

Europe in Transition

Lesson 3: ECONOMICS AND THE ENVIRONMENT

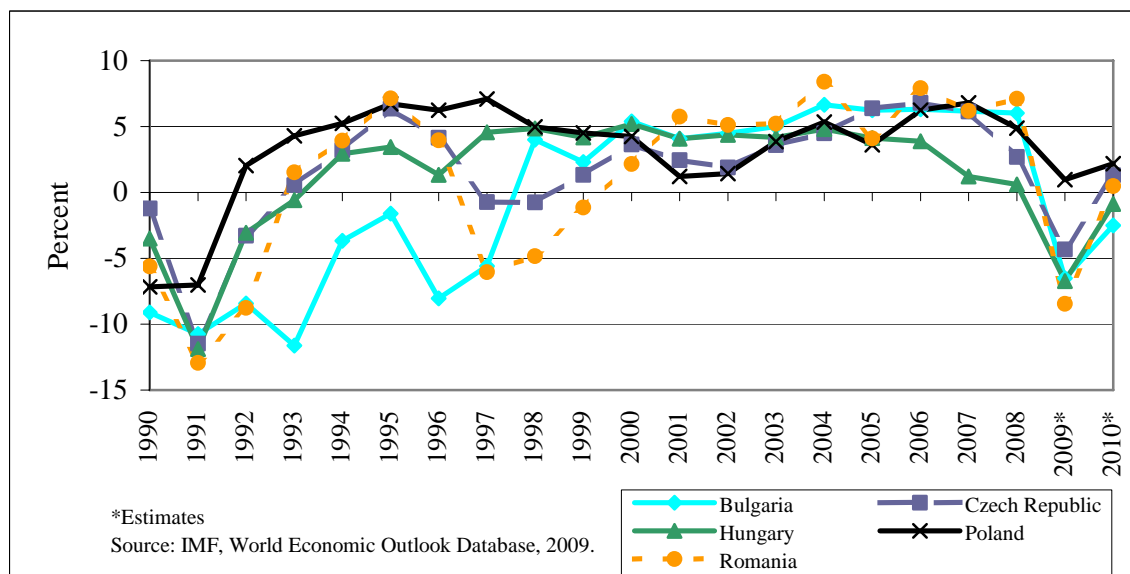
ECONOMIC REFORM IN CENTRAL EUROPE

(insert after "Conclusion" on page 129)

Because of the legacies of communist economics, moving the Central European states toward a Western-style market economy required dramatic measures. These measures initially triggered increased levels of unemployment and inflation. The reduction or loss of government welfare benefits made these economic strains all the more painful. Some countries, such as Bulgaria and Romania, were poor even by Central European standards and faced even more difficult situations. However, the promise of a more prosperous lifestyle and the hope of inclusion into the European Union helped many Central Europeans tolerate the hardships of economic reform.

Progress was seen even before eight Central European countries joined the EU in May 2004, and two more in 2007, with several already beginning to show significant economic growth (see Chart 1). Much of this growth can be attributed to how far behind economically the Central European countries were. However, the accomplishments of their governments should not be minimized.

Chart 1
GDP Growth in Select Central European Countries



CASE STUDIES OF CENTRAL EUROPEAN ECONOMIES

The Czech Republic

The Czech Republic can boast of one of the most developed and industrialized economies among the former communist countries in Central and Eastern Europe. Encouraged by the process of joining the European Union in May 2004, the country has undergone a number of economic reforms, such as reducing or eliminating trade barriers and improving infrastructure. The Czech Republic's skilled labor force has helped to attract

large inflows of foreign direct investment (\$10.4 billion in 2008).¹ Today, it has higher living standards than Portugal – a country from the wealthier Western Europe block.

Since 2008, to avert the country's growing debt, the **social welfare** system has undergone a series of tax and social policy changes. Welfare benefits, such as parental and sickness benefits and children allowances, as well as social security benefits for those with higher incomes, have been cut considerably; payments for prescriptions and doctor visits have been introduced. Despite reforms, the budget deficit is likely to exceed 4 percent of the GDP in 2010.²

The Czech Republic's economic transformation is still in progress. The government faces challenges in battling corruption, transforming the industry and housing sectors, adjusting the welfare system, and dealing with serious environmental problems. Still, the Czech Republic was not hit hard by the global financial crisis, and its economy is expected to grow by 1.3 percent in 2010.³

Slovakia

Under the leadership of reform-minded Prime Minister Dzurinda, many foreign businesses, including Volkswagen, Siemens, and U.S. Steel, began to take a renewed interest in the country. Between 1999 and 2000, foreign direct investment (FDI) skyrocketed from roughly \$350 million to more than \$2 billion. Slovakia's economic reforms helped the country join the European Union in May 2004 that encouraged even more investment from abroad. After the 2006 election of a left-wing government, which promised to soften Dzurinda's policy impact, FDI inflows shrank from \$4.7 billion in 2006 to \$3.4 billion in 2008,⁴ but still accounted for much of the economic growth during that period.

