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## Beyond neoliberalism? Revisiting the welfare state in the Baltic

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## **Beyond neoliberalism? Revisiting the welfare state in the Baltic**

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### **Abstract**

Political economy scholars have criticised the Baltic countries' transition to capitalism as socially 'disembedded' and exposed to a zealous form of neoliberalism. Relying on the traditional definition of the welfare state, i.e. solely focusing on cash compensation of the losers of transition, these accounts have failed to recognise the Baltic countries' re-orientation towards social investment. This article argues that the Baltic welfare states have experienced a more complex post-socialist transformation than suggested by the neoliberal retrenchment narrative. To that end, it uncovers high investment in education, comparatively generous labour market policies and an expansion of public sector employment.

Keywords: welfare state; social investment; capitalist diversity; knowledge economy; Baltic states

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## **Beyond neoliberalism? Revisiting the welfare state in the Baltic**

Political economy scholars have criticised the Baltic countries' transition to capitalism as socially 'disembedded' and exposed to a zealous form of neoliberalism. Relying on the traditional definition of the welfare state, i.e. solely focusing on cash compensation of the losers of transition, these accounts have failed to recognise the Baltic countries' re-orientation towards social investment. This article argues that the Baltic welfare states have experienced a more complex post-socialist transformation than suggested by the neoliberal retrenchment narrative. To that end, it uncovers high investment in education, comparatively generous labour market policies and an expansion of public sector employment.

### **Introduction**

Transition from socialism to capitalism in Eastern Europe was described as the 'great economic experiment of the 20th century' (Stiglitz 1999, p. 3). It was also likened to 'rebuilding the ship at sea' (Elster *et al.* 1998), due to the unprecedented economic restructuring and institutional reforms that were taking place at the same time. In the early 1990s, Eastern European countries faced the colossal tasks of privatising their state-owned enterprises, introducing property rights and tax systems, and establishing democratic political competition, while also having to find a way to attract private capital and jumpstart their economies from the initial recessions that they confronted following the collapse of socialism. Following the demise of collective ownership of production inputs, new social contracts had to be established which would determine the dynamics of redistribution between workers, owners of capital and the state in these emerging capitalist economies.

Since these institutional and economic reforms were shaped through interactions between transnational capital, international epistemic communities and domestic political actors (Orenstein *et al.* 2008), as well as the countries' specific historical path dependencies and their demographic and geographic characteristics, different post-socialist economic and institutional structures emerged across the region. Comparative political economy literature has acknowledged a variance between the capitalist development trajectory pursued by the Baltic countries—Estonia, Latvia and Lithuania—on one hand, and the Visegrad countries—Czech Republic, Hungary, Poland and Slovakia—on the other. The Visegrad countries have pursued economic growth by upgrading their industries towards higher value manufacturing products (Stockhammer *et al.* 2016). Instead, the smaller Baltic countries focused on rapid liberalisation to attract foreign capital into high value service sectors

such as banking, information and communication technology (ICT) and real estate (Bohle and Greskovits 2012). Both of these stylised<sup>1</sup> trajectories have been characterised by high dependence on foreign capital and international markets in the context of integration with the European Union (EU) (Nölke and Vliegenthart 2009), which has raised concerns over the sustainability of such externally dependent economic models, especially since the 2008 economic crisis.

Policy and academic literature has stressed the Baltic countries' neoliberal characteristics, their rapid and effective market liberalisation, macroeconomic stability, simplified tax systems as well as the reduction in total public spending (Aslund 2002, 2013). Comparative political economists also underlined their zealous pursuit of macroeconomic stability and economic openness, as well as was minimal state involvement in the functioning of the economy. Bohle and Greskovits (2007, 2012) identified the Baltic trajectory of economic reform as 'disembedded neoliberalism', characterised by minimal state efforts to establish new welfarist contracts and compensate their population for the redistributive losses that they endured due to the collapse of socialism. Literature has also juxtaposed such a trajectory of capitalist development to the more socially 'embedded' form of neoliberalism that was implemented in Visegrad, and which was characterised by substantial cash compensation of the losers of transition via unemployment benefits and early retirement schemes (Bohle & Greskovits 2012; Vanhuysse 2006).

This article revisits and challenges such an interpretation of the Baltic vs the Visegrad countries' economic transitions and the respective welfarist contracts that emerged from them, by throwing light on those components of the Eastern European emerging welfare states which have not been examined in the above literature. To do this, it relies on the new generation of comparative welfare state research which focuses on social investment policies, such as state investment in education and training (e.g. see Morel *et al.* 2012), and the positive impact they have had on the reduction of social inequalities in the era of liberalisation (Thelen 2014). The article shows that a social investment agenda has been implemented in the liberalising Baltic countries, following which it suggests a revision of the retrenchment narrative surrounding the Baltic welfare states. In other words, by showing that a lot more than a passive disintegration of the welfare state took place in the Baltic, the article challenges existing accounts of capitalist diversity in the region which are based on the traditional definition of the welfare state as solely the provider of passive social welfare programmes.

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<sup>1</sup> We refer to them as stylised because they do not examine the differences between countries which are grouped within these broader regional classifications of capitalist development.

Specifically, the article shows that educational expenditures, labour market policy and employment in the knowledge-intensive parts of the public sector, all of which have been associated with social investment in the literature, have been generally more extensive in the Baltic than in the Visegrad states. Based on this empirical evidence, the article then argues that post-socialist welfare state development in the Baltic has been characterised by a more complex set of reforms than simple retrenchment, and a re-orientation towards social investment.

Since the article takes a comparative approach to analysis within the context of Eastern Europe, this trajectory of post-socialist welfare state development in the Baltic is juxtaposed to the one found in Visegrad. The article is exclusively interested in this intra-regional comparison between the Baltic and the Visegrad countries because these countries are at similar levels of economic development, which allows us to uncover the policy and spending patterns that are not visible in the more frequently encountered comparisons between Eastern Europe and the more developed western European economies, where the focus is on whether the Eastern countries are catching up with the core of the EU.

Furthermore, while we acknowledge that the three Baltic countries have smaller populations than the Visegrad countries,<sup>2</sup> as well as somewhat different historical legacies (they were part of the Soviet Union) and geographies (their proximity to the Nordic countries), the starting assumption of this article, which is the common approach in comparative political economy, is that economic policy and politics since the early 1990s have also shaped Eastern European capitalist growth models and welfare states and that socialist legacies and the countries' geographies alone cannot entirely explain these countries' welfare state developments since the onset of transition.

Finally, by showing that social investment oriented social policies have been more developed in the Baltic than in Visegrad countries, the article also expands the comparative welfare state literature on Eastern Europe and aligns it with the ongoing debates on welfare state developments in western Europe which focus on social investment and its role in underpinning knowledge-based competitiveness in the era of ICT-led growth. Arguments presented in this article thus also revisit the existing political economy narrative that the Baltic countries' approach to organising the economy and stimulating growth has simply been based on services

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<sup>2</sup> Estonia has 1.3mn inhabitants, Latvia 1.9mn, and Lithuania 2.9mn. On the other hand, Slovakia is the smallest in the Visegrad group, with 5mn inhabitants, Hungary and the Czech Republic have 9mn and 10mn respectively, and Poland is by far the largest with 38mn inhabitants.

liberalisation and credit expansion, and point out that educational investment, relative flexicurity in the labour market and digitalisation have also been important components of the competitiveness agenda in the region, and most notably in Estonia.

The article adheres to the following structure. The next section discusses the existing literature on the changing role of the welfare state in the era of ICT- and knowledge-intensive growth and literature on capitalist diversity in Eastern Europe. The key argument is then presented. Section 3 shows statistical indicators on R&D expenditures, educational policy, labour market policy and public sector employment in the Baltic and Visegrad spanning from the 1990s to the second decade of the 21<sup>st</sup> century, and supplements it with some primary sources, such as government documents and reports. The final section summarises the article's contribution and its theoretical and empirical implications.

