Bachelor Thesis

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The Baltic countries in the crisis

Is better Fiscal policy the reason for Estonia's better recovery?

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Abstract

The Baltic countries were for a long time a European success story with the highest growth rates of all European countries. In the recent economic crisis however the three countries were among the hardest hit and their economies suffered dramatically. All three countries opted to pursue counter-cyclical policies as a reaction to the crisis. As a result all three countries recovered quickly and successfully, although Estonia was more successful than the other two countries. This thesis has the aim to find out what exactly made Estonia more successful. To achieve this 5 variables were identified, that are important factors for the economic performance after relying on counter-cyclical economic policy. After comparing the three countries it has become clear that Estonia was more successful, due to its quicker reaction, to the crisis and its better financial situation before the crisis and also closer following the recommended course of actions than Latvia and Lithuania.

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1. Introduction

In this thesis I will deal with the economic crisis in the Baltic countries. The Baltic countries experienced a period of high growth followed by a crash in the financial crisis of 2008. All three countries decided to follow roughly the same economic policy. They all opted for a cyclical economic policy of spending cuts and tax increases. The choice of a policy of fiscal retrenchment was surprising for some economic experts, since the classic reaction to a recession would be a counter-cyclical policy. Nevertheless all three countries decided to pursue a cyclical fiscal policy. Although all countries followed in principle the same strategy, Estonia seems to be more successful in dealing with the effects of the economic crisis. In this paper I will try to answer the question of why Estonia was more successful and which role the details of fiscal policy played in this success.

In order to answer the research question, I will compare the economic situation of the Baltic countries before the crisis, look at the different policy measures the countries used to combat the crisis, and then look at the economic data of the countries after the crisis, to see how successful the different measures have been. Success in this case will be defined by a collection macroeconomic indicators.

The thesis is divided into five sections, with this introduction as the first section.

The second section of this thesis will deal with the theoretical aspects of cyclical fiscal policy. I am going to explain the general philosophy behind those policies and then explain, which course of action is recommended by academic literature, to pursue those policies successfully. The five most important variables that, could explain economic differences after the crisis are identified.

The third section will deal with the actual research. I am going to analyze the three different Baltic countries with regard to five different variables: their economic situation before the crisis, the swiftness of their reaction to the crisis, the front loading of their fiscal changes, their reliance on spending cuts versus tax increases and the shifting of their tax burden from labour related to consumption related taxes.

In the fourth section I am going to compare the different policies the three countries have chosen and explain how those policy differences resulted in different results for their respective economies.

The fifth section concludes the thesis, with a short summary of the findings and how they fit in the current research.

2. Theory

2.1 Cyclical fiscal policy

During recessions countries have different choices to adapt their policies. Countries have the possibility to stimulate the economy through expansionary fiscal policy to encourage economic growth, or they can try to keep a balanced budget through fiscal retrenchment. Without a change in fiscal policy countries automatically pursue a slightly expansionary fiscal policy. When the economy contracts, unemployment numbers rise and tax revenue declines. This leads to rising expenditures and declining revenue, which in turn increases the budget deficit or decreases the budget surplus (Lane, 2003). Those effects are called automatic stabilizers. This policy is slightly expansionary, because the state spends more money than before, which can partly replace the declining activities in the general economy. Unemployed people spend money they get from the state, instead of their wages, which can slow the decline in economic activity. Economic literature has long advocated counter-cyclical fiscal policy. In developed countries fiscal policy seems to be more counter-cyclical, while developing countries often pursue more cyclical fiscal policies (Alesina, Campante & Tabellini, 2008). Since the Baltic countries are not generally counted as developed countries, but as developing former socialist states, cyclical policy could be expected. However, although all three counties might be economically less developed than Western Europe or North America, they are not third world countries with no trust in their financial institutions. Therefor both expansionary cyclical and counter-cyclical policies might have been options for the Baltic countries.

Armingeon (2012) argues that counter-cyclical fiscal policy is the standard policy governments use during economic downturns. To pursue a different policy governments must be able to react swiftly. If a country does not reacts quick enough the automatic stabilizers kick in and the country pursues an slightly expansionary fiscal policy for a while. This can lead to drastically increased public deficit. Pursuing a pro-cyclical fiscal policy happens mostly under pressure from outside organizations. Because pro-cyclical policy comes with economic hardships for the population, governments often shift the blame for pursuing pro-cyclical fiscal policies on outside actors. Those actors could be international organizations like the IMF, World Bank or the EU. In other cases there might be economic incentives for pro-cyclical policies, like the possibility of joining the Eurozone, in the case of the Baltic countries (Armingeon, 2012).

