

UNIVERSITY OF TARTU
Faculty of Social Sciences and Education
Centre for Baltic Studies

Péter Leányfalvi

**DIFFUSE SUPPORT AND BUDGET DEFICIT:
EVIDENCE FROM ESTONIA AND HUNGARY**

Master's thesis

Supervisor: PhD Viktor Trasberg

Tartu 2010

Abstract

The current paper investigates why persistent differences exist among countries in their ability to pursue disciplined fiscal policy. It contributes to the literature that emphasizes the importance of multidisciplinary approach in understanding economic phenomena. An existing theory - that focuses primarily on old EU member states – is used as framework. In the first part of the paper the theory's general applicability to the Central and Eastern European Region is tested. In line with the framework theory's suggestion, evidence from 10 Central and Eastern European countries shows that in the absence of extreme external factors, that would push governments towards fiscal restraint, the key to persistent fiscal discipline is a favorable institutional setting (adequate fiscal rules). It primarily depends on certain domestic political and social factors whether this institutional setting is created in a country. The framework theory emphasizes the importance of consensus within the elite and diffuse support in the society towards the political system. In the second part the cases of Estonia and Hungary (the two extremes of fiscal performance in the region) are compared and the results support the validity of the above suggestions. Nevertheless the theory has major shortcomings in the operationalization of diffuse support, which is essential for general applicability. Based on the results of the case comparison the current paper suggests that focusing on attitudes regarding the previous political system is a promising direction for further research on the operationalization of diffuse support as far as post-communist transition countries are concerned.

Contents

1. INTRODUCTION	3
1.1. The goal and relevance of the research	3
1.2. Choosing the framework theory	5
1.3. The theory	8
1.2.1. External and domestic factors	10
1.2.2. Trust and diffuse support	12
1.2.3. Four types of states	13
1.2.4. Assessment of the theory	15
1.3. Methodology	16
1.3.1. Structure of the research	16
1.3.2. Estonia and Hungary as optimal cases for comparison	17
2. FISCAL RULES	20
2.1. The theory's suggestions regarding fiscal rules	20
2.2. Fiscal rules in Central and Eastern Europe	22
2.2.1. Conceptualization of fiscal rules	22
2.2.2. Budgeting rules in Central and Eastern Europe	25
2.2.3. Creating and testing the aggregate index	29
3. EXTERNAL FACTORS	34
3.1. The theory's suggestions regarding external factors	34
3.2. External pressure in Central and Eastern Europe	35
3.3. Currency board arrangements	38
3.3.1. Currency boards as incentives for persistent consensus	39
3.4. Currency board arrangements and fiscal rules	44
4. CONCLUSION OF FISCAL RULES AND EXTERNAL PRESSURE	46
5. DOMESTIC FACTORS AND DIFFUSE SUPPORT	49

5.1. The theory's suggestions regarding domestic factors	49
5.2. David Easton's concept	52
5.2.1. Support, its objects, and stress on support	53
5.2.2. Specific and diffuse support	54
5.2.3. Dimensions of diffuse support	56
6. DOMESTIC FACTORS IN ESTONIA AND HUNGARY	59
6.1. Overview of the past two decades	59
6.2. Elite Consensus	63
6.2.1. Consensus in Estonia	64
6.2.2. Consensus in Hungary	68
6.3. The background of consensus	72
6.4. Summary of findings	81
6.5. Suggestions for operationalization	83
7. CONCLUDING REMARKS	90

1. INTRODUCTION

1.1. The goal and relevance of the research

The issue of budget deficits and more generally fiscal policy has central importance in economic discourse. The provision regarding budget balance forms a crucially important part of the European Monetary Union's Maastricht criteria and the fact that precisely this element seems to cause the biggest problem for most member states and that this issue is so widely discussed certainly underlines its importance. At the same time it is a rather controversial topic that has sparked endless debates. What is the right fiscal policy to conduct? What level of budget deficit is still acceptable? How to determine sustainability in fiscal policy? What is the best way to measure deficits? What is the best way to finance deficits? These are only examples of the questions economists have been trying to clarify. Nevertheless it seems to be clear that persistently high budget deficit is harmful for the economy thus – at least on the long-run – it has a negative effect on the wellbeing of the society. Most recently the Greek crisis has drawn attention to the dangers of profligate fiscal policy, where years of overspending created an enormous debt pile whose weight now seems to crush the economy. The current topicality of fiscal policy certainly makes research about the underlying reasons of budget deficits relevant. The motivation behind this paper lies however not in current Greek or world events, rather in another negative example: the case of Hungary demonstrates well the long-term problems that persistently high budget deficit can cause.

Hungary has been a front runner in the political and economic transition throughout the '90s yet development has clearly lost steam in recent years. In many respect Hungary has fallen from the position of being “the best performer in the class” to the bottom of the group of transition countries. High budget deficit, although to a

varying degree, has constantly been a major macroeconomic problem of Hungary during the past two decades of transition. As the country's worsening performance - particularly vis-à-vis other transition countries in the region - became more and more obvious the deficit problem received increased attention from economists, as well as politicians, journalists and the public. In 2008 a group of leading experts has conducted a widely debated study to identify the causes of problems in the Hungarian economy and to provide policy recommendations. The conclusion of the study – in a somewhat simplified way - was that the economy is trapped in a vicious circle where the pressure induced by high budget deficit pushes governments to raise taxes (mainly on labor) which then suffocates the labor market and slows economic growth. Without substantial economic growth in turn it is impossible to lower the high budget deficit. (Barabás et al [2008]) While it was not the authors' aim to reduce explanation of all problems to one single factor, nevertheless an important conclusion of the study is that - through the above mechanism – persistently high budget deficit substantially reduces the economy's mid- and long-term growth potential. From a Hungarian perspective therefore it is a highly relevant question why certain transition countries managed to maintain fiscal restraint while Hungary has been persistently pursuing lax fiscal policies.

Although it might seem that budget deficit and fiscal policy are issues where economics has the first and foremost relevance, a purely economic approach is often insufficient to explain the true reasons behind differences in fiscal performance of countries. Therefore the current research uses an existing theory as framework wherein the political and social aspects are given priority in examining potential determinants of fiscal performance. The goal of the research is twofold:

(1) Applying the theory to the cases of Hungary and Estonia to identify social and political factors that influence persistent differences of the two countries in their fiscal performance. The results shall be used to alter and suggest amendments to the theory. (2) At the same time the theory's applicability to the Central and Eastern European transition countries will be tested in order to prepare ground for further research in this direction.

The aim is not to come up with a holistic explanation for such complex issue as budget deficit or fiscal policy. Clearly for that goal a much wider focus is required and a much greater number of factors need to be taken into consideration. Instead the current paper investigates how budget deficit and fiscal policy is connected to areas that are not in the focus of economists, but still can provide valuable information for better understanding the nature of fiscal policy and deficits. It is certainly not implied that factors outside the focus of this research are irrelevant, rather the goal is to prove that issues discussed here are also highly relevant.

For the purpose of the current research fiscal performance is defined as the level of general government budget deficit (or surplus), that is general government's net borrowing (or net lending). Data provided by the European Commission will be used, primarily. Central and Eastern European transition countries include the 10 new European Union member states that joined in 2004 and 2007, that is Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Romania and Bulgaria. The time period in focus is the period of transition up until present days, roughly 20 years. The starting point of the transition period varies among the 10 countries. A convenient starting point could be 1989, the year of major political changes in Central Europe. However on one hand many of the countries in question weren't even independent at that time, on the other hand profound changes have occurred already prior to 1989 or prior to the date some countries officially gained independence. Since comparable, uniform data is only available since 1995, the ambiguity of an exact starting point is not a major problem.

1.2. Choosing the framework theory

Economists and other social scientists have always struggled to find explanations why in certain periods of history certain countries or group of countries managed to develop much faster to a much higher level than others. Cases are even more curious, where this difference appears between countries that seem to enjoy (or suffer) similar initial conditions. Unfortunately it can not be claimed that today we have the knowledge to provide exact answers. In retrospect we seem to be able to find the

relevant factors behind the success or failure of one or another country, yet future predictions even in the medium run are proven to be absolutely wrong far too often.

It has a long tradition in social sciences to explain such differences in development by factors that are outside the focus of classical economics, such as history, society, institutional setting, etc. Nils Goldschmidt [2006] has called this the cultural approach to economics. Culture has been considered as key factor in economic development by such classics as Max Weber, Friedrich Hayek or Joseph Schumpeter. From more recent times authors like Francis Fukuyama, Samuel Huntington or Robert Putnam can be highlighted as illustrious figures of this approach.

Another very important scholar is Douglass C. North, who in 1993 received the Nobel Prize for his achievements in new institutional economics. In his works North deals with the importance of institutions in economic performance. He distinguishes two types: formal and informal institutions, the latter being unwritten, social norms, “a part of the heritage that we call culture”. His work is particularly relevant for transition countries. According to North’s theory the decisive factor in the success of a transition is how the imported formal institutions (i.e. market capitalism and liberal democracy) interplay with the informal institutions of a given society. (North [2005]) This approach has been applied to Central and Eastern Europe by several authors, see for example Pejovich [2006], Winiecki [2004], Norkus [2007] or Zweynert and Goldschmidt [2005]. All of these works emphasize the cultural background of societies, more precisely whether this background is compatible or not with western capitalism, as relevant factor that influences the success or failure of these countries in the transition process.

While this “cultural” approach certainly provides an interesting and valuable additional aspect to the study of economic development, workers based on it often lack specificity: they provide grandiose explanations, yet fail to explain exactly how, according to what mechanisms the proposed factors work or how these factors can be operationalized. Therefore they are less useful in research where the goal is to explain more specific outcomes. Moreover purely such an approach does not seem to be more successful than for instance neoclassical economics in predicting the future development of countries. (Here enough to think of Max Weber and the countries that without a Calvinist background managed to reach leading position in development.)

