REFORM REVERSAL IN FORMER TRANSITION ECONOMIES OF THE EUROPEAN UNION: AREAS, CIRCUMSTANCES AND MOTIVATIONS

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ABSTRACT

The rapid journey from central planning to EU (euro area) membership stress-tested the social learning processes of FTEs. The desire to be anchored to the West, and to enter the EU spurred major reform waves and led to the introduction of best practice institutions very rapidly. This process most likely accelerated social learning, but apparently in many FTEs this learning was not fast enough to keep pace with the rapid reforms, leaving best-practice institutions with social norms that were not sufficiently strong to maintain them. So not surprisingly, wide-spread reversals emerged in the region, especially when the crisis hit these countries. In other words, reversals seem an inherent characteristic of the FTEs' journey towards a modern social market economy. Reform reversals can be formal reversals, which change legislation (or formal rules), or behavioral reversals, which erode the quality of an institution by materially changing the way it works, or a combination of the two. Spillovers, from formal to behavioral reversals (and vice versa), from reversals in one area to another one, and from one institution to another can play an important role in reform reversals by strongly impacting their nature and dynamics. In many cases, it was this interaction of reversals in different sectors that created a full-blown reform reversal episode. The financial sector seems particularly prone to behavioral reversals, both in public and private institutions. The Washington institutions played a dominant role in shaping the transition process. Following the start of the EU accession process, however, the EU gradually took over as the dominant external anchor. The EU acted as a strong anchor that could prevent or reverse formal reform reversals in areas covered by EU law. The anchoring role of the EU was however much weaker in the case of behavioral reversals. Our analysis naturally leads to the conclusion that the ultimate solution to prevent reform reversals is to accelerate social learning processes, particularly among parallel communities. It is also important to focus on the quality and internal coherence of reforms and newly created institutions.

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ABBREVIATIONS

AQR Asset Quality Review
BoS Bank of Slovenia
CB Central Bank
CSR Country Specific Recommendation
COMP Directorate-General for Competition
DG Directorate General
BAMC Bank Asset Management Company
EBRD European Bank for Reconstruction and Development
ECB European Central Bank
ECFIN Directorate-General for Economic and Financial Affairs in the European Commission
EDP Excessive Deficit Procedure
EIOPA European Insurance and Occupational Pensions Authority
EPC Economic Policy Committee
EU European Union
EWG Euro Working Group
FSAP Financial Sector Assessment Program
FSC Financial Supervision Commission in Bulgaria
FTE Former transition economies of the EU
FISMA Directorate-General for Financial Stability, Financial Services and Capital Markets Union in the European Commission
IMF International Monetary Fund
MIP Macroeconomic Imbalance Procedure
MTO Medium Term Objective
SGP Stability and Growth Pact
SLT Social Learning Theory
SOE State-owned enterprise
SPC Social Protection Committee
SPC-AGE Ageing Working Group of the Social Protection Committee
SRSS Structural Reform Support Service of the European Commission
SSM Single Supervisory Mechanism
ST Stress test
TAXUD Directorate-General for Taxation and Customs Union in the European Commission
USSR Soviet Union

1. INTRODUCTION

Several former transition countries that joined the EU in and after 2004 (FTEs) have reversed economic reforms in recent years, sometimes central reforms. The reversals in Poland and Hungary, previously star performers of transition, have caught media attention, as they have touched the very foundations of a social market economy, such as the independence of the courts.[2] These reversals triggered strong political reactions, also at the EU level. Reform reversals in other countries have been less in the media, but have in some cases been equally important.

These countries started the transition process with an overwhelmingly strong desire to move away from the previous economic and social system towards "the West" (Roland, 2001), and towards a then rather vaguely and not uniformly defined concept of a market economy. As EU accession moved into reach, this strong desire to belong to the West took a more concrete form - the perhaps even stronger desire to join the EU, and in a way, institutionally anchor these countries to the developed world. EU accession gave a further major impetus to reform implementation, while also defining the directions for them: very precisely in those areas to which EU law applied, but also rather clearly overall (the Copenhagen criteria). After joining the EU, several of these countries went on to join the euro area, the very core of the EU, which required further reforms and entailed further requirements on policy coordination.

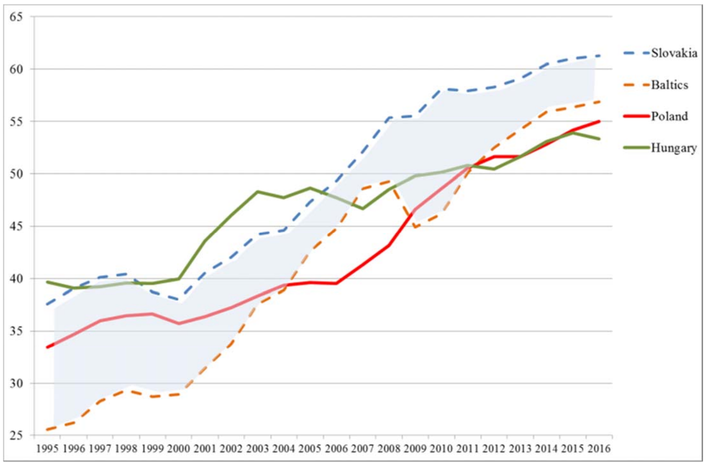
That is, a path was clearly defined to a long-desired destination, and this path was followed (Székely, 2017). Using the framework of Aumann (2017), people in these countries *wanted* to take this journey, which created a strong potential for '*mechanism design design'*, that is, for a system of credible positive and negative incentives that could turn this desire into concrete actions. As we shall show, this momentum and potential was well utilized prior to EU accession (and for countries that wanted to join the euro until euro area accession), but much less so afterwards as the reversal episodes we will discuss below demonstrate. Once inside the club, it seems that the "*want"* might have become weaker in many of these countries, shaking the very foundation of the existing mechanism design (carrots and sticks). Moreover, the mechanism design, domestic and European, may not have been strong enough to prevent the reversals, particularly behavioral reversals.

Reversals are not at all unique to FTEs, not even within the EU, but their experiences in this regard may offer uniquely important lessons for several reasons. First, because these countries

[2] In this paper, we shall not deal with these aspects, such as the rule of law in general. For the position of the European Parliament regarding developments in Poland, see http://www.europarl.europa.eu/news/en/press-room/20171110IPR87824/rule-of-law-and-democracy-in-poland-at-risk-parliament-ready-for-next-steps
For the Polish position on the matter, see
http://www.mfa.gov.pl/en/news/position_concerning_the_european_parliament_s_resolution_on_the_rule_of_law_and_democracy_in_poland
Regarding Hungary, see http://www.europarl.europa.eu/news/en/press-room/20171011IPR85823/hungary-meps-to-assess-whether-there-is-a-risk-of-seriously-breaching-eu-values

implemented reforms that were unprecedented in terms of their depth and scope within just one generation.[3] This journey thus entailed a uniquely fast social learning process, one that stress-tested these societies but nevertheless might not have been fast enough in many areas and countries to make reforms lasting. Second, external anchors have played a uniquely strong role in this process, and all the way through; at the beginning, the Washington institutions (IMF and World Bank), later the EU institutions (most importantly the European Commission). Third, a relatively large group of countries travelled down this road together. Countries that were not only geographically but also culturally rather close to each other. Their initial social norms, albeit historically not necessarily homogenous, had been shaped by common factors prior to the start of this journey. Moreover, those countries who have now turned their back on earlier reforms see some of the others in their peer group continue on the path and pull ahead (Chart 1). So not only the direct costs and benefits to the country (society) concerned, but also the opportunity costs of reforms and their reversals can be observed, and there is potentially a strong peer pressure at work, pushing in either direction.

Chart 1: Per capita GDP relative to frontier (in PPS, group of high income countries=100)



Note: the frontier (=100) is defined as the average of high income countries (Sweden, Denmark, Netherlands and Austria). Baltics is a simple average of the series for Estonia, Latvia and Lithuania. Source: Eurostat

Many of the reform reversal episodes we discuss here took place during the recent crisis, which brought out some of the design problems with previous reforms and increased the pressure on governments to quickly find answers while minimizing negative political consequences. A crisis is an environment where decision horizons get shorter, not only for politicians. This makes reforms more vulnerable to reversal attempts. But, as we shall see when discussing the episodes, it was always the lack of sufficiently strong social norms that eventually allowed the reversal attempts. Where social norms were strong, temporary reversals were later reversed.

[3] Perhaps the best example in this regard is Slovenia, which moved from being on the verge of a war to gain independence in 1991 to joining the euro area in 2007, in slightly more than half generation.

While there is a massive literature on the political economy of reforms, and in particular on reforms in the transition economies (Rodrik, 1995, 2006, Roland, 2001, 2002), there is surprisingly little attention paid to reform reversals (Abiad and Mody, 2005, Campos and Coricelli, 2009). It seems that there are no general models of reform reversals, or models that could capture many of the important aspects of the reversal episodes discussed below. That is, why societies that had already gone down the avenue of massive systemic reform, who had already paid the price of those reforms (with politicians on all sides repeatedly facing the Juncker curse (Buti et al, 2008) in the process), who as a result had successfully entered the EU and fully integrated into the global economy, all of the sudden turned back and in a way wasted the previous efforts. Moreover, the available models do not yet capture how internal and external social norms and social learning processes interact, and more broadly, how external anchors work, most importantly what role European law and institutions have played in this process.

Episodes of reform reversals in these countries may thus offer many important lessons when it comes to understanding how the reform process evolves in a society, how domestic institutions work and interact with each other, how internal social norms evolve through social learning and interact with external social norms, and how all this promotes and anchors reforms, or leads to their reversal. In particular, many of the reform reversal episodes discussed here can help to understand how domestic and EU institutions, each of them being backed by different social norms and evolving as a result of social learning in different social spaces, interact in this process. This is perhaps the most unique contribution of this paper.

However, reversals deserve special attention not only because they can offer useful lessons for theorists, but also because they can have a major negative impact on the economies and societies concerned which is perhaps larger than the original, positive impact of the reforms they reversed. Reversals can be particularly harmful to future development, since they can make it particularly difficult, if not impossible, for politicians to later on (re)embark on reforms in the same areas. Moreover, concerted reversals in several policy areas can put a country on a lower development path for an extended period of time (path dependency).

This paper aims to address two fundamental questions. First, why do countries or societies turn back? Particularly, why do very successful countries and communities reverse reform, in some cases in a fundamental way? Second, what characteristics do reform reversals take and what could possibly explain them? Section 2 spells out the conceptual framework we use, which builds on the ‘evolutionary institutionalist perspective’ that Roland (2001) offers. Section 3 looks into the role of external anchors, the Washington and the European institutions, in promoting reforms before EU accession, and describes the areas in which EU laws and institutions can protect previously implemented reforms in these countries. Section 4 discusses the reform reversal episodes considered in this paper. Section 5 concludes with drawing the lessons from these episodes.

2. Conceptual framework for reforms and their reversal

In what follows, we develop the 'evolutionary institutionalist perspective' that Roland (2001) offers in his seminal paper on the first ten years of transition. We start from the viewpoint that the reform reversal episodes we discuss below simply cannot be understood without carefully considering how developments in national institutions helped or hindered reform, and also how this process was shaped by the interaction of national with European institutions. In fact, the very essence of EU membership is the common EU law (the acquis)[4] and the institutions that are there to guard different parts of this law. Moreover, the EU also has rules and institutions to coordinate policies, particularly fiscal policy and structural reforms.[5]

Roland (2001, p. 30) argues that "If anything, the experience of transition shows that policies of liberalization, stabilization, and privatization that are not grounded in adequate institutions may not deliver successful outcomes." He also points to the importance of self-enforcing social norms, which drive society's acceptances and aversions and can help ensure that institutions gradually evolve toward more perfect institutions, in a sort of experimental way. Hence some flexibility in the national design of these institutions is important. Iancu and Ungureanu (2013) emphasizes the role of 'social learning' and show how the lack of social learning leads to reform reversals in civil service reforms – an area where there is an absence of legal and institutional anchoring by the EU. The interaction between institutions on the one hand and social learning and norms that shape their legal forms (through laws) and behavior, on the other, plays an important role in the reform reversal stories we shall discuss later in the paper.

Social norms are thought to evolve slowly, sometimes over centuries, through social learning (Young, 2015, Rotter, 1954). A key element of this process is reinforcement - some positive or negative reaction to an action by an individual or a group of people (Chart 2). The likelihood that the reinforcement happens and the value of the reinforcement action, be it positive (carrot) or negative (stick), to the individual or the group concerned determines the likelihood that a certain behavior will be performed. The same applies to politicians and political parties (movements), for whom elections (and polls between elections) deliver a very clear reinforcement. Through this process, a social norm emerges and effectively guides societal behavior. Norms therefore emerge bottom up, through learning in a society.

Chart 2: Social learning theory

Source: http://www.changingstates.co.uk/tutorials/02-PG-Cert-Dip/Locus%20of%20control/Julian_Rotter.pdf

[4] https://ec.europa.eu/neighbourhood-enlargement/policy/glossary/terms/acquis_en
[5] See Section 3.2.

The countries considered here moved away from centrally-planned, fundamentally autarchic economies with rather isolated societies. The social norms of this society had interacted with external social norms of a particular type – from the USSR and other similar countries.[6] They thus underwent a very different type of social learning to the other societies of a modern social market economy, developing social norms that in many aspects were fundamentally different from the ones that had previously acted as the dominant external anchors.

While norms emerge bottom up, laws and public institutions are top-down in nature as they are created by elected national (and European) law makers (parliaments), typically but not always broadly reflecting the evolution of a society's social norms. For the countries in the region, the process leading to EU accession entailed major improvements in institutions, perhaps most importantly in those areas falling under EU law, but also in other areas; in fact following a pattern closer to the Washington Consensus idea of introducing best-practice institutions (Roland, 2001). This top down process installed new laws and institutions reflecting social norms which were in many cases distinctly different from the ones prevailing in FTEs. Moreover, as a reaction to the crisis, the EU embarked on a rapid change, and improvement, of its own legal and institutional set up in central areas, such as policy coordination, banking and finance and fiscal systems. As several recent events suggest, social learning has not yet caught up with this process, even in many of the core euro area countries which are culturally, historically and geographically much closer to the center where these decisions were taken. From this perspective, it should perhaps not be surprising that FTEs have faced some major challenges in following the rapid evolution of the European institutional framework with their internal social learning processes.

The picture gets even more complex if we introduce the concept of parallel social norms and parallel social learning processes in these societies, which in our view are important to understanding what has been happening in Poland and Hungary (and perhaps also in Romania) lately. The notions of "*Polska B*" (Poland B, https://en.wikipedia.org/wiki/Poland_A_and_B) or "*vidéki Magyarország*" (Hungarian countryside) are essential in this regard, as in all likelihood they reflect distinctly different social norms, social learning processes and reinforcements than those prevailing in other parts of these countries. As the social learning theory (SLT) emphasizes (Rotter, 1954), the psychological situation is much more important than the objective situation. Moreover, if the levels and types of education are characteristically different in parallel communities, their assessment of the objective situation may also be very different. If in addition, as it happened during the crisis, the uncertainty regarding the objective situation is also

[6] A beautiful memory of this period has been given recently by President Tusk in his acceptance speech at the University of Pecs where he received an honorary doctorate. He said: "To put it simply, Hungary was, for my generation, a reflection of the West, dreamed of and unreachable for decades." http://www.consilium.europa.eu/en/press/press-releases/2017/12/08/acceptance-speech-by-president-donald-tusk-upon-receiving-honorary-doctorate-from-the-university-of-pecs/#

heightened (that is, the second momentum changes), the psychological element becomes even more dominant in both communities.

Furthermore, in these parallel communities, the relative importance of psychological needs, most importantly those of independence and protection dependency, can be significantly different, so that the value of certain types of reinforcement actions varies across parts of society. Most importantly, the reinforcement value (positive and negative) of the changes that a stronger and more centralized state brings about can be very different in these parallel communities. Therefore, in all likelihood, it is not just by chance that a common central element of the Polish and Hungarian new approaches is a much stronger and much more centralized state.

As research on artificial intelligence shows, if the intensity of interaction between two communities declines below a critical level, parallel norms can emerge and become stable (Sen and Airiau, 2007). In all likelihood, if such parallel norms exist in these countries, they emerged a long time ago. Why then did they not create the same outcome much earlier? Perhaps a few important recent developments might explain why these parallel social norms might have started to diverge only lately. FDI in these countries (and elsewhere in the region) tends to be heavily concentrated in certain areas and even where present, has little interaction with local firms (Bisztray, 2016). Tourism is also heavily concentrated in a few areas, and so are foreign students (Erasmus). Generally, market forces have tended to produce strong agglomeration effects and particular migration routes (flows) within and across countries. EU accession accelerated both elements, bringing global forces much closer to these countries than they were before. EU accession also made significant resources available for these countries to help promote regional development, and convergence more broadly, significantly boosting infrastructure investment and rural incomes. However, it seems this major financial support helped less with exposing the more isolated communities, where market forces were less at work, to external social norms and social learning processes.

Part of the puzzle of reform reversals may also be explained by social learning reversing its direction and, as a result, social norms changing (deteriorating). When we talk about reforms, we tend to believe that reforms are, by nature, a good thing, at least for an economy or society as a whole. Moreover, we also assume that policy makers know what reforms are needed and how to introduce them. We economists, tend to assume that reforms by nature increase growth potential because there is a large body of literature that provides theoretical arguments and empirical evidence in this regard, and thus long-term benefits, over time, outweigh any possible short-term cost (e.g., Varga and in ’t Veld, 2014). We assume that reforms are sufficiently well designed and well implemented, so that, implementation does not change the original balance of costs and benefits. Good design involves careful sequencing and flanking measures to mitigate short-term costs and/or the impact of reform on particular social groups (losers). Good implementation also involves a continuous monitoring of the actual impact of implemented reforms so that unwanted and/or unforeseen negative impacts and genuine design problems can be identified and mitigated in a timely fashion. We correspondingly tend to assume that a government has full capacity to pay for any necessary mitigating measures, and can thus maintain a stable and supportive macroeconomic environment, in which households and firms can relatively easily judge the true impact of reforms and the true intentions of policy makers. Therefore markets are also assumed to be able to see through and judge the long-term (positive) impact of reforms.[7]

In short, we tend to assume that policies are sufficiently close to optimal and are fully credible. So, once reforms are introduced, self-enforcing social norms and social learning should catch up with the new reality fast enough to create a domestic anchor for reforms that have also have been introduced with external support or pressure, coming either from international organizations or financial markets.

But the reality in FTEs has been very different on almost all fronts. Apparently, in many cases, social learning has been slow and thus most institutions remained fragile, in many cases vulnerable to special interest group's attempts to (partly) capture them. For the same reason, laws and institutions created to promote good policies could fulfil this role only to varying degrees. Moreover, as we shall see in the episodes discussed, the design of many of the reforms or institutions have been less than perfect (e.g. pension reforms) or reforms may have caused unforeseen negative side effects that were not carefully monitored and addressed at the implementation stage (e.g., the reform of the utility and energy sectors in Hungary).

The crisis that started in 2009 was a huge shock which in the early phase of the crisis dramatically reduced the growth potential and increased economic uncertainty, also of many FTEs (Chart 3). Moreover, as we shall see in many episodes, it both brought to the surface existing problems with previous reforms and triggered behavioral reversals against and in many institutions, including private ones (e.g. Bulgarian private banks and companies). During the crisis, external anchors, particularly the EU, had to focus on much bigger and broader problems in Europe, whilst also realizing design omissions in the European structure as well.[8] In this highly uncertain environment, it may well have been the case that the benefits of former reforms (reinforcement value) were lost or masked. The motivation for opportunistic (formal or behavioral) reform reversals by governments or political coalitions become also stronger in such an environment, the increased uncertainty about the advantages of previous reforms could be politically exploited and a reversal could be more easily portrayed as a necessary and helpful correction of formal reforms, or even as a desirable new direction.

