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Why Eastern Europe Acted So Responsibly

He who has clean hands and a pure heart, who has not lifted up his soul to falsehood and has not sworn deceitfully.

—Psalm 24:4

Eastern Europe stands out for its virtuous fiscal and structural policies. At the end of 2008, the CEE-10 countries had an unweighted average public debt of 27 percent of GDP compared with 58 percent of GDP in the EU-15. These new EU members kept their public deficits small thanks to comparatively low public expenditures. Their taxes were generally moderate, especially corporate profit taxes, which were around 19 percent, and personal income taxes were mostly flat in the range of 10 to 23 percent.

After the crisis hit, virtually all countries in the region pursued a responsible economic policy. They had no room for additional fiscal stimulus but cut public expenditures and salaries as they found necessary. In spite of the crisis hitting Eastern Europe slightly more severely than Western Europe, thus undermining their state revenues more, the CEE-10 countries had an average budget deficit of 5.7 percent of GDP in 2009 compared with 6.5 percent in the wealthier EU-15.

Many observers worried that the crisis would provoke social unrest in the European transition countries, but it has been minimal. A few incidents occurred—minor riots in Riga on January 13, 2009 and similar protests in Vilnius the next day, but the unrest stopped there. Also, strikes and other social upheavals have been rare. The biggest might have occurred in Romania in May 2010 in a second round of cuts, involving public-sector wage and pension cuts.

Strong Center-Right Tendency in Elections

In early June 2009, all EU countries elected a new European Parliament. Participation in these not very important elections tends to be low, and protest votes for populist or extreme parties are common, but they reflect the political mood. The big winners in the 2009 European elections were the center-right parties, which stood for fiscal constraint and free markets. Together the center-right parties and the liberals won a substantial majority in every single CEE-10 country. The biggest winner in the region was Poland's ruling center-right party, Civic Platform. The hard right benefited in only two countries, the Jobbik party in Hungary (14.8 percent of the votes) and the Greater Romania Party in Romania (8.6 percent), which is not much in comparison with Jean-Marie Le Pen's National Front in France. The big losers were the remaining socialist parties, while the communist parties had already been eliminated. The voters clarified that they wanted stricter market economic policies, and the protest vote surprised with its near absence.

The democratic process in the CEE-10 has continued to function as before. No regime change has occurred, though several countries have changed governments, and they have done so in a normal democratic manner. Government changes have been frequent after the end of communism. Traditionally, the three Baltic states, Poland, and Bulgaria have altered government almost every year. The changes of government have not been dramatic, but their overall tendency is clearly center-right favoring more resolute crisis managers.

Elections in Eastern Europe focus on corruption, and voters rightly judge the incumbents as guilty, so the loss of the incumbent government is standard. But the financial crisis has been a major theme in recent national parliamentary elections. The political trend has been overwhelmingly toward the center-right parties, which have won in nearly all the CEE-10 countries. Eight changed government in the 22 months from September 2008, and in seven countries the same forces were victorious. As of August 2010, only one CEE-10 country, Slovenia, has a center-left government, while the nine others have center-right governments. The moderate right has grown stronger than ever because of the crisis and has won and advocated stricter fiscal policies, with Hungary being a possible exception where a right-wing populist party rules.

Lithuania. In October 2008, the socialist government lost parliamentary elections to a center-right coalition led by the Homeland Union party, whose leader Andrius Kubilius became prime minister.

Latvia. In February 2009, the rather oligarchic Latvian center-right government under Ivars Godmanis collapsed and was replaced with a more free-market center-right government under Valdis Dombrovskis, although its parliamentary base was similar.

Bulgaria. Ordinary parliamentary elections on July 5, 2009 led to the ouster of the center-left government by the new center-right party Citizens for European Development of Bulgaria, headed by Boyko Borisov, who became prime minister with a big majority.

Romania. Close presidential elections in November and December 2009 eventually led to the victory of the incumbent center-right President Traian Băsescu, and a renewed center-right government under Prime Minister Emil Boc tightened fiscal policies.

