Varieties of capitalism and the Estonian economy: Institutions, growth and crisis in a liberal market economy

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This article examines Estonia’s economic institutions, performance and vulnerability to the global economic crisis in the context of the varieties of capitalism framework. It shows that Estonia shares many characteristics of a liberal market economy, but that there are also some features which do not fit the classical model, notably its corporate governance institutions. It also suggests that the varieties of capitalism framework can account for key features of Estonia’s economic performance, including its growth trajectory and adjustment to the global financial crisis. The article also reflects on the broader significance of these findings for understanding post-communist capitalism.

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Many of the academic and policy debates about Central and Eastern Europe in the first decade of post-communist transition revolved around market reform and construction of capitalism. The introduction of a market economy, alongside democratization, was viewed as one of the most important goals of transition and a key task for policy-makers. Apart from some dissenting voices, most analysts did not address the question of what kind of market economy might emerge (Amsden et al., 1994). Instead the end goal of this process was generally taken to be a generic capitalist economy based on private property and the predominance of free markets. The World Bank, the EBRD and other organizations developed various indicators to measure progress towards this goal, and they provided advice on how to make further advances (EBRD, 2009; World Bank, 2002).

By contrast, in the last few years a new debate has emerged among political scientists, sociologists, economists and geographers working on the political economy of post-socialist transition. Scholars have started to ask whether transition has led to multiple varieties of capitalism (VoC) in Central and Eastern Europe and the former Soviet Union. This debate is in large part inspired by the seminal volume on varieties of capitalism edited by Hall and Soskice (2001) – one of the most influential books in political science and political economy in recent years.¹ The Hall and Soskice volume identified two distinct varieties of capitalism in the OECD – liberal and coordinated market economies. Each variety is characterized by a different set of institutions and comparative institutional advantages, yet both kinds of market economies can be viewed as efficient and successful. Scholars working on Central and Eastern Europe have sought to make sense of capitalist diversity and explain economic performance in the region. Some scholars have built on the VoC framework (Feldmann, 2006; Buchen, 2007; Adam et al., 2009), whereas others have sought to go beyond it by identifying new varieties (Nölke and Vliegenthart, 2009) or developing new typologies (Bohle and Greskovits, 2007; Lane and Myant, 2007; King, 2007).

1 According to Google Scholar it had been cited 5820 times by October 2013 (http://scholar.google.co.uk/scholar?hl=en&q=hall+soskice&btnG=&as_sdt=1%2C5&as_sdtp=), accessed on 28 October 2013.

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Estonia has become a key focus of this debate. On the one hand, its economy has been touted as very successful. Estonia has joined the EU in 2004, the euro zone in 2011 and also the OECD in 2010, which is often viewed as a confirmation of a country’s status as an advanced market economy. International organizations and various scholars have pointed to Estonia’s rapid growth and convergence with the West, as well as other economic indicators to suggest that it is a model for other transition countries to emulate. Many of these observers have attributed Estonia’s success to the fact that it has systematically implemented market reforms and that it can be seen as a paragon of a free market economy (Laar, 1996). A number of scholars have also suggested that Estonia is, at least in many respects, a good example of a liberal market economy (Feldmann, 2006; Buchen, 2007).

On the other hand, Estonia was recently hit by a sharp recession during the global economic crisis in 2008–2009. While growth resumed in 2010, some critics have suggested that the Estonian economic miracle was built on a shaky foundation. In particular, they have noted that there was excessive private borrowing and that there has been limited upgrading of Estonia’s economic structure. They have pointed to the predominance of low-quality manufacturing in the country’s export profile and suggested that it can therefore not be viewed as a pure liberal market economy. Unlike in the USA, the role of cutting edge innovation and high tech industries in Estonia’s exports is rather limited (Myant and Drahokoupil, 2012; Bohle and Greskovits, 2007). The crisis and its aftermath therefore provide an important reason to re-examine the Estonian model (Kuokstis, 2011).