2.2 Internal Devaluation

The concept of internal devaluation has become more important in the recent past. With the establishment of the Eurozone many European countries gave up control over their monetary policy, which can lead to consequences in economic recessions. If a country is hit hard by an economic shock or suffers a decline in competitiveness it usually is possible to depreciate the currency (Armingeon & Baccaro, 2012). Quickly rising wages may lead to a decline in competitiveness because production of goods becomes more expensive in such a country, which can lead to rising unemployment and economic problems. If the country has control over its currency, it is possible to depreciate the currency by monetary policy. This leads to cheaper exports and more expensive imports, which stimulates the domestic economy, because both internal as well as external actors now buy more of the cheaper domestic products. In the event of an economic shock the same is true.

Members of the Eurozone gave up control over their economic policy. If wages rise faster in one of the member states than in others and this wage raise is not accompanied by productivity gains, this country loses competitiveness. Since the currency cannot depreciate, unemployment will rise and the economy might begin to shrink.

Although the Baltic countries were not members of the Eurozone at the beginning of the crisis, they experienced the same effects. The Baltic countries decided to join the Eurozone as fast as possible due to economic and political reasons. While they could theoretically depreciate their currencies during the financial crisis, they decided against it due to these political reasons. Would the Baltic countries have stopped to peg their currencies to the Euro, accession to the common currency would have been delayed for

years, since countries have to be part of the ERM for two years before adopting the Euro. As a consequence, the currencies of all three Baltic countries stayed pegged to the Euro throughout the crisis.
When it is impossible to raise competitiveness through currency devaluation (External devaluation), internal devaluation is an alternative. Since it is not possible to cheapen exports through depreciation of the currency, labour costs in the country have to be lowered. That can be achieved through a combination of measures. The tax burden should shift from labour related taxes, to taxes on consumption. This would have the effect that products for export would become cheaper since consumption taxes are only relevant domestically. In addition to that the government can reduce wages in the public sector. This should lead to a general decreased wage level and therefore enhance competitiveness (Armingeon & Baccaro, 2012).
Furthermore it is important that the budget stays stable in order to keep the trust of financial markets. With a pegged or common currency, financial markets could lose trust in struggling countries, to be able to pay their debts. In this case cutting expenditures and raising taxes helps to increase trust (Armingeon & Baccaro, 2012).
The academic literature general seems to support the opinion that internal devaluation could be ineffective. Armingeon & Baccaro (2012) argue that internal devaluation can lead to an economic downward spiral, as seen for example in Greece.

2.3 Tax increases vs spending cuts

Governments that decide to pursue a cyclical fiscal policy during a recession, have in general two tools to keep the budget stable. The first tool is expenditure cuts. The government reduces its spending to save money and reduce the deficit. The second tool are tax increases. The government tries to raise more money through raising taxes, closing loopholes or in some cases selling assets. In general the literature recommends to rely mainly on expenditure cuts, than tax increases to stabilize the budget (Alesina & Ardagna, 2010 & Poterba,1993). It has been shown that expenditure cuts have a bigger and more lasting effect than tax increases.

Time is of importance for fiscal policy during recessions. While it often takes time for tax increases to show an effect, expenditure cuts can have an almost immediate effect. Tax increases often have an effect only in the next fiscal year. Poterba (1993) has shown that US states that rely mostly on expenditure cuts were able to achieve a neutral budget much faster than states that relied on tax increases. Furthermore Alesina (2010) has shown that the general size of budgetary change is not as important as the composition of that change. In other words tax increases that increase the revenue for a certain amount are not as effective in stabilizing the budget as expenditure cuts that amount to a lower sum.

Tax increases and spending cuts can be further differentiated (Raudla & Kattel, 2013). Spending cuts could be across the board or targeted, and then permanently or just temporarily. Similar tax increases can differ. The government could simply increase taxes, or broaden the tax base, by reducing tax exemptions. Furthermore direct taxes like income taxes or indirect taxes could be increased. To increase revenue, governments might also sell assets, like state owned enterprises. This can be useful to raise revenue quickly, but is of course a one-off measure (Raudla & Kattel, 2013).