### **Literature review and argument**

Inspired by a new generation of social policy literature which focuses on new social risks, the argument put forward in this article revisits the political economy account on post-socialist welfare state reform in the Baltic, which is currently based on the traditional definition of the welfare state. The traditional social policy view is that European welfare states have been shrinking and disappearing over the past few decades (Allan and Scruggs 2004; Pierson 2006), driven by neoliberalism that reduces the state to regulation as the main instrument of economic governance (Schmidt and Thatcher 2013). More recent scholarship has, however, challenged this perspective (Fougner 2006; Hemerijck 2012; Jenson 2010; Morel *et al.* 2012), by arguing that European welfare states have in fact been adapting to new economic circumstances and new social risks which have emerged in response to the changes in demographic, family and labour market structures, as well as growing fiscal pressures.

These emerging trends have generated a scholarly interest in the so-called social investment policies which focus on creating and enhancing the human capital of the population to support the expansion of the knowledge-intensive economy as a key vehicle of modern era growth (Morel *et al.* 2012). These focus on the reduction of labour market vulnerability of individuals through investment in their human capital from early childhood through life rather than via passive social insurance of adults. The logic of social investment is to subsidise disadvantaged citizens to improve their marginal productivity, so that they can access higher wages and better quality jobs. It is a very different approach to managing an economy from a laissez-faire one which

sees the state as a regulator only. In that context, Jensen (2008, p. 160) argues that education should be considered part of the welfare state and that its absence from the literature and welfare state measurements may be more a matter of convention than anything else. Furthermore, efforts to expand the definition of the welfare state beyond social transfers and also focus on social services have been rife in the more recent literature (see Schelkle 2012 for an overview).

This reconceptualisation of the welfare state has also had consequences for how political economy scholars view the role of social policies in economic development. Social investment policies have been theoretically and empirically associated with the so-called knowledge economy and knowledge-based competitiveness. Over the past 20-30 years, deindustrialisation and expansion of the service economy have come hand in hand with the onset of the so-called digital era and proliferation of information and communication technology (ICT) as an important input for growth. These multifaceted changes in economic structure across the developed market economies have updated economists' beliefs about the nature of the service economy and its implications for jobs and growth in the following fashion, which has had an important influence on policy makers. Namely, standard economic theory suggests that services are less productive than manufacturing, and that wages in the service economy are necessarily lower than wages in manufacturing. This is because a traditional service worker cannot service more than one client at once without decreasing the overall quality of their work, while technological progress in industry can substantially increase a worker's output and thus their wages. Emergence of the ICT and knowledge-based economic model has changed this traditional perspective on the potential of the service economy. A new narrative has emerged around these new developments that growing educational attainment, along with an increase in digitalisation and flexibility of the workplace, can substantially increase the productivity of service work, and thus lead to better quality jobs and higher wages across a wide range of service sectors which benefit from these technological and institutional innovations. This is the logic that underlines the influential concept of knowledge-based growth in the digital era, which has been strongly advocated by intergovernmental organisations such as the European Commission (EC) and the Organisation for Economic Cooperation and Development (OECD) over the past two decades, and which goes beyond the IT sector and emphasises the economy-wide productivity enhancing role of new technologies.

So what adaptations has the welfare state experienced along with the emergence of the idea of knowledge-based competitiveness? Instead of assuming that the role of the welfare state is to protect the population from market forces through cash benefits that smooth their income in times of need, there has been

a growing interest in understanding how welfare state reforms are used to support countries' knowledge-intensive growth trajectories (Hassel and Palier *fm*; Morel *et al.* 2012). Given the emergence of the 'new' ICT-driven and knowledge-based service economy, tapping into the knowledge and skills of the workforce has been recognised as a key driver of economic growth and development across the European Union (EU) and beyond. Public investment into human capital has thus become a key welfare state input for the knowledge-intensive growth model. Thelen (2014), most notably, has shown that liberalisation in some countries, most notably in Scandinavia and in the Netherlands, has gone hand in hand with social investment policies delivered by the state, which has led to a collectivisation of new social risks and provided a cushion against increasing flexibilisation of the labour force. She differentiates such a liberalisation trajectory from the one pursued by the United States and United Kingdom, which has been characterised by deregulation and has led to individualisation of risk. Nelson and Stephens (2012) have shown that, contrary to conventional wisdom about liberalisation, substantial public sector investment is needed to support growth of high productivity service jobs.

Social investment can therefore be viewed as a political strategy that transforms the current distributional conflict over cash resources in the era of liberalisation and knowledge-intensive growth into a future-oriented welfare for all through equitable production, mobilisation and maintenance of human capital. In other words, instead of looking at social investment only as a supply side intervention, it can also be seen as an alternative perspective on redistribution, or a government strategy for strengthening the negotiating position of labour vis-à-vis capital by providing them with more education, which then feeds into higher productivity, higher wages, better living standards and economic growth (Midgley 1999).

This new generation of political economy and social policy research that focuses on knowledge-based competitiveness and social investment has not yet made significant inroads into political economy scholarship on Eastern Europe. In an initial attempt to analyse capitalist diversity in Eastern Europe, Feldmann (2006) classified Estonia as a liberal market economy (LME), without making specific reference to the fact that such economies are considered internationally competitive in high-end services, ICT and other sectors that rely on radical innovation and changing market conditions (Hall and Soskice 2001). Bohle and Greskovits (2012) have argued that the Baltic countries have pursued market liberalisation and deregulation, which has resulted in a high level of individualisation of social risks and social disembeddedness (also see Vanhuysse 2009). They briefly mention these countries' substantial investment into education, ICT and reduction of new social risks, but do not develop the argument further. Finally, they argue that such rapid liberalisation of the Baltic



economies was possible due to little political pressure to compensate losers of transition and that the Baltic neoliberal model was feasible because of these countries' emphasis on identity politics of nation building and alienation from the Soviet Union, which resulted in high social tolerance for inequality. According to them, the perceived threat of Russia united the people politically and made it feasible to impose a high economic and social cost on the population. They go on to conclude that, because of this high social tolerance for inequality, the Baltic countries could focus on economic growth only, rather than also on redistribution and monetary compensation of the losers of transition.

On the other hand, micro studies and country case studies, most of which focus on Estonia, indicate that ICT and education have played an important role in the Baltic growth model. Lumiste *et al.* (2007) recognise the key role that investment in ICT has played in the stellar economic performance of Estonia, not only in the IT sector but more widely, through its overall impact on productivity. Runnel *et al.* (2009) amply discuss the country's strategic plan to develop into a modern ICT-intensive service economy. Estonia's achievements have also been hailed as outstanding by international media. 'When Estonia regained its independence from the Soviet Union in 1991, less than half of its population had a phone and its only independent link to the outside world was a Finnish mobile phone concealed in the foreign minister's garden. Two decades later, it is a world leader in technology' (*The Economist* 2013). In OECD's 2015 Programme for International Student Assessment (PISA), Estonian 15 year olds were ranked third in the world by educational attainment, after Singapore and Japan (*The Economist* 2016).

Furthermore, in the introduction to the special issue of *Social Policy and Administration* which compares the Baltic and Nordic welfare states, Greve (2017) explains that the two neighbouring regions have some similarities vis-à-vis the social investment orientation of their social policies, while in other aspects, the Baltic states have gone down the Anglo-Saxon deregulation route. He further points out that this assessment depends on the specific policies that are being examined and that there is also variation both within the Baltic as well as within the Nordic states. This special issue, however, does not compare the Baltic countries to the Visegrad ones, which is the approach taken in this article. In other words, this article acknowledges that the Baltic welfare states are not at the level of the much more developed Nordic countries, but also argues that they are shaping in that direction, in contrast to the Visegrad states, which are at the similar levels of economic development and where absence of social investment policies is much more pronounced.

Finally, policy interest towards educational reform in the Baltic could have been further spurred by their nation-building efforts following the region's secession from the Soviet Union, which would have

generated an initial political impetus towards educational and social investment-oriented reforms. This hypothesis stems from the literature such as Gellner (1983), who has argued that nation-building and educational policy have historically been ‘bedfellows’. There is also the theory of ‘education as compensatory legitimation’ model originally developed by Offe (1976) and Weiler (1983), where ‘educational reforms are a mechanism of state policies aimed at legitimating the state’s authority in a conflicted civil society’ (Khavenson & Carnoy 2016, p.180).

These various literature strands offer substantial indications that social investment policies would have been implemented in the Baltic, at least to a greater extent than this has been the case in Visegrad countries, and motivate the next section of this article, which provides an empirical assessment of welfare state trends in the region.

