2002, pp. 209-210).

According to George Soros (2002), those who control the centre of the global financial system practice financial and economic policies being completely opposite in orientation from those policies literally forced on poorer countries who have no choice but to comply with IMF programmes. Despite the evidence only partially supports the Soros accusations or rather the reality concerning the functioning of the international economic organisations is more complex (Sergi, 2005b), he states:

'The [global] crisis of 1997-1999 revealed a fundamental flaw in the architecture of the international system. The countries at the center [US] of the system are in position to apply countercyclical policies. For instance, in the current downturn [2001-2002], the United States has aggressively reduced interest rates and cut taxes. But the conditions imposed by the IMF are pro-cyclical: They push countries into recession by forcing them to raise interest rates and cut budgetary expenditures – exactly the opposite of what the United States is doing in similar circumstances ... Since the 1997-1999 crisis, however, the emperor has no clothes: the IMF programs fail to impress the markets. The afflicted countries seem to be caught in a downward cycle' (Soros, 2002, pp. 120-121).

From this perspective, the ability of the Washington Consensus to offer ethical examples of leadership might be negligible. Soros (2002) clearly wants the US to lead by example, but for actual conduct recommended to poorer countries. But what should one make out of this? Although it has been called for the adoption of a new consensus in Europe (i.e. the *Bruxelles Consensus*, Sergi, 2003a) to replace the one launched in Washington, D.C., the point, however, is that we must judge the theories and models with respect to the merits of their outcomes. Some answers are most revealing when addressing the use of the early Washington Consensus in Latin America.

1.3. A Look at Latin America as a Precursor of Europe's Issues

It might be appropriate to begin by addressing the realities of those countries nearest the US, which directly experienced the policies and results emanating from the Washington Consensus. It is clearly in the interests of the global business community and of the European institutions to be aware of such outcomes as well.

To elaborate, we expected Venezuela, for example, to become a global economic leader, especially after the country became the world's leading oil exporter in 1928. Surpassed in oil production only by Saudi Arabia and Iran in the early 1970s, one would think until 1970 economic realities would steadily improve. Not so as in 1988, the IMF intervened but the results of the IMF adjustment simply accelerated the already rapid economic decline faced by most Venezuelans. The Venezuelan example is enlightening also considering the free market approach of its President Carlos Andrez Perez. Elected in December 1988, he immediately started restructuring the economy on the bases of free market principles. Although known as an economic reformer, and after the 1989 further austerity policies, Perez in fact was forced to accept the entire IMF programme or nothing at all (see e.g. Chomsky, 1993). This example illustrates that no matter who the leader of Venezuela was from 1988 to the present, the Washington Consensus was to be fully accepted and carried out. By January 1992, the results were in major impoverishing the country to the point where the vast majority of Venezuelans directly experienced a 60 per cent reduction in purchasing power, while the traditional financial community and the largest business groups clearly benefited at the expense of everyone else. This could only have been the result when one sees that Venezuela was another direct recipient of the IMF Washington Consensus, according to Chomsky (1993).

The so-called good news was there for all to see: an increase in foreign reserves, very low inflation and the fastest economic growth in all of Latin America. Good news indeed but the all-important point concerning the massive increases in poverty suffered by the vast majority of the population. In the capital city itself, Caracas, the wealthiest area of Venezuela, witnessed a 44 per cent decline in the minimum wage, huge declines in nutrition levels and a huge increase concerning the concentration of wealth (Chomsky, 1993). As if this is not alarming enough, only three years into the IMF adjustment, only 57 per cent of the entire populace could afford more than one meal a day with real per capita income falling by 55 per cent during the same three-year period. We had never witnessed declines of this size before. Surely, business groups and leaders realise that the so-called good news, low inflation, is the direct result of the Washington Consensus: few people have enough money to spend in Venezuela following IMF structural adjustment policies. Low inflation is the result.

Note that elsewhere in Latin America, similar patterns emerge. The results of the Washington Consensus are also found in Guatemala, which since the early 1990s, has had a higher level of child malnutrition than Haiti, a country completely impoverished and devastated (Chomsky, 1993) and we can observe these unfortunate consequences from the international television coverage in these days. Other countries felt the realities of the Washington Consensus, such as the neo-liberal economic doctrine applied to Guatemala in the very early 1980s, when an incredible 87 per cent of the population was in complete poverty, which was up from the 79 per cent total of the late 1970s; this is in contrast to only 2 per cent of the entire population of Guatemala that owns 70 per cent of all land throughout the country (Chomsky, 1993).

Again, one must ask the most basic of questions: is this good for business, both ethically and economically? Low inflation could be there with this kind of reality growing in depth for the vast majority of the populations in these countries. Is this the kind of low inflation the business community would like to see elsewhere before they invest? Can anyone plausibly argue that business is better off in any purely business sense of the term, much less ethically, when inflation is brought down and kept down by having side effects like in Costa Rica, El Salvador, Brazil and many others throughout Central and South America, besides the ones just discussed, are looking for another consensus, which might respect the ethical implications for both businessperson and business interests globally.

1.4 Structure of the Thesis

Although Commission President Barroso tried to tackle potential critics by underlining that the overarching goal of the Lisbon strategy is sustainable development, we endeavour to do so in a way to update the original *Bruxelles Consensus* and put in the framework of the Social Agenda 2005-2010, to be able to focus on job and equal opportunities in the new market economies. In fact, the March 2005 summit has discussed the Commission's midterm review of the Lisbon strategy for economic, social and environmental renewal. The European Council and the Commission decided to prepare a midterm review of the Lisbon process, this after having March 2004 European Council mandated Former Dutch Prime Minister Wim Kok to lead a group of experts with the objective of reviewing the Lisbon goals (European Communities, 2004). The Kok report, *Facing the Challenge: The Lisbon Strategy for Growth and Employment,* concluded in November 2004 that we had made little progress over the first five years and recommended to refocus the agenda on growth and employment. It also underlined the need for real ownership by the member states of the reforms needed.

The EU's enlargement and numerous financial and political supports given to new member states spur different angles of analysis: all these issues would be the key analysis of this thesis. Central purpose here is to link this thesis with all our works, by connecting the general and well-known literature that can relate to the newly market economies in Central-East Europe. After this introductive chapter, we construct the thesis around certain aspects of the *Bruxelles Consensus*:

- Chapter 2 explains the few alternative models of transition. The shock therapy, the gradualist model of transition, the post-Keynesian approach, the *Bruxelles Consensus* and the Chinese transition. The shock therapy is a mixture of neoclassical economic equilibrium joint with pluralistic political structure and hasty transition, and this stands against the gradualist model of transition, which is gradual in nature though with much the same pluralistic political structure. The post-Keynesian approach makes use of the post-Keynesian economic analysis plus pluralistic political structure while the Chinese model of transition has being characterised by non-pluralistic political authorities and gradual transition in the sphere of agriculture and industrial policy. Chapter 2 also analyses the issue of investment in information technology and innovation that are regarded as the principal driving force behind economic development. Moreover, we include an analysis on unemployment in Slovakia and apply a formal model to attest a positive relationship of employment to GDP. We find that the responsiveness of employment deviation from its trend to the deviation of GDP from its trend is weak and a negative correlation of cyclical development of labour forces on cyclical development of employed: these facts denote that cyclical unemployment was not very pronounced in Slovakia. The nature of high unemployment was rather structural than cyclical and this may have some cogent policy-related to fighting unemployment in transition economies (World Bank, 2005; Sergi, 2003a).

- Chapter 3 gives a forum of discussion concerning the development of the banking system, ranging from the main economic reforms carried out during the 1990s and the giving up of the one-tier banking system in favour of the western-type two-tier system. A strategy was adopted towards an effective functioning of central banking (Sergi, 1994, 1997a), and the continuing strategy to set up commercial banks. In it, the inherited bad and nonperforming loans added up to new debts due to bad banking lending, delayed enterprise restructuring and prolonged economic crises. This much constrained the ability of commercial banks to act as protagonists of investments and recovery during the 1990s. We focus on the experiences in the Czech Republic, Hungary and Poland that faced the problem of non-performing loans from the portfolio of the state-owned commercial banks. These loans would have worsened banks' liquidity and solvency once hard budget constraints were imposed and banking crises resolutions were therefore essential measures. Most of these commercial banks were technically insolvent or chronically undercapitalised and authorities had to recognise and estimate the true value of inherited non-performing loans in the portfolio of previously state-owned commercial banks.

- Chapter 4 concerns the role of tax competition. This piece of economic thinking is regaining strong momentum today in the light of mounting tax competition in Central-East Europe to the benefit of international investors (Sergi, 2007, 2006b, 2005d). However, on one side, policymakers might think that lowering tax rates would be a means to reinforce the efficiency of the economy and to incentive national and international business leaders. On the other side, the linkage between tax competition and foreign capital inflow in Europe is unambiguous for the majority of economists, yet its long-term rationale is not when modelling Western and Central-East Europe as a central versus periphery tax rivalry case. Tax competition might benefit peripheral regions versus central regions in the short term. However, peripheral regions' decision makers have incomplete information on long-term optimal taxes, and this fact routed them to engage in methodical tax rivalry among themselves and against central regions. This reality would make short-term tax advantages in the peripheral Europe either disappear in the long-term or exert negligible weight on investment decision at best (Sergi, 2007, 2006b).

- Chapter 5 investigates the relevant issue of globalisation, internationalisation, and global entrepreneurship it has been partially applied to Central-East Europe (Sergi, 2005b, 2006a; Adekola and Sergi, 2007a, 2007b and 2007c). Multinational corporations see globalisation as producing a wide spread of democratisation and development for new market economies. Entrepreneurial enterprises and competition among them had an important role in fostering economic growth regionally and globally, providing a significant addition to real GDP growth and employment opportunities. Surely, globalisation provided more opportunities than threats for entrepreneurs to expand their business opportunities worldwide. In the chapter, we offer a view on how international management and global entrepreneurship have so many opportunities and challenges. Society has quite often divided the world into north and south, rich and poor, communist and capitalist and much other convenient stratification. Splitting the international community once more finds continuity around the process of globalisation and its institutions, which is perceived as both positive and negative at the same time. This study compares these theories in the context of small and medium-sized technology-based enterprises. Findings suggest that the merits of internalisation and externalisation vary with market contexts and the resources under the firm's control. These new market economies in Central-East Europe aim to built recovery on information technology and the sharing of knowledge and intellectual capital. This process is also related to the new knowledge economy and it is fundamentally different from the economic and political contexts of the past decades. In a knowledge-based economy, a competitive advantage will be achieved by those countries that have the capacity to deliver quickly and have innovative forms of work organisations that raise productivity.

- Chapter 6 analyses transition in Europe in the light of the social and economic foundations of the EU and its social model. This traces back to the first Social Action Programme of 1974 up to the Lisbon Agenda and latest developments. This term is used very frequently, although most of those who use it, agree that there is no single European Social Model. The term refers to the specificities of the main European versions of the welfare state, making them different from developed countries in other parts of the world. However, while the term covers one of the major achievements of Europe, the old continent is increasingly concerned by the problems of preserving it in a changing international economic environment.

- Chapter 7 concludes a thesis being built on our previous research output and offer a tentative explanation of how a new model of socioeconomic growth could be sustainable in newly market economies in Central-East Europe (Sergi, 1996, 1997b, 1998a, 2003a). Such a model of growth in Europe should evolve enough to guarantee social equilibrium and ethical outcomes in a context of global actions and interactions. There is the need to reinterpret the Washington Consensus and rationalise those supranational institutions that impose economic policies and socioeconomic standards. While short-term solutions usually have short-term effects, we suggest economic applications necessary for long-term benefits. We need to call for a new consensus to apply to the new European vision and reality that already helped the transformation of newly market economies in Central-East Europe.

Consequently, we stand to get a clearer vision of what occurred in former communist countries, which in turn elevates the current debate over what went wrong or not to a new level. Understanding occurrences and the role of the European Union is now more important than ever to assess as accurately as possible because this process imposes new dynamics on all forms of economic development. Therefore, it becomes clear that differences between countries in Central-East Europe regarding transition economics, economic models of transformation, the role of new technologies and labour markets depend on inherited capabilities from the previous, socialist period, and the adoption of diverse economic theories. Next chapter offers a grasp of economic models of transformation and reforms' unintended and intended consequences that have permanently altered the development process in Central-East Europe.

Chapter 2

Economic Models of Transition and Innovation Policies

2.1 Introduction

Political and economic reforms in Central-East Europe caused deep changes in the overall sphere of market and economic relations. By and large, new policy-making has been transformed the vertical relationship between central authorities and enterprises have pushed newly formed enterprises to accept market oriented principles. We consider alternative policies in several spheres such as international cooperation, foreign aid, foreign investment and new technologies.

Five alternative models of transition can be considered: the shock therapy, the gradualist model of transition, the post-Keynesian approach, the so-called *Bruxelles Consensus* and the Chinese way to transition. The shock therapy is a mixture of neoclassical economic equilibrium together with pluralistic political structure and hasty transition, and this stands against the gradualist model of transition, which is gradual in nature although with the same pluralistic political structure. The post-Keynesian approach uses the post-Keynesian economic analysis and pluralistic political structure. The new model based on the European financial and social aid is the *Bruxelles Consensus* (Sergi, 2003a). The gradual Chinese model started at the end of the 1980s when Deng Xiaoping proposed and conducted an economic reform. This specific example in Asia is important because since then China's economy has steadily improved although it was a Marxist-Maoist model in nature along with non-pluralistic political structure.

2.2 The Shock Therapy and the Gradualist Approach

The shock therapy transition model was initiated in several Central-East European countries at the beginning of the 1990s. Poland inaugurated this new economic strategy on 1 January 1990, Czechoslovakia on 1 January 1991 and other countries followed (e.g. Bulgaria, Russia, Albania, Estonia and Latvia) (Sachs, 1991; Sergi, 2003a; World Bank, 2005). The forces that have been driving this type of economic transition evolved in conjunction with domestic realities but both Jeffrey Sachs (an adviser to the Polish government) and Anders Aslund (an adviser to the Russian from November 1991 to January 1994) shared the belief that the economy was in such a terrible mess that a radical programme would be needed to introduce any kind of rational order. The supporters of the shock therapy model argued that the model would ensure growth at full employment with low inflation and stability, and 'the tasks and instruments of macroeconomic stabilisation are the same in Russia as elsewhere' (Aslund, 1995, p. 181). As such, an approximation to competitive capitalism was feasible and there would be fewer opportunities for corruption and rent seeking (Aslund, 1994), although the outcomes in Russia have been quite the opposite (Stiglitz, 2002; Sergi, 2004a).

While the general belief was a gradual process would have resulted in the wastage of the precious reserve of political capital developed after the collapse of centrally administered socialism, however, the shock therapy caused undesirable outcomes resulted such as unemployment and high inflation caused social and political instability. For the shock therapy supporters, the reasons for such negative outcomes were due to the inadequate response by the mature economies and the international financial institutions in helping the transition economies or that transition economies were forced to implement orthodox stabilisation policies based only on fiscal and monetary policies (Aslund, 1995). Among mature market economies and international organisations, there was no intellectual understanding of what to do (Sachs, 1995b), there was an unwillingness to make any substantial commitment, and there was no political will (Aslund, 1995).

To draw a comparison, China (see section 2.6) has been recognised as a successful model of implementing a gradual process of transition. The sectors of the Chinese economy that responded successfully to the new economic conditions were agriculture, exports-oriented firms and services. These industries took advantage of a reform programme that was 'gradual' but rapid in selected sectors (Woo, 1994). Gradualism in China is not the result of a particular theory of reform and economic growth was initiated in the agriculture sector. In contrast, in Central-East Europe a majority of the labour force was employed in urban industry and therefore the main transformation had to be in the state sector. They directly linked the provision of government assistance to the culture and the perceptions of the people about the exact extent of the state in society and the role state – businessperson (Lipton and Sachs, 1992; Sergi, 2003a and 2004c).

The liberalisation of international trade and the establishment of a convertible currency were among the most important prerequisites for a successful transition to capitalism. Trade liberalisation was essential to a successive trade performance as it could create positive externalities when coming down to innovation, efficiency and privatisation (Frydman, Rapaczynski and Earle, 1993). It was believed that these countries could benefit from rational price systems (Boycko, 1991), foreign trade and aid (Marangos, 2007) and productivity growth. The exchange rate should have been liberalised at the same time as domestic prices, which would have reaffirmed both the complementary nature of economic policies and the need for a shock therapy approach. A flexible exchange rate could be adjusted to reduce inflation and stimulate competition and the achievement of a stable foreign exchange market could be possible by maintaining a restrictive monetary policy. In theory, both fixed and flexible exchange rates were consistent with the shock therapy, since neither involves government intervention. If a fixed exchange rate eliminates instability, it is possible to argue that it would have been beneficial to resort to a pegged exchange rate at the very beginning of any stabilisation programmes, only to move to flexibility in the exchange rate policy after a couple of years or so (e.g. Sachs, 1996, 1997a; Aslund, 1995; Sergi, 2003a). The international experience revealed that successful stabilisation programmes were based on a pegged exchange rate, such as Bolivia in 1985, Israel in 1985 and Mexico in 1987 and in Central-East Europe the countries that pegged their currencies at the beginning – Czechoslovakia, Estonia, Hungary and Poland – performed better than the floaters in reducing inflation.

Moreover, protectionism was inconsistent with the shock therapy model. As for foreign direct investment, it could be encouraged through free markets, political stability and the development of stronger institutional structures. The shock therapy also assumes debt cancellations, international transfers, balance of payments, and budgetary support as a means of overcoming stagnation and maintaining political support.

Note that Sachs (1995a) wrote that no any single country has undertaken radical market reforms during this century if not through the help of sizeable foreign aid and as some of these countries in Central-East Europe were burdened by large debts, foreign financial support would have reduced the need for the monetary financing of government deficits and increase the credibility of reforms. Sachs argued that all external debt should have been frozen and rescheduled and that the responsibility of advanced and rich economies was to help transition economies, because 'the world has much to gain from the emerging system and much to lose if we fail to act decisively to put it in place' (Sachs, 1995b, p. 50). The role of foreign aid was considerable for the transition economies, since it was intended to speed and increase the likelihood of the success of the transition reforms. This, of course, was in the interest of mature market economies. Partial debt forgiveness was necessary, which was anathema to the IMF and World Bank. The World Bank's technical assistance and long-term project support would have remained invaluable, as well as the IMF's role as a short-term international crisis manager. However, Western aid did not have positive effects and there was excessive optimism and naïve hope placed in the scale of Western economic aid and its helpful stimulating impact on production. Had the transition economies followed the optimum order of liberalisation recommended by neoclassical gradualist economists, their need for external finance would have been limited, claims McKinnon (1993).

2.3 The Post-Keynesian Model

Post Keynesians recognised the positive benefits associated with international trade. Meanwhile, because open economies are more complex than closed economies, the market outcome would have been even less likely to be a socially desirable outcome. Active government intervention was essential from the start to restructure external trade and payments appropriate to what post-Keynesians define a 'civilised market economy' (Davidson, 1994; Sergi, 1996, 1998a).

Contrary to the neoclassical view, post-Keynesians argued that an appropriate level of protection would have been essential for enterprises to survive on an uneven playing field. The experience of mature market economies revealed that their development and industrialisation was strongly linked with protectionist measures. Consequently, globalisation did not automatically result in trade liberalisation; rather, there seemed to be powerful forces which supported the construction of trade barriers. According to post-Keynesians, a flexible exchange rate system encouraged only financial currency speculation and not production, discouraged forward contracts, and encouraged stagnation in the domestic and world economy. It prompted countries to solve the problems of unemployment and inflation by shifting them onto their trading partners (Davidson, 1994).

The comparative advantage theory of international trade was developed in a specific historical period where natural resource endowments and capital-labour ratios determined economic location. Today, this has been replaced by an era of knowledge-intensive industries where comparative advantage is human made. Natural resources have ceased to dominate economic activity. Long-run economic growth is the result not only of the country's resource endowments but also, most importantly, of its capacity to satisfy both domestic and foreign knowledge-intensive production processes. Differences in production opportunity costs are due to what each society believes to be acceptable working conditions. The presence of high and persistent unemployment and of very large transaction costs contradicts the assumptions of comparative advantage.

For the post-Keynesians, co-ordination of international trade was essential and the collapse of the trading system increased the complexity of the transformation (Marangos, 2007). For example, intra-trade between the ex-Soviet Union republics comprised 80 per cent of their total trade (Sergi, 2003a) and trade diversion would have been extremely costly and trade restrictions between transition economies would have reduced output. Moreover, post-Keynesians viewed the recommendation for the establishment of a payments union by neoclassical gradualist economists as a positive element in the transition process (Marangos, 2007). However, they were very critical of the temporary nature of the payments union in establishing only convertibility, after which it would have ceased to exist since no other goal justified its existence. The payments union would have evolved, if it was established, to an Eastern European Clearing Union similar to the International Clearing Union suggested by Keynes for the international financial system. Through the clearing union, a fixed exchange system would have eliminated the instability and negative outcomes caused by the flexible exchange rate system. There would have been no advantage in engaging in export-led growth and importing inflation. In this international system, fiscal and monetary policies would remain the responsibility of the sovereign state. Through the clearing union, all participants might enjoy a win-win situation (Davidson and Davidson, 1996; Marangos, 2007).

The free trade initiated by the shock therapy approach was causing a deindustrialisation (Yavlinsky and Braguinsky, 1994). The post-Keynesian model recommended an adaptive strategy that combined open but managed trade whereby a fixed exchange rate regime along with an intelligent internal demand and incomes management policies could create a beneficial environment to all (Davidson, 1994). Economic policy co-ordination has, therefore, become a necessary condition for achieving sustained economic prosperity in the new globalised economic environment. A concurrent generalised expansion of income across countries, through a co-ordinated approach, might have helped to mitigate the problems of trade deficits and capital flight driven by international differences in inflation and interest rates. This would have enabled countries to stay on an expansionary course. In the absence of such co-ordination, the adverse policy incentives that promoted the macroeconomics of austerity and the lowering of the wage floor would have inevitably asserted themselves.

The financial assistance provided by the mature market economies has been disappointing. The transition economies had to depend on their own resources. In addition, due to the relative scarcity of foreign capital and international aid, transition economies competed only in providing concessions to foreign investment. This may have enabled them to acquire the necessary financial resources, post-Keynesians conceded, but it has had irreversible consequences for the future. It has created a heavy reliance on the voluntary movement of capital and handouts from international organisations, reducing national sovereignty and jeopardizing the development of the society. The transition economies would have been able to stand on both feet only after an extensive debt cancellation programme, together with substantial foreign aid to political support efforts.

Foreign aid benefited the donor economy as well as the recipient transition economy because it helped to stimulate increased international trade and strengthened relationships in the international community. A prime example is the Marshall Plan's large military and economic aid programmes after World War II. The European countries received financial aid to buy American products. This facilitated restructuring in both Europe and the US. The development of any society requires an international financial system that prohibits the movement of financial capital for speculative reasons and post-Keynesians conclude that the transition economies, due to the flexible exchange rate and the international trade market, were contributing to the international debt problem.

2.4 The *Bruxelles Consensus*

The *Bruxelles Consensus* has been put forward by Sergi (2003a). The failure of the Washington Consensus in the past and the much needed economic dynamics and changes in Central-East Europe brought the case for new economic strategies and solutions. New ideas came into life to address the parameters of these changes. How can we define the current problems and what are the solutions? Sergi (2003a) proposed a new strategy how to deal with the transformation and transitional economies. He proposes the multiple-goal strategy and post-Washington Consensus. Sergi's scenario of multiple-goal and post-Washington Consensus policies is a new set of political economies which ought to shape new markets in the old continent, in addition to modernising institutions, economic infrastructures, and standards of living. This approach helps understanding the policies of the European Union and its candidate countries.

Sergi's proposal (2003a) named after Bruxelles that houses the government of Europe concerns a replacement of the role played by the Washington Consensus and to rebuilding and strengthening its weaken credibility in some parts of the globe; to offer a new hope and to strengthen transitional and Central-East European realities. The new consensus calls for activist state policies, though not intended as Keynesian per se but as a form of stimulus to the Schumpeterian entrepreneur, for results that go beyond those of the Washington Consensus; still Sergi does not deny the importance of the market and neoliberal policies towards market stability and incentives. To put it in a different way, the *Bruxelles Consensus* by Sergi (2003a) aims to shape an innovative political economy focused at steering the recovery of transitional economies, but also of creating a simulative economic framework in Western Europe and attempts to define the European way for the new century and makes it successful. It is an informative road map of the past, present and future paths to a global economy. Sergi (2003a) enlightens us with important explanations which define the differences between the Western and Eastern club economies and the related social perspectives and politics. This new approach clearly explains the logic of Central-East economic inefficiencies and what developments have occurred and still need to in such transitional economies. It offers concrete investment strategies and insight with examples of backward-looking investment choices prevalent among those not as forward thinking as Sergi, who prefer to restructure enterprises that were only successful in a past-distorted economy. The constantly changing scenes of the EU becomes a confusing commotion of combined national perspectives, regulations and recommendations, but Sergi helps clarify critical points of interest regarding the impact on both sides which come with the eastward enlargement.