Hungary. The socialist government of Ferenc Gyurcsány fell at a party convention in March 2009 because of its prior fiscal irresponsibility and his statement that he had been systematically lying. His government was quickly replaced by another socialist government led by Gordon Bajnai, which carried out a radical fiscal restructuring. It was devastated in the parliamentary elections in April 2010 by Viktor Orbán's center-right Young Democrats party, which won on a populist platform and currently appears the least fiscally responsible government in the region.

Czech Republic. The center-right government of Mirek Topolanek fell in March 2009 in a vote of no confidence. His government was fatally wounded by a series of scandals rather than by any looming financial meltdown and also by personal opposition from fellow conservative President Václav Klaus. The outcome was a nonpolitical caretaker government, and economic policy did not change. In April 2010, three center-right parties—two of them new anticorruption parties—unexpectedly won a big victory.

Slovakia. A center-left populist three-party coalition government sat firmly until the parliamentary elections in June 2010, which were won by three center-right parties, contrary to expectations, just as in the Czech Republic.

Slovenia. The only exception to the center-right trend was Slovenia, which held parliamentary elections on September 21, 2008, just before the financial crisis broke. The social democrats became the biggest party, formed a new center-left coalition, and took over from the incumbent center-right coalition, while economic policy hardly changed.

Causes of Popular Fiscal Restraint

The CEE-10 countries were hit by tremendous shocks of GDP declines. Yet their populations did not protest but opted for more determined right-wing governments, which favored strict fiscal policies and market-oriented structural reforms in the midst of the crisis. This picture runs counter to much of the current academic writing on political economy along the ideas of "rational expectations" and "tradeoffs" between different social groups. Yet voters were not looking for their own marginal benefits but for a viable future of their nations.

Why did these nations behave so responsibly? Quite a few alternative explanations are possible. One can distinguish between at least four groups of explanations: excellent prior growth, concerns about national sovereignty, recent experiences of crises, and equitable reform programs.

All of Eastern Europe had enjoyed nearly a decade of high economic growth from 2000 to 2007. Many thought that they had just been too lucky and that a severe setback was inevitable. In this, the East Europeans seem similar to the South Koreans, who took their hardship in 1997–98 with the same surprising equanimity. After all, the average growth of Eastern Europe even including the crisis was 42 percent for the decade.

The Baltic states, in particular, which were new nations, remained concerned about their national sovereignty. They had been parts of the Russian or Soviet Empire for most of the time since the early 18th century, and they did not want to risk their independence again. They feared the financial crisis could undermine their sovereignty and stood up for their nations.[1]

The political economy of crisis differs greatly from that in ordinary times, and these nations knew how to handle crises. They had all undergone transition from socialism to capitalism, and all but Hungary had experienced severe inflationary crises after the end of communism. They also had experienced political crisis managers, whose careers revived when the crisis arrived, such as Lithuania's Prime Minister Andrius Kubilius, Latvia's Finance Minister Einars Repse, and Romania's omnipresent Mugur Isărescu. As the *Financial Times* put it: "The vicious 1990s post-Soviet slump made Latvians hardily resourceful."[2] Both people and leaders were prepared to do what was necessary.

The ideological wind was clearly liberal right-wing: favoring a somewhat purer market economy and a moderate retrenchment of the social welfare state. The Central and East European financial crisis is remarkable for everything that did not happen. There was no significant reaction against globalization, capitalism, the European Union, or the euro. The biggest losers were the irresponsible socialists in Hungary and the irresponsible oligarchs in Latvia. The big winners were the moderate center-right forces. The sensible Central and East European public wanted decisive action from their leaders to resolve their problems. This was reminiscent of the political economy of postcommunist transition, when radical reform and democracy went hand in hand.

Both ideology and organizations of the left had been severely weakened. In his book *The Rise and Decline of Nations*, Mancur Olson argued that countries that had suffered a major catastrophe, such as Germany and Japan during World War II, abandoned obsolete institutions that impeded

1. In 1994, Jacek Rostowski taught me that people do not care about financial stability on its own. The key to convincing them that financial stability is vital is to explain its significance for national sovereignty.