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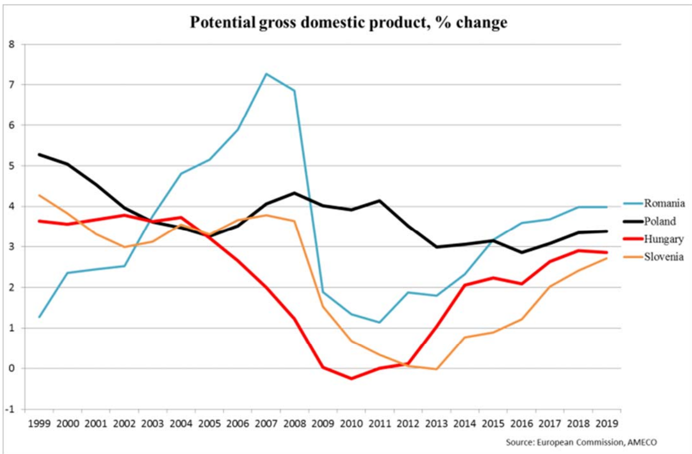
[7] If this is the case, as Buti et al. (2008) argue, one could even use financial markets to bring forward the long-term benefits of reforms, and thus strengthen the support for (and the re-election of) reformist governments.

[8] A small but perhaps telling sign in this regard is that the comprehensive assessment of the experiences of the first five years of EU enlargement (Keereman and Szekely, 2010) has not been followed up since then.

Chart 3: Estimates of the rate of potential growth in some of the FTEs



Source: European Commission, AMECO

In the next part, we build extensively on the evolutionary institutionalist framework in describing some of the reform reversal episodes, looking into the role and behavior of institutions and the interaction among them; into the spill-overs from one area to another, from behavioral changes to formal (legal) changes, and vice versa, that is, into the dynamics of reform reversal episodes.

3. THE ROLE OF EXTERNAL ANCHORS

3.1 THE ROLE OF THE IMF AND THE WORLD BANK

Until EU accession negotiations started, the IMF and the World Bank served as the main external anchors for economic policy and structural reforms (Roaf et al, 2014, Annex B). The longest involvement was in Romania, which had IMF arrangements almost continuously from the start of transition until EU accession in 2007. Slovenia, on the hand, is the only country which has had no IMF arrangement of any sort since it gained independence in 1991.

Following EU accession, the IMF got involved in the region again in 2008 when the financial crisis started, first in Hungary, followed by Latvia and Romania. Its assistance here took the form of disbursing programs with conditionality attached, arranged jointly with the EU and the World Bank (Annex B). In addition, Poland got an arrangement in May 2009 under the Flexible Credit Line facility which it continuously renewed. Hungary requested a second EU-IMF precautionary assistance program in November 2011. The ECOFIN Council agreed in principle to the request but program negotiations were not concluded. In Romania, the first disbursing program was followed by two precautionary (non-disbursing) programs, which lasted until 2015.

At the time of the renewal requests by Hungary and Romania in 2011, financial market conditions and the macroeconomic situations in these countries were justifying the need for a financial assistance program. The program for Romania usefully served this purpose as well

(European Commission, 2013b), while the main rationale for the second precautionary program (2013-2015) was to assist the country with structural reforms (European Commission, 2016). This latter program (2013-2015) got off track soon after it began as the forces that slowed down, or in some areas started to reverse reforms, gradually overwhelmed the original reform intentions that had underpinned the request for the program in the first place. Significantly improved macroeconomic fundamentals and an overall strong macroeconomic performance allowed the government to easily secure its financing needs, thus lowering the potential signaling value of the EU-IMF program. This, combined with the gradual strengthening of forces against reforms, pushed the program off track. The experiences of Romania and Hungary with EU-IMF financial assistance programs suggest that such programs can play a limited role in promoting reforms and/or preventing reform reversals outside crisis periods.

The IMF has also played a long established surveillance function via the Article IV process. As the experiences of the countries discussed in this paper show (Tables 1-4), the IMF has consistently identified the episodes of slow-down or reversal of reforms. However, its anchoring role has been weak at best.

3.2 The role of EU membership

While the first wave of reforms in early transition was driven by the desire to get away from a centrally planned economy towards a western-type market economy, the second wave was driven by the desire for EU membership. Membership offered an institutionalized anchor to the West. It secured access to the largest market in the world, the single market, the free movement of capital and labor (following a specified waiting period), and a massive, historically unprecedented, financial support to promote convergence. It thus further increased and made tangible the perceived cost of a policy reversal, which carried with it the risk of being left out of the EU enlargement process. The public viewed such a possible outcome as very negative. In reality, causality was most likely running in both directions. On the one hand, the desire to join the EU spurred reforms, at some point, directly monitored by the EU in the framework of membership negotiations. On the other hand, more progress with reforms made the countries more credible candidates for EU membership, making the prospect of EU membership more plausible, itself a reform mobilizing force.

Once these countries entered the EU, most of the advantages became granted, while many of the reforms were not protected by EU legislation and apparently, self-enforcing social norms and social learning were not emerging fast enough to protect some of the previously undertaken reforms in those areas. In fact, as we will see in the next section, reforms started to be reversed soon after EU accession and not only in combination of the negative impact of the crisis. Annex A provides some empirical evidence on the role of the EU as an external anchor based on the Transition Index of the EBRD, also supporting this finding.

EU membership, however, also comes with a number of obligations and mechanisms that monitor and enforce the fulfillment of those obligations. Traditionally, the macroeconomic surveillance of a member state concerned fiscal policy under the Stability and Growth Pact (European Commission, 2017b), supported by a systematic monitoring of the long-run sustainability of public finances (European Commission, 2015b and 2017b). Lessons from the recent crisis led to the fiscal component being enhanced by the addition of surveillance of imbalances in the private sector, particularly the financial sector, called the Macroeconomic Imbalances Procedure (MIP), in 2012.[9] Later on, the whole surveillance and policy coordination work was integrated into what is called the European Semester, with an increased emphasis on structural reforms. In this framework, every year, the European Commission issues Country Reports for all member states which have no EU-IMF financial assistance program. Based on the analyses and assessments in these reports, the European Council, upon the proposal of the European Commission, issues Country Specific Recommendations (CSRs) to the member states. These CSRs contain the reform measures that the European Union recommends to its member states each year. The country reports also assess the implementation of the previously issued CSRs.[10] In discussing the reform reversal episodes below, we shall point to the role the EU surveillance played, and in Section 5, we shall draw some lessons on this aspect.

The European Commission is also the guardian of the EU treaty, that is, it has the obligation and the legal power to enforce it. To this end, it (DG-COMP) monitors the compliance of the member states with state-aid rules, and takes action in case of unlawful state-aid. Sanctioned (notified) state aid also involves well specified and enforceable measures to make the beneficiaries (companies) of such aid viable again, to ensure that the company does not have to rely on state aid in the future (one time-last time principle). [11] As we shall see in the examples below, most reversal episodes in the banking sector also entailed state-aid procedures, which played a role in locking in commitments to reverse the reversals (e.g., to privatize a bank that was bailed out with public funds). Other parts of the European Commission are guardians of regulations regarding fiscal systems (DG ECFIN)[12], central bank independence (DG ECFIN in cooperation with the ECB), tax regulations (DG TAXUD), free movement of capital (DG FISMA), and the banking union (DG FISMA). Many of these areas will feature in the discussion of reform reversal episodes below. In case a country does not comply with a given part of the treaty, and does not address problems when they are detected by the European Commission, it can be subject to an infringement procedure, which eventually may lead to the country being taken to the European

[9] For more information on the Macroeconomic Imbalances Procedure, see https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/macroeconomic-imbalance-procedure_en

[10] For more information on the European Semester, see https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester_en

[11] For more information on state aid rules and their administration, see http://ec.europa.eu/competition/state_aid/overview/state_aid_procedures_en.html

[12] For a description of the work of DG ECFIN in this area, see Annex C.

Court of Justice to enforce the Treaty. Like other national legal enforcement measures, such procedure, however, typically requires a significant amount of time to reach this final stage.

4. Episodes of reform reversals and their characteristics

In this section we define a reversal *either* as a formal reversal of a previously taken reform measure, *or* as a deterioration in the quality of an institution (behavioral reversal) which was central to one of the dimensions of the reform space. This definition reflects the fundamental point made in Roland (2010) that the transition to a modern market economy requires the necessary quality institutions that can make the economy work in the way we expect it to work. The first type is relatively easy to identify, as one can refer to a formal/legal action. This is what is mostly done in Tables 1-4. Changes in behavior are much more difficult to identify, usually being observed through a negative outcome captured in country surveillance (by the IMF, OECD or the European Commission), or through an episode of market turbulence or crisis (like, for example, in the episodes of critical weakening of banking supervisions in certain periods in Bulgaria and Slovenia). For reversals which were identified when problems reached a critical level, it is virtually impossible to pinpoint the time when the institutional behavior changed. Furthermore, reversals in the behavior of institutions, public or private may also remain latent for a relatively long time. Consequently, there may have been other similar episodes of behavioral reversals that have not (yet) been identified.

In the part that follows, we discuss episodes along several dimensions:

- *Internal factors*:
  - Whether a reversal was *formal* (changing laws and regulations) or *behavioral*.
  - The *spillovers* between formal and behavioral changes and among reform areas.
  - The strength of national institutions (*social learning* and *social norms*).
  - The nature and strength of the government (governing coalition) and the presence and nature of any (strong) interest groups.
- *External factors*:
  - The nature and extent of external involvement in the design and implementation of the original reform.
  - The role of external anchors, the presence or not of EU law and regulation, and the capacity of the regulator to enforce.
  - The *interaction* among internal and external factors.
- *Other circumstances*: such as the economic conditions; the circumstances surrounding the original reform prior to reversal; the quality of the design, any monitoring/follow after introduction; the time since the introduction of the original reform.

4.1 Fiscal policy and fiscal system

Romania was among the first countries where the crisis led to a rapid deterioration of its fiscal situation and in its external financing conditions, forcing the country to ask for a joint EU-IMF financial assistance program in 2009, which was also supported by World Bank funding (Annex B). This and the subsequent (joint EU-IMF) precautionary program helped the country to fully stabilize its fiscal position and more broadly rebalance its economy (European Commission, 2013b). In fact, by the end of the second program, Romania exited the Excessive Deficit Procedure (EDP) of the SGP through bringing its deficit below the 3% of GDP threshold. In addition, it brought its structural deficit below its Medium Term Objective (MTO), which was in fact a performance better than was needed to ensure the long-term sustainability of its public finances[13]. During the third, stalled EU-IMF program (2013-2015, see Annex B), albeit the political intention to relax fiscal discipline and disregard national and European fiscal rules started to emerge (which was one of the reasons why the program went off-track), Romania kept its structural fiscal position above the MTO,[14] while the economy grew above potential, in fact increasingly so, as growth accelerated. From 2016 onwards, however, fiscal policy embarked on a course of highly pro-cyclical loosening, moving from a close-to-balance structural position in 2015 to a structural deficit of over 3% of GDP by 2017 - all this in a high growth and fast job creation environment. The only apparent limit to loosening was the 3% of GDP threshold specified within the EDP. Thus in fact the structural loosening that continued was the result of the headline deficit being kept at 3% of GDP, while the output gap closed rapidly in 2016 and became positive in 2017 and the public debt ratio is now forecast to start increasing again (European Commission, 2017c).

To show the full extent of the behavioral reversal behind this episode (as we shall see in the next section), in order to keep the rapidly growing deficit stable at the 3% threshold, the Ciolos government started to opportunistically downsize the second pillar of the pension system, turning a behavioral reversal into a formal (legal) reform reversal in another area. All this occurred in a booming economy, unlike many of the similar pension reform reversal episodes we discuss below, which occurred within the context of difficult economic environments and under funding constraints. Such fiscal behavioral and formal reform reversals are very uncharacteristic of a technocratic government. The fiscal behavioral reversal, however, continued after the elections (in late 2016) in which a central-left coalition formed government.

[13] The MTO, a central concept of the preventive arm of the Pact, defines the structural fiscal position a country in the preventive arm needs to achieve and maintain. Romania had signed up for the Fiscal Compact which limited the lower range for MTO at -1% of GDP (without this Romania could have had an MTO at or above -1.75% of GDP).

[14] At that time, based on the then available calculations of the output gap, the structural fiscal position was at or close to the MTO. Since then, however, these calculations have been updated and now they show that the structural fiscal position was significantly above the MTO.

The lack of social norms (and the full extent of the lack of social learning in this area) to maintain sound fiscal policies is revealed by the fact that the otherwise-best-practice domestic fiscal framework of Romania did very little to stop the fiscal behavioral reversal. The subsequent governments of very different types (political orientation, strength, etc.) simply disregarded their own domestic fiscal responsibility law (European Commission, 2017c, 2017g) and the stark warnings of their Fiscal Council (all created under an EU-IMF program). The public did not react negatively to any of this either. In fact, in the 2016 elections, it elected the central-left coalition with a program to continue the fiscal behavioral reversal.

The EU anchor did not work well in preventing the reversal either. Based on the 2016 fiscal outcome, the European Commission triggered the Significant Deviation Process in May 2017 (European Council, 2017a). This was the first time that the procedure had been triggered since its creation. However, this only lead by October 2017 to establish that the Romanian authorities had not taken effective action (that is, they did not implement the recommended structural fiscal adjustment) by the given deadline (European Commission, 2017e). In fact, forecasts showed (European Commission, 2017c) that, instead of the recommended ½% of GDP tightening that should have taken place, the Romanian authorities had further loosened their fiscal stance (by more than 1% of GDP). In other words, they had disregarded the European anchor and continued their fiscal behavioral reversal.

In fact, the spillover into formal reform reversals in other areas intensified, as the government started preparations to create a 'sovereign fund' that would include state-owned enterprises (SOEs), which in turn would be exempted from the law that governed the selection of SOE managers, an important former reform (also introduced under the EU-IMF program). Moreover, they started to reduce the contribution rate to the second pillar (whereas the previous government had only stopped the scheduled increase, see below) to keep the deficit at the 3% EDP threshold in 2018 and they indicated that they might do more, if needed, throughout the year. All this was again largely tolerated by the public. Signs of further possible spillovers into other policy areas emerged as well. For example, the Government started to publicly criticize foreign-owned banks for not paying enough taxes in Romania and opposition MPs accused the government of planning to introduce a special bank levy (Romania Insider, 2017). The Government also started to publicly criticize the National Bank for not stemming the rise in interbank rates (Reuters, 2017). The return of fiscal dominance in Romania is narrowing the room for maneuver for the central bank, and thus increases the potential for a conflict between the government and central bank.

4.2 Pension system

Bielawska et al. (2017), also presented in this session, give a more detailed account of reform reversals in the area of pensions, covering a large set of countries. This paper takes a broader perspective, thus we focus here only on a few of the key characteristics of this category of reversals which are relevant to our discussion. Specifically we focus on the role played by the EU fiscal rules, by sovereign funding motivations, by the design of the original reforms and by internal and external anchors.

The need for fiscal consolidation, either because of market pressure during the crisis, or because of the fiscal rules of the EU (under the Stability and Growth Pact) has been a major, but not the only, motivation for the temporary or long-lasting (possibly final) reversal of previously introduced pension reforms (Bielawska et al., 2017, Naczyk and Domonkos, 2016). Besides shorter-term budgetary constraints, other apparent reasons for downsizing private pension schemes in FTEs included high management fees, low real returns, ineffective and/or insufficient risk-diversification strategies and problems with regulating annuities needed for pension pay-outs.

While in most cases, these reversals have not improved the sustainability of public finances (and in some cases in all likelihood they worsened it, as Bielawska et al., 2017 argues), they helped to reduce the headline public deficit and the public debt ratio in the short to medium run. This, in turn, apparently helped to mitigate market concerns and to comply with EU fiscal rules. The mitigation of market pressures suggests that policy makers expected, and successfully persuaded, markets not to see through the immediate impact of such measures and not to realize their potentially negative implications on long-term sustainability. Moreover, the maturity of prevailing market instruments was probably so short that such negative long-term impact on fiscal sustainability did not materially impact market investment decisions. So markets typically accepted such reform reversals as genuine fiscal consolidation measures.

Financial assistance programs are put in place to ease sovereign funding constraints and thus help avoid myopic economic policies. Such headline-reducing measures had also been taken in the framework of EU-IMF financial assistance programs (e.g., by Latvia in 2009, or Romania in 2010, see Bielawska et al., 2017 Naczyk and Domonkos, 2016) suggesting that international organizations also shared the expectation that market reactions to such measures would be positive. Since the short-term reductions in the required funding stemming from the pension reform reversal measures were small, relative to the total funding available in these programs (Bielawska, 2017, Table 3, around 1% and 0.1% of GDP annually in Latvia and Romania, respectively), the reduction in the short-run sovereign borrowing requirement does not appear to have been the motivation behind accepting this type of reversal in an EU-IMF program. It seems rather that it was indeed the signaling value of a faster decline in the headline deficit that was the reason for accepting such reversal measures in financial assistance programs.

Concerning the EU fiscal rules, the FTEs concerned repeatedly asked for a modification of the Stability and Growth Pact to reduce or fully eliminate the incentives for such reversals. In several waves, these concerns were addressed by first allowing for a temporary adjustment, and later a more permanent one in the calculation of the deficit rules, but not in the debt rules (Bielawska, 2017).[15] However, in Poland, meeting the national, constitutional debt rules might also have played a role in the decision to reverse reforms.

As the choice of the pension system is the responsibility of Member States and thus it is not covered by EU legislation, the European Commission had no mandate to intervene in the design of and legislation on national pension systems. It could only point out, in its country surveillance documents, the impact of these (and other) reversals on the long–term sustainability of public finances. Another important channel through which these reversals impacted on the EU fiscal rules was via the calculation of the medium-term objective (MTO) (European Commission, 2017b). The calculation of the MTO fully incorporates the impact of a pension reform reversal on the long-term sustainability of public finances. However, a revised, more binding MTO still leaves room for a short-term gain (in terms of fiscal effort) for a country following a pension reform reversal and thus does not fully eliminate the incentive for such reversals.[16] Moreover, the European Commission regularly monitors through joint work carried out with MS, in the context of the Ageing Report (EPC/AWG), and the Pension Adequacy Report (SPC/SPC-AGE) and publishes its assessment of the sustainability of pensions systems of the EU Member States (European Commission 2015b and 2017a). But apparently, as the discussion of pension reform reversal episodes below suggests, this monitoring does not seem to have had a strong or immediate impact on how domestic political constituencies or financial markets viewed pension reform reversals.

A case can be made for easing the introduction of a funded component of the pension system via an adjustment to the requirements under the EU (or national) fiscal rules, and such adjustments have indeed been made in the SGP. However, a full and permanent adjustment would undermine the very purpose of a whole reform. For example, such a change would allow the government to fully match the accumulation of assets in the pension system with an increase in public debt, which would consequently not result in an increase in aggregate savings.[17] The criticized elements of the SGP are intended to prevent exactly this, thus revealing that long-term gains in pension and debt sustainability cannot be achieved without first adjusting a governments' fiscal

[15] Systemic pension reforms could however be taken into account as a relevant factor when assessing compliance with the debt criterion and in subsequent steps, specifically when deciding whether to launch an EDP or deciding upon the deadline for correction, i.e. in the so-called "126(3)" report the European Commission writes in the framework of an EDP.

[16] In September 2014, ESA 2010 entered into force with specific provisions for some transactions between funded pension pillars and social security schemes which are part of general government. Under the new rules, the transfer of both financial assets and pension liabilities, if these are deemed to have equal net present value, no longer has an impact on government deficit at the moment when this transfer is made. Instead, such a lump sum payment is viewed as a prepayment of social contributions which will offset pension expenditure in future. Hence, the incentive to eliminate a multi-pillar pension system to improve the deficit figure in one year has been reduced.

[17] In fact, especially at the beginning, a large part of the accumulated funds in the second pillars were invested into bonds that the governments had to issue to finance the deterioration in the budget deficit as a result of the pension reforms (and the lack of sufficient subsequent fiscal adjustment).

stance in the short run. Importantly, political decisions on pension reform reversals in these countries could not internalize this trade-off and allowed short-term considerations to fully determine the political choice. That is, as in many other areas and countries, political decisions tended to be myopic, and so were the reactions of the people concerned (the voters) and of financial markets.