2.4 Conclusion

Taking all into account there are five important variables that contribute to successful counter-cyclical policy.

1. Economic stability before the recession
2. Swiftness of the policy reaction
3. Front loading of measures
4. Relying on Spending cuts more than on tax increases
5. Shift in tax burden (from labour related to consumption taxes)

3. Empirical findings

To evaluate weather Estonia's Fiscal policies lead to a better recovery from the economic crisis I analyzed several EU documents and economic statistics of the three countries. Important are the Action plans for economic growth 2008-2011, which were submitted to the EU by the member states, the implementation reports from 2009, the convergence reports of the countries for the stability and growth pact, convergence programmes of the Baltic countries from the relevant years and country specific recommendations from the EU towards the member states. The action plans for economic growth describe the basic economic strategies of the member states. They were written before the crisis hit the world economy in full force. The implementation reports from 2009 describe how the countries implemented the planned policies from the action plans. They also describe how the crisis influenced those plans and what measures the countries took to combat the effects of the crisis. The convergence programmes describe the economic and financial situation of the member states and outlines planned measures to ensure economic and fiscal stability. They are reported to the EU by the member states. Finally the country specific recommendations are documents adopted by the European council, which evaluate the successes of the action plans and give recommendations on how to proceed further. The economic data is from Eurostat and is about GDP, GDP growth rate, government deficit, government gross debt, the unemployment rate and Inward FDI.

The countries will be compared in regard to the five identified variables, that could explain outcome differences. The policy variables I will compare are economic performance before the crisis, swiftness of policy change, front loading of measures, reliance on spending cuts and the shifting of the tax burden. As indicators for economic performance before and after the crisis I choose, GDP growth, GDP per capita, unemployment rate, public deficit, gross public debt and foreign direct investment (FDI). Possible weaknesses of this research approach is that unidentified differences in the economies of the countries from before the crisis might influence the outcomes of policies. Comparisons of countries can not be perfect since countries can not be perfectly equal. However the three Baltic countries are probably as similar as countries get in the real world. Estonia, Latvia and Lithuania are geographically close, have a really similar history and population size and their economic are very similar in structure and size. There are not many countries as similar as the three Baltic states, therefor a comparison between those countries works better than comparisons between nearly all other different states.

3.1 Situation before the Economic crisis

The three Baltic countries went through a real similar development after the fall of the Soviet Union. All three countries became independent in the early 1990's, introduced their own currencies and economic policies and tried to strengthen the relationship to Western countries. After independence the economy crashed heavily in the Baltic states. Estonia for example experienced a 21,2% loss in GDP in 1992. But after the introduction of economic reforms and own currencies the Baltic economies developed extremely fast. Once the crisis after the independence was surpassed, growth was consistently high, with the exemption of the ruble crisis of the late 1990's (Erixon, 2010). Fiscal and monetary policy in the Baltics was since the beginning focused on keeping the exchange rates stable. The currencies were early on pegged to the Euro. After accession to the European Union in 2004, growth in all three Baltic states accelerated even more. The Baltic's were the fastest growing economies in the European Union in the time before the financial crisis. In 2006 the Latvian GDP grew 11,2% and the Estonian GDP grew 10.6%, which marks the most successful year for the Baltic economies. During this time the Baltic currencies kept being pegged to the Euro and the public deficit remained very low. The general government gross debt was higher in Lithuania with 18% of GDP in 2006, while Estonia showed especially low debt levels with 4,4% of GDP in 2006 and a consistent budget surplus from 2004 to 2007. Latvia's debt level was in between of the higher level of Lithuania and the low level of Estonia. Although the general situation and politics are very similar in the Baltic countries, the budget is one area where the countries policies differed even before the crisis. The above mentioned budget surplus in Estonia was used to create a rainy day fund, which is quite atypical for a transition economy in Eastern Europe (Erixon, 2010).

The unemployment rates in all three countries steadily went down after accession to the European Union. Unemployment was highest in Latvia and lower in Estonia and Lithuania, which were approximately on the same level after the crisis.

FDI can also be an important indicator for a nations economic well being, since a higher FDI is caused through more trust in the countries economy and stability by third parties (Kekic, 2011).