Additionally, he helps answer a contemporary prodding question of when the economic transition will be over for the Central-East club and perhaps more appropriately to stray from popular economists who deliver what we want to hear in exchange for what we need to know by throwing a temporarily unfavourable light on the existing reality for Central-East countries, yet suggesting economic methods to aid them in leaving the Western club's shadow. This new approach wisely points out that short-term solutions usually have short-term effects but that long-term outcomes should be based upon short-term strategies as well. We know all business schools support thinking 'outside of the box', and Sergi does just this by forecasting long-term economic effects of applications necessary for long-term benefits across what he defines as the '4 P-governments'. Sergi cannot only speak from painfully in-depth research, but also from his own actual related international experience to support his sound and worthy of adoption theories. Overall, the *Bruxelles Consensus* provides great benefits for understanding economics in Central-East Europe and its new theory viewed from the traditional supply side perspective is an improvement upon the traditional Washington Consensus, an outmoded term not least because of its unpopularity in many areas of the world. The *Bruxelles Consensus* is a vast improvement upon that of 'Washington' not least because the approach calls for an activist state role based on a Keynesian, Schumpeter interpretation of supply-side economics. This is to novelty as the Washington view misinterprets Keynes-Schumpeter supply side views.

2.5 The Chinese Way

In 1979 in China, trade liberalisation policies were introduced to facilitate exports and, for the first time, to allow for foreign investment. In essence, these efforts involved the break-up of the monopoly of foreign trade held by the central government, transferring this authority to local governments. Special economic zones were set up to free foreign investors and domestic exporters from red tape. Real devaluation, comparative advantage and the entrepreneurial energies of a receptive expatriate community also contributed to China's trade performance. Nevertheless, it is doubtful that trade would have grown in the way that it did if restrictive national regulations had not been substantially mitigated by local authorities taking advantage of the possibilities offered by extensive decentralisation.

It is possible to argue that Chinese reforms of the industrial structure presented an extreme form of the infant industry argument Nolan (1995). Almost the whole of the Chinese industrial sector could be considered an infant industry. An infant industry is not just one, which did not exist in any form and required protection to start up. An out-of-date and uncompetitive industry on international markets can be considered to have the same characteristics as an infant industry. It is rational to argue that an industry, which today is uncompetitive and would be bankrupted in open international competition, but which is thought likely to become competitive, to be given protection.

Extensive state action, through protection, was required to construct a competitive industrial sector, so that China could shift from a traditional anti-comparative advantage and heavy industry oriented development to a strategy that relied on comparative advantage. In this process, one of the key functions of planning was to identify sectors that were likely to become internationally competitive and to take measures to assist them. The East Asian experience demonstrated that government discretionary policy was exercised prior and during the opening up of the economy to the world markets. In contrast, the typical advice of the IMF and World Bank to transition economies was to liberalise foreign trade immediately, which has driven them out into the world competition before their economies were able to withstand the pressures. The Chinese did not make the same mistake.

China went to great lengths to attract foreign capital and foreign technology. Both rapid economic growth and higher incomes increasingly depended on the input of ever-larger amounts of capital from abroad, and expatriate investors were a potentially important source of linkage with the world economy. In contrast to China, transition economies had relied too much, and to some extent even passively, on foreign aid and foreign advice in carrying out economic reform. In the Chinese case, foreign advice was accepted only selectively and in fact China's reform programme was largely shaped despite, not because, of foreign advice (Nolan, 1995).

The Chinese themselves are caught between their desire to hold on to an historic independence, which is seen as inseparable from the protection of national sovereignty, and their need for foreign investment and trade. In the first place, whether largely foreign-funded capitalist development, intentionally introduced by the government, can be controlled, or whether the most powerful figures in the current leadership even want to control it, is a fundamental issue today. No doubt a complete reversion to a capitalist system is the goal of many within the burgeoning privatised sector, while some elements within the government, especially those most closely tied into foreign ventures and joint enterprises, must share these ultimate aims. In reality, local governments competing to attract overseas capital typically bend to investors' demands.

Moreover, many local cadres cultivate good relations with foreign owners in their own personal interest and the Chinese concept of 'guanxi' or 'personal relationship' facilitates successful business relationships (Wong and Leung, 2001). Even though they know perfectly well what the working and living conditions in foreign owned factories are, they would never intervene to do anything about them (Qinglian, 2000). In addition, illegal outflow of private funds, amounting to USD 20 billion annually, even before the Asian financial crisis of 1997-1998, which has induced further illegal capital flight. In this way, the internal socialist market and the external capitalist market have been employed to stimulate and accelerate economic growth, and have become inextricably linked, to the point that they are not distinguishable.

2.6 Toward Free Trade

A sustained movement towards free trade was crucial for the successful transition to a market economy, to promote the growth of exports, curb the rise in imports and improve the trade balance and the balance of payments, as the neoclassical gradualist economists argued. However, since the economies in Central-East Europe had inherited obsolete production methods, participation in international competition was very difficult. The collapse of trading among former Soviet-type economies had a serious impact on economic sustainability. There was an argument for maintaining a moderate level of tariffs and transforming quantitative restrictions into tariffs. This would have provided protection and given time for the firms to adjust, while also providing the government with an income. Temporary protection for some domestic industries had to be determined on the basis of economic rationality, no pressure from lobby groups, and to be in line with the prescriptions of World Trade Organisation (WTO) so that it did not lead to protectionist retaliation by foreign trading partners. International trade would have also contributed to the process of creative destruction.

However, closer economic ties of these economies with Western European markets were the natural consequence of the implosion of the Soviet-type system. These larger trade linkages with the Western market are made within a non-distorted framework of comparative advantages, being this in contrast to the CMEA system when economic distortions implied closer relationships with those countries that were behaving in a similar distorted fashion. The CMEA's collapse explains part of the output loss: aggregate demand by domestic consumers, producers and export sides shrank and affected output as much as a 50 to 60 per cent contraction (Haddad, 1998), with the lowest estimate at 5 percent according to Berg (1994). The fall of CMEA alone would have brought about 20 to 30 per cent of the total output decline. The subsequent and increasing relationship with Western Europe (Winiecki, 2000; Sergi, 2003a) can be named a process of trade reorientation in the direction of the European Union's markets (a 'natural' trade linkage, as in Piazolo, 2001) or what Winiecki (2000) explained as a 'return to normality in foreign trade' by which the enterprises' system started to correct the inherited microeconomic distortions. As a matter of fact, larger trade ties with the West produce more microeconomic and macroeconomic efficiency, but also through the multiplier they affect income too. Besides, a shift in the aggregate saving schedule could probably take place because the propensity to save might be larger in the export sector respect to the other sectors, although it may induce the latter sectors to increase the marginal propensity to save as well.

In contrast, it might have been in the interests of transition economies, especially the former republics of the Soviet Union, to have co-ordinated economic reforms. Some economists such as Williamson (1991, 1992), Kregel *et al.* (1992) and Dornbusch (1993) recommended the establishment of a payments union between transition economies, because the convertibility of the currency would not otherwise have been sustainable, due to the inelasticity of import and export demand. Permanent current account deficits would have encouraged depreciation and detracted from the gains in international competitiveness due to the inflexibility of wages. International financial markets were controlled heavily and capital account currency exchanges were only allowed in exceptional circumstances. If convertibility had been initiated immediately, rather than the

European payment union, European incomes would have been reduced by one to two per cent, which was the same as the contribution made by the US under the Marshall plan. This was an all-too-familiar scenario among the transition economies. Through the Payments Union, transition economies would have been able to establish current account convertibility more rapidly between member states and the rest of the world and avoid large depreciation. This could have helped to achieve currency convertibility, intra-regional economic collaboration, exploitation of comparative advantage, the development of rational trade and prices and have prepared transition economies for participation in international trade. The payments union did not require the removal of financial or fiscal policies by the sovereign state.

However, the idea was rejected. The international organisations did not permit this idea to flourish, probably because the newly formed former Soviet republics and Eastern Europe had to depend on trade with Russia for a substantial number of years. Such a union might have provided a mechanism to impose centralisation of trade and restrictions on the free movement of capital, despite the political union was its major long-term goal (Balaev and Southworth, 2007).

2.7 The Role of New Technologies

Another crucial key point to analyse is investment in information technologies. Innovations, is today widely regarded as the principal driving force in all long-term socio-economic development. Governments in Central-East Europe should strengthen links between service firms and public research institutions; improve worker-training education; direct research to better suit the needs of particular service industries; and help service firms use technology more effectively (World Bank, 2005).

OECD countries are taking more seriously the need to invest in research and development as a means to boost economic performance and remain competitive. China doubled its spending on research and development between 1995 and 2002, calculated as a percentage of GDP, from 0.6 per cent to 1.2 per cent of GDP. Over the same period, Israel increased its spending from 2.74 per cent to 4.72 per cent of GDP, a ratio higher than that of any OECD country. The European Union increased their level of R&D in 2002, to 1.17 per cent of GDP up from 1.15 per cent in 2000. Also, a number of countries have set long-term targets for increasing R&D spending, with Austria aiming for 2.5 per cent of GDP by 2006, Germany 3.0 per cent by 2010, and the UK 2.5 per cent by 2014 (Eurostat, 2004).

In comparison, the general picture of innovative activities in Central-East Europe is not well developed and innovation centres and agencies have only achieved some of the objectives (Radosevic and Walter, 2002; Hogselius, 2007). In fact, in Slovenia and Russia the first steps concerning these forms of innovative activities were not well articulated and implemented and this was due to the conceptual weakness of having them work as network agents (Radosevic and Walter, 2002). It is well known that business and economy are inextricably linked with the development and implementation of new technology policies and innovation processes and there is a clear evidence Internet technology has positive impact on the economic growth and that technology is becoming an integral part of today's enterprises. They use technology in a variety of ways and the most successful enterprises use technology to help gain competitive advantage in their industry. Companies that provide networking solutions have been impacted greatly by technology and the information age. The large advances in technology have made technology more affordable and accessible even to smaller firms. The lower cost of technology and its ease of use have prompted a new wave of E–commerce (i.e. business transacted over the Internet) and it is reaching new heights in both business–to–business and business–to–public consumer sales (e.g. Pohjola, 2000). A stimulus of the information technology has come through a profound change in the fields of microelectronics, new and improved hardware and software, telecommunications and the like. These processes are reinforcing the process of globalisation in investment and trade.

That being said, Internet technology and a beginning of E-commerce have a positive impact on the business sector in Central Europe very recently and have increased businesses' desire to hire skilled workers and also increasing skills are driving technological change (as for the US experience, see Lewis, 2006). But the information revolution aided by the revolution in the telecommunications and institutional innovations had initially promised to change the nature of the market altogether but we are far away from the degrees of penetration of the Internet technology and the rapid growth of E-commerce as in the US or North and Western Europe. While it is quite possible that these new technologies might transform the future of socioeconomic landscape in Central-East Europe soon, firms invest on average only about half as large a share of their GDP into R&D as do typical OECD countries.

There are a few encouraging examples of countries that show signs of slowly catching up with the more advanced economies along this measure. In terms of innovative outcomes, the difference between Central-East European countries and the more advanced Western countries is even more dramatic, and this fact signals inefficiency of R&D for innovation. For example, within the European Union, the new Central-East European member states are on average only about 4 per cent as active in patenting new inventions as are the Western member states (measured per capita) (Dyker, 2001). In other words, for every single patent that a Central-East Europe firm applies for in the European Patent Office, a corresponding Western firm applies for no less than 25 patents (Hogselius 2007).

Technologies, organisations and institutions in Central-East Europe have already acted in this direction and the Slovak Republic, for example, has given universities more autonomy and made it easier for them to work more closely with industry (OECD, 2004). Norway and Switzerland recently introduced laws to make it easier for public research institutions to own and market intellectual property, and other countries in Central-East Europe are seriously thinking about preparing similar legislation. Governments are increasingly looking to public/private partnerships to better link public research to national needs. Several are taking action to increase supplies of skilled scientists and engineers (OECD, 2004).

Under a certain angle of view, between 1995 and 2001, the share of manufacturing output and employment in foreign affiliates rose in all OECD countries except Germany and Holland, contributing to productivity growth in home and host countries. Their share of R&D is also growing. In 2001 foreign affiliates accounted for 15 per cent to 20 per cent of total manufacturing R&D in

France, Germany and the US; more than 70 per cent in Hungary and Ireland. Governments take further action to benefit from globalisation, such as by enhancing their countries' attractiveness to foreign investors and strengthening links with R&D institutions in other countries (OECD, 2004).

Moreover, investment on technology advances accounts for much of the surge in productivity growth in the US. But IT-producing sectors are equally productive in Europe and the US. The real difference lies in the IT-using sectors and the US advantage can be found in wholesale, retail and financial securities. IT-producing sectors have made larger contributions to productivity growth in the EU than in the US (van Ark, Inklaar and McGuckin, 2003). In addition, the difference in output per person is derived from the fact that US workers work longer hours than the European employees and the gap could be seen as all about working time.

Moreover, going back to the logic of the 'soft budget constraints' (Kornai, 1990), the threat of bankruptcy was much weaker in Soviet-type systems than in capitalist economies and was the slow diffusion of innovations through the economy. The enormous efforts in terms of personnel and financial resources devoted to scientific discoveries and technical inventions through the different stages of the innovative process was not matched by any pull from production enterprises. The latter were often reluctant to change, and the whole way of thinking about innovation was different from typical capitalist technology-based firms, deeply devoted to survival and expansion through Schumpeterian competition (Sergi, 2003a).

In the Soviet industrialisation drive in the 1930s, inspiration from and imitation of Western technologies played a crucial role as Russia as well as other East European countries had been far behind in industrial development relatively to Western Europe, and foreign sources of knowledge and technology thus played important roles (Sergi, 2004a). While the new states created in Central-East Europe after World War I built their industrial development largely on more direct relationships to the West, the Soviet bloc built up a R&D system initially concerned precisely with screening and copying Western technology (Sergi, 2004a).

It is clear that the collapse of socialism in the years around 1990 was a radical turning point with respect to innovative activities. In comparison to the earlier reforms that were attempted already during the socialist era (Sergi, 2004a), the transition in the 1990s was a revolution that opened up innovation in a way that it could act as a driving economic force. This transformation could not conceal the fact that the transformation of innovation still had to take as its point of departure the existing socialist systems of innovation. The empirical evidence indicates that the farewell to socialism has as a rule led to a dramatic collapse of large parts of the inherited R&D system (e.g. Radosevic, 1997a). Organisations engaged in applied R&D have as a rule not been able or allowed to adapt to the new situation, and the base for their funding by the state has usually been withdrawn.

Organisations involved in basic research, i.e. mainly academies and universities, have also faced a lack of financial resources and employment has decreased considerably. After 1989, hopes were raised about possibilities of strengthening Central-East Europe university-industry links, but with the almost total disappearance of organisations in the spectrum between basic research and production enterprises, and therefore a problematic lack of important bridging actors, this is obviously contradictory to the actual prospects.

The R&D complex in Central-East European countries has thus been radically downsized but while in most Western countries it is typical for the public sector to contribute with around one-third of total R&D expenditures, with private firms contributing with the remaining two-thirds, the situation is sometimes the reversed in Central-East Europe where governments financed up to two-thirds of the total R&D expenditures. And the interesting aspect of development is that there are no clear indications that the pattern has not changed during the 1990s and early 2000s.

As a matter of fact, the public research sector in Central-East Europe is typically of a comparable size to that of Western countries. Thus, for example, a country such as Poland has actually a higher number of university researchers per capita than Germany (OECD, 2004). However, the most important challenge rather relates to the relevance and competitiveness of the research carried out from the perspective of the system of innovation as a whole. This issue is directly linked to the relationships between R&D organisations and the business sector. Similarly, the links between R&D organisations and other public bodies are likely to be of key importance. The overall challenge is to integrate the inherited R&D complex into the context of market-based economies.

For example, competencies in R&D generated under central planning were obsolete when compared with the standards prevailing in Western Europe and the US (Pavitt, 1997; Sergi, 2004a). However, there are a number of cases where Soviet-type competencies have been successfully exploited in the post-Soviet period because individuals who have accumulated far-reaching competencies have very often come to play important roles in the post-socialist system of innovation.

Under a certain perspective, when the capitalist experiment erupted in the newly democratic countries of Central-East Europe in the late 1980s, the relevance of this experiment has soon become a privileged subject of research. The spirit of this second society and of the dissident intellectuals was to steer the domestic system towards capitalism without capitalists (Sergi, 2004b; Eyal, Szelényi and Townsley, 2000. This could have been possible by lending more importance to civil society and the economic managerial rationalism that had permeated the system even before 1989 (Sergi, 2004b). A permanent bureaucratic-capitalist class dampened the emergence of a middle class, says Sergi (2004b), which was the peculiar aspect in Western societies. As things were developing, these economies were searching for a new social rationale and this could be seen in new elites of capitalists and in the application of the strongest measures of capitalist regulation, which imposed stability in the 1990s through either currency boards or tight monetary policy, rather than with planning. The technocratic component of the new elite was only partially accustomed to western-type practices and to plan bargains. As it happened, some of the powerful people lost favour to a group of young communist technocrats, which had created a form of managerial capitalism using state property and bureaucracy. They obtained the means of power through political and cultural dominance, preserving some 80 to 90 per cent of their positions in economic and land management (Tsyganov, 1999). Simply, they have not squandered their political and economic gains and found enough power to manoeuvre themselves to control important resources, and maintain support within the political establishment. That is, a new class of capitalists able to implement the decisive monetarist strategy, despite the distress caused by stringency of reforms.

The formation of a class of state managers and a class of young entrepreneurs trace their origins to the previous paternalistic structure. This class of new managers forms a vital component in the society of today, though the chaotic situation may have transformed political and managerial capital into a hegemonic oligarchy in Russia. A major source of such important individuals, who possess important competencies accumulated under communism, appear to be R&D organisations of various kinds. Even more important, however, is the availability of socialist-era graduates from technical and other universities; these people show up nearly everywhere where creative innovation occurs.

At the level of organisations, the power of inherited competencies is not at all as obvious in the post-socialist context as at the individual level. Through the collapse of old enterprises and applications-oriented R&D organisations, in particular, great deals of competencies were lost at the organisational level. These lost competencies may in many cases have been obsolete, while in other cases they may have been potentially useful in the post-socialist era. It may also be seen that the formal or informal reintegration of inherited socialist networks following their legal split-up may in fact play important roles in stimulating innovation (Radosevic, 1997b).

With respect to inherited universities, post-socialist universities have suffered from a loss of teachers and researchers, mainly because of compressed financial resources. This line of reasoning can be generalised to include the entire educational infrastructure. In particular, secondary schools are probably an underestimated source of competencies and absorptive capacities in Central-East Europe. Compared to Western Europe, Central-East European countries are placed much more favourably with respect to the number of graduates from secondary schools. Thus the share of adult population with at least secondary education was 64.6 per cent for the Western part of the EU, while the corresponding figure for Estonia was 87.5 per cent, for Latvia 82.6 per cent, for Lithuania 84.8 per cent, for Poland 80.8 per cent, for Slovakia 85.8 per cent, for the Czech Republic 87.8 per cent and for Hungary 71.4 per cent (see Ny Teknik, 28 April 2004).

In addition, Central-East Europe inherited from the past a European tradition of seeing science and technology as integral parts of society at large and the introduction of a capitalist system with decentralised decision-making implied that innovation was not anymore something that was enforced from outside. Even though privatisation was going slow in some countries due to political pressures and difficulties in dealing with big enterprises and military complexes, enterprises were free to choose their suppliers and partners and a powerful change in inter-organisational linkages occurred in connection to privatisation, especially when the buyers were foreign investors. This view is supported by the observation that privatised firms are in general more strongly networked internationally than the remaining state-owned firms (Radosevic, 1999).

Great hopes have been raised in Central-East Europe in the 1990s concerning the potential roles that firms and other actors from more advanced countries can play in the rebuilding of the economy. In theory, foreign direct investment has thereby been seen as a powerful vehicle also for rebuilding innovative capabilities under post-socialism. Foreign investors are expected to bring with them modern technologies that increase productivity and inspire further innovation. The impact could be substantial if the use of new technologies simplifies a broad collection of complementary innovations within firms and the benefits of computers becomes apparent when we combine new technologies with organisational aspects. In reality, empirical research indicates that foreign investment is as a rule not associated with any rebuilding of technological and innovative capabilities in Central-East Europe. The only exceptions are the new R&D centres have been established directly by multinational firms and this has had a strong impact on small domestic firms. Several analysts suspect that small and medium-sized firms in Central Europe have a much too low level of technological competency and are too static technologically for contributing in any significant way to building innovative strength in the region (Gabor, 1997; Radosevic and Walter, 2002).

Other research has shown that small firms in reality often play key roles in many innovative projects, especially companies with foreign ownership (both in joint ventures and even more in fully owned subsidiaries) significant improvements in productivity, products quality, modernisation of equipment and technology has occurred (Radosevic, Majcen and Rojec, 2003). This was connected with changes in management style and reshaping organisation culture. Foreign subsidiaries are in average better prepared to compete at the EU market than purely local firms. When foreign investors buy a local firm, they usually start with changing the organisation structure and training of top and medium-level managers. New training and organisational changes are a precondition to effective employment of new technology and subsequent productivity growth. As the privatisation process is almost completed in all analysed countries, the importance of greenfield investments will probably increase in the future. In such cases, there will be no need of organisational restructuring or adjusting existing plants to foreign investors requirements and standards. However, even in the case of greenfield investment, training of employees will be important and new foreign investors will probably try to adjust work organisation, work ethics and the whole culture in new firms to the parent company's standards. An advantage of new foreign entrants is that they can find labour force either directly trained by established foreign investors or indirectly prepared to meet high demands of foreign investors. Business environment is more favourable now and this can be true regarding possibilities to use local suppliers network. Local companies today are more aware of high demands on quality at the EU market, more reliable and more flexible.

Of course, not all companies become global in the same way and different companies start their globalising process in different ways. In order for technology to become successful internationally, the current mindset has to be changed and configuration of resources and management practices. There is no doubt that interaction with foreign actors and foreign systems of innovation has the potential to contribute to innovation. However, it is also clear that this potential is not at all utilised to the extent that it could be. Most promising in cross-border relationships are clearly the relations with culturally and/or geographically close countries. Notably, Central and East European countries can in this sense be argued to have an advantage over other catch-up countries in more remote parts of the world, to the extent that most of the Central and East European countries have a multitude of historical, linguistic, demographic and cultural linkages to Western European countries. While India has the best reputation as an outsourcing destination among top US companies (Adekola and Sergi, 2007c) a potential challenger is the Philippines, which has a large pool of English speakers thanks to its American occupation in the 20th century. However, despite the language handicap, Central-East European countries such as Hungary, the Czech Republic, Russia and Slovakia also have potential, particularly for outsourcing from Western European countries like Germany and France.

To conclude, with the growing complexity of the economic world, particularly with the economies of India and China growing so dramatically, it is important that one recognises the key factors which determine economic growth. These factors help to explain why some countries are much more successful than others in raising income levels and opportunities for their citizens. Therefore, the dynamics of innovation must not be thought of primarily as a transfer of Western technologies. Instead, one has to point at the opportunity for Central-East Europe to use inspirations from and interactions with culturally and geographically close neighbours in the West to boost domestic innovation in accordance with local markets and inherited scientific and organisational capabilities. This, however, might lead to different scenarios where new systems of innovation may continue building on the availability of low-cost environments. Central-East Europe would thus continue to be a conveniently business location of relatively simple manufacturing services for large Western multinationals.

When wages rise, this style risks being eroded through relocation of production to other low-cost countries, and this is likely to result in increasing unemployment and dramatic declines in exports. The only thing which could rescue this development path on the long term would be to imitate the East Asian experience of climbing the ladder towards increasing involvement in innovation.

In this era of globalisation, rapid technological changes and significant shift in wealth creation, Central-East Europe might become an important region for new developments, which would often surpass Western countries through the still much more loosely defined institutional landscapes in the Central-East countries. Global competition would then also encourage the formation of East-West joint corporations and conglomerates which would gradually learn to use the continuous flows of knowledge across countries and differing systems of innovation in order to boost the whole process of innovative development (Sergi, 2006a; Adekola and Sergi, 2007c). Western support helps Central-East countries revive their advanced and unemployment is reduced in connection to the appearance of new technological advances.

2.8 The Case of Slovak Labour Markets: An Econometric Analysis

Labour market frictions and severe unemployment dynamics have always exerted a strong impact on economies around the world. A general concern rests on labour market distortions that might result in a high unemployment and the resulting social costs. On one side, unemployment negatively affects the economy and the population's well-being. On the other, most governments embark upon countering unemployment, but these policies should draw on judicious principles before becoming valuable pillars in policy agendas. Given that the causes of these circumstances merit appropriate assessment, scholars have been involved quite extensively in this field of research (see e.g. Abbring *et al.*, 2002).

Enquiring into the Slovak case it is important to take to account three aspects. First, this economy has been the most industrialised among those designed by communist nations in east central Europe during preceding decades. This definitive passage may disclose exclusive effects and broaden our learning concerning Slovak transformation, once we are able to put a comprehensive understanding in appropriate context. Second, we would like to expand the economic literature with regard to what we define as post-structural economic policy carried out in a small open economy. Third, Slovakia has experienced a cumulated real GDP fall of approximately 25 per cent and approximately 35 per cent of real industrial output drop before starting recovery in 1993 (Sergi *et al.*, 2005).

The relevance of studying Slovakia to the overall understanding of economic transformation is that this country has been one of the most dynamic economies in Central-East Europe since the late 1990s, but showing scant effects on labour markets during the early 2000s. The very opening of the transformation path during the 1990s gave rise to destructive impact on Slovakia's real economy and labour market. There were detected major failure in preserving real GDP and full paternalistic employment, from early transformation in 1989 through 1993. Beyond 1993, however, unemployment kept escalating and real output turned to growth as well. While one may expect unemployment rates to decline in the light of significant economy recovery, as in the widely used terminology applied to transition countries, labour and real economy variables disclosed conflicting developments. Transformation recession occurrences found thorough rationalisation in a transformation-type recession and the new industry structure.