The Hungarian case points to another motivation for pension reform reversals. Part of the accumulated pension funds, which were transferred back to the government, were used to purchase shares in MOL, the largest Hungarian energy company. This was part of a drive to increase state ownership in the energy sector (discussed in Section 4.4), and the move provided liquidity, without borrowing from the market, for implementing policy intentions in other areas in an overall environment in which sovereign borrowing constraints were strong.

The design of the original reforms also played a role in explaining the reversals of pension reforms. The privately managed and funded second pillar turned out to be costly and not always well managed and governed. This produced returns significantly below what was envisaged at the time of their introduction (Szekely, 2005) While these problems could have been addressed without reducing or eliminating the second pillar, that is, without reform reversals, it made these systems more vulnerable.

Also, the involvement of international organizations, most importantly the World Bank, in the introduction of pension reforms was rather strong (Bielawska, 2017) raising the question of how far national ownership of these reforms extended beyond the narrow group of policy makers that had been involved in their design and introduction. The reversed pension reform was introduced in Hungary during an IMF financial assistance program in 1997, while in Poland preparations for the reversal had started during a program and in both cases the World Bank's involvement was close (Annex B).

In Hungary, pension reforms were reversed 12 years after their introduction (Table 1) when annual contributions to, and accumulated funds in, the second pillar accounts had reached significant levels (1.4% and 11.2% of GDP, respectively, Bielawska, 2017, Datz and Dancsi, 2013). Moreover, the reversal occurred in the midst of a crisis when the headline deficit was high, well above the 3% of GDP limit of the SGP, and thus the country’s fiscal position was under pressure. The government was from the center-right, formally a coalition, but dominated by one party, with a 2/3 majority in the legislature. As the discussion in Section 4.4 shows, reform reversals by this government were numerous on several fronts (Table 1), also reflecting a new and demonstratively unorthodox economic policy approach.

In Poland, some of the modifications to the original pension reform started relatively soon after its introduction (first in 2003 and then in 2007, see Table 2), during the term of the continuously-weakening centre-left coalition (2003) and right-wing (2007) governments and reflecting pressures from well-defined interest groups (uniformed services, miners and teachers, people close to retirement age) that held strong privileges under the system prior to the original reform (in 1999). The major reversal in 2011 and 2014, albeit smaller, was similar in nature to the Hungarian reform, and it was introduced during the terms of a centre-right coalition government. It was in the midst of the crisis, in which Poland did exceptionally well, but the fiscal pressure was nonetheless building up. Moreover, public debt had approached a level where the constitutional debt rule (60% of GDP) would have imposed a binding constraint on fiscal policy.

Like in Hungary and Poland, the international involvement in promoting and designing the pension reform was strong also in Romania. Here too, the decision to introduce a reform was taken in 2004, during an IMF program (with effect in 2007). The first temporary reversal took place in 2009, when the scheduled increase in the contribution rate was postponed by one year under the EU-IMF program. This measure was comparable in nature to the one Latvia took under its EU-IMF program. With motivations similar to those described for Hungary and Poland, an attempt was made in Romania during the second precautionary EU-IMF program (2011-2013) to wind down the funded second pillar. As in Hungary and Poland, the government was a center-right coalition government and the country was in the midst of a crisis with strong pressure to consolidate its fiscal position. This attempt was successfully held back by the EU-IMF program (and hence does not appear in Table 3), made easier by the fact that both the contributions and the accumulated funds were still rather small, so the short-term fiscal gains from such a reform reversal would have been small. The reform was relatively new and the contribution rate was still rather low in line with the design of a gradual phasing-in of the ultimate contribution rate. As was previously mentioned, following the crisis, a technocratic government had come into power after the collapse of a center-left coalition and had already reduced the scheduled increase in contributions to the second-pillar funds to a minimum while pushed the budget deficit to 3 percent in 2016, in an overall very good economic environment. Recently, the center-left coalition government has reduced the contribution rate to the second pillar to prevent the scheduled increase in total contributions to the second pillar funds in 2018. Although the economy has further accelerated and is growing well above potential, an increasingly pro-cyclical fiscal stance has kept the headline deficit very close to the 3% of GDP SGP threshold in 2017 and the European Commission has forecast a 3.9% of GDP deficit in 2018, based on current polices (European Commission, 2017c). In other words, despite a booming economy, there is a strong pressure on the fiscal side to consolidate. On the other hand, public debt is still considerably below the 60% of GDP SGP threshold (37.6% of GDP in 2016) and there are no apparent funding constraints.

Turning to Slovenia, there was no major original pension reform that was similar in nature to those introduced in Hungary, Poland and Romania. Also, Slovenia has had no IMF program since it gained its independence after the break-up of Yugoslavia in 1991. In fact, it postponed the reforms of the pension system which were necessary to address immediate sustainability concerns (until 2013) and still needs further reforms to address remaining major long-term sustainability concerns.

To sum up, with the exception of the two modifications to the Polish system in 2003 and 2007 (that appear to be a typical push-back by well-defined, previously privileged interest groups relatively soon after the introduction of the original rather radical reforms), the pension reform reversals discussed above seem to have been rather opportunistic in nature. Short-term fiscal gain seems to have been the overwhelming motivation. Political orientation, or other characteristics of the government, seem to have played a minor role, although the small size of the potential gains from a reversal may have played an important role in arresting such intentions in Romania during an EU-IMF program. Important design issues in the original reform in all likelihood also made these reforms more prone to reversals, although these had been pointed out relatively early (e.g., by the IMF) and could have been addressed inside the original system without a reform reversal. Furthermore, the original systemic pension reforms were introduced with a very strong involvement of the World Bank (and during IMF programs), suggesting the existence of a rather weak domestic ownership of these reforms. The relevance of this factor is corroborated by the fact that there was surprisingly little resistance from the public to such major reform reversals, despite their affecting the accumulated funds of contributors. It is also important to mention that the original pension reforms were neither required nor protected by EU legislation, and thus the European Commission had no mandate to formally intervene the legislative process. Its broader fiscal surveillance work, while fully revealing the reversal and its nature, was apparently not a strong enough factor to stop any of the pension reform reversals.

4.3 Financial sector

The macroeconomic imbalances that Slovenia had started to develop during the crisis were identified first in the in-depth review carried out under the MIP, immediately after the introduction of this procedure in 2012 (European Commission, 2012). A major source of imbalances was the financial system where non-performing loans started to accumulate fast and banks' capital positions weakened. These imbalances became excessive in 2013, which triggered special monitoring by the European Commission as part of the MIP (European Commission, 2013c). The 2013 in-depth review zoomed in on this area (European Commission, 2013, pp. 23-29) and revealed the full extent of the problem.

The Country Specific Recommendations (CSRs) addressed to Slovenia by the European Council specifically recommended a system-wide asset quality review (AQR) and stress test (ST) for the banking system and a review of the bank regulatory framework, and based on this a strengthening of the supervisory capacity (European Council, 2013, p 80.). The subsequently conducted AQR/ST fully revealed the extent to which state-owned banks' balance sheets had deteriorated and the weaknesses of the banking supervision at the time. Three large banks were recapitalized in late 2013 and 2014 with state aid, two small banks were wound down and a smaller bank was merged with one of the large recapitalized banks. In total, a capital shortfall of EUR 4.8 bn (or 13.2% of GDP) in the banks covered was revealed by the AQR/ST of 2013, dominantly in the domestic majority state-owned banks, three of which were subsequently recapitalized with an immediate cost of EUR 3 bn (or 8.3% of GDP). As a prerequisite for the recapitalization with public funds, subordinated debt had to be bailed in first as required by the state-aid rules.[18] The state aid decisions for these banks (European Commission 2013f, 2013g) required their full or partial (but majority) privatisation within a given, relatively short time-table. In fact, NKBM, one of the banks concerned had already been privatized to a foreign investor.

The fact that a large amount of public money was needed to rescue the state-owned banks triggered a demand by the Slovenian parliament to ask the Bank of Slovenia (the Central Bank) to look into the role of different factors, including those of the banking supervision (undertaken at the time by the central bank) and the corporate governance of the state-owned banks concerned. The 2013 and 2014 in-debt reviews of the European Commission (European Commission 2013a, 2014b) also looked into these factors, and also analyzed the performance of the SOEs. The latter was of particular importance, since many of the large bad loans in these banks were to SOEs and two of the banks concerned were partially owned by SOEs. Regarding the state-owned banks, the Bank of Slovenia (2015, p. 99) study finds that "There has been in particular poorer governance and business operations, along with the assumption of greater risks by domestically owned – and especially state-owned – banks, for which a strengthening of the capital base had not been ensured in good times, as is evident from the pre-tax profit trends and capital returns, as well as from the asset side throughout the period before and during the crisis." More importantly, their analysis and the in-depth reviews of the European Commission rather convincingly showed how the different factors interacted and how the reversals in the behavior (quality) of different institutions interacted to strengthen each other's negative impact, which had eventually brought about a full-scale banking crisis. The strong capital inflow prior to the crisis, which the euro area membership somewhat further accelerated, offered ample funding, but it was the weak corporate governance of state-owned banks and that of SOEs that turned this into a massive capital misallocation. Institutional weakness in the banking supervision, in interaction with the apparent reluctance on the part of the state to address the rapidly accumulating loan quality problem in the state-owned banks, further distorted the behavior of the state-owned banks, and amplified the problem. In fact, as the 2014 in-depth review shows (European Commission, 2014 pp. 39), the state in general tried to postpone the rapidly accumulating problems in the SOEs, also by rapidly increasing state-aid. Some of these actions were later on looked into by the European commission under state-aid rules.

[18] In fact, this was the first state-aid case for a bank recapitalization that was subject to the Banking Communication of the European Commission (2013d), which required the bailing in of subordinated debt as a precondition for state-aid to banks.

As these episodes of reversals are all on the behavioral side, they are not listed in Table 4. Interestingly however, they triggered a backlash that led to several formal attempts to change central bank legislation, a criminal investigation on the conduct of the AQR/ST potentially against the governor and senior managers of the BoS, and in this process a potential violation of the EU legislation on CB independence (see Table 4). While again, the enforcement of EU legislation by the ECB (through legal opinions) and the European Commission (through infringement procedures) helped to stem the formal reversal of a key element of the reforms, the underlying behavioral reversal is rather apparent and again suggests weaknesses in the social learning in this particular area of central bank independence. The cover page of a weekly magazine shown in Chart 4 demonstrates this very well.

Chart 4: The Cover page of the Slovenian weekly Mladina of April 7, 2017

Note: The person in the front of the cartoon is Bank of Slovenia President Jazbec, the one at the back is ECB President Draghi. The two characters are standing in front of the Bank of Slovenia building. The title in Slovenian says "Banksters"

To sum up the take-aways from this episode, until recently, the identified reform reversals were fundamentally behavioral in nature. This reflected the characteristically different path that Slovenia had taken during the transition in many areas and the fact that it had not implemented many of the more radical (formal, institutional) reforms that, for example, Hungary, Poland or Romania had implemented. The interaction of these behavioral reversals led to a deterioration in Slovenia's financial and macroeconomic stability that was revealed by the MIP process. By implementing the pointed CSRs from the European Council (within the framework of the European Semester) the reversals were in large part reversed. The state aid decision on the rescued state-owned banks also played a central role in reversing the behavioral reversals. However, such progress was not matched by social learning and by a sufficient weakening of vested interests. As a result, the vested interest groups fought back, via heavy criticism of the actions taken by the BoS in the AQR/ST and the subsequent recapitalization of the banks concerned. In some cases, formal reversals in other areas were also triggered, most importantly in CB independence. These reversal attempts were in turn stemmed by the ECB and Commission. Nevertheless, there are apparent signs of a significant behavioral reversal in this area, which in the future may eventually weaken the previously achieved reversals of reversals in the behavior in banking supervision. This latter development also suggests the limitations of the EU's role as an external anchor through formal (legal) instruments in the absence of sufficiently strong social norms and sufficiently fast social learning.

Bulgaria was another country in the region that experienced major problems in the financial sector, leading to excessive financial and macroeconomic imbalances and a strong external intervention via the framework of MIP (excessive imbalance). This gave a strong impetus to the reversal of reversals, albeit in a much less complete manner than in the case of Slovenia discussed above.[19] Or perhaps it is more precise to say that attempts to re-reverse the reversal of reform reversal (to partially restore the original reform reversal) kicked in earlier in the process.

In Bulgaria, domestically-owned private banks started to expand their balance sheets in 2011 as the local operations of Greek banking groups gradually withdrew from the market and the activity of other foreign-owned banks levelled off (the latter two reflecting developments also in the European banking markets). That is, these domestic banks started to expand at the deepest point of the European crisis, in a period in which cross-border capital movements were minimal and domestic lending stagnated in Bulgaria.

The rapid growth of domestic banks, particularly of the two largest, posed a challenge in itself. But as later events revealed, there was a major behavioral reversal at work, as the corporate governance of these banks deteriorated (European Commission, 2015c, pp. 14-23). The fast expanding loan book contained a large share of large (relative to the capital of the banks concerned), concentrated, related-party (either in the strictly defined or broader economic sense) loans, the quality of which quickly deteriorated. These developments culminated in the collapse of one of the large banks and a rapid and sizable deposit withdrawal in the other large bank in the summer of 2014, which eventually needed a European Commission sanctioned (DG COMP, under state-aid law), and large, liquidity support (European Commission, 2014c). In the case of the collapsed bank, eventually all non-guaranteed liabilities were bailed in, but the deposit guarantee scheme made the payments to the deposit holders with a 5 months delay, despite EU legislation allowing a maximum delay of two weeks. The latter was not fully adopted into the national law in Bulgaria and the bank supervisor delayed the necessary action to trigger the payout under the existing national law.

[19] For a detailed description of the events in the Bulgarian financial sector and more broadly in the Bulgarian economy, see European Commission (2014b, 2015c, 2016b). For an overview of the country surveillance work of the European Commission concerning Bulgaria, see https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-performance-country/bulgaria/macroeconomic-surveillance-bulgaria_en

Reflecting the rapid deterioration in financial stability and overall macroeconomic imbalances, the European Commission (2015d) concluded under the MIP that Bulgaria experienced excessive imbalances. As a result, the European Council (2015) issued CSRs with pointed recommendations to conduct a system-wide independent asset quality review and stress test of the banking sector, in close cooperation with European bodies. Based on the in-debt review (European Commission, 2015c) it also recommended improving corporate governance in financial intermediaries and to review and fortify banking supervision. Reflecting the fact that the analysis also found similar problems in the non-banking sector, the recommendations to improve corporate governance and strengthen supervision also covered the non-banking sector.

The Bulgarian authorities acted on these recommendations and carried out AQR/STs in the banking, insurance and pension fund sectors in 2016, in cooperation with European bodies; and took important steps to strengthen the supervisions. Supervisory actions were also taken to strengthen corporate governance in companies in these sectors that had been flagged in the AQR/STs (European Commission, 2016b). However, the AQR/ST in the banking sector was eventually not undertaken to the standards established in the Slovenian 2013 exercise (which was endorsed by the European Commission) and the in-depth review identified the remaining problems (European Commission, 2017). Reflecting these issues and remaining economic imbalances, the in-depth review of the European Commission (2017d) under the MIP found that, despite the actions taken and the apparent improvement in imbalances, Bulgaria continued to experience excessive macroeconomic imbalances. The Bulgarian authorities also took decisive actions to improve the financial supervisory authorities. In this area, the IMF (via the FSAP) and the EIOPA provided support to the National Bank of Bulgaria (the banking supervisor) and the FSC (non-banking supervisor) to improve supervisory capacity and institution.

To sum up, the interaction of behavioral reversals in banking supervision and corporate governance in domestically-owned banks and non-bank companies in the private sector, led to a rapid deterioration in financial stability. This in turn triggered a strong external intervention from the EU (the finding of excessive imbalances under the MIP and the subsequent CSRs and the close monitoring of their implementation). This, and earlier (summer 2014) events in the banking sector brought about action by the Bulgarian authorities to reveal the nature and full extent of the behavioral reversals, and to reverse the reversals. The latter, also in the case of Bulgaria, triggered reactions from those who took a hit from the attempt by the authorities to reverse the reform reversal, which were seen by many as successfully slowing down or even partially neutralizing the reversal efforts. The dissipating market pressure on the country was conducive to these counter efforts. One of the large banks that experienced a major deterioration in its corporate governance collapsed, so the problem it represented was eliminated by market exit, albeit at a major cost to the taxpayer.

There are strongly prevailing social norms on fiscal discipline (or more broadly disciplined macroeconomic policies) in Bulgaria, which nonetheless ensured that the cost to the tax payer was minimised in this situation, by a full bailing-in of private claims on the bank, including a significant amount of unsecured corporate and retail deposits. This process was thus much stricter than in the Slovenian case in 2013 (or what was typical in Europe),[20] and apparently so far has not created a backlash. This aspect of this episode shows again that social learning can prevail and social norms can be resilient in one area, while massive reversals can take place in another area, in turn deteriorating social norms in the latter area. Interestingly, the Bulgarian currency board system was set up in 1997 following a traumatic banking crisis, and the social norms regarding the key prerequisites of a stable currency board system, well anchored fiscal policy and safe financial system and strong and independent supervision, emerged from this episode simultaneously.

Regarding the external anchoring role of the EU, the behavioral reversal in banking supervision delayed the payout from the deposit insurance scheme despite a hard (legal) EU anchor in the form of EU legislation (though not fully implemented in Bulgaria).[21] While the indications are that the behavioral reversal started on all fronts much earlier, the country surveillance of the European Commission (MIP) identified some of the underlying problems in the banking sector first in 2014 (European Commission, 2014b) and revealed the full extent and nature of the problems and the related behavioral reversals only in its 2015 report (European Commission, 2015c), that is, after the summer 2014 major turbulence in the banking sector and after the subsequent collapse of one large bank and liquidity support to the other one. In other words, the massive behavioral reversals on several fronts remained latent in all likelihood for a rather long time. Apparently, the IMF surveillance did not fare any better.[22] The other large bank involved still needs to strengthen its capital position, most likely through an outside investment (raising equity). As we mentioned above, the Bank of Slovenia argued that a weak capital position of banks was conducive to a behavioral reversal (deterioration in corporate governance) in Slovenia. We would agree with this argument and find it relevant to this case as well. The literature also supports the above assessment by the BoS (see, e.g., Peek and Rosengren, 2005, Caballero et al., 2008).

[20] Lithuania dealt with two failed domestic banks in a similarly strict manner in 2011-13, based on its own national legislation (that is not because of European rules and regulations). The Banking Communication of the European Commission (2013d), which required the bailing in of subordinated debt as a precondition for state-aid to banks, took effect in mid-2013 after the bank resolution in Lithuania but before the bank resolutions in Slovenia. Lithuania revoked the licenses of the banks concerned, so there was no state-aid involved, but Slovenia recapitalized them using public money and thus had to comply with state-aid rules.

[21] The delay in deposit insurance payment concerned a large number of individuals and companies, large and small. Nevertheless, public reaction to this was rather mild, making the political cost of it small.

