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Aftermath of the Great Recession: Challenges of coordinating fiscal consolidation and growth enhancing innovation policies in Central and Eastern Europe

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Abstract

For overcoming the Great Recession, the EU has proposed a strategy that combines austerity-driven fiscal policy and growth enhancing financing through innovation policy supported by fiscal and economic policy surveillance and coordination mechanisms. Based on the analysis of three diverse Central and Eastern European economies – Estonia, Slovenia, and the Czech Republic – we show that this strategy seems to lead to convergence of fiscal and innovation policy practices thereby eroding existing varieties in policy coordination, increasing potential conflicts in policy-making processes, and potentially leading to increasingly de-contextualised fiscal and innovation policies.

Keywords: Great Recession; fiscal policy; innovation policy; Estonia; Slovenia; Czech Republic

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Introduction

The Great Recession has laid bare the major institutional deficiencies of the EU: a monetary union without a fiscal (and full political) union. The search for short-term and long-term institutional solutions to these deficiencies – from European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM) to Two and Six Packs, Banking Union and the European Central Bank's (ECB) expanded asset purchase program – have set in motion deeper political and economic integration of the EU and a policy choice to pursue austerity as an exit strategy (at least in 'deficit countries' – Mody 2015). Given the less-than-expected success of this strategy, the EU has sought to balance austerity with other strategies by recommending member states to '*sustain and where possible promote growth enhancing expenditures within overall fiscal consolidation efforts*'; that is, to regard research and development and innovation (RDI) investments as sources of renewed growth (EC 2014a), and to coordinate fiscal and economic policies accordingly.

Yet, Veugelers (2014) has shown that during the Great Recession innovation-lagging and fiscally weak countries have cut their public funding while innovation-leading and fiscally stronger economies have increased their RDI expenditures. In other words, shorter-term fiscal policy concerns have dominated policy debates and also influenced longer-term RDI policy choices. As a result, the growth and competitiveness divergence within the EU seems to persist. Further, Izsak et al. (2014) argue that between 2004-12 we have witnessed in the EU member states even too extensive convergence in innovation policies overlooking structural differences (in demand conditions, innovation capabilities) between countries.

In this paper, we are specifically interested in how the proposed 'growth enhancing' strategy – to pursue fiscal consolidation while maintaining growth oriented innovation policy – has evolved since 2008 in the newer member states from the Central and Eastern Europe (CEE[1]). These economies represent a rather unique group of countries in the EU in terms of how these policy strategies emerge and evolve in domestic policy arenas. Reinert and Kattel (2014; also Pula 2014) argue that the logic of CEE integration to the EU has suffered from the onset from structural contradictions leading to *integrative yet asymmetrical integration* (attempts to integrate countries at different levels of economic development into a welfare state), or even to *welfare colonialism* (de-industrialisation and erosion of productive factors in the peripheral economies is paralleled by increasing welfare transfers via EU cohesion policy and remittances). Further, as opposed to also peripheral Southern European member states, CEE countries have participated as full members in the EU decision-making processes only since 2004, but at the same time have also acted as *rule takers* when adopting the Euro and/or relying on the EU cohesion policy for financing economic restructuring (Bruszt and McDermott 2012). Thus, the pressures and likelihood for de-contextualised policy convergence – both in processes and outcomes – seem to be rather high both in fiscal policy (Myant and Drahokoupil 2012; Myant et al. 2013) and innovation policy (see Karo and Kattel 2010; Suurna and Kattel 2010; Izsak et al. 2014). In most analyses these potential tendencies remain hidden as the EU – as a *transnational integration regime* (Bruszt and McDermott 2012) – formally prioritises institutional and capacity building as a prerequisite for integration. In essence, ever since the Werner report in 1969, the EU integration has assumed that EU wide rules are adapted to local circumstances. We argue that in the aftermath of the Great Recession, the EU's initiatives for fiscal and innovation policy coordination engender almost opposite processes, and further reinforce pressures for de-contextualised convergence. We focus on the practices of policy-making as the design of strategies and actions plans for the current EU financial period (until 2020) has brought about institu-

[1] We include in the discussion the countries that joined the EU in 2004: Estonia, Latvia, Lithuania, Poland, Hungary, Slovakia, the Czech Republic, and Slovenia.

tional innovations – in fiscal and innovation policies – with potentially significant impacts on the future policy-making processes and outcomes.

In the next section we provide a brief overview of the EU economic and fiscal policy coordination before and during/after the crisis. This is followed by a discussion of the evolution of the varieties in economic policy coordination in CEE. Thereafter, we analyse how have three different CEE economies – Estonia, Slovenia, and the Czech Republic (representing specific subtypes of CEE capitalisms) – responded through national policies to the Great Recession and EU developments in fiscal and innovation policy coordination. The concluding sections summarise and discuss the broader implications of our findings.

Economic and fiscal policy coordination in the EU

Without going into the details about the flaws in the architecture of the EU and the Eurozone, the last 10 years of economic and fiscal policy coordination in the EU show significant inconsistencies. Overall, this process has been characterised by growing integration while resisting further supranationalism (Bickerton et al. 2014; Schimmelfenning 2015) leading to what Habermas (2012) has labelled *executive federalism* (i.e. integration taken further by intergovernmental agreements and institutional solutions). Though, Savage and Verdun (2015) show that also the Commission (especially the Secretariat General and DG for Economic and Financial Affairs), as the enforcer of the of fiscal and economic policy coordination agreements and rules, has changed its internal structure, coordination practices and increased its administrative capacities to be able to survey and advise economic, labour market, taxation and other polices on a country-by-country basis. We are interested in how these processes have influenced domestic policy-making processes of rule takers, such as the CEE economies. We concentrate on two distinct periods – pre-2008 crisis and post-2008 crisis – in two distinct policy domains – fiscal and innovation policy (as a subset of economic policy) – that have become increasingly intertwined.