FDI was much higher in Estonia than in Latvia and Lithuania. FDI reached a height of 7,9% of GDP in Estonia in 2007, while the numbers in Latvia and Lithuania stayed much lower with 1,3% and 1,7% of GDP.

GDP

GEO/TIME	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
European Union (28 countries)	23,200	24,400	25,800	25,900	24,300	25,300	26,000	26,500	26,600	27,300
Estonia	8,300	10,000	12,100	12,300	10,600	11,000	12,300	13,300	14,200	14,800
Latvia	6,100	7,800	10,300	11,200	8,800	8,600	9,800	10,900	11,600	12,100
Lithuania	6,300	7,400	9,000	10,200	8,500	9,000	10,300	11,200	11,800	12,400

GDP growth rate

geo\time	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
EU (28 countries)	1.5	2.5	2	3.4	3.1	0.5	-4.4	2.1	1.7	-0.5	2.5	2.5
Estonia	7.5	6.5	9.5	10.4	7.9	-5.3	-14.7	2.5	8.3	4.7	1.6	2.1
Latvia	8.6	8.9	10.2	11.6	9.8	-3.2	-14.2	-2.9	5	4.8	4.2	2.4
Lithuania	:	:	:	7.4	11.1	2.6	-14.8	1.6	6.1	3.8	3.3	2.9

General government deficit in % of GDP

GEO/TIME	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Estonia	1.6	1.6	2.5	2.4	-2.9	-2.0	0.2	1.0	-0.3	-0.5
Latvia	-1.0	-0.4	-0.6	-0.6	-4.0	-8.9	-8.2	-3.4	-0.8	-0.9
Lithuania	-1.5	-0.5	-0.4	-1.0	-3.3	-9.3	-6.9	-9.0	-3.2	-2.6

General government gross debt in % of GDP

GEO/TIME	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Estonia	5.0	4.6	4.4	3.7	4.5	7.1	6.5	6.0	9.7	10.1
Latvia	4.2	11.7	9.9	8.4	18.6	36.4	46.8	42.7	40.9	38.2
Lithuania	19.3	18.3	18.0	16.7	15.4	29.0	36.3	37.3	39.9	39.0

Unemployment Rate

GEO/TIME	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
European Union (28 countries)	9.0	8.2	7.2	7.0	8.9	9.6	9.6	10.5	10.9	10.2
Estonia	8.0	5.9	4.6	5.5	13.5	16.7	12.3	10.0	8.6	7.4
Latvia	10.0	7.0	6.1	7.7	17.5	19.5	16.2	15.0	11.9	10.8
Lithuania	8.3	5.8	4.3	5.8	13.8	17.8	15.4	13.4	11.8	10.7

Inward FDI as % of GDP

GEO/TIME	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Estonia	2,2	5,0	6,6	7,9	4,7	8,0	0,7	-6,4	4,3	1,5
Latvia	0,8	0,8	0,9	1,3	0,7	-0,2	0,1	0,2	0,7	1,1
Lithuania	1,2	1,3	1,0	1,5	0,7	0,5	0,0	0,1	0,9	0,2

3.2 Swiftness of Policy reaction

As mentioned in the theoretical part of this thesis, the swiftness of policy reaction is important to keep the deficit stable, before automatic stabilizers force countries in a slightly expansionary fiscal policy.

Latvia was hit by the crisis in 2008. In the beginning the prognosis seemed not to bad for the Latvian economy. The government stated the goal “not to allow a rapid fall of the growth" (Republic of Latvia, 2008, p.5). The country much like the other two Baltic countries stated the goal of restrictive fiscal policy to keep the budget deficit small and even strive for a surplus. Although the Latvian economy was still projected to grow, the growth prognosis was relatively low compared to economic growth before the crisis. This forced the Latvian government to already plan budget cuts in 2008. Government expenditure could not rise as projected because of lower projected tax revenue, due to slower economic growth. Across the board cuts of government expenditure was planned.

Wage moderation was a stated goal of the Latvian government in 2008, in order to increase competitiveness.

Since economic growth was much lower than projected and actually negative in 2008, automatic stabilizers kicked in and increased the needed spending and decreased revenue. As a result the public deficit increased dramatically. The stated goal of a balanced budget was upgraded to a balanced budget in the future (Republic of Latvia, 2009). The budget deficit was planned to be decreased yearly to 6% in 2011. The introduction of the Euro would therefore only be possible to a later date. Nevertheless fiscal changes were necessary to achieve those updated budget goals.