Most of the rationale for this outcome, traces back to industrialisation beliefs that have dominated post World War II central planning, aimed at prioritising heavy industry and high military production; this was highly concentrated in the former Czechoslovakia. The paternalistic system favoured industry over tertiary sectors and industry in the GDP ratio reached roughly 59 per cent at the end of the 1980s. Indeed, it was the highest (together with Bulgaria) among the former Soviet bloc member countries, recording for the economy 23 per cent of over-industrialisation in 1990 – calculated as the difference between actual and predicted industrialisation, as a percentage of GDP by de Melo *et al.* (2001).

Hence, in the new Central-East European context, authorities had to move away from previous over-employment and over-industrialisation towards market type approaches capable of stimulating productivity and efficiency (Estrin, 2002; Sergi, 2003a; Stockhammer, 2004). In fact, the primary factor explaining the evolution of outflows for the labour force was the prerequisite to start and conclude output restructuring, not economic growth; otherwise the worsening of unemployment would have stopped. However, the need for industry to undergo profound reforms was prevalent everywhere. The population and policymakers were conscious of this inevitability, even though they had to suffer some cost.

The transformation recession ended by 1993, when the economy recorded the last year of a drop in economic output (i.e. -3.7 per cent). The outcome has been a constant shrinking of industrial employment, along with moderate growth of industrial output since 1994. As a result of reforms undertaken during the second part of the 1990s, the shifting away from previous priorities brought about a further boost: the percentage share of industry in GDP shrank to 26 per cent in 2001, down from 30 per cent in 1994.

A possible foundation of the new economic rationale has been the impact with foreign investment inflows. The phenomenon of recovery on the side of real GDP occurred while the economy recorded major reform (more efficiency) and profound restructuring (less industry and more services for GDP). Efficiency and productivity came through the privatisation of old state-owned enterprise and emergence of new private firms, with a private sector, for example, accounting for approximately 90 per cent of GDP nowadays, up from almost nothing during the communist era. In general, it is possible to state that foreign investors have boosted productivity (e.g. Barrell and Holland, 2000; Scheve and Slaughter, 2003) and hasted domestic tendencies closer to business attitudes, thinking and practice.

Policies aimed at searching for expanded efficiency and structural convergence along western productivity standards, have caused the structure of GDP to alter, while output and employment in industry diverge during the 1990s. The abating of total employment in industry also made reality the flow of workers from one productive sector to the next. Nowadays, the Slovak economy has overcome most of its initial problems and created a pattern of economic growth, though it is still desirable to end the last stage of transformation policies. However, what have been the primary effects of transition restructuring and GDP development on the labour market?

Excellent economic growth and overall promising Slovak outlook is being at odds with troublesome unemployment rates, the plague of long-term unemployment and regional disparities. Total employment slightly increased between 1994 and 1996, but the gap between real GDP and unemployment rates stretched. Beyond this, total employment has declined during the period 1997-2000, losing 0.9 per cent, 0.3 per cent, 3 per cent and 1.4 per cent, respectively. Part of the labour force originally being prepared to work in heavy industry factories became one of the main groups of unemployed, generating part of today's long-term unemployment. High unemployment rates appear in Slovak labour market during whole 1990s and rose at the beginning of this decade. While at the end of the year 1994 unemployment rate reached 13.7 per cent and was stable until

1999, since the year 2000 it has been increasing and at the end of the years 2003 and 2004 it reached 17.5 per cent and 18.1 per cent respectively. According to the OECD's data on the standardised unemployment rates, unemployment rate in Slovakia of 17.3 per cent in 2003 was the second highest among OECD countries.

Data on unemployment by duration shows that long-term unemployment prevails in the Slovak labour market. The unemployment exceeding 12 has been prevailing. Concerning unemployment by age, unemployed are mostly economically active persons at the age of 25-49 followed by group of young persons up to the age of 24. According to the Labour Force Survey (2004) the most frequent cause of unemployment of persons who were ever employed in the first quarter of 2004 was 'release due redundancy'. At the same time, proportion of persons who lost their job due redundancy was 24.8 per cent with inter-year increase by 3.1 per cent. One fifth of all unemployed worked in their last job as auxiliary and unskilled workers (19.7 per cent), craftsmen and qualified producers, processors and repairers (14.8 per cent), operational workers in services and retail (10.9 per cent), and operators of machines and technologies (9.4 per cent). In addition, the country has been suffering regional disparities in unemployment. There are disparities among regions as concerns level of unemployment rate as well as disparities concerning dynamics of unemployment rate. While Bratislava region shows unemployment rate at 4.0 per cent in the first quarter of 2005 with 4-months dynamics at -40 per cent, the region of Kosice in East Slovakia shows much higher unemployment rate of 21 per cent with 4-month dynamics of -20 per cent.

It is common in economic literature to investigate economic cycles and labour markets to understand the exact nature of unemployment (e.g. Blanchard and Wolfers, 2000). This has a large impact on policy-related issues and labour policies to implement. Whilst cyclical component of unemployment is linked with economic cycles and short-run movement of output, long-term economic and institutional changes account for structural unemployment (Schnabel, 2002).

2.8.1 Testing for Cyclical Responsiveness of Unemployment

To shed light on the labour market, and how to end transformation while benefiting working groups, we scrutinise the Okun Law econometrically. A milestone in the development of labour markets is the empirical regularity found by Okun (1970) – the chairman of the US Council of Economic Advisors under President Lyndon Johnson – who scrutinised the American economy through the fifties and sixties. Following Okun's notion acknowledged as Okun Law, empirical regularities found that whenever real GDP grows 2 per cent above its potential (i.e. the output gap), the unemployment rate decreases by 1 per cent. Note, however, Okun originally estimated a relationship to be -3 (or 3 to 1) on the unemployment gap's coefficient for the US economy. This would signify that a 1 point change in the unemployment rate has an impact two times larger (three times in his early work) on real output. Put differently, one percentage point of the unemployment rate below the natural rate, leads to 2 per cent in the output gap. In addition, it is worth noting that impact larger than one is due to changes in unemployment being associated with changes in labour force participation, labour hours and capital utilisation (explained by unemployed searching for jobs discourages them from continuing searching as new workers are being fired; plant and equipment tends to be used less intensively; and hidden unemployment causes workers to tend to work less intensively).

In practice, most specifications assume a symmetrical relationship between changes in unemployment and real output, which, however, may be an incorrect assumption along with a relationship that may fluctuate over time or among different institutional contexts. This mismatch between current and potential output might bring about the design of effective non-inflationary expansionary counter unemployment policies, as long as GDP is below its potential (Sergi, 1998b)[4].

[4] Critics of a permanent trade-off between unemployment and inflation rates suggest governments cannot rely on this trade-off and therefore they do not have to engineer any expansionary policy (e.g. Friedman, 1968; Phelps, 1967).

Although the Friedman and Phelps tenets are now widely shared among experts, the fashion of countering political economy permeated some economic schools, and experts began to think in terms of responsiveness of labour markets to domestic production. To this end, we test the cyclical responsiveness of employment and unemployment to GDP cycle. Cyclical volatility of unemployment leans on economic cycles (i.e. the short-run fluctuation around the trend), and the structural component of unemployment on the long-term transformation of the economy, which is anchored to institutional design. A broad approach that keeps apart the two components helps secure a better insight into Slovak transition, offering better judgment concerning more effective economic policy (Sergi and Kubicová, 2005e).

We calculate the cyclical responsiveness of Slovakia's labour market to the evolution of real GDP growth. Okun's approach may be searched for unravelling cyclical and structural aspects of unemployment. Recalling the Okun's notion it is possible to write:

$$U_t - U_t^* = -\gamma(Y_t - Y_t^*) \tag{1}$$

where U is the actual rate of unemployment, U_t^* is the unobserved rate of structural unemployment, Y_t is actual real GDP, $Y_t - Y_t^*$ is the measure of output gap (OG), the gap between actual and potential GDP, and γ is Okun coefficient. By rearranging of the equation (1) we obtain:

$$U_t = U_t^* - \gamma \times OG_t \tag{2}$$

And taking first difference of the equation (2), we obtain:

$$U_t - U_{t-1} = U^* - U_{t-1}^* - \gamma(OG_t - OG_{t-1}) \tag{3}$$

where OG is the output gap. The change in unemployment rate features a structural change in unemployment and cyclical change in the output gap.

An estimate for Okun's γ can be derived in a mechanical sense: cyclical fluctuations in output may lead to changes in employment. Accordingly, changes in employment may generate different reaction of labour force and consequently of unemployment. Using this logic, it is possible to estimate two coefficients: the first for the cyclical responsiveness of employment to GDP, the second coefficient for responsiveness of labour force to GDP. Thus, Okun's γ coefficient is calculated as (1) * [1-(2)], where (1) and (2) are the two coefficients from the two regressions. Okun's γ coefficient may be interpreted as implying the transmission of the cyclical output fluctuations into cyclical variations in the unemployment rate (Sergi and Kubicová, 2005e).

At first, by applying OLS method we estimate regression of the deviation of employment from its trend on the deviation of real GDP from its trend. Similarly, by using OLS method we estimate responsiveness of the labour force to employment. It is estimated by regressing the trend deviation of the labour force on the trend deviation of employment. To detrend time series of labour force, employed and GDP we adopted the Hodrick and Prescott (1997) filter. The Hodrick-Prescott filter was presented as a working paper in 1981 and published only in 1997. It extracts a trend from a time series. The filter minimises the weighted sum of two components, the squared deviations of the filtered series from the unfiltered series and the curvature of the filtered series. The procedure involves finding the cyclical component of the variable, and this is calculated as the current value of the variable less a trend of the variable, where the latter is a weighted average of past, current and future observations. This method yields a series that is reasonably close to the unfiltered data (first component), reasonably smooth (second component), while residuals form the cyclical component. For more details concerning the properties of macroeconomic time series and linear filtering, see Stock and Watson (1999). Data are collected on quarterly basis.

This approach relaxes the widely spread though that GDP growth is sufficient to decrease unemployment, and it could prove adequate to evaluate the responsiveness of employment to GDP and to make effective suggestions.

Table 2.1 – Definition of the Variables in Final Regression

Variable	Description	Source
GDPREAL	Gross domestic product, constant 1995 prices, millions Slovak koruna.	Statistical Office of the Slovak Republic.
GDPREALDEV	Deviation of gross domestic product from its trend. GDP trend was calculated by using Hodrick-Prescott filtering with the smoothing parameter of 1600.	Own calculations.
LABFORCE	Labour forces, thousands persons. Labour forces represent part of population total and accounts for economically active persons. It is sum of total employed and total unemployed persons.	Statistical Office of the Slovak Republic.
LABDEV	Deviation of labour forces from its trend. Labour force trend was calculated by using Hodrick-Prescott filtering with the smoothing parameter of 1600.	Own calculation.
EMPL	Employed, thousands persons. Employed persons represent subgroup of economically active persons.	Statistical Office of the Slovak Republic.
EMPDEV	Deviation of employed from its trend. Trend was calculated by using Hodrick-Prescott filtering with the smoothing parameter of 1600.	Own calculation.
UNEMPL	Unemployed, thousands persons.	Statistical Office of the Slovak Republic.

The regression coefficient of employment deviation from its trend on deviation of GDP from its trend has positive sign, and attests positive relationship of employment to GDP. The coefficient is low (0.011573), suggesting that the responsiveness of employment deviation from its trend to the deviation of GDP from its trend is weak. In contrast, results suggest negative correlation of cyclical development of labour forces on cyclical development of employed. Simply, findings suggest that a negative output gap of 1 per cent has drawn up unemployment by 0.00027 percentage points. This denotes that cyclical unemployment was not very pronounced in Slovakia. The nature of high unemployment was rather structural than cyclical, resulting from structural changes. These facts may have some cogent policy-related implications concerning the adoption of new policies aimed to counteract a growth without new jobs or jobless growth.

Findings are important because the country has experienced a strong recovery on the side of productivity, and entrepreneurs do not seem to behave as in Holt and David's (1966) view, where firms would create vacancies in anticipation of future needs. The recent increase in GDP did not pay off in terms of less unemployment

– even though the share of employed on the economically active population moved from 80.92 per cent in 2002 to 82.16 per cent in 2003.

2.2 – Cyclical Responsiveness of the Slovak Labour Market – Calculation of Okun's γ

	(1)[a] EMPDEV on GDPREALDEV	(2)[b] LABDEV on EMPDEV	(3)[c] Okun's γ
coefficient	0.011573	-0.011753	0,00026995180
standard error	0,001883	0,069897	
t-statistic	6,144656	-0,168154	
R-squared	0,467537	0,000657	
Durbin-Watson stat	0,950038	1,136359	

Notes: [a] Deviation of employment from its trend on the deviation of GDP from its trend. [b] Trend deviation in the labour force on the trend deviation on employment. [c] γ is calculated using the formula (1) * [1-(2)].

Slovak government counteracted unemployment by adopting active labour policies (Slovak National Action Plan for Employment, 2002). After the general elections held in 2002, in April of that year its has been adopted the 'National Action Employment Plan', which took the country closer to the European strategy of employment, the so-called 'Principles of Employment Policy', adopted at the Luxembourg Summit in November 1997. This European way to boost employment builds around four pillars: improvement of employability, expansion of entertainment, support adjustment of companies and their employees, and strengthening equal opportunity policies.

Nevertheless, even before 1997, the issue was of concern to the EU's leadership: during a Madrid Summit in 1995, it was recognised that the need for fighting long-term unemployment through improved jobless skills and reducing the non-wage costs of employment, makes it more attractive to hire new workers.

2.9 Conclusion

To conclude, economic transformation in Central-East Europe was intended to keep pace with extremely competitive environment in the EU. On one side, macroeconomic stability has been introduced over time. On the other side, these economies must improve the educational system to favour increasing demands for high skilled workers and invest on technological advancement beyond a critical degree of penetration. Tailoring policies to specific regional and long-term unemployed in order to avoid deepening regional discrepancies and social instability is another objective. Pragmatic fiscal policies of the type described by (Sergi, 1996, 1997b) and different financial incentives that may affect unemployment duration and smoother bureaucratic practices could be pillars. Attracting more investment and promoting exports to push domestic savings up as in Maizels' hypothesis (Maizels advanced this hypothesis in 1968 as for the developing countries and the hypothesis relates a boost to savings from export). Sergi (2003c and 2004d), has been the first to test the relationship between saving and export in Slovakia and the Czech Republic. He found support for the Maizels hypothesis and this condition will prove an additional step for the benefit of the economy in Central-East Europe.

As for the specific Slovak case, the Slovak government must not simply leave this issue to market forces. If the 'National Action Employment Plan' has been a good starting point, more must be accomplished than simply what envisaged in official plans. Market principles are important in the long-term restructuring strategy, and further public initiatives to bypass current obstacles and long-term unemployed must mould new policy strategies as well.

Chapter 3

Commercial Banks towards European Standards

3.1 Introduction

Since the beginning of transition, the banking market has been undergoing constant consolidation. The approach taken towards developing a viable banking sector has varied amongst countries and was dependent on several internal macroeconomic and microeconomic factors. The research interest here are the most advanced transition economies during the 1990s and early 2000s – i.e. the Czech Republic, Hungary and Poland – that like other transition countries, faced the problem of non-performing loans (NPLs) from the portfolio of the state-owned commercial banks (SOBs). These loans worsened banks' liquidity and solvency once hard budget constraints were imposed. Moreover, during the late 1990s and this decade, the structural transformation has accelerated through mergers, takeovers and other restructuring measures.

Nevertheless, specific banking crises resolutions were therefore essential measures (Šević, 2002; Matousek and Sergi, 2005). Authorities had to calculate the true value of inherited non-performing loans and in fact, most state-owned banks were technically insolvent or chronically undercapitalised. The fundamental changes of banking sector consolidation were performed in a legislative environment tailored to the command economy and not into line with EU legislation. There was not only an underdeveloped institutional framework, but also a legislative framework as, for example, the bankruptcy law, corporate law, laws protecting creditors as well as debtors, accounting standards and reliable auditor firms.

During the last decade, there has been considerable literature on banking sector crises and restructuring overall (Hoggarth *et al.*, 2004) and particularly in transitional countries (Hernes and Lensink, 2000; Matousek and Sergi, 2005).

However, there is still a lack of research explaining the differences in progress among the transitional countries.

Here we attempt to provide evidence and a critical analysis of the best practice of handling banking crises in three transitional countries: the Czech Republic, Hungary and Poland. In fact, a critical analysis is offered of the various methods in resolving banking crises estimating what would have been the optimal way of resolving crises in SOBs and small and medium sized commercial banks (SMBs) in the Czech Republic, Hungary and Poland.

3.2 The Economic Environment and Banking Systems

Looking at the development of banking sectors across Central-East Europe, some differences are observable. Hungary, for example, already initiated banking reforms in the early 1980s. The other factor, which had an impact on the future development of banking systems, was whether transition countries followed the so-called rehabilitation or the new entry approach. The rehabilitation approach is based on recapitalisation and consolidation of state banks, including their incomplete privatisation and limited openness of the banking system for new banks mostly domestic ones (Matousek, 2002). This was carried out, for example, in Hungary, Poland and, to some extent, the Czech Republic. The second approach applied mostly in the countries of former Soviet Union which had been based on a kind of liberal entry of new banks including rapid privatisation.

The replacement of the earlier monopolistic banking system (one-tier banking system) in favour of a two-tier one (central bank and commercial banks) was one of the basic preconditions for making the banking sector functioning on commercial principles and sound financial flows (Sergi, 1994). Given the low starting capital strength of the banking sector as a whole, the resulting profitability was also low. With banks building their infrastructure, this brought about a major increase in their fixed assets while starting and consequently an increase in the operational leverage. This imposed both increased demands on banking supervision and a gradual build-up of control mechanisms, which would provide prudential banking activities. The entry of the foreign capital and technical expertise were additional factors which considerably affected the development of the banking sector through accelerating structural changes, production innovation and a wider range of products and services. In Central Europe (specifically Hungary), in aggregate foreign entry may even have been associated with expanded credits to small and medium-size enterprises when the domestic banks had to search for a broader clientele for lending (Bonin and Abel, 2000) and contributed to the overall soundness of local banking systems by screening and treating problem loans more aggressively (Goldberg, 2007). At the time, this process was not perceived as an instrument decreasing the average lending rates, as the resulting profitability of the majority of debtors did not achieve the level which would provide the leverage effect. The profitability was lower than the interest rates on loans. It was decisive, however, that the new banks ensured the reproduction of loan flows while insisting on the fulfilment of the credit exposure parameters. Another significant factor influencing the economic position of the banking sector was the radical process of restructuring which was aimed at the recovery of the loan portfolio.

More strategies to make effective the functioning of the new central banks (Sergi, 1997a) and the network of commercial banks followed. The mono-bank system featured the lack of an institutional separation between monetary policy and commercial banking. Therefore, a separation of central and commercial banking was identical for most of the former communist countries undergoing banking sector transformation. Specific efforts were made to reinforce the independence of central banks (Sergi, 1994) and to continue a strategy to set up commercial banks. As well to offer evidence for deeper macroeconomic stability, better governance structures and additional institutional developments (e.g. Šević, 2002).

Therefore, in the past has never existed a central bank as such, and it conveys two implications during the early phase of transition: the inexistence of a system of commercial banks and the missing banking culture. State banks acted as lenders of last resort and commercial banks. After the break up of the socialist economy, the two-tier banking system was privileged[5]. This new approach stresses the autonomy

[5] Note that the two-tier banking system has been set up in Yugoslavia by the mid 1960s.

of domestic central bankers as a way to keep inflationary pressures under check (Sergi, 1998b), as well as to assure the minimum feasible strategy of overall banking supervision. In addition, we shed light on the comparative models of recapitalisation and restructuring the banking system by the means of centralised (e.g. in Albania, Bulgaria, the Czech Republic, Hungary and Romania) and decentralised (pro-market) approach models (Croatia, Poland and Slovenia). Commercial banking operations in command economies were closely linked to line ministries and their main objective was to fulfil the credit plan, which was in integral part of the production central plan. The mono-bank and its asset and liabilities were transferred to newly created commercial banks. This process went along with further expansion and openness of banking systems. However, several shortcomings can be identified in applied measures (e.g. Šević, 2002).

When transition economies began to establish a two-tier banking system, it was believed that the more banks operating within the financial market the better and the banking system as a whole becomes more competitive and efficient. The rapid growth of new commercial banks in the first stage of transition brought a certain degree of competition into the financial market but afterward the financial position of the new established banks was considerably impaired (Matousek, 2002; Hoggarth *et al.*, 2004).

Building an efficient banking system requires, among other, two policies to be carried out simultaneously – i.e. liberalisation of the sector and the prudentially regulated entry of new banks. One can observe that newly created banking systems in transition countries faced several disturbances. In the Czech Republic, a deterioration of the portfolios within the group of state-owned banks that inherited loans from the Central Bank needed to be resolved in the early stage of transition. SOBs were either technically or actually insolvent. The liberalisation of entry for small and medium sized banks (SMBs) that were significantly undercapitalised in the first half of the 1990s created additional problems within the banking sector, testifying further risks.

All three transition countries have been undergoing a complex process of liberalisation similar, but more radical, to those in the EU countries in the 1970s and 1980s. The authorities set the basic regulatory and supervisory framework, new operational guidelines and principles for banks' prudential behaviour. However, regulatory and supervisory capacity was severely limited and banks lacked, among other things, the basic credit skills.

Central-East countries had a unique opportunity to build a two-tier banking system almost from scratch. There are several questions regarding the expansion and openness of the banking system in transition economies. The way of how banking systems were set up had also implications on the extent of rescue operations by governments and central banks (Sergi, 1994, 1997a). In the first stage, commercial banks were created out of a mono-bank. This step seemed to be identical for most of the former communist countries undergoing banking sector transformation. However, there are significant differences as for a market segmentation of state owned banks. In Poland, nine state-owned regional banks were established instead of one or two large banks (Balcerowicz and Bratkowski, 2001). The advantage of such a policy is to avoid creating 'capture banks' that served mainly the business activities of their shareholders in the absence of adequate banking regulation. Decentralisation led to covering all major regions in the country and the allocation of credit was better monitored. However, the experience shows that a regional break-up limits the competitiveness within a given market since one bank plays a dominant position in that market.

In contrast, in the Czech Republic, five state-owned commercial banks were created at the beginning of 1990. All five banks were highly concentrated, centralised and specialised banks. Since these banks had only a few branches across the Czech Republic except Česká spořitelna (Savings Bank), there was a lack of financial services in the regions outside of Prague. A similar strategy was adopted in Hungary where four banks had an oligopolistic position within the Hungarian market (Abel, 2002). These banks were created from the commercial banking departments of the mono-bank.

3.3 Banking Crises Resolution Strategies

The pace of macroeconomic stability and further banking reforms determined the degree of the future development (stagnation) within the banking sector. The two-tier banking system was not established at the same time in all three countries and by no means had the countries identical starting conditions. The state-owned commercial banks, which inherited loans from the monopolistic banking system, were either technically or actually insolvent. The liberalisation of entry for small and medium sized commercial banks later further deteriorated the stability of banking sectors.

If the governments and central banks wanted to have a competitive, efficient and credible environment in the banking sector, then to clean up the portfolio of undercapitalised state-owned commercial banks was an essential condition. Since the origin of the banking crises was, at the beginning of the transition, an inheritance from the planned economies government and central bank support was not surprising. Banks were fully or partially owned by governments and options of banking crisis resolutions through private involvement were limited. The fast and significant restructuring of both SOBs and SOEs was crucial. Authorities did not have to search for new specific methods of dealing with NPLs and distressed banks. However, they had to decide which strategy should be appropriate for the banking system in question. With the benefit of hindsight, this was indisputably an uneasy task for most transition economies.

It was opted for either a centralised or decentralised government liquidity support (Matousek, 1995). In the first stage of the transition, the Czech Republic and Hungary applied a centralised government support within a framework of the banking sector consolidation programme. Non-performing loans were transferred to a centralised asset management company (AMC) or so-called 'hospital bank' that was set up to deal with NPLs transferred from the portfolio of the financially distressed SOBs. Simultaneously the banks that participated in the consolidation programme had discretion to write-off remaining non-performing loans when the likelihood of recovery was low or its burden could cause the bankruptcy of viable firms.

The centralised loan consolidation programmes applied in the Czech Republic and Hungary improved to some extent commercial banks' portfolios. Nevertheless, these banks remained undercapitalised and additional measures had to be taken later on. This method created a problem of double moral hazard and required higher financial injection into banks with troubles. In Hungary, it was only recognised later, unlike in the Czech Republic, that the high concentration of assets in one institution would impose a severe constraint on an efficient recovery of NPLs. Klingebiel (2000) and Hoggarth *et al.* (2004) argue that the centralised approach has the advantage of economies of scale but there was not such evidence in the Czech and Hungarian cases. On the contrary, an accumulation of a large amount of the heterogeneous NPLs in one institution, as in the Czech case, rendered the asset management a technically impossible task.

In the case of the decentralised approach, as applied in Poland and later adopted in Hungary, the government did not carve out NPLs from the banks' portfolio but left them with banks. Banks had to take own responsibility for restructuring portfolio. Two alternatives were applied. Banks could either sell NPLs to an AMC at a discount or recuperate them by establishing subsidiaries that had the form of the Special Purpose Vehicle (SPV). Although the restructuring process was time consuming and the outcome uncertain, this regime left banks with the possibility to restore their business activities without the imposition of any conditionality. Polish commercial banks set up special departments within banks in question that were directly accountable for the resolution of NPLs. This method was apparently more efficient since regional banks had a good knowledge of local markets and could target assistance on a selected basis to companies with a restructuring potential.