The goal of the current paper is to explain a very specific outcome: budget deficit, more precisely the persistent difference in budget deficit levels between countries. Economics (or rather neoclassical economics), the discipline that certainly has primary relevance in this issue, is interested largely in the methods how deficit should be financed and how these different methods influence the level of deficit. This involves issues such as the automatic stabilizers (tax system and unemployment), inflation, debt level, government spending, etc. and how changes in these factors influence the level of deficit, therefore which one is the economically most advantageous option. (See for instance Alesina and Perotti [1996]) It is mostly beyond the scope of orthodox economics to explain why certain countries choose the obviously inferior ways of financing deficit (e.g. indebtedness), therefore why in certain countries high deficit persistently causes problems while it is not the case in others.

At this point the political economic approach to deficits appears to be helpful which is based on the widely accepted notion that fiscal policy is one of the politically most sensitive areas of economic policy, therefore one should study the political system (party structure, electoral system, etc.) in order to understand differences in fiscal performance of countries. Some authors highlight the connection between coalition governments and high deficits (for instance Roubini and Sachs [1988]) while others emphasize the importance of political business cycles in deficit, i.e. deficits tend to increase around elections (Buchanan and Wagner [1977]¹ or Soós [2005]). Empirical evidence does not seem to support the first approach (countries with high and low deficits can be found with both types of governments), while the second approach fails to provide explanation to persisting differences between democracies which all face the problem of possible budget inflation before elections. The institutionalist approach amends the political approach insofar as it emphasizes the importance of fiscal institutions in restricting politicians in fiscal discretion: more centralized fiscal rules are more favorable for fiscal restraint. (See for example Alesina and Perotti [1994]; Hallerberg and von Hagen [1997]; Perotti et al [1998]²; Kopits [2001])

The theory chosen for the framework of the current research aims to explain the specific problem of persistent difference in fiscal position among certain countries. The starting point is an institutionalist approach and the theory agrees that favorable fiscal

¹ Referred to by Györfly [2007]

² Referred to by Györfly [2007]

institutions yield strict fiscal policy. Yet also a further step is taken and it explored why certain countries choose to introduce stronger institutional framework while others do not. In search for explanations the theory's approach is reminiscent of the "cultural approach to economics" insofar as its focus extends to areas that are not the primary concern of economics (first and foremost issues concerning the society). Therefore this work can be regarded as a "missing link" that - implicitly - recognizes the importance and relevance of cultural approach at the same time aims to apply it to a very specific problem. Two more works could be mentioned here that attempted to achieve this concerning the same problem – budget deficits. Krogstrup and Wälti [2009] have explicitly looked for connection between deficit levels and cultural attitudes, more precisely the difference in preferences for thrift, in certain countries. Similarly, the importance of culture in determining fiscal policy is emphasized also by Talpos et al [2007]. Compared to these two, the theory chosen here is the most elaborated and most advanced. This does not mean however that it is perfect or that it does not deserve strong criticism. On the contrary: particularly the forceful suggestions regarding the Central and Eastern European countries make it necessary to approach it with considerable suspicion.

1.3. The theory

The following section is a summary of Gyórfy's argument taken from Gyórfy [2007]. In any other case the source is referred to. The theory has been developed by Dóra Gyórfy in frame of a PhD dissertation. Her work examines two questions:

- (1) Under what conditions governments implement a stricter budgetary framework and limit their discretion over fiscal policy decisions?
- (2) In countries where such rules are implemented why do governments adhere to them and forego discretionary spending?

The work includes quantitative as well as qualitative research. The comparative analysis of Hungary and Sweden in connection with their fiscal reform attempts provided

qualitative results that allowed the development of generalized suggestions. Quantitative data on the 12 founding members of the European Monetary Union was then used to test the theory. The main focus of Gyórrffy's work was on the old member states of the EU (with the exception of Hungary) still there are suggestions also concerning the new member states in Central and Eastern Europe.

The theory has the following major suggestion: a country's success or failure in setting up and sustaining an institutional framework favorable for fiscal restraint depends on external and internal factors. If a certain group of countries experiences similar external pressure (i.e. globalization in form of market pressure) then obviously domestic factors should be examined in order to explain differences in fiscal performance. The theory emphasizes two domestic factors that have crucial importance in this regard:

(1) the degree of consensus within the political elite

(2) the level of public trust in the system

Consequently in face of similar external pressure the difference in the capability of countries in establishing fiscal restraint can be mainly explained by the above two domestic factors. How the above conclusion was reached will be explained below.

Gyórrffy's theory has an institutionalist approach, which emphasizes the importance of institutional arrangements in restricting overspending. Evidence from earlier researches is cited to support this notion. Thus it can be established that countries with strong fiscal rules have substantially lower budget deficits than those with weak or non-existing rules. According to Gyórrffy however existing literature fails to explain why certain countries implement such restrictive rules while others do not. Moreover it is still unclear what factors ensure the sustainability of these rules under subsequent governments. As it has been mentioned above these are the two issues Gyórrffy's work attempted to answer.

1.3.1. External and Domestic factors

Besides focusing on domestic factors the analysis includes external factors as well. In order to establish the relevance of domestic factors, first external factors have to be examined, that is it has to be made sure that the group of countries in focus experience similar external pressure and incentive setting. Gyórfy mentions two major external factor: the pressure from international financial markets to signal commitment to good macroeconomic fundamentals and the protective shield against such pressure provided by the EMU and the credibility of the common currency. The mechanism through which the above factors affect governments and fiscal policy can be summed up as following: The liberalization of the capital markets in the 1970s resulted in a jump in the amount of available capital for countries to borrow. As a consequence there has been a worldwide growth in debt levels and almost inevitably currency crises became more frequent. Governments around the world came to the conclusion that signaling credibility of economic policies (monetary and fiscal policies) towards the markets is crucially important in order to minimize the risks imposed by the volatile nature of liberal markets.

The European Monetary Union is a response to the pressure from the international markets. The EMU's effect on its member states is twofold: on one hand it shelters them from external pressure through the credibility of the common currency on the other hand its own rules supposed to enforce fiscal restraint. The problem is that the latter purpose couldn't be served effectively due to the weak enforcement mechanisms, thus the EMU neutralizes market pressure but does not provide an effective incentive for discipline. Currently we can observe substantial variation among EMU member-states regarding budget deficit levels. Since the external pressure and incentive setting is similar for all of them, these differences can be explained mainly by domestic factors. In order to identify these domestic factors the cases of Sweden and Hungary – two countries outside the EMU - were compared. The former is an example of successful

fiscal consolidation and currently a model country for fiscal restraint, while Hungary is an example of failed/ non-sustained reforms.

Fiscal management reforms or the introduction of rules based fiscal policy (which are key drivers of fiscal discipline) do not explicitly hurt any interest groups. They do not produce evident winners or losers it is more technical issue. Since such rules have no immediate direct consequences on any interest groups (like in the case of health care or local government reforms) it is unlikely that these groups would mobilize against such reforms. Although it is true that later adhering to these tight rules might require taking exactly such unpopular measures. This is where it becomes important whether the opposition also respects those rules or it tries to gain popularity by condemning them, therefore the realization of fiscal rules is primarily up to the elite's willingness to do so. In the absence of external pressures (e.g. imminent crisis) mainly **two domestic factors** determine whether the political elite is willing to create and adhere to fiscal rules that would tie its own hands and limit discretionary fiscal policy:

- (1) Elite consensus
- (2) Public trust in the political system

Consensus within the elite is crucial because the government has to be sure that the opposition is going to respect those rules that are tying the governments own hands in spending. If such consensus does not exist the opposition is likely to exploit the situation through populist election promises financed by overspending. Elite consensus thus implies that “regardless of which political parties form the government economic policy is conducted with a commitment to fiscal restraint” (Gyórfy [2007] p. 183).

Once such fiscal management reforms are implemented public *trust in the political system* is crucial for sustaining it, since high trust level of the society decreases incentives for members of the political elite to deviate from the original consensus. At this point it is necessary to take a small detour in order to explain the concept of trust in Gyórfy's work.

1.3.2. Trust and Diffuse support

A large part of Györffy's theory is based on David Easton's system's theory for political analysis. A central element of the theory is the concept of 'diffuse support'. Easton has defined diffuse support as "a reservoir of favorable attitudes or good will that helps members to accept or tolerate outputs to which they are opposed or the effects of which they see as damaging to their wants. Outputs and beneficial performance may rise and fall while this support, in the form of a generalized attachment, continues." (Easton [1975] p. 444) In other words people have trust in the political system and believe that it produces favorable outcomes in the long run even if sometimes the immediate outcomes are disadvantageous for them. Györffy is using the term "trust" as an equivalent of David Easton's concept of "diffuse support." As William Mishler and Richard Rose have put it "institutional trust is frequently equated with diffuse political support". (Mishler and Rose [2005] p. 1051) Thus in Györffy's use trust means institutional trust, which is different from interpersonal trust. (Nevertheless, as it will be discussed in later sections, the approach that renders trust and diffuse support equal is not necessarily correct and it is not entirely in line with Easton's concept either.) It is easy to see why diffuse support is necessary for the sustainability of fiscal management rules. In an environment where diffuse support is low towards the system, where the public does not believe that the system brings benefits on the long-run, politicians are tempted to buy votes of the electorate through populist promises offering short-term benefits for the voters, thus abandoning fiscal restraint. According to Györffy's theory elite consensus and public trust are strengthening each-other in a virtuous circle: consensus enables the creation of fiscal management rules that can be sustained due to high level of public trust. Sustained fiscal rules produce positive outcomes over a long enough period which in turn strengthen trust in the system. Finally continuous trust makes it less tempting for the members of the elite to break the consensus and come forth with populist promises.