The pre-crisis period

In hindsight, we can see that during the years preceding the crisis the EU was almost giving up – due to lax enforcement – on its earlier agreements for fiscal policy coordination. In 2005 the EU revised the *Stability and Growth Pact* to provide more flexibility for interpreting the deficit and debt rules (Hallerberg 2011). As a result, fiscal governance was relatively flexible and countries could deploy their established fiscal policy approaches to finance (i.e. via deficit financing, or other means) their varieties of capitalism (Schmidt 2002). These varieties seem to have persisted into the

For CEE, the pre-crisis period overlapped with the accession to the EU (in 2004) and the commitment to eventual Eurozone accession. While in the 1990s economic policies in CEE concentrated mostly on macro-economic stabilisation and monetary, liberalisation, privatisation, taxation, and labour-market policies with significant varieties in specific approaches (see Lane and Myant 2007), by mid-2000s many of these policy domains either 'matured' (e.g. privatisation), or converged through the EU accession processes (e.g. financial liberalisation and monetary policy). This limited the scope of policy tools that could be employed for specific domestic challenges that differed from the 'old' EU. Since most CEE economies had been competing for FDI through different tax policy models already in the 1990s (from tax exemptions to low or no taxes on reinvested profits), the scope for tax policy competition was also rather limited (Cass 2007; Bohle and Greskovits 2012). Thus, *innovation policy* in the broad sense (including industrial, R&D, educational policies both on the national and regional level) became one of the key policies through which government could in theory try to differentiate economic policies and tackle their unique growth and development challenges.

At the same time, it became increasingly evident on the EU level that the expectations set on the *Lisbon Agenda* for supporting growth and competitiveness were not being fulfilled (Rodrigues 2009). The flexible open-method-of-coordination type mechanisms and high-technology biased horizontal innovation policy approaches contributed to policy convergence on *European Paradox* based thinking and policy focus on supporting commercialisation, collaboration and networking between innovation system actors (Dosi et al. 2006). Yet, this has not been the main structural problem in many especially lagging economies in CEE (Karo and Kattel 2010; Izsak et al. 2014). On the EU level, this recognition resulted in the search for alternative logics of competitiveness and innovation policies already in mid-2000s and in growing emphasis on more targeted and customised policy mixes (see EC 2004; 2005; Foray et al. 2009).

The crisis and post-crisis period

The Great Recession brought about a policy shift in the fiscal policy coordination in the EU (see Bickerton et al. 2014; Hallerberg 2011; Verdun 2015). After a short period of fiscal stimulus, the EU and especially Eurozone shifted to austerity as the key policy response (see Mody 2015). Institutionally, this shift started with the initiation of the *European Semester* as a coordination mechanism in 2010. It was followed by the reinforcement of the *Stability and Growth Pact* via the reforms of the secondary legislation in 2011 (*Six Pack*) that combined fiscal and economic policy supervision under the European Semester. This was followed by more strict surveillance mechanisms (e.g. European assessment of draft budgets, domestic fiscal councils, graduated monitoring for countries under *Excessive Deficit Procedure*) for the Eurozone members via the so-called *Two Pack* and the *Fiscal Compact* (i.e. the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*) adopted in 2013.

These shifts in economic and fiscal policy coordination overlapped with the development of a new approach to competitiveness and innovation in the Europe 2020 strategy. Polices shifted away from a horizontal focus on framework conditions for innovation and development. The EU RDI policies have taken a clearer focus on the EU-wide grand or societal challenges (Leijten et al. 2012). Especially for the CEE economies and other lagging regions, this shift has also overlapped with new perspectives of regional and cohesion policy. *Smart specialisation* as an *ex ante* conditionality emphasises the need to design regional and national innovation policies taking into account not only local economic and RDI capabilities, but also the relative advantages and specialisations of regions and countries within the EU (McCann and Ortega-Argiles 2013; Karo and Kattel 2015). Thus, the EU has sought to coordinate regional and national policies through more explicit conditionalities, guidelines and recommendations.

By now, under the European Semester and other coordination mechanisms, the EU seeks to coordinate and guide innovation policies together with the coordination and supervision of fiscal and other economic policies. Veugelers (2014) argues that the outcomes of these processes – mostly policy recommendations – seem to be of uneven quality indicating that the EU still lacks sufficient capacities for such coordination and supervision. Yet, in peripheral economies acting as rule takers (while finalising the adoption of the Euro and relying on the EU cohesion policy financing) and/or being under stricter fiscal supervision (i.e. Excessive Deficit Procedure), these recommendations may have rather strong conditionalities attached to them and may lead to more concrete policy implications and potential conflicts with established models of economic coordination.

The evolution of CEE modes of capitalism

CEE economies are often treated as a homogeneous group (especially the eight countries that joined the EU in 2004), but detailed within-group comparisons have often emphasised their differences. For example, the *varieties of capitalism* literature has distinguished Estonia and Slovenia as almost ideal-type cases of *liberal market economies* and *coordinated market economies* with other CEE economies following more mixed models

(Feldman 2006; Lane and Myant 2007). Since the Great Recession and resulting policy evolutions, there have been studies from different perspectives of political economy confirming some and questioning other claims of the original varieties of capitalism research.