The purpose of this article is to revisit this controversy and to investigate whether Estonia, known for the pursuit of free market policies, has also developed into a liberal market economy (LME). It develops a framework for applying the theory of VoC to relatively new market economies, such as the countries in Central and Eastern Europe. Unlike the long-established market economies in Western Europe and North America, where it is possible to identify stable institutions and patterns of specialization that have generated strong economic performance over many decades, market-supporting institutions are relatively new in Estonia. Many of them have been changing over time not only as part of the transition process itself, but also as a result of EU integration. This article shows that Estonia shares many characteristics of a LME and that it is in some respects arguably even more liberal than the classical LMEs, such as the UK or the US. However, there are some features which do not fit the classical model, notably corporate governance institutions. This article suggests that the VoC framework is useful for understanding key features of Estonia’s economic performance. In contrast to analyses emphasizing the success or failure of free market policies or specific sectors, this approach can account for the consequences and trade-offs associated with the kinds of institutional arrangements that Estonia has adopted, including the foundations of rapid growth as well as the vulnerability to the global financial crisis and the nature of subsequent adjustment policies. More generally, such an analysis of the Estonian experience through a varieties of capitalism lens makes it easier to compare and contrast the Estonian experience to growth and crisis trajectories across the OECD.

The article begins with an overview of the theoretical literature on varieties of capitalism and the controversies surrounding its application to Eastern Europe. The following two sections examine whether Estonia can be viewed as an LME in terms of its economic institutions and whether this can account for patterns of economic specialization and performance. The final section concludes with some general lessons about the strengths and weaknesses of the VoC approach for understanding the transition process in Estonia and post-communist capitalism more generally.

1. Varieties of capitalism and its application to Central and Eastern Europe

Political economists have long focused on the differences between market economies. The literature on capitalist diversity could be said to date back to the works of classical economists and social theorists, such as Max Weber. In the post-World War

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2 Difference is discussed below.
Il period this has increasingly become a core concern among political economists working both on the OECD (Shonfield, 1965) and developing countries (Wade, 1990; Perkins, 1994). Scholarship has focused on the ways in which the role of the state, modes of governance and the regulation of markets vary across countries. The literature on the communist world – that is, the so-called comparative economic systems approach – has often built on this work and compared capitalist systems to varieties of socialist systems (Bornstein, 1985).

More recently, debates surrounding the varieties of capitalism (VoC) approach developed by Hall and Soskice (2001) have dominated the field of comparative political economy. This framework identifies two kinds of market economies – liberal market economies (LME) and coordinated market economies (CME). While there are important differences between them in terms of economic institutions, both LMEs and CMEs can be viewed as successful market economies. VoC theory suggests that ‘pure’ LMEs and CMEs perform better than hybrids or mixed market economies (MMs) (Hall and Gingerich, 2009) (Table 1).

The VoC framework can be characterized as a firm-centric and institutional approach to capitalism. In other words, it views firms as the main actors of a capitalist system, and the core goal is to understand how institutions shape their operation (Hall and Soskice, 2001, 6ff). It focuses on firms’ organization of their activities in five key domains – industrial relations, employee relations, corporate governance, education and training and inter-firm relations. The VoC approach suggests that these relationships can be managed in two distinct ways – either by market coordination or strategic coordination. Market coordination means that key relationships are managed by means of market transactions and formal contracts. By contrast, strategic coordination implies that firms rely more heavily on long-term negotiated relationships and implicit contracts with workers, creditors and suppliers. As a result of synergies between activities or ‘institutional complementarities’ a particular mode of coordination tends to be predominant in any given economy. Firms rely on market coordination in liberal market economies and on strategic coordination in coordinated market economies.

In liberal market economies industrial relations are decentralized and individualized. Both employers’ associations and trade unions tend to be relatively weak. If there is any collective bargaining, it typically occurs at the company level. Corporate governance is based primarily on the discipline imposed by stock markets, which means that firms seek to maximize shareholder value in order to maintain the confidence of footloose investors. This also implies that they need to adjust rapidly to shocks, for example, by reorienting activities or shedding labor. As a result workers invest in general and portable skills which maximize the prospects of gaining employment in a fluid labor market in the case of redundancies, especially since welfare states tend to be less generous (Iversen, 2005). These institutions are associated with a comparative advantage in rapid innovation, including new medical and information technologies. The key examples of liberal market economies in the OECD include the United States, the United Kingdom, Canada, Australia and New Zealand.