1.3.3. Four types of states

Based on the presence or absence of the two domestic factors – elite consensus and trust – the theory created four ideal categories of states. It has to be emphasized that these are ideal types and they don't exist in pure form nevertheless most democracies can be categorized more or less under one or the other group. The four types are presented in a matrix:

	CONSENSUS	DISSENT
TRUST	Type 1 Democratic ideal	Type 2 Liberal democracy
DISTRUST	Type 3 Philosopher's state	Type 4 Mass democracy

The different types are not equally stable. Type 1 is the most stable, but for instance an external shock or accumulation of special interest groups can still break the equilibrium state. Type 2 and 3 are the least stable and generally they most likely move either to type 1 or type 4. Furthermore the theory suggests that a successful fiscal reform has four consecutive stages:

- (a) Recognition of fiscal problems
- (b) Fiscal consolidation
- (c) Institutionalized consensus on fiscal restraint
- (d) Institutional sustainability.

Different types of states have different ability to reach these stages Only Type 1 states are capable of taking all four steps necessary for a successful fiscal reform, thus Type 1 states have the highest chance to conduct persistently disciplined fiscal policy. Type 2 states are likely to take only steps (a) and (b), type 3 countries can reach stage (c), while type 4 states are unlikely to proceed further than step (a). According to Györffy's argument Sweden – through the successful fiscal adjustment of the early '90s – is an

example of a state moving from Type 2 to Type 1, while Hungary undoubtedly has the attributes of a Type 4 states, where attempts during the past 20 years for fiscal reforms have always failed.

The theory's general assumptions are based on results from research focusing on EMU member states, Sweden and Hungary. The research did not pay particular attention to Central and Eastern Europe however it contains a short section where the theory is applied to this region (more precisely to the eight new member states from the region that joined the EU in 2004). Consequently Györffy's work contains implications for the region nevertheless the validity of some of these implications seems at some points doubtful. The theory suggests the following regarding Central and Eastern Europe:

In order to test the results of the research Györffy compared trust levels of EMU member states with their level of budget deficit. Trust was measured as level of satisfaction with democracy based on Eurobarometer survey results from 1998-2005. After running a linear regression analysis it was found that the level of trust explained over 56% of the fiscal deficits. The same analysis was tried on the new member states, yet in their case no such connection could be detected. The theory's explanation for this phenomenon is that in contrast with EMU member-states CEE countries face very different external incentives: notably the currency boards of the Baltic States have disciplining effect on fiscal policy, whereas the Visegrad countries (V4) do not face such constraints.

Another suggestion of the theory is that since level of public trust is substantially lower in the CEE countries than in the old member-states, all of them belong to the group of Type 3 or 4 countries. Therefore these transition countries are facing serious challenges in sustaining fiscal discipline. According to Györffy - at the time the research was conducted - only the Czech Republic, Estonia and Slovenia had good chances to become a Type 1 country, as during the few years investigated, these countries showed relatively high level and - more importantly - growing tendency of trust.

1.3.4. Assessment of the theory

The theory has several advantages. It recognizes that for examination of budget deficits an interdisciplinary approach is more suitable than a purely economic approach. Moreover it discusses the intensely complex reality through a simple model, which enables relatively easy testing. Perhaps most importantly the theory also passed the first real-life test. The current Hungarian government has recently been praised for the drastic measures in frame of a fiscal adjustment attempt. Indeed budget deficit has been reduced below the level of most of Hungary's regional peers. This however only supports the theory, which suggests that in face of external pressure the government is willing to take drastic measures in order to avoid disaster, despite the continuously existing threat that the opposition takes advantage of it. In Hungary's case the external pressure was a looming bankruptcy in 2008 which is indicated by the fact that Hungary was the first country in the region that had to ask for IMF bailout. Sustainability of the recent fiscal restraint is however doubted by many experts, which is in line with the theory: the two domestic factors are still missing in case of Hungary.

Despite the above advantages a noticeable shortcoming is that the theory does not seem to sufficiently explain variance across CEE countries. This is partly due to the fact that the main focus of the research was on the EMU member-states and on the comparison of Hungary and Sweden. Some suggestions are offered also regarding the new member-states however these do not seem to be very convincing, therefore it can be suspected that the theory requires some major alterations. This issue will be discussed in details in the second part of this paper.

The above part has been a summary of the framework theory in order to better understand its logic and how individual elements connect to each other. Nevertheless in the beginning of each chapter a separate section will be devoted to the theory's suggestions regarding the topic of the chapter.

1.4. Methodology

1.4.1. Structure of the research

The research can be divided into two structural parts. The first part (chapters 2, 3 and 4) clarifies whether the pre-conditions for the examination of domestic factors are met in Central and Eastern Europe. Thus, the second chapter discusses the issue of fiscal rules in the countries of the region. The goal of this chapter is to see whether – in line with the theory’s suggestion - fiscal rules are crucially important determinants of fiscal performance in the region. The third chapter then focuses on external factors. Its purpose is to examine the external pressure and incentive setting of the CEE countries and to establish that these are similar enough for all countries, so that focus can be shifted to domestic factors in search for determinants of different fiscal performance. Special attention will be devoted to the issue of currency board arrangements. Gyórfy suggests that the existence of currency board arrangements in several countries create substantially different external incentives for these countries thus rendering the effect of domestic factors irrelevant. Therefore this issue needs to be clarified in frame of this chapter. The first structural unit will use secondary sources: scholarly articles, existing calculations, indexes.

The second structural part (chapter 5 and 6) of the paper discusses domestic factors in frame of a comparative analysis wherein the cases of Estonia and Hungary will be compared. Here again research is guided by the theory, thus comparison will primarily concern the issues of elite consensus and public trust in the system. As it has been mentioned, Gyórfy’s work has some brief suggestions for the Central and Eastern European countries however serious doubts arouse regarding their validity. Therefore in this second structural part one step will be taken back and David Easton’s theory of diffuse support will be examined more closely, as it forms an important basis of Gyórfy’s theory. The case comparison will be then guided also by Easton’s theory besides Gyórfy’s work. Primarily existing literature and at some points survey results

will be used as sources for comparison. Based on the results suggestions will be made on how to amend or alter Györffy's theory.

1.4.2. Estonia and Hungary as optimal cases for comparison

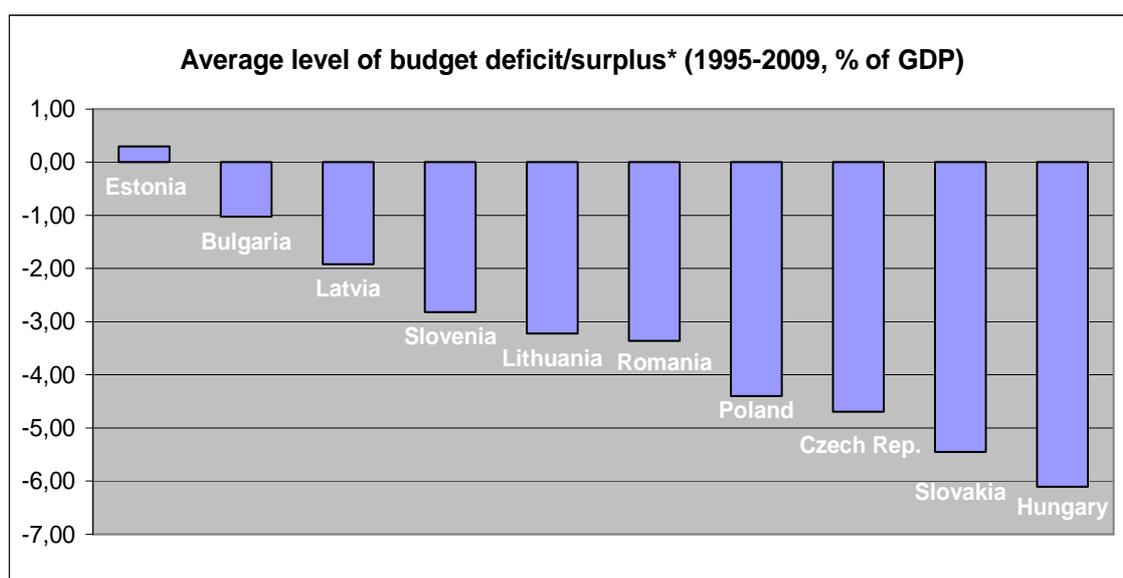
In the comparative analysis the most similar systems design with different outcomes (MSDO) approach will be used. That is the analysis aims to explain differences in outcomes between similar cases by comparing instances of variation among them. This approach is suitable for a research with very few cases. In comparative analysis the case selection is a crucially important stage. Besides the clear definition of the outcome another consideration “concerns the extent of diversity within the selected universe. In this regard, a maximum of heterogeneity over a minimum number of cases should be achieved.” (Berg-Schlosser and De Meur [2009] p. 21) For the MSDO approach this means that optimal case selection achieves “sufficient homogeneity of the universe of cases considered and maximum heterogeneity within this universe”. (Berg-Schlosser and De Meur [2009] p. 23)

Based on these criteria pairing up Estonia with Hungary is ideal for comparative analysis. As far as homogeneity of the universe is concerned all 10 Central and Eastern European countries share a number of similar characteristics. From a global perspective all are located in the same geographical region. All of them have undergone a very specific transition period from an authoritarian political and centrally planned economic system to democracy and market-economy. As far as the main trends are concerned this transition meant economic, political and social development to the same direction, that is, all of these countries have aimed to “return” to Europe by becoming full members of the EU and NATO and these organizations have required from candidates essentially the same changes in their economic, political and social life. These similarities ensure that these countries are ideal candidates for comparison to each other when the research concerns the period of transition. It can be said that no other countries in the world share these same important characteristics.

Further important similarities can be observed when focusing only on Estonia and Hungary. Both countries have been considered frontrunners in transition (As it has

been noted, while Estonia largely managed to retain this position the same can not be said about Hungary due to current economic hardships.), moreover their level of development – in terms of GDP per capita – is very similar even within the region.

It is true that for both cases more similar countries could be found from the region then however the requirement of maximum heterogeneity would not be met. Estonia and Hungary at the same time represent the two extremes as far as the outcome – that is budget deficit – is concerned. The chart below demonstrates well this fact.