Bohle and Greskovits (2009; 2012) develop a more detailed approach to *political dimensions* of the CEE modes of capitalism. They argue that the Baltic States can be treated as a group following a *neoliberal* approach, the Visegrad countries as *embedded neoliberal* economies, and Slovenia as a distinct *neo-corporatist* outlier in CEE. These categories reflect not only ideological positions, but also the forms of *state-market-society relations* (from the dominance of free market imperative in the neoliberal countries towards more embedded tri-partite relationships and societal compensation of marketization reforms through welfare state policies). Further, they note (see also Stanojevic 2014) that both the Slovenian and Visegrad model have been pressured to converge towards the neoliberal end of the spectrum by Europeanization and financialisation.

Myant and Drahokoupil (2012; Drahokoupil and Myant 2015) argue that the political-economy explanations of the CEE developments – especially after the Great Recession – should also account for the varieties in the *modes of international economic integration*. Thus, CEE economies discussed in this paper can be divided into *exporters of complex manufacturing goods* (historically more West-integrated and FDI-driven Visegrad countries and less FDI-driven Slovenia) and *financialised economies* (historically more peripheral and technologically lagging Baltic States). These modes of integration have also been mirrored by different economic policy approaches: from less interventionist macro-economic and innovation policies in the Baltic States to gradually more active industrial and FDI policies in the embedded neoliberal and neo-corporatist economies. Still, looking at industrial and innovation policies, Török (2007) has argued that after the differences in crisis management approaches in the early 1990s and by mid-2000s all CEE economies were converging on rather similar horizontal policy approaches (see also Izsak et al. 2014; Karo and Kattel 2010; Suurna and Kattel 2010 confirming the further convergence since mid-2000s). In Table 1 we have summarised these key variables before the Great Recession in three CEE economies – Estonia, Slovenia, the Czech Republic – to account for some of the key regional variations in the initial conditions (political and economic legacies) leading to different models of political and economic integration, forms of societal coordination, and current policy-making models and governance systems.

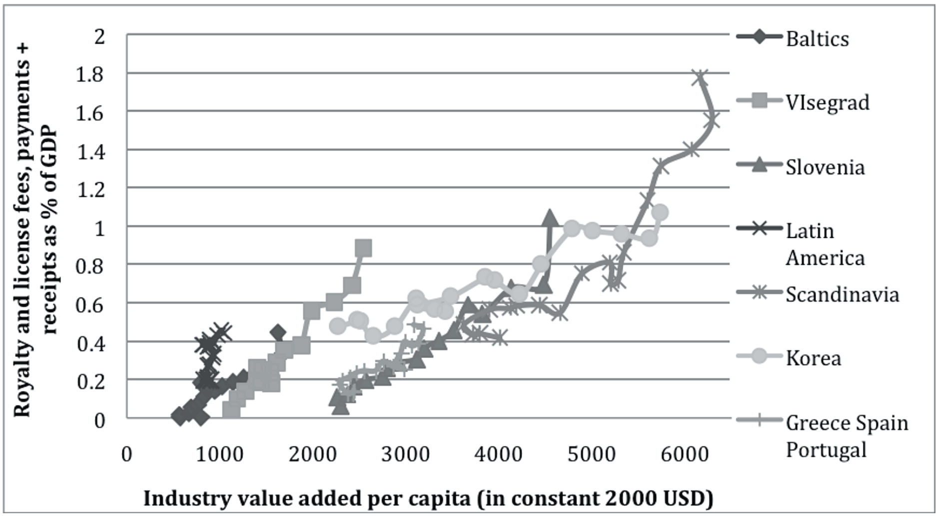
Table 1. Models of integration and economic coordination in CEE

	Estonia as a neoliberal state	Slovenia as a neo-corporatist state	Czech Republic as an embedded neoliberal state
Political and economic legacies	Political and economic integration within Soviet Union	Political and economic integration within Yugoslavia, but acting as its export hub to the West	Czechoslovakian command economy (until 1993) with Western production and export ties
Dominant political ideologies since the 1990s	Centre-right (with neo-liberal parties in government since 2005) with weak social coordination and compensation mechanisms	Social-democratic (centre-left) stability until 2004 followed by left-right swings and erosion of previously strong social coordination	Shifting between centre-right and centre-left (first centre-left government in late 1990s) and relatively strong social coordination
Political integration since the 1990s	EU (2004) and Eurozone member (2011); clear ideological stance towards the EU	EU (2004) and Eurozone member (2007); gradualist approach to integration	EU member state (2004) with some Euro-scepticism (e.g. out of Fiscal Compact until late 2014)
Economic integration since the 1990s	Low value-added subcontractor within the Scandinavian production networks	Exporter of complex manufacturing goods (and close export links to ex-Yugoslavia)	Exporter of complex manufacturing goods
Financial integration since the 1990s	Strong financialisation: currency board and pegged currency, liberalised FDI, external financing of banking system; no significant domestic banks (by 2008+)	Regulated FDI and finance (production-driven) until mid-2000s followed by early adoption of Euro (2007) and financialisation (banking, industry)	Openness to FDI in export/manufacturing sectors with strong domestic finance of banking (domestic savings and currency) and relatively low financialisation
Modes of economic restructuring policies	From no policy industrial policy (1990s) to horizontal and Europeanised innovation policy (2000s)	From national capitalism based industrial policy (1990s) to gradually Europeanised innovation policy (2000s)	From national capitalism based (hidden) industrial policy and FDI-supporting industrial policy (1990s) to gradually Europeanised innovation policy (2000s)

Source: Authors.