By contrast, in coordinated market economies, where strategic coordination predominates, corporatist collective bargaining or negotiated agreements between employers’ associations and trade unions tend to play an important role. Corporate governance is based on long-term relationships between firms and creditors, who provide ‘patient capital’, that is, credit on a long-term basis, which also enables them to exercise voice rather than just exit, as many portfolio investors holding shares might do in times of crises. The classic example of such creditors who provide patient capital and exercise influence on firm governance are the traditional Hausbanken of German companies. Given the emphasis on long-termism, workers are also more willing to invest in firm- or industry-specific skills, which are insured by a generous welfare state in the case of redundancies or the obsolescence of these skills. Such long-termism is also viewed as associated with a comparative institutional advantage in skill-intensive manufacturing and sectors characterized by incremental innovation, such as the car industry. Classic examples of coordinated economies include Germany, Austria, the Netherlands and the Nordic countries. In Central and Eastern Europe Slovenia has been classified as a coordinated market economy as well (Feldmann, 2006; Crowley and Stanojevic, 2011).

Given its influence the VoC framework has triggered great controversy. Critics have argued that it is too focused on efficiency, that it underplays the role of politics, that the notion of institutional complementarity is too simplistic and that it is too static (Hanké et al., 2007; Bohle and Greskovits, 2009). More recent formulations have sought to address some of these criticisms (Hall and Thelen, 2009). Even in empirical terms critics have suggested that the framework is too focused on the two ideal types – LMEs and CMEs – and that it pays insufficient attention to the extensive variation that occurs even within these categories. Nevertheless, the VoC framework remains a central reference point even for its critics, and therefore it is important to reflect on its applicability to Central and Eastern Europe.

There has already been extensive debate about capitalist diversity in Central and Eastern Europe. There are a number of obvious limitations to VoC as a theory of post-communist capitalism.

First, economic institutions in Central and Eastern Europe have undergone dramatic change since the early 1990s – both as a result of the transition process and EU integration. Therefore one cannot assume any stable institutional environment, let alone long-standing patterns of comparative institutional advantage or institutional complementarities. While existing institutions have shaped OECD economies for many decades, post-communist institutions have been created, reshaped and modified in the course of the transition process. Economic actors have often had to respond to policies and institutional changes as they were being introduced.

Second, unlike the OECD economies analyzed by Hall and Soskice (2001), the Central and Eastern European countries did not begin the transition process as high-income economies. Although several transition countries have converged on Western European living standards and also acceded to the OECD, they have not yet caught up with the most advanced countries. Therefore another core feature of the classic varieties of capitalism, namely that they are among the most prosperous
economies in the world and that there are world-leading sectors resulting from an LME’s or CME’s comparative institutional advantage, does not necessarily apply to countries that are in the process of catching up with the most advanced economies.

Third and related to the previous point, transition economies are capital-scarce compared to the most advanced economies. Therefore they are likely to be net importers of capital and dependent on international investments and financial markets. In other words, unlike the canonical VoC model which distinguishes between bank-based and stock market-based corporate governance, various foreign sources of capital can be expected to play a leading role in these economies. Domestic savings or national investors may play a more secondary role in many cases, especially if the economies in question have embraced global markets.

Given these features of transition economies, they should be viewed at best as ‘emerging varieties of capitalism’ rather than longstanding VoC with stable and complementary institutions. To test this weaker claim a few modifications need to be made (Buchen, 2007; Feldmann, 2006). First, instead of seeking to identify long-standing configurations of complementary institutions, one can examine whether a particular type of coordination – market coordination or strategic coordination – tends to predominate within a given economy. Second, one can explore whether countries that come close to a pure LME or CME model belong to the most successful economies in the region in terms of economic performance and convergence and whether they face similar challenges to LMEs and CMEs elsewhere. One can also examine whether there is any emerging comparative institutional advantage in terms of sectoral specialization. This does not necessarily imply that a sector in question is world-leading, but rather that certain sectors seem to be stronger than others. Third, one can explore whether patient capital plays any role in the provision of investments or whether capital is primarily short-term. Finally, given the controversy surrounding the application of VoC theory even to canonical cases and the view that these models may be best viewed as ideal types, one can also explore whether certain empirical anomalies from the perspective of VoC theory are unique to Central and Eastern Europe or whether they can also be found in LMEs elsewhere in the world (Table 2).