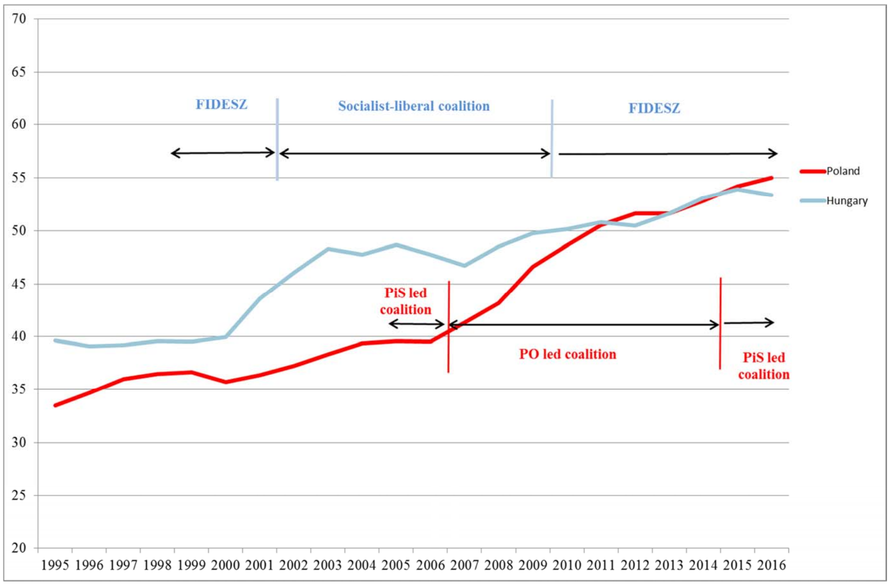
[22] In its November 14, 2013 Article IV Concluding Statement it said "The financial system remains stable, well capitalized, and liquid, but profitability remains low. Prudent supervisory policies have resulted in a high system-wide capital adequacy ratio of 16.9 percent, comfortably above the 12 percent regulatory minimum, and aggregate Tier 1 capital is 15.6 percent. Gross NPLs are 17.2 percent of total loans but are well provisioned, and NPLs net of IFRS provisions are 10.6 percent. Weak credit demand and strong deposit growth have boosted liquidity, allowing banks to further reduce external financing." IMF (2013).

4.4 Reform reversals in Hungary and Poland

We have already discussed the pension reform reversal episodes in Hungary and Poland in a horizontal manner. Here we focus on reform reversal episodes in these two countries (starting in 2010 in Hungary and in 2015 in Poland, following the respective elections) together, since the nature of these reversal episodes is rather different from those in the other FTEs (Tables 1-2). In both cases, we see a characteristically different overall approach to the whole functioning of the economy.

The Hungarian episode started in the middle of the last crisis, perhaps at its deepest point in Hungary, when the country had an EU-IMF financial assistance program. Convergence had paused for a long time prior to the crisis (Chart 5) and the social-liberal coalition that governed the country previously had disintegrated. The country was led by a technocratic government prior to the 2010 elections.[23]

Chart 5: Per capita GDP relative to frontier (in PPS, group of high income countries=100)



Note: the frontier (=100) is defined as the average of high income countries (Sweden, Denmark, Netherlands and Austria). Source: Eurostat

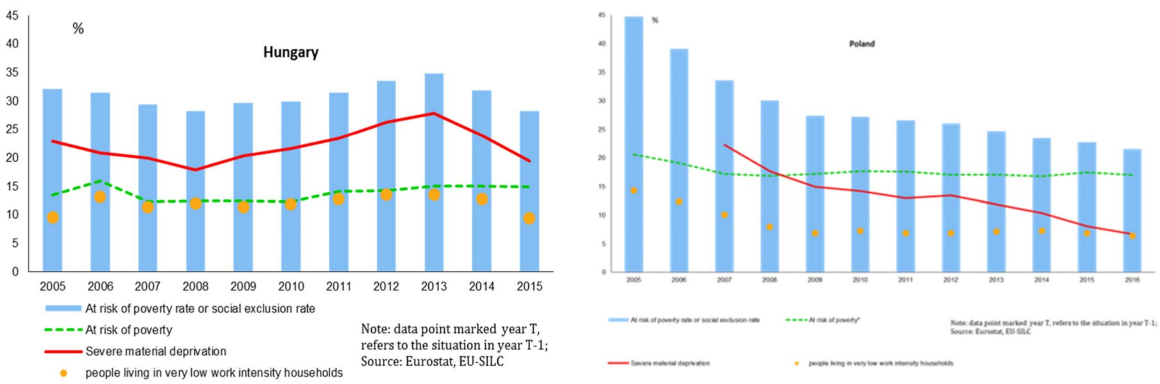
Moreover, social inequality had increased, albeit not dramatically (Chart 6). More importantly large groups in society, mostly in the middle of the income distribution, were caught in a difficult situation with escalating monthly payments on foreign exchange loans (dominantly mortgage and car loans).[24] Moreover, a partly overlapping group (albeit somewhat more skewed towards the

[23] The junior coalition partner in the socialist-liberal coalition (SZDSZ) disintegrated soon after the 2010 elections

[24] For the strong impact of these two problems on the voting patterns, see Enyedi et al., 2015). FIDESZ benefitted most from the dissatisfaction of these people, especially among those that were in the middle of the income

lower end of the income distribution), was struggling with paying their utility and energy bills. In both cases, the industries involved (energy, utilities and banking) were showcases of the Hungarian transition reform drive, and the firms in these industries were almost fully privatized, predominantly to foreign strategic investors. The reform in the energy and utility sectors also included major regulatory reforms, creating an almost textbook-type clean system, with the state focusing on the basic infrastructure and regulation, and with a rule-based pricing system for services that also took into account the capital investment needs of the private companies and the need for a reasonable return on their investments, overseen and enforced by a rather independent regulatory agency. In both cases though, unexpected negative side effects emerged. These were in the form of strong pressures on family budgets, that for many reached unbearable heights when the crisis kicked in.

Chart 6: Social inequality in Hungary and Poland



Source: Eurostat

Many of the first reform reversals took place, and were justified by the need to address these problems under a rather tight fiscal constraint, imposed by both the market (difficulties with and high cost of market funding) and by external anchors (EU-IMF program, see Annex B, and EDP under the SGP). The previous model for the utility and energy sectors had been largely dismantled, companies in this sector renationalized and retail price controls in the utilities and energy sector re-introduced. A special tax was levied on the banking sector and the cost of unwinding the foreign exchange loans was largely pushed on the banks (most of which were foreign). The unwinding of the foreign exchange loans was key to removing the existential threat to the middle class, while the price control measures in the energy and utilities sectors were central to address the mounting pressure on low-middle income families, and thus solidify the

distribution. The far right Jobbik seems to have benefitted from these problems more among those who had pressing daily financial problems who could make ends meet, but overall not significantly. The parties of the previous ruling coalition suffered significant vote losses because of these problems.

political support for the ruling coalition.[25] It was also considered essential to reestablish room for maneuver for the central bank, so that the weaker exchange rate of the domestic currency, which was an essential element of the new macroeconomic policy course, did not hit the families that had foreign exchange-denominated loan. This trade-off between the need of the economy to have a weaker exchange rate and the interest of foreign exchange loan-holders to keep the exchange rate strong in order to avoid the escalation of their payments, made the necessary external adjustment politically painful and put a strait-jacket on monetary policy previously under the socialist-liberal government and under the EU-IMF financial assistance program. As we mentioned above, funds transferred back to the government from the second pillar pension funds greatly enhanced the government's capacity to move ahead with the re-nationalization of companies in the energy sector (and possibly later in banking), in an environment where its borrowing capacity was rather limited. This was especially the case following the end of the EU-IMF program and the decision of the FIDESZ government to end the negotiations for the follow-on EU-IMF precautionary program in 2011 (Annex B).

Fundamental changes in economic policy did not stop there. Many of the next steps entailed reversals of previous reforms, sometimes central ones. Energy and utility companies were repurchased, also made easier by the regulatory changes. Two large banks (MKB, and Budapest Bank) were repurchased from their foreign owners, in both cases in market transactions initiated by their foreign owners. Regulatory changes in the food retail trade sector targeted foreign-owned chains. Tobacco trade was restricted to state licensed shops. Barriers to entry were introduced in the pharmacy market. Education and health care service provision was centralized, and more generally, many of the previously main functions of local governments (e.g., education) were removed and centralized, and the entire approach to social benefits was overhauled. Major labor market reforms which were directed at returning older workers, people with partial disability and previously long-term unemployed to the labour market, were reversed A main element of the labor market reforms was a major expansion of the public work scheme, which supported by reforms of the social benefit system, made this the principal form of income support for many people. As a result of the labor market reforms, labor force participation increased rapidly.

While in the non-tradable (or perhaps more non-traded) sectors, some of the measures targeted foreign-owned firms, in the tradable sectors, support to FDI increased, and the government signed strategic collaboration agreements with large foreign companies operating in Hungary. The exchange rate policy also strongly supported this sector. The role of the state increased on many fronts, and many of its functions got more centralized. The economic situation stabilized and the economy returned to relatively strong growth by the next elections in 2014. Growth was

[25] For an interesting analysis of how these problems were utilized by FIDESZ to gather and maintain strong public support to its new, unorthodox economic policies and more broadly to its policies, based on the punctuated-equilibrium theory (True et al., 2007), see Böcskei (2015).

also greatly helped by an acceleration of the disbursement of EU funds, the domestic value of which was boosted by the weak exchange rate. With growth kicking in, and employment picking up, poverty indicators improved and inequality started to subside, reversing the previous trends and improvements accelerating in the past three years. Real disposable family income got a first kick at the start (2009-11), mostly driven by policy measures, while it started to increase again in 2013 as the economy accelerated more broadly and became more market-based (Chart 8).

In sharp contrast, the PiS-led coalition took over in Poland in late 2015 in an overall strong economic environment, and following an overall enviable economic performance during the crisis, under =the previous PO-led central-right coalition governments.[26] As a result, convergence progressed at a rapid pace (Chart 5) during the two terms of the PO-led coalition, following a period of previously rather slow convergence. In fact, the PO-led coalition took over from a short-lived PiS-led coalition that was overall not very successful. Moreover, unlike in many other countries during the crisis, social inequality continuously declined during this period from an already modest level (Chart 6, DG ECFIN, 2017). The Polish middle class was perhaps the biggest winner of this period, gradually improving its position inside the country and enjoying an enviable income growth, also relative to its peer groups in Europe before and during the crisis (Charts 7 and 8).

Chart 7: Income share of the middle income quintiles in Hungary, Poland and the euro area

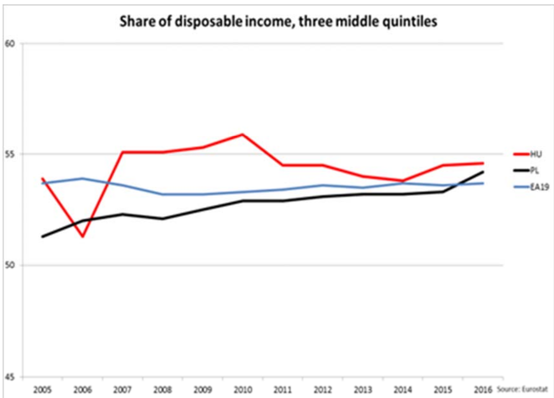
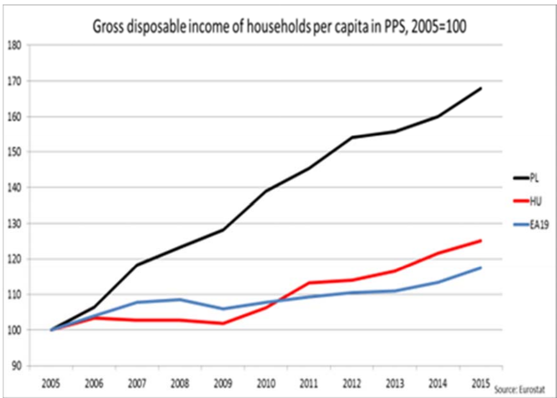


Chart 8: Household income developments in Hungary, Poland and the euro area



Source: Eurostat

Unlike in Hungary in 2010, there was no need for an immediate fiscal adjustment, although the government's plan to increase child support put some upward pressure on the budget deficit which was rather close to the 3% of GDP EDP threshold, since Poland had just exited the EDP

[26] Piatkowski (2015), went as far as calling Poland the growth champion of Europe.

process prior to the 2015 elections.[27] Moreover, there were no apparent sign of pressing issues posing (real or perceived) economic (existential) threat to any particular segment of society.

While in the political arena, a conflict with the European institutions emerged rather soon after the new PiS-coalition took power, on the economic front the attitude and communication was demonstratively more in conformity with the EU requirements. The key document setting out the economic strategy of the PiS-led coalition, and its government, was the Responsible Development Plan (Ministry of Development, Poland, 2017). The diagnosis underlying this plan and the main direction for economic policy actions (Chart 9) were very close to the ones the European Commission offered in its European Semester Country Reports for Poland in recent years (European Commission 2016d, 2017f). In many areas, the plan also built on the recent European initiatives to address similar issues across Europe.

A main element of the plan is the intention to rebalance the roles of foreign and Polish (domestic) firms in the Polish economy, by increasing the share of the latter. The state is envisaged to play a major role in this process, including in channeling capital into commercial (export and innovation oriented) projects as well as into infrastructure. The role of SOEs is also to increase and their corporate governance and control by the state are also to be changed. As Table 2 shows, previous privatization plans (by the PO-led coalition) have already been put on hold, and with the repurchase of PKO SA and transfer to the state-owned insurance (financial) group (PZU), reversal in a central area has started, albeit initiated by the foreign parent bank group (Unicredit) and carried out on market terms. So, like in Hungary, a stronger role for the state, and within this, a centralization of functions and a consolidation of institutions, is a key characteristic of the developments in Poland.

The formal (legal, institutional) changes in this plan, some of which are clearly reversals relative to the transition reforms and to the reforms taken in the run-up to EU accession (or even to directions followed by the previous coalition), in themselves are not necessarily creating major deviations from a well-functioning and well-governed social market economy. In fact, their declared goal is to achieve just that, as interpreted by the PiS-led coalition. Moreover, most certainly, they do not create unresolvable conflict with EU law. They may well test the limits of the existing capacities of the Polish state, so capacity building is essential (as realized by the strategy itself), but the biggest source of potential risk, as we have seen in many of the episodes described above, is behavioral reversals inside institutions, and the oft-problematic interactions and spill-overs of these reversals. As we have seen in the reversal episodes in Slovenia and Bulgaria, the financial (banking) sector is a particularly vulnerable part of the economy in this

[27] Actually, in closing the EDP, Poland still benefitted from the allowance introduced for pension reforms, so it could exit EDP with a deficit somewhat over 3% of GDP. So the SGP rules were apparently not the ones that put pressure on the previous PO-led government to reverse pension reforms, it seems it was the national debt rule. See the discussion in Section 4.2.

regard, and one which can propagate the behavioral reversals in a quick and for long undetected manner. SOEs are another similarly vulnerable part of the system. So the plan, and the underlying approach, clearly faces this major challenge (behavioral reversal in banking and SOEs).

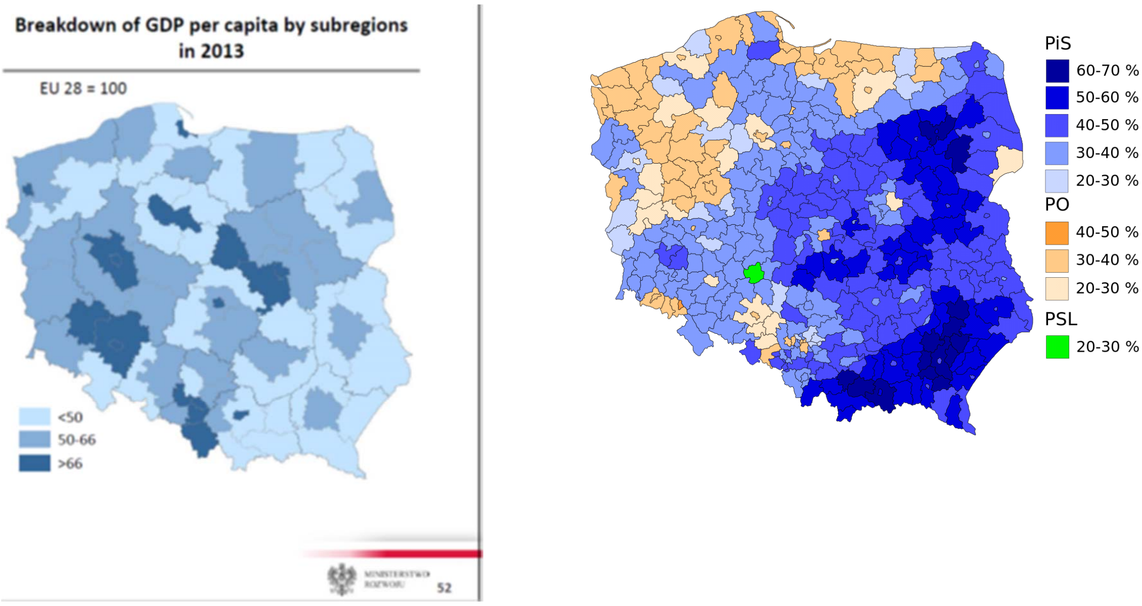
Chart 9: The key elements of Poland's Responsible Development Plan

Source: Ministerstwo Rozwoju, Poland, http://www.mr.gov.pl/media/14873/Responsible_Development_Plan.pdf

Another important element of the plan is the close attention to the underdeveloped parts of Poland (Polska B), which is also a traditionally strong voter base of the incumbent coalition (Chart 10). The simultaneous emphases on a stronger role of the state, on a more top-down approach, and on the development of these parts of Poland is not a coincidence, but a key characteristic of the overall approach.

To sum up, while the Hungarian and Polish reform reversal episodes show some similarities, they seem to be fundamentally different in nature. The Hungarian reform reversal episode seems a classical case in political economy and also fits well into our overall framework. It starts with an election crush of a disintegrating coalition, which had significantly and for a long time, underperformed on the economic front - for the poor and for the middle class, and in absolute and relative terms (relative to other countries in the region). It left unaddressed major existential problems faced by the middle class (forex loans) and lower-middle class and poor families (utility and energy cost). This was a period in which the reinforcement value of previous reforms was anything but tangible for wide groups in society, and in a society where protection-dependency was traditionally strong. The long period of uncertainty made the benefits of previous reforms look smaller, even for those who did perceive such benefits, as the discount factor was likely to be high.

Chart 10 Regional income differences (2013) and voting patterns (2015) in Poland



Source: Ministry of Development Poland (2017) and Wikipedia

The Polish reform reversal episode does not fit any of these predictions. It followed a period of enviable economic and social performance, in which not only social inequality had been continuously reduced but in which the Polish middle class enjoyed an unparalleled absolute and relative (to other countries) income gain and Polish private business thrived. Unlike in Hungary, there were no apparent signs of any existential threat to any group in society. All this seems to be in sharp contrast with the prediction of the evolutionary-institutional school, which expected the middle class and the emerging new private sector to support and protect reforms (Roland, 2001, Table 1). In many aspects, the economic (development) strategy of the PiS-led coalition demonstratively builds and relies on the EU approach, and in many places uses the same language. Nevertheless, similarly to the Hungarian approach, it entails a much stronger role for the state, a much more centralized and consolidated state, and aims to increase the role of Polish capital (firms) in the economy. But unlike the Hungarian approach, the focus of the latter is the tradable sector with a strong emphasis on the move towards an innovation-based economy. Similarly to Hungary, the underdeveloped parts of the country (Polska B) are given particular attention.

5. SOME LESSONS

The rapid journey from central planning to EU (euro area) membership stress-tested the social learning processes of FTEs. The desire to be anchored to the West, and to enter the EU spurred major reform waves and led to the introduction of best practice institutions very rapidly. This process most likely accelerated social learning, but apparently in many FTEs this learning was not fast enough to keep pace with the rapid reforms, leaving best-practice institutions with social norms that were not sufficiently strong to maintain them. So not surprisingly, wide-spread reversals emerged in the region, especially when the crisis hit these countries. In other words, reversals seem an inherent characteristic of the FTEs' journey towards a modern social market economy.

Reform reversals happened in several countries and in a variety of sectors. Like with factors and motivations that promote reforms, the reversal episodes described above suggest that there are several, sometimes rather different, forces at work that can create reversals. We have identified some factors which are common in certain areas of reform, such as reversals of the pension system, across several countries, political families, types of governments. Some factors appear to be present when certain types of governments are in place, and work across many areas, as appears to be the case in Hungary and Poland at present.

Reform reversals can be formal reversals, which change legislation (or formal rules), or behavioral reversals, which erode the quality of an institution by materially changing the way it works, or a combination of the two. Spillovers, from formal to behavioral reversals (and vice versa), from reversals in one area to another one, and from one institution to another can play an important role in reform reversals by strongly impacting their nature and dynamics. In fact, in many cases, it is this interaction of reversals in different sectors that has created a full-blown reform reversal episode.