### **Empirical analysis**

This section starts with a brief assessment of the extent to which the ICT-intensive and knowledge-based model of competitiveness has been pursued by the Baltic countries in comparison to their Visegrad neighbours, which have been at similar levels of economic development. The assessment is based on indicators related to research and development (R&D) expenditures, employment in knowledge-intensive services, and digital literacy. The intention of the section is not, however, to provide a comprehensive overview of the Eastern European capitalist models of growth, but to motivate a further exploration of our suggestion that there may be more to the Baltic welfare states than is suggested by current political economy scholarship.

Following this overview, and in line with empirical studies on social investment policies from social policy and comparative political economy literature (see Morel *et al.* 2012 for an overview), the section goes on to compare education policy, labour market policy and public sector employment trends between the Baltic and Visegrad countries over the past two decades. While some of the literature also associates work-family reconciliation policies such as childcare with social investment (Morgan 2012, Nelson and Stephens 2012), this article does not examine these policies since formal childcare provision has not become a politically salient topic in Eastern Europe until very recently. Following the comparative political economy approaches advocated by Shalev (2007) and Collier (2011), these policies are analysed using country level statistical indicators, which are supplemented by primary literature sources, such as governmental and intergovernmental country reports.

The data are obtained from Eurostat, OECD, the Comparative Welfare Entitlements Dataset (CWED), the Mutual Information System on Social Protection (MISSOC) and the ICTWSS database (Viser, 2016).

*R&D, knowledge-intensive employment and digital literacy*

While R&D expenditures as a share of total government spending throughout Eastern Europe have expectedly lagged behind the more developed western market economies, Figure 1 (left panel) indicates their variation within the region. Since 1995, which is the first available data year, R&D expenditures across the seven countries have been the highest in Estonia followed by Lithuania, as well as the Czech Republic (which has generally been at a higher level of economic development than the rest of the region). While the upward trend has continued in Estonia and the Czech Republic since the 2008 crisis, it has reversed in Lithuania, where the impact of the crisis was more severe. Latvia, on the other hand, has lagged behind all seven Eastern European countries throughout the period of observation (Figure 1, left panel). A very similar pattern can be observed when R&D expenditures as a share of government spending are replaced by R&D expenditures as a share of GDP. It is also worthwhile to note that the higher growth rates in the Baltic countries than in Visegrad during the 2000s imply that these R&D allocations in Estonia, followed by Lithuania, were even more substantial than these indicators show.

A similar picture emerges when we look at R&D personnel as a share of total employment (Figure 1, right panel), with Estonia, Lithuania and the Czech Republic as regional leaders. Also, in contrast to the trend seen for R&D expenditures, the share of R&D personnel in total employment has not dropped in Lithuania following the onset of the 2008 economic crisis, possibly because the country also experienced a temporary fall in employment in other sectors. Latvia has seen an increase in R&D personnel over time, and it has been at the level of Slovakia throughout the period of observation, while Poland has fared the worst among the seven countries (Figure 1, right panel).

< Figure 1 about here >

Figure 2 (left panel) shows knowledge-intensive service employment as a share of total working age population in the Baltic and Visegrad countries. According to Eurostat, an activity is classified as knowledge intensive if more than 33 per cent of employees in that activity have tertiary education. Therefore, it is important to note that knowledge-intensive employment is not considered as exclusively located in the IT sector, but in every sector, including parts of the public (administration, health and education), where there is a critical mass

of knowledge and digital technologies that can boost the productivity of the workforce. According to Figure 2 (left panel), knowledge-intensive employment in the Baltic, and particularly in Estonia, exceeds that found in the Visegrad countries. While proving a causal relationship between policy inputs and labour market outcomes would require a more rigorous empirical analysis, this descriptive trend indicates that the service economy in the Baltic is more dynamic and knowledge-based than in Visegrad.

<Figure 2 about here>

The level of digital literacy, proxied by internet usage skills,<sup>3</sup> is also higher in the Baltic than in Visegrad countries (Figure 2, right panel). Furthermore, according to *The Web Index*, Estonia is ranked very highly in a number of dimensions of the Internet's contribution to social, economic and political progress in countries across the world.<sup>4</sup> For example, in terms of the *Access and affordability of the Internet* component of the Index (which includes indicators such as access to internet in schools, cost of broadband per capita income and policies promoting free and low cost internet access), Estonia ranked third in Europe and Central Asia in 2014, right behind Denmark and Finland. While Lithuania and Latvia are not included in this survey,<sup>5</sup> the Czech Republic was in the 17<sup>th</sup> place, followed by Hungary which was in the 18<sup>th</sup> and Poland in the 22<sup>nd</sup>. In terms of the *Education and awareness* component of the index, Estonia was also ranked third, after Iceland and Denmark, while Visegrad countries lagged substantially.

Estonia also ranked higher than Latvia and Lithuania in terms of its educational and ICT infrastructure already during the early 2000s, as well as its high-technology exports. Latvia appears to have been slightly more advanced than Lithuania in terms of hi-tech exports, but weaker in communication technology and R&D efforts (World Bank 2003, p. 8). Lithuania has also continued its progress in communication technology, and by 2013 the country was ranked 8<sup>th</sup> in the EU according to usage of electronic government services (KPMG 2014). Less information is available on the role of ICT and innovation in the Latvian and the Lithuanian growth models than

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<sup>3</sup> Individuals with proficient internet usage skills can complete 5 or 6 of the following activities: used search engine, sent mail with attachment, posted messages to chatrooms/newsgroups or online discussion forum, made phone calls, done peer-to-peer file sharing or created a web page.

<sup>4</sup> This index is produced by the World Wide Web Foundation and it is the world's first measure of its contribution to social, economic and political progress at country level.

<sup>5</sup> While this index does not include Lithuania and Latvia, other sources indicate that these two countries, although lagging after Estonia, are aspiring European leaders in ICT.

on the Estonian one, which is likely the case because Estonia has become an internationally recognised emerging leader in this field, while the two other Baltic states have not adopted this knowledge-based model of competitiveness and growth to the same extent. Nevertheless, the indicators presented in this section offer enough anecdotal evidence on the Baltic countries' generally greater commitment to ICT-led economic growth than Visegrad's, which motivates us to examine the nature of welfare state reform in the region and assess to what extent it has been adjusted to the needs of this 'new' economy.

### *Education policy*

The collapse of the Soviet Union in 1989-1991 led to structural changes in the educational systems of the newly independent Baltic states. OECD reviews of national education policies during the 1990s show that all three Baltic countries started the process of vigorous and all-encompassing education reforms which shared similar concepts and principles (OECD 2002: 15). The countries differed in terms of the sequence of implementation of educational reforms, but they nevertheless shared many similarities. All three also saw unprecedented grassroots engagement of educators and drastic increases in tertiary educational enrolment numbers already during the early stages of transition (OECD 2001a, 2001b, 2002).

Apart from the many legislative changes which served to reform the higher education curricula, strengthen the research infrastructure and create more flexible degree programmes, the Baltic countries' educational reforms were also characterised by strategic thinking about how education could strengthen their position in the global economy. The reform of the educational system towards a 'technological revolution' also had an additional aim to revitalise democracy and bring citizens closer to the state which was rebranding itself as efficient and modern (Runnel *et al.* 2009). Using a range of indicators to measure the types of skills that characterise educational systems in Eastern Europe, Martinaitis (2010, pp. 89-91) shows a stronger orientation towards general skills in all three Baltic countries in comparison to the Visegrad ones. Originating within the *Varieties of Capitalism* analytical framework, general skills are considered those which are transferable across firms, and even across sectors. They underpin high-end services, ICT and other sectors that rely on radical innovation and changing market conditions. Martinaitis (2010, pp. 82-3) also argues that the three Baltic countries paid much less attention than Visegrad countries to the development of vocational education and specific skills which are geared towards the manufacturing industry and are not easily transferable across sectors. This indicates their intention to reform their educational systems towards general skill regimes, and

thus make them more responsive to a liberal, services-oriented model of growth.