While one should not necessarily assume that most countries in the region fit the VoC framework, Estonia could be viewed as a most-likely case for the LME model. Estonia has consistently pursued market liberal policies since the early 1990s. It proceeded very quickly with liberalization both domestically and internationally, and it became one of very few countries in the world to introduce a unilateral free trade regime. There has not been any significant state intervention in the economy either in terms of industrial or social policy. The goal of policy-making has been to create a business-friendly environment, which has included a variety of free market policies, such as the flat tax. In other words, given this strong commitment to free market policies, one might expect Estonia to have developed institutions for market-based coordination and to be a likely case of a liberal market economy.

However, there is no consensus in the literature about whether Estonia should be classified as a liberal market economy. Feldmann (2006) focuses primarily on industrial relations and argues that Estonia can be viewed as an LME. Buchen (2007) extends the analysis to cover further dimensions of VoC and confirms this finding, albeit with some caveats, notably with respect to corporate governance. Bohle and Greskovits (2007) define Estonia along with the two other Baltic States as a neoliberal market economy, but their framework is based on a different ‘Polányian’ logic of state policies. They suggest that there are major discrepancies between the Baltic political economies and the LME model, notably due to the predominance of low- and medium value-added production. Finally, in a recent paper Kuokstis (2011) suggests that Estonia should be viewed as a completely new variety of capitalism, namely a flexible market economy. This paper seeks to revisit this debate, notably in light of the recent crisis.

2. Estonia as a liberal market economy: institutions

This section will examine the coordination of industrial and labor relations, education and training, the welfare system, corporate governance and the sectoral structure of the economy to assess whether Estonia can be viewed as an LME.

The governance of labor markets bears substantial resemblance to the LME model. Industrial relations are decentralized, and wage bargaining occurs at the company level, if at all. The unionization rate – 6.7% in 2009 – is the lowest among the ten Central and East European EU member states. Membership in employers’ associations was 23.8%, and the coverage rate of collective bargaining agreements was 19% in 2009. Among the new member states of the EU only Lithuania scored lower on these two indicators (Visser, 2011). Social dialog between organized labor and employers’ associations plays a relatively limited role, as do tripartite negotiations at the national level. They have been more important when the Social Democratic Party, or its predecessor the Moderates, have been in government (Vare and Taliga, 2002). While employment protection used to be quite high in the early transition period – which runs counter to the classic LME model (Buchen, 2007) – this has...
changed somewhat in recent years, partly as a result of the new employment law that was introduced in 2009. Estonia now has a more flexible labor market in comparative terms (OECD, 2011, 3).

This is also reinforced by the education and training system, which puts a heavy emphasis on general skills. The apprenticeship system which was in place during the communist period has largely been dismantled. The role of vocational secondary education is comparatively small in Estonia, and the number of graduates has fallen since 2000, notably in programs related to ICT and computer sciences which have become more popular as university subjects (Tiits and Kalvet, 2012, 15–17). The role of vocational education is much more limited than, for example, in Slovenia (Kogan and Unt, 2008), which is often viewed as a coordinated market economy (Crowley and Stanojević, 2011). By contrast, there has been an expansion of higher education during the transition period, and in the first years of transition fifteen new private institutions of higher education were opened (Tomusk, 1996). More recently, there has been some consolidation of the higher education sector, as a result of the absorption of the private Akadeemia Nord into the University of Tallinn in 2010, and also a variety of reforms related to the Bologna process of creating a common European Higher Education Area by harmonizing university systems across Europe. However, these changes do not affect the emphasis on general skills within the Estonian education system.

Innovation policy has also become a more central priority for Estonian policy-makers, in part as a result of Europeanization pressures (Kattel et al., 2009, 27). R & D spending, which is mostly publicly financed in the Estonian case, has increased over time. Estonia ranked 27th in the world (and third among the new Central and Eastern European member states behind Slovenia and the Czech Republic) in 2008 in terms of R & D spending as a share of GDP. The Estonian share of GDP was 1.29% in 2008 and 1.44% in 2009 (World Bank, 2012). Therefore both the increasing emphasis on general skills in the education and training system and growing role of innovation could be viewed as consistent with the development of an LME in Estonia.