While the crisis made countries undoubtedly more prone to reversals, reform reversals, even fundamental ones, can also happen when a country weathers the crisis remarkably well and when inequalities have declined. Although the Polish middle class enjoyed an unparalleled absolute and relative (to other countries) income gain and Polish private business thrived during the crisis, contrary to previous expectations (Roland, 2001), this did apparently little to protect previously introduced reforms.

Partial and opportunistic reversals, particularly in areas where the implications of these reversals are not immediate and not easily visible (such as pension reforms), can happen. This type of reversals in fact has tended to happen more frequently when governments are weak. In contrast, major and multifaceted reversals seem to require strong and stable governments.

While reversal attempts seem to be successful when institutions and social norms are not sufficiently strong, and social norms tend to impact different sectors similarly, there are sometime interesting asymmetries. As we have seen in the reversal episode in Bulgaria, social norms that had emerged following the creation of the hard currency board in the 1990s, and which supported strongly-anchored fiscal policy and strong and independent banking supervision, changed asymmetrically. While fiscal discipline remained apparently rather strong, the quality of banking supervision was allowed to deteriorate significantly. Moreover, the well-anchored fiscal policy regime remained sufficiently strong to allow and encourage a reduction in the cost of bank failure to the taxpayer by promoting a full bail-in of creditors in a failed bank. In comparison, strict bail-in did not happen in Slovenia, in fact even the bail-in of a relatively small amount of subordinated debt, which was necessary because of the European rules and regulations (external anchor), triggered a behavioral reversal in another area (central bank independence). Interestingly, Romania showed a pattern of asymmetric reversals which was the opposite of what was observed in Bulgaria, banking supervision remained strong and independent but fiscal discipline eroded.

The banking (and more broadly the financial) sector seems particularly prone to behavioral reversals, both in public and private institutions. Like in the other cases, it is the confluence and the interplay of behavioral reversals in different areas and institutions (banking supervision, private and state-owned banks, non-bank corporations) that has led to a fully-blown reversal episode. But the overall rather low level of transparency and public scrutiny in this sector also seems to be conducive to reversals. For example, the very restricted access to decision making in banking supervision, or central banking, may have provided a convenient veil in some countries for forces that have tried to bring about behavioral reversals in financial institutions. The functioning of state control over state-owned banks and non-bank companies is another area which is frequently not subject to strong public scrutiny and where the level of transparency tends to be low. Finally, the public scrutiny of private banks and companies is perhaps even weaker and the degree of transparency even lower. As the reform reversals are dominantly behavioral in nature in this area, and thus by nature more difficult to detect, reversals may tend to remain latent for a long time and are typically revealed only when they lead to a crisis or a major event (such as the collapse of a large bank).

Well-designed fiscal systems, national or European, are thought to be the best anchor for fiscal policy, an efficient way to limit myopic political intentions to opportunistically loosen fiscal policy. This is the most traditional area of EU policy coordination and rules (SGP), and reforms at the European level following the crisis also focused on further strengthening national fiscal systems and rules (Annex C). However, as the Romanian example shows, if social norms are not sufficiently strong, such national fiscal systems (rules), even if they are close to best practice, will have little impact. The preventive arm of the SGP (the SDP) in this case, which was the EU anchor in this episode, does not seem to have been strong enough either.

When fiscal rules and systems are sufficiently strong (such as the 3% of GDP EDP deficit limit or the Polish national debt rule), but social norms are not, the intention to create more fiscal space may generate spillovers that lead to reform reversals in other areas. This has occurred most frequently in the area of pension systems, but also in tax policy (e.g., levying special distortionary taxes on banks, telecom and retail companies) and in corporate governance and state control of SOEs.

While the opportunistic fiscal behavior of governments is a phenomenon well described by the traditional political economy models, spillovers from the fiscal side into reform reversals in other areas seem a unique characteristic of countries with weak social norms, particularly some of the FTEs. Perversely, a perhaps premature pension reform introduced with strong external involvement might have been an easy target for opportunistic politicians in such an environment. So in a way, the major pension reform reversals in Hungary and Poland were accidents waiting to happen. As the arrested reversal attempt indicates, the same might be true for Romania if and when the accumulated funds become temptingly large. The apparent design problems and other circumstances might have only added to the temptation and made it easier for such government actions to be accepted by the public. The political orientation, or any other characteristics of the government, do not appear to have mattered much. The ultimate determining factor has clearly been the strength (or weakness) of social norms. The fact that such opportunistic temporary reversals that happened in the Baltic countries were later stopped or even reversed further supports this conclusion.

Finally, there are important objective circumstances that can make certain reforms more prone to reversals, but these circumstances rarely fully explain the reversals, certainly not in the episodes we have discussed. Poor design of the original reforms and a lack of systematic assessment of reforms after their introduction may have made certain reforms more prone to reversal—particularly if the political system allowed such problems to accumulate, and the negative consequences impacted on distinct groups in society. However, in almost all cases discussed here, such design problems could have been addressed without a reform reversal. Such accumulated problems made these areas more vulnerable to reform reversal attempts.

External Anchors

The Washington institutions played a dominant role in shaping the transition process form the very beginning until the EU accession process started, and played a key role thereafter. Following the start of the EU accession process, the EU gradually took over as the dominant external anchor.

IMF financial assistance programs—which were pervasive in the region until EU accession and played an important role again in some countries during the crisis (as joint EU-IMF arrangements)—were clearly strong forces that promoted reforms and discouraged or even arrested reform reversal intentions. But it seems they could not resist opportunistic reform reversals, such as a temporary reversal of pension reforms, especially if markets did not see through such measures. The surveillance work of the IMF, while apparently highly effective in detecting formal reform reversals, was less effective in detecting behavioral reversals, and overall could do little to prevent or re-reverse such reversals. This is of course also explained by the nature and legal underpinning of the IMF's surveillance activity (Article IV).

The strong desire to join the European Union has been a major force promoting reforms in the region, stronger than other factors, also in areas beyond what is required by EU legislation. The capacity of the EU to promote reforms or deter reversals following accession has, however, been markedly weaker. Euro area membership seems to have worked in a similar way. While the crisis seems to have made countries more prone to reversals, the political ambition to join the euro area, even as an exit route out of a program (as in Latvia), could turn the tide and not only prevent reversals but also promote a new wave of reforms. The experiences of Latvia, Estonia and Lithuania are good examples to demonstrate the reform power of the ambition to join the euro area. On the other hand, as the example of Slovenia shows, euro area membership in itself cannot arrest reform reversals, including critical areas such as banking supervision, if the area is not covered by EU Law and regulation, nor overseen by a euro area institution.

The EU acted as a strong anchor that could prevent or reverse formal reform reversals in areas covered by EU law (the Acquis). The European Commission has strong legal instruments to act against reform reversals in areas which are covered and thus protected by EU legislation, such as competition, state-aid, or central bank independence. It has therefore been a major force in stemming the tide of formal reform reversal in FTEs. In almost all episodes discussed here, this anchor was at work, in a wide range of areas. But as the repeated attempts to change central bank legislation in Slovenia show, this may still not be strong enough to make political forces fully internalize a very basic building block of the EU, namely central bank independence. And if this is the case, reversal attempts are likely to emerge in other forms, in forms that may be more difficult to stem with the existing legal instruments.

The anchoring role of the EU was however much weaker in the case of behavioral reversals, even in areas where EU law had some relevance to the case and/or EU institutions had a mandate to intervene (such as the MIP). Generally, it seems that institutions in FTEs are still rather fragile and their quality is at risk from erosion. They also tend to be prone to partial capture by interest groups. These forms of reform reversal are much more difficult to address with formal instruments. In fact, strongly protected (also by EU legislation) independent institutions in such an environment can be abused as platforms for reform reversal.

Besides its classical role as the guardian of the SGP, that is, the set of rules and procedures that were introduced to anchor the fiscal policies of its member states, the EU has given new mandates to the European Commission to promote reforms via the Macroeconomic Imbalances Procedure and the European Semester. These new mechanisms, particularly the MIP, have the power to reverse reform reversals. But, as the above examples of reversal in Slovenia and Bulgaria show, it has only been when these reversals have led to excessive macroeconomic imbalances that effective action has been taken. The preventive power of these new instruments appears to be much weaker.

COMPREHENSIVE REFORM REVERSALS

The reform reversal episodes in Hungary and Poland entail special characteristics, raising the question of whether these episodes represent more than just the usual manifestations inherent to the transition process in FTEs. In fact, it is the nature of developments in some area that are not covered by this paper, such as the independence of courts and media, which raises this question more forcefully than the reform reversals described above. While in the past, the Hungarian government perhaps used more confrontational rhetoric about the issues discussed in this paper, the Polish government's Responsible Development Plan in many aspects are very close to the mainstream in Europe. In both countries, standard legal processes could in most cases resolve the conflict with EU law. The main problem from our view point is path dependence, the risk that such reversals can put these economies on a lower growth path for a long time, and thus can partially take away the benefits of EU membership. If this happened, even if other conflicts of a more political nature were resolved, such episodes could fall into the category of dangerous aberration.

HOW TO MAKE THESE COUNTRIES MORE RESILIENT TO REFORM REVERSALS

Our analysis naturally leads to the conclusion that the ultimate solution to prevent reform reversals is to accelerate social learning processes, particularly among parallel communities. The best way to achieve this seems to be to increase the exposure of people in FTEs to communities with stronger social norms. This seems particularly important for parallel communities, also inside their own countries.

It is also important to focus on the quality and internal coherence of reforms and newly created institutions, and to carefully monitor their functioning to detect behavioral reversals as early as possible. External anchors, particularly EU institutions can help a lot in this regard by deepening their surveillance work and also focusing on behavioral reversals and the typical spillovers patterns found in this paper. The risk that a successful formal (legal) step to stem a reform reversal can trigger a behavioral reversal in the same or another area deserves particular attention.

The ambition to join the euro area could boost reform efforts in FTEs that are not yet a member of the euro area. Creation of the Banking Union has significantly deepened integration in the euro area in the area of banking supervision via the creation of the SSM. There is now also a formal way for non-euro area members to establish a close cooperation with the SSM, [28] which may offer a route for aspiring euro area Member States, such as Bulgaria, to anchor the necessary improvements in banking supervision early on in the process towards membership. Close cooperation with the SSM may also help to avoid the kind of banking reform reversal episodes that are discussed in the paper in other countries where there are new developments (such as a major increase in the market share of domestically-owned, private or public, banks) which suggest increased vulnerabilities in this regard. Given the central role of the banking/financial sector in propagating (behavioral) reversal in the system, it seems important to look for ways to strengthen the external anchors in this area.

The recent initiative of the European Commission to set up a Structural Reform Support Service (SRSS)[29] and the new plans to significantly increase its size can help to strengthen the anchoring role of the EU. The SRSS can help to promote quality reforms and coherence amongst reforms. If, for example, the success of a reform in a certain area depends on the quality of (private or public) institutions in other areas, this service, in cooperation with other parts of the European Commission, could identify this link and offer its help in those areas as well, perhaps in one package. In this activity, more cooperation with the IMF and the World Bank could also be helpful. This service could perhaps also look into how the social learning process could be accelerated to create stronger domestic anchors for reforms. More generally, European institutions should develop a better understanding of the social learning processes in these countries and finds ways to help strengthen them.

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[29] For more information on this service, see https://ec.europa.eu/info/departments/structural-reform-support-service_en

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Table 1 Hungary: Reform reversal episodes

Number	Area	Initial reform		Initial reform entry into force	
1	**Pensions**	**Mandatory second pillar private pension schemes** To better cope with the ageing population, mandatory funded pillar was set up. Participants of the second pillar would have received 1/4 of their pensions from the pension fund to alleviate the burden of the budget in long term. 25% of the social security contribution was diverted to the private funds and this caused a revenue loss to the budget in short-term. It increased deficit by 1-1.5% of GDP every year. However, similar saving could have expected in long term.	[A major overhaul of the old-age pension system was introduced in 1998. The system comprises three pillars: i) a public defined-benefit pillar financed mostly from earnings-based contributions and providing earnings-related old-age, survivors and disability pensions; ii) a mandatory private defined-contribution pillar; and iii) a voluntary pillar introduced in 1993. New entrants to the labour force in 1998 were automatically enrolled in both mandatory pillars, while mid-career workers were given the option of participating in both mandatory pillars or to remain in the first pillar only. Participants opting into the mixed public-private scheme were given the right to reverse their decision at any time before 2013, as long as they have less than 10 years of work experience] (OECD Economic Surveys 2010)	1998	**The government decided to abolish the mandatory second pillar and took over private pension assets.** After the financial crisis the government needed fiscal space. The abolition of the funded pillar improved the budgetary deficit as the full social security contribution was paid to the budget. Public debt decreased as assets of the pension funds reclassified into the general government sector.
2	**Privatisation of state owned enterprises to foreign investors**	**Privatisation of public assets, in particular in network industries and in the banking sector.** After the transition Hungarians does not have enough capital to perform the needed investment to catch-up. Privatisation of big state-owned companies was a way to attract capital-rich foreign investors. FDI brought innovative technology as well. The Hungarian state privatised network industries (energy, electricity, telecommunication, waste management, etc) and banks. These sectors needed a lot of capital and new technology the Hungarians did not have.		1994 to mid2000	**U-turn in economic policy resulting in the renationalisation, in particular in the energy sector.** The government imposed sector-specific taxes on network industries and banks and administratively set lower retail energy prices. These measures decreased the value of the companies, which created a good ground for the state to acquire the firms.
3	**Product market liberalisation**	**Deregulation in service industries.** After the transition Hungary had to build a market economy. One of the main features of the market economy is the freedom of entrepreneurship, liberalisation and loose regulatory environment.		Early 1990' onwards	**Imposition of restricted regulation in previously open markets** (eg. supermarkets, tobacco retail, pharmacies, mobile payments, textbook publishing and distribution). The government used its regulatory power to influence or redistribute or fully centralise several services. After the intervention, the services are provided by the actors and persons favoured by the government.
4	**Modernisation of fiscal system**	**Modernisation of the fiscal system (Fiscal Council).** In 2008, under the financial assistance programme of the EU/IMF, Hungary set up a fiscal council to reinforce fiscal discipline, which was weak before the crisis. The council had a permanent staff, which was able to carry out high level analytical work.		2008	**The scrapping of the analytical capacity of the fiscal council.** The government reduced the staff of the council from more than 50 analysts to a small secretariat. Now, the necessary analytical work is carried out by the central bank and the state audit office.

	A	G	H	I	J
1	Table 1 I				
2	Number	Reform reversal			Date of reversal entry into force
3					
4	1	[A number of parametric reforms to benefits have been introduced over the years, with differing impacts on the financial strength of the system. Key measures through 2008 thatmade the system more generous include the provision of a 13th month pension and a change in the indexation of earnings histories for the calculation of the pension base. At the same time, some measures reduced benefits, including the elimination of the deduction of unemployment and social security contributions from the earnings base for computing new pensions, a strengthening of penalties and bonuses to discourage early retirement, a tightening of eligibility for disability benefits, and a capping of the value of the 13th month pension benefit. The authorities took further actions in 2009:	pensions are now indexed to the consumer price index (CPI) (rather than by the "Swiss" method of 50% wages, 50% prices) unless real GDP growth exceeds 3%; the 13th month pension has been abolished; and increases for certain disability pensions planned for 2010 have been revoked. Finally, starting in 2012, the statutory retirement ages for early and full pensions will be increased by six months each year to reach progressively 65.](OECD Economic Surveys 2010)		2010
5		2010 p.62			
6	2				2010
7					
8	3	[Restrictive regulation for specific products has also been introduced. To make tobacco less accessible, especially for the youth, tobacco retail was monopolised from July 2013. Licensed retailers, selected through tenders and expected to reach around 5 000 nationwide, are around nine times less numerous than tobacco vendors before, and also enjoy a higher profit margin (10%). Post-monopolisation data shows a marked increase in tobacco prices (12% in June-November 2013), while expected tobacco excise revenues in 2013 were slightly revised downwards, and are forecast to decline further in 2014, in contrast with strong increases in 2011-13 on the back of excise hikes.	Barriers to entry have also been raised in the pharmacy sector. After substantial liberalisation in 2006, which made the number of pharmacies increase by around 20%, 2010 legislation reinstated geography and demography-based entry barriers (minimum thresholds for residents per pharmacy and distance between pharmacies) as well as ownership constraints. Pharmacists must own a majority stake by January 2017, a requirement which is currently not met by around one third of all pharmacies. Further, one pharmacist can own only four pharmacies (existing larger chains will not be disintegrated and will have a transition period to move to majority control by a pharmacist). Some evidence suggests that restrictions of this kind lower productivity and allocative efficiency without offsetting gains in service quality.] (OECD Economic Surveys 2014)		2010 onwards
9		2014 p.67			
10	4				2010
11					

Table 1 I

Number	Description of circumstances	Consequences	
1	The main reason of the reversal was the improve the budgetary situation, but the main advertised argument was that pension funds operated expensively using high commission. Moreover the SGP did not take into account fully the cost of the pension reform. The majority of the fund members were unhappy with the measures, because they considered that the money collected by private pension fund was their private property, and the government has no right to nationalise them. In addition, they considered that their future pensions are ensured more in the mixed system than in a pure pay-as-you-go system.	Short to medium term fiscal benefits, but higher pension spending in the longer term	[There is little doubt that these measures, if sustained, will reduce the growth of public pension outlays. The European Commission's 2009 Ageing Report is informative on this question (European Commission, 2009b). In 2006, expenditures on public pensions in Hungary were projected to grow by close to 6½ percentage points of GDP to reach 17.3% of GDP by 2050; by early 2009, the projected increase over the same period had been reduced to just under 2½ per cent of GDP. To the extent that the parametric reforms could be incorporated in the Commission's projection, the decomposition of the sources of change in the ratio of pension outlays to GDP is revealing. The reduction in the growth of pensions is attributable to changes in all four factors affecting outlays, the single largest impact coming from reduced benefits. 2010
2	**Rising scepticism in market solutions.** The foreign owned firms in the network industries and banking sector were profitable before the crisis years. There was a perception that these companies are making extra profits using their monopolistic situation. The government disliked the situation that Hungary depends on decision of some multinational companies in strategic industries. Disfavouring foreign companies enjoyed a broad support in Hungary.	Increase state control and increased risk on contingent liabilities	
3	**Preference towards domestic ownership against foreign one.** The motivation of the government was to favour Hungarian ownership against foreign one (supermarkets), or to favour people close to government against other Hungarian people. There is a broad support toward the restrictive measures on foreign own firms, but there is a general discomfort when the government redistribute businesses to people close to the government from other Hungarians.	Reduced competition	[Monopolisation may thus be leading to higher profits for the few licensed retailers to the detriment of t uneven, with only gradual improvement in the coverage 2014
4	**Motivation to strengthen the authority of the governments and dispreference towards the institutional set up of checks and balances.** The government has a different view on the design of checks and balances. It preferred a set up with less control and monitor on the operation of the government.	Reduced transparency of budgetary policies	

	A	N	O
1	Table 1 I		
2	**Number**		**Political context**
3			
4	1	Whereas the benefit ratio contributed to an increase in the public pension expenditure/GDP ratio as of 2006, changes in prospective benefits since then contribute to a lowering of the expenditure to GDP ratio, and to a lowering of public benefit ratios. All the recent 2009 measures will clearly reduce further the growth of public pensions.] (OECD Economic Surveys 2010)	Prime minister: Viktor Orban, FIDESZ, right -conservative
5		p.63	
6	2		Prime minister: Viktor Orban, FIDESZ, right -conservative
7			
8	3	ne public purse. A related concern is black market growth, as the geographical distribution of retailers is of small settlements.] (OECD Economic surveys 2014)	Prime minister: Viktor Orban, FIDESZ, right -conservative
9		p.67	
10	4		Prime minister: Viktor Orban, FIDESZ, right -conservative
11			

	A	B	C	D	E	F
2	**Number**	**Area**	**Initial reform**		**Initial reform entry into force**	
12	5	**Modernisation of social system**	Decentralization of social service and education		1992 onwards	Centralisation of services by establishing large government controlled entities managing health and education services. The government set up giant centralised institutions (KLIK), which operates primary and secondary education. Only few tasks remained at local level.
13						
14	6	**EMU**	Prohibition of monetary financing		Prior to / upon accession to the EU	Establishment of MNB foundations, enlabled to buy government debt on the primary market
15	7	**EMU**	(1) Prohibition of monetary financing (2) Central bank independence		Prior to / upon accession to the EU	Exception to the conflict of interest rules in the Central Bank Act in the context of the MNB foundations
16	8	**EMU**	Central bank independence		Prior to / upon accession to the EU	Various legislative acts
17	Sources: Compiled by the authors based on various sources as indicated for each item in the table.					