These categorisations are also quite well supported by data on economic performance in terms of knowledge-based or innovation-related competitiveness. All countries (especially Estonia and Slovenia) are among the leading innovation performers in CEE (though as ‘innovation followers’ in the EU Innovation Union Scoreboard). Figure 1 depicts the evolution of knowledge intensity and industrial productivity in selected regions and economies. Plotting these two measures should show virtual development ladder: as economies get more knowledge intensive, we expect them to also exhibit higher industrial productivity.

Figure 1. Knowledge intensity and industrial productivity, 1990-2008.



Source: World Bank WDI Online database, calculations by the authors (for regions we use simple averages).[2]

As we can see, not all countries and regions have moved along the development ladder with similar speed or following similar trajectories. The Baltic States, Slovenia and Visegrad form three different patterns; although, the Baltics and the Visegrad countries are quite similar (in particular as a lot of the growth in knowledge intensity took place in Hungary). For these two regions, vicinity to core European exporting economies (Scandinavia and Germany respectively) has brought about increasingly complex production, but this is not reflected in increasing productivity. Both regions exhibited signs of asymmetrical integration in the wake of the Great Recession.

The Great Recession and policy responses in CEE

The differences in the *financial systems* affected how the Great Recession unfolded in different CEE economies. Myant et al. (2013, pp. 385) have depicted the emergence and the evolution of the crisis through the following steps:

> First came a sharp halt to credits that affected most severely those countries that had been dependent on financialised growth, but also led to increased caution from banks in all countries. Next came a fall in demand for exports from those countries exporting products that were sold with the help of credits, meaning motor

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2 WDI online database, available at: http://data.worldbank.org/data-catalog/world-development-indicators, accessed 1 September 2015.

> vehicles and other high-value consumer goods. The reductions in incomes through lower profits and wage payments led to a further reduction in domestic demand and to lower tax revenues and this, plus any additional spending undertaken in the context of the crisis, led to deepening state-budget deficits.

Thus, the crisis unfolded in different time-scales and patterns in different CEE modes of capitalism (see also Table 2).

Table 2. Economic and policy performance in CEE

	2007	2008	2009	2010	2011	2012	2013	2014
Real GDP growth %								
Estonia	7.7	-5.4	-14.7	2.5	7.6	5.2	1.6	2.9
Slovenia	6.9	3.3	-7.8	1.2	0.6	-2.7	-1.1	3.0
Czech Republic	5.5	2.7	-4.8	2.3	2.0	-0.9	-0.5	2.0
Unemployment rate (% of labour force)								
Estonia	4.6	5.5	13.5	16.7	12.2	10.0	8.6	7.4
Slovenia	4.9	4.4	5.9	7.3	8.2	8.9	10.1	9.7
Czech Republic	5.3	4.4	6.7	7.3	6.7	7	7	6.1
General government deficit/surplus (% of GDP)								
Estonia	2.5	-2.7	-2.2	0.2	1.2	-0.2	-0.2	0.6
Slovenia	-0.1	-1.4	-5.9	-5.6	-6.6	-5.0	-14.9	-4.9
Czech Republic	-0.7	-2.1	-5.5	-4.4	-2.7	-3.9	-1.2	-2.0
General government gross debt (% of GDP)								
Estonia	3.7	4.5	7.0	6.5	6.0	9.7	10.1	10.6
Slovenia	22.7	21.6	34.5	38.2	46.5	53.7	70.3	80.9
Czech Republic	27.8	28.7	34.1	38.2	39.9	44.6	45.0	42.6
Total government expenditures (% of GDP)								
Estonia	34.3	39.7	46.0	40.5	38.0	39.8	38.8	38.8
Slovenia	42.2	44.0	48.5	49.2	49.8	48.1	59.7	49.8
Czech Republic	40.0	40.2	43.6	43.0	42.4	43.8	41.9	42.0
EU fiscal transfers (% of GDP) (calculated based on Eurostat)								
Estonia	0.46	0.70	3.40	3.67	1.47	3.78	3.15*	
Slovenia	0.26	0.37	0.92	1.31	1.38	1.55	1.37*	
Czech Republic	0.25	0.71	1.11	1.40	1.17	2.02	2.22	
Fiscal consolidation (% of GDP) (OECD 2012)								
Estonia			9.20	6.40	3.70	3.10	3.10	
Slovenia				2.60	3.80	4.50	5.30	
Czech Republic				2.70	4.70	5.70	6.30	
Government financed GERD (% of GDP) (OECD MSTI database[3])								
Estonia	0.49	0.63	0.68	0.69	0.77	0.83	0.83	
Slovenia	0.51	0.51	0.64	0.73	0.76	0.74	0.70	
Czech Republic	0.58	0.55	0.61	0.59	0.65	0.66	0.66	
GBOARD (% of total general government expenditure)								
Estonia				1.73*	2.02*	2.08*	2.11*	
Slovenia	1.22	1.14	1.4	1.22	1.19	1.1	0.81	
Czech Republic	1.34	1.27	1.34	1.33	1.51	1.47	1.56	

Sources: Eurostat database[4] (if not stated otherwise; *provisional/estimated).