The emphasis on general skills is also reinforced by the welfare state, which is small and therefore inadequate to insure specific skills. Estonia has consistently had one of the lowest levels of social spending in the EU. In the period 2000–2004 Estonia spent on average 13.6% of GDP on social expenditures, which was the lowest share of GDP among the eight new post-socialist member states that acceded to the EU in 2004 (Bohle and Greskovits, 2007). In 2008 and 2009 social spending amounted to 15.1 and 19% of GDP respectively, mostly as a result of the economic crisis (Statistics Estonia, 2012). Due to the recession national output fell and the number of benefit recipients grew, which led to an increase in social spending as a share of GDP, although many benefit entitlements were cut back. However, in comparative terms the Estonian welfare state remains one of the smallest in the EU and well below the EU average of 26.4% in 2008. In that year only Latvia and Romania devoted a smaller share of GDP to social expenditures than Estonia (Eurostat, 2012).

However, it is less clear whether the corporate governance system corresponds to the LME model. Buchen (2007) noted that Estonia has a dual board system and also high ownership concentration, as a result of the outsider privatization model adopted in the 1990s. As both of these characteristics are typical of CMEs, he concludes that Estonia can be viewed as an imperfect stakeholder model. However, both Buchen (2007) and Feldmann (2006) suggest that stock market capitalization has been relatively high in Estonia by transition country standards. This is no longer the case. In 2001 the Tallinn stock exchange was sold to the Helsinki stock exchange, which subsequently merged with the Stockholm stock exchange and later with NASDAQ. As a result the level of trading in Tallinn is very limited, as many companies are listed elsewhere. Stock market capitalization only amounted to 7.2% of GDP in 2011 and 10.7% in 2012 (World Bank, 2013). In any case, most companies use other funds, including retained earnings or bank credits, for investments. As FDI plays a significant role in the Estonian economy, foreign companies have a range of international sources of finance at their disposal as well. Therefore the stock market plays a much smaller role in economic governance than in a quintessential LME, as defined by Hall and Soskice (2001). This appears to be true throughout Central and Eastern Europe, and Nölke and Vliegenthart (2009) have suggested that the Visegrád countries should be seen as ‘dependent market economies’ given the central role of foreign companies in their economies. Given the size and openness of the Estonian economy, it is not surprising that companies from capital-rich countries, such as Finland or Sweden, play a significant role and they have a variety of alternative sources of finance at their disposal. This suggests that the institutional structure of the financial system may depend on capital abundance and levels of development (Gerschenkron, 1962). Some authors suggest that common pressures facing the advanced OECD countries have also led to substantial convergence between LMEs and CMEs in recent years (O’Sullivan, 2003; Dixon, 2012). While the limited role of the stock market – and the correspondingly great role of external finance, via foreign-owned banks and foreign investors – seems to be an anomaly, the core logic may potentially be a functional equivalent of the LME model in an emerging market economy (Buchen, 2007). In any case it seems clear that Estonian companies cannot draw on patient capital or maintain long-term relations with their creditors, as German companies have traditionally been able to.

VoC theory also predicts that liberal market economies will be characterized by distinctive patterns of comparative institutional advantage. If one takes into account the fact that Estonia is still in the process of converging to Western European standards, one should not necessarily expect the country to have developed such a durable and world-leading production profile as long-established LMEs. Nevertheless, many features of the Estonian economy are well aligned with the LME model. First, as in many LMEs, notably the United Kingdom and the United States, the private service sector, including real estate and financial services, has grown fast over time. Although real estate and financial services have declined somewhat as a result of the crisis, they remain important sectors, and two of Estonia’s three largest companies: banks Hansapank and SEB Ühispank, are both owned by Swedish banks – Swedbank and SEB respectively. Transport and logistics are also important sectors, notably given Estonia’s location as a transit hub between Russia and Western Europe.

The telecom and IT industries have played a significant role. Both Ericsson and Elcoteq established manufacturing activities in Estonia. More strikingly, the engineering department of the much newer IT company, Skype, which has become a
key provider of international calls, is in Estonia (Tiits and Kalvet, 2012). Estonia has also put great emphasis on its reputation as ‘E-stonia’ and on developing e-government, including electronic voting (Álvarez et al., 2009).