General government expenditures on education as a share of GDP in the three Baltic countries have been significantly higher than educational expenditures in Visegrad countries, especially in comparison to the Czech Republic and Slovakia (Figure 3, left panel). Particularly Estonia has allocated substantial public funds to education, reaching up to 7 per cent of GDP in some years. This makes it one of the biggest spenders on education in the EU, as well as the OECD.<sup>6</sup> Moreover, since the three Baltic countries had exceptionally high growth rates during the 2000s (and higher than those in Visegrad), their nominal allocations towards education would have been growing even during the periods which saw dropping shares of educational expenditures in GDP.

< Figure 3 about here >

Furthermore, Hungary and Poland, who have spent higher shares of their GDP on education than the Czech Republic and Slovakia, especially during the mid-2000s, have not had such a clear focus of educational reform as the Baltic states, which were clearly committed to the establishment of general skill formation systems, as shown by Martinaitis (2010) using fuzzy set analysis. He further shows that Hungarian and Polish educational policy was neither entirely focused on the strengthening of manufacturing and specific skills nor on the development of the general ones (Martinaitis 2010).

High expenditures on education in the Baltic states along with their overall smaller government size also demonstrate that educational spending has been a high political priority for their governments. In other words, education devours a significantly higher share of total public expenditures in the Baltic than in Visegrad countries. Overall public revenue/public spending as a share of GDP in 2002 was 36 per cent in Estonia, and 35 per cent in Latvia and Lithuania, while it was 51 per cent and 45 per cent in Hungary and Poland respectively. Therefore, expenditures on education which amounted to 7 per cent of GDP in Estonia in 2002 constituted 20 per cent of the country's total public expenditures. In contrast, Hungary allocated 11 per cent of its total public expenditures to education in the same year (Figure 3, right panel).

Furthermore, the Estonian government launched the Tiger Leap National Programme in 1997 with the aim to modernise the educational system, and create an inclusive learning environment that is more suited to the needs of 'a knowledge-based, information technology-intensive economy' (OECD 2001a, p. 54). The

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<sup>6</sup> EU-15 average spending on education is around 5 per cent of GDP.

programme equipped schools with ICT, linked them to the internet and offered ICT education and teaching/learning software to teachers. The country also established the Estonian Education Forum, a working group in charge of producing strategic documents on the country's future education scenarios with the aim to inform education policy making (OECD 2001a, p. 54). Lithuania and especially Latvia, however, have lagged when it comes to investment in R&D and ICT as vehicles of growth.

Moreover, all three Baltic countries boast of very high levels of tertiary educational attainment (Figure 4). While a separate analysis would be needed to establish a causal relationship between expenditures on education and educational attainment, it is worthwhile noting that by the end of post-socialist transition, the Baltic countries had a substantially higher share of the population with tertiary education than Visegrad countries, which has been at even higher levels of economic development.<sup>7</sup> In 2014, 32.6 per cent of the working age population had tertiary education in Estonia in comparison to 19.1 per cent in the Czech Republic (Figure 4). Latvia and Lithuania also stood out in terms of the higher educational attainment of their populations in comparison to Visegrad countries. While the earliest available Eurostat data on tertiary educational attainment shows that the Baltic countries were at higher levels than Visegrad countries already in the early 2000s, Terama *et al.* (2014: 116) underline that enrolment in tertiary education in Estonia increased by 168 per cent between 1994/95 and 2005/2006, which constituted the highest growth rate in the OECD during that period.

< Figure 4 about here >

Investment in ICT in the region may have also spurred further demand for higher education. Skill-biased technological change can, in theory, increase the demand for higher education because the complementarity between information technologies and skills can increase individuals' returns to schooling (Castelló-Climent and Hidalgo-Cabrillana 2012).

EU funds have also provided an additional stimulus for educational and innovation-oriented public investment in Eastern Europe. The EU began to heavily shape Eastern European growth models and EU co-financing became an essential factor for the development of the region since the countries became members in 2004. For the programmatic period 2007-2013, EU funds have represented 18.5 per cent of Estonia's GDP, while they have represented 19.4 per cent and 19.6 per cent in Latvia and Lithuania respectively (versus 16.2 per cent Eastern European average). Thus, the Cohesion Fund, European Social Fund and Horizon 2020 have

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<sup>7</sup> Measured in terms of GDP per capita and GDP per capita PPP.

played an important role in promoting social investment in the region, both as part of the Lisbon Agenda, Europe 2020 and the 2013 Social Investment Package. Ever since 1993, member states have been determining the types of activities they spend the EU funds on. Therefore, allocation of funds and their structure reflect the countries' individual economic strategies. In contrast to the other Eastern member states, many of the EU funds in Estonia have been channelled to the development of the knowledge-intensive economy, such as boosting international competitiveness of enterprises through research and development (R&D) investment and technology development. In Latvia and Lithuania the funds have been directed towards training of the unemployed and teachers, as well as increasing knowledge and competences of the workforce, thus indicating their strong orientation towards labour force activation (KPMG 2014), which is endemic to the social investment agenda.

Finally, quality of education in Estonia, in particular, has received substantial international recognition. In the most recent 2015 PISA assessment, the country came only after Singapore and Japan in terms of the proficiency of 15-year-old students in science, reading and mathematics, while it has also become one of the world's top performers when it comes to the inclusion and fairness of secondary education. More than four in ten Estonian students with a disadvantaged background score among the top quarter of students in all PISA participating countries despite the odds against them (OECD 2016). Khavenson & Carnoy (2016) argue that the Estonian long-term commitment to educational performance as an input for international competitiveness has allowed them to achieve such high rankings in international academic assessment exercises. Latvia was also one of the few countries which saw consistent improvements in their PISA scores from 2000, and its performance is at the level of the OECD average, along with the more developed economies such as the United States, Austria and Sweden. Lithuania, on the other hand, has lagged after the OECD average. Therefore, while the data presented in this section indicates that all three Baltic countries have devoted more policy effort to educational reform and expansion than this has been the case in Visegrad countries, Estonia has been a leader in this regard.

#### *Labour market policy*

A range of indicators presented in this section show greater generosity of labour market policy in Latvia and Lithuania in comparison to the Visegrad states, while this comparatively superior performance of the Baltic has been less pronounced in the case of Estonia. This finding may appear surprising at first glance, and also contradictory to the welfare state literature on Eastern Europe, which argues that the Visegrad countries have provided better protection for the unemployed than the Baltic ones. However, this discrepancy in narratives can



be explained by the fact that the Visegrad countries were more generous to those who were losing employment during the initial stages of transition. However, this policy of unemployment compensation and early retirement schemes, which was particularly prevalent in Hungary and Poland, generated serious fiscal pressures following which these policies had to be reformed (Vanhuyse 2009). As shown by the data presented in this section, this process was inverse in the Baltic, where labour market policy gradually became more generous over time. The higher levels of employment in the Baltic throughout transition have likely made the payment of benefits to jobseekers more fiscally sustainable than in Visegrad. This is also the reason why a cross-national comparison of labour market policy expenditures as a share of GDP would not be very informative, since the Baltic countries have had less unemployed persons to spend on than the Visegrad ones.

The specific indicators are examined in the figures that follow. All three Baltic countries have been allocating around 20 per cent of their labour market policy expenditures to training while this category of expenditures has been almost non-existent in Visegrad countries (Figure 5). While there was a dip in expenditures on training during the period of economic recession, their share has recovered in Estonia and Latvia since, while it has continued to lag in Lithuania.

< Figure 5 about here >

Importantly, these expenditures in the Baltic have not come at the expense of unemployment compensation which guarantees income security to the unemployed. Coverage rates, i.e. the percentage of those insured for unemployment risk, have increased in all countries except in Hungary during the early 2000s (Figure 6, left panel). They have also been the highest in the three Baltic countries and the Czech Republic throughout the period of observation. Furthermore, since the mid 1990s in Latvia and since the early 2000s in Lithuania and Estonia, net income replacement rates have substantially increased for the unemployed single individuals earning the average wage, while they slightly decreased in the Visegrad countries (Figure 6, right panel).

< Figure 6 about here >

Figure 7 offers further detail on net income replacement rates, and particularly their progressivity, by showing their levels for married individuals with two children and an unemployed spouse who were earning 50% and 100% of the average wage at the time of unemployment. By focusing on these two categories of social security beneficiaries, we assess income replacement adequacy for those unemployed in the most precarious and vulnerable circumstances. Furthermore, these income replacement rates are obtained from the *OECD Tax and Benefits Calculator* which includes social assistance, family benefits, housing benefits that the person is eligible

for on top of the unemployment benefit, and thus offers a more comprehensive picture of the social security system in the countries of interest.