	A	G	H	I	J
2	**Number**	**Reform reversal**			**Date of reversal entry into force**
12	5	[In 2013, the responsibility for primary and secondary education was transferred from municipalities to the central government. Only school maintenance in larger municipalities (over 3 000 inhabitants) remains a municipal responsibility. The central government took over the financing of schools, which no longer have independent budgets, as well as certain responsibilities that were traditionally devoted to school directors, such as hiring and firing teachers. To manage these new responsibilities, a new administrative layer, the Klebelsberg Institute, was created, with a network of around 200 local branches.	Teachers' wages in primary and secondary education were increased by an average 34% in September 2013. Further increases of about 10% per year are envisaged for the three coming years. In exchange, teachers' low working time is to be increased. The measure, which follows a recommendation in the 2010 Survey,* should help the recruitment and retention of better teachers as, after many years of wage freezes, teachers' wages had become very low vis-à-vis other occupations at the same qualification level. A number of largely EU-financed measures aim to increase the chances of disadvantaged students. Pre-school will be made compulsory for children over three years-old in 2015 (94% are already attending), which is a positive step given that enrolment generally enhances education outcomes of children with poor backgrounds.	A so-called Sure Start programme aims to support young children in disadvantaged areas by providing pedagogic and social support in dedicated centres and promoting parental involvement. To reduce school dropout, Bridge programmes were launched in 2013 to help pupils performing poorly in elementary education to acquire basic skills and a partial vocational qualification, and an after-school support programme (TANODA) was launched. A "For the Road" programme provides support to disadvantaged pupils (at least half of them Roma) from 7th grade to the first year of university, in the form of a monthly scholarship (of an amount depending on academic results) and mentoring.] (OECD Economic Surverys 2014)	2010 onwards
13		2014 p.93			
14	6				2013
15	7				2015
16	8				
17	Sources:				

	A	K	L	M
2	**Number**	**Description of circumstances**	**Consequences**	
12	5	To increase the control by the central government in the face of heterogeneity of service quality and increasing local government debt	Managerial rigidities of the newly established large organizations and reduced budgetary uncertainty at municipality level	
13				
14	6	An amendment to the Central Bank Act allowed the central bank to establish six foundations ("MNB foundations") under its Pallas Athena programme, and endow them with central bank money. According to their Articles of Association, these foundations have to invest their endowment in low-risk securities, such as government bonds. End-2015 results demonstrate that 76% of their assets included government securities.	Possible violation of Article 123 TFEU which prohibits direct purchases by a national central bank of debt instruments. It can be argued that a national central bank violates the monetary financing prohibition and defeats the underlying purpose of ensuring fiscal discipline in a Member State if it creates legally separate entities (=MNB foundations) which are under its direct influence and control and serve as a mechanism to use central bank resources for direct investments in debt instruments issued by the Member State concerned.	
15	7	On the basis of national law, members of the MNB Monetary Council (including the Governor) are legally allowed to undertake activities in the MNB's foundations and business associations that are incompatible with their central bank decision-making duties.	Possible violation of Articles 123 and 130 TFEU.	
16	8	The combination of the changes to the institutional framework of the Magyar Nemzeti Bank and the frequency of changes to the Law on the MNB, not always backed by robust justification for the need to amend the Magyar Nemzeti Bank's institutional framework, adversely affect the organisational and governance stability of the Magyar Nemzeti Bank and impact its institutional independence. The principle of central bank independence requires that a central bank has a stable legal framework to enable it to function.	Possible violation of Article 130 TFEU.	
17	Sources:			

	A	N	O
2	Number		Political context
12	5		Prime minister: Viktor Orban, FIDESZ, right -conservative
13			
14	6		
15	7		
16	8		
17	Sources:		

	A	B	C	D	E	F	G	H
1	Table 2 Poland: Reform reversal episodes							
2	**Number**	**Area**	**Initial reform**	**Initial reform entry into force**	**Reform reversal**	**Date of reversal entry into force**	**Description of circumstances**	**References**
3	1	**Pensions**	Introduction of a defined-contribution general pension system with 3 pillars, with mandatory, fully-funded private 2nd pillar (open pension funds - OFE)	1999	Exclusion of new members of the uniformed services from the new pension system and their transfer to their special pension scheme	2003	(i) the uniformed services pension system was based on a system of specific privileges, including relatively short period of contributions before retirement (e.g. 15 years of service in case of policemen), irrespective of the actual retirement age, (ii) the separate system was retained to keep the incentives to take up the work in the services to compensate relatively low wages. (iii)The retirement age was somewhat increased in 2013; there was a CSR on this.]	Ustawa z dnia 23 lipca 2003 r. o zmianie ustawy o systemie ubezpieczeń społecznych oraz niektórych innych ustaw (Dz.U. z 2003 r. nr 166, poz. 1609).
4	2	**Pensions**	Introduction of a defined-contribution general pension system with 3 pillars, with mandatory, fully-funded private 2nd pillar (open pension funds - OFE)	1999	Extension of pension preferences for miners and teachers fulfilling certain criteria - mainly the right to early retirement	2007	(i) the law was voted in the last weeks of the term of the then weakened Marek Belka government, (ii) the government conceded under the pressure of trade unions	Ustawa z dnia 27 lipca 2005 r. o zmianie ustawy o emeryturach i rentach z Funduszu Ubezpieczeń Społecznych oraz ustawy - Karta Nauczyciela
5								
6	3	**Pensions**	Introduction of a defined-contribution general pension system with 3 pillars, with mandatory, fully-funded private 2nd pillar (open pension funds - OFE)	1999	Significant lowering of the contribution to OFE and retaining it in the 1st, public, pillar - Social Security Institution (ZUS).	2011	(i) mounting fiscal pressures in the crisis period (ii) need of higher revenues for the ZUS	Ustawa z dnia 25 marca 2011 r. o zmianie niektórych ustaw związanych z funkcjonowaniem systemu ubezpieczeń społecznych, Dz. U. 2011, nr 75, poz. 398.
7								
8	4	**Pensions**	Introduction of a defined-contribution general pension system with 3 pillars, with mandatory, fully-funded private 2nd pillar (open pension funds - OFE)	1999	(i) OFE becoming voluntary (with default opt-out), OFE were banned to advertise (ii) transfer of 51.5% of the total OFE assets (consisting mainly of State bonds) to the ZUS, restrictions on OFE portfolio, (ii) introduction of the "zipper" system - funds on individual OFE accounts to be systematically transferred to ZUS during 10 years preceding retirement	2014	(i) further lowering of fiscal burden, (ii) de facto: exiting the EDP.	(i) Ustawa z dnia 6 grudnia 2013 r. o zmianie niektórych ustaw w związku (ii) z określeniem zasad wypłaty emerytur ze środków zgromadzonych w otwartych funduszach emerytalnych. Dz. U. 2013, poz. 1717.
9								
10	5	**Pensions**	Gradual increase and equalisation of the statutory retirement age for men and women to 67 years from initial 60/65 (women/men).	2013	Lowering of the retirement age to 60 (women) and 65 (for men).	2017	fulfilment of an election campaign promise	Ustawa z dnia 16 listopada 2016 r. o zmianie ustawy o emeryturach i rentach z Funduszu Ubezpieczeń Społecznych oraz niektórych innych ustaw (Dz. U. z 2017, poz. 38)
11								

Table 2 I

Number	Consequences
1	(i) increased fiscal burden, (ii) complication of the pension schemes in Poland
2	(i) increased fiscal burden, (ii) complication of the pension schemes in Poland
3	(i) decreased contributions to OFE, (ii) shift of the fiscal burden over time: decreased in the short- and medium-term, increase in the very long-term (iii) higher dependency of the pension system on the first pillar (ZUS), (iv) indirect impact on the Warsaw Stock Exchange
4	(i) exiting the EDP, (ii) shift of the fiscal burden over time: decreased in the short- and medium-term, increase in the very long-term (iii) radical limitation of the role played by OFE both in the pension system and in the economy (including Warsaw Stock Exchange).
5	Following the 2017 country report: (i) possible decrease of the labour force participation, (ii) negative impact on the pension adequacy ratio (in particular for women), (iii) significant negative fiscal impact (up to 1% of GDP per annum, according to some estimates), (iv) a risk of even higher future fiscal costs if the lowered adequacy ratio is politically unsustainable.

	A	B	C	D	E	F	G	H
2	**Number**	**Area**	**Initial reform**	**Initial reform entry into force**	**Reform reversal**	**Date of reversal entry into force**	**Description of circumstances**	**References**
12	6	**Privatisation**	Following the fall of communism and the need to departure from the centrally-planned economy, Poland proceeded with privatisation of state-owned enterprises	1990 onwards, including the 1996 mass-privatisation programme (*Program Powszechnej Prywatyzacji* , *PPP*)	There is no legal act that would undermine the principle of privatisation, however the government has recently expressed explicitly its will to de facto stop privatisation (very low privatisation income planned in the 2017 budget) and "repolonise" some important areas (banking, energy).	2016	implementation of the government "polonocentric" agenda	(i) 2017 budget law, (ii) the Strategy of Responsible Development
13								
14	7	**Judiciary**	Following the fall of communism, Poland reinforced the principle of the separation of powers, with an independent and self-governing judiciary	1990	(i) entrusting the Minister of Justice with a right to dismiss and nominate the heads of general courts, (ii) changes in the functioning of a school for judges and prosecutors giving the Minister of Justice more influence on the nomination of new judges, (iii) de facto undermining the position of the Constitutional Tribunal (Other legislative attempts were made in 2017 - broadly they could even further limit the independence of judiciary and entrust politicians with more powers in the area. They included changes in the composition and functioning of the National Council of Judiciary (a constitutional body governing the profession) and changes in the composition and functioning of the Supreme Court. Relevant laws were vetoed by the President in July 2017. However, new legislative proposals in this respect are expected.)	2015 - 2017	(i) officially: the government wants to reform the judiciary, (ii) unofficially: the reforms limit the independence of judiciary	(i) Ustawa z dnia 11 maja 2017 r. o zmianie ustawy o Krajowej Szkole Sądownictwa i Prokuratury, ustawy (ii) Prawo o ustroju sądów powszechnych oraz niektórych innych ustaw (Dz.U. 2017 poz. 1139), (iii) Ustawa z dnia 12 lipca 2017 r. o zmianie ustawy – Prawo o ustroju sądów powszechnych oraz niektórych innych ustaw (Dz.U. 2017 poz. 1452) (iv) Ustawa z dnia 19 listopada 2015 r. o zmianie ustawy o Trybunale Konstytucyjnym (Dz.U. 2015 poz. 1928), (v) Ustawa z dnia 22 grudnia 2015 r. o zmianie ustawy o Trybunale Konstytucyjnym (Dz.U. 2015 poz. 2217), (vi) Ustawa z dnia 22 lipca 2016 r. o Trybunale Konstytucyjnym (Dz.U. 2016 poz. 1157), (vii) Ustawa z dnia 30 listopada 2016 r. o organizacji i trybie postępowania przed Trybunałem Konstytucyjnym (Dz.U. 2016 poz. 2072). (viii) Ustawa z dnia 30 listopada 2016 r. o statusie sędziów Trybunału Konstytucyjnego (Dz.U. 2016 poz. 2073), (ix) Ustawa z dnia 13 grudnia 2016 r. - Przepisy wprowadzające ustawę o organizacji i trybie postępowania przed Trybunałem Konstytucyjnym oraz ustawę o statusie sędziów Trybunału Konstytucyjnego (Dz.U. 2016 poz. 2074)
15								
16	8	**Education**	Reform of the education system - introduction of a new school system model: 6-3-3 years (primary, lower secondary, upper secondary) instead of 8-4 years (primary, secondary).	1999	Phasing out lower secondary schools and return to the pre-1999 structure: 8-4 years.	2017	fulfilment of an election campaign promise	(i) Ustawa z dnia 14 grudnia 2016 r. - Prawo oświatowe (Dz.U. 2017 poz. 59) (ii) Ustawa z dnia 14 grudnia 2016 r. - Przepisy wprowadzające ustawę – Prawo oświatowe (Dz.U. 2017 poz. 59)
17								
18	9	**Freedom of economic activity**	Following the fall of communism and the need to departure from the centrally-planned economy, Poland opened and deregulated many professions	1990 onwards	The right to open and run pharmacies has been limited. Pharmacies may now be owned only by pharmacists and there are proximity restrictions on new pharmacies.	2017	officially government wanted to support family-owned, small pharmacies	Ustawa z dnia 7 kwietnia 2017 r. o zmianie ustawy – Prawo farmaceutyczne (Dz.U. 2017 poz. 1015)
19	10	**Public administration**	A new model was established to ensure professional, unbiased and politically neutral civil service.	1997	(i) managerial posts in the Polish civil service are no longer filled by way of open competitions but by direct appointment, (ii)eligibility criteria for those posts are less restrictive.	2016	officially given rationale: to make managerial appointments more flexible in order to help government better implement its policies	Ustawa z dnia 30 grudnia 2015 r. o zmianie ustawy o służbie cywilnej oraz niektórych innych ustaw (Dz.U. 2016 poz. 34)
20	11	**Rule of law**	Independence of the judiciary	Prior to / upon accession to the EU	Various legislative acts.		Attempts to reverse the reforms made include: (1) the Law on the Constitutional Tribunal, (2) the appointment of judges of the Constitutional Court; the lack of publication and implementation of judgments of the Constitutional Tribunal; the lack of effectiveness of constitutional review on new legislation; the appointment of President, VP and Acting President of the Tribunal, (3) the Law on the Supreme Court; the Law on the National Council for the Judiciary; the Law on the Ordinary Courts Organisation; and the Law on the National School of Judiciary.	Commission recommendations regarding the rule of law in Poland of 27 July 2016, 21 December 2016, 26 July 2017.

	A	I
2	**Number**	**Consequences**
12	6	(i) lower revenue on privatisation,(ii) higher role of the state in the economy, (iii) risks of inefficient management.
13		
14	7	(i) limitation of the independence of judiciary, (ii) potentially lower investors' confidence, (iii) criticism of many national and international institutions and NGOs, (iv) conflict with the EU over the rule of law.
15		
16	8	Following the 2017 country report (i) increased inequality in education: earlier tracking into vocational or general stream may affect the basic numeracy and literacy skills of the most disadvantaged students, (ii) disruptive effects on the provision of education, in particular with strong projected variation in the size of school cohorts,(iii) potential risk of suboptimal use of certain past investment in the lower secondary schools, (iv) a number of operational issues for local governments (including infrastructure, reorganisation of teachers' work etc.)
17		
18	9	(i) limitation of competition (ii) risk of increase pharmaceutical prices, (iii) blockage of development of network pharmacies.
19	10	(i) undermining the principle of a politically neutral civil service, (ii) changing the incentives for careers in civil service (less security of employment at managerial level, stronger links of career prospects to political situation)
20	11	(1) The Constitutional Tribunal is prevented from fully ensuring an effective constitutional review, which adversely affects its integrity, stability and proper functioning, one of the essential safeguards of the rule of law in Poland (2) (3) These Laws, in their current form, will structurally undermine the independence of the judiciary in Poland and have an immediate and very significant negative impact on the independent functioning of the judiciary.

	A	B	C	D	E	F	G	H
2	**Number**	**Area**	**Initial reform**	**Initial reform entry into force**	**Reform reversal**	**Date of reversal entry into force**	**Description of circumstances**	**References**
21	12	**Rule of law** **Fundamental rights**	(1) Independence of the judiciary (2) Gender equality	Prior to / upon accession to the EU	Discrimination on the basis of gender due to the introduction of a different retirement age for female judges (60 years) and male judges (65 years). Discretionary power of the Minister of Justice to prolong the mandate of judges, as well as to dismiss and appoint Court Presidents, etc.	[2017]		Infringement case No. 20172119 Letter of Formal Notice sent to PL in July 2017. Press release IP/17/2205.
22	Sources: Compiled by the authors based on various sources as indicated for each item in the table.							

	A	I
2	**Number**	**Consequences**
21	12	Possible violation of Article 157 TFEU and Directive 2006/54 on gender equality in employment. Possible violation of Article 19(1) TEU in combination with Article 47 of the EU Charter of Fundamental Rights (independence of the judiciary).
22	Sources: Co	

	A	B	C	D	E	F	G	H
1	Table 3 Romania: Reform reversal episodes							
2	**Number**	**Area**	**Initial reform**	**Initial reform entry into force**	**Reform reversal**	**Date of reversal entry into force**	**Description of circumstances**	**References**
3	1	**Public Finance**	Sharp increase of public deficit via tax cuts and public wages increases	2016-2017	The general government deficit increased to 3.0 % of GDP in 2016. It is projected to deteriorate further to 3.5 % in 2017 and 3.7 % in 2018, driven by significant tax cuts and expenditure hikes. This undid past consolidation efforts. Romania over-achieved its MTO of a structural deficit of 1% in 2014 and 2015 only. In 2016, however, the structural deficit was 2.6% and it is projected to widen to 3.9% in 2017 and 4% in 2018.			The expansionary fiscal stance was adopted in a context of strong GDP growth (4.8% in 2016 and forecast at 4.3% in 2017). A Significant Deviation Procedre was opened in June 2017. RO is expected to report on action taken by 15 October.
4								
5	2	**Rule of Law**	Independence of the judicial system and the rule of law	Since January 2017; on going.			Soon after taking office, in January, the government approved na energency ordinance (GEO 13/2017) sharply reducing penalities for corrpution charges. This was nulified a weak later (GEO 14/2017) after massive street protests. Since then, however, there is a several initiatives continued to threaten to weaken the fight against corruption. In August the government adopt draft changes to the judicial law that could undermine judicial indpeendence.	A CVM mission will visit Bucharest in mid-September.
6	3	**Pension reform reversal**	Pension reform may be reversed by a proposal to reduce by half the mandatory annual transfers to the second pillar of the pensions system	Intention announced in August 2017. No draft legislation exists yet.			Current European statistical rules, together with the SGP obligations, give the governments an incentive to dismantle second pillars of the pension systems. Second pillars, although mandatory, are classified outside of the general government (GG). A reduction of social contributions transferred to the second pension pillar immediately increases the revenues of the GG (while the corollary increase of expenditures by the GG - pension obligations - is recorded in the future, once the pensions are paid out). Therefore, a reduction of social contributions going to the second pillar would decrease the general government deficit in the short/medium term.	Thesecond pillar was introduced in Romania as part of the pension reform started in 2008 and legislated in 2010 and 2011 under the EU/IMF financial assistance programmes. The contributions to the second pillar were to be increased 0.5% of gross wages every year until reaching 6% in 2016. This target was postponed by successive governemnts. In 2016, the contribution to the second pillar was increase from 5% to 5.1%. This level was maintained in the 2017 budget law. The reduction from 5.1% to 2.5% of of gross wages is equivalent to 0.3% of GDP.
7	4	**Privatisation**	Privatizations were *de facto* stopped in 2014 and are not part of the current government's plans	Since mid-2014			Concrete plans for the privatisation of minority or majority stakes in several SOEs were agreed as part of the EU-IMF financial assistance programmes. The goal was to increase private oversight and the operational efficiency of management of SOEs as well as to support the development of the local stock market. However, after three successful IPOs in October and November 2013 and June 2014, the privatisation process has stalled. Only one privatisation has officially been attempted since then (that of loss-making chemical complex Oltchim) but the odds have always looked unpromising.	Privatisations are not part of the current governemnt's programme. In spring there were comments by leading politicians in the current majority criticising privatisations in principal.
8	5		The legislation governing corporate governance of SOEs is being weakened	Since Spring 2017			Legislation on the corporate governance of SOEs was first approved in Romanian in 2011 (GEO 109/2011) under the EU-IMF financial assistance programmes. It was revised in 2016 (Law 111/2016), does implementing a CSR addressed to Romania the previous year. In March 2017, however, a proposal to exempt 2 small companies from the provisions of law 111/2016 was used by the Parliament to prepare a long list of exemptions. In May, the Senate's committee for economy, industry and services approved the exemption of some 30 SOEs , including all water companies and most companies producing military equipment. This draft will now be discussed and voted by the lower house of Parliament. No date has been announced for this debate.	The governemnt is planning the creation of a "Sovereign Invetsment Fund". According to the draft legislation put under public consultation, the government will transfer to the fund the ownership of 27 profitable SOEs, most of them in energy, oil and telecomunications. Still according to the draft legislation, the Fund will be exempted from law 111/2016. It is not clear whether the companies it will control will also fall out of the SOEs coporate governance legislation.