A recent OECD report points out that Estonia’s innovative capacity has improved greatly over time and highlights some areas of success, notably in health R&D (OECD, 2011). More recently, biotechnology has also been defined as a priority sector for the future (Kukk and Truve, 2008). By contrast, Estonia has not had any success in attracting, for example, the car manufacturing, which has been an important industry in Central Europe and the Western European CMEs (Bohle and Greskovits, 2007). The above trends can be viewed as suggesting that Estonia has acquired many features of an LME in terms of sectoral structure.

On the other hand, low and medium value sectors, such as wood processing or a variety of services, play a significant role in Estonia’s exports – indeed a much greater role than in Central Europe (Bohle and Greskovits, 2007). This had led some observers to criticize the Estonian economic record for limited upgrading, and some have suggested that this disqualifies it from being viewed as an LME (Myant and Drahokoupil, 2012). During the EU accession process the European Commission urged Estonia to develop an integrated industrial policy, notably by promoting competitiveness, stimulating innovation and regional dispersion of foreign investment beyond Tallinn (European Commission, 2003).

This would seem to contradict some of the central features of the LME model. However, even abstracting from the fact that Estonia is an emerging variety of capitalism and thus unlikely to satisfy all the LME criteria, this may not necessarily be the case. This critique may overestimate the institutional coherence and economic performance of other LMEs. Many scholars have criticized core LMEs, notably the UK, for having ‘too few producers’ (Bacon and Eltis, 1976) and for the anemic growth record of industry during the post-war period (Hall, 1986). It should also be noted that the sectoral structure varies a great deal across liberal market economies, as evidenced, for example, by the centrality of agriculture in New Zealand, but not in the UK. Second, given that the skill and wage distributions are relatively unequal in LMEs, there are also large numbers of workers in low productivity jobs in these countries (Pontusson, 2011). Given that labor costs are still low in Central and Eastern Europe compared to Western Europe, many firms have located there primarily to take advantage of low costs, which is also a key factor accounting for the prevalence of low-to-medium value-added sectors.

Therefore, the institutional structure – with respect to the labor market, welfare state and education and training – can be said to correspond quite closely to an emerging LME model. The sectoral composition of the Estonian economy - including a heavy emphasis on services, some emerging high-tech sectors, along with some low- and medium value-added activities – could also be seen as consistent with the LME model. The corporate governance system does not fit the LME model, but this is also in line with the experience elsewhere in the region and also fits with the observation that Central and East European economies are relatively capital-scarce and therefore likely to be more dependent on foreign capital.

3. Estonia as a liberal market economy: growth and crisis

To what extent can the prevalence of liberal market institutions explain Estonian economic performance? The degree to which institutions in general and VoC institutions in particular can explain economic growth remains controversial. In principle VoC theory would predict pure LMEs (and CMEs) to perform very well and outperform mixed market economies, that is, countries where institutions do not correspond as closely to these two blueprints (Hall and Gingerich, 2009).

There is some evidence to support the contention that Estonia has been a successful transition economy. After the end of the long transformational recession of the early 1990s, Estonia grew fast and converged on living standards in Western Europe. The period from the mid-1990s onwards (except for the short downturn in the aftermath of the Russian crisis) until 2007 Estonian GDP per capita grew at an average annual rate of 7.2%, and Estonia was commonly viewed as an economic success story.

However, as in Ireland, the US and the UK, three LMEs which also performed well during this period, growth turned out to be fragile as a result of rapid credit growth and booming real estate markets. All of these countries were characterized by relatively light financial regulation and limited attempts by the governments to curb excessive borrowing or reduce aggregate demand during the boom years. These countries also experienced rapid growth in the financial sector. As Chinn and Frieden (2011) have shown, the US crisis was largely the result of a ‘capital flow cycle’ financed by extensive and unsustainable foreign borrowing, although there were also a variety of complex domestic factors that contributed to this outcome. In the UK the financial sector accounted for 5% of GDP and had over a million employees, which generated the largest surplus in financial services in the world (Gamble, 2009, 16). In the Irish case – often labeled the Celtic Tiger thanks to its rapid growth – Economic and Monetary Union (EMU) membership also contributed to a great housing boom, which resulted from the availability of cheap mortgages and a rapid expansion of credit (Hay et al., 2008). Much of the rapid growth in the financial and real estate sectors was not sustainable.