Latvia and Lithuania, along with the Czech Republic, have the highest net income replacement rates for married with two children earning 50% of the average wage prior to loss of employment—around 100% (Figure 7, left panel). While the replacement rate is substantially lower in Estonia, there has been a significant increase in the country since 2008, following which the country has reached the level of Hungary and Poland, and stood at 80% during the last year of observation, which was 2015. Slovakia has had the lowest income replacement rates throughout the period of observation. When it comes to those earning 50% of the average wage, Latvia and Lithuania have remained among the top performers, and Estonia has caught up with them following the 2008 reform (Figure 7, right panel).

< Figure 7 about here >

Finally, when it comes to the duration of unemployment benefits, the Baltic countries have not been less stringent than the Visegrad countries, except for Poland, where the prescribed benefits' payment period has been longer, but also decreasing over the years (Table 1).

< Table 1 about here >

Finally, Masso and Krillo (2011) show that expenditures on both passive and active measures in the Baltic countries have grown significantly since the onset of the 2008 economic crisis, also thanks to the use of EU funds which compensated for some of the fiscal constraints that the countries faced at the time. These observations indicate a strong response of labour market policy in the Baltic states to the adverse impact that the recession has had on the countries' labour markets.

### *Public sector employment*

Public sector employment trends in the two regions are also puzzling from the perspective of comparative welfare state and political economy literature on Eastern Europe. The figures below show that the 'disembodied neoliberal' Baltic countries, as the literature has referred to them, have had higher employment in public administration, education and health services than the 'socially embedded' Visegrad states.

Figure 8 shows employment trends in the following parts of the public sector: i) public administration and defence, including compulsory social security, ii) education, and iii) health and social work. According to

the Eurostat classification, these are the knowledge-intensive public sector activities. Because of the variation in employment rates across the Eastern European countries analysed in this article, and following Gaddis and Klasen (2014), employees in the public sector are calculated as a share of the total working age population instead of a share in total employment. This is because two countries can have identical shares of employees in the public sector out of all employees, but when the overall employment rate is much lower in one country, that indicator hides the fact that a significantly lower portion of working age people work in the public sector in that country. Finally, public sector employees which work in state owned public companies are omitted from the analysis, also because of the significant variations in company privatisation levels across Eastern European countries.

< Figure 8 about here >

Public employment levels in the Baltic have risen steadily during the 2000s, and by 2008 the region had by far the highest share of public sector employment in Eastern Europe (Figure 9). The 2008 economic crisis had an adverse impact on the level of public employment in Latvia only, but the trend had recovered by 2010 and continued going upward. The education sector has particularly driven the overall higher trends in public sector employment in the Baltic. Employment in the education sector as a share of total working age population was around 2pp higher in the Baltic countries than in Visegrad by the end of the period of observation (Figure 9).

< Figure 9 about here >

Alternative explanations for the higher employment in the knowledge intensive parts of the public sector, that have little to do with social investment, could certainly be conceived. For example, the Baltic governments could have intended to reduce employment in these sectors, but trade unions could have resisted pressures for retrenchment. Likewise, more staff in the education sector could reflect the lower population density and thus smaller numbers of pupils per teacher in the more remote areas. Finally, due to population ageing, the number of school age children could have dropped in some of the observed countries, but not in others, which could explain the cross-country variation in educational workers as a share of the total working age population.

Figure 10 (left panel) shows that trade union density, defined as the ratio of wage and salary earners that are trade union members divided by the total number of wage and salary earners, has not been higher in the Baltic than in Visegrad countries during the period of observation. It has in fact been lower in all three Baltic

republics, following the initial drops in trade union membership levels after the demise of socialism which took place across the board.

< Figure 10 about here >

While the teacher per pupil ratio in primary schools has been lower in the Baltic countries than in the Czech Republic and Slovakia, it has been higher in Estonia and Latvia than in Hungary and Poland, while Lithuania has been at the level of Hungary and Poland (Figure 10, right panel). There is therefore no direct correlation between employment levels in the educational sector and pupil density in primary schools.

< Figure 11 about here >

Finally, Figure 11 indicates that population ageing has taken place in both the Baltic and Visegrad countries. Between 1991 and 2017 the share of those aged 0-19 in total population has been reduced in all seven countries, and in 2017 it stood at exactly 20% in all of them (Figure 11). We can therefore conclude that the higher shares of employees in education sector in the Baltic vis-à-vis Visegrad are not due to the greater demographic need for education.

## **Conclusions**

This article shows that, in comparison to the Visegrad countries, the Baltic countries have had higher expenditures on education, better educational attainment, higher levels of employment in public administration, education and health sectors, and at least as high social protection in case of unemployment. The article also shows that the Baltic countries, and most notably Estonia, have pursued a growth model which is geared towards ICT-led and knowledge-based competitiveness, which has not been limited to the IT sector but has had a wider effect in terms of the overall higher levels of digitalisation of the economy.

Based on these empirical findings, the article argues that the Baltic countries have acquired some features of the Nordic model of 'embedded liberalisation' which is characterised by concurrent increases in labour market flexibility and generous labour market benefits along with investment in human capital and privatisation of public service delivery (Thelen, 2014). Although it is undisputable that the Baltic welfare states have been substantially weaker and less generous than the Nordic ones, this article focuses on comparing their trajectory of development to those found in the Visegrad countries, which have been at similar levels of

economic development, and which appear to have followed the Bismarckian tradition of welfare state reform, which is typical for countries such as Germany.

While these are unexpected findings for the political economy literature on Eastern Europe, given its disembodied neoliberal interpretation of the Baltic transition, they are not surprising for the literature on social investment and the 'new' knowledge economy, which suggests that knowledge-based competitiveness needs public sector expenditures and services to underpin it, as most notably argued by Thelen (2014) and Mazzucato (2015). The article's findings could also be used to challenge the economic account that the region's successful educational and labour market performance can be attributed to the sound implementation of the Washington Consensus, which has put forward by Aslund (2013), but further analyses on the relationship between social investment policies and labour market outcomes would need to be conducted to that end.

The argument that this article puts forward is also in line with the insight by Jensen (2011) that deindustrialisation is a key driver of public investment in education, and also that left-wing governments do not spend more on education than the right-wing ones. In fact, all three Baltic countries have had mostly right-wing governments since the early 1990s. This observation indicates that, paradoxically, the right-wing Baltic governments have created more opportunities for the reskilling of large segments of the population and their greater labour market inclusion with better implications for the long-term security of the workforce than the Visegrad countries, which had more left-wing governments and implemented traditional welfare policies, such as passive cash compensation of the losers of transition.

The revised account of welfare state development in the Baltic put forward in this article, however, does not intend to spread false optimism about the overall success of the Baltic transition. Its intent has been to expand the definition of the welfare state used in the political economy literature on Eastern Europe by including new social risks and showing that the Baltic states have fared comparatively better in this respect than the Visegrad countries. These conclusions are in line with findings from literature on social investment in advanced market economies which has suggested that some types of welfare state liberalisation trajectories have had more equalising effects for the population than the traditional Bismarckian welfare states (Morel *et al.* 2012; Thelen 2014). In that sense, the article uncovers what has been concealed in the previous narratives about the Baltic welfare states. Furthermore, the article does not claim that the Baltic growth models and their complementary welfare institutions have been or will be more sustainable than the Visegrad ones. Such a research question would require a separate analysis, which would include examining the implications of these countries' dependencies on foreign capital on their long-term development.

Furthermore, while the micro analyses of social policy in the Baltic have emphasised differences between the three countries (Aidukaite 2006, 2013), which can also be teased out from the empirical section of this article, the analytical focus of this article has been on their similarities in order to juxtapose the Baltic trajectory against the Visegrad countries, in line with the political economy literature on the two regions. Therefore, while the article recognises that Estonia has done better in terms of innovation activities and education, and Latvia and Lithuania in terms of labour market protection policies, it also argues that a stylised Baltic trajectory of welfare state reform exists. An effort to provide cushioning for the growing labour market flexibilisation both via investment in human capital and increasingly generous unemployment benefits can be observed in all three countries. Furthermore, since the article's focus is on welfare institutions and their similarities across the three cases and in opposition to Visegrad, it also does not engage with the issue of credit fuelled growth, which has certainly been more pronounced in Latvia than in Estonia, and which may explain some of the differences that can be observed between the countries.