The Hungarian government recognised the bottlenecks of the centralised method in 1992. The new bankruptcy law, which resulted in companies being declared bankrupt, reinforced the urgency of applying the decentralised approach. The new consolidation programme was introduced in December 1993. It was phased in three steps and aimed at increasing capital adequacy ratios to reach the regulatory required level – i.e. 8 per cent. The main limitations of these programmes were the lack of transparency and the application of discretionary policies, which left incumbent managers with no incentive to recover NPLs.

The flaws of the centralised method, applied in the Czech Republic, laid above all, in the unresolved issue of insufficiently restructured SOEs. By creating Konsolidační banka, the authorities disposed NPLs from banks' balance sheets that enabled commercial banks in continuing to provide financial services. However, banks in many cases faced a recurring problem of new NPLs. In fact, that needed repeated rescue operations by the authorities in the second half of the 1990s caused by extensive credit expansion of SOBs to SOEs. These operations postponed a further restructuring process of SOEs.

The Czech and Hungarian case clearly confirmed that the centralised method is not an optimal solution in the case of transitional economies. It materialised soon that the government did not prevent newly created NPLs that occurred in the second half of the 1990s. The government overemphasised a resolution of NPLs originated under a command economy and problems of newly created NPLs were overshadowed.

The lack of transparency and a clear message about no future interventions by the government, coupled with the too-big-to fail issue for large banks, gave rise to banks' expectation of a future government bail out. Indeed, the presence of a moral hazard problem became evident in the early stage of banks' consolidation. This had the direct consequences on the business behaviour of the incumbent management. Particularly dangerous was the double moral hazard problem when SOBs and SOEs formed, unfortunately, correct expectations about future governments' bailouts. An example of this effect occurred in the Czech Republic. The Czech government cleaned up the state-owned or partial state commercial banks' portfolios during 1991-1993. However, the ratio of new NPLs had increased in SOBs immediately after this consolidation process ended. An essential explanation of this situation was unimproved corporate governance and cross-ownership among SOBs, SOEs and private firms (Balcerowicz and Bratkowski, 2001; Matousek, 2002; Matousek and Sergi, 2005).

A cross-ownership structure between SOBs and SOEs or even private companies had generated a vicious circle of credit flows particularly in the Czech case. In order to avoid writing off these loans, SOBs started providing new loans for paying off old claims, which led, in essence, to the classical case of Ponzi finance, that is, a scheme that offers high short-term returns in order to entice new investors but that is doomed to collapse because there are in fact no underlying earnings (see Zuckoff, 2005). The presence of soft budget constraints and the unbusinesslike behaviour of SOBs were strengthened by the implicit state guarantee in the form of financial support for covering any financial difficulties that the banks might have. State owned banks expectations about future governments capital injections relied on two doctrines. The bank is too big to fail or too important to fail, including other factors that provided, if not assurance, and then at least hope for financial support. In the second half of the 1990s, the idiosyncratic behaviour of partially state-owned banks started to be labelled as financial socialism.

The Polish authorities focused attention not only on NPLs from the central planned economy but also took into consideration preventing repeating problems. The Act on the Financial Restructuring of Enterprises and Banks set the legal framework in which SOBs and SOEs could operate. The Polish method so-called Bank Reconciliation Procedure was considered the most promising approach to loan restructuring, and moral hazard issue was present also there (Chudzik, 1999; Balcerowicz and Bratkowski, 2001). The Polish programme allowed banks to reschedule their loans according to individual conditionality partial debt write-off or even debt-equity swap for borrowers. Banks then had to outline and implement a rescue programme for firms that have thought to have adaptive potential to the market environment. However, political considerations played an important role in deciding the extent to which banks wrote off companies' debt.

3.4 Bank Privatisation and the New Market Model in Central Europe

Privatisation of SOBs was an alternative solution to government bail out. This method, however, incorporates some difficulties and may fail to achieve the objective of stabilisation. The co-existence of cross-ownership between SOBs and SOEs induces conflict of interest. The Czech Republic, Hungary and Poland applied three different privatisation techniques. Poland applied the initial public offering (IPO) and the privatisation programme for the nine commercial banks was based on selling 40-50 per cent of total shares of the state-owned banks to domestic investors through IPOs on the Warsaw Stock Exchange; 10-20 per cent of total shares to bank employees and 10-20 per cent of total shares to foreign investors, reserving 30 per cent for the state. Bank privatisation in Poland was intensified from 1998 after rules were relaxed on ownership.

Hungary adopted two different methods of bank privatisation. The first method was the sale of shares by public offering to a dispersed group of foreign and domestic investors similar to the Polish way (Balcerowicz and Bratkowski, 2001). The second method was the sale of a large stake to strategic investors. Making portfolios attractive by the loan and bank consolidation programmes, the government intended to search for strategic financial investors for each bank with the exception of OTP, the National Saving Institution. In the case of Postabank, the third largest bank in Hungary, a special combination of the two methods was adopted: the public offering followed four years after the initial sale of minority shares to foreign professional investors. Hungary can be taken as a textbook example of bank privatisation in Central-East Europe. In all cases, foreign strategic owners received the majority of the shares. By the end of the privatisation process in 1997, the market share of state-owned banks had fallen to 20 per cent.

The Czech experience was principally based on voucher privatisation (Matousek, 2002). The majority of large state-owned banks went through voucher privatisation: the state kept 26-67 per cent of the shares of the largest banks and the other shares were sold by vouchers. Since the large banks collected the major stake of vouchers through the investment privatisation funds founded by them, significant cross-ownership evolved between the banks and their clients and amongst the banks. In 2000 the Czech government completed the privatisation of four SOBs, following a clean up of these banks' portfolios through government intervention or guarantees.

The fast and efficient privatisation of the state-owned commercial banks would have gained momentum in transition economies since state control over the banking sector exerted long-term effects by distortion the economy through non-commercially based lending. Four main shortcomings of the government intervention can be identified: delaying restructuring, restricting competition, allowing bad loans to accumulate and postponing bankruptcy particularly of the largest companies. In order to avoid the political consequences of widespread bankruptcies and consequently unemployment, government has had an interest in saving failing politically important firms. Therefore, strong political pressure has been put over state-owned banks to subsidise loans to such firms. The bank-state relationship is not explicit. Personal relationships and unexpressed understandings between bankers and government agencies are factors that are difficult to evaluate. The bank management and the government have been involved in a sort of preliminary game: they interact in a game whose outcome is the set of rules under which they subsequently play another game whose outcomes are economic payoffs.

The relationship between banks and the government has been complicated by persisting expectations about the government bail out if banks face financial distress in the future. The probability of government bail out is in many cases positively correlated with the banks' lending policy. If banks provide new credits according to what it is perceived by government to be national interest rather than based on a commercial decision, it leads to a situation where no large company facing real difficulties, becomes bankrupt. Therefore, state ownership control or past government interference in the banking sector increases the moral hazard problem. The expectations of bank managers are critical for the bank lending decision. A sound capital base that countries tried to create to solve the inherited bad loans problem is a necessary but not sufficient condition to ensure that banks have incentives to make good investments. If bank managers believe that poor performance will trigger a government bailout in the future with little or no consequences for themselves, then their incentive to take difficult decisions on existing borrowers and to screen carefully potential borrowers are not durable. Moreover, to the extent that these bailouts are expected, their existence is taken into account when the bank plans are made. If banks cannot expect such government assistance, then the incentive for good performance is much stronger.

In December 1998, the Czech government carved out the nonperforming loans of CZK 10 billion (around USD 300 million) of Česká Spořitelna. In August 1999, the Czech government increased the capital of Komerční Banka, by CZK 9.5 billion from which the state ownership in the bank was increased from 49 to 74 per cent. In the case of Hungary, the situation was similar. In January 1999, the Hungarian government bailed out Postabank, injected Ft 152 billion (some USD

706 million), and saved the bank from big losses. Although two Polish banks – the Savings Bank PKO and Agricultural Bank BGZ – were bailed out in 1994, they suffered heavily from the subsidised loans given to housing credit and strong agricultural lobby respectively. The privatisation of these banks was accompanied by a further government bail out.

3.5 Crises Resolution of Small and Medium Sized Commercial Banks

When the segment of small and medium sized commercial banks faced solvency problems, different authorities applied rescue strategies. Newly established banking systems exhibited, among other problems, low competitive pressures, relatively high concentration, and an inadequate supply of financial services. SOBs had a dominant position in the market and the increase in the demand for financial services could not be satisfied.

In the early stages of transition, the main weakness in this segment of small and medium banks was a generalised undercapitalisation of the banking sector. A further issue was the lack of primary deposits. Newly established small and medium banks had a few branches to collect primary deposits and they had to compete with the large established savings banks, which traditionally collected customer deposits. The shareholders structure of banks was non-transparent and executive management was only a veil over the real structure of corporate governance. Further, during the period of high inflation in the early 1990s (Sergi, 1998b), even banks that wanted to pursue true business activities faced a dilemma of adverse selection and moral hazard. In an environment where thousands of new businesses were created without any credit history, the banks faced a difficult decision of how to ration credit, this of course also applied for SOBs. In addition, creditor rights have been limited by non-effective debt workout; laws on collateral and foreclosure were unenforceable without the consent of debtors, which increased a moral hazard problem.

A sharp increase in new entrants small and medium-sized domestic banks was the root cause of the banking crises in this segment of the banking system from 1994 onwards. The rapid growth of new commercial banks in the period 1989-

1991 in Hungary, as well in the Czech Republic and Poland during 1991-1993, brought a certain degree of competition into the banking market but later the financial position of these banks was considerably impaired. An unrestricted entry into the banking sector adopted because of the perceived benefits of competition has in fact been detrimental. All three countries stopped providing new banking licenses after problems were identified.

One argument that has justified ceasing to provide banking licenses was largely grounded in the fact that the banking system proved overbanked and that there were elements of instability at several banks. Therefore, when establishing a banking environment, stricter selection criteria for granting banking licenses should be used. In addition, first class foreign commercial banks should be allowed to set up greenfield sites or merged with domestic banks if they have an interest.

The number of SMBs in the Czech Republic expanded rapidly after 1991 and it was evident later that the owners and management of most of these banks primarily provided loans to their shareholders' and a likelihood of future repayments was significantly low. The Hungarian experience was different since some of financially distressed small and medium sized commercial banks were state-owned and operated during the previous regime in the 1980s. In Poland, the crisis occurred at the cooperative banking level, where one state-cooperative bank and a network of 1,663 small, local cooperative banks, providing financial services for communities in villages and small towns that lacked the local presence of commercial banks. The sector of the Polish SMBs also faced difficulties but to less extent.

Central banks responded to the fragile segment of SMBs by imposing strict licensing policy on new entrants including foreign banks. Foreign investors would be allowed to access the market only via acquisitions of financially distressed banks. Only in the Polish case the authorities were able to attract foreign investors to take over some of these banks. Polish authorities may have successfully applied moral persuasion in these cases, because there was no other economic rational for these take-overs. Although Poland proved successful in avoiding a systemic crisis in the segment of SMBs, real difficulties in the cooperative banks sector emerged.

Hungary was partly successful in selling distressed small banks to foreign investors. The small and medium size banks' problem was more pronounced in the Czech Republic where takeovers by foreign banks did not materialise. Therefore, the authorities had to find a fast and credible solution to prevent a systemic crisis in this sector. The authorities opted for a merger of these small banks with other domestic banks. However, this solution did not improve to be viable. Although the share of all small sized banks in the Czech banking market was around 5 per cent in terms of total assets in 1993, continuing bankruptcies within this sector undermined gradually public confidence in the banking system as a whole. Rescue operations though mergers and acquisition had to be assisted by government financing in order to avoid a systemic crisis.

The CNB requested financially distressed banks to increase their capital in order to cover NPLs. If they were not able to do so, the CNB put these banks under forced (special) administration and looked for a strategic partner. During this period, the authorities tried to find bridge banks that would maintain the banking activities of the failed banks. Such a method was, for example, applied when Barings failed in 1995 and its activities were transferred to another bank.

These standard instruments for banking crisis resolution, however, only postponed the closure of many banks and substantially raised the fiscal cost of transition. The CNB decided to run the so-called (Consolidation Programme II) and later the government announced a further programme helping medium and small sized commercial banks through a Stabilisation Programme.

It should be emphasised that the regulatory and supervision activities in these three transition countries under analysis were limited not only because of an insufficient legislative framework, but also by the lack of experience of regulators and supervisors. Therefore, the authorities had to opt for measures that alleviated this obstacle. The implementation of subordinated debt or subordinated deposit might be a powerful regulatory device. Another measure that might reduce the likelihood of a crisis would be to increase the minimum capital requirement for banks – i.e. a measure that has a relatively fast and positive impact on the banking structure. However, a side effect of rising capital requirements is that a few of small banks, which do not have any difficulties, would also have to either increase their capital or merge with a larger bank.

The last, but not necessarily worst, way of dealing with failed institutions is to revoke the banking license of the bank in question. Such a step avoids a further deterioration of the situation. On the other hand, liquidations can have negative consequences for the credibility of the banking sector as a whole. In addition, this solution can be costly particularly if a deposit insurance scheme is not established.

3.6 Effects of Banking Crises Management

In transition countries, the resolution of banking crises had three basic objectives. First, to reintroduce the intermediation function of commercial banks. Second, to mitigate the risk of systemic crises. Third, to accelerate the institutional and legislative changes supporting a market oriented economy. The method of achieving these tasks in practice has varied across countries and time. A crucial question is how to measure an optimal solution of banking crises. Dziobek and Pazarabasioglu (1997) make a decision based on improvements in banks' performance, overall economic performance and intermediation capacity. The effect of banking crises resolution has a significant lag and it is problematical to compare banks' performance when the systems face continuing disruptions.

If profitability ratios are used as a performance criterion then all three banking systems have performed poorly. The sudden fall in profitability in Hungary in 1998 is probably due to the impact of new strategic investors consolidating banks through provisions and reserves. The pre-tax return on assets (ROA) ratio is surprisingly low in all three countries, given a relatively high inflation environment. Higher inflation may also explain the better profit performance in Poland than the Czech Republic notwithstanding the more competitive environment in the latter case.

Intermediation capacity of the banking sector measured in terms of financial deepening has also limitation. This indicator shows only the dependence of an economy on credits but does not explain the impact of banking crisis resolution on the system. An extension of these indicators is therefore desirable for transition countries. The cumulative total fiscal costs of banking crisis resolution to GDP might explain not only the extension of the crisis resolution (relative to GDP), but also the efficiency of the rescue operations in individual countries. In the Czech Republic the cumulative costs of banking restructuring for the government and central bank were 25.2 per cent of GDP in 1998 (Matousek and Sergi, 2005). This is twice as high as in Hungary (12.9 per cent) and two and half times higher than in Poland (8.7 per cent). It has been clearly shown that incomplete and partial resolution in banking and corporate sectors required additional actions as in the Czech Republic and Hungary in the early 1990s. In contrary, it may be argued that this measure is biased since the scale of problems varies across countries depending on the heritage of the past.

Another indicator such as the ratio of NPLs to total loans (assets) might help us with indicating whether rescue operations were sufficient. The trajectory of NPLs is a more specific indicator of banking sector performance. Only the Hungarian banking system showed a continuous decline in NPLs. The increase of NPLs in Poland, mainly in the late 1990s, could be explained by foreign investors either overestimating true proportions of NPLs or by disclosing a true value of NPLs after privatisation.

3.7 Conclusion

Reforming the banking system proved one of the first problems for the economies in Central-East Europe. Although this issue was present in all transition countries, we have focused on the experience of the three largest countries in Central Europe. After having launched a powerful restructuring drive and also electronic banking is starting to take off, the banking market in Central-East Europe shows a much better shape than it had during the 1990s as well as a high level of convergence with current EU market; still foreign banks and capital will continue to play a key role when it comes to integrate these new commercial banks into the wider European financial market.

We saw that the indicator of non-performing loans when combined with the applied privatisation methods was the primary explanatory power in analysing an optimal banking crisis resolution. Hungary demonstrates the lowest proportion of non-performing loans and it was the first country that finished the privatisation process of the banking sector. Based on the Hungarian current situation in the banking sector, it may be concluded that the timing and the way of privatisation proved to be an essential element of banking crisis resolution. In addition, we state that the decentralised approach of banking crisis resolution combined with rapid privatisation to strategic foreign banks can represent the best solution available to domestic banking authorities.

After having reinvigorating financial and banking systems, domestic authorities in Central-East Europe started focusing on boosting the efficiency of national economies by resorting to 'friendly' tax policy, which became an additional tool of domestic economic policy in order to attract foreign investors and improve domestic business and labour competitiveness. This is the issue we analyse in the next chapter.

Chapter 4

Tax Policy and Saving in the Ongoing Process of Integration

4.1 Introduction

For the past decades, decision-makers and economists have been discussing on fiscal policy as a means of reviving economic growth and accomplishing social fairness. This piece of economic thinking is regaining strong momentum today in the EU countries and Central-East Europe as well, especially in the light of increasingly competitive economic strategies of small and medium-sized enterprises (SMEs), multinationals and governments. Two alternate options show up at the expenses of either market efficiency (i.e. the more a government steps into the economy the larger the inefficiencies would be) or a government's ability to redistribute income and provide a broader array of services (i.e. low revenue lessens a government's expenditure capability). A trade-off between a government's involvement in the economy and a higher visibility for businesspeople explains these difficulties, perhaps the absence of complete information to decision-makers to observe an optimal balance.

The tendency towards higher tax rates and brackets enabled governments to finance growing expenditures on the welfare sector and labour markets have been widespread in the advanced countries during the previous century. Nevertheless, major changes with these tendencies have been taken in the US when as part of the Tax Reform Act of 1986, the US cut the CIT from 46 per cent to 34 per cent, move that happened nearly concurrently with rate reductions in the UK and Canada. Such choices of the US President Ronald Reagan and the UK Prime Minister Margaret Thatcher to reduce tax bands and tax rates in the mid 1980s were in line with the well-known Arthur Laffer curve (he was a member of Reagan's Economic Policy Advisory Board) that there exists an optimum rate of tax at which the government revenue is maximised (see Canto, Joines and Laffer, 1982). Contenders, however, point the finger at the risk for the state not to be able to offer adequate economic infrastructures for attracting investors and competing internationally. On balance, experts and decision-makers straddle between the risks of weakening government policies and the benefits that the system can draw from efficiency and incentives (Oates, 1972).

One possible reason to resort to this tax strategy is to discourage tax evasion. Second, it can persuade unemployed to find a job or for whom are already at work to work harder. These two rationales would promote the marketplace's efficiency. A third reason behind this round of innovative tax policies is these can intercept international flows of investments and this is the novelty in market economies in Central-East Europe, as well as in the Balkan region. Following recent waves of interest on tax strategies (Sergi, 2005a, 2006b, 2007), we wish to explore this crucial theme by calling attention to the importance of overall competitiveness policies.

On one side, policymakers might think that lowering tax rates would be a means to reinforce the efficiency of Central-East European economy and to incentive national and international businesspersons as well. On the other side, policymakers have incomplete information over optimal taxation policy and this fact may inspire one country to initiate cutting tax rates while prompting other countries to respond similarly (Sergi, 2006). In the first case, we should be able to explain the causal relationship between tax policy and the economic system; in the second case, a dynamic tax policy response would cause methodical tax rivalry and the long-term effect of this is uncertain, however.

The widely held idea that governments should introduce businessperson oriented tax reforms has been regaining strong momentum in the light of mounting tax competition in Central-East Europe to the benefit of international investors. These economies are experiencing a tendency towards reducing tax rates on personal income and profits – the direction of changes is homogenous among all countries when it comes to taxes of profits – and this fact should be interpreted as a central versus peripheral tax competition game (Sergi, 2006b, 2007).

As there is no doubt that tax incentives might fuel locational decisions in the short-term, it is not less important to evaluate the long-term effectiveness of tax slashes as remedy for attracting foreign investors and the concept of tax rivalry. Such a remedy builds around mounting beliefs that a country may record large foreign investment inflows by competing on taxes. Still we have no definitive answer on how this kind of tax policy fits a country's long-term policy choice.

Historically, governments have long financed growing expenditures on the welfare sector through the use of progressive income taxes. Major ruptures with these tendencies have been taken in the US when as part of the Tax Reform Act of 1986, the US cut the CIT from 46 per cent to 34 per cent, a move that happened nearly concurrently with rate reductions in the UK and Canada. After the aforementioned Ronald Reagan and Margaret Thatcher who became the paladins of tax bands and tax rates smash in the 1980s then spurring a worldwide reduction, several other countries followed. As reported by the UNCTAD (2001), nearly 95 per cent of the almost 1,200 changes in national foreign direct investment legislation from 1991 through 2000 were favourable to foreign investors, taking the form of special incentives such as lower income taxes, income tax holidays, and import duty exemptions for foreign enterprises as well as subsidies for infrastructures. Two special examples are Saudi Arabia that reformed the tax system in 2004 and Switzerland, where 18 of the 26 Swiss cantons lowered their taxes in 2006 to attract wealthy residents gains momentum and there is a strategic tax setting by cantonal governments.

No doubt, supply-side economists influenced new tax strategies on private incentives and pre-empt inflation (Wanniski, 1978; Fink, 1984; Henderson, 1989; Sergi, 1998b). This occurred in the US, where a large part of taxpayers moved from high inflation into higher marginal tax brackets due to mounting inflationary pressures in the late 1970s. Note that the Keynesian view suggests that tax changes influence output and revenue primarily by changing the demand for goods and services: higher tax rates might amplify revenue in theory but when tax rates are above certain levels revenue may fall whereas lower taxes would spur production, which in turn reflects in a positive revenue response. The idea that a friendly tax system introduces fairness and an efficient use of resources is the other main tenet of this tax approach.

Those who were opponents during the tax debate in the US in 1975-1986, argued that expecting an increase in tax revenues on lower tax rates was unrealistic apart from a large elasticity of labour supply (i.e. an increase in hours worked due to higher after-tax wages). Empirically, however, tax cuts in the US in the 1920s (inspired by the Secretary of the Treasury Andrew Mellon) and in the 1960s (the Kennedy-Johnson tax cuts) supported the supply-side position: tax revenue collected from low-income taxpayers decreased while revenues collected from high-income taxpayers increased.

Apart from the occurrences in the US and supply-siders views, the key issue here is why several decision-makers and experts favour innovative tax policies in Europe. In theory, this approach can discourage tax evasion, persuade unemployed to find a job or for those who are already at work to work harder, thus promoting the marketplace's efficiency and acting as a break on corruption. All transition European countries are sticking to all of these rationales although the novelty is to turn a new tax strategy into an effective tool for luring international investment. Particularly the countries that need to revive their economies are at the forefront of the new fiscal strategy. Overall, new tax policies have been meeting with success. Firms tend to establish operation centres abroad and move investments and profits to low-producing cost countries, low-taxes havens; however, a country's long-term tax strategy has to be built with awareness. All these aspects come together here in Central-East European economies and serve to interpret the direction of economic reforms and future strategies.

4.2 Tax Rivalry in the Literature

We strive to relate to two strands of the literature: one of these focuses on the impact of changes in taxes on foreign investments; the other strands concentrate on the relationship between taxation and economic freedom. Firms discriminate against location advantages and disadvantages and foreign investors resort to a country's tax advantages or move away from highly taxed location (for an empirical literature survey, see de Mooij and Ederveen, 2006).

Desai, Foley and Hines (2004) found that both direct and indirect taxes exert strong impact on location investment by multinationals, and that the tax rate elasticity found is 7.7 concerning Europe and 2.3 for other countries for the direct taxes. Under a different perspective, the tendency to fiscal policy induced investment decision might escalate over time (e.g. Kubicová, 2004) due to high capital mobility. Experts believe intergovernmental tax competition is advantageous to enhance domestic efficiency; though it is not clear whether distortions from fiscal competition do arise and eventually to what extent they do, they exist in the case of asymmetric competition between small and large countries.

This latter case known as the hypothesis central – peripheral regions which is advanced by Baldwin and Krugman (2004), suggests that central regions tend to agglomerate, thereby having the chance to levy higher taxes with no risk of losing investment in the direction of peripheral regions, seeing that agglomeration might compensate for the tax advantages peripheral countries offer to investors (Baldwin and Krugman, 2004).

Egger and Winner (2004) find a link between economic freedom and taxation; a large part of the literature has already suggested with positive arguments that economic freedom fosters growth. Egger and Winner estimated the impact of economic freedom on the national tax policy (corporate tax revenues to GNP) for forty-six developed and less developed countries between 1980 and 1997: firms would be willing to pay more in exchange for economic freedom. Economic freedom would attract investors and this would enable governments to levy higher business taxes. Egger and Winner's work reveals that changes in economic freedom have equalised the international distribution of corporate tax revenues to GNP. Huizinga and Nicodeme (2003) have shown that the countries that witness foreign investment tend to have higher corporate taxes than other countries.

Moreover, increasing economic integration among countries may lead to strategic statutory tax setting. This has been found by Devereux *et al.* (2002a) in selected OECD countries in the 1980s and 1990s, and would have similar effects on corporate income tax ratios in GDP. Devereux *et al.* (2002a) have found decreasing taxation rates. Statutory corporate tax rates and effective tax rates (note that the statutory tax rate does not mirror the effective tax rate) fell for the two last decades. Grubert and Mutti (2000) observed that average effective tax rates shrank by ten percentage points between 1984 and 1992 in a sample of 60 countries.