Much of this also fits the Estonian boom-bust-cycle, but there are also some important differences. As noted earlier, Estonia grew fast from the mid-1990s until 2007 (with a short downturn in conjunction with the Russian crisis in 1998).

3 Some scholars have suggested that the ethnic dimension of inequality in Estonia and the other Baltic States is a unique feature of their capitalist model (Bohle and Greskovits, 2007). However, ethnic and racial income differences exist in other LMEs as well. In the USA African Americans consistently earn less on average than whites. Some comparative research has suggested that ethnic and racial diversity may be one of the key causes of the small welfare state in the US as well (Alesina et al., 2001).

4 While CMEs were also hit by the crisis, it began in the UK and US. And the crisis in Continental Europe was at least in part due to the exposure of their financial institutions to the US mortgage market (Claessens et al., 2010).
However, after Estonia acceded to the EU in 2004, inflation started increasing rapidly despite the fact that there were budget surpluses. Inflation was related to a variety of factors, such as one-off accession effects and rising energy prices on international markets. It may also have been partly caused by Balassa–Samuelson effects, which imply that rapidly converging countries may for some time experience higher inflation (Egert, 2002). However, overheating, especially of credit and real estate markets, was also an important factor (Vanags and Hansen, 2006). Much of this was driven by capital inflows, as the real estate and financial services sectors accounted for about 48% of the total FDI stock in September 2008. Given that Estonia had a currency board, there was very little that could be done to prevent it. There was no scope for independent monetary policy, as money in circulation is fully determined by the Central Bank’s foreign reserves under a currency board.

Further fiscal tightening would have been very difficult to implement for political reasons, especially since there had already been surpluses every year since 2001. Moreover, credit policy might not have worked either, as virtually the entire banking sector was foreign-owned. These banks were competing hard for market share in the booming Baltic States and might have circumvented any credit restrictions by funneling funds to Estonia directly from the, mostly Swedish, mother banks (Feldmann, 2013). While the fact that banks were foreign-owned and that public deficits were very small distinguishes Estonia from other LMEs like the USA, high credit growth associated with a booming real estate sector was a key common factor. The VoC framework has tended to focus mostly on explaining long-run economic performance and comparative advantage rather than short-run fluctuations. However, the boom-bust-cycle of the Estonian economy displays interesting parallels with key LMEs and the so-called Anglo-Liberal Growth Model characterized by the central role of the financial sector and private borrowing (Hay and Smith, 2012). This suggests the need for a more detailed assessment of the sources not just of growth, but also of financial vulnerability within the VoC framework, and the Estonian experience shows how market-based institutions can simultaneously contribute to growth and increase the risks of a financial crisis by contributing to unsustainable capital inflows and credit growth (Iversen and Soskice, 2012).

Estonia’s response to the crisis has arguably been even more distinctive than its causes. Despite a very deep recession – output contracted by 14.3% in 2009 – there has not been any attempt by the state to bail out ailing industries or to take over banks, which are in foreign ownership. Estonia had a currency board at the time and categorically ruled out the prospect of a devaluation of the exchange rate. Therefore the adjustment to the crisis had to occur by means of an internal devaluation, that is, price and wage cuts and adjustments in the real economy. As the country was also preparing for euro adoption, the government sought to keep deficits below 3% in order to meet the Maastricht convergence criteria for adopting the common currency. In the face of rapidly contracting GDP and tax revenues, this required making very substantial reductions in public expenditure. Planned expenditure was cut by about 13% as part of three austerity plans in 2009, which included significant cuts to sick leave and unemployment benefits, reductions of the government’s operating expenses, including significant public sector wage cuts, reductions of infrastructural investments in roads and caps on pension increases (Raudla and Kattel, 2011, 170–172). These cuts along with increases in VAT, unemployment insurance contributions, excise duties on fuel and pollution charges effectively made fiscal policy pro-cyclical (Feldmann, 2013). There have not been any attempts to launch statist intervention or to negotiate any social pacts to address the crisis. The government has introduced the austerity programs unilaterally, and the key adjustment mechanisms have been market-based, that is, wage, price and quantity adjustments. Many experts cautioned against this strategy and believed that the fixed exchange rate would not be sustainable under such circumstances, but Estonia managed to implement this strategy. Although this did not prevent the recession or a significant increase in unemployment, Estonian wages were more flexible downwards than elsewhere in the EU (Dabusinskas and Rõõm, 2011).