* General government deficit/surplus; Source: Eurostat, World Bank

The case selection is further supported once the table with yearly breakdown is taken into consideration. It shows that fiscal performance of Hungary and Estonia has not only been on average very different, but this difference has been persistent and steady from year to year throughout the entire period. Most other countries in the region have had higher volatility in budget deficit levels. For the entire table see Appendix A, below the summary of key findings is presented:

	Range of deficit (1995-2009, % of GDP)	No. of years with highest deficit	No. of years with lowest deficit
Bulgaria	18,2	1	7
Czech Rep.	12,6	1	0
Estonia	6,1	0	9
Latvia	10,2	1	0
Lithuania	11,5	1	0
Hungary	6,3	7	0
Poland	5,2	0	0
Romania	7,1	1	0
Slovenia	8,4	0	0
Slovakia	10,4	3	0

An important additional characteristic of Estonia is that the extreme fiscal discipline does not seem to have stalled economic development. On the contrary, Estonia has been constantly ranked in top positions among regional countries in the World Economic Forum's annual Global Competitiveness Report. The report defines competitiveness on a very broad basis, thus includes dimensions such as education, healthcare, state of infrastructure, etc. In all of these dimensions Estonia has scored substantially better than most of its regional peers including Hungary. Therefore by selecting Estonia as case for comparison with Hungary, the mistake of selecting a country that is only performing well in the narrow field of the research interest, is avoided.

Before moving on to the case comparison and the examination of domestic factors in Estonia and Hungary, the following two chapters will investigate whether conditions in Central and Eastern Europe correspond the theory's suggestions regarding the importance of fiscal rules and the similarity of external factors.

2. FISCAL RULES

The goal of this chapter is to examine fiscal rules in CEE and to see whether the theory's suggestion regarding the importance of fiscal rules is also valid in the region. The first section provides a more detailed summary of the framework theory's suggestion on this issue.

2.1. The theory's suggestions regarding fiscal rules

A major conclusion of the theory is that fiscal institutions are crucially important determinants of fiscal performance. Györfy's theory asserts that specifically the existence of rules-based fiscal policy (as opposed to discretionary fiscal policy) is the relevant factor. This is mainly based on the results of the research conducted by Marc Hallerberg and Jürgen von Hagen. In their article they contested the widespread view among institutionalists that electoral systems strongly influence fiscal deficit. Nouriel Roubini and Jeffrey Sachs for instance argue in their often cited paper that proportional electoral systems are more deficit prone than plurality systems, as the previous tends to generate coalition governments where negotiations between coalition partners creates bigger pressure for inflated budget than under a one party government in a plurality electoral system. (Roubini and Sachs [1988])

Hallerberg and von Hagen examined the fiscal performance of the 15 old member states of the European Union in the period between 1981 and 1994. According to the results merely the type of electoral system does not determine fiscal outcomes as countries under both systems can achieve low deficits if they choose the right institutional setting. In a plurality system - where the government is usually formed by one party - delegating authority to a finance minister who oversees the spending of other ministers proves to be a feasible solution. Multi-party governments in turn can

achieve lower deficit through a system of fiscal contracts wherein the ministries (and other spending bodies) of the government agree on a fiscal target in the very beginning of the budgeting process, which implicitly puts a limit to all ministries bargaining power for larger spending ceilings. Empirical evidence supported the theory: those countries that had either one of the systems in place (matching their electoral system) exhibited substantially lower deficits during the above period than those without, regardless of electoral system. (Hallerberg and von Hagen [1997])

The work by Perotti et al. – also cited by Györffy – focuses on the importance of fiscal institutions for sustainable fiscal policy in the old member states of the EU. Similarly to Hallerberg and von Hagen, they find correlation between strong institutions and low deficits, however here the difference between countries regarding fiscal institutions is gradual: countries are ranked according to the strength of their fiscal institutions and this rank then shows correlation with budget deficit levels. (Perotti et al [1998])³

Györffy's work then goes on to explain why fiscal rules are important and how exactly they contribute to the reduction of deficits. Referring to Per Molander she identifies five major rationality-related problems with budgeting: aggregation problems, prisoner's dilemma situations, long time horizons, uncertainty and ignorance, principal-agent situations. In the following a brief overview is given on how different types of fiscal institutions can tackle the above problems.

When a budget consists of thousands of line items the outcome depends very much on the aggregation method, thus reduction in the dimension of the budget or implementation of the agenda setter's preference are ways to overcome challenges of this type. The prisoner dilemma in budgeting refers to the situation where the ministries ask for extra spending limits without having to bear the full social costs of the inflated budget, thus of a larger deficit. To overcome this problem, fiscal institutions should enhance cooperation among ministries. There is strong incentive for most actors within a budgeting process to live up future resources through increased spending on the short run. Sustainability requires institutions that extend time horizons by setting medium-term targets. Uncertainty / ignorance and the principal agent situation problems refer to the relation between the voters and representatives and the problems arising from

³ Györffy [2007] quotes the results

asymmetric information. Thus, transparency becomes an important feature of fiscal institutions. (Molander [2001])⁴

2.2. Fiscal rules in Central and Eastern Europe

Now that the theory's suggestions regarding fiscal rules have been clarified, the purpose of this chapter is to examine fiscal rules in the CEE region. If the theory's suggestions can be applied also to this region then - just like in the case of old EU members - connection between quality of fiscal rules and level of budget deficit should be observable in these countries.

First and foremost however fiscal rules should be defined: what exactly are fiscal rules for the purpose of this paper?

2.2.1. Conceptualization of fiscal rules

The recognized researcher of fiscal institutions, George Kopits gives the following definition for fiscal policy rules: "A fiscal policy rule is [...] [a] permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance. The rules under consideration cover summary fiscal indicators, such as the government budget deficit, borrowing, debt, or major components thereof – often expressed as a numerical ceiling or target, in proportion to gross domestic product (GDP)." (Kopits and Symansky [1998] p. 2.) He thus provides a definition which is rather limited in scope, wherein only simple numerical rules, such as an overall balanced budget rule or limits on borrowing can be regarded as fiscal rules. When considering the above described five rationality-related problems of budgeting, numerical rules only answer the problems of aggregation and time horizon, however are less effective in tackling the issues connected to transparency and the prisoner dilemma. Transparency is challenged through the inherent incentive of numerical rules for creative accounting. The prisoner dilemma remains unsolved since merely an overall limit to the entire budget – though

⁴ Quoted by Gyórfy [2007]

increases the bargaining power of high level decision makers - provides very little incentive to ministries and bureaucrats to limit their requests for extra spending. (Györffy [2007] p. 55-58) If we adhere to the above definition of fiscal rules and consider only simple numerical rules than little differentiation is possible among the countries of the CEE region. Only Poland and Estonia has in place such rule. The constitution of Poland provides that the government debt can not exceed 60% of the GDP. (Constitution of the Republic of Poland, Article 215.) In Estonia the State Budget Law of 1999 regulates budget deficit: in case expenditure exceeds receipts the budget has to be balanced through lending and by using a special reserve fund.⁵

Györffy's theory defines fiscal rules in broader terms. Besides numerical rules she considers independent fiscal councils and more importantly procedural rules as possible elements of such fiscal policy. Fiscal councils need to be independent from the government as the main purpose for such a body is to guard macroeconomic stability by preventing unsustainable and deficit prone fiscal policy of the government which is allocating the funds. While fiscal councils can solve the time horizon problem their major disadvantage is the lack of tools to influence fiscal policy. In a democracy the elected government by definition is responsible for the allocation and distribution of funds. Independent central banks have tools like interest rates, open market operations, etc. to influence monetary policy similar means are not available for fiscal councils. Therefore their role is confined to advising the government. This is not to say that independent fiscal councils can have no impact on fiscal policy. If they are reputable and widely accepted by the political forces then their say on fiscal issues definitely have weight. Since 2008 and independent fiscal council operates in Hungary.⁶

The most complex set of fiscal rules is the group of procedural rules or budgeting rules. All those rules that coordinate the procedure of budget creation are included. For the purpose of this research this group is the most important for two reasons: (1) procedural rules include numerical rules and fiscal councils at different stages of budget preparation, thus procedural rules represent the widest set of fiscal

⁵ There is no unilateral consensus whether the provisions of the above law are sufficient to consider Estonia a country with an explicit balanced budget rule in place. See for instance: Kraan et al [2008] p. 10. or see Andrus Säälük's presentation, downloadable at:

www.jvi.org/fileadmin/jvi_files/DG.../Andrus_Saalik_presentation.pdf

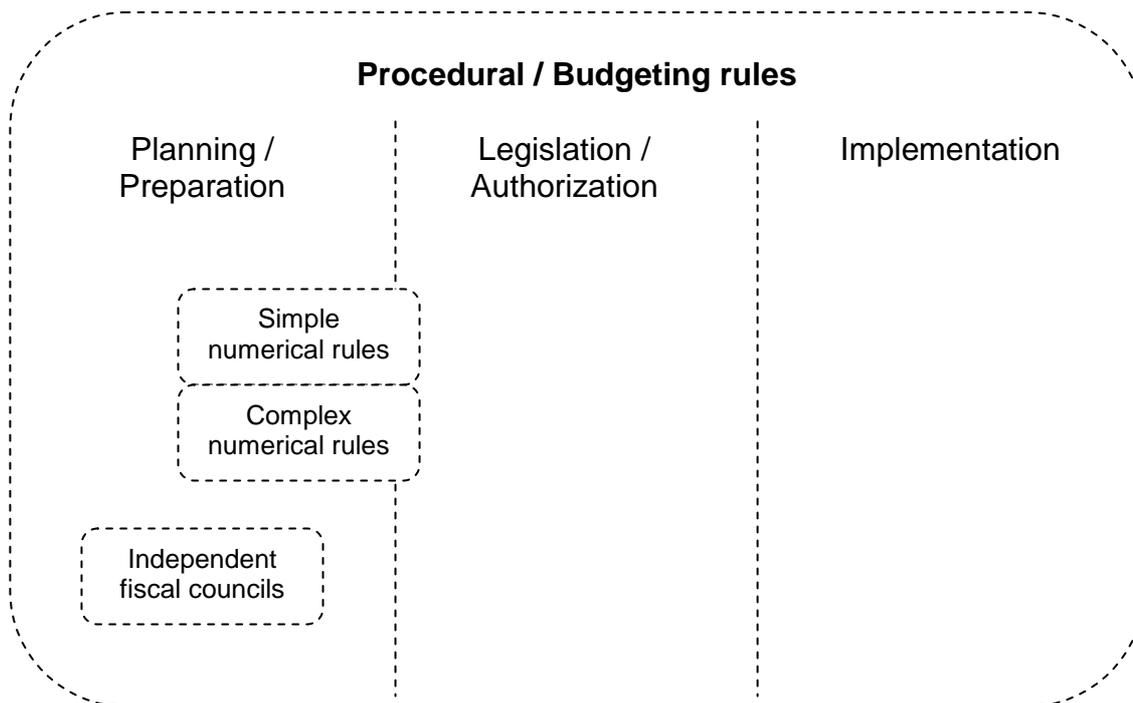
⁶ Homepage of the Fiscal Council of Hungary <http://www.mkkt.hu/en/>

rules. (2) Examining procedural rules allows us to differentiate countries more delicately and rank them more precisely according to the quality of their fiscal rules.