Devereux *et al.* (2002b) experiment with tax competition with each other to attract investment and calculate a fiscal reaction function for twenty-one OECD countries in 1983-1999. They develop two models with firm mobility and capital mobility; countries would compete only over the statutory tax rate or the effective average tax rate in the first case, while countries compete only over the effective marginal tax rate in the other case with capital mobility. Devereux *et al.* (2002b) estimate the parameters of 'fiscal reaction functions' and prove that countries compete over all the three measures, particularly over the statutory tax rate and the effective average tax rate. In contrast to the aforementioned perspective, Grubert (2001) maintained that tax rates shrank over time but tax rates did not converge; this implies that tax competition has been absent.

Also, when governments compete against each other for FDI, profits from the investments may shift from the host country to multinational enterprises (Oman, 2000) and according to Blomstrom and Kokko (2003), the types of long-term benefits generated by FDI may not justify the short-term costs because perceived benefits are easily observable while some costs (tax breaks and fiscal incentives) are distributed over the long-term and hard to measure.

However, Sergi (2006a, 2007) offers another explanation of recent realities in Europe. While the linkage between tax competition and foreign capital inflow in Europe has been unambiguous for the majority of economists, yet its long-term rationale was not when modelling this part of Europe as a central versus periphery tax rivalry case. Tax competition might benefit peripheral regions versus central regions in the short term. However, peripheral regions' decision makers have incomplete information on long-term optimal taxes, and this fact routed them to engage in methodical tax rivalry among themselves and against central regions. This reality would make short-term tax advantages in the peripheral Europe, and in our case Southeast, either disappear in the long-term or exert negligible weight on investment decision at best, writes Sergi (2006a, 2007).

In this context, some suggest that the EU should harmonise corporate income taxes. However, it is claimed that tax competition requiring corporate tax rate harmonisation is not yet compelling or that peripheral regions have to compensate for missing agglomeration that is present in the central regions and harmonisation would aggravate the central – peripheral relationship (Baldwin and Krugman, 2004). When facing the trade-offs between tax autonomy and fiscal neutrality in coordinating taxes on consumption, labour, and capital, the EU member states' tax reforms should precede tax harmonisation, because the costs of distortions within member states may be greater than the gains from reducing intergovernmental tax competition, states Cnossen (2003).

This literature generates main issues: the long-term sustainability of tax competition and its degree of fairness in the wider European Union.

4.3 Dynamic Tax Policy Strategies

Central-East European countries have campaigned for lashing taxes since the 1990s, particularly implementing national level flat type tax rate. This was understood to reduce red tape and discrimination among taxpayers, to counterbalance tax dodging and cheating, to create more incentives to work, save and invest. The success of the flat tax type depends on the actual level of the tax rate: the lower it is, the more efficient it will become to swell tax revenue and spark off economic growth.

The first country to implement a uniform flat tax for personal incomes and corporate profits (26 per cent) was Estonia in 1994, although a decisive step towards lower rates was adopted since 1991. This country started a highly favourable attitude towards foreign investment, which was governed by new legislation striving to maintain liberal policies in order to attract investments. Estonia set further tax reduction in stages to be introduced by 2007, but surely important has been the Estonia decision to eliminate the tax on retained earning in 2000. Latvia followed and together with Lithuania, both have a corporate tax of 15 per cent, and tax rates on personal income at 25 per cent and 33 per cent, respectively. The three Baltic States have embarked on this fresh tax strategy in early 1990s (see *Structures of the Taxation Systems in the European Union*, 2006; as for corporate tax rates and indirect taxes, see KPMG, 2006a and 2006b, respectively).

Russia launched the kind of truly radical tax effective by of January 1, 2001. President Putin's first step was to introduce a 13 per cent personal income flat tax rate, which replaced three-bracket tax with a top rate of 30 per cent. Effective January 1, 2002, also introduced a 24 per cent corporate flat rate down from 35 per cent. Since January 1, 2003, small business enterprises have been granted either a 20 per cent flat tax on profits or an 8 per cent flat tax on revenues. Small business enterprises have also been exempted from value-added-tax, sales tax, property tax and social insurance tax.

Table 4.1 – PIT, CIT and VAT Trends in Eight EU's Central European Countries (the 1990s and 2000s)

Country	PIT	CIT	VAT
Czech Republic	1994: 6 rates 15, 20, 25, 32, 40, 44% 1996: abolition of 40% 1997: abolition of 44% rate, restoring of 40% rate 2000: abolition of 40% rate	1991: 55% 1993: 45% 1994-1998: gradual reduction of the rate to 35% 2000: another reduction of the rate to 31% 2004: 28% rate	1998: standard rate 23%, reduced rate 5% 1995: standard rate reduced to 22% 2004: single 19% rate, lowering of registration threshold
Estonia	1993: 3 rates 16, 24 and 33% 1994: flat rate 26%	1991: 3 rates 15, 23 and 39% 1992: single 35% rate 1994: rate lowered to 26% 2000: abolition of the tax, if profits are invested	1991: 10% rate 1992:standard rate 18%, 1994: limiting of exemptions 2000: reduced rate 5%
Hungary	1988: 10 rates: 20, 25, 30, 35, 39, 44, 48, 52, 56 and 60 % 1990: 4 rates 15, 30, 40, 50% 1992: 3 rates: 25, 35 and 40% 1994: 2 rates added: 20 and 44% 1997: 6 rates: 20, 22, 31, 35, 39 and 42%	1989: 40 and 50% rates 1990: rates reduced to 35 and 40% 1991: 40% rate 1994: 36% 1995: 18% rate 2002: limiting of investment deductions (according to EU rules), and	1988: 3 rates 0, 15 and 25% 1993: standard rate 25%, reduced rate first 6, then 10% 1995: reduced rate raised to 12%

	1999: 3 rates 20, 30 and 40%	introduction of simplified system for companies (including individuals running businesses) with turnover up to 15 million HUF, 15% rate 2004: 16% rate	
Latvia	1991: 5 rates from 15 to 35% 1997: flat rate 25%	1991: 3 rates 15, 25, and 35% 1993: basic rate 25% and higher rates for financial sector and trade 1995: single 25% rates 2001: rate reduced to 22%	1992: 10% turnover tax 1992-1993: rate raised to 12% and 18% 1995: VAT standard rate 18% 2003: reduced rate 9%
Lithuania	1991: rates from 18 to 33% 1994: single 33% rate	1991: basic rate 29% 2000: rate lowered to 24%	1994: VAT basic rate 18%, reduced rate 9% 2000: reduced rate 5% 2001: second reduced rate 9%
Poland	1991 – 3 rates 20, 30 and 40% 1994 – rates raised to 21, 33 and 45% 1997-1998: top rate reduced to 44% and 40% 1999: 3 rates 19, 30 and 40%	1992: 40% rate 1998-2002: gradual reduction of the rate to 27% 2004: rate lowered to 19%	1993: standard rate 22%, reduced rate 7% and numerous exemptions, 1994-2002: gradual curtailing of exemptions
Slovakia	1993: 6 rates from 15 to 47% 1994: top rate reduced to 42% 1999: 7 rates from 15 to 47% 2001: top rate reduced to 42% 2002: 5 rates from 10 to 38% 2004: flat 19% rate	1993: 45% rate 1994: rate reduced to 40% 2000: rate reduced to 29% 2001: rate reduced to 25% 2004: rate reduced to 19%	1993: standard rate 23%, reduced rate 6% 1999: reduced rate raised to 10% 2003: standard rate 20%, reduced rate 14% 2004: single 19% rate
Slovenia	1993: 6 rates 17, 35, 37, 40, 45 and 50%	1994: 30% 1996: 25%	1999: standard rate 19% reduced rate 8% 2002: reduced rate 8,5%

Sources: Various governments' statistics.

Ukraine has implemented in 2003 a 13 per cent tax on personal income (replacing five brackets 10-40 per cent) and a 25 per cent tax on profits (down from 30 per cent). Moldova is bringing its corporate tax rate down to 20 per cent from 25 per cent and lowering top tax rate on personal income to 22 per cent from 32 per cent. Poland cut taxes on profits from the 40 per cent in 1992 gradually to 27 per cent in 2002 and again a further reduction of 8 percentage points to 19 per cent as of 1994.

Slovakia reduced CIT 29 per cent in 2000 to 25 per cent in 2002 and 19 per cent effective January 1, 2004. Slovenia, unveiled a plan to reduction taxes on profits from the current 25 per cent (introduced in 1996) to 23 per cent in 2007 and to 20 per cent by 2010. In 2005, comprehensive tax reforms took effect in Georgia and a 12 per cent flat tax on personal income has been inaugurated by parliament.

In other countries, tax burdens are already low though a definitive move towards a flat tax and tax burdens much lower than those in place in Western Europe and North America is advocated. Former Poland's Finance Minister, Mirosaw Gronicki, has suggested a flat tax rate of 18 per cent on personal income, business profits and value-added-tax attempting to win back voters in September 2005 and overcome the proposal made by the Civic Platform party to introduce a 15 per cent flat tax on personal income and profits (note that Poland is still now applying a top 40 per cent tax on personal incomes and a top 19 per cent tax on profits). Since the general elections took place and two major right-wing coalition parties won the majority, we should expect a major change in Poland's tax policy in the future. The Czech Civic Democratic Party proposed a 15 per cent flat tax on individuals' and corporations' incomes, down from the actual top 32 per cent and 24 per cent rates, respectively (note that the Czech Republic is applying a top 32 per cent tax on personal incomes and a top 24 per cent tax on profits).

4.4 Recent Tax Strategies and Unveil Tax Plans in Western Europe

The Irish experience and decisive steps in rearranging tax systems throughout Europe have received large attention. The most radical feature in Central-East Europe is the adoption of the typical tax strategy for a market economy (i.e. personal income tax, corporate income tax, and value added tax) starting at the end of the 1980s and in the 1990s. Given the importance of the issue, these reforms are of great importance and interest for their own sake. However, after this new tax approach has been started, national policymakers tighten up the experiment in a way to not only modernise their economies, and make the system more efficient and transparent, but especially with the promise to be highly attractive for foreign investment. The trend towards lowering taxes on personal income, which began in the 1990s, and the passage from the turnover tax to the value added tax, has attracted attention. Also, the direction of change in corporate income taxes and the associated tendency to engage in a tax game between peripheral and central regions in Europe, which started in the 1990s and reinforced in 2000s, was and is a remarkable event in itself and has inspired some to believe that this tax practice is 'harmful'.

A campaign against the so-called 'harmful tax practices' began in May 1998, when the OECD published *Harmful Tax Competition: An Emerging Global Issue*, still the main logic behind the report deserves a coherent analysis. This is particularly true in Europe, which is characterised by poor and advanced areas, or rather central and peripheral regions.

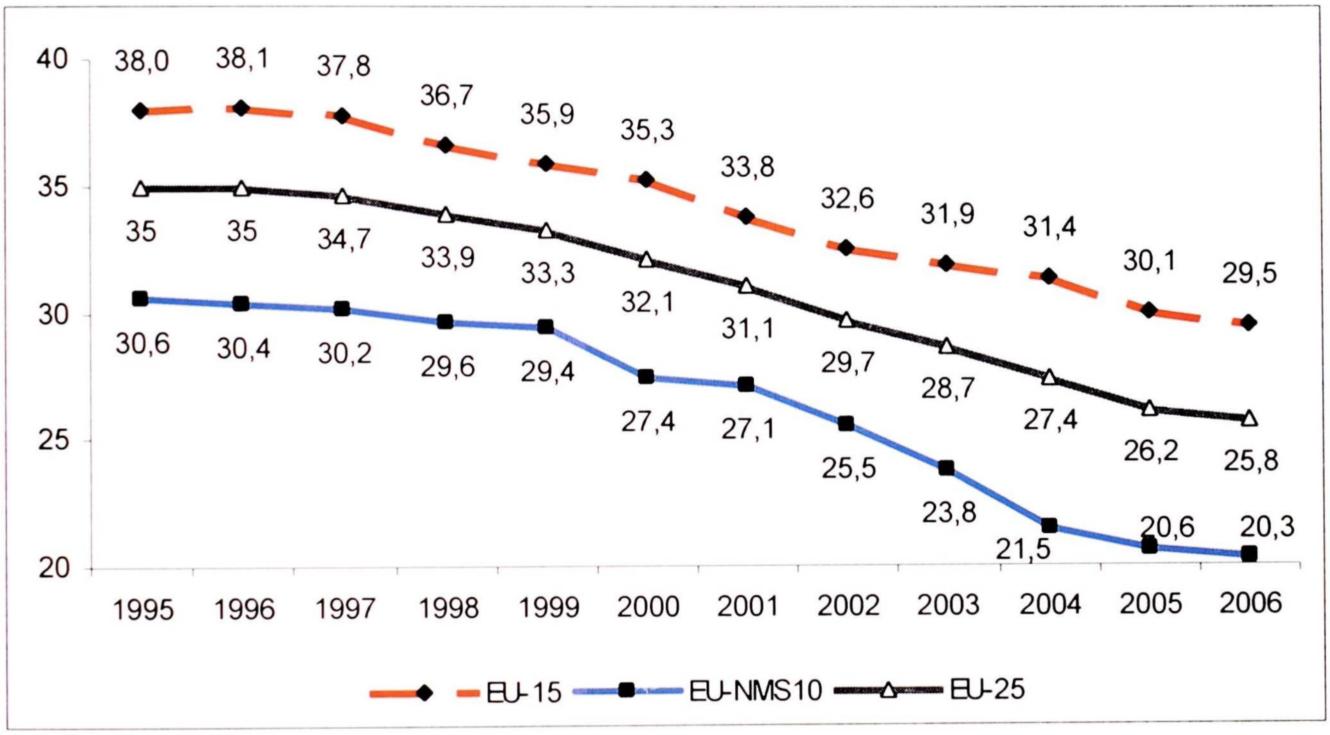
We confront with this issue here by starting with Ireland. Ireland had adopted friendly tax regimes in the 1980s and since that time, other countries have significantly cut their tax rates. This resulted – with other investment incentives to investors – in a foundation stone of an economic success, the creation of one of the wealthiest countries in the EU. The overall tax burden in Ireland is now one of the lowest in Europe, and its 12.5 per cent corporate tax rate has been cited as a major ingredient in Ireland's economic growth in recent years. This rate has been conforming to the European Commission's plan to replace the 10 per cent tax rate on manufacturing profits in place since 1981. A phasing out regime applies to industrial manufacturing until 2010, licensed Shannon operations approved on or before 31 May 1998 and other services operations (*Structures of the Taxation Systems in the European Union*, 2006; KPMG, 2006a).

As Ireland has been the first country in Europe to embark on a comprehensive new tax strategy as a main instrument of economic recovery, does current tax competition in Europe resemble Ireland's policy? In actuality, the debate that followed the Irish experience concerned tax policy and several countries in

Central-East Europe have adopted a similar competing approach, as we have seen in the previous section.

Statistical figures substantiate occurrences in other Western European countries. Austria cut the tax rate on corporation profits from 34 per cent in 2003 to 25 per cent in 2005; Portugal from 33 per cent to 27.5 per cent; Belgium reduced its corporate income tax from 40.2 per cent to 33 per cent in 2003. Denmark agreed upon slashing corporate income taxes from 32 per cent in 2000 to 30 per cent in 2001; Greece a cut to 35 per cent in 2003 from 40 per cent in 2000 and the country announced further cut tax rates. Iceland cut corporate tax rates to 18 per cent in 2002 from 33 per cent; Luxembourg to 30.4 per cent from 37.5 per cent.

Fig. 4.1 Development of Adjusted Top Statutory Tax Rate on Corporate Income (1995 to 2005, in per cent)



Also the Spanish Prime Minister Zapatero has considered the adoption of a flat tax rate on incomes in that, following the recommendations of Miguel Sebastian, one of the government's advisors (i.e. 30 per cent instead of the current tax bands, which tops out at 45 per cent; the corporate top rate is 40 per cent). To face unemployment now, over 6 per cent of the workforce, the Dutch government wants to offer tax breaks and boost spending for education and the environment. The Prime Minister Jan Peter Balkenende attempting to face low approval rating ahead of general elections in 2007, planned to reduce taxes at middle-income families with children and reduce corporate taxes. In addition, the Swedish Social Democratic government is facing high unemployment and the government wants to reduce taxes on lower- and middle-income workers, lower payroll tax on new hires by small, one-person firms.

However, Germany is a very enlightening example being the largest European economy suffering from companies that are shifting production to countries in Central Europe where corporate taxes and labour costs are comparatively competitive. Germany's unemployment rates hit a post-war high in March 2005, with a 12 unemployment (according to seasonally adjusted figures), compared with about 5 per cent in the UK and the US (seasonally unadjusted figures are even worse). Schröder announced in March 2005 an extension of the labour market reform known as 'Agenda 2010' in such a way that he would push through tax reforms and drop federal tax on profits from 25 per cent to 19 per cent. Note, however, that this slashes the 38.3 per cent to roughly 32 per cent when taking into account local business taxes and the solidarity tax; closing tax loopholes and raising taxes on dividends will mostly offset Germany's tax cut rate, and this fact represents a key issue to debate next. In spite of announcements before general election in 2005, the new German government will not push for tax slashes.

Recently, Switzerland is an example of strategic tax setting. The country has some of the lowest corporate tax rates in the world, attracting multinational companies to set up holdings in one of its 26 cantons. A recent survey showed that 18 cantons intend to lower their taxes in 2006, to slash the levy on wealth and share dividends to attract wealthy residents and businesses. This gains momentum in cantons such as Zug, Schwyz, Nidwalden and Obwalden, to attract wealthy people and international investors with the lure of low taxes heated up on January 1, 2006, when Obwalden introduced the lowest corporate rates among cantons, and to introduce a regressive income tax system that reduces rates as income rises (especially for those earning over USD 233,000 a year). Empirical evidence shows that Swiss taxpayers reside where income taxes are low and that there is a strategic tax setting by cantonal governments: the result is that the income tax rates in cantons are lower, lower tax rates than neighbours (see Feld and Reulier, 2005).

To summarise, the unweighted average for corporate income taxes decreased from 33.6 per cent in 2000 to 30.8 per cent in 2003 in OECD countries, from 35.1 per cent to 31.7 per cent in the EU-15 and figure 4.1 depicts this tendency in the EU-15 and the ten new member states over the prior ten years, showing a decline in both sides of the EU though more marked appears the decline in the new member states. Note, however, when engaging in tax competition, OECD decision-makers should bear in mind that taxes on corporate income provide some 8 per cent of their countries' overall tax revenues and that the average ratio of corporate income taxes to GDP has been constant over the past twenty-five years. Moreover, this might not be changed abruptly in non-peripheral regions and there are difficulties about how to set an unvarying optimal tax policy in theory as well. Finally, we cannot even rule out the hypothesis that decision-makers cannot observe the optimal trade-off because of incomplete information or rather that they plan to interpret tax policy demagogically ahead of a general election.

Last but not least, a brief look at the competition between Europe and the US is noteworthy. The US combined (i.e. federal plus state level) corporate tax rate is at 39.4 per cent, that is, a 34 per cent CIT introduced in 1986, which in fact rose by 1 percentage point to 35 per cent in 1993, plus roughly 4.5 per cent state CIT (after accounting for the deductibility of state income taxes against federal income taxes). *The Wall Street Journal Europe* (28-30 January 2005, p. A9) reported that the effective tax rate for US companies operating in Europe in 2002 would have been 9 per cent in Portugal and in the Netherlands, 12 per cent in Belgium and 13 per cent in Spain, according to Martin A. Sullivan (2005). By way of comparison, the effective tax rate in the US has been calculated at some 32 per cent in 2001 by Jane Gravelle of the US Congressional Research Service, or approximately 10 percentage points higher in the US than the European average, as calculated by Margie Rollinson at Ernst & Young (Gravelle's and Rollinson's studies are quoted in *The Wall Street Journal Europe*, 28-30 January 2005, p. A9).

Nevertheless, a comparison between statutory corporate tax and the average effective tax rate across the Atlantic is not straightforward. This is a result of the American system that taxes less labour and consumption than the practice in vogue in Europe. Second, the distribution of tax revenue among major taxes explains differences between the two sides of the Atlantic. While Europe relies more on social security contribution, the US collect more money from personal income and property taxes. Third, the tax-to GDP ratio was 25.4 per cent in the US while 40.6 per cent in the EU-15 in 2003. Therefore, the US tax base is narrowly defined and our reported figures and tax policies should be judged with more care when making comparison (see also Weiner, 2006).

4.4.1 Recent Experience in Southeast Europe

In Southeast Europe, the reform of tax systems is largely enhanced due to a more stable political climate in the region. Yet, however, the reforms are being implemented at a varying degree of intensity and in different modes and ways. Serbia launched a new tax codes in 2003, by resorting to a comprehensive 14 per cent flat tax on personal income and corporate profits, though the country has been setting up a 10 per cent flat tax for most forms of personal income. In an attempt to lure further resources and compete more strongly with other neighbouring markets, Hungary lowered corporate taxes to 16 per cent from 18 per cent and dropped the top tax rate on personal income to 38 per cent from the previous 41.5 per cent (although recent difficulties in meeting public finance equilibrium prompted a sort of U-turn in tax policy).

In 2005, tax reforms took effect in Romania: Prime Minister Calin Popescu Tariceanu implemented a flat income tax rate of 16 per cent and adopted a flat corporate income tax rate of 16 per cent to be enforced starting 1 January 2005, which aims at preventing tax evasion, time corruption and at attracting foreign investment. The new system enforced with a special ordinance on 29 December 2004, replaced the previous personal income tax, which consisted of five brackets (top of 40 per cent), and top business profits rate of 25 per cent.

Table 4.2 – Personal Income Tax (PIT), Corporate Income Tax (CIT) and VAT Trends in Southeast Europe (the 1990s and early 2000s)

Country	PIT %	CIT %	VAT %
Albania	6 rates from 5% to 30%	30% rate	1996: 20% rate
Bosnia and Herzegovina	Flat rate of 10% for income from work, other income covered by rates from 30% to 50% In Republika Srpska: 9% rate on income from work and 4 rates, from 0% to 25%	30% rate In Republika Srpska 20%, 15%, 12% and 10% rates (regressive schedule)	Sales tax: 24% and 10%, food: 0% In Republika Srpska: 20% and 10%, and 0%
Bulgaria	1992: 6 rates 20%, 24%, 28%, 32%, 36% and 40% and 4 rates from 20% to 40% 2002: rates from 0% to 29%	2000: 25% rate, 20% for small businesses 2002: 23.5% rate	1994: 22% rate 1999: reduced to 20%; exemptions
Croatia	1994: 00:00 2001: 3 rates from 15%, 25%, 35% 2003: additional rate of 45%	1994: 20% rate	1998: 22% rate, 0% on books, basic food, medicines, municipal and financial services exempt
Kosovo (UNMIK: (United Nations Mission in Kosovo)	2002: 3 rates 0%, 5% and 10%	2002: 20% rate for big companies and simplified for small businesses	2001: VAT rate 15%, few exemptions 2002: reduction of turnover registration threshold to EUR 50,000
Macedonia	2 rates: 15% and 18% (previously: 3 rates from 23% to 35%)	15% rate (previously 30%)	2000: 19% rate, reduced rate 5% on electricity, agricultural products
Montenegro	2006: 4 rates: 0% (up to EUR 65), 16% (+0 EUR on income from EUR 65 to 218), 20% (+24.40 EUR on income from 218 to 381), 24% (+57 EUR on income over 381 EUR).	2006: 15% rate	2006: 17%
Romania	2003: 5 rates: 18%, 23%, 28%, 34% and 40%	2003: 25% rate (previously 38%)	1993: 22% rate and 11% reduced rate 2003: 19% rate and 9% reduced rate, exemptions: financial and public utility services
Serbia	14% flat rate on income from work; from other income rates of 10%, 15% and 20%	Rates: 20%-30% 2003: 14%	Sales tax: 20% rate, exemptions: public utility services, some food products 2005: VAT rate 15%, 8 and 18% rates

Sources: Various governments' statistics.

Bulgarian Parliament has unanimously passed a law by which the corporate tax rate is cut from 15 per cent down to 10 per cent from 1 January 2007. Macedonia enjoys a 12 per cent flat tax on profits and personal income will cut both to 10 per cent as of January 2008.

Table 4.3 – Current Tax Rates in Southeast Europe (flat or top)

	PIT	CIT
Albania	20 Top	20 Flat
Bosnia-Herzegovina	5	30
Bulgaria	10	10
Croatia	15 – 45	20
Hungary	18 – 38	16 Top
Kosovo (UNMIK: (United Nations Mission in Kosovo)	15	20
Macedonia	12*	12*
Montenegro	16 – 24	15
Romania	16 Flat	16 Flat
Serbia	14	14
Slovenia	17 – 50	25

Notes: *) 10% from January 2008; tax exemption on reinvested profits. **) 10% for most of personal income.
Sources: Various governments' statistics.