In 2008, due to the global economic slowdown, Slovakia's highly export-dependent economy began to contract, and shrank by 4.7 percent in 2009. However, it is expected to grow by 3.7 percent in 2010.⁵ This is a very good prospect when compared to the same year estimates for the United States (1.5) and a number of Western European countries, such as France (0.9), Germany (0.3), or Italy (0.2).⁶ Such recovery is partially driven by the fact that, in January 2009, Slovakia joined the European Monetary Union, which shielded Slovakia from some of the effects of the financial crisis.

Poland

The Polish economy has seen continuous growth since the mid-1990s, after it retracted under shock therapy. In 2008, it received 31 percent of all the foreign investment flowing into the twelve new EU member states.⁷ Indeed, since 1990, Poland has accumulated more than \$160 billion in foreign direct investment.⁸ Also, Poland's entrance into the EU has helped increase exports and has made significant EU development funds available to the country. Despite signs of slowdown in many areas of the economy, Poland managed to be the only country in Europe to get through the global financial crisis without stumbling into a recession in 2009. In fact, it enjoys one of the highest GDP growth rates in the EU. Today, Poland has the eighth-largest economy in Europe.⁹

Despite Poland's progress, problems remain. These include: ongoing obstacles in establishing the legal and bureaucratic institutions that are necessary for free-market capitalism; persistent corruption; high levels of unemployment (9.8 percent in 2008, and an expected 12 percent in 2010); an inefficient agricultural sector, which employs 17.4 percent of the Polish workforce, but accounts for only 4.5 percent of the country's GDP;¹⁰ and stalled reforms in the ship, coal, and steel industries. In his 2007 inaugural speech, new Prime Minister Donald Tusk promised to speed up Poland's economic reforms, but progress has been slow.

Hungary

With more than \$63 billion in FDI since 1989,¹¹ Hungary has been a leading recipient of the foreign direct investment in central and eastern Europe, although the level is beginning to go down. In 2004, after a series of successful economic reforms and a continuous close relationship with members of the European Union, Hungary joined the EU. Since then, the country has been struggling to meet the economic criteria necessary to adopt the euro. One of the most persistent problems has been a high budget deficit (roughly 10 percent of GDP in 2006).¹² Hungary's government was able to reduce it to 3.4 percent in 2008,¹³ but further proposed reforms, which would have included tax and price hikes, coupled with spending cuts and a radical health care package, prompted widespread social discontent. That same year, the opposition sponsored a referendum calling for the abolition of new fees for health care and higher education. An overwhelming 82 percent of the electorate voted to abolish the fees. The government's loss in the referendum was a setback for economic reform.

Furthermore, in 2008, Hungary experienced its most serious budget crisis since the fall of communism in 1989. Investor confidence plummeted and the *forint*, the country's currency, weakened. To respond to the crisis, the government enacted a series of economic reforms and spending cuts. While some taxes for businesses and employees were reduced, the value added tax (VAT) was raised, and the introduction of a property tax was proposed. In October of the same year, aiming to restore financial stability, Hungary reached an agreement with the IMF and EU for a rescue package of \$25 billion.

The combined effect of the Hungarian austerity program and the global financial meltdown pushed GDP growth down to -6.7 percent in 2009. The economy is expected to further shrink by 0.9 percent in 2010.¹⁴

Romania

Romania's economic situation started to improve in the early 2000s. After years of negotiations with the European Union, Romania joined the EU in January 2007. The pre-accession economic reforms, such as accelerated privatization, resulted in economic growth and a significant increase in foreign investment. Even with the global slowdown in 2001-02, Romania's economy averaged over 6 percent growth between 2001 and 2008.¹⁵ In 2008, the country attracted more than \$13 billion in FDI, more than twice as much as two years before.¹⁶ Still, these gains have not done enough to address the country's widespread poverty. Furthermore, 2009 left the newest EU member in a deep recession, with GDP growth for 2009 estimated at -8.5 percent, and the recession is

expected to last into 2010. In March 2009, to help the country weather the effects of a sharp drop in private capital inflows, the Romanian government agreed to a stabilization plan with the IMF and the EU. While Romania successfully joined the European Union, some question whether the country, one of the EU's poorest members, will be able to compete with its European neighbors any time soon.