Adequate procedural rules address the challenges stemming from the prisoner's dilemma situations or as it is often called the common pool resource situation. "As financing is shared by all tax payers, while benefits from spending can be targeted, individual policy makers consider the full benefits from expanding projects in their districts or relevant policy areas, but take into account only that share of the social marginal costs of higher taxes or borrowing that is borne by their constituents. The incomplete internalization of the social costs of expenditures leads policy makers to demand an overspending on and/or excessive debt financing of their preferred projects compared to the social optimal level that equates social marginal costs and benefits." (Gleich [2003] p. 8) Therefore an optimal procedural rule setting creates incentives for the bureaucrats to internalize the costs of government spending. Besides the common pool resource situations, these rules also concern the aggregation problem (for instance through strengthening the agenda setter role of the finance minister) and might increase time horizon, by creating multi-annual targets.

Budgeting rules are usually examined according to the different stages of budget creation: preparation or planning, legislation or authorization, and implementation. During preparation the main issue is how to limit spending requests of the different ministries and spending bodies. This can happen for instance through setting overall targets or strengthening the position of the finance minister vis-à-vis other ministers. When the draft budget is in the parliament for consideration procedural rules should limit the legislation's ability to increase the total expenditure. Finally during implementation it has to be made sure that the budget is adapted according to the plan and only justified amendments are made to the original version.

The diagram below provides an overview of fiscal rules thus it gives a graphical summary of the content of this subsection:



2.2.2. Budgeting rules in Central and Eastern Europe

The current section examines budgeting rules in CEE then tests the connection between the quality of rules and fiscal performance in these countries. A number of researches have been completed on the procedural rules of the CEE countries. The three works that will be considered here were chosen because all of them quantify their results as index values, making thus comparison of countries easier according to quality of their budgeting rules. Moreover they provide data about budgeting rules in different times. Since the scores and values reflect the state of budgeting rules only at a given point in time and since stark changes are possible in budgeting rules from year to year (as it is suggested by the literature) it is important that data is examined from multiple years, thus having more reliable information on the quality of budgeting rules in each country.

The first index was created by Holger Gleich. He examined the quality of budgeting rules in 10 countries: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia. In order to rank these countries he created an index, which is compiled of 13 dimensions divided among the three stages of budgeting with each dimension comprising of two to five institutional characteristics.

More details about the structure of Gleich's index can be found in Appendix A. The index reflects the state of budgeting rules in 1997 while it also includes amended values that reflect changes that occurred in 1998, 1999 and 2001. When testing the results Gleich compared only the index values of 1997 with average budget deficit levels of the respective countries in 1994-1998. The results have shown strong connection between quality of budgeting rules and deficit levels. (Gleich [2003]) Therefore also in this paper only the values of 1997 will be considered from this index.

1. Quality of Budgeting Rules - Gleich's Index				
	Preparation	Legislation	Implementation	Total 1997
Bulgaria	1,00	1,33	3,00	5,33
Czech Rep.	1,50	2,93	2,00	6,43
Estonia	2,25	2,40	3,67	8,32
Hungary	1,25	1,87	2,34	5,32
Latvia	3,00	1,33	3,67	8,00
Lithuania	1,00	1,87	3,33	6,20
Poland	1,50	0,93	3,00	5,43
Romania	1,25	0,27	3,67	5,19
Slovakia	1,75	1,87	2,67	6,62
Slovenia	2,75	2,27	2,76	7,69

Source: Gleich [2003]

Gleich's index only covers a part of the period in the focus of the current research, therefore more recent data is required additionally to have more reliable picture of the budgeting institutions during the past roughly two decades. The second index that will be considered here has been compiled by Stefania Fabrizio and Ashoka Mody. The logic and structure of Gleich's index is largely followed by them. The only difference in the structure is that instead of Gleich's 13 dimensions Fabrizio and Mody use only 12, leaving out the issue of power relation between the parliament's upper and lower house. (For details see Appendix B) This second index shows the quality of budgeting rules in 2003 in the same 10 countries. Since the structure of the two indexes is very similar they are largely compatible with each other. In order to make them comparable one minor technical change needs to be applied: in Gleich's index the total index score is a sum of subtotals for preparation, legislation and implementation stages, while in the Fabrizio and Mody's index the total is calculated by taking the average score received for the three stages. For the sake of comparability, in this paper the total scores of the

second index are calculated according to the logic of Gleich's index, that is they are the sum and not the average of subtotals. It has to be noted that this amendment to the second index does not distort the information as both methods assign equal weights to the individual budgeting stages.

When testing their index values Fabrizio and Mody, similarly to Gleich, have found strong connection between budgeting rules and average deficit levels: "For a measure of the quality of fiscal institutions, intended to capture checks and balances through hierarchical rules and collegiality, we find that a higher quality of institutions has a material bearing on the budgetary discipline." (Fabrizio and Mody [2006] p. 25)

2. Quality of Budgeting Rules - Fabrizio and Mody's Index				
	Preparation	Authorization	Implementation	Total 2003
Bulgaria	1,75	0,67	3,00	5,42
Czech Rep.	1,75	2,34	2,67	6,76
Estonia	2,25	2,34	3,67	8,26
Hungary	1,50	1,33	1,33	4,16
Latvia	2,50	0,67	3,67	6,84
Lithuania	1,75	1,67	3,00	6,42
Poland	2,25	3,00	3,00	8,25
Romania	1,50	1,33	3,34	6,17
Slovakia	0,75	1,34	2,34	4,43
Slovenia	2,75	2,33	2,67	7,75

Source: Fabrizio and Mody [2006]

The third index considered here has been compiled by Mark Hallerberg and Sami Yläoutinen. This index provides quantified data on the quality of budgeting rules in 2007. This third index is less compatible with the previous two indexes, nevertheless it is still possible to consider it for this research. This third work follows the structure of the research conducted by Hallerberg and von Hagen [1997]. This earlier research forms the basis of Györffy's argument about the importance of fiscal institutions as it was referred to earlier (see section 2.1.). Thus the third index is the application of Hallerberg's and von Hagen's earlier findings on the CEE region. Similarly to the previous two indexes Hallerberg and Yläoutinen examine the different stages of budget creation as well but along different dimensions than Gleich or Fabrizio and Mody did. Therefore their findings are less compatible with the previous two indexes. More importantly –as it has been discussed earlier in chapter 2.1. – this model distinguishes

between plurality and proportional electoral systems, arguing that both systems have an optimal budgeting rule setting which are different from each other: the former (mostly one party governments) should increase the power of the finance minister, whereas in the latter system (mostly coalition governments) fiscal contracts negotiated before the budgeting process can increase fiscal discipline. Therefore two separate indexes were created that assess budgeting institutions according to the requirements of proportional and plurality electoral systems, named “contract” and “delegation” indexes respectively. (For details see Appendix B) Both indexes assess the 10 countries according to the state of institutions in 1998, 2003 and 2007. (Hallerberg and Yläoutinen [2008]) Nevertheless since data for 1997 and 2003 are already provided by the previous two indexes, from the third index only the values of 2007 will be considered in this paper.

3. Quality of Budgeting Rules - Hallerberg and Yläoutinen's Index		
	Delegation 2007	Contract 2007
Bulgaria	55,0	62,5
Czech Rep.	38,8	56,3
Estonia	50,9	81,3
Hungary	29,6	62,5
Latvia	63,0	62,5
Lithuania	51,3	62,5
Poland	49,9	62,5
Romania	45,7	56,3
Slovakia	41,6	62,5
Slovenia	68,2	81,3

Source: Hallerberg and Yläoutinen [2008]

In order to assess the strength of a country’s budget rules one is advised to consider the index value that corresponds the country’s electoral system. All CEE countries have some form of proportional system in place. In case of Hungary however it is more appropriate to consider the “delegation” index, due to the peculiarity of the party system, where in the past one of the two major parties has been in power with a significantly smaller coalition partner. This situation thus qualifies Hungarian politics to be regarded a one party government system. (Hallerberg and Yläoutinen [2008] p. 11) For all other CEE countries the “contract” index is relevant. Unfortunately the “contract” index differentiates less among the countries, since it is comprised of only one sub-index: the “long-term planning constraint” index which consists of only four

components (the issues of multi-annual targets, the degree of commitment to them, length of time-horizon and the nature of budget forecasts). All other examined dimensions can only be used for constructing the “delegation index”. The appropriate index for CEE countries – according to Hallerberg and Yläoutinen - thus consists of the “delegation” value for Hungary and the “contract” values for all other countries.