Lithuania was the last of the Baltic countries, hit by the financial crisis. The Lithuanian economy only began to contract in late 2008. The government stated the goal to join the Euro as soon as possible, which gave not much leverage to fiscal policy. Fiscal policy had to be strict, like in the other Baltic countries. In 2008 the government still projected economic growth for Lithuania in 2009 (Republic of Lithuania, 2008). The fact that Lithuania was hit later by the crisis makes the National reform plan of 2008 less valuable for this analysis.

Although Lithuania still projected economic growth at the beginning of the crisis, the slowed down economic growth meant an increase in the public deficit, due to a reduction in expected revenue. Even without negative growth Lithuania already violated the stability and growth pact in the end of 2008. Fiscal discipline therefore had to already start before the crisis really reached Lithuania. Nevertheless the fiscal reaction was not quick and strong enough to prevent a public deficit of 9.3% in 2009.

Estonia started to react to the crisis very early. As mentioned above Estonia was hit by the crisis before Latvia and Lithuania, because of a financial system that is structured somewhat differently. In the Estonian action plan 2008-2011 (Republic of Estonia, 2008) the crisis was already mentioned. The Estonian economy had already begun to shrink and was projected to shrink further. The established goal of the Estonian government was fiscal stability to join the Euro as soon as possible and to enhance productivity. Productivity was identified as a problematic area because of fast wage gains that made the Estonian economy less competitive in combination with low productivity. Already in the beginning of 2008 an additional budget was deemed necessary, to keep public finances stable. Automatic stabilizers had already started kicking in, and the Estonian government was forced to cut expenditure to keep the deficit in check. The immediate reaction made it possible that the deficit never slid under the 3% mark that is necessary to join the Euro (Republic of Estonia, 2009).

3.3 Front loading of measures

The front loading of the fiscal changes is important because measures taken at the beginning of a crisis can have positive impacts in the subsequent years of a crisis. Furthermore it might be psychologically easier for the voters to accept drastic changes at the beginning of a steep economic downturn.

The fiscal changes in Latvia were front loaded with the bulk of the measures coming into effect in 2009 and smaller packages in 2010 and 2011. With this the Latvian government followed the literature recommendations of fiscal balance. However a small fiscal change was already made at the end of 2008, when 0,5% of the budget was cut (Republic of Latvia, 2009).

The fiscal changes were front loaded in Lithuania, were in 2009 the fiscal changes amounted to 7,4% of the budget and the fiscal consolidations slowed down in 2010 and 2011 with 3,7% and 1,4 % of the budget (Republic of Lithuania, 2011).

In Estonia the changes also were front loaded. Government expenses were cut from 17,4 billion Kroons in 2008 to 15,7 Billion kroons in 2009 and 14,7 billion kroons in 2010. The budget cuts amounted to 9% of GDP in 2009 from which 5% were achieved through budget cuts and 4% through revenue increases (Republic of Estonia, 2009). In 2010 and 2011 the fiscal consolidations were significantly smaller. It is especially interesting that Estonia could already cut its budget by 2& in 2008 when the crisis had just started.

3.4 Tax increases vs spending cuts

It is recommended by economists and the relevant literature to concentrate more on spending cuts, than on tax increases, since the first ones tend to show effects immediately and do not hinder productivity.

The Latvian government relied more on spending cuts than on revenue increases in general. In 2009 6,7% of GDP got cut on the expenditure side and revenue increased by 2,8% of GDP. In the following two years the balance shifted to revenue increase. To cut spending, the number of public employees was cut drastically by 20% and the pay of the remaining workers was cut by 18%. Furthermore Sickness benefits and unemployment benefits were reduced. The cuts were not targeted, with two exceptions. Contributions to EU and NATO, as well as teachers wages were not cut at all. In the areas of Health care and interiors expenditure got cut by 3-5%. All other expenses were cut by 20% (Republic of Latvia, 2010).