3 OECD MSTI database, available at: http://www.oecd.org/sti/msti.htm, accessed 1 September 2015.

4 Eurostat database, available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database, accessed 1 September 2015.

Kattel and Raudla (2013) argue that in the Baltic States two clear patterns emerged. Although the *Estonian* economy was highly financialised, no real sovereign banking crisis occurred owing to the foreign ownership of the banks (largest Estonian banks were owned by Swedish banks). However, the impact of financial contraction quickly spread to the real economy as industrial production contracted by 25.8% in 2009. In the face of falling tax revenues (resulting from the economic contraction), the crisis quickly came to be viewed mostly as a crisis of public finances. At the same time, a single domestically owned bank that had relied on external financing created a banking crisis in Latvia. *Slovenia* entered into recession in the first part of 2009. Initially, the manufacturing and construction sectors became the 'hotspots' of the crisis (see Guardiancich 2012) spreading (especially from 2012 onwards) to the banking sector and public finances (Pevcin 2014). Myant et al. (2013) show that within the Visegrad group, some countries (i.e. Hungary) faced significant problems in the financial/banking system – due to the vulnerability of the financial sector and dependence on external financing – and strong pressures to reverse its policy models. *The Czech Republic* had a more internally controlled financial systems (conservative lending even by foreign banks, higher saving rates and loans denominated in domestic currency) and less need for fast crisis responses. Thus, the crisis was treated as a temporary external event (Šlosarcik 2011).

Crisis responses in 2008-11

Estonia entered the crisis the earliest (in 2008) and with the most significant slump. In the early phases of the crisis the government responded with large fiscal consolidation (9.6% of GDP in 2009) through fiscal tightening and a wide range of expenditure cutting measures (6.2% GDP in 2009). After 2009, the worst seemed to be over as the economy returned to growth and in the second half of 2010 employment started picking up again. (Kattel 2010; Kattel and Raudla 2013) Still, the economic conditions (growth based on relatively small export sector not supported by strengthening domestic demand and credit supply) did not lead to a comprehensive exit from the crisis. In 2010, the government's fiscal consolidation policies centred more on revenue side (in 2010 the expenditure reduction measures were about 2.3% of GDP while the revenue measures totalled 4.0% of GDP). These austerity policies were implemented by a centre-right government (minority coalition from 2009) that legitimised these crisis management choices through the prospect of adopting the Euro as a crisis exit strategy (Raudla and Kattel 2011).

The *Slovenian* centre-left government tried (from 2008-11) to implement in parallel both consolidation and fiscal stimulation measures (Pevcin 2014; Mencinger 2014). The government had to function within a new model of politico-economic coordination – weak unions and abolished tri-partite coordination model – established by the outgoing centre-right coalition (in power from 2004-08 after long social-democratic dominance) (Stanojevic 2014). Thus, Maatsch (2014) has shown that during the early days of the crisis the ideological positions of the Slovenian political elite (all major parties of the parliament) showed universal ambiguity about whether to follow more Keynesian (stimulatory) or neo-liberal (austerity) model of crisis management. The political elite was waiting for the EU responses and recommendations and the early responses were rather ad hoc (also Pevcin 2014). The *Excessive Deficit Procedure* (EDP), under the Stability and Growth Pact, was launched in 2009 (it is projected to last at least until 2015). The EU (Council 2009) recommended implementing both fiscal consolidation measures and structural reforms (pension, labour market and economic policies). The Slovenian Exit Strategy for 2010-13 combined short-term crisis management measures (guarantee schemes for banking and other sectors, job maintenance subsidies, incentives for investment in new job creation) and long-term structural measures (balancing budget via operational austerity measures and not via tax increases; reforming pension systems, labour market). The government failed to reinitiate the coordination with unions and tried to implement these policies unilaterally. This led to losses in referenda and in the early general elections in 2011 (Stanojevic 2014).

The Czech Republic government adopted in late 2008 and early 2009 crisis plans including stimulus measures – tax reductions, temporary reduction in employers' social security contributions, increased expenditures on R&D – of about 2.2% of GDP (over 2009 and 2010; OECD 2010; Myant 2013). The EU launched the *Excessive Deficit Procedure* in 2009 (ended in 2014). Further, a technocratic government - oriented towards reducing the budget deficit (to 5% and later to 3% of GDP) in order to join the Eurozone – replaced the government in power (Myant 2013). The government succeeded in negotiating a consolidation package that was supported by the labour unions and employers' representatives. However, the 2010 budget created a political stand-off and the centre-left parties negotiated extra spending provisions making the deficit climb from 5.3 to 5.7% of GDP.[5] The 2010 elections brought a coalition of three centre-right parties that positioned themselves as strong supporters of austerity (back-tracking from tripartite-agreed cri-

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5 Radio Praha (2009) 'Left-wing triumphs in dramatic debate over 2010 Czech budget', available at: http://www.radio.cz/en/section/curraffrs/left-wing-triumphs-in-dramatic-debate-over-2010-czech-budget, accessed 1 September 2015.

sis measures), but showed also Euro-scepticism.[6] Their austerity plans (to cut public sector wages, tax hikes, reforms in healthcare and pensions) brought strikes and protests not seen since the late 1980s[7].