It has been suggested that this feasibility of an internal devaluation turns Estonia and the other Baltic States into a new form of market economy – a flexible market economy (Kuokstis, 2011). However, this adjustment strategy and the fact that wages were relatively flexible downwards could also suggest the Estonian political economy may come closer to the theoretical ideal type of a pure LME than the canonical examples of LME economies, like the UK or the US, given this strong emphasis on market-based adjustment mechanisms.

4. Conclusion

The Estonian economy is a fascinating case study for political economy, considering its focus on free market policies, the attention many international organizations have paid to it and the influence many of its policy innovations have had in Central and Eastern Europe. It could be viewed as a most-likely case of a liberal market economy in the post-communist world. With respect to the question whether Estonia constitutes a liberal market economy, as defined by Hall and Soskice (2001), this article argues that the criteria need to be adapted somewhat to examine the specific features of emerging varieties of capitalism in the transition countries. In particular, given that they are relatively new market economies which are still in the process of converging on Western European living standards, assuming long-standing and stable institutions, comparative advantages and the existence of world-leading sectors is too restrictive. As long as they are in the process of catching up with the leading economies of the world, they are likely to compete, at least partly, on price rather than in high quality niches.

This article argues that many features of the Estonian economic institutions, notably the governance of labor markets, welfare states, as well as education and training, bear great resemblance to the LME model. Indeed, given the predominance of market coordination, Estonia may even come closer to the ideal type of an LME on some of these dimensions than the canonical LMEs, discussed in the traditional literature. This is much less true of corporate governance, but it should be noted...
that these institutions do not fit the traditional CME model of patient capital either. Patterns of sectoral specialization could be viewed as consistent with many features of LMEs, notably given the growing importance of the service sector and information technology. Estonia has experienced rapid growth, but also, as in the case of the US and UK, high credit growth and financialization, which made the country vulnerable to a boom–bust cycle. In that sense many of the most striking features of LME performance are also present in Estonia, and a VoC analysis can account for the institutional sources of Estonia’s economic trajectory.

The analysis of the Estonian economy from a VoC perspective can shed light on the potential and limitations of cross-regional comparison. This article has illustrated many similarities in institutions and economic patterns between Estonia and advanced market economies. Such comparisons may enrich our understanding both of the trade-offs facing Central and East European countries and of the portability of the VoC framework. While the market-based policies adopted by Estonia have led to very good economic performance in many respects, there are also trade-offs associated with the adoption of such a model. Some of the challenges pertain to rapid growth of the financial and real estate sectors in the context of a currency board, which made Estonia very vulnerable to the global economic crisis. Comparative analysis may shed more light on the degree to which LME institutions are inherently more likely to be affected by financial instability (Konzelmann and Fovargue-Davies, 2011). This could enrich our understanding of the pros and cons of different types of VoCs and economic institutions, both in new and longstanding market economies.

However, there are also limitations to the VoC approach as a framework for understanding the Estonian economy. First, as noted above, corporate governance does not fit the LME model, which suggests that other factors, such as capital abundance or levels of development, may be a more important determinant of financial systems than institutional complementarities with a range of market-supporting institutions. Second, the VoC framework fits most other transition economies much less well, except for Slovenia and perhaps the other Baltic States. This suggests that the identification of alternative or complementary typologies is also an important task for comparative political economists working on Central and Eastern Europe. Finally, as many critics of VoC have suggested, many formulations of VoC theory do not provide a clear account of the origins of institutions. While some scholarship on this topics has highlighted the role of legacies and policies (Feldmann, 2007) and other scholars have examined the role of the state (Bohle and Greskovits, 2007), there is great potential for further comparative work on the origins of economic institutions and institutional convergence.

References