Under a different angle, value added tax (VAT) has been introduced in Bosnia and Herzegovina and in Serbia in 2006 (KPMG, 2006b). Kosovo (UNMIK: United Nations Mission in Kosovo) introduced a new tax system, which presents a unique case of a system created in absence of internal pressures or political dialogue (Grabowski, 2001). The new tax system has been kept simple and taxpayer-friendly. In this respect, it should be noted that the VAT has a single rate of 15 per cent, whereas a reduced rate of 0 per cent applies to agricultural production inputs. Tariff rates on imports are 10 per cent. A reduced rate of 0 per cent is also applicable, and it applies to imports of certain capital and intermediary goods. As regards personal income tax rates, they vary from 0-20 per cent. In any event, the general trends regarding the taxation of income in Southeast Europe show a considerable degree of similarity with the trends observed in many EU countries. In all Balkan countries, the rates of both corporate income tax and personal income tax are very low, sometimes even lower than in several EU countries. Taxes on profits are also very low in Bosnia and Herzegovina, Montenegro and Serbia.

4.5 Peripheral Versus Central Regions Tax Competition in Europe

The tax ratio has fallen below the levels in advanced market economies. Indeed Central-East Europe is jumping on the flat tax bandwagon. This strategy could be a magnet for investment and economic growth, this has led to the accusation of 'unfair tax competition' and 'tax dumping', and simply that some governments are strategising their tax rates at the expenses of other countries' attractiveness. In the light of previously mentioned figures, statutory corporate income tax rates in the EU-15 declined from 35.1 per cent in 2000 to 31.7 per cent in 2003, partially to face tax rate competition and to avoid losing further business activities because of 'an unequal corporate-tax burden in Europe'. Germany is the largest European economy that is suffering from the fact that many companies are shifting production to countries in Central-East Europe where corporate taxes and labour costs are comparatively lower.

Fears of negative effects on labour markets are scattering in Europe, as new EU-member states could lure companies, jobs and investment flows. To thwart risky tax competition, a tax corridor has been proposed through which minimum and maximum corporate tax rates could be put in place. In addition, during the hearing of Laszlo Kovacs, the then designated European Commissioner for Taxation, he expressed in favour of the creation of a common consolidated corporate taxation base (European Parliament, 2004). Recently, Kovacs told a gathering of the Irish Business and Employers Federation, the Irish Bankers' Federation and members of the European Parliament that formal plans for a common EU corporate tax base will be unveiled soon and the Commission will present revised proposals on a Common Consolidated Corporate Tax Base[6]; this would be in line with the suggestions made in the Bolkstein Report and published

6 <http://www.tax-news.com/asp/story/Ireland_Prepares_Defences_Against_European_Tax_Harmonisation_xxxx27087.html>.

by the European Commission in 2001 aimed to skip unfair competition for foreign investment and prevent uneven foreign investment distribution. Commissioner Kovacs hopes the proposals would be in place by the end of 2008. This move is intended to bring transparency and simplification and a significant reduction in compliance costs for businesses operating within the EU ad this idea is favoured by France and Germany[7]. In fact, some complain that their contributions to the EU budget to support structural and cohesion funds in favour of new members could end up paying for tax cuts and Western European leaders expressed fears that transition economies cut taxes because any lost revenue would have been more than compensated by subsidies from Brussels, this leading to 'unfair tax competition' or 'dangerous tax-dumping', luring investment away from higher tax countries. For example, Gerhard Schroeder even accused some Central-East European countries of filling the hole left by the low tax income with their high EU payouts and 'it would surely not be conceivable that through the EU budget we end up effectively financing an unfettered internal tax battle', Schroeder said in 2004[8]. The transition states that could undergo negative effects have repeatedly refuted this argument.

Our discussion of the key issue will be in three main points. The first point is whether 'tax dumping' is at work in the EU. Undeniably, Central Europe has lower corporate tax rates, and tax burdens on corporate profits are approximately 15-20 per cent, much lower than in Western Europe, and the East proffers several investment incentives too. All the same, this reveals nothing about the effective tax burden and how the tax base is formed (i.e. a company's debt, machinery depreciation, etc.). This approach can be deceiving when comparing countries. First, the statutory corporate income tax rates have fallen in the EU countries during the 1990s, but have been accompanied by a broadening of the base rate. Second, several European governments grant deductions, exceptions and kinds of tax relief (e.g. R&D, investment in poor areas). As a result, effective tax rates vary from statutory tax rates and for instance tax systems are so thorny in some

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7 Note that initiatives towards tax harmonisation in Europe date back to the early 1960s at the time of the Neumark Report in 1962.

8 <http://www.eupolitix.com/EN/News/200405/4763d60f-eb7c-4a8a-81a4-9b6ed29fb441.htm>.

countries that the effective corporate tax rate can be estimated much lower than the statutory rate, and some larger companies enjoy so many tax breaks that their effective tax rate is very low somewhere in Europe.

The second point is about whether the EU is actually financing peripheral Europe's tax cuts through its common budget. The EU has put aside approximately €40 billion for enlargement in 2004-2006, while the newcomers also have to pay their dues into the EU budget, leaving them notionally with a net balance closer to €25 billion. The EU financial support is earmarked for regional development and farmers, which means that it will only help to keep Central-East European taxes low as long as it can still replace national budget spending. Therefore, this criticism goes too far also in the light of the current tendency to harmonise tax base in Europe. The European Commission just adopted several common rules about tax base, and this policy is expected to continue. One study that simulates the effects of tax coordination Sorensen (2001) concludes that the welfare gains from such coordination would be modest in the EU, between 0.16 per cent and 0.35 per cent of GDP. This is true particularly in the case that this sort of coordination should remain within the EU. On the other hand, only regional tax coordination can end with advantages for non-participant countries, as they may become even more attractive for investors. Nevertheless, the EU cannot oblige member states to design a specific tax system (apart from common rules for those taxes that shape the functioning of the single market, such as value-added tax, excise duties, and some aspects of direct taxes), except fighting against what it is perceived as a harmful tax competition. In doing so, the EU has asked the newcomers from Central-East Europe to phase out all discriminatory tax incentives, and have cut overall statutory tax rates for both domestic and foreign investors in the run-up to membership.

The third point relates to the question of how much of a country's competitiveness and investment decision is tax-driven in the peripheral regions in Europe? How much of FDI and thereby economic growth achieved in Central-East Europe was realised through tax slashes? Concerning the first question, we do not want to deny the importance of tax incentives on economic growth, yet the economic growth in Central Europe and the first wave of foreign investment flows have been rooted in the economic reforms and positive economic expectations (Sergi, 2003b and 2006). Foreign capitals have helped to carry out privatisations largely but no one can deny that tax competition was not generalised in Europe in the 1990s. Granted a new tax system with precedent economic growth in Central-East Europe is not entirely truthful: the economic growth could happen in the 1990s on positive expectations of further economic expansion; still the positive impact of changes in the tax systems has been one of the factors contributing to buoyant foreign investment in the 2000s.

4.6 Rejuvenating Central-East Europe

It is well known that effective tax rates on corporate profits have been a significant tool to attract foreign investors and this fact will be equally important over coming years. Investors and policymakers focus on the importance of the overall investment climate, as several other factors besides taxes determine a country's competitiveness over the long-term. In actuality, competitiveness in an interacting and multifaceted international business environment which asks for continuous efforts to keep costs in labour markets pace with workers' productivity growth, to eliminate regulatory restrictions whenever possible, to reduce the high tax wedge and payroll taxes in order to cut the cost of hiring.

These changes could have consequences for many aspects of the economy and for investors' long-term strategies. By way of example, Hungary's experience is very revealing: the country has witnessed close to ten foreign investors, such as IBM and Philips, moving some or all of their Hungarian operations to cheaper locations further East and South in Europe.

Perhaps less valued is the fact that international and regional competition depends on the strength of several factors that drive the business process. As fierce competition is growing increasingly important, decision-makers in Europe introduced the cutting of tax rates (and other incentives such as cash grants, fixed-term tax relief, and labour subsidies) to keep attracting investors. Moreover, policymakers do not have complete information on optimal tax rates and cutting tax rates could have become a systematic policy in Europe where a country's first move is followed by another country's reaction.

However, the combined implication of this action-reaction tax policy has been less considered. Although authors have calculated that FDI are also elastic to tax changes and we can conclude that taxation incentives can play an important role in the investment decision in a country, the tax competition argument is central when confined to a short-term horizon; much less when we shift the analysis from the short-term to the long-term. Decision-makers in peripheral regions keep competing against each other because they emphasise tax breaks as a long-term panacea, or rather, they simply fail to spot the optimal tax rate: both these facts push them to initiate an endless tax game. That is, long-term effects from tax competition have been emphasised (although Blomstrom and Kokko, 2003, state that perceived benefits are easily observable while some costs are distributed over the long-term and hard to measure), but the rationale behind these occurrences could steer the business environment towards a convergence of investment opportunities when they are based on tax advantages only. That is, starting a tax competition between central and peripheral countries in Europe could likely manoeuvre national business environments towards tax equalisation. In the long-term, resorting to systematic tax slashes necessarily makes peripheral EU regions work with a fiscal tool that would exert no impact on investors' international strategic decisions in the long-term simply because effective tax rates would converge on the same level (Sergi, 2005a, 2006b, 2007). Therefore, if taxation incentives are important in the short-run, other factors can contribute to investment decisions. This aspect needs another piece of information. Buoyant economic growth in peripheral regions is helping maintain state revenues adequate for a budget in equilibrium; nevertheless, what would happen to public finance should the economic growth slow down sometime in the future without a serious restructuring of policy priorities and public revenues? Therefore, the debate has to be firmly based on the long-term wisdom of tax strategy among peripheral and central regions, without overlooking competitiveness taken as a whole. If competition in Europe calls for innovative policies, rejuvenating peripheral regions in Europe rests also on technological innovation, less rigid labour regulations, and the smallest tax wedge. If it seems that the most important challenge for the European Commission is to introduce a definitive tax policy harmonisation, tax competition race could hit a new level. Should the latter be the case, short-term fiscal policy advantages would become vague among peripheral regions in the medium- and long-term.

If, on one side, lower effective corporate tax rates are partially conducive to attracting foreign investors and there is no theoretical doubt about that, observers should focus more on the importance of the overall investment climate. It is possible to call attention to the fact that a number of other factors besides taxes determine a country's competitiveness. For instance, a peculiar reason that has pushed wholesale and retail investors towards Central-East Europe could have been an expected rising income, as found by consultancy firm A.T. Karney (2004). The report expresses good confidence by ranking Hungary 2nd, Poland 4th, Russia 5th, the Czech Republic 7th, and the Baltic States 13th. Competitiveness in an interacting and multifaceted international business environment ask for continuous efforts to keep labour costs under control, to eliminate regulatory restrictions whenever possible, and further overhauls.

Turning now to foreign investment, the point is, what most serious risk to competitiveness goes first, labour costs, tax rates, political instability or other factors? It is worth resorting to the 'FDI Confidence Index' survey for 2004 published by consultancy firm A.T. Kearny, based upon CEOs, CFOs, and other top managers of world's largest 1,000 firms concerning their standpoints of best FDI destinations. While China maintained its position as the best and most attractive FDI location and India jumped from sixth to third most convenient place (note that almost all Asian economies jumped in the highest position in the index); the top Central-East European countries are Russia and Poland, which however lost grounds as Russia ranks 11th most attractive market globally but moving down from the 8th place in 2003; and Poland 12th from the 4th place. The survey shows some fading confidence in terms of investors' attractiveness and expected profitability. While the Czech economy ranks 14th from the 13th, Hungary ranks 19th down from the 17th post. And 'With the novelty of EU membership fading, corporate investors are anxious to see how these markets perform given the challenges that the EU accession poses' (A.T. Kearney, 2004, p. 21).

This same survey pinpoints the most important risks to the competitiveness of the new ten new EU member states. Analysts vary in scoring these risks and perhaps a blend of factors would affect competitiveness. Despite business-friendly tax policy, a large part of this debate is focusing on having a business-friendly tax system, investors would like a 'business-friendly marketplace', which should be characterised by low taxes, low labour costs and low regulatory restrictions, among others. To back up fast growth rates and improve business, the overall business environment is at least as important as low-wage, high-skilled workers and business oriented tax system. The two most important risks are poor infrastructures and corruption. A role for a broad tax policy could partially be seen in a few cases (e.g. erosion of low cost advantage, labour market rigidities, low purchasing power, phasing out special investment zones), but tax competition is not directly reported in the survey and seem not to be crucial to investors.

Table 4.4 – Most Serious Risks to Competitiveness in the New European Union Member States, (2004)

	Percentage of total respondents
Poor infrastructures	*67*
Corruption/lack of transparency	*60*
Erosion of low cost advantage	*53*
Macroeconomic instability	*41*
Inefficient supply chain	*35*
Poor labour skills/education	*28*
Managing market reform	*28*
Labour market rigidity	*27*
Political instability	*27*
Low purchasing power	*20*
Phasing out special investment zones	*13*
Limited offshore/outsourcing opportunities	*13*
Completion of privatisation programmes	*11*

Source: Kearney (2004), p. 21, Fig. 9.

One appealing feature of any tax system to be the major factor contributing to significant increase in FDI is that tax advantages are 'generous' and 'persist over time: these two characteristics secure the attention from foreign investors. While it is difficult to get a precise measure of the relative contribution of tax advantages to FDI, recent statistical figures indicate that changes in the tax system in European emerging markets may have been one of the key factors contributing to this outcome. However, as long as tax competition hits a new level in Europe, the interest of international investors in one particular country or another tends to vanish. That is, tax elasticity could equalise among these peripheral regions and a tendency towards equalisation in turn would happen between peripheral and central regions. The probability that a multinational enterprise prefers one country or another within the same peripheral area upon mere tax advantages fades away.

If tax advantages could have been advantageous in the recent past, unit labour costs, other financial incentives, and geographical locations are equally important, and laying emphasis on tax advantages would be an oversight in the long-term. In addition, shifting profits to tax havens is another way to skip national tax disadvantages; this could induce big corporations to have plants in several countries. It follows that tax advantages may not be enough to attract FDI in the end because big corporations could still exploit a specific country's tax legislation while having a plant somewhere else at the same time. Simply, the phenomenon of FDI, outsourcing (what Bhagwati, 1984, termed the 'long-distance' purchase of services abroad) and international business in Europe requires a comprehensive rather than a narrow tax-policy scrutiny in the end.

Governments in Central-East Europe introduced and developed one-size-fits-all tax regimes and new labour market regulations during the transition from paternalistic economics to the market. No doubt, new tax policies had very different implications for the behaviour of economic agents and international business competitiveness, as explained by the economic theory. Low taxes on corporate profits augmented these countries' chances to receive larger awareness from international investors. In addition, this unique tax policy encouraged better governance, increased the willingness of people to work and magnified the positive effects of entrepreneurship in a number of respects.

Yet, the economies that initiated this kind of tax competition policy must be able to conceive long-term business policies. Policymakers overemphasised the all-cure virtues arising from tax reduction and we believe there are no questions concerning the effectiveness of this kind of strategy to shape and incense short-term investment decisions. However, triggering international tax competition in order to energise national economies carries several implications as well. European peripheral regions underwent tax rebates in order to entice foreign investors and incurred no major budget deficit issues. Although one possible answer to this dilemma is that these economies are still experiencing sustained economic growth rates, we find that a country's competitiveness engineered by the way of tax slashes, pushes a concurrent country to systematically neutralise its tax disadvantages by systematic waves of tax reduction. However, when tax competition increases, concurrent countries are more than willing to offset national economic disadvantages by way of tax reduction. It follows that statutory and effective tax rate differences among countries trim shrink over time and converge to equilibrium; this contradicts any tax system that aims to be a major factor to FDI if tax advantages are not 'generous' and 'persistent over time.

Therefore, focusing on short- and long-term strategy under a coherent and unique business strategy is crucial towards a successful strategy in Central-East Europe. As we are apt to accept the Sergi (2007) reading of Europe as a central versus periphery tax rivalry case, tax competition might benefit peripheral regions versus central regions in the short term but winning international investment inflows should shift from mere national tax advantage approach, which is short-term based, to overall business competitiveness. Foreign investment may fill an unsatisfactory endogenous capital supply in the short-run, but an effective business climate should become the unavoidable national policymakers' long-term plan.

4.7 Conclusion

In an attempt to lure further resources and to compete more strongly with other neighbouring markets, Central-East European economies implemented new tax policies of the type already introduced in Ireland in the 1980s. Tax policy became a means to revive national economies under a supply-side point of view and to make these economies more efficient and open to foreign businesses. While foreign investment and the presence of foreign enterprises both in financial and manufacturing sectors has become quite relevant, the issue of international interactions with other markets and international competitiveness of these economies. There is no country in the world today that is economically self-sufficient without some sort of interdependence with other countries. The international community once more finds continuity around the process of globalisation and its institutions, which is perceived as both positive and negative at the same time. Because globalisation is becoming highly competitive, the European and international environment have created enormous challenges for Central-East European economies and this issue is analysed in the next chapter.

Chapter 5

Towards Globalisation and Economic and Cultural Transformation

5.1 Introduction

Globalisation, internationalisation and global entrepreneurship have never been of such significance as they are today and it is indeed paradoxical that such a phenomenon could be so revered by some while dispersed by others. In many of his works, Streeten (2001) recorded up to thirty-five definitions of globalisation; multinational corporations see globalisation as producing a wide spread of democratisation and development for underdeveloped nations, and, of course, is good for business. Antiglobalists purport that globalisation manifests famines, wars, diseases, and to them, the only good thing about it is boosting profits for transnational corporations (TCs) who are indeed undemocratic. In contrast to this view, entrepreneurial enterprises and competition among them had an important role in fostering economic growth regionally and globally, providing a significant addition to real GDP growth and employment opportunities (OECD, 2002). Surely, globalisation provided more opportunities than threats for entrepreneurs to expand their business opportunities worldwide.

Globalisation is the comprehensive solution that many companies are now exploring. Many of the world's largest firms are truly global, and even their smaller counterparts increasingly participate in cross-border activities by subcontracting – having customers and joint venture partners collaborate with them around the globe. The arena of international management and global entrepreneurship has never offered so many opportunities and challenges to individual managers, businesses, governments, and the academic community alike. The expansion of the global market has created a need for managers who are familiar with the problems of international trade such as culture, political structure, foreign exchange, geographical terrain, time, food, and technology, which indeed is a paradox in itself. Hence, the paradox of something perceived to be so beneficial could be problematic in terms of obtaining the necessary skills to manage while maintaining cultural and national identity. More importantly, international management demands a contingency approach to the ever-changing environment. This means the choice of management system and style depends on the nature of the country and the people involved. So, is a Lithuanian or Nigerian Manager, for an example, ready to sacrifice cultural and national identity in the interest of globalisation? On the other hand, has an American or Japanese Manager relinquished his or her identity in pursuit of globalisation?

Globalisation is problematic to small and medium-sized firms who are planning to enter the international market. They face a difficult decision with regard to the choice of governance methods. Existing theories contradict each other about the strategic benefits of these options. We must compare these theories in the context of small and medium-sized technology-based enterprises (as developed in section 2.7) and findings suggest that the merits of internalisation and externalisation vary with market contexts and the resources under the firm's control and this is of extreme importance for Central-East Europe also (Sergi, 2006a; Sergi and Adekola, 2007a, 2007b, 2007c). In fact, the trend towards a single global economy is expanding markets and providing unlimited opportunities for international managers. To remain parallel and compatible to other technologies, for example, countries need to work together as more of a global economy. The course of the globalisation paradox could not have been very far-fetched from the impact of culture and ethical issues. Culture, as observed, is the sum total of beliefs, rules, techniques, institutions and artefacts that characterise human populations. When considering the ethics of a company, one can view the conduct of an international organisation to determine if they neglect the correct procedures in order to gain an ethical consensus on the mainstream programmes they realise in less advantageous economies (Sergi, 2004, 2006a).

The new economy is built on information technology and the sharing of knowledge and intellectual capital. This process of globalisation and international agencies is also related to the new knowledge economy, though it is fundamentally different from the social and economic contexts of the past two centuries. In a knowledge-based economy, a competitive advantage will be achieved by those countries that have the capacity to deliver quickly and have innovative forms of work organisations that raise productivity. In such an environment, SMEs have tremendous opportunities. To be a player in this competitive arena, a large investment in personnel and infrastructure is required. Technological, organisational, and marketing hurdles are also making it more difficult for SMEs to succeed in knowledge-based economies.

5.2 Process of Globalisation

The process of globalisation that is shaping all Central-East European economies has been a gradual evolution over time; hence, merchants who traded internationally in the early 19th century saw themselves as agents of the progressive revolution. After World War I, attempts were made to establish global institutions to aid post-war reconstruction: increasing trade interdependence and the need of preventing conflicts exhorted political leaders despite discordances over the extent of national economic and political interests (Besley and Burgess, 2003; Bhalla 2002). The ability of these institutions to direct and control the global economy that developed over the next half-century were, largely, extensions of American political-economic power, writes Preet (2003).

From a financial perspective on the process, a triad of the IMF, the World Bank and the WTO became the order of globalisation, but global is synonymous with multinational, intra-national, transnational, and cross-national, however, for the purpose of this discussion, the word globalisation will mostly be used. It is any activity of an organisation conducted beyond its national boundaries. Theoretically, globalisation involves factors of production such as land, labour, capital, technology, and entrepreneurship across ones sovereign national boundary. However, in practice, especially in the 21st century, globalisation has defied some of the theoretical frameworks that place restrictions on geographical boundaries. One theory of globalisation that the authors of this paper feel is still constant is that a managerial approach that works in one country does not necessarily work in another due to environmental, cultural, political, legal, economic and climatic differences across countries.

Continuing with the process discussion, it should first be stated that a trend towards global interplay is not the outcome of modern times. Consider now ancient trade routes - the Amber Road or the Silk Road, which were linking various regions of the world spreading from the Baltic Sea to the Mediterranean, Central Asia and China. Trade routes were implying international trade as well as culture and civilisation linkages. Global trends have always existed, and what is occurring today is nothing different from what took place during ancient times. Over the last centuries, trade, finance, and technology flew from one side of the globe to the next, with the Internet and high technology not yet existing in that history. In the case of small firms, they typically lack the necessary resources, such as money, information, and expertise, to upgrade their operations, resulting in low innovation rates, missed opportunities, and under-investment in productive technologies and best practices. In today's hyper-competitive marketplace, it is pivotal for firms to master the art of integrating disparate sources of knowledge. Consumers' wealth is much higher today than it was even decades ago. Consumers number more than six billion and they are increasingly demanding more in terms of quality, supply availability, and so forth. Nevertheless, the market sells and purchases what is available at any given point in time. Globalisation is quite different in qualitative and quantitative terms today, but the microeconomic principles remain constant.

Second, the rationale and logic of these events did not change radically, but simply evolved with the world. Thus, globalisation is the outcome neither of regulatory international organisations nor of transnational corporations (TCs) as many believe; it is an evolutionary process that changed over time, which has the tendency to adjust to new conditions such as domestic economic policies, institutional constraints, consumers' preferences, and technology advances.

Third, global institutions and TCs are expanding because the world requires regulation, thus the world will increasingly rely on them. As concerns TCs, they find their opportunity in a broader market. In sum, therefore, many observers lose sight of the correct causality regarding these processes. Production and efficiency expanded, with the quality and process of production helping to keep prices down to the advantage of the general well-being of many. Nevertheless, despite current success that is notable in China, India and Central Europe, corruption could endanger economic growth and force countries into economic troubles, as it is the case of some African countries where national leaders have stockpiled personal fortune abroad (Boyce and Ndikumana, 2001). Boyce and Ndikumana (2001) have calculated the accumulated stock of capital flight for twenty-five sub-Saharan African countries over the period 1970-1996. It would have amounted to 19.2 per cent of Angola's GDP and 12.2 per cent for that of Mozambique; 3.8 per cent for the twenty-five countries on average. Moreover, many small states have had a lack of financing, enough of which to diversify their economies, link with world trade, and obtain technologies, which directs us to the following fourth point.

Fourth, globalisation trade-offs exist in a closed society as well. The overall impact from globalisation could be a positive sum game for all, in spite of a negative impact which may show up for some participants in the short run. We cannot deny the long-term positive effects for all. With this being said, the other side of the coin is about political choices. Were progress on trade liberalisation achieved for those countries that face rich country's protectionism in the agriculture sector, the flows of final aid would have been better allocated, meaningful national policies would have started, and current sub-Saharan African countries and others that are experiencing low per capita income would have grown at higher rates. Market reforms, democracy, less corruption, and the ability to attain the opportunities of the global economy are the way forward without losing sight of the fact that no issues individually are a panacea. For example, holding partially responsible regulatory institutions amid poor economic outcomes is certainly valid, yet one cannot neglect the most basic and positive forms of causality and direction of actual events since we live in a multifaceted world system.

In this new setting, the IMF should be concerned about short-term stabilisation programmes and the World Bank on long-term structural adjustment lending. Macroeconomic policy stabilisation and balance of payments adjustments followed a strong, rightist market-oriented approach after 1981. In addition, the debt crisis in the 1980s and the increasing World Bank loans given contingently on policy reforms led to more extensive conditionality (often to fifty or more measures) with respect to the ten or even fewer policy measures requested by the IMF.

A change in the World Bank's attitude and a renewed emphasis on poverty issues was spurred on from within its own management and by the appointment of Barber Conable as president in 1986. Furthermore, it has been under James D. Wolfensohn (from 1997 to 2005) that the World Bank supported an integrated approach to development in closer relationship with other institutions. The World Bank was trying to circle the criticisms and it has appeared receptive to criticism (Peet, 2003), more so than the IMF and the WTO. Recently, William Easterly (2006) asserts that the Western world has failed to accomplish its ill-formed plans because it assumes it knows what the best strategy and policy choices are for everyone. Although the impact of aid on growth diminishes as aid increases, and countries having stronger institutions may absorb aid more effectively (Clemens, Radelet and Bhavnani, 2004), a big aid, per-se, is not the sole answer, assert Berg and Qureshi (2005). Surely, scaling up development efforts at the country level must be conceived in a way that inspires country-owned poverty reduction strategies. That being said, current aid strategies provide neither accountability nor response, Easterly stresses. Yet we most often succeed against poverty through ground level planning, listening to people other than corrupt dictators and 'self-congratulatory bureaucrats' in judging international-aid projects (Easterly, 2006).