Crisis responses since 2011

Estonia managed to adopt Euro in 2011 and since then, the imminence of crisis has petered out. This vindicated the centre-right government's approach to the crisis (they formed a new coalition after 2011 elections) and austerity (or 'doing more with less') has been treated as the new normalcy. Although Estonia implemented front-loaded austerity plan and has not had official expenditure cuts since 2010 (but concentrated on revenue increasing measures of about 3% of GDP for the following years) (OECD 2012), the fiscal position of the government has remained fragile and while some of the temporary austerity measures (i.e. halt of government contributions to the second pension pillar) have been reversed, others (e.g. increase in VAT, deregulation of labour market without complementary security measures) have not been totally solved. Estonia has been a clear supporter of the *Fiscal Compact* and other EU-level initiatives to strengthen the coordination and governance of economic and fiscal policies in the EU (EC 2015a). At the same time, there has been more public discontent with government policies (e.g. strikes by teachers and doctors in 2012). In 2014, the leading centre-right Reform Party changed its main coalition partner (Pro Patria) for the centre-left Social Democrats, but this did not change the general stance towards fiscal governance and acceptance of the EU rules (same three parties formed a new coalition after 2015 elections).

By 2011/12, it was evident that *Slovenia* faced more complex crisis than previously thought and the government had to – under the Excessive Deficit Procedure and given the weak performance of export partners – implement more stringent fiscal consolidation (cuts also in social transfers) than initially planned (government deficit was reduced from 6.3% of GDP in 2011 to 3.8% in 2012; OECD 2012). Pevcin (2014) claims that 2012 was the beginning of 'true' austerity led by the returning centre-right government and initiated through the Fiscal Balance Act adopted in May 2012. This reflected a new and more coordinated approach to fiscal consolidation (stronger role for the Ministry of Finance, engagement of

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6 Aktualne.cz (2010) *'Hopping on austerity bandwagon: 2010 in Czech politics'*, available at: http://zpravy.aktualne.cz/hopping-on-austerity-bandwagon-2010-in-czech-politics/r~i:article:686614/, accessed 1 September 2015.

7 Reuters (2010) 'Czech public sector workers on strike, government firm', available at: http://www.reuters.com/article/2010/12/08/czech-strike-idUSLDE6B70H620101208, accessed 1 September 2015.

social partners) (Pevcin 2014; Guardiancich 2012). By 2012/13, the main focus shifted to the problems in the banking sector (these resulted from financing the construction boom and the 2nd wave of privatisation through management buyouts – Guardiancich 2012) that were downplayed in the Slovenian Exit Strategy 2010-2013. The *Measures to Strengthen the Stability of Banks Act (ZUKSB)* foresaw strengthening the banks via capital increases, the purchase and transfer of claims to Bank Asset Management Company (BAMC), and guarantees by the state for liabilities of BAMC and for requisite liquidity to banks as the last resort (Mencinger 2014). Since 2013 and despite political instabilities (between 2012-14 there were three governments of different political affiliations), austerity policies have remained in place (eventually including also significant tax increases alongside expenditure cuts). The government managed to borrow money from the markets to avoid a bailout and set up the 'bad bank' (BAMC) set to receive almost half of the total bad loans during 2013-14 (it was estimated that the related guarantees – about 4 billion euros – increase the government debt by 11.4% of GDP; see Republic of Slovenia 2013). In adopting the EU-level agreed fiscal rules (including the stipulation of structural deficit rule in national legislation), Slovenia has been one of the laggards in the EU and the processes are expected to be finalised for the 2016 budget process. (EC 2015b)

By 2011, the GDP growth started to slow down again in the *Czech Republic* as austerity measures cut domestic demand and output. The country was reported to be back in technical recession by early 2012 also due to the dependence on Eurozone markets. (Myant 2013) The government strategy maintained the goal to lower the budget deficit further via raising taxes, pension and healthcare reforms, and the centralisation of public administration.[8] In 2013, a high-profile scandal led to arrests of multiple civil servants, which led to the resignation of the prime minister and the austerity driven government as a whole (replaced by an interim technocratic government). The 2013 elections were won by the left-wing Social Democrats (promising no further tax hikes, expect for 'big business') who formed a coalition with the Christian Democrats and the new party ANO 2011.[9] While the prior governments had been rather sceptical of the Eurozone and further integration, the new government formally

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8 Aktualne.cz (2011) *'Czech govt presses for higher taxes, stronger state'*, available at: http://zpravy.aktualne.cz/czech-govt-presses-for-higher-taxes-stronger-state/r~i:article:697120/, accessed 1 September 2015.

9 Aktualne.cz (2013a) '2013: The year that shook Czech politics', available at: http://zpravy.aktualne.cz/2013-the-year-that-shook-czech-politics/r~i:article:798454/, accessed 1 September 2015. Aktualne.cz (2013b) 'New coalition kicks the can down the road on taxes', available at: http://zpravy.aktualne.cz/new-coalition-kicks-the-can-down-the-road-on-taxes/r~i:article:796964/, accessed 1 September 2015.

supported the Fiscal Compact in 2014. But as of 2015, some key institutional developments (i.e. establishing a fiscal council) are still lagging and the Commission (EC 2015c) considers the fiscal rules framework to be among the weakest in the EU.