Bulgaria

From 1998 till 2008, Bulgaria's economic growth was rather impressive: GDP grew by over 5 percent annually.¹⁷ In 2008, the country attracted \$9.2 billion in FDI – a remarkable difference from \$0.5 billion in 1998.¹⁸ Such stable improvement came partly from the fact that, as prime minister of the newly elected parliament in 2001, the country's former King Simeon II committed himself to keeping Bulgaria on the road to economic reform. Due to continuous economic changes in the country, the European Commission declared Bulgaria a "Functioning Market Economy" in 2002. In 2007, Bulgaria became a member of the European Union.

However, in 2008, the European Commission took the unprecedented step of suspending hundreds of millions of euros in aid as a response to Bulgaria's extreme levels of corruption and organized crime. Furthermore, the country's economy has been significantly damaged by the global financial crisis. In 2009, the GDP growth shrank by 6.5 percent and is expected to decrease by 2.5 percent in 2010.¹⁹ While progress is being made, Bulgaria remains the poorest country in the European Union, with low productivity, persistent corruption, high unemployment, and low living standards.

ECONOMIC TRENDS IN WESTERN EUROPE

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In the wealthier countries of Western Europe, prevailing economic trends are quite different. Key economic issues include those surrounding EU integration, and those surrounding the extensive social welfare programs found in much of the region.

The Economics of the European Union

(insert before "Social Welfare in Western Europe" on page 131)

The EU's foundations date back to the post-World War II period. At that time, a number of European countries hoped to promote peace and prosperity through economic integration. Today, the integration process continues, and includes such issues as the introduction of the euro, the future of national economic sovereignty, and the different levels of economic development among EU members.

The Introduction of the Euro. On January 1, 2002, the euro became the currency of the twelve euro-zone countries. By March 1, the national currencies of Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain had been completely withdrawn. Denmark, Sweden, and the United Kingdom, the other three members of the EU at the time, did not join the euro zone, adopting a "wait and see" stance. When the EU admitted ten new members in 2004, and two more in 2007, none initially adopted the euro due to stringent fiscal requirements. However, they are obligated to do so as soon as they meet euro-zone requirements. So

far, Cyprus, Malta, Slovakia, and Slovenia have adopted the euro as their currency.

Arguably, the euro has fostered much greater price stability across Europe, and has done much to increase trade and investment within the euro zone. During the third quarter of 2009, while a number of countries were still battling global recession, the euro zone recorded positive GDP growth, helped largely by export growth and improved industrial production in Germany. Still, challenges remain, including the region's continued slow economic growth and lingering questions concerning economic sovereignty.

Economic Sovereignty. One of the most prominent arguments against economic and monetary union is that it limits the ability of member states to make their own national economic decisions. Members of the EU have given up control over some aspects of their economic policymaking, such as setting external tariff rates and agricultural subsidies. Members of the euro zone have made even more sacrifices, handing over their monetary policy to the European Central Bank (ECB).

One part of economic sovereignty is fiscal policy. Fiscal policy includes government decisions to spend, or not to spend. Countries needing to stimulate economic activity generally want to spend money to stimulate growth. Countries experiencing strong growth generally want to balance their budgets. In 1997, the EU adopted the Stability and Growth Pact (SGP). This pact is designed to enforce budgetary discipline on the countries in the euro zone. Without budgetary discipline, countries could run up huge debts, causing significant zone-wide problems. In July 2002, Portugal became the first country in the euro zone to break from the SGP. France and Germany quickly followed suit.