A most controversial aspect of the IMF's choices was the adoption of multiple exchange rates made by Latin America countries, and later by the Third World as well, although it was accepted on a case-by-case basis. This aspect resulted in the conditionality policy, that is, a power of surveillance granted under Article IV and expressed by the letter on multiple currency practices, and the letters of intent. Until the mid-1970s, the IMF acted as a 'kind of global Keynesian club' (Peet, 2003). However, following the IMF's loans to the United Kingdom in the mid-1970s, the Third World and Central-East European countries recently switched to the facilities provided by the IMF as well. The oil crisis during the mid-1970s augmented deficits in the Third World and exacerbated the role of oil in the world economy. Additionally, the debt crises in Latin America during the 1980s and in Asia during the 1990s were severe enough that the IMF-World Bank supervised three-quarters of the Latin American states and two-thirds of the African states by the mid-1980s. In Peet's words, 'After 1977 the role of the IMF effectively changed from being a means of collaboration on exchange rates and payments, mainly among industrial countries, to being a means of First World control over Third World economic policy' (Peet, 2003, p. 71). Overall, freedom of trade, international flows of investment, fiscal and monetary discipline, and exchange rate devaluations became the pillars of the IMF.

In reality, the necessity to reform the IMF and a new emergency loans facility for crisis which hit emerging markets is mounting. The proposal for a short-term lending mechanism for emerging markets was a reform of the IMF and its operations set out by the IIF (Duncan 2006) or for the IMF to do a better job policing the policies of the systematically important countries (Truman, 2006). However, there is a growing international debate over IMF reforms to be able to work more closely with private sector financial institutions in the markets and in partnership with capital markets and nations, stated also Charles Dallara, a managing director at the World Bank Group (Duncan, 2006). These approaches are in line with what in reality we are suggesting to transform international organisations in more efficient agencies of socioeconomic growth and worldwide financial stability. If Easterly (2006) is a very critical voice of international organisations that assume to be aware of best strategies and policy choices for everyone, Rodrigo de Rato, the IMF's managing director, having recently set out a very preliminary draft proposal to overhaul countries' voting rights and rearranging chairs, and simplify the quota formula in the running of the Fund (Truman, 2006), the institute threw its weight behind reforms that would give greater influence to emerging economies, reflecting their growing importance in the global economy today.

In his *Capital and Collusion* (2005), Hilton Root argued that institutions lessen everyday economic risks to levels low enough to make people receptive to opportunities for profit, stimulating developments in technology and science, but not so in developing countries. In these countries, institutions that specialise in sharing risk are scarce. These are countries where citizens hide their savings under mattresses and in teapots, creating a gap between a poor nation's savings and its investment. As a result, the developing world faces a growing disconnect between the value of its resources and the availability of finance.

5.3 The Specific Case of the Failure of the Communist Economic System

The October Revolution in 1917, the Marxist-Leninist model, and Stalin's totalitarian dictatorship was easily observed by many, however, the main cause of the failure of communism economic attempts towards market forces lay in the basic notion of communism, for having been an antihuman social and economic system, exerting a negative impact on economic culture, causing inefficiencies, and affecting cultural developments among workers and nomenclature. Distinguishing between the bureaucracy in the West and in the East, while bureaucrats are accountable in the West, Communist bureaucrats created rules themselves without any legal responsibility. While increasing productivity and introducing ineffective incentives have been a constant during communism, facing today's transformation in Central-East European countries based on simplistic theories, is difficult.

Communist thinking exerted an impact on modern neo-liberal tendencies by becoming aware of the irrationalities of the Communist economics that would eventually be critical in adjusting the trajectory of transition economics, and includes these in the world context calling upon the function of international regulatory bodies. Some failure in transition economics and the need to have effective global institutions offer a route to scrutinise in-house failures of the Communist economics and to compare beliefs in a way to reinterpret economic affairs.

Antiglobalists find fault with neo-liberal economics concerning Central-East Europe as well, whereby neo-liberalism would surely be the cause of failure concerning economic transformation. Antiglobalisation tinkers and activists deem confidence of having had exhaustive knowledge of present days, certainty over the culpability of those economic institutions, and of chimerical alternative economic systems.

In neutrality, the world community should have tried introducing effective ways to hold all players accountable. For example, it has been argued by the proponents of globalisation that antiglobalists lack feasible alternatives to the market, while pro-market notions hold up the world economy. Economic organisations and neo-liberal corporate capitalism should have been perceived under the aim of regulating world linkages and sidestepping regional lack of economic growth, and economic events that are neither global or country specific, but undoubtedly not enforceable to yield the expected result for all sides. Meanwhile, right after the collapse of Russian communism in 1991, the Russian people were very eager to move towards democracy, and had Russian reformers had effective western support from the US in particular, which would have been easy to offer, the reformers had a string possibility of transforming Russia. Instead, the exact opposite occurred, according to Sachs (2005).

Regional economic organisations could also be blamed for the inefficiency of these international bodies, or the failure to prevent further state aid to less developed countries. However, we must become aware of two facts. First, international organisations have understood their operational mistakes and oversights, thus they began reforming themselves. For instance, it is good that the IMF recognised that the conditionality policy needed to be revised, so the Executive Board revised guidelines in September 2002 (firstly introduced in 1979, not in 1944). Even before that, the IMF had set up a permanent Independent Evaluation Office in 2001, and its new focal point shifted to distinguishing between what is relevant but not critical to the objectives of a programme, and also to improve the division of operations between the IMF and World Bank in ways that both would share conditionality policy when possible (Caballero, 2003; Sergi, 2003a).

It is possible to say that the failure in Central-East Europe during the early 1990s did not tell the whole story, as these countries underwent a new economic approach with over expectations of quick painless reforms when it should have been known that productivity and reallocation of resources take time to have positive effects. The failure should also be laid at the doorsteps of national leaders who should hold the Bank or the WTO responsible for outcomes. Reform output has been quite disappointing in the former Soviet system because of infelicitous sequencing of policy reforms. Simply, policy sequencing takes time and one cannot judge the reforms impulsively like in other reforming countries in Latin America during the 1980s and 1990s.

Rather than attempting to counteract globalisation and dismiss the IMF and the other international economic institutions, a better approach is to develop linkages with the world economy, have stable national institutions, create an IT base, and let regulatory institutions be accountable and to work 'shoulder-to-shoulder with clients' (Stern 2003, p. 49). IT raises standards of living and creates new jobs and it cannot disown the view that central banks' institutional design and independence have increased the level of competition, increased globalisation deregulation, and prompted a political economy of low inflation (Sergi, 1994, 1997a, 1998b). This tight policy brought about lower inflation in transition economies, decreasing to 10 per cent in 2003 from 363.2 per cent during 1990-1994. All these are standard prescriptions of market ideology and the attempt of inhibiting them would be costly, at the least, taking into account our scarce economic knowledge concerning an alternative system.

One of the primary realities being realised concerns a prevailing misreading of global economics and consequently of global institutions. Globalisation is not a recent phenomenon; therefore, the world needs regulatory institutions. Instead of suspending these institutions as some have suggested, the world should have additional ones such as a world tax organisation. Secondly, saying these institutions alone are responsible for disappointing achievements in certain regions of the World is being over simplistic in the analysis, along with the fact these overly simplistic criticisms apply avant-garde economic notions imposed by the Washington Consensus of Williamson (1990), it is also superficial because most economists around the world share free market notions (i.e. free trade, economic stability, etc.). Third, it is a failure not to recognise that the World Bank first and the IMF later, started a process of rethinking their *modus operandi*, with the very first policy decision to revise guiding principles coming from presidents of the World Bank who have always been US citizens.

5.4 Effect of Culture

It is commonly thought that cultural differences influence the competitive environment of international operations (Adekola and Sergi, 2007c). These cultural differences have been changing because of social changes. For example, the impact of these social changes could be viewed from unsuspected cultural shift such as cigarette smoking, which could have an impact on an organisation's performance. Consider a country where cigarette smoking is very prevalent – Greece and Lithuania or other Central-East European countries. With many employees who may smoke, the business might have to allow additional smoke breaks to keep their employees happy.

If an employee from Lithuania or Greece for example moves to Norway, for instance, where cigarette smoking is not as common, or to the US where the rules have changed drastically in many cities who have implemented rules against cigarette smoking in the work place, that employee might not be happy with the rules. This is because smoking is addictive and he or she may not be able to handle going all day without having access to fulfil the nicotine urge. The businesses may find that such employee will try to sneak out for smoke breaks when the employee feels a cigarette is needed and consequently affecting productivity and the company's bottom line.

Hofstede proposed in 1983 four dimensions of culture. Using these dimensions, it is possible to identify differences in management styles, organisational preferences, and motivation patterns. These dimensions explain how differences can affect the way in which managers from different cultures behave and perform individually and in a team. Often, multinationals see the cultural diversity within their operations as an area of difficulty rather than as an opportunity to build competitive advantage. For example, Japanese and African societies are collective, making decisions as a group, whereas most of Europe and the US are more individualistic. These examples demonstrate how differences between countries, their values and customs, are ultimately their society's ideas of what is right and acceptable in their culture and environment which sometimes create the complexities and paradox of globalisation.

This leads us to the issue of global paradox and national cultural identity. As with any development, there will in time, emerge a paradox. For example, often what at times began as a global business and social benefits, results in detriment or negative outcomes. In examining how a new view of globalisation is slowly appearing, we should consider how the values of globalisation such as the free flow of trade, competition, productivity, and investment across borders, can actually impose a conflicting relation with the social values in underdeveloped countries. The ongoing changes that occur on the international scene in the political, economic, cultural, and social levels at times can almost give rise to inconsistent relations with the traditional and contemporary values in some societies.

As an example, recently on the US National Public Radio station (Wilson, 2005), there was a discussion on how some developing countries are experiencing chronic health care shortage. 'In the sense that when they most need the health care personnel, their physicians and nurses leave for green pasture to practice in Canada and the US after being educated in those less developed countries'. A study published recently in the New England Journal of Medicine discovered that immigrants from India, the Philippines and Nigeria account for the largest number of foreign doctors working in the Western countries of UK, the US and Canada (Wilson, 2005).

That being said, the undeveloped nation of Africa, with their resource of oil, is becoming a very lucrative sight for China. China has realised that energy is an instrumental product for their continued economic growth and there is a large quantity of oil in Africa. Hence, China in its search for energy sources has its eye set on Africa. This realisation is causing some marked concern in the US and Europe as to China's growing economic power. China business is not only with oil in Africa. They have railways in Angola, roads in Rwanda, a port in Gabon and a dam in Sudan, all of which has tripled Chinas trade with Africa in the last 5 years.

Business with Nigeria and South Africa has been on the upswing, and this year China is expected to overtake the UK as Africa's third largest trading partner.

For the past decade, the US and other Western countries have stayed clear of Africa when it comes to serious business such as FDI or manufacturing high level products as they once referred to it as the 'Dark Continent' due to its leaders' corrupt practices and, religious/political conflicts. Interestingly, the Chinese see enormous symbiotic opportunities in this same continent. The dichotomy or contradictions here are evident – in fact, there are two:

Western indifference towards Africa and its corruption and conflict, may, ironically, be a gift to China. African governments tend to appreciate China's ability and practice of maintaining its communist attitude and keeping distant from Africa's domestic affairs. In contrast with the demands for transparency that accompany loans from international bodies such as IMF, Chinese help comes on a strictly no questions asked basis. The irony here is that culture as totally different as they are between these two nations may join them – China with their secretive, 'mind my own business attitude' and Africa with its oil riches and ingrained corrupt practices of doing business and disregard for human rights.

Human rights activists warn that this forward moving expansionism simply offers assistance to rogue leaders and adds fuel to the fire of Africa's most disreputable governments. Earlier this year, Angola's president, Jose Eduardo dos Santos, head of a famously oil-rich but poverty-stricken country, received a 1.1 billion dollar line of credit from Beijing (Sergi and Adekola, 2007c). Beijing also came to the rescue of Zimbabwe's embattled president, Robert Mugabe, presenting him with ornamental tiles for the roof of his palace and an honorary degree in recognition of his remarkable contribution in the work of diplomacy and international relations.

Many, including the UK and the South Africans worry that communist China or other formerly communist countries in Central-East Europe are not the right partners, since their culture might fuel bribery and corruption. However, there is speculation that this perception is shifting, since China and other formerly communist countries have recently deployed peacekeepers to UN missions around the world (Chinese peacekeepers are deployed in Liberia and Congo), suggesting that the Chinese and other countries are becoming more aware of their images.

Worlds Apart, written by Milanović (2005), addressed the inequality between all citizens of the world. Complex forces often working in different directions shape inequality. Milanović, a lead-economist at the World Bank's research department, looks at income distribution throughout the World using household survey data from over 100 countries. His study measure inequality among individuals, and discusses the relevant policies of first-world countries and nongovernmental organisations. As is shown, inequality has increased between nations over the last half century, that is richer countries have generally grown faster than poorer countries. Yet the two most populous nations, China and India, have grown fast. While a few poor countries are catching up with the rich world, the differences between the richest and poorest individuals around the globe are huge and likely growing (Milanović, 2005).

On a smaller scale, consider the Internet. With the inception of this super-highway of international communication systems, people all over the world revelled in its following miracles: It allow its users to keep in closer touch with distant family members and friends, and to find information in a fraction of a second. It provides opportunities to access rich educational and cultural resources that are otherwise unavailable to most people or may take much longer to locate at the library. It allows its users to obtain current and up-to-the-minute information, sometimes before the facts are even corroborated and it allow us to break the boundaries of time and distance. Paradoxically, the following could be said of this same factor of globalisation.

In September 2001, Chinese police arrested the country's first Internet hacker in a Wuhan hotel. The 19-year-old had been spending weeks attacking government-run websites. Ironically, the hacker, whose alias is Yu Hua, posted his contact details on a website, and police used those details to then track him down (Chinese Hacker Captured, 2005). Eric Harris and Dylan Klebold, high school seniors and killers of 12 students, one teacher and themselves in the US Columbine High School massacre in 1999, used the Internet to find recipes to make pipe bombs and other explosives and the intent was to kill hundreds of fellow students (Columbine High School Massacre, 2005). This is the ultimate paradox.

Business globalisation represents advancement and progression, but in attempting to level the playing field to many countries through it, we may instead be creating a contradiction of exactly what it is we want to achieve for those less fortunate. In studying this further, although globalisation refers mainly to stronger economic, political, and cultural ties among many countries, it is becoming evident that globalisation is not universal in its appeal to all people of every nation and definitely not embraced by many people in the less developed countries.

The current model, which to this point has been highly embraced, defines a fairly collective way of doing business globally, with some regard to different countries cultures and less regard to their stages of development. For instance, operators of financial institutions in Vilnius-Lithuania, Delhi-India, or Accra-Ghana will have to comply with the rules imposed by those people in London, Paris, or New York if they want to access international financial markets. As a result, it may be argued that the world will become one big market place dominated by the most powerful multinationals. There are important cultural differences between countries that shape the existing multinational corporations themselves and the question is, whose interest should they serve? In the US, for example, there is consensus that it is the shareholders. However, in Japan it is considered irresponsible to run companies exclusively in the interest of shareholders; other stakeholders and societies at large have to be considered as well. This supports Hofstede's cultural differences of collectivistic and individualistic.

In the underdeveloped countries, foreign factors of production such as capital and technology have become the main determinants of economic progress and socio-political life. While the same world market promoted the expansion of development in Europe and America, it has a tendency to limit development in the dependent countries by restricting the flows of such factors, which in itself is a paradox. To sustain that, with competitors coming from China, competitors coming from India, where more than half the computer software in the world is made now, we have to find more customers. We have to have more partners. This buttresses the fact that there is no country in the world today, including the US, which is economically self-sufficient without some sort of interdependence with other countries.

5.5 Conclusion

When considering Central-East Europe and the issues of globalisation and global entrepreneurship, there are many questions to ponder as well as paradoxes: Should the balance between the freedom to operate and the accountability to shareholders and international community be the same everywhere? Alternatively, should managers be allowed more leeway in less efficient markets? Should we insist on compliance with international best practices or does this delay economic growth in selected transition countries? The international community is slowly becoming divided regarding the benefits of globalisation. Should there be universal rules or is it more important to preserve national and cultural values? A single global model may be inappropriate due to differences in cultural, social, and economic levels of development in the developed countries versus those in less developed countries. As the concept of globalisation and global entrepreneurship impresses on the choices of a society and alternatives between domestic values and the values of globalisation policies, the difficulties can swing from developing dynamism to absolute inconsistency that leads to economic stagnation, social dysfunction and less cultural value in some parts of the world.

Herein lays the challenge of participating with an international system while keeping one's national interests at heart while developing and expanding a country's social model. In growing and challenging complex environments, leaders are forced to be decisive, making decisions that have far-reaching consequences. Effective leadership requires a broad base of knowledge concerning the impact of culture of newly market economies in Central-East Europe that cannot be ignored while dealing with EU membership and the wider globalisation since it drives the concept and the process of building up a new social and political consensus. This is the primary issue in the next chapter.

Chapter 6

The European Social Model

6.1 Introduction

Most Western European members of the EU are envied by many in the World because of their high level of economic and social development. This level of development is also one of the main attractions for countries that are actually in different stages of their negotiations on joining the EU. While there are cross-country differences, generally, in a number of social aspects, Western European countries provide much more than Europe's main competitors in the world economy (Rifkin, 2004). This extra performance is often expressed by the term 'European Social Model'.

This term is used very frequently, although most of those who use it, agree that there is no single European Social Model. The term refers to the specificities of the main European versions of the welfare state, making them different from developed countries in other parts of the world. However, while the term covers one of the major achievements of Europe, Western Europe is increasingly concerned at the problems of preserving it in a dramatically changing international economic environment.

The unsatisfactory reactions to the changes in the last decades have also led some analysts to question the chance of getting to a meaningful European Social Model. Slow growth, high unemployment and long-term unemployment figures in some countries can be evaluated as unsatisfactory results, but they are at the same time two of the most important factors, which make the system unsustainable. This is especially true in the era of globalisation, where competition is stronger than ever: the challenge can, in principle, also lead to important systemic reforms (which can be an important positive impact), but most European welfare states have not yet reached this point of breakthrough. With the time passing by without successful responses, the challenge becomes more and more difficult.

This difficulty is clearly reflected in the actual tendencies in the public opinion about the European integration process. The French and the Dutch 'no' to the Constitutional Treaty meant very probably also a protest against a Europe which is not able to respond to the challenges it faces, and thus, not able to defend its citizens from these challenges. In most new member states having joined the EU in 2004, public opinion about the EU also show scepticism but it is also true, however, that purely national aspects influence largely the public opinion about the EU.

This last point is a very important reason why the issue of the European Social Model needs a careful analysis. In order to summarise the main features, problems and possible options, the chapters proceeds in four points. First, it provides a background and different interpretations of the notion 'European Social Model'. Second, it shows the main challenges to this model in Western Europe. Third, it tackles the specific issue of reforming the welfare state in Central-East Europe. Fourth, it provides an overview of the possible proposed solutions of the present problems. Finally, some of the main ideas are summarised as concluding remarks.

6.2 An European Social Model

The history of the Welfare state has begun in the second half of the 19th century. The institutions created then in some leading European countries served for correcting some of the undesirable consequences of the highly industrialised capitalist system. While these early traditions are still important, the present versions of the European welfare state are much more sophisticated both in their objectives and in their functioning.

The Beveridge Report (1944) first formulated the foundations of the modern welfare state during World War II. The document listed the main conditions in which welfare states can function. Regarding the age structure, a society, where less than 10 per cent of the population is older than 65 years, is conform to the one analysed in the Beveridge Report (see Janssen, 2006). After World War II, Western Europe developed examples of welfare state, and we might distinguish four models: *(i)* the Nordic countries model; *(ii)* the Anglo-Saxon countries; *(iii)* a continental model; *(iv)* the Mediterranean model. Resorting to traditional analysis regarding their achievements in the reduction of income inequality and poverty, protection against labour market risk, and incentives to labour market participation, the Nordic model shows high efficiency and high equity, the Anglo-Saxon model shows high efficiency, but low equity, the continental model shows low efficiency, but high equity, and the Mediterranean model is characterised by low efficiency and low equity. From the point of view of sustainability, only the Nordic and the Anglo-Saxon models can be seen as promising in their actual form. If also equity is considered to be important, the Nordic model can be seen as the optimal solution.

Although these different models are rooted in different national traditions, the features of these models all might be important elements towards a European Social Model. Of course, in the light of this complex background, it is not easy to find a clear definition of the European Social Model. In the literature, there are very different opinions about the existence of such a model, and even those who agree that such a model does exist, differ very much in their opinion about the main objectives and key features of such a model. The objective here can only be to find a definition being concrete enough to shed some light on the main specificities of the European Social Model, while being also general enough to be able to play the role of the highest common denominator between the different views and interpretations. We can define the European Social Model as a system that offers a high level of social protection and enough social dialogue in order to cover activities vital for social cohesion. If one wants to discover what the EU wants to achieve under the slogan European Social Model, and where the problems hide, it can be a good solution to depart from an official and relatively recent EU definition.

Welfare states in general, their most sophisticated Western European species in particular must face a number of challenges. These challenges are due to important demographic, social and economic changes. These changes mean that the initial conditions are not met any more by the societies of most developed countries, causing deteriorating dependency ratios (see Carone *et al.*, 2005). This means that the share of people in their active age continuously decreases, while the share of the elderly increases and this has a strong impact on average productivity and the capability of elder workers to adapt to new technologies and challenges. This is a well-known phenomenon in the developed economies for a long time, but it is only in the last years that it has become a factor menacing the sustainability of the welfare states in Europe.

Developed welfare states cost a lot. Between 1945-1975, characterised by rapid economic growth, this did not constitute a problem. However, with the changes in the early 1970s, this favourable situation has changed, as well; the demographic and social changes referred to above contributed to deepening the problem, increasing financial needs of welfare states.

Beyond demographic factors, the financial cost and the question of the efficiency of the system are not less important factors. It is that not only the share of people in active age decreases, but also that the share of people within this group being active is very low in international comparison. The high unemployment rate worsens the situation further.

Among social changes, family models as well as employment patterns are different from those fifty years ago. In the present situation, the increasing importance of atomised families means also new tasks for the welfare states. Unemployment is in many countries high, even with relatively low activity rates, which has also important consequences both for society and economy and as a reaction, in many countries new forms of employment (in addition to full-time employment) appeared. The growing share of employment forms that have earlier been often called atypical also can be interpreted as a challenge for the European Social Model. The main reason to consider these new forms of employment as a challenge is not their consequence on the financing of the welfare state, but in the fact that different country experiences with these new forms show very clearly the differences within the EU, and thus put national characteristics of the welfare state into the foreground.

Rates of economic growth in the most developed countries of Western Europe have become very low, while Europe's traditional main competitors perform clearly better in this field, and also new rivals (e.g. China and India) appear with extremely high growth rates and extremely low production costs although as a study by Ernst and Young (quoted in Janssen, 2006) and based on interviews with 650 global business leaders, it concludes that Western Europe is beating off competition from China and the US and it is the most attractive investment location. This result would be explained, among others, by the flexibility and diversity of many Western European markets as well as the availability of highly trained workers. To substantiate this, nearly two decades into India's phenomenal growth as a centre for high technology, the industry is running out of workers. Although Indian schools churn out 400,000 new engineers every year, as few as 100,000 are actually ready to join the job world (Sergi and Adekola, 2007c). The high-tech industry is expanding so fast that the country cannot keep up with the demand for high-end workers and despite this immense English-speaking population might appear to keep up; India has a potential shortfall of 500,000 technology professionals by 2010, according to the National Association of Software Services Companies.

In this international context, we must be aware of the fact that the basic principles of globalisation are not about countries competing with each other for the lowest social standards or the highest profits for shareowners, but it should be understood as countries that specialise in the areas for which they are most suited while serving the interest of workers, consumers and social standards overall. The objectives of the Single Market included enhanced competition within the EU and enhanced competitiveness of Central-East European enterprises. The Single Market is still far from being perfect, and its main deficiencies concern the free movement of services (although this sector represents today about 70 per cent of the EU economy and that of labour. Recent cases of obstacles for M&A in the EU also show that capital movements are still not entirely free. All these deficiencies of the Single Market weaken its expected positive effects on growth, employment and European competitiveness.

The EU must face all these deficiencies of economic integration in a period of rapidly intensifying global competition. Competitors enjoy low production costs, lost transportation costs, and another challenge is that these economies are modernising very rapidly, and they are already highly competitive in sectors where wages are not the decisive factor. At the European level, despite ambitious plans concretised in the Lisbon strategy (see Watt and Janssen, 2006), Europe is still far in many respects (rates of growth, activity and employment, innovation) behind its traditional main reference point, the US. This, together with the challenge coming from Asia means that the position of Europe in the competition of the development poles of the world economy is continuing to weaken. In reality, European countries can only preserve their achievements in the social field, if they stand better in global competition; this, in turn, requires a reform of the welfare state on the national level, and, if one aims at a social Europe, also steps on the EU level.