2. "The Lex Column: Greece/Latvia," *Financial Times*, May 7, 2010.

development and built new, better institutions.[3] In the same fashion, the new EU states had rid themselves of all obsolete institutions. Similarly, big capitalists were uncommonly weak after the old, big Soviet enterprises had collapsed.

The public and leaders in several of these countries stood remarkably firmly against devaluation. The political economy of devaluation seems to be poorly understood. The main capitalists, who are the biggest exporters, have the most to gain from devaluation, which would lead to greater income disparity. The majority of the population in the countries with fixed exchange rates preferred "internal devaluation" with wage cuts and deflation, presuming that their social cost would be less. Therefore, the currency boards of Estonia, Lithuania, and Bulgaria enjoyed amazing popularity and turned out to have many institutional strengths. They forced their governments to stay transparent and honest, especially checking their fiscal balance. Remarkably, Bulgaria, which the European Commission accused of being under the sway of organized crime, maintained a fiscal surplus until 2009.

The main opponents of radical fiscal adjustment, during both the postcommunist transition and the financial crisis, were the rent-seeking oligarchs or red entrepreneurs, typified by young communists who had made their money through dubious insider privatization or asset stripping—that is, seizing public enterprises or property by questionable means. Hungary, Romania, and Bulgaria suffered from the presence of big networks of more or less criminalized red entrepreneurs. Latvia had three oligarchs, who each controlled one center-right party and opposed fiscal tightening, while intermittently favoring devaluation.[4] As Joel Hellman noted on postcommunist transition, the main threat was not the people but the few rent-seeking winners. While they were the winners of postcommunist transition, these rent seekers appear the losers of the financial crisis.[5]

Most political scientists have perceived the fragmented parliamentary systems and their lack of stability as a problem, but these systems appear to have been beneficial for crisis resolution. In Hungary, one reformist socialist prime minister was replaced by a much more reformist socialist leader. Similarly, Latvia went through three center-right prime ministers, each more determined to resolve the crisis than his predecessor, like Winston Churchill replacing Neville Chamberlain as conservative British prime minister in 1940. East European politics would not have functioned

3. Mancur Olson, *The Rise and Decline of Nations* (New Haven: Yale University Press, 1982).

4. They were Aivars Lembergs (mayor of Ventspils), Andris Skele (former prime minister), and Ainars Slezers (former minister of transportation).

5. Joel Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions," *World Politics* 50, no. 2 (1998): 203–34.

so smoothly if these countries had had presidential systems with a president of a precrisis mind. These multiparty coalition governments adopted and carried out the radical public expenditure cuts and structural reforms that were necessary, proving their efficacy. The fragmentation was no obstacle but made more forceful policies possible. The least successful country has been Hungary, which stands out for having the greatest party consolidation and the most stable and long-lasting government.

Finally, the European Union had great and varied impact on its new member countries, which had acceded to the European Union in 2004 and 2007. In the 1990s, the candidate countries benefited from greater market access to the vast European market. As the accession process became serious, they were forced to adopt all the rules and regulations of the now 125,000 pages of legal text in the *acquis communautaire*. Most of it was beneficial improvement of legislation. As accession took place, a tremendous integration of trade and investment occurred, which contributed to high economic growth but also to the financial bubble. The Maastricht criteria or the Stability and Growth Pact were taken more seriously in the east than in the EU-15, since the easterners had to comply with the convergence criteria to be allowed to adopt the euro. The new East European EU members, the CEE-10, were stalwarts of EU standards.

These conclusions go against the grain of much of the academic writing on the political economy of reform, which has not stood this empirical test. First, it does not appear to be desirable to have a stable government in the midst of the crisis. On the contrary, a government that is perceived as the cause of trouble should be ousted as soon as possible. If its successor does not deliver, it should be sacked as well, or at least be disciplined by such a threat. Second, the worst form of stability is a steady presidential mandate. Therefore, a parliamentary system appears better suited to handle a severe crisis than a presidential one. Third, multiparty coalition governments seem more adept at handling severe crises than one-party majority governments (as in Hungary).