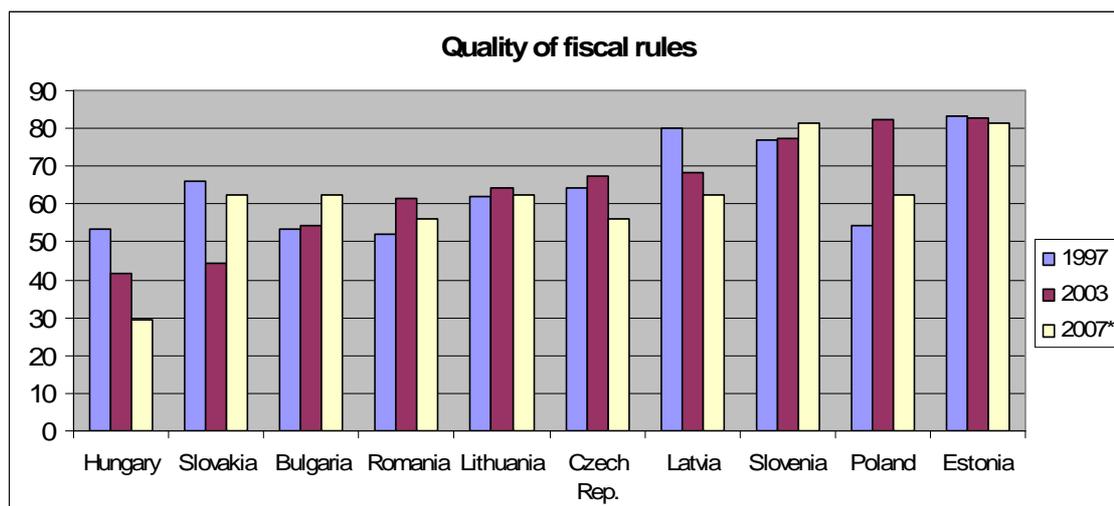
2.2.3. Creating and testing the aggregate index

As it has been mentioned the main goal of this chapter is to establish that the quality of fiscal rules is a crucially important determinant of fiscal performance also in CEE. So far in this sub-section three indexes were examined, each of them providing data on the quality of budgeting rules in 10 CEE countries in three different times: 1997, 2003 and 2007. In case of all three indexes it has been established (by the scholars who compiled them) that budgeting rules have determined budget deficit levels in the respective observed period. It thus seems that sufficient evidence supports the notion about the significance of fiscal rules.

Nevertheless the construction of an aggregate index is still useful. This aggregate reflects the average quality of budgeting rules using the values of the three above indexes. Therefore the aggregate provides an approximate picture about the state of budgeting rules during a longer period. Thus it is possible to compare the aggregate scores to the average deficit levels of 1995-2009. This test can be regarded on one hand as double checking the results of authors who constructed the above indexes. On the other hand aggregate index creation and testing is necessary to see whether significance of budgeting rules stays valid also when observing the entire period (not just periods of few years), that is the period from the beginning of transition up until now. In the following the issues concerning the creation of the aggregate index will be discussed.

The aggregate index consists of the total values from 1997, 2003 and the values of the combined “delegation”/”contract” index from 2007. Since the indexes of 1997 and 2003 are highly compatible with each other the real issue is whether the data from 2007 can be included without significantly distorting the overall picture. First the values from the three indexes should have the same order of magnitude. This can be achieved

by simply multiplying the values in the 1997 and 2003 indexes by 10. The range of values is quite similar in the three indexes except for the fact that the 2007 index “punishes” Hungary with a much lower score relative to the other countries than either one of the 1997 and 2003 indexes did. Secondly it needs to be checked whether the 2007 index ranks countries similarly to the previous two indexes?



* The values for 2007 are from “contract” index except for Hungary where it is from “delegation” index

Source: Fabrizio and Mody [2006]; Gleich [2003]; Hallerberg and Yläoutinen [2008]

As it can be seen also in the 2007 index previous high performers notably Slovenia and Estonia continue receiving the highest scores while Hungary continues to be at the lower end.

If the rankings were very different it had to be suspected that the 2007 index is not compatible with the other two indexes. Of course it could be argued that similar ranking merely does not suffice for declaring compatibility as it could very well be the case that rules in certain countries have changed by 2007, which would change overall scores, while the precise magnitude of these changes could only be assessed through a research that follows the structure of the 1997 and 2003 indexes. Indeed the degree of compatibility of the 2007 index is arguable, nevertheless in my opinion it can still be used for creating an aggregate index for several reasons: (1) the aggregate index intends to capture major tendencies to see whether fiscal rules substantially influence fiscal performance in the region. (2) All authors have examined procedural rules even if in different structure, thus the results can not be widely different. (3) This is also reflected

by the above noted fact that the 2007 index does not change country ranking significantly.

The aggregate index is created as an average of the values in the three indexes, which is then tested - using linear regression analysis - on average budget deficit levels between 1995 and 2009:

Quality of Budgeting Rules - Aggregate Index					
	1997 (Gleich)	2003 (Fab.-Mody)	2007 (Hallerb.)	Aggregate	Average deficit*
Bulgaria	53,3	54,2	62,5	56,7	-1,03%
Czech Rep.	64,3	67,6	56,3	62,7	-4,69%
Estonia	83,2	82,6	81,3	82,4	0,29%
Hungary	53,2	41,6	29,6	41,5	-6,11%
Latvia	80,0	68,4	62,5	70,3	-1,92%
Lithuania	62,0	64,2	62,5	62,9	-3,22%
Poland	54,3	82,5	62,5	66,4	-4,40%
Romania	51,9	61,7	56,3	56,6	-3,36%
Slovakia	66,2	44,3	62,5	57,7	-5,45%
Slovenia	76,9	77,5	81,3	78,6	-2,82%

*In the period: 1995-2009; Source: Eurostat, World Bank

The results of the regression analysis can be found below:

	Aggregate index (independent var.)	Average deficit (1995-2009) (dependent var.)
Bulgaria	56,7	-1,03%
Czech Rep.	62,7	-4,69%
Estonia	82,4	0,29%
Hungary	41,5	-6,11%
Latvia	70,3	-1,92%
Lithuania	62,9	-3,22%
Poland	66,4	-4,40%
Romania	56,6	-3,36%
Slovakia	57,7	-5,45%
Slovenia	78,6	-2,82%

Results for CEE-8 (excluding Romania and Bulgaria):

Y = Average level of deficit; X = Aggregate index of fiscal rules

$$Y = 0.141 X - 12.771$$

$$\text{Sig.} = 0.006$$

$$N = 8; \quad R^2 = 0.748$$

Results for all 10 countries:

$$Y = 0.113X - 10.454$$

$$\text{Sig.} = 0.035$$

$$N = 10; \quad R^2 = 0.446$$

Results for CEE-9 (without Bulgaria):

$$Y = 0.132X - 12.034$$

$$\text{Sig.} = 0.005$$

$$N = 9; \quad R^2 = 0.694$$

As it could be expected there is strong positive connection between the quality of fiscal rules and the degree of fiscal discipline in case of the eight CEE countries (quality of budgeting rules explains 75% of the variation fiscal deficits). The connection is still significant if Romania is included (budgeting rules explain 69% of variation in fiscal performance), however the inclusion of Bulgaria weakens the result substantially ($R^2=0.446$). It is worth noting that Bulgaria has showed considerable fiscal discipline since the introduction of a currency board arrangement in 1997. Its budgeting rules however remained weak, hence the weaker connection between budgeting rules and deficit levels if Bulgaria is included in the sample. Based on this it could be suspected that currency boards substantially influence fiscal performance. It will be discussed in the next chapter whether this is true and how the existence of currency boards in CEE countries influence the applicability of Györffy's model to the region.

It can be concluded that similarly to the case of old EMU member states, fiscal rules have a decisive role in fiscal performance also in the eight CEE countries, which are in the focus of my research.

3. EXTERNAL FACTORS

In this chapter it will be examined whether the CEE region fulfills the theory's criteria regarding similar external pressure/incentive setting.

3.1. The theory's suggestions regarding external factors

The theory's assumption is that external factors have some disciplining effect on the individual countries' fiscal policy, nevertheless this effect is limited. In a nutshell, the theory implies that after abandoning the Bretton Woods system and the liberalization of the global financial markets in the early '70s governments around the world step by step learned (as a result of some crisis) that demonstrating credibility, exhibiting sound macro economic fundamentals is crucially important to reduce a country's vulnerability to financial volatility. Sustainable fiscal position is a key element of those fundamentals. (Gyórfy [2007] p. 78-87.) Once the credibility suffers the market forces punish the country mainly through increasing interest rates on external borrowing and if the country is unable to restore credibility the downward spiral culminates in bankruptcy.

Another assumption regarding external factors is that they enhance policy transfer among countries. Since governments are aware of the importance of credibility they are looking for best practices from around the world, in this process international organizations like the IMF play an important role. In the field of monetary policy such widely accepted policy "best practice" has been the independence of central banks, while - according to Gyórfy - in recent years fiscal rules are receiving more and more attention.

Before 1993 the prospective EMU member states were exhibiting rather large budget deficits (Gyórfy [2007] p. 189). The situation however changed radically in the

years preceding the creation of the Eurozone: all prospective members underwent substantial fiscal adjustment in order to meet the Maastricht criteria necessary to join the monetary union. In this case external pressure – namely fear of missing the first group of states creating the monetary union - created substantial consensus in these countries about the importance of fiscal restraint. Once inside the Eurozone however the member states' fiscal performance varied strongly. The theory has the following explanation for this phenomenon: while on paper the EMU imposes very specific fiscal constraint on its member states (the well known 3% of the GDP threshold for budget deficit) the enforcement mechanisms are very weak. Thus the EMU membership's disciplining effect is much weaker than that of the market forces at the same time the monetary union provides a credibility shield for its members against market forces, therefore in case of the member states external pressure is neutralized.