6.3 Welfare Economics

Central-East Europe can be treated as one of the external challenges for European welfare states, but the accession of eight Central-East European countries to the EU have deeper consequences for the European Social Model. Despite their relative economic backwardness, by the end of the 1980s, these countries spent a very large share (in some cases around 25-30 per cent of their GDP, similarly to Northern European countries) on social policy. After the systemic change, their welfare systems have rapidly been transformed, following generally one of the Western European welfare state models and sometimes moving even beyond Western welfare models and paradigms. The challenge of financing developed welfare systems pushed them to keep expenses low and many of these countries followed a very liberal approach regarding social issues and their approach was much more liberal than in the case of established Western European welfare states.

As we have seen, after their accession, these countries are also concerned by the deficiencies of the Single Market. In the case of some transformation countries, the need to comply with the Maastricht criteria can further limit the room for welfare responsibilities to be taken on by the state (Sergi, 1997a). On the other hand, while there is a Lisbon Agenda on the EU level, conflicts between complying with the Maastricht Criteria and Lisbon objectives are likely in some of these countries due to overlapping priorities and financial bottlenecks (Sergi, 1997a).

With the EU-accession of eight Central European countries in 2004, this issue has become part of the debates on the European Social Model. Although the difference in economic development does not necessarily threaten with social dumping for the case of Spain and Greece, it can be more difficult to reach important agreements on developing economic integration and strengthen the common core of values of the European Social Model. If on one side, central to the analysis of the OECD's *Jobs Study* (1994) was the classical statement that Keynesian demand management proves self-defeating in structural weaknesses in the economy mean that inflations pressures appear as soon as this technique is used; more coherent macroeconomic and social policy should be configured to respond effectively to new realities. Therefore, the long story of the services directive or other directives and plans are very clear indicators of this increasing difficulty. To the problems listed above, no satisfactory solution has been elaborated until now. There are, however, proposals, which can contribute to the improvement of the present situation concerning growth and employment, and thus to the sustainability of the main achievements understood under the notion European Social Model.

One of the main tasks of Europe is to complete the Single Market. This could strengthen European competitiveness in the world, thus the economic foundations of the European Social Model. The free movement of services (all services from all member states in the whole EU) is of key importance in this respect. Despite cultural and language barriers, cross-country labour mobility (a way of reaction partly replacing the general European choice between being employed or unemployed in the home country) could also be increased in a less imperfect Single Market; for this, regulations concerning intra-EU labour mobility should be further simplified.

Another driving force of the required changes could be the (renewed) Lisbon strategy. Opinions about its chances differ to a large extent, especially with regard to the open method of coordination. While there is no realistic chance for a rapid step ahead by binding European legislation regarding the European Social Model, alternative (or complementary) approaches, and also using the experiences of best practice and effective responses need policy and institutional reform.

From the above analysis of the European Social Model, we the European Social Model may seem as a virtual notion. National traditions are important; while European action is limited, it is necessary to separate national problems from problems stemming from the integration process and complete the Single Market and the Economic and Monetary Union. Moreover, it is of crucial importance to reconcile global with social competitiveness of Europe. Strategies should be realistic and clear in their objectives and mechanisms, including national and EU responsibilities as well as financing. The mistakes of the first years of the Lisbon strategy should be bypassed and only flexible solutions seem to have chances on the EU level in social issues. If the role of the EU can become stronger in this field, any strategy should take into account that the European Union is a player in the larger global context and this is not only as a danger but also as an opportunity. If the controversial elements of the jobs strategy model are absent from the Lisbon Agenda, as there is nothing about collective bargaining, employment protection legislation etc (the European Union has competences about working time to the extent that working hours are a health ad safety issue), the mid-term review of the Lisbon strategy put forward very interesting issues such as more flexibility and investment in technology.

The adoption of employment rate targets that were characterising the Lisbon Agenda (which also incorporated the European Employment Strategy launched in 1997) were welcome by trade unions across Europe, more must be done to reinvigorate the European economy. It can be seen that while there are no miracle remedies for the problems of Europe in general, and of the European Social Model in particular, the consistent implementation of already agreed policies can bring positive results. These positive results can lead to increasing credibility of both national and European actions, which is crucial for accomplishing comprehensive reforms, which are to be carried out jointly on national and supranational level.

6.4 The Quest for a Definitive *Bruxelles Consensus*

The collapse of the centrally planned economies in Central-East Europe caused new market relations between the state and enterprises. For example, the new system transformed the decision-making process that was characterised by a vertical link from central authorities to enterprises, to one in which horizontal relation between enterprises became prevalent. For that reason, the innovative form of relationship substantially reduced the relative value of vertical relationships. This was not the only novelty: the hegemony of market process among economists for stimulating growth implied a transformation in all dimensions of the economic system, also in terms of political actors and the role of the institutions. Different new market economies, varying degrees of institutional correctness and stability have developed market relations in a different manner and the question here is what kind of ethical outcome has been emerging in various regions in the light of the exact role of national institutional actors.

Authors offer various views about the right model to apply in Europe. For example, Rifkin (2004) has been talking of a 'European Dream', a mirror opposite of the American Dream that is becoming elusive. Despite the American dream is languishing and the new European Dream is capturing the attention and imagination of the world (Rifkin, 2004), in reality, twenty-five nations now forming the US of Europe require a definitive socioeconomic model for the next decades. Although the EU is today the largest economy in the world, the world's leading exporter as well as the largest internal trading market, Europe has still to ameliorate and calibrate its model to fit non-homogeneous economic and social circumstances and multicultural diversity. What it has been labelled as the *Bruxelles Consensus* (Sergi, 2003a) fits this new European perspective very much, at least from a theoretical point of view. This Consensus applied to the European soil would have several key aspects: be an effective model of engineering economic growth when applied to those countries that were abandoning the Soviet type system and needed recovery after the Berlin Wall events of 1989; be the lasting and successful model for the European continent; introducing and consider strongly the ethical implications of any political economy, such as the dilemma of economic growth, social justice and poverty reduction, and how all these aspects could join together in a real and successful model of governance.

Statistical data can substantiate our point of view. A recent Eurostat (2005) study illustrates this issue well. For example, the EU-25 would be characterised by closeness to poverty for 72 million inhabitants as of 2003, as found by Eurostat in the report *Poverty and Social Exclusion in the UE-25* (2005). Eurostat defines Risk-of-poverty rate as the share of persons with an equalised disposable income below the risk-of-poverty threshold, which is set at 60 per cent of the national median equalised disposable income (after social transfers). This share is calculated before social transfers (original income including pensions but excluding all other social transfers) and after social transfers (total income). Figures given by Eurostat put on top Slovakia, Ireland and Greece: they have a 21 per cent risk of poverty rates. On the other side, the Czech Republic (8 per cent), Luxembourg and Slovenia both at 10 per cent. Eurostat (2005) has calculated this risk bearing in mind social expenditures at the national levels; the poverty risk net of any kind of contribution (i.e. also pensions) tops the rank in Poland with 49 per cent of population risking poverty while EU-25 average would be 40 per cent.

Also at the global level, we have serious concerns regarding unemployment. Global unemployment rose to record highs in 2005 in spite of continued strong economic growth, reports the International Labour Organisation (ILO, 2006). Most notably affected are among those between fifteen and twenty-four years of age. This group makes up half of the World's unemployed, and their chance to remain unemployed is three times as high as that of adults. Rising unemployment is a result of rapid population growth in some parts of the World. Since the employment growth did not match the population growth, this explains the rise. ILO (2006) makes it clear that about half of the World's 2.85 billion workers are subsisting on less than the USD 2 a day poverty line, the same as a decade ago. In spite of the world economy, growing by 4.3 per cent in 2005, the number of unemployed climbed to 191.8 million. This represented an increase of 2.2 million in 2004 and 34.4 million in 1995. As evidence of this, the global unemployment rate remained steady last year at 6.3 per cent after two years of decreases. It was down from 6.6 per cent a decade ago – employment as a share of the working age population stayed virtually unchanged at 61.8 per cent in 2004. The rate in Central-East Europe rose to 9.7 per cent from 9.5 per cent in 2004, and Asia's overall unemployment rate remained steady. In East Asia, unemployment is 3.8 per cent, the lowest in the world. In contrast, Middle East and North Africa show a

13.2 per cent unemployment rate, the highest in the world; in Latin America and Caribbean, the unemployed rose by about 1.3 million to an unemployed rate of 7.7 per cent (ILO, 2006). Despite these unfortunate numbers, certain countries in Europe and Central Asia have succeeded in sustaining low levels of unemployment without an acceleration of inflation pressures or a worsening of income inequality. In addition, the failure of many economies to create new jobs out of GDP growth, combined with natural disasters and rising energy prices, affected especially the worlds poorest. Of the 500 million poorest people, only 14.5 million managed to clamber above the USD 1 a day income level last year (ILO, 2006).

These very recent harmful figures prove the importance for new thoughts concerning the European model, its social effects and how a new broader consensus, that is the *Bruxelles Consensus*, could probe realistic and feasible when applied in the wider European context. At the heart of the European social model was the notion that all citizens should be involved in the wealth creation and its balanced distribution, and then participate fully in the society. If having a job is a sort of precondition to wider social and political participation, the new challenges arising from the 'enlarged European social model' are to rethink the policy and the social model in a way that are created better conditions for wealth creation and distribution and prevent a worse situation to materialise in selected Central-East European countries and/or regions.

One can think the deliberate maintenance of overvalued currencies when the home country prefers devaluation to be nothing more than protection of foreign creditors and their related interests inside the country in question (this is an important issue when referring to the different models of economic transformation, i.e. shock therapy, gradual model, post-Keynesian model, Chinese model).

As ten new Central-East market economies now belong to the European Union, a proper renewal of the *Bruxelles Consensus* must take account of the Social Agenda that the European institutions are pushing forward (see e.g. Adnett and Hardy, 2005; Jovanovic, 2005). In the light of the importance of this issue (for instance, the Commission's Employment, Social Affairs and Equal Opportunities DG publishes a quarterly periodical titled *Social Agenda*), the new European

Commission wants to concentrate on the key message that economic, employment and social policies be geared to reinforce each other mutually, with the focus on more and better jobs and greater social cohesion (Argandona and Gual, 2002).

As a matter of fact, the 22-23 March 2005 summit outcomes discussed the Commission's midterm review of the Lisbon strategy for economic, social and environmental renewal. The European Council and the Commission decided to prepare a midterm review of the Lisbon process, to be presented to the Spring Summit in March 2005. The March 2004 European Council mandated Former Dutch Prime Minister Wim Kok to lead a group of experts with the objective of reviewing the Lisbon strategy (Sergi, 2005c). In fact, Wim Kok supervised an earlier report, *Jobs, Jobs, Jobs* at the time of the Lisbon summit, but in this mid-term review of progress towards the Lisbon objectives, Kok's report – or the report of the High Level Group on the Lisbon strategy that he chaired – concluded that the disappointing delivery of the strategy has been due primarily to a lack of determined political action and that we had made little progress over the first five years and recommended to refocus the agenda on growth and employment (European Communities, 2004). The report also underlined the need for real ownership by the member states of the reforms needed and for determined action to be taken urgently across five key policy areas: *(1)* the knowledge society to increasing Europe's attractiveness for researchers and scientists, making R&D a top priority and promoting the use of IT; *(2)* the internal market to complete as for services, especially financial services and removing obstacles to the free movement of goods; *(3)* the business climate to reduce the total administrative burden; improving the quality of legislation; facilitating the rapid start-up of new companies; and creating an environment that is more supportive to businesses; *(4)* the labour market to rapidly delivering on the recommendations of the European Employment Taskforce; developing strategies for lifelong learning and active ageing and partnerships for growth and employment; *(5)* environmental sustainability to stimulate eco-innovation and pursuing policies which lead to long-term and sustainability.

Focusing on growth and employment, and simplifying domestic ownership via more effective and realistic national action plans are the key elements to relaunch the Lisbon reforms agenda. Nevertheless, the Commission's proposals to relaunch the Lisbon agenda have raised controversy about the equality of the three pillars in the process, i.e. economic growth and competitiveness, social inclusion and environmental concerns; the dispute is between various political forces in the European Parliament[9]. Others, focus on how the Commission could force the member states to establish national action plans (and even if governments would agree to such plans) and to monitor their carrying out (Sergi, 2005c).

6.5 Conclusion

In this chapter, we examined the dispute over a definitive economic model and offered more coherent information concerning the *Bruxelles Consensus*. A new model of growth in Europe should evolve enough to guarantee social equilibrium and ethical outcomes in a context of global actions and interactions (see chapter 5). Therefore, there is the need to abandon the policies of the Washington Consensus, rationalise supranational institutions that impose economic policies and socioeconomic standards, and call for a new consensus to be applied to European vision and reality.

Although we have called it the *Bruxelles Consensus*, this one needs to be calibrated again as the original proposal was aimed to address the model that European institutions were introducing during the 1990s. In fact, while the unique and original proposal of the *Bruxelles Consensus* was meant to address a process of enlargement of European Union boundaries, additional work will develop a final European model so that it takes into account all aspects of Europe that is setting up a more ambitious agenda. The sensible and reasonable new model in Europe would attest the fundamental implications, changes and opportunities of the new Europe in its past, present and future effects. The European Union has

[9] The Socialists, Greens and other extreme left oriented groups in the European Parliament have accused the 'business-friendly' Commission of selling out Lisbon to a 'neo-liberal' growth-only agenda.

adjusted our model but future waves of enlargement towards Southeast Europe will prompt the opportunity to elaborate and shape a definitive coherent and self-reinforcing European approach. This is the major accomplishment of the European Union in the near future.

Next chapter concludes our analyses and even though Europe is today the largest economy in the world, the world's leading exporter and the largest internal trading market: Europe has still to relieve and calibrate its model to fit non-homogeneous economic and social circumstances across its member countries.

Chapter 7

Conclusion

We developed an analysis that regards the directions of economic transformation in Central-East Europe. By making use of our previous research output, our aim was to highlighting and establishing the necessity of having a definitive, more coherent model of socioeconomic growth that is sustainable in the enlarged European Union. Such directions and a new model of growth in Europe should evolve enough to guarantee social equilibrium and ethical outcomes in a context of global actions and interactions.

The past decade has witnessed several attempts at the European and national levels to build up a unified and worldwide unique political economy model intended to fulfil stability, social improvements and shared economic well being by introducing and European-type standards. Despite budget constraints these and other circumstances led to measure finalised to reinforce the European model, to redirect economic resources towards weak regions to ensure other social goals. The scope of this evolving model and its success or failure in the future its intended and unintended consequences included. That is, the European institution and the *Bruxelles Consensus* helped the transformation of new market economies in Central-East Europe, and in fact the unique and original proposal of the *Bruxelles Consensus* was meant to address a process of recovering and enlargement of the European Union's boundaries.

In Europe, there is the need to reinterpret the Washington Consensus however, and rationalise supranational institutions that impose economic policies and socioeconomic standards, such as labour market strategies and the paradigm of the Maastricht Treaty and the Growth and Stability Pact (Sergi, 1997a). While short-term solutions usually have short-term effects, we support thinking 'outside the box' and suggesting economic applications necessary for long-term benefits as well. In order words, we need to call for a new economic and social consensus to apply to the new European vision and reality, what has been called the *Bruxelles*

Consensus (Sergi, 2003a). This new theory came at the time of the beginning of the European enlargement and the fact that the Washington Consensus had already lost much credibility in many parts of the world. However, the analysis on the *Bruxelles Consensus* needs to calibrate the original proposal that we aimed to address the model that European institutions were adopting during the 1990s.

As aforementioned, the membership of new states into the European Union calls for an updated and realistic analysis of to integrate all these countries into the European Union and to create a very dynamic socioeconomic block (Sergi, 2003a). To begin with, we have seen that one of the first steps undertaken by new market economies in Central-East Europe has been the transformation of the banking systems concerning the restructuring and consolidation process seems to have been finished. Most of the specific factors of the transformation process have also been dwindled. Economies are stabilised and are not suffering from the external and internal shocks of the beginning of reforms. A legislative and institutional environment has been cultivated, regulator and prudential rules have been systematically introduced and applied, privatisation is ending, and corporate governance has been gradually improved. The analysis presented in Chapter 3 shows that applied measures in dealing with banking crises have varied among transition countries and they were dependent on a political consensus. Bad loans clean up has turned out to be complex and a delay in restructuring increased costs and eventually required a stronger response (Matousek and Sergi, 2005). Although the experience does not offer us firm conclusions about the optimal crisis resolution in the banking sector in transition, however, looking back we could argue about the essential elements of what could have been an optimal resolution, elements that have, to some extent, characterised a quasi-optimal crisis resolution as in Hungary.

Macroeconomic stability, enterprise restructuring and replacement of inept management must simultaneously accompany rescue operations and consequent consolidation, and abolishment of forced subsidised credits. If this is not achieved then it will be reflected in the continuous inefficient credit loans. The failure to recognise the problem of establishing a firm line between old and new loans (stock vs. flow) called for repeated bailouts in the Czech Republic. Another observed mistake of banking crisis resolution is that government interventions did not guarantee a 'level playing field' for enterprises and banks. In addition, the presence of moral hazards due to budgetary softness was evident in all three countries. The Czech and partly even Hungarian case shows that without an incentive structure, a re-capitalisation programme would fail.

A crucial aspect for stabilisation of banking sectors, among others, was privatisation. Delays in privatising (state-owned banks) had negative external effects on the restructuring process and the economy as a whole. Partial privatisation – e.g. as that applied in the Czech Republic at the outset of reforms – was undoubtedly positive but a further delay caused additional costs. Bank privatisation, however, should not be perceived as a panacea for all shortcomings within a given economy, but is essential to eliminating distortions caused by mixed ownership structure. Therefore, the inherited bad and nonperforming loans added up to new debts due to bad banking lending, delayed enterprise restructuring and prolonged economic crises. This fact has constrained the ability of commercial banks to act as protagonists of investments and recovery. This experience encourages three main policy recommendations: *(i)* the borrowing of the experiences concerning central banking from advanced countries concerning a strategic restructuring of commercial banks through internal deeper micro restructuring; *(ii)* the importance to enhance collaboration across the region, nonetheless consistent with the European integration and the global level; *(iii)* a clear opening of domestic markets to foreign banks and competition.

A second step of our realistic analysis is to consider globalisation and global entrepreneurship as being not less relevant, because this issue poses questions to ponder as well as paradoxes. Should the balance between the freedom to operate and the accountability to shareholders and international community be the same everywhere? Alternatively, should managers/insiders be allowed more leeway in less efficient markets? Should we insist on compliance with international best practices or does this delay world economic growth? The international community is slowly becoming divided regarding the benefits of globalisation. Should there be universal rules or is it more important to preserve national and cultural values? A single global model may be inappropriate due to differences in cultural, social, and economic levels of development in the developed countries versus those in less developed countries. As the concept of globalisation and global entrepreneurship impresses on Central-East European society's choices and alternatives between their native values and the values of globalisation policies, the difficulties can swing from developing dynamism to absolute inconsistency that leads to economic stagnation, social dysfunction and less cultural value in some part of the world. Herein lays the challenge of participating with an international system while keeping one's national interests at heart. In such an environment, can business legitimately function in its own eyes as well as in the eyes of the local and regional population? That question still awaits a definite answer. Movement in the direction of a new consensus may not be occurring and growing with momentum provided by the growing realities of wealth disparity globally and the growing chorus for change (Tumpel-Gugerell *et al.*, 2002). In the final analysis, the impact of culture cannot be ignored while dealing with globalisation since it drives the concept and the process.

The third step is reconsidering the role of the European Union's institutions in inspiring a durable recovery in Central-East Europe. This calls for an active and pragmatic European policy that puts transition in Central-East Europe and overall growth in the wider European Union under innovative economic and social dimensions. Overall, these new realities urge us to recognise the history and developments of this European model. The steps undertaken in Lisbon and its after-effects serve the purpose to modernise European prospects and expectation of those social groups who do not benefit from growth. The question one must answer is whether international realities mark the new model with consistency. The implications for decision makers are enormous and although the European Union is today the largest single economic block in the world, the world's leading exporter as well as the largest internal market, Europe has still to improve and calibrate its model to fit no homogenous economic and social circumstances and multicultural diversities. Under such a new European Union dimension, which is much due to the definitive adoption and development of the *Bruxelles Consensus*, this thesis features the development of a strategic model for European socioeconomic policies resting on some assumptions set forward by Keynes, Schumpeter and supply-side economists (Sergi, 1996, 1997b, 1998a, 1999b, 2003a). Our thesis is that the European policy could move in this more diverse way across national experiences and become an example of successful structural reforms by that proving that there is more than logical links among the three visions than the standard account would suggest. By that, the major achievement that we made in our publications and that was pertinent to infer the European model of the 1990s and the early part of this decade, has to endeavour to introduce an ethical perspective and effective policy headed for the new Europe.

In addition, it would be of interest to think about the March 2005 summit that has discussed the Commission's midterm review of the Lisbon strategy for economic, social and environmental renewal. As we have seen, the European Council and the Commission decided to prepare a midterm review of the Lisbon process, this after having March 2004 European Council mandated Former Dutch Prime Minister Wim Kok to lead a group of experts with the objective of reviewing the Lisbon strategy (European Communities, 2004). The Kok report concluded in November 2004 that we had made little progress over the first five years and recommended to refocus the agenda on growth and employment. It also underlined the need for real ownership by the member states of the reforms needed. If the report focuses on the knowledge society, the internal market completion for services, especially financial services and removing obstacles to the free movement of goods, improving the business climate, reinforcing the labour market, and environmental sustainability, four of the five issues (except the environmental sustainability) have been touched in this thesis.

We have analysed in the previous chapters the investment on information technology and the passage from the past Soviet-type system to a market economy, investment on IT, effective and realistic national action plans to relaunch the Lisbon reforms agenda, labour markets (in Slovakia). Nevertheless, the Commission's proposals to relaunch the Lisbon agenda have raised controversy about the equality of the three pillars in the process, i.e. economic growth and competitiveness, social inclusion and environmental concerns; the dispute is between various political forces in the European Parliament. Others focus on how the Commission could force the member states to establish national action plans, and even if governments would agree to such plans, to control how we will carry out these) (Sergi, 2005c).

It follows that focussing on growth and employment, simplifying domestic ownership via more effective and realistic national action plans, is the key element to restart the Lisbon reform agenda and prepare the whole Europe to restructure the European Union budget purposely by 2009. Despite the Commission's proposals to restart the Lisbon agenda caused controversies, in the light of previous scrutiny, which is evidence for tremendous effects on the logic of decisions taken at the European Union level, the additional work to be done in Europe will develop the final project of European model so that it takes into account all aspects of European realities. The European model has to assess the potential development of the new model in a broader context we have to reflect on different socioeconomic realities and uneven economic growth. Despite this fact adds to diversity of problems and policies, on the contrary the opportunity to elaborate and shape definitively coherent and self-reinforcing European approach is the major accomplishment of political and business leaders. In the light of previous scrutiny, which is evidence for tremendous effects on the logic of decisions taken at the European Union level, the additional work at the European level is to develop a model that takes into account all aspects of European realities, focusing on social solidarity and economic growth by dealing with the problems that undermine the effectiveness of market-based competition in certain sectors (for the health sector, see Kornai and Eggleston, 2001). The sensible and reasonable new model in Europe that is known as the *Bruxelles Consensus* would attest the fundamental implications, changes and opportunities of the new European model in its past, present and future effects on Central-East Europe.

The European model has been systematically adjusted and past and future waves of enlargement to the East have to be interpreted carefully. The high level of social protection that has long characterised the European model is an enjoyable opportunity for the whole Europe. To assess the potential development of the new model in a broader context one has to reflect on different socioeconomic realities and uneven economic growth. Therefore, the necessity of elaborating a coherent and self-reinforcing European approach is the major accomplishment for European leaders. In this European context, however, one should not oversee another main point to consider, that is, the many interactions between the international economic organisations and national governments. It is true that international economic interaction and the role of economic organisations with their guidelines to national governments, but said organisations have broadened their roles during the past decades and attempted to adjust their policies in order to comply with national realities.

7.1 Final Reflections

Most traditional political and economic interpretation regarding the European economy and its enlargement towards Central-East has relied on a seemingly separate and distinct differentiation, or even official separation, between traditional economic development analysis and social judgment. In the post-1989 environment of the entire Central-East Europe, this reality has represented the single most serious mistake concerning the vast majority of official analyses. This because the obvious gap between expectations at the public level and actual development realities have been so overwhelming, the public has simply given up on experts have still referred to as official analysis. The public naturally wishes to assume that expectations created by experts and business leaders are realistic and can be assumed to represent a certain degree of development reality. However, post-1989 predictions and assessments have been so far from reality, and the public began to assume a level of cynicism. This is why experts must create expectations that are scientifically consistent and that meet the level of ethical expectations carried by the public.

The political aspects of the European Union's enlargement were expansive but successful overall. Managing the costs attributed to trade, the independence of central banks, commercial banks and management of domestic firms reveals positive outcomes, but controversy developed when social restrictions were loosened while its political environment continued to contradict with economic, cultural and social standards of transforming countries. Proponents of totally free trade and the other pillars of the Washington Consensus argue that we already establish positive standards of living. Weighing the social, economic and political aspects of a country is a critical issue whose costs can be high, but ultimately can determine the success or failure of the venture in the end. The *Bruxelles Consensus* explored in this thesis, represents the way Europe has dealt with the transformation in Central-East European economies. A renovated *Bruxelles Consensus* enhances the chances of Europe growing healthily, establishing a smoothly socioeconomic growth while providing a broad social consensus.

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Appendix 1

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