Evolution of innovation policies since the Great Recession

Underneath the austerity and consolidation measures and in the context of maintaining growth-supporting investments, one can witness increasing (though somewhat hidden) importance of the EU cohesion funds as an important crisis management policy tool. In official operational plans for 2007-13 cohesion policy period Estonia designated 20.02% (681.3 MEUR), Slovenia 24.69% (1012.6 MEUR), and the Czech Republic 15.11% (4009.5 MEUR) to projects and activities related to RDI. Between CEE, Estonia and Slovenia had the highest proportions and the Czech Republic was on the fourth place. (EC 2013) Further, Veugelers (2014) has calculated (based on 2007-13 data) that in many CEE countries cohesion funds more than doubled the volume of government R&D funding (that is included in the GBAORD data). In Estonia, cohesion funds allocations for RDI equalled 79% of GBAORD, in Slovenia 59% and in the Czech Republic 56%. Further, especially in smaller CEE economies, the FP7/Horizon 2020 RDI funds (not covered in GBAORD data) have accounted for significant additional 'public' funds to R&D, i.e. in Estonian and Slovenia FP7 funds equalled (between 2008-12) 14% of GBAORD and in Czech Republic about 5% (Malta had the highest rate in the EU equal to 25%).

During the early years of the crisis, *Estonia* (and other Baltic States) chose (see also Table 2) a conscious strategy of front-loading economic restructuring oriented cohesion funding investments (from support to businesses and universities to active labour market policies) to re-balance cost-cutting activities (see Table 2; Kattel 2010). Also, many elements of the *Slovenian Exit Strategy* for 2010-13 (guarantee schemes, job maintenance subsidies, incentives for investment in new job creation) were partly financed by the faster utilisation of the EU funds that was seen as a mechanism to offset the drop in tax and other revenues. In parallel, one can witness a gradual decline in government funding of RDI especially since the 'real austerity' from 2012 onwards (see also Udovic and Bucar 2013). In the case of *Czech Republic*, Schrolec (2013) argues that it also used EU funding to reduce the budget deficit in 2008-11 (using more EU funds to finance activities, including RDI, that would have had to been cut otherwise).

To summarise, while the EU cohesion funds are designed as *additional* funding for activities that speed up convergence-oriented restructuring in the newer member states and lagging regions, the EU-driven austerity policy has further incentivised CEE economies to use this funding for shorter-term policy concerns (balancing budgets by off-loading certain elements of policies to the EU funds), but also for shifting innovation policies from measures with long-term impact (e.g. financing R&D projects and institutions) towards measures with more short-term impact (e.g. tax reliefs and export, training and other subsidies to firms). We can argue that the crisis, austerity and fiscal governance rules have further institutionalised the previously softer drivers – EU policy learning – that act as key elements in innovation policy convergence (Izsak et al. 2014; Karo and Kattel 2010). It is also evident that off-loading innovation policy (that requires significant input from private actors in policy implementation processes) to EU funds and policy logics has fitted better into and created less conflicts in policy coordination in more simple and non-interventionist politico-administrative systems (i.e. in Estonia) than has been the case in more corporatist countries (i.e. in Slovenia) where the EU financed innovation policy has faced constant institutional reshuffles (see Karo and Looga 2014).

Paralleling the evolution of economic and fiscal coordination framework, the EU cohesion policy has gone through a significant shift as well. There is much stricter *ex ante* conditionality to link and coordinate regional and innovation policies via *smart specialisation*. Yet, fulfilling this criterion has been a major hurdle (see also Karo and Kattel 2015). Estonia adopted the formal strategy in early 2014, Czech Republic in late 2014, and Slovenia submitted its final draft (after several revisions) to the EU (for revisions and coordination) only in mid-2015. The outcomes of this strategy-making process seem to lead to similar policy thinking in all CEE countries, despite the above-discussed differences in their economic integration patterns and financial systems. All three countries plan to focus – next to some historically important local domains, such as auto industry in the Visegrad region – on similar and rather broad domains (such as the use of ICT in industry; healthcare and medical devices; smart materials, construction and energy system) and move only slightly beyond the previous (2007-13) common policy emphasis on ICT, biotechnology and material sciences. Sörvik and Kleibring (2015) also show that the EU regions in general have tended to choose rather similar domains of specialisation with weak links to existing economic and innovation structures.

Overall, partnership agreements to use the cohesion policy funds have been signed (throughout 2014) while there are on-going debates between the Commission and member states on the processes and content of smart specialisation. In the case of Estonia, the Commission has repeatedly emphasised in the cohesion policy negotiations that the Estonian policy approach towards smart specialisation has been rather vague in determining national focus areas. While the EU expects smart specialisation to be the key focus of RDI oriented cohesion funds, Estonia tries to interpret it as one of the many potential focuses, next to scientific excellence etc. (EC 2014b). In the case of Slovenia, the Commission has been even more critical of the processes and requested significant overhaul of the processes (EC 2014c). Thus, in 2014, the Government Office for Development and Cohesion Policy took over from ministries specialised in RDI the coordination, design and implementation of the smart specialisation strategy (to the extent of re-drafting the strategy and carrying out new processes of public consultation) (see Republic of Slovenia 2014).

Given the difficulties in designing strategies and policy approaches that fulfil the EU conditionalities, innovation policy is also gaining a more prominent place also in the European Semester based economic coordination and supervision, especially since 2014. In reviewing the *National Reform Program of Estonia*, one of the recommendations formally by the Council and informally by the Commission staff (through Country Reports) for the 2014/15 has been to work further on the prioritisation and specialisation in the research and innovation systems and to enhance cooperation within the innovation system (see Council 2014a; 2015a; EC 2015a). Similarly, the Council and Commission recommendations have emphasised that Slovenia needs to improve the coordination between policy actors and also between smart specialisation strategy processes and the 2011 Research and Innovation and the 2013 Industrial Policy Strategies (Council 2014b; EC 2015b).