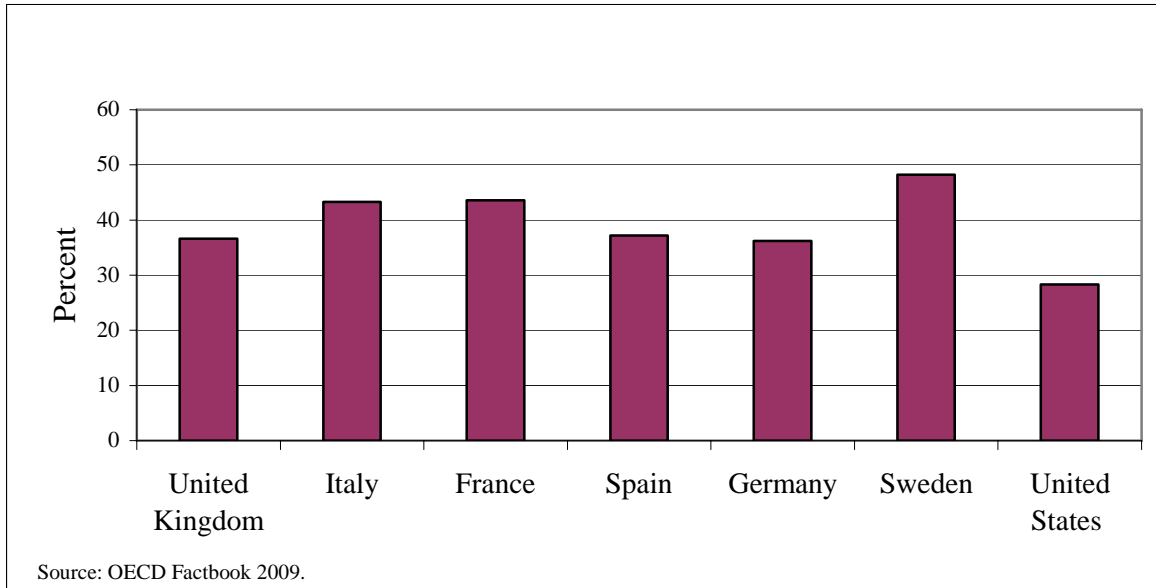
Initially, potential penalties for violating the SGP were severe. If a country exceeded an annual budget deficit of 3 percent of its GDP for three consecutive years, it faced fines from the European Commission reaching into the billions of euros. After much divisive controversy, in March 2005, an agreement was reached to relax the SGP. This agreement made it easier for countries in the euro zone to run temporary deficits if the spending serves a worthwhile goal. These goals include such needs as financing research and development, enhancing national defense, or restructuring the nation's economy. For example, worsening of the economic situation during the most recent global recession justified certain EU countries' spending to battle the economic slowdown and extended the deadline for the correction of the budget deficits.

Social Welfare in Western Europe

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Since they began rebuilding their societies and economies after the end of World War II, a number of Western European countries have created extensive social welfare systems. The primary objective of the Western European social welfare state is to create a "safety net" which protects the overall well-being of all members of the society. In these countries, governments provide large benefits in the areas of health care, education, pensions, and unemployment. To support these systems, tax rates in Western Europe tend to be high (see Chart 2).

Chart 2
Total Tax Revenue as a Percentage of GDP, 2007



In recent years, critics have called for the scaling back of Western European social welfare states; however, attempts to reform the systems are often difficult and run into strong public opposition. For example, in 2003, German Chancellor Gerhard Schroeder's government introduced a series of reforms called "Agenda 2010." The scheme included measures to reduce taxes, restructure health services, cut pension and unemployment benefits, and reform the labor market. The reforms, however, proved to be unpopular with the voters. In 2005, when Schroeder's Social Democratic Party (SPD) lost in an important regional election, the loss was attributed to the chancellor's controversial reforms. Subsequently, the government of Chancellor Angela Merkel has sought to introduce additional reforms and has presided over the rollback of those already implemented.

CASE STUDIES OF WESTERN EUROPEAN ECONOMIES

(insert before "Summary" on page 136)

In spite of increasing levels of economic integration, there are still great differences among the economies of Western Europe. For example, some countries have stronger social welfare systems than others. There are also different levels of economic growth and unemployment. Here we take a brief look at the economies of six Western European countries.

Germany

The German economy is Europe's largest, and the fourth largest in the world.²⁰ With a gross domestic product comprising 27 percent of the overall GDP of the 16 euro-zone states,²¹ the strength of the German economy is central to the future strength of the euro. Like many of its neighbors, Germany has a social-market economy, maintaining a sizable

state involvement in the economy and providing relatively generous social welfare programs.