When Lithuania was hit by the crisis in 2009, the government reacted by expenditure cuts and tax increases. The government concentrated mainly on cutting expenditure. There were some tax increases, but the bulk of the measures were on the expenditure side. Public sector employment and wages were cut by 5% for politicians and judges and by 8% for most other state employees. Government contributions to the second pillar pension funds, were also cut. Additionally the criteria to qualify for social security benefits were made stricter, with the goal to still provide adequate support for those who really need assistance (Republic of Lithuania, 2010). The cuts were across the board, all areas and layers of government had to cut by the same percentages. On the revenue side, personal income tax actually decreased from 24% to 21%, but the tax base was broadened. Corporate income tax was increased temporarily. VAT was increased and new taxes, like the real estate tax were introduced. Furthermore the government planned to broaden its tax base through fighting the shadow economy (Republic of Lithuania, 2010).

Estonia also concentrated mainly on expenditure cuts. In 2008 only revenue was cut, without any tax increases. In 2009 The expenditure cuts were more than twice as big as the tax increases as a percentage of the general budget. Measures included across the board cuts of government wages and expenditures. Furthermore the annual increase in pensions was reduced from 14% to 5% and the contributions to the second pillar of the pension system were suspended till 2010 (Republic of Estonia, 2009). In 2010 However budget cuts and tax increases were nearly on the same level with 1,6% ad 1,3% of the general budget (Raudla & Kattel, 2013).

3.5 Shift in tax burden

Tax rates in Latvia were in general increased. The goal of shifting the tax burden from labour related to consumer taxes was not achieved during the financial crisis. Personal income tax first decreased but later increased in Latvia. The VAT was also increased and VAT tax base broadened (Republic of Latvia, 2010). Especially punitive taxes on alcohol and cigarettes increased.

In Lithuania the tax base did not really shift from labour towards consumption taxes. Some labour taxes were lowered but others were increased. Consumption taxes were increased in general (Republic of Lithuania, 2009).

In Estonia in general the government planned to shift the tax burden from labour related taxes to taxes to taxes on consumption. For example the VAT should be increased and taxes on gas, alcohol and cigarettes were planned to be raised, while income tax was planned to be decreased (Republic of Estonia, 2010). Furthermore the general tax base should be broadened.

The government planned to make the labour market more flexible while at the same time increase social security for workers.

On the revenue side, VAT was increased as planned before the crisis. Labour related taxes did not decrease as planned before the crisis, because of the need for revenue to keep the budget stable. There was some shift from labour based taxes to taxes on consumption and environmentally-taxing behaviour. Taxes on alcohol and cigarettes increased, as well as taxes on petrol (Republic of Estonia, 2010).

4. Comparison of the policies and their results

4.1 Economic data during and after the crisis

The Baltic countries were the hardest hit countries of the global financial crisis in terms of loss of GDP (Raudla & Kattel, 2013). The high GDP growth that was experienced in the boom years after the accession to the European Union turned around into high negative growth. In 2009 all three Baltic countries experienced negative growth rates of above 14%. The recession already started in the end of 2007 in Estonia, hit Latvia in 2008 and Lithuania in the end of 2008. The different timing can be explained through a different structure of the banking sector and credit market. Whereas the Estonian banking sector is completely controlled by foreign (mostly Nordic) banks, Latvia and Lithuania have a greater share of domestic owned banks (Kuokštis & Vilpišauskas, 2010). This lead to the situation, that credit and consumption was shrinking in Estonia, earlier than in the two other countries. Lithuania even experienced positive growth of 2.6% of GDP in 2008, when the other two countries and especially Estonia were already in recession.
The unemployment rates of all Baltic countries starkly increased in 2009 and 2010. In 2010 the unemployment rate reached 19.5% in Latvia and 17.8% in Lithuania. In Estonia the unemployment rate also drastically increased, it reached a maximum of 16,7% in 2010. Since 2010 the unemployment rate slowly went back to nearly pre-crisis levels. Estonia reached an unemployment rate of 7,4% again in 2014, while Latvia and Lithuania both had an unemployment rate of about 10%. The lower rate of Estonia is especially remarkable, taking into account, that Estonia experienced far less emigration during the crisis years than the other two countries (Kuokštis & Vilpišauskas, 2010).
The recession ended and GDP growth set in again in 2010 for Estonia and Lithuania and 2011 for Latvia. Growth rates were 5% or higher for all Baltic countries in 2011, but slowed down since then. Estonia was able to fulfill the Maastricht criteria even during the crisis and joined the Euro area in 2011. Latvia and Lithuania could fulfill the Maastricht criteria after the recession ended and the public deficit was under control again and were able to join 2014 (Latvia) and 2015 (Lithuania).