	A	I
1	Table 3	
2	**Number**	**Consequences**
3	1	The government insists that it remains committed to avoid a breach of the 3% Treaty reference value. Based on the usual no-policy change, the Commission estimated in spring a deficit of 3.5 % of GDP in 2017 and 3.7 % in 2018.
4		
5	2	Weakening investment sentiment may have a negative impact on investment, including international investment, and growth.
6	3	the reversal of the reform is lekly to have a negative impact on the systems long term sustainability. It will also slow down the development of the romanian capital markets.
7	4	
8	5	

	A	B	C	D	E	F	G	H
2	**Number**	**Area**	**Initial reform**	**Initial reform entry into force**	**Reform reversal**	**Date of reversal entry into force**	**Description of circumstances**	**References**
9	6		A substantial reform of the public administration planned under the BoP programs was never operationalized and has been abandoned				With the support of the EU-IMF financial assistance programmes, Romania prepared na all encompassing strategy for strengthening the public administration. The document was approved by the government in October 2014 but was never implemented.	The technocrat government of PM Ciolos tried to revived the public administration reform with a more focused (and less ambitious) "civil service strategy" but this too was abandoned.
10	Sources: Compiled by the authors based on various sources as indicated for each item in the table.							

	A	I
2	**Number**	**Consequences**
9	6	The unstable organisational structure, weak administrative capacity and inconsistent human and financial resources policies limit the capacity of public institutions to develop and implement policies in a strategic and coordinated manner. Inefficiencies are not only related to low professionalization, but also to politicisation and lack of empowerment of civil servants(29). Decision-making and legislation often lack predictability and transparency. This situation has a far reaching impact on a wide variety of issues, from the delivery of structural reforms up to the success in providing efficient and effective services to the population and a stable and business-friendly environment to investors.
10	Sources: Co	

Table 4 Slovenia: Reform reversal episodes

Number	Area	Initial reform	Initial reform entry into force	Reform reversal	Date of reversal entry into force	Description of circumstances	References	Consequences
1	**Privatisation**	There was commitment to reduce state ownership in the economy at the onset of the crisis in 2013. The list of 15 companies to be privatised was adopted in 2015.	2013	Cancelled privatisation processes of specific companies (Telekom Slovenije in 2015, the largest bank NLB in 2017). The Asset Management Strategy adopted in 2015 classified most of the state assets as important or strategic and introduced the restriction on ownership concentration by private investors.	2015	Strong vested interests, trying to keep control in state owned companies.	http://www.sloveniatimes.com/telekom-sale-over-as-cinven-backs-out; Country Report 2017: p.1, 2, 4 13, 25, 31	Negative impact on resource allocation and public finance. State involvement in the economy remains high despite the privatisation programme initiated in 2013. The state is the largest employer, asset manager and corporate debt holder in Slovenia. Combined with weak corporate governance, high state ownership has had considerable fiscal and economic implications. They are estimated at EUR 13 billion or about one third of GDP in 2007-2014, primarily due to financial sector stabilisation measures and foregone profits of state-owned enterprises compared to their private peers.
2	**Banking**	Conduct of AQR/ST to address the immediate stability risks	2013-2014	A number of pending legislative initiatives motivated by criticism around the conduct of AQR/ST are in the pipeline such as: (i) changes to the Governing Board of the Bank of Slovenia (ii) audit of Bank of Slovenia operations by Court of Audit (iii) disclosure of the AQR report by the Bank of Slovenia outside litigation context (iv) access to Bank of Slovenia documents by parliamentary inquiry committees.		Strong vested interests, trying to keep control in state owned banks. Complaints from bailed-in bondholders.		The legislative initiatives may violate independence of the Bank of Slovenia and EU laws.
3	**Banking**			Legal proceedings on the conduct of AQR/ST against the Governor and officials at the Bank of Slovenia.				
4	**Public finance**:	(1) Introduction of consolidation measures (Intervention Measures Act in 2010 and additional measures to this Act in 2012; ZUJF in 2012) as a response to the emerging crisis (2) There have been no structural measures to contain public expenditure since 2008 despite quadrupling of public debt in this period.	2010 and 2012 onwards	Some consolidation measures have been reversed; including those that were initially meant to be permanent (e.g. means testing of social benefits).	2015	A strong public perception that society as a whole needs to benefit from the recovery, which started in 2014.		Structural deficit is worsening due to lack of structural measures. In addition, public debt almost quadrupled since the beginning of the crisis and reached more than 80% of GDP in 2015. Albeit the debt ratio has since started to slowly decline and it is below the euro area average, it remains an important source of vulnerability.
5	**Public finance**:	Postponed reform of the pension system. CSR since 2011	The pension reform was adopted in 2012; however, it is partial and does not ensure long term sustainability.			Until 2012 the institutional arrangements of calling a referendum were an important hurdle for reform. A proposed pension reform was voted down in the referendum in 2011. Furthermore, the party of pensioners (DESUS) is in any government a junior coalition party and effecitve in resisting pension reforms.	Country Report 2016, p. 35-36	Slovenia faces high risks on the long-term sustainability of public finances and its long-term sustainability gap indicator is the highest of all Member States
6	**Public finance**:	Postponed reforms of health care. CSR since 2015	There has been no health care reform in the last 20 years (the main health care act is from 1992).			There have been several attempts to reform health care, however, no consensus has been achieved. The current government considers the health care reform a priority, however, the reform has been delayed and it is unclear whether the goal will be achieved.	Country Report 2016, p. 37-45	Slovenia faces high risks on the long-term sustainability of public finances and its long-term sustainability gap indicator is the highest of all Member States
7	**Public finance**:	Postponed reforms of long term care. CSR since 2013	The long term care reform is in the pipeline for more than 10				Country Report 2016, p. 33-34	Slovenia faces high risks on the long-term sustainability of public finances and its long-term sustainability gap indicator is the highest

Table 4

Number	PM (at the time the reversal was voted) / party	References	IMF article IV assessment	OCED assessment	
1	Miro Cerar / Modern Centre Party - centre left party		The privatization of the two remaining large state banks is of key importance to ensure that they continue to operate on commercial principles, expand into new activities, and reduce costs. This is especially important given the history of connected lending practices that prevailed in Slovenian state-owned banks prior to the 2012–13 crisis. After the sale of NKBM in 2016, the authorities are preparing to privatize the largest bank (NLB) via IPO in 2017. Staff supported the sale but expressed concern about the restriction that no private investor can have more than the state's 25 percent stake. Dropping the restriction would allow strategic investors to take a controlling stake and further improve the bank's performance. Moreover, staff encouraged the authorities to complete the sale of the last state owned commercial bank (Abanka) well before the mid-2019 deadline agreed with the EC. An early sale would allow dropping the constraints on the bank's activity imposed by the use of state aid and thus help its competitiveness and profitability. (2017 Article IV Consultation)	Ongoing bank restructuring could boost access to finance. But state-owned banks are still large, representing approximately half of total bank equity. Such banks are widely seen as less effective in allocating capital: they may extend credit to under-performing SOEs and other public bodies, or provide preferential financing to favoured regions or sectors as well as crowding out credit to the private sector. According to EU rules, the financial support from the state to its banks during the financial crisis will be considered as illegal state-aid, unless they are privatised. As recommended in past Surveys, the second largest bank (Nova KBM) was privatised in 2016. To avoid having its public financial support classified as unauthorised state aid, at least half of the largest bank (NLB) must be sold by end-2017 and a further 25% by end- 2018.	In June 2017, the initial public offering was cancelled, and the government is in discussion with the EU Commission on ways forward. Previous privatisation attempts have foundered on the requirements that the government maintains a 25% controlling stake and no individual investor can acquire more than 25% of the bank's shares. Withdrawing the requirements on ownership would allow a well-capitalised investor full control to restructure the bank to make it viable in the medium term. (OECD Economic Surveys 2017)
			2017 p.13	2017 p.33	
2	Miro Cerar / Modern Centre Party - centre left party		The AQR and ST together with the prompt bank recapitalization are key milestones along the path toward stability and growth. The comprehensive and independent AQR and ST were crucial to remove the uncertainty about the strength of the banking system and restore confidence. The prompt bank recapitalization will reduce short-term deleveraging pressures in the banking system. (2013 Article IV Consultation)	The Asset Quality Review (AQR) from December 2013 identified several weaknesses in the banks' risk management systems. The data integrity validation highlighted deficiencies in IT systems and paper records, with significant gaps in several loan files. Most banks did not assign rating classes in line with the regulations issued by Bank of Slovenia and in many instances the collateral valuations were out of date. BAMC likewise notes that credit files received from the banks were in many cases incomplete and of poor quality. The risk management in banks should be of higher standard and bank supervisors should more closely follow that regulations and guidance are properly followed by the banks. (OECD Economic Surveys 2015)	
			2013 p.22	2015 p.23	
3	Miro Cerar / Modern Centre Party - centre left party		No information found	No information found	
4	Miro Cerar / Modern Centre Party - centre left party		Fiscal adjustment via structural, rather than one-off, measures is critical to strengthen credibility. By providing confidence about the ultimate objectives of fiscal policy, a credible medium-term consolidation plan could give the authorities additional flexibility for discretionary measures in case economic developments turn out worse than projected. In particular, provided the overall fiscal consolidation effort is underpinned by credible reforms, the authorities could consider front-loading capital spending, including through acceleration of EU-funded projects. Front-loading capital spending would be justified given the currently low level of government borrowing costs, and the temporary interest savings brought by the ECB's QE. (2016 Article IV Consultation)	Consolidation has relied too much on one-off measures instead of structural efforts, making longer-term expenditure control challenging. Moreover, the fiscal framework has no credible mechanism to reach medium-term objectives. The rapid rise in age-related public expenditure from pensions, health care and long-term care is further complicating future consolidation. (OECD Economic Surveys 2015)	
			2016 p.14	2015 p.12	
5			Staff suggested focusing on structural fiscal reforms in expenditure areas where Slovenia had been spending more than its peers without achieving better outcomes: Pensions, by indexing pensions to inflation only, abolishing the pension bonus and pensioners' preferential tax treatment, and, once the retirement age reaches 65 as planned, continuing its increase to 67 and then linking it to life expectancy. Part of the savings should be directed to support low-income pensioners through the social assistance system. (2016 Article IV Consultation)	A higher replacement rate will further increase future pension spending. Several changes in pension entitlements should be envisaged to lower that burden. The main focus of reform should be to extend working lives and raise the effective retirement age. Increasing the retirement age to 67 would be an important step in this respect. (OECD Economic Surveys 2017)	
			2016 p.13	2017 p.35	
6			While these proposals are steps in the right direction, staff recommended additional structural reforms to improve the budget permanently: put in place further health and education reforms that reduce the distance to the efficiency frontier by maintaining the high quality of service but reducing costs, such as expanding centralized procurement in the health care sector to benefit from stronger supplier competition and economies of scale. (2017 Article IV Consultation)	The Resolution on the National Health Care Plan 2016-2025 is the basis for health-care reform to meet the challenges associated with population ageing, financial pressures and constraints as well as new technologies. The amended Health Services Act is being discussed in Parliament and includes new criteria for granting concessions for public healthcare services to improve transparency and accessibility. The 2017 Health Care and Health Insurance Act focuses health-sector reforms on improving financing of hospitals, cost containment and revenue stabilisation. (OECD Economic Surveys 2017	
			2017 p.8	2017 p.37	
7			In the medium-to-long term, Slovenia is facing significant fiscal challenges. Health care and long-term care spending will also come under pressure. (2016 Article IV Consultation)	Revenue will be increased by expanding the health contribution base to include non-labour income and introducing a unified contribution rate. A draft of a new Long-Term Care Act was submitted to public consultation in mid-2017. (OECD Economic Surveys 2017)	

Table 4

Number	European Commission Country report	Press	EBRD
1			
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4			
5			
6			
7			

Number	Area	Initial reform	Initial reform entry into force	Reform reversal	Date of reversal entry into force	Description of circumstances	References	Consequences
			years.					of all Member States
8	**EMU EU institutional matters**	(1) Privileges and immunities of the ECB (2) Formulation of monetary policy by the ESCB (3) Principle of sincere cooperation between the ECB and Slovenia	Prior to / upon accession to the EU	Seizure of ECB documents	Jul-16	In the context of pre-criminal proceedings against certain officials of the BoS, including Governor Jazbec, the Slovenian authorities seized, amongst others, ECB documents in violation of the inviolability of the ECB archives, and have failed to engage in constructive discussions with the ECB.	Infringement case No. 20172071 Letter of Formal Notice sent to SI in May 2017. Press release IP/17/1184.	Possible violation of Article 2 and 22 of Protocol N° 7 on the Privileges and Immunities of the EU in conjunction with Article 18 of said Protocol and Article 4 (3) TEU, Article 343 TFEU and Article 39 of Protocol N°4 on the Statute of the ESCB and of the ECB
9	**(1) Supervision of credit institutions (2) EMU EU institutional matters**	(1) Independence of supervisor (2) EU law principles, including legal certainty	(1) Upon entry into force of Regulation (EU) 1024/2013. (2) Prior to / upon accession to the EU	Auditing actions taken by BoS which have led to the use of public funds. Retroactive audit over the past 10 years.	2017 (law voted on 26/9/2017)	A draft law amending the BoS Act established rules for the auditing og BoS operations by the national Court of Audit.	ECB Opinion CON/2017/24. See also ECB Opinions CON/2016/24, and CON/2016/59 on earlier draft bills of a similar scope, and opinions CON/2015/57, CON/2015/8 and CON/2014/25 on relevant proposals submitted by the opposition.	Possible violation of the supervisor independence requirement under Regulation (EU) 1024/2013. Possible violation of the principle of legal certainty.
10	**EMU**	(1) Central bank independence (2) Prohibition of monetary financing	Prior to / upon accession to the EU	Judicial relief to holders of qualified bank credit	[2017]	Burden of proof reversed in that wrongdoing on the part of the BoS is assumed, unless proven otherwise, in combination with a lack of adequate safeguards concerning the standard to ascertain the BoS's due diligence. BoS de facto obliged to file a claim against the Republic of Slovenia in order to prove that the necessary due diligence was exercised when issuing the extraordinary measures of 2013.	ECB Opinion CON/2017/16. ECB Opinion CON/2017/41.	May result in BoS assuming the liability of the Republic of Slovenia for damages that are not directly applicable to BoS, in violation of the prohibition of monetary financing (Article 123 TFEU).
11	**Banking**	State aid	Prior to / upon accession to the EU	Judicial relief to holders of qualified bank credit	[2017]	A requirement to verify whether the methods and the basic premises underlying the methods used in the assessment of the conditions necessary for imposing extraordinary measures, as laid down in Article 253.a of the ZBan-1, were consistent with the standards of banking supervision adopted by the ECB, the European Commission and the EBA.		Depending on how this future law will be implemented in practice, there could be a risk undermining the effectiveness of the 2013 Banking Communication, in particular the burden sharing mechanism.
12	**Supervision of credit institutions**	Professional secrecy	2015 - 2017 (transposition of EU Directive)	Obligation on BoS to disclose asset valuations.	[2017]	Measure taken in the context of the draft bill on the judicial relief to holders of qualified bank credit.	ECB Opinion CON/2017/41.	Possible violation of articles 53 and 54 of Directive 2013/36/EU (professional secrecy and use of confidential information)

Sources: Compiled by the authors based on various sources as indicated for each item in the table.

Number	PM (at the time the reversal was voted) / party	References	IMF article IV assessment	OCED assessment	
			2016 p.12	2017 p.37	
8					
9					
10					
11					
12					
Sources					

Number	European Commission Country report	Press	EBRD
8			
9			
10			
11			
12			
Sources			

ANNEX A AN AGGREGATE INDEX-BASED ANALYSIS OF REFORMS AND REVERSALS IN FTES

As the development of the EBRD transition index shows (Charts A1 and A2), reform progress first accelerated. It then leveled off, either 2-3 years prior to membership (in 2004 or 2007), when preparedness had to be demonstrated to be included in the first membership round, or before the second membership round when the stakes were perhaps even higher as it became clear that future membership opportunities may be few and far between. The desire for EU membership not only accelerated reforms, it also made them more comprehensive, with reforms covering more policy areas, thus also strengthening their overall positive impact. In fact, reforms progressed also in areas not covered by the Transition Index, such as central bank independence and the banking sector, and in areas neither demanded nor protected by EU legislation, such as the reform of national public administrations (Meyer-Sahling, 2011).

Chart A1 Reform space filled in by countries in the first wave of EU enlargement, 1989-2004

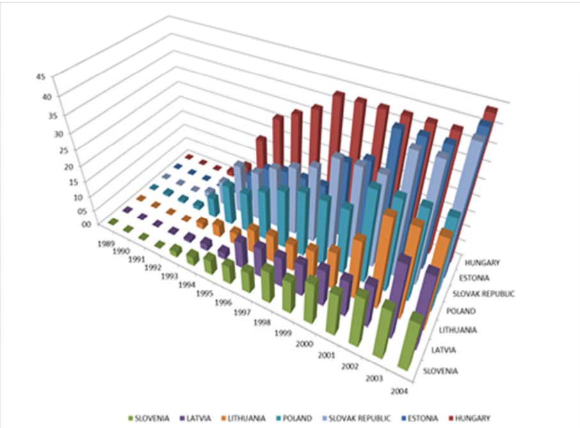
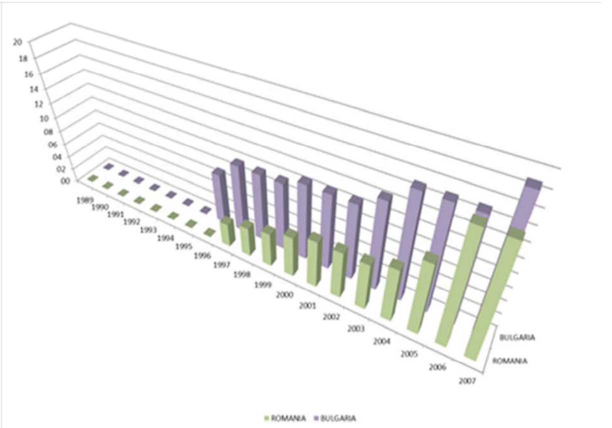


Chart A2 Reform space filled by countries in the second wave of EU enlargement, 1989-2007



Note: On the vertical axis the percentage share of reform space filled with measures is shown. Reform space is a multidimensional space spanned by the six individual subcomponents of the transition index and the space filled is the product of the individual indices, each measured as a percentage of the maximum progress in that area. As indices run from 1 to 4.33 the percentage is calculated as (X-1)/(3.3), where X is the value of the subcomponent as published by the EBRD. The space is fully filled (=100) if all subcomponents reach the maximum value (4.33) and remains zero as long as any of the subcomponents remains at the value of 1.
Source: Authors' calculations based on EBRD Transition Index

Following EU entry, EU membership very quickly lost its role as a reform catalyst (Chart A3) and further reform momentum was confined to rare and isolated episodes, mostly associated with the EU-IMF financial assistance programs during the crisis. From the viewpoint of our discussion, the only notable and important exceptions were the reform efforts of those countries that held the desire to join the euro area, such as Estonia, Latvia and Lithuania. For Latvia, the two factors coincided since their strategy was to move from program to euro area membership, a strategy that was eventually successful. As can clearly be demonstrated by the difference between the Baltic countries on the one hand and Slovenia and Slovakia on the other, it was not euro area membership in itself that promoted reforms. Rather it was the desire to join the euro area and the perceived importance of demonstrating reform efforts to the existing members before being accepted into the fold. The traumatic experiences during the crisis and the general reluctance on the part of existing euro area members towards euro area enlargement made the new applicants even more willing to demonstrate their commitment to reforms that improved their growth potential and strengthened the resilience of their economies. Nevertheless, a significant part of the reform space was not filled even by these countries.