Among the Visegrad countries – being also larger in size in comparison to both the Baltic States and Slovenia – at least *Czech Republic* seems to show different policy dynamics. The Czech Republic is considered as the most successful outlier in the Visegrad because it has industrially the most advanced and balanced regional setting (see OECD 2011). Throughout the 2000s, Visegrad countries in general have had stronger regional levels of governance and the EU structural funding has (at least formally) had a clear regional focus (the Baltics States are single NUTS2 regions and Slovenia will be divided into two NUTS2 regions for the 2014-20 period). Thus, also the EU feedback to the Czech Republic on national policies has not mentioned innovation policy issues other than that the national smart specialisation strategy has to be complemented by 14 regional (NUTS2) strategies and be more decentralised. At the same time, the regions of South Moravia and Prague are considered as the only regions with functioning innovation policy capacities and other regions seem to face significant challenges in introducing contextually defined innovation policy into their regional policy mixes (see Shrolec 2013).

In sum, the EU seems to pressure for more policy change and to adopt its proposed innovation and regional policy models as part of growth-enhancing policy across the EU. At the same time, the concept of smart specialisation itself lacks still a clear policy rationale (see Karo and Kattel 2015) in the EU and needs to be first coordinated between DG Regio and DG Research and Innovation to become a sustainable and systemic policy instrument. Yet, Savage and Verdun (2015) show that the European Semester processes and national recommendations are now coordinated mostly between the Secretariat-General, Eurostat, DG Economic and Financial Affairs, DG Employment, DG Taxation. Thus, the EU itself might be imposing conditionalities that are not yet fully operationalized and coordinated on the EU level.

Discussion: the future of CEE modes of capitalism?

While austerity and related economic and fiscal policy coordination mechanism in the EU have turned RDI into a crucial growth enhancing policy, we see that the evolution of EU crisis management policies and national strategies seems to be creating some unintended hurdles.

First, austerity-driven balanced budgets approach has reduced the policy space for economic restructuring policies. In addition to lacking or limited monetary policy, also fiscal policy space is becoming increasingly constrained and with a short-term focus. The case studies indicate that this seems to be the case even in countries where prior traditions have favoured close forms of state-society coordination (stronger welfare state policies) and state-market coordination (industry-specific industrial and innovation policies). Estonia has taken up the key EU fiscal coordination principles the easiest and there are signs that thinking of austerity-as-a-way-of-life is gaining ground among politico-administrative elite. At the same time, the adoption of the EU institutional framework for fiscal coordination seems to be much more delayed both in Slovenia and the Czech Republic given the resulting political instabilities and erosion of the past corporatist and embedded coordination models. The politics of achieving balanced budget in the short-term seems to contradict these modes of coordination and hence undermine the inner logics of these types of capitalism.

Second, the increasing importance of innovation policy in the EU economic coordination seems to be the outcome of both domestic and EU level processes. During the 2000s and especially since the crisis kicked in, CEE economies have themselves given up a lot of policy space in this policy domain by shifting innovation policy funding to the EU finances. Since early 2010s, the EU has gained new roles for coordinating national and regional innovation policies through both revised coordination of economic and fiscal policies and shifts in the framework and conditionalities of cohesion policy. To date, this process seems to follow rather one-sizefits-all treatment of member states as the EU seems to lack capacities to propose contextually suitable policy-making and implementation designs (see also Karo and Kattel 2015). Especially smaller member states (Estonia and Slovenia) seem to find it difficult to combine the regional logic of cohesion policies with their national-level policy-making dynamics.

Taken together, these developments have led – especially in the embedded neoliberal and neo-corporatist economies – to significant redrawing of state-market-society coordination models. While the Estonian governance and institutional framework seems to have very few conflicts with these evolutions, the Slovenian and Czech models have potentially multiple conflicts leading to political instabilities and bottom-up action against governments and policy initiatives. In other words, the EU initiated and more top-down coordination and constraints have narrowed the room for policy choices and maintenance of more corporatist state-market coordination models.

Conclusions

Some schools of thought in political science argue that the Great Recession has increased the intergovernmentalist and executive federalist tendencies in the EU (Habermas 2012) overlooking the political and economic varieties, especially in the context of the widening of the EU (Stanojevic 2014; Reinert and Kattel 2014). We have argued that we are witnessing these tendencies also in innovation (and regional) policies, at least in CEE. The EU cohesion policy funds remain as the few sources through which CEE economies can finance new growth and convergence oriented strategies. CEE economies could also benefit from policy learning from more developed countries and institutions such as the EU. Yet, the EU's intergovernmentalist integration patterns, while seeking to manage the Great Recession, seem to create policy compromises, conditionalities and institutions that reinforce de-contextualised policy convergence in Europe's periphery.

In contrast to fully federalist systems, these policy mixes are inherently unstable because they do not allow for significant fiscal transfers (via automatic stabilisers of welfare systems) and movement of labour in order to offset slumps in demand. Politically, they seem to strengthen external constraints on domestic politics and policy-making and simultaneously increase instabilities in more corporatist and embedded political systems. Thus, the EU needs not only to decide upon its further path of federalisation (or not), but regardless of the former choices, the EU also needs to build in its institutions and policies flexibilities that allow for context-fitting policy choices considering the varieties in the modes of capitalism and in the traditions of policy coordination found in CEE.

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