The budget deficit is a major difference between the three Baltic countries in the crisis. Latvia and Lithuania suffered large public deficits from 2008 to 2011. Estonia managed to keep the budget deficit below 3% of GDP and was even able to achieve a little surplus in 2010 and 2011. Resulting from this Estonia kept the general gross national debt relatively low at 10%. In the same time the gross national debt in Latvia increased from ca 10% to 40% of GDP and from ca 17% to 40% in Lithuania.
Another difference is the level of FDI in the Baltic countries. As mentioned above the level of FDI was much higher in Estonia, before the financial crisis. During the Crisis the level of FDI flowing into Estonia was reduced in absolute numbers and capital started flowing out. However after the crisis ended the FDI flows into Estonia went up again, although pre-crisis levels are not reached yet. FDI inflow in 2013 was just 1,5% of GDP, which is just slightly higher than the numbers for Latvia (1,1%) and Lithuania (0,2%). FDI is of great importance for countries like the Baltic states. Because of their historic background the Baltic countries did not have much access to domestic capital. But since capital intensive industries tend to be more productive foreign capital is needed (Erixon, 2010). Furthermore FDI in general seems to be more profitable than domestic investment (Portes, 2013).

4.2 Comparison of policies

Policy variables

	Latvia	Lithuania	Estonia
Economic situation pre-crisis	High growth, low debt, signs of overheating economy, medium unemployment	High growth, low debt, low unemployment	High growth, low debt, low unemployment, High FDI
Swiftness	First reaction in first year of crisis, most policy changes in following year	First reaction in first year of crisis, most policy changes in following year	immediate reaction

Front loading of measures	Front loaded	Less front loaded	Very front loaded
Spending cuts vs tax increases	Focus on spending cuts	Focus on Spending Cuts	High Focus on spending cuts
Shift in tax burden (from labour towards consumption taxes)	No shift	No shift	Shift towards consumption taxes

Economic situation before and after Financial crisis

	Latvia	Lithuania	Estonia
GDP per capita 2007	10300	9000	12100
GDP per capita 2012	10900	11200	13300
Unemployment rate 2007 in %	6,1	4,3	4,6
Unemployment rate 2012 in %	15,0	13,4	10,0
Government gross debt 2007 as % of GDP	8,4	16,7	3,7
Government gross debt 2012 as % of GDP	40,9	39,9	9,7
Inward FDI 2007 as % of GDP	1,3	1,5	7,9
Inward FDI 2012 as % of GDP	0,7	0,9	4,3

In general all three Baltic countries followed similar policies. However details and results varied. All countries stated as their goal a conservative fiscal policy, so that the Euro could be introduced as fast as possible. All countries front-loaded their fiscal changes, which means that the biggest part of the fiscal contraction was done in the beginning of the crisis. However Latvia and Estonia front-loaded their fiscal changes stronger than Lithuania which cut a large chunk of its expenditures in 2009 and in 2010. All three also concentrated mainly on budget cutting with additional revenue increasing policies. Also all three countries stated higher competitiveness as a goal. In general the governments wanted to pursue a policy of shifting tax burden. The tax burden should be shifted away from labour costs and towards consumption. This should theoretically lead to internal devaluation and an increase in competitiveness. Increased competitiveness should be indicated by sinking labour costs and unemployment. Latvia and Lithuania, barely shifted the tax burden, whereas the tax burden in Estonia actually shifted towards consumption taxes. In reality unemployment indeed went down in all three Baltic states, although pre-crisis levels are not reached yet. Estonia was most successful in reducing unemployment and has now a the lowest unemployment rate with 7,4% in 2014. Lithuania which had an unemployment rate on the same level as Estonia before the crisis had an unemployment rate of 10,7% in 2014. Latvia is approximately on the same level as Lithuania with regards to the unemployment rate.

The most important difference is the timing of the measures. Estonia was hit first by the crisis. Latvia's and Lithuania's economies were affected a few months later. While all countries reacted with budget cuts to counter automatic stabilizers when the economy stopped growing, only the Estonian reaction was quick enough to prevent a steep incline of the public deficit. The Estonian government managed to react quick enough to keep the deficit inside the boundaries set by the stability and growth pact. Estonia even reached a budget surplus during the crisis. Latvia and Lithuania did not react as quickly and were subsequently confronted with increased public deficits. The consequence of this is that, now after the crisis ended, Estonia has the lowest gross public debt off all EU states, whereas Latvia and Lithuania now actually have a considerable amount of public gross debt. Before the crisis they were both also among the countries with the lowest debt. The low debt levels let to a quick adoption of the Euro by Estonia in 2011.