Chart A3 Reform space filled by first-wave enlargement countries after entering the EU

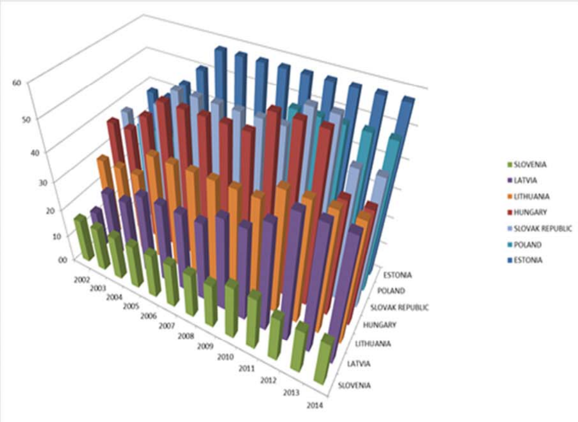
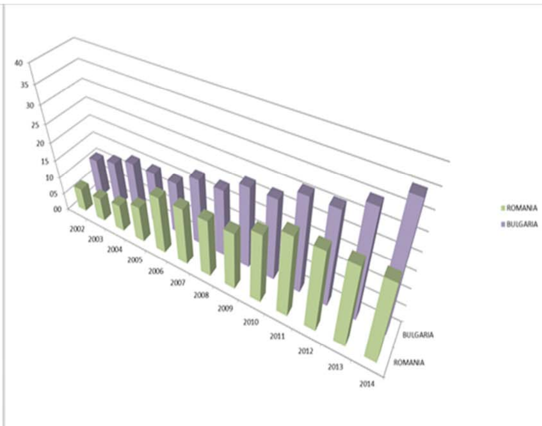


Chart A4 Reform space filled by second-wave enlargement countries after entering the EU



Note: On the vertical axis the percentage share of reform space filled with measures is shown. Reform space is a multidimensional space spanned by the six individual subcomponents of the transition index and the space filled is the product of the individual indices, each measured as a percentage of the maximum progress in that area. As indices run from 1 to 4.33 the percentage is calculated as (X-1)/(3.3), where X is the value of the subcomponent as published by the EBRD. The space is fully filled (=100) if all subcomponents reach the maximum value (4.33) and remains zero as long as any of the subcomponents remains at the value of 1.
Source: Authors' calculations based on EBRD Transition Index

Existing euro area members, on the other hand, gradually switched into reverse gear, into reform reversals - first Slovenia and later Slovakia (Chart A3). Slovenia tittered on the verge of an EU-IMF financial assistance program by mid-2013. In fact, it was the strong political desire to avoid a program and being classified as a country with excessive imbalances under the Macroeconomic Imbalances Procedure (see next section) that made the country ready to act and start addressing its problems with a set of ambitious policy measures.

Romania and Bulgaria seem to have followed a different reform pattern after entering the EU in 2007 (Chart A4). Both countries were subject to the Cooperation and Verification Mechanism (CVM)[30] and remained outside the Schengen Area.[31] Romania filled in some more reform space in 2010-2011, in the midst of the crisis, the first disbursing EU-IMF financial assistance program,

[30] When they joined the EU on 1 January 2007, Romania and Bulgaria still had progress to make in the fields of judicial reform, corruption and (for Bulgaria) organised crime. The Commission set up the Cooperation and Verification Mechanism (CVM) as a transitional measure to assist the two countries to remedy these shortcomings. For more information on the CVM see https://ec.europa.eu/info/strategy/justice-and-fundamental-rights/effective-justice/rule-law/assistance-bulgaria-and-romania-under-cvm/cooperation-and-verification-mechanism-bulgaria-and-romania_en

[31] The free movement of persons is a fundamental right guaranteed by the EU to its citizens. It entitles every EU citizen to travel, work and live in any EU country without special formalities. Schengen cooperation enhances this freedom by enabling citizens to cross internal borders without being subjected to border checks. For more information on the Schengen Area, see https://ec.europa.eu/home-affairs/what-we-do/policies/borders-and-visas/schengen_en

and thus at a time when the only source of financing for the country was from IFIs (Annex B). But reform reversals started in 2014 (see Section 4 and Table 3) under the, by then, mostly dysfunctional second precautionary EU-IMF program of 2013-2015. Bulgaria on the other hand, while showing continuous improvement was characteristically different in that it did not strive to join the euro area. The discussion in Section 4.3 on reform reversals in the banking and non-banking sectors nuances this picture somewhat, since the significant weakening of banking supervision and the rapid emergence of domestic banks with severe corporate governance problems pushed Bulgaria onto the verge of an international financial assistance program and into excessive macroeconomic imbalances under the MIP in 2015.

ANNEX B FINANCIAL ASSISTANCE PROGRAMS IN FTES

BULGARIA

IMF arrangements

Facility	Date of Arrangement	Expiration Date	Amount Agreed	Amount Drawn	Amount Outstanding
Standby Arrangement	Aug 06, 2004	Mar 31, 2007	100,000	0	0
Standby Arrangement	Feb 27, 2002	Mar 15, 2004	240,000	240,000	0
Extended Fund Facility	Sep 25, 1998	Sep 24, 2001	627,620	627,620	0
Standby Arrangement	Apr 11, 1997	Jun 10, 1998	371,900	371,900	0
Standby Arrangement	Jul 19, 1996	Apr 10, 1997	400,000	80,000	0
Standby Arrangement	Apr 11, 1994	Mar 31, 1995	139,480	116,240	0
Standby Arrangement	Apr 17, 1992	Apr 16, 1993	155,000	124,000	0
Standby Arrangement	Mar 15, 1991	Mar 14, 1992	279,000	279,000	0
		Total	2,313,000	1,838,760	0

Source: IMF.org

EU Balance of Payment Assistance Facility supported programs: None

CROATIA

IMF arrangements

Facility	Date of Arrangement	Expiration Date	Amount Agreed	Amount Drawn	Amount Outstanding
Standby Arrangement	Aug 04, 2004	Nov 15, 2006	99,000	0	0
Standby Arrangement	Feb 03, 2003	Apr 02, 2004	105,880	0	0
Standby Arrangement	Mar 19, 2001	May 18, 2002	200,000	0	0
Extended Fund Facility	Mar 12, 1997	Mar 11, 2000	353,160	28,780	0
Standby Arrangement	Oct 14, 1994	Apr 13, 1996	65,400	13,080	0
Total			823,440	41,860	0

Source: IMF.org

EU Balance of Payment Assistance Facility supported programs: None

CZECH REPUBLIC

IMF arrangements

Facility	Date of Arrangement	Expiration Date	Amount Agreed	Amount Drawn	Amount Outstanding
Standby Arrangement	Mar 17, 1993	Mar 16, 1994	177,000	70,000	0
		Total	177,000	70,000	0

Source: IMF.org

EU Balance of Payment Assistance Facility supported programs: None

ESTONIA

IMF arrangements

Facility	Date of Arrangement	Expiration Date	Amount Agreed	Amount Drawn	Amount Outstanding
Standby Arrangement	Mar 01, 2000	Aug 31, 2001	29,340	0	0
Standby Arrangement	Dec 17, 1997	Mar 16, 1999	16,100	0	0
Standby Arrangement	Jul 29, 1996	Aug 28, 1997	13,950	0	0
Standby Arrangement	Apr 11, 1995	Jul 10, 1996	13,950	0	0
Standby Arrangement	Oct 27, 1993	Mar 26, 1995	11,625	11,625	0
Standby Arrangement	Sep 16, 1992	Sep 15, 1993	27,900	27,900	0
		Total	112,865	39,525	0

EU Balance of Payment Assistance Facility supported programs to Estonia: None

HUNGARY

IMF arrangements

Facility	Date of Arrangement	Expiration Date	Amount Agreed	Amount Drawn	Amount Outstanding
Standby Arrangement	Nov 06, 2008	Oct 05, 2010	10,537,500	7,637,000	0
Standby Arrangement	Mar 15, 1996	Feb 14, 1998	264,180	0	0
Standby Arrangement	Sep 15, 1993	Dec 14, 1994	340,000	56,700	0
Extended Fund Facility	Feb 20, 1991	Sep 15, 1993	1,114,000	557,235	0
Standby Arrangement	Mar 14, 1990	Feb 20, 1991	159,210	127,370	0
Standby Arrangement	May 16, 1988	Jun 30, 1989	265,350	215,350	0
Standby Arrangement	Jan 13, 1984	Jan 12, 1985	425,000	425,000	0
Standby Arrangement	Dec 08, 1982	Jan 07, 1984	475,000	475,000	0
		Total	13,580,240	9,493,655	0

Source: IMF.org

EU Balance of Payment Assistance Facility supported programs to Hungary

On 4 November 2008, the European Council approved financial assistance of €6.5billion from the European Community under a balance of payments assistance facility approved, as part of a €20 billion financing package from the IMF, the World Bank and the EU.. A total of €5.5 billion in EU financial assistance was released, instead of the €6.5 billion initially scheduled.

On 21 November 2011, Hungary requested a second (precautionary) financial assistance from the EU and the IMF because of deteriorating financing conditions. The ECOFIN Council of 30 November agreed in principle to the request. Problems with the respect for independent institutions (notably the central bank) delayed the start of negotiations. Eventually, negotiations were limited to 1 official round from 17 to 25 July 2012 because Hungary was able to finance itself through the international market and did not request further assistance.

Source: European commission website on Financial assistance to Hungary: Information on Hungary's balance of payments (BoP) programme and post-programme surveillance, December 4, 2017
https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/which-eu-countries-have-received-assistance/financial-assistance-hungary_en

LATVIA

IMF arrangements

Facility	Date of Arrangement	Expiration Date	Amount Agreed	Amount Drawn	Amount Outstanding
Standby Arrangement	Dec 23, 2008	Dec 22, 2011	1,521,626	982,240	0
Standby Arrangement	Apr 20, 2001	Dec 19, 2002	33,000	0	0
Standby Arrangement	Dec 10, 1999	Apr 09, 2001	33,000	0	0
Standby Arrangement	Oct 10, 1997	Apr 09, 1999	33,000	0	0
Standby Arrangement	May 24, 1996	Aug 23, 1997	30,000	0	0
Standby Arrangement	Apr 21, 1995	May 20, 1996	27,450	0	0
Standby Arrangement	Dec 15, 1993	Mar 14, 1995	22,875	9,150	0
Standby Arrangement	Sep 14, 1992	Sep 13, 1993	54,900	54,900	0
		Total	1,755,851	1,046,290	

Source: IMF.org

EU Balance of Payment Assistance Facility supported programs to Latvia

The EU balance of payments assistance programme to Latvia was agreed in December 2008. Multilateral financial assistance of €7.5 billion was agreed, of which €4.5 billion was eventually paid out. The programme expired on 19 January 2012. The EU financial assistance was eventually disbursed in 4 instalments at a total of €2.9 billion, instead of the 6 instalments of €3.1 billion as initially scheduled.

Source: European commission website on Financial assistance to Latvia: Information on Latvia's balance of payments (BoP) assistance programme, post-programme surveillance and an overview of disbursements, December 4, 2017

Lithuania

IMF arrangements

Facility	Date of Arrangement	Expiration Date	Amount Agreed	Amount Drawn	Amount Outstanding
Standby Arrangement	Aug 30, 2001	Mar 29, 2003	86,520	0	0
Standby Arrangement	Mar 08, 2000	Jun 07, 2001	61,800	0	0
Extended Fund Facility	Oct 24, 1994	Oct 23, 1997	134,550	134,550	0
Standby Arrangement	Oct 22, 1993	Oct 24, 1994	25,875	5,175	0
Standby Arrangement	Oct 21, 1992	Sep 20, 1993	56,925	56,925	0
		Total	365,670	196,650	0

Source: IMF.org

EU Balance of Payment Assistance Facility supported programs: None

Poland

IMF arrangements

Facility	Date of Arrangement	Expiration Date	Amount Agreed	Amount Drawn	Amount Outstanding
Flexible Credit Line	Jan 13, 2017	Jan 12, 2019	6,500,000	0	0
Flexible Credit Line	Jan 14, 2015	Jan 12, 2017	13,000,000	0	0
Flexible Credit Line	Jan 18, 2013	Jan 13, 2015	22,000,000	0	0
Flexible Credit Line	Jan 21, 2011	Jan 17, 2013	19,166,000	0	0
Flexible Credit Line	Jul 02, 2010	Jan 20, 2011	13,690,000	0	0
Flexible Credit Line	May 06, 2009	May 05, 2010	13,690,000	0	0
Standby Arrangement	Aug 05, 1994	Mar 04, 1996	333,300	283,300	0
Standby Arrangement	Mar 08, 1993	Apr 08, 1994	476,000	357,000	0
Extended Fund Facility	Apr 18, 1991	Mar 08, 1993	1,224,000	76,500	0
Standby Arrangement	Feb 05, 1990	Mar 04, 1991	545,000	357,500	0
		Total	90,624,300	1,074,300	0

Source: IMF.org

EU Balance of Payment Assistance Facility supported programs to Poland: None

Romania

IMF arrangements

Facility	Date of Arrangement	Expiration Date	Amount Agreed	Amount Drawn	Amount Outstanding
Standby Arrangement	Sep 27, 2013	Sep 26, 2015	1,751,340	0	0
Standby Arrangement	Mar 31, 2011	Jun 30, 2013	3,090,600	0	0
Standby Arrangement	May 04, 2009	Mar 30, 2011	11,443,000	10,569,000	0

Standby Arrangement	Jul 07, 2004	Jul 06, 2006	250,000	0	0
Standby Arrangement	Oct 31, 2001	Oct 15, 2003	300,000	300,000	0
Standby Arrangement	Aug 05, 1999	Feb 28, 2001	400,000	139,750	0
Standby Arrangement	Apr 22, 1997	May 21, 1998	301,500	120,600	0
Standby Arrangement	May 11, 1994	Apr 22, 1997	320,495	94,265	0
Standby Arrangement	May 29, 1992	Mar 28, 1993	314,040	261,700	0
Standby Arrangement	Apr 11, 1991	Apr 10, 1992	380,500	318,100	0
Standby Arrangement	Jun 15, 1981	Jan 31, 1984	1,102,500	817,500	0
Standby Arrangement	Sep 09, 1977	Sep 08, 1978	64,125	64,125	0
Standby Arrangement	Oct 03, 1975	Oct 02, 1976	95,000	95,000	0
		Total	19,813,100	12,780,040	0

Source: IMF.org

EU Balance of Payment Assistance Facility supported programs

BoP precautionary assistance programme 2013 - 2015

The third EU BoP programme was formally agreed in October 2013 and expired in September 2015. It ran in parallel with an International Monetary Fund (IMF) stand-by arrangement (SBA). As with the 2011-13 BoP programme, the 2013-15 programme was treated as precautionary. It was not drawn upon. The precautionary assistance by the EU amounted to €2 billion

BoP precautionary assistance programme 2011 - 2013

In February 2011 a follow up joint EU/IMF precautionary financial assistance program was requested to support the re-launch of economic growth with a focus on structural reforms, while improving fiscal sustainability and consolidating financial stability.On 12 May 2011, the Council of the European Union adopted a decision to make available a precautionary medium-term financial assistance of up to €1.4 billion for Romania. EU assistance for Romania under the BoP facility was provided

BoP assistance programme 2009 - 2011

In May 2009 an agreement was reached to provide multilateral financial assistance to Romania with an overall amount of € 20 billion, consisting of the following contributors

- European Community, €5 billion under the BoP assistance programme
- International Monetary Fund, SDR 11.44 billion (around €12.95 billion) under an IMF Stand-by arrangement
- The World Bank, €1 billion under a development policy loan
- The EIB and the EBRD, €1 billion combined

Source: European commission website on Financial assistance to Hungary: Information about financial assistance programmes for Romania from 2009 onwards, and about post programme surveillance.EU Balance of Payment Assistance Facility supported programs to Romania, , December 4, 2017

https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/which-eu-countries-have-received-assistance/financial-assistance-romania_en

SLOVAKIA

IMF arrangements

Facility	Date of Arrangement	Expiration Date	Amount Agreed	Amount Drawn	Amount Outstanding
Standby Arrangement	Jul 22, 1994	Mar 21, 1996	115,800	32,150	0
Total			115,800	32,150	0

EU Balance of Payment Assistance Facility supported programs: None

SLOVENIA

Slovenia had no IMF arrangement or EU supported program.

ANNEX C NATIONAL FISCAL SYSTEMS IN THE EU[32]

National fiscal governance (or national fiscal framework) is a policy area which provides an excellent example of how EU legal requirements are able to shape essential mechanisms operating in the Member States. A national fiscal framework consists in the set of specific rules, procedures, arrangements, and institutions for budgetary policy in place in a Member State. The fundamental rationale of such framework is to support fiscal responsibility, understood as attaining sound budgetary positions, in particular by containing the deficit bias, and reducing the cyclicality of budget policy making.

The 2008-09 downturn revealed critical underlying issues in the fiscal positions of most Member States and acted as a wake-up call to the importance of robust fiscal frameworks as a driver of domestic budgetary discipline but also as a key pre-requisite for complying with the Member States' budgetary obligations derived from the Treaties, as reflected in the requirements of the Stability and Growth Pact. This crisis-enhanced awareness materialized in the gradual adoption of several legislative proposals, namely the Six-pack's Directive on requirements for national budgetary frameworks adopted in 2011, the inter-governmental Fiscal Compact signed in 2012 and the Two-pack's regulation on enhanced monitoring of budgetary plans adopted in 2013.

The above-mentioned EU level initiatives aimed at strengthening the basic 'building blocks' of fiscal frameworks, i.e. numerical fiscal rules, annual and multiannual fiscal planning and independent fiscal institutions. They provided a strong impetus for far-reaching reforms in virtually all Member States, which is evident in the way in which national fiscal frameworks have been introduced or revamped across the whole EU. Evidence shows that reforms primarily driven by the recently adopted EU legal requirements have touched in just a few years all the key elements of national fiscal frameworks:

[32] The authors are grateful to Stefan Ciobanu for his contribution to this section.

- The number and strength of national fiscal rules has been on a steep rise, with balanced-budget rules in structural terms becoming the central feature of reinforced fiscal frameworks in ¾ of the Member States.
- The scope, quality and transparency of annual budgeting and medium-term fiscal planning have been upgraded.
- Independent institutions have been set up (or reinforced) with a mandate to monitor public finances, in particular fiscal rules in force, and – in the euro area - to produce or endorse macroeconomic forecasts used for fiscal planning.

The above-trends are even more evident in the so-called "new Member States" which joined the EU as of 2004 ('EU-13'). The EU level requirements adopted in 2011-2013 provided a clear guiding thread for a raft of reforms which changed fundamentally the way in which the national fiscal policy making was taking place as well as the transparency of the budgetary process. Information available in DG ECFIN's Fiscal Governance[33] database reveals the extent and speed of the structural changes introduced by those Member States as against a before-the-crisis baseline characterized by generally rudimentary fiscal frameworks. To give just one example, it took five years for the index measuring the average strength of the design of national fiscal rules in EU-13 to close the significant gap versus the similar index for EU-15, whereas there significant improvements were registered in both groups of countries.

[33] https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/fiscal-governance-eu-member-states/what-fiscal-governance_en