Finally, the article shows that educational and labour market policies and outcomes in the Baltic countries have generally been resilient to the impact of the 2008 economic crisis. While the three countries were severely impacted by the recession, and most notably Latvia and Lithuania, both in terms of their GDP decline and employment losses, empirical evidence has shown a pro-active labour market policy during the recession, following which their employment rates recovered to almost pre-crisis levels by 2010. The resilience of these policies during a severe recession indicates that they are not auxiliary strategies, but are in fact key pillars which have underpinned the region's knowledge-intensive services oriented model of growth. Future studies could explore family policy as an additional component of this social investment policy package, to understand whether the Baltic countries have been evolving into more comprehensive social investment oriented welfare states.

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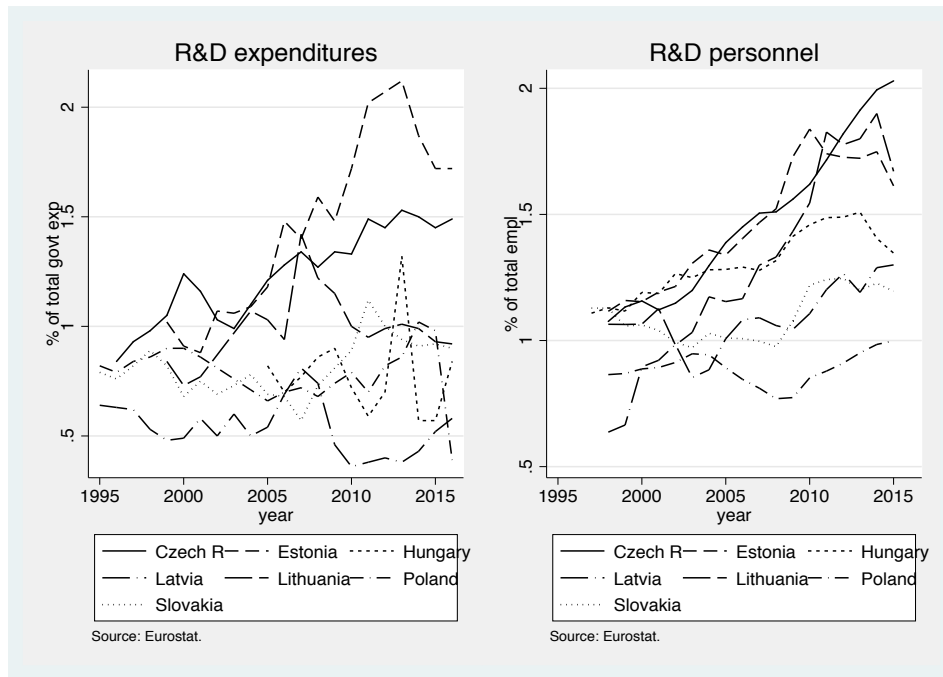