Due to the quickly raising debt and its inability lend money on the market the Latvian government was forced to take out a 7,5 billion Euro loan from IMF, World Bank and other member states.
Foreign direct investment was already much higher in Estonia before the financial crisis. During the financial crisis Foreign direct investment went back in all Baltic states, but especially in Estonia. However towards the end of the crisis the FDI in Estonia was higher again than in Latvia and Estonia. This is an indicator for higher trust of markets in the Estonian economy and will probably foster long-term economic growth.
Taking all into account Estonia the most important difference was the reaction time of the government's. The quick reaction of the Estonian government at the beginning of the crisis can be linked to the lower debt level after the crisis. Furthermore the shift from labour to consumption taxes implies a more successful internal devaluation, which can be linked to the lower Estonian unemployment rate and the higher amount of FDI Estonia can attract. In the areas of balance between spending cuts and tax increases and front loading of budgetary changes, Latvia and Lithuania followed nearly the same policy as Estonia. As an outcome the Estonian economy seems to be stronger than the Latvian and Lithuanian economies. However Estonia's economy seemed to be a bit stronger even before the beginning of the crisis.

5. Conclusion

To answer the research question whether the differences in fiscal policies made Estonia more successful in dealing with the effects of the crisis, I shortly described the policies recommended by the scientific literature for successful counter-cyclical policy. The five most important variables linked to the success of the economic strategy where identified and the three Baltic countries were then compared with regard to those five variables. The Baltic countries started from a similar economic position, although it could be said that Estonia was more fiscally responsible even before the economic crisis. During the crisis all three countries followed pro cyclical fiscal policies. All countries concentrated on mainly expenditure cuts, as recommended by the relevant literature. However Estonia’s focus on spending cuts was bigger than in the other two countries.

There were two main differences between Estonia and the other two countries. Estonia reacted much more timely than the other two countries, which gave Estonia a huge advantage in regards to the public debt level. However to control the budget the same way Estonia did, both Latvia and Lithuania, would have had to pursue an even more strict austerity policy, which might not have been feasible. As a result Estonia's economic data are better than Latvia's and Lithuania's after the crisis. The main difference, that can be connected to Estonia’s quicker reaction is the level of debt. While Automatic stabilizers kicked in, in all three countries, a quick reaction ensured that expenditures immediately got cut in other areas and Estonia could avoid to slide into a big deficit.

The second big difference between Estonia and Latvia and Lithuania, is the shift in taxation. While all three countries stated the goal to shift the tax burden from labour to consumption, only Estonia succeeded in doing so. However this is an important part of internal devaluation. This could be connected to Estonia’s lower unemployment numbers. Lower labour costs allow for more employment. Furthermore Estonia’s FDI, is also much higher than Latvia’s and Lithuania’s, which could be connected to the same policy, since Investors are more likely to invest in countries with lower labour costs.

It seems to be likely that differences in fiscal policy did indeed influence the economic differences that can be observed between the countries.

However the degree of how much the policies influenced the outcome cannot be deducted from this thesis. Furthermore it would be interesting for future research to explore what made it possible for Estonia to react quicker than the other countries, since time seemed to be the most important factor to explain the differences. This thesis only took into account economic factors, but authors like Wenzelburger (2011) looked at other factors like election cycles or the systems of political decision making to explain policy differences. It would be interesting to link both approaches for further research in the area.

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Appendix

Consolidation Measures Taken on Expenditure and Revenue Side of the Budget (percent of GDP), 2008–2011

		Expenditure Side	*Revenue Side*
Estonia	2008	2	0
	2009	6.2	2.7
	2010	1.6	1.3
	2011	0	0.06
Latvia	2008	0.5	0
	2009	6.7	2.8
	2010	1.9	2.1
	2011	0.7	1.6
Lithuania	2009	5.8	1.6
	2010	3.7	0
	2011	1.3	0.1

Source: OECD, 2011, Convergence Programs.