A number of Germany's financial struggles stem from the reunification of its eastern and western spheres in 1990. While many other Europeans feared the economic and political might of a unified Germany, so far reunification continues to place a tremendous economic burden on the German economy. It has cost much more than predicted because of East Germany's decayed economic infrastructure, highly polluted environment, and cultural discrepancies between East and West. The former East Germany has failed to catch up to the West in terms of economic growth and output, in spite of tens of billions of dollars worth of annual aid from the German government. In November 2009, the East's unemployment rate was close to 12 percent, nearly twice that in the West, creating a national rate of 7.6 percent.²²

In 2008, Germany entered its deepest recession since World War II. However, by the summer of 2009, the country was one of the first European states to rebound from the global economic slowdown, boosting hopes of faster recovery in the broader euro zone. The estimate for Germany's GDP growth in 2010 is 0.3 percent.²³

France

France, the world's fifth-largest economy,²⁴ has strong service and industrial sectors. The country is the leading producer of farm goods in Europe and the fifth-largest exporter of agricultural goods in the world (after China, Germany, the United States, and Japan).²⁵

Taxes in France are among the highest in Europe, almost 44 percent of GDP in 2007 (see chart 2). Much of this money funds generous social welfare programs, including pensions, public housing, and subsidized health care. However, the French government has been taking some steps to reduce its role in the economy. For example, while the government has a long tradition of owning major industries, in recent years several have been sold.

Since taking office in May 2007, President Nicolas Sarkozy has worked on a number of pro-market reforms to improve economic growth and tackle persistently high unemployment (8.4 percent in 2007).²⁶ These reforms include tax cuts, flexibility in the implementation of the 35-hour workweek, and additional privatization. His efforts have been met with considerable opposition, mainly organized by the unions. For instance, in November 2007, hundreds of thousands of government, transport, and energy workers staged long strikes and protests against pay and job cuts and reforms of pension benefits.

In January 2009, massive strikes won promises of more than \$2 billion in new benefits for the low paid and unemployed. In March 2009, up to two million people marched against what they saw as the government's unjust economic policies. Demands, including higher minimum wages and protection from job cuts, will be hard for Sarkozy to meet. France's economy went into a recession in 2008, which lasted until the middle of 2009, accompanied by rising unemployment (9 percent in 2009). Cushioned by a considerable

fiscal stimulus package, the country's GDP is expected to grow by 0.9 percent in 2010, but unemployment is likely to top 10 percent.²⁷

Italy

Over the years, Italy has grown to become the world's seventh-largest industrial economy.²⁸ However, in 2007, it remained the slowest growing economy in the euro zone,²⁹ due in part to tight fiscal and monetary policies adopted prior to entry into the European Monetary Union. With much land unsuited for farming (agriculture generated only 2 percent of the country's GDP in 2008),³⁰ Italy is a net food importer. Its economy is based primarily on tourism, machinery, ceramics, chemicals, fashion, iron and steel, machine tools, and textiles. However, the country's underground economy is estimated at about 27 percent of Italy's GDP.³¹ This includes the Mafia, which earned \$167 billion, or roughly 8 percent of Italy's GDP in 2008.³² This money is not subject to taxation and thus remains a source of lost revenue to the country's government.

In many respects Italy is economically divided. In the prosperous north, privately-owned industry is the norm, with large numbers of small and medium-sized enterprises, particularly in the fashion-related sectors of jewelry, furniture, and clothing. Italy has relatively few large private companies, but those that do exist, such as Fiat and Pirelli, carry great weight in the economy. The largely agricultural south is poorer and less developed. Unemployment is a major problem in this region, comprising roughly twice the national average of 6.8 percent in 2008.

Italy was one of the first EU countries to enter a severe recession in 2008, but towards the end of 2009, the economy started to rebound. In 2010, the GDP is expected to grow by 0.2 percent; unemployment, however, is likely to top 10 percent.³³ Italy's debt-to-GDP ratio, which measures country's federal debt in relation to its gross domestic product, and which is already one of the highest in the world, is set to climb to 120 percent. The main provision in the government's "anti-crisis" package in 2009 was a 12-month, 50 percent tax break on reinvested profits. This is not expected to encourage much-needed consumer spending.

The United Kingdom

Once the world's leading industrial power, the United Kingdom remains economically strong. It has the world's sixth-largest economy in terms of GDP,³⁴ and in 2008, it was the second (after the U.S.) largest recipient of foreign direct investment worldwide.³⁵ The UK has an especially strong service sector (particularly banking, insurance, and business services). Over the past ten years, its industrial output has declined slightly, but it is still important. Britain's capital, London, is one of the world's leading financial centers.

In recent years, the United Kingdom's economic growth, for the most part, has been concentrated in London, eastern England, and Scotland. Other areas, such as Wales and Northern Ireland, have not seen as much growth. Nevertheless, the United Kingdom's 2008 unemployment rate of 5.5 percent remained lower than the rates in many other European countries.³⁶ This lower rate is attributed to the country's strong economic growth, fewer labor regulations, and smaller social welfare state than that of many other

European countries.