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**Figures and Tables**

*Figure 1: Research & Development*



*Figure 2: Knowledge-intensive employment and digital skills*

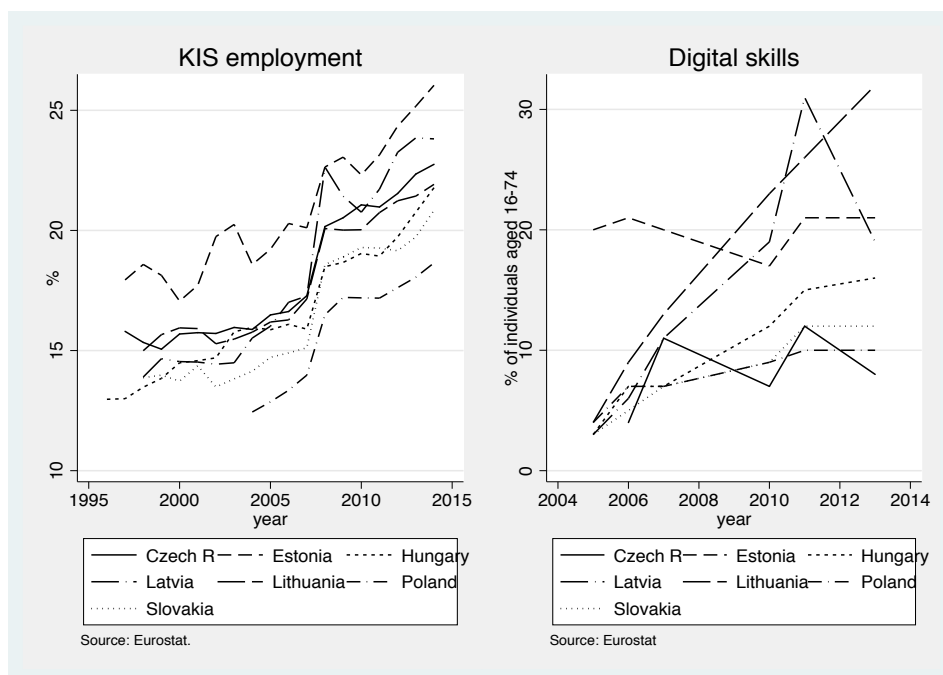


Figure 3: Educational expenditures

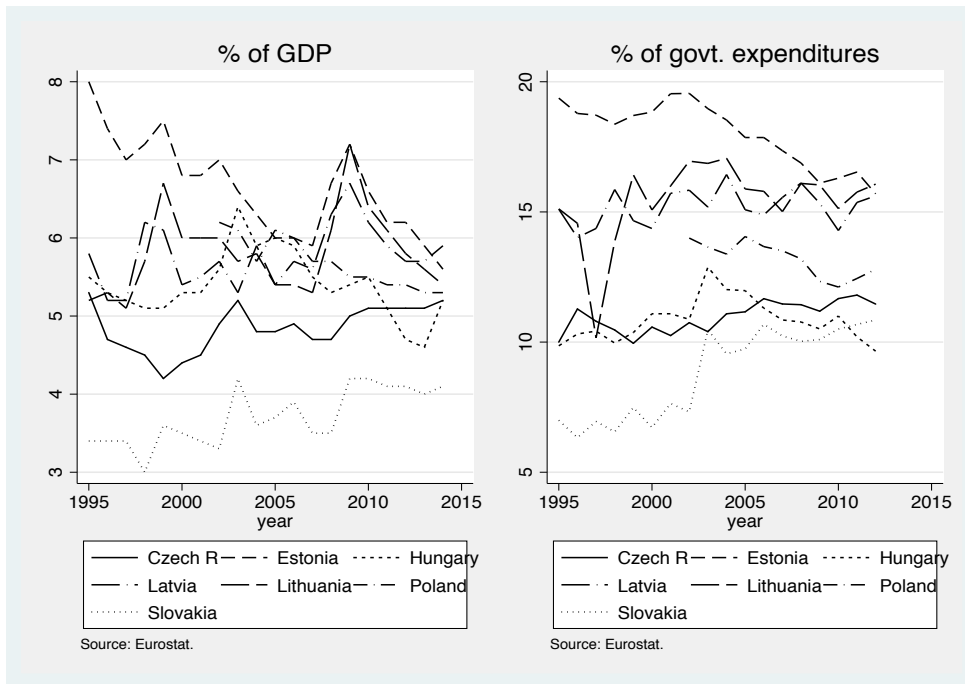


Figure 4: Educational attainment

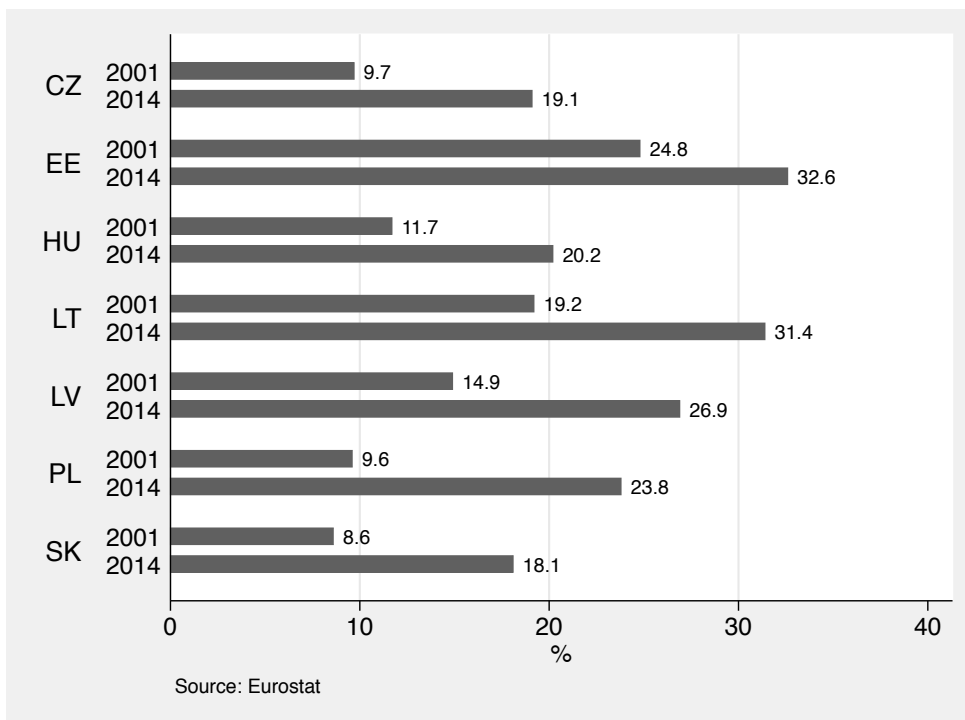


Figure 5: Expenditures on labour market policies, composition

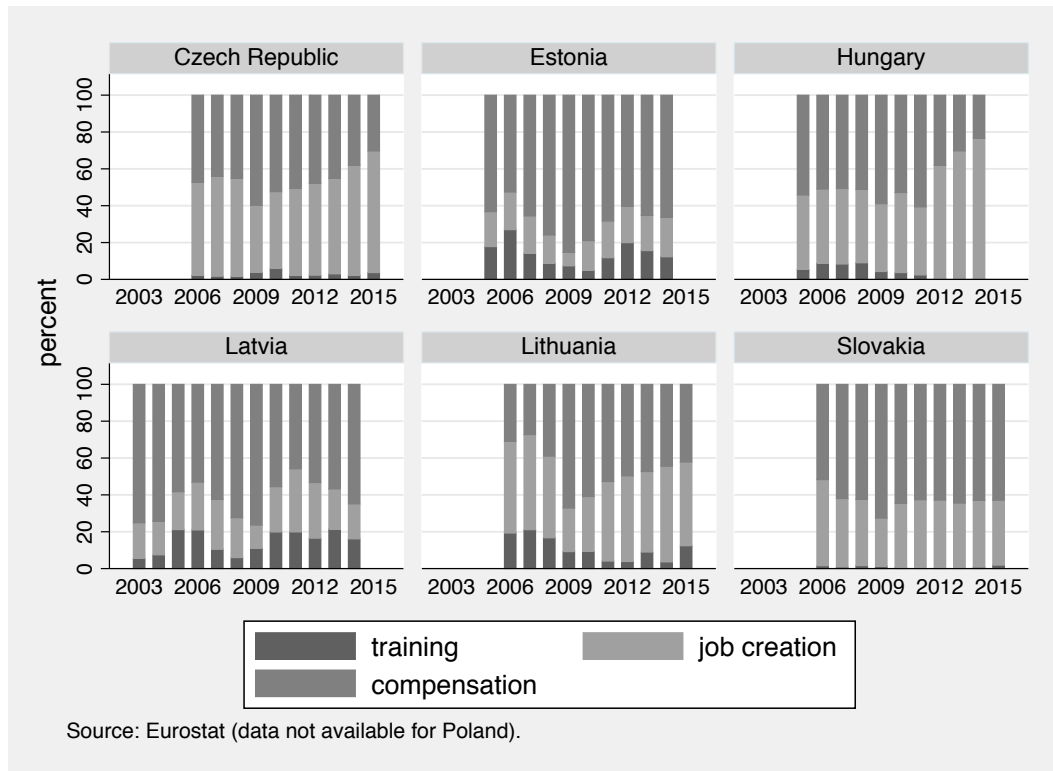


Figure 6: Unemployment compensation

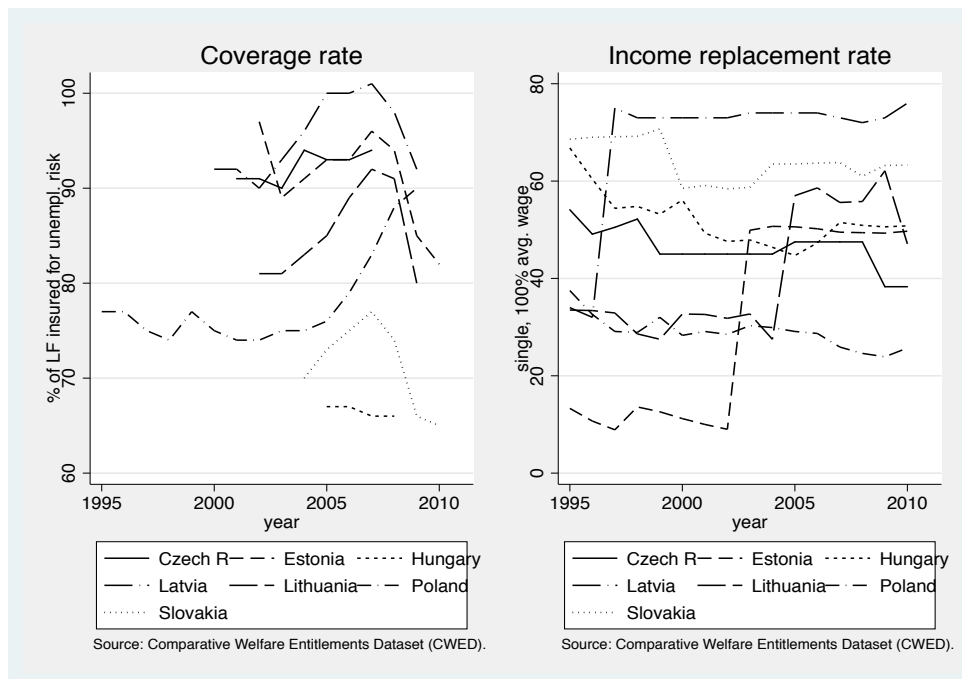


Figure 7: Income replacement rates for married with two children

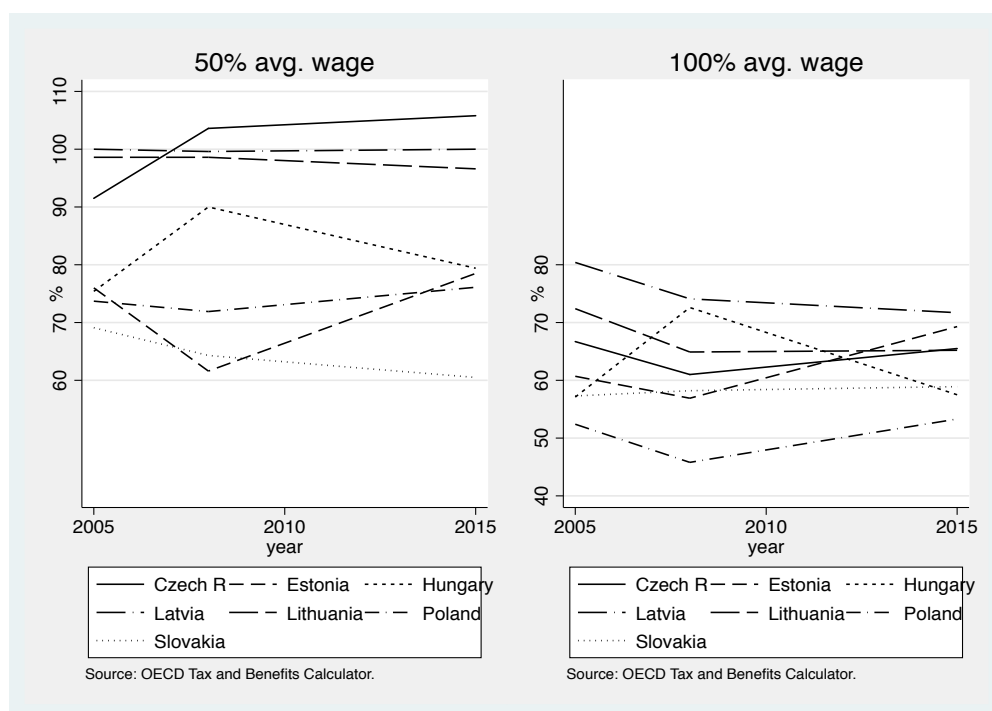


Table 1: Duration of unemployment benefits

	2005	2008	2015
<b>Estonia</b>	6m (<5 yrs of contributions) 12m (10+ yrs of contributions) 9m unemployment assistance for uninsured	no change	no change
<b>Latvia</b>	9m	4m (<10 yrs of contributions) 6m (10-19 yrs of contributions) 9m (20+ yrs of contributions)	9m