Some members nevertheless continue to display considerable fiscal restraint. In a number of countries the EMU “did induce a lasting move towards discipline [and] it proved to be a useful anchor in countries, which have started fiscal adjustment.” (Gyórfy [2007] p. 110). These countries have domestically imposed fiscal rules and this fact reflects the essential importance of domestic factors.

Further evidence for the limited effect of external factors and the importance of domestic factors is brought about through the comparative analysis of Hungary and Sweden. None of them are members of the EMU, thus both face external market forces without enjoying the protective shield of credibility provided by the Euro and both have faced crises (Sweden in the early '90s, Hungary in 1994/95). While the disciplining effect of the crises induced fiscal adjustment in both countries only Sweden managed to use this momentum and create a system of sustainable fiscal discipline, while Hungary – after the immediate threat of the crises faded – returned to lax fiscal policy. The explanation of this difference – once again – lies in domestic factors.

3.2. External pressure in CEE

First, it has to be examined whether similar tendencies regarding external pressure/incentives can be detected in CEE. Here mainly two issues need to be

addressed: (1) did the pre-accession period, the period of preparation for EU membership, mean similar external disciplining effect for the CEE countries as did the preparation for EMU membership for current EMU members? (2) Does EU membership provide protection from market forces for the CEE countries? The short answer for both questions is: “no” or “very modest” at best

Soon after the regime changes in 1989/91 all of the eight CEE countries have declared their intention to join the EU. The accession procedure meant close monitoring by Brussels on the progress of meeting the membership criteria. Theoretically this could have evoked a strong incentive for fiscal discipline in a similar way the EMU membership preparation affected the performance of its 12 prospective members. However during the accession period the EU’s main concern was to ensure that crucial structural reforms are taking place even if this means (temporarily) higher budget deficit for these countries. (Berger et al [2004] p. 10-11) In the words of the Commission: “CEECs are not required to fulfill the Maastricht nominal convergence criteria, but rather to comply with the Copenhagen criteria. The primary fiscal concern in the pre-accession period is medium-term budgetary sustainability, rather than achieving any particular target for the government balance. [...] Setting of specific budgetary targets could be misleading and the priority should remain on improving the functioning of the budgeting process, carrying out structural reforms, implementing the *acquis communautaire*, and supporting catching up.” (Commission [2002]) Not insisting on sound macro economic performance as a criterion for membership, Brussels could not effectively impose fiscal discipline on the accession countries.

By becoming members of the EU these countries agreed to eventually join the monetary union as well. However the lack of a clear, binding deadline for EMU accession combined with weak enforcement mechanisms of the EU against members that are persistently breaching the 3% budget deficit level deprived the system of any disciplining effect. Berger-Kopits-Székely [2004] offers a game theoretic model to explain differences in fiscal performance among countries of region, wherein fiscal behavior of these countries influences each other’s conduct of fiscal policy. In line with the model it can be argued that as more and more new member states are adopting the Euro the incentive will gradually increase for the remaining new-members to meet the criteria avoiding the obvious embarrassment of being the last country to join. At the

same time recent developments somewhat amended the overall picture and it is now questionable whether EMU membership is still unequivocally attractive option for new EU members. The not in every aspect positive experiences of Slovenia and particularly Slovakia with the Euro moreover the fundamental problems of the Euro-area becoming very visible due to the Greek crisis increased voices in CEE that question whether it is still in the best interest of these countries to adopt the Euro as soon as possible.

Regarding the protective effect of EU membership: since EU membership – at least theoretically – also means eventual Euro adoption (which – again theoretically – requires sound macroeconomic fundamentals), EU members might enjoy slightly higher market confidence than non-member states. This was reflected in decreasing long-term interest rates of new members, also in cases (i.e. the Visegrad countries) where this was not justified by fiscal performance. (Györffy [2007] p. 102) Nevertheless mere EU membership does not provide as strong protection against market forces as EMU membership.

Moreover it has to be noted that the above external factors affected all eight countries in the region to a similar degree: all of them have existed in the same international environment equally exposed to market forces, all of them had the strong intention to join the EU (which they did at the same time) and officially all of them aim to introduce the Euro as soon as possible, thus the observable large differences in their fiscal performance can be ascribed to differences in domestic factors.

Györffy's work however has one important statement regarding external incentives / constraints in the CEE region. Evidence from the EMU countries seems to support the theory's assumption, about the importance of domestic factors namely that the degree of public support is an important domestic factor in determining a country's fiscal discipline. In case of EMU member states Györffy has found strong correlation between the level of satisfaction with democracy and a country's budget deficit level. The same test however fails to give supportive results in the CEE region: Unlike in the case of EMU member states, for the eight new EU members no correlation could be detected between the level of public trust and the level of budget deficit. Györffy gave the following explanation for this phenomenon:

“Unlike EMU member states, which face similar external incentives with regard to fiscal policies, the new member states have rather different constraints. In the Baltic States the widely known dangers of pursuing profligate policies with a currency board arrangement ensure the maintenance of consensus over different governments. At the same time the Visegrad countries do not face such constraints [...]” (Györffy [2007] p. 196)

The above statement is crucially important from the perspective of my research therefore it has to be carefully examined. The statement has two elements:

- (1) A currency board creates substantial external incentives for fiscal discipline
- (2) This external incentive overrides the effect and importance of domestic factors (hence the impossibility to recognize similar correlation concerning public trust and fiscal deficits as in the case of EMU countries)

Before discussing these two points in detail, it is necessary to see what a currency board arrangement (CBA) is and how it affects fiscal policy.

3.3. Currency board arrangements

The currency board is an exchange rate arrangement which has three major elements (Pikkani [2000] p. 5):

- (1) Fixed exchange rate of the domestic currency to an anchor currency
- (2) Free convertibility of the domestic currency at this fixed exchange rate
- (3) Full backing of the emitted domestic currency by foreign reserves

These are the elements of an ideal CBA however there might be certain deviations from it. In fact CBA does not exist anywhere in its pure form. The example with the smallest deviation in Europe is the Estonian CBA. (Grigonyté [2003] p. 119)

The anchor currency can also be a currency basket (this was initially the case in Lithuania). Regarding the issue of full backing it needs to be clarified what has to be backed, how broad interpretation of domestic currency the legislation uses: emitted notes and coins, the liabilities of the central bank, or even broader interpretation? What can be considered as an instrument to back the domestic currency might also vary from case to case: In Argentina for instance initially only 66.6% of the monetary liabilities of the central bank had to be held in foreign reserves, the rest could be held in Argentinean bonds denominated in foreign currency (Hanke-Schuler [2002] p.44). An interesting case is Estonia, where – to overcome initial shortage of reserves – the Supreme Council 150 million dollars worth of state forests to the Bank of Estonia reserves. (Kallas [1994] p. 9)

The CBA first and foremost is a very tight monetary regime whereby the country abstains from conducting an independent monetary policy. The aim is to achieve confidence in the currency thus fighting inflation. Sustaining credibility however requires sound macroeconomic policies thus - besides monetary policy - the CBA has strong implications for fiscal policy as well. Persistent fiscal deficit leads to increasing debt, which reduces reserves. Eventually this can lead to the collapse of the currency peg. (Camilleri Gilson [2002] p. 16-17; Grigonyté [2003] p. 113-114)

3.3.1. Currency boards as incentives for persistent consensus

According to the first claim of Györffy's statement currency boards are external incentives, which might seem rather surprising given the fact that a CBA is consciously chosen by countries and not externally imposed upon them. Györffy's work mentions two types of external incentives / pressures: (a) a looming or already existing crisis following the shaking trust of markets in the countries macroeconomic fundamentals creates a positive incentive towards fiscal discipline – at least temporarily; whereas (b) a monetary union (e.g. the EMU) where the credibility of common currency creates a protective shield from market pressure which is an obvious disincentive for fiscal discipline.

Although Györfly doesn't mention explicitly, it seems that – according to this first part of her statement – currency boards should be some sort of mixture of the above two: they signal credibility – like the EMU- yet have a positive effect on fiscal discipline – like crisis threats and unlike the EMU. However while in the EMU there are many “free rider” states which enjoy the benefits of the credibility of the common currency but themselves are not contributing to its stability with their lax fiscal policy, in case of CBA both the advantages of credibility and the price for maintaining it are 100 percently incumbent on one country. In this sense CBAs rather resemble fiscal rules, whereby the government ties its own hands at the same time the existence of the rules signals credibility.

As it was discussed in the introduction, the third stage of implementing a successful fiscal reform is institutionalized consensus on fiscal restraint that is the creation of rules for disciplined fiscal policy. The fourth stage in turn is sustaining these rules, which requires – according to the theory – public support for the system, since only high public support can eliminate incentives to deviate from the consensus.

The second element of Györfly's statement implies that the effects of CBA on fiscal policy create favorable conditions for both third and fourth stages. How exactly can this happen? CBA has a disciplining effect similar to market forces since if unsound macroeconomic policies fail to sustain the system the eventual outcome will be currency devaluation just like in the case of financial crises under different currency regimes, e.g. free floating. The main difference and the additional feature of a CBA is that cause and effect relationship is much more transparent and visible also to the public. Under a CBA persistently unsound fiscal policies lead either to default on debt and/or to the abandonment of the currency peg, which means devaluation of a previously stable currency. Currency devaluation is a phenomena which makes the otherwise complicated macroeconomic developments very much understandable for the wider public, as it effects them immediately and directly. The CBA reduces “the incentive to inflate, because the devaluation costs attach an extra penalty to inflation, and this disincentive scheme is public knowledge. Thus a credible commitment to a highly visible target such as the exchange rate provides an effective way to strengthen domestic financial discipline and eliminate an inflation bias.” (Grigonyé [2003] p. 113)

The second element of Györfy's statement implies that the political costs of a possible abandonment of the fixed exchange rate (which most likely implies devaluation) in the future are so high that merely the fear from it is sufficient to sustain elite consensus regarding the importance of fiscal discipline. Thus in countries where a CBA is in place the level of public support is irrelevant regarding fiscal outcomes. Logically this also means that would currency board arrangements not exist in any country of the region one could observe in CEE similar correlation between level of public trust and budget deficits like in the EMU.