After taking office as prime minister in June 2007, Gordon Brown has faced the danger of an economic slowdown and rising inflation. Like the United States, the UK has experienced a severe housing crisis and a credit crunch. In order to ward off recession, Prime Minister Brown has proposed some economic change, such as tax cuts, banking reform, and assistance for first-time home buyers. Despite these precautionary measures, the United Kingdom's economy hit a recession in 2008, accompanied by rising unemployment (7.8 percent in September 2009).³⁷ In response, the British government implemented an extensive recovery plan, which included a fiscal stimulus package, credit stimulus schemes, and financial sector support. While the economy is set for recovery, the road uphill will be bumpy with GDP expected to grow by 0.9 percent in 2010.³⁸

The Republic of Ireland

Until 2008, Ireland had one of the most vibrant economies in the world, helped by booming exports and substantial levels of foreign direct investment. After Ireland's *punt* was replaced by the euro in 2002, house prices soared, the building sector boomed, and cheap credit became available. In fact, between 2004 and 2007, the country outperformed the original 15 EU member states in GDP growth.³⁹ Fast economic development encouraged immigration. Interestingly, Ireland went from being 95 percent ethnically Irish Catholic in the early 1990s to having non-nationals comprising roughly one-fifth of the population in 2009.⁴⁰

However, the housing bubble burst, and in October 2008, Ireland became the first country in Western Europe to officially fall into recession in the wake of global financial crisis. Within a year, the GDP had shrunk by 8 percent.⁴¹ In an attempt to curb the crisis, the Irish government announced draconian cuts in government spending, including significant reductions in public-sector pay and welfare payments. Moreover, a "bad bank" bill was passed that would pay the country's largest banks more than \$80 billion for troubled real estate loans. Despite the government's efforts, Ireland's economy is expected to continue with a negative growth of -2.5 percent, and unemployment rates as high as 13 percent in 2010.⁴²

Sweden

The Swedish government plays a strong role in funding social services related to education, health, old age, disability, and unemployment. To cover the expenses associated with these benefits, Swedes must pay high taxes. Workers earning an average wage of \$34,000 turn over almost 50 percent of their income to the government. Those earning \$56,800 or more find themselves in the highest tax bracket of 56 percent.⁴³ But in spite of this great cost, the Swedish economy has been able to grow and thrive, thanks in large part to the presence of export-competitive industries such as shipbuilding, automobiles, telecommunications, paper, and iron and steel. Swedish companies that have established international reputations include Volvo, H&M, and Ericsson.

Sweden has not been affected by the global financial slowdown to the same extent as the United States and a number of European countries, since Swedish banks have been more

restrictive with loans due to lessons learned from the financial crises in Sweden during 1990 and 1994. While it went into recession in 2008, the economy has rebounded and is expected to grow by 1.2 percent in 2010.⁴⁴

THE ENVIRONMENT

(insert before “Summary” on page 140)

Protection of the environment continues to be one of the most important concerns for European Union legislators and the overwhelming majority of European citizens. A 2008 Eurobarometer survey shows that more than 95 percent of Europeans feel that it is important to protect the environment, and over two-thirds prefer policy decisions on the environment to be made at the European Union level rather than the national level.⁴⁵ Climate change, water and air pollution, man-made disasters, and the use of chemicals in everyday products have been identified as top environmental concerns for Europeans.

In 2002, the EU adopted the 6th Environmental Action Programme (6EAP), which outlines ambitious environmental goals and sets priorities for action for the period 2002–2012. The 6EAP sets four priority areas: combating climate change, protecting biodiversity and nature, reducing environmental impacts on health, and sustainable management of natural resources and waste. The new member states that joined the EU in 2004 and 2007 are required to adopt all existing environmental policies and comply with EU environmental standards. The cost of this compliance has been estimated at \$157 billion, as the cleanup from years of communism continues.⁴⁶ Although Central European countries still have a lot of environmental problems, there are early signs of significant improvements. For example, water quality in the new member states, except for Hungary, Romania, and Bulgaria, nears EU standards.

In an effort to limit global climate change, in March 2007, EU leaders endorsed an integrated energy and climate change policy. The goal of this policy is to move toward a climate-friendly economy based on low-carbon technologies and energy sources. As part of this policy, the EU has raised its goal of cutting 1990 levels of greenhouse gas emissions from a reduction of eight percent by 2012 to twenty percent by 2020.⁴⁷ By setting high environmental standards, the EU hopes to become the world leader in ecotechnologies, and to establish an example in the area of environmental protection for other countries to follow.

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