<b>Lithuania</b>	6m (<25 yrs of contributions) 9m (35+ yrs of contributions) extensions for elderly unemployed	no change	no change
<b>Hungary</b>	max 9m (1 day of benefit for each 5 days of employment)	no change to UB job-seeker aid introduced: 3m if age < 50, 6m > 50	max 3m (1 day of benefit for each 10 days of employment)
<b>Poland</b>	6m to 18m, depending on regional unemployment rate	no change	6m to 12m, depending on regional unemployment rate
<b>Czech Republic</b>	6m	6m if age < 50 9m if age = 50-55 12m if age > 55	5m if age < 50 8m if age = 50-55 11m if age > 55
<b>Slovakia</b>	6m	reduced to 4m for temporary employees	no change

Source: MISSOC database.

Figure 8: Public sector employment

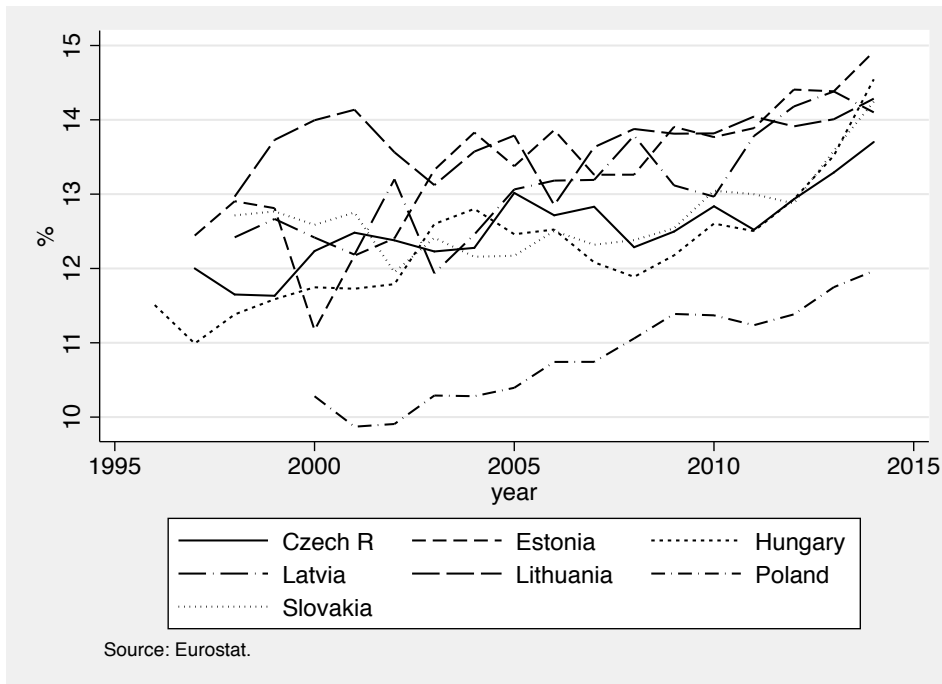


Figure 9: Employment in education

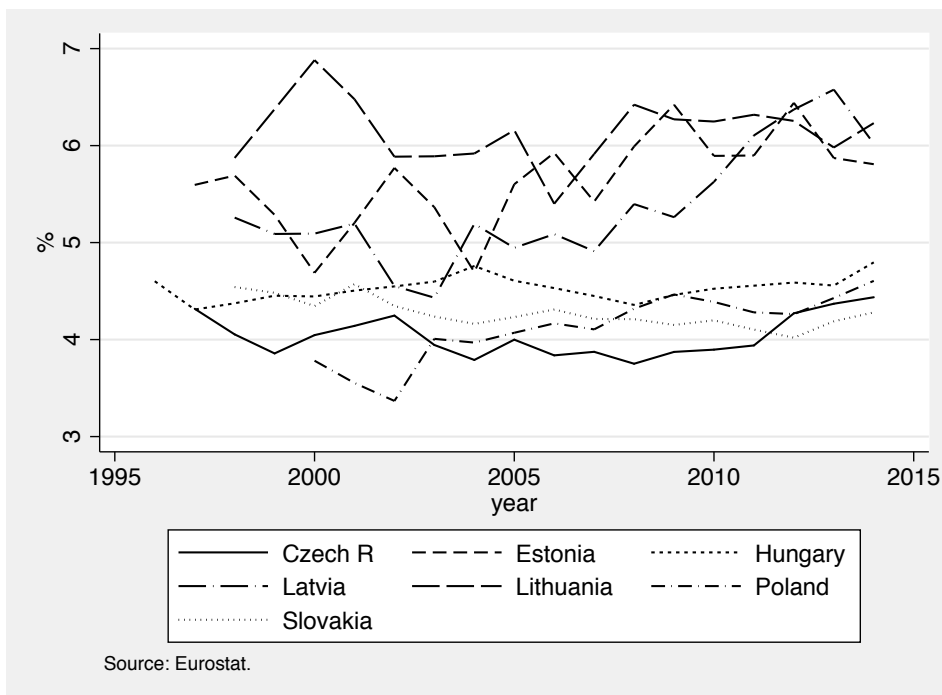


Figure 10: Trade union density and pupil/teacher ratio

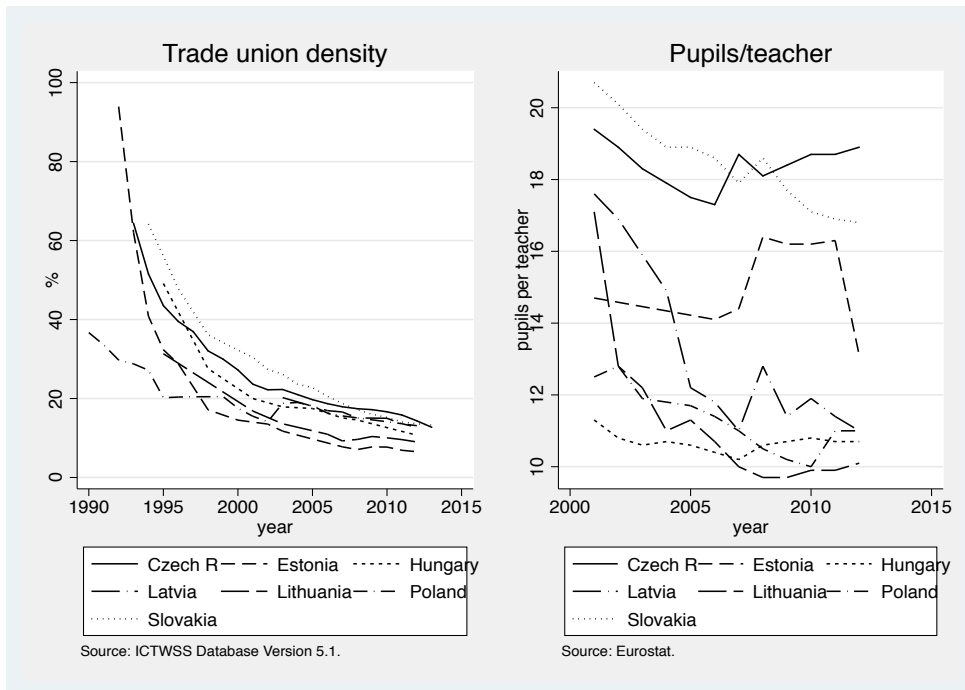


Figure 11: Age structure of the population in 1991 vs 2017