Some evidence – at least from the region – seems to support the crucial importance of CBAs in fiscal outcomes. Dalia Grigonyté examined the fiscal performance of 10 CEE countries between 1994 and 2001. In the region Estonia, Lithuania and Bulgaria has a CBA in place. She has found that the CBA has significant negative effect on budget deficit (that is CBAs increase fiscal discipline) and this holds even if the quality of budgeting institutions are controlled for (she used Holger Gleich's data on budgeting institutions). (Grigonyté [2003]) It has to be noted here that once we take into consideration also the period after 2001 the evidence is even more supportive. This is mainly due to the fact that the period examined by Grigonyté included the Russian crisis which hit the Baltic countries particularly strong, resulting in temporarily higher deficits in the three countries out of which two has a CBA in place, decreasing thus the overall performance of countries with CBA. When comparing CBAs and simple pegs other authors (Fatas-Rose [2001]; Alberola-Molina [2000]; Grimm [2007]) also found that the former induces fiscal discipline while the latter rather has negative effect on it.

However not everyone shares this view. Guillermo Calvo and Frederic Mishkin focused on "hard peg" systems (i.e. CBA and dollarization) and came to the conclusion that "the key to macroeconomic success in emerging market countries is not primarily their choice of exchange rate regime, but rather the health of the countries fundamental macroeconomic institutions, including the institutions associated with fiscal stability [...]". (Calvo-Mishkin [2003] p. 115) Similar conclusion has been drawn by Adalbert Knöbl, Andres Sutt and Basil Zavoico, when assessing CBA's role in Estonia's economic transition. They found that "the CBA in Estonia [...] was more symptomatic of a broader intellectual and political commitment to the rapid transition to a market

economy and prudent and transparent macroeconomic policies than it was a cause of the very apparent success of the Estonian economy.” (Knöbl et al [2002] p. 21) Furthermore the above mentioned notion that CBAs are superior to conventional pegs concerning fiscal discipline is also doubtful if we take a look at the evidence. The only country with a conventional fixed exchange rate regime in the region is Latvia. Although theoretically Latvia should have substantially larger deficits than its two Baltic neighbors with a CBA, in fact it has shown more fiscal restraint than Lithuania. The case of Argentina demonstrates that it is unjustified to assume automatic fiscal discipline even under a CBA. Moreover it has to be noted that – somewhat contradictory to her previous statement – even Györffy acknowledges the limitations to the unconditional disciplining effect of currency boards and refers to Berger et al [2004], who state that differences in fiscal performance of the eight CEE countries can not be explained by the different exchange rate regimes. (Berger et al [2004] p. 6)

In light of the above discussion it can be stated it is at least ambiguous whether a CBA substantially induces fiscal discipline and if it does to what extent. Furthermore assuming that a CBA has automatic disciplining effect on fiscal policy regardless of other factors seems to be far fetched. Therefore Györffy’s suggestion that the existence of CBAs in CEE overrides the importance of domestic factors has rather weak fundamentals.

To prove the invalidity of her hypothesis we can test it using the original data presented by Györffy, yet excluding the cases of Estonia and Lithuania, the two countries with a CBA in place. If the correlation between public trust and budget deficit level can not be detected due to the effects of the CBA, then we would expect significant connection between the two variables once we only observe the cases without a CBA. However as it can be seen below the results show no connection even for the six CEE countries without a CBA.

Satisfaction with democracy*					
	2002	2003	2004	2005	Average
Czech Rep.	42	41	43	48	43,50
Estonia	32	32	30	44	34,50
Hungary	55	33	31	27	36,50
Latvia	37	40	35	44	39,00
Lithuania	36	37	29	24	31,50
Poland	28	23	16	29	24,00
Slovakia	19	17	18	26	20,00
Slovenia	45	50	43	56	48,50

* Percentage of respondents who are very or fairly satisfied
Source: Gyórfy [2007] p. 194

Fiscal balance (percent of GDP)*					
	2002	2003	2004	2005	Average
Czech Rep.	-6,8	-12,5	-3	-3,2	-6,38
Estonia	1,5	2,6	1,7	1,1	1,73
Hungary	-8,5	-6,5	-5,4	-6,1	-6,63
Latvia	-2,3	-1,2	-0,9	-1,2	-1,40
Lithuania	-1,4	-1,2	-1,4	-2	-1,50
Poland	-3,3	-4,8	-3,9	-3,6	-3,90
Slovakia	-7,8	-3,8	-3,1	-4,1	-4,70
Slovenia	-0,3	0,2	1,6	1,4	0,73

* Adjusted for costs of pension reforms
Source: Gyórfy [2007] p. 195

Results for CEE-6 (without Estonia and Lithuania):

X = Average satisfaction with democracy; Y = Average level of deficit

$$Y = 0.095X - 7.078$$

$$\text{Sig.} = 0.473$$

$$N = 6; R^2 = 0.135$$

These findings have several consequences: (1) the effects of a CBA do not override the effects of public trust, (2) public trust – at least the way it is measured by Gyórfy – does not seem to be a crucial domestic factor in determining sustainability of fiscal

restraint in CEE, (3) this does not mean that a CBA has no effect on fiscal restraint however there are several ambiguities surrounding this issue: (a) how strong is this disciplining effect? Does it override domestic the effect of unfavorable domestic factors that otherwise would predestine the country for lax fiscal policies? (b) the exogeneity / endogeneity issue: “It is [...] possible that the countries with the potential for restrictive fiscal policy were those more likely to adopt fixed exchange rates.” (Grigonyté [2003] p. 115)

3.4. Currency board arrangements and fiscal rules

There is one more issue regarding currency boards that needs to be clarified. As it was mentioned during the discussion on fiscal rules, Bulgaria is the only clear case which does not seem to support the notion that fiscal rules determine budget balances. Since the introduction of the CBA in 1997 Bulgaria has shown remarkable fiscal discipline, nevertheless the quality of its procedural rules remained rather low. Although Bulgaria is not part of the eight CEE countries that was included in Györffy’s theory and the focus of my research is also rather on these eight countries, due to the small number of cases, Bulgaria can not be completely ignored when discussing CBA. There are two reasons why the case of Bulgaria does not fundamentally challenge the theory’s suggestion about the importance of fiscal rules:

(1) It can be argued that the Bulgarian case does not fulfill the important criteria about similar external pressure. It has been discussed that during the observed period the eight CEE countries existed in a similar external pressure/incentive setting: none of them had an effective shield against market forces like the credibility of the EMU. Unlike any of the CEE-8 Bulgaria did experience full-scale economic crisis and effective collapse in 1996-1997, with collapsing currency, inflation, budget deficit and public debt growing out of control. With this event Bulgaria experienced substantially different external environment than the aforementioned countries of the region and had to turn to the IMF for help. The introduction of CBA was a consequence. “The IMF signaled it would provide the foreign exchange reserves needed for the smooth CBA operation. In fact, its introduction was the condition under which the IMF would

continue providing financial support to Bulgaria.” (Roussenova [2002] p. 24) It is hard to judge whether subsequent fiscal restraint is a consequence of the automatic and unconditional disciplining effect of the CBA or it is the consequence of the still lasting effect of the crisis experience which was able to fuel consensus on fiscal restraint. In order to answer this question we would need another case from the region that experienced similar external shock. In short, the different external pressure experienced by Bulgaria makes the case unfit for unproblematic comparison with the CEE-9 countries.

(2) Since a CBA has strong implications for fiscal policy, namely under a CBA fiscal discipline is a well articulated interest of the government and since we have no reason to believe that governments are not aware of these implications, a CBA is in certain ways similar to fiscal rules: both are self imposed rules that limit the government’s discretion in fiscal policy. The important difference is that a CBA is a monetary arrangement, its rules are binding the monetary policy whereas it has only implications, not clear cut rules for fiscal policy and as the case of Argentina has shown these implications can be disregarded. Nevertheless I believe it can be argued that fiscal rules and CBA are not excluding rather complementing each other and CBAs could be considered as special types of fiscal rules, influencing fiscal policy although according to different mechanisms. Therefore a country displays fiscal discipline if it either has high quality fiscal rules or a CBA in place. Latvia and Slovenia use no CBA, yet they do have good procedural rules consequently both countries have had rather small deficits. Bulgaria, with low quality fiscal rules, yet a CBA in place has performed equally well. Lithuania with somewhat lower quality rules than Latvia or Slovenia and with CBA in place has shown similarly small budget deficit as Slovenia, whereas Estonia that has both high quality fiscal rules and a CBA has had the best fiscal balance in the region throughout the period.

4. CONCLUSION OF FISCAL RULES AND EXTERNAL PRESSURE

The previous two chapters were necessary in order to see whether the two important preconditions of Gyórrffy's theory are also present in CEE. The first chapter dealt with fiscal rules: whether fiscal rules are crucially important determinants of fiscal outcomes also in the region. The second chapter looked at the issue of external pressure. According to the theory the external incentive / pressure setting for countries has to be fairly similar, otherwise examining the role of domestic factors in deficit levels makes no sense, as the external pressure overrides the effect of domestic factors. Once it is established that fiscal rules do determine fiscal outcomes and that countries of the region face similar external pressure we can focus on domestic factors.

Based on the results of earlier researches it can be concluded that just like in case of old EU member states, also in CEE fiscal rules are important determinants of fiscal outcomes. The available data focuses on the quality of budgeting rules (procedural rules), which give rather comprehensive picture of countries' fiscal rules, as they include the consideration of different numerical rules and the existence independent fiscal councils – the two other groups of fiscal rules mentioned by Gyórrffy and other literature. Evidence shows strong positive connection between the quality of procedural rules and the fiscal balance in CEE.

As far as external pressure is concerned it can be established that countries of the region have faced similar incentives / pressures. Preparation for EU membership did not provide strong incentive for fiscal restraint as it was the stated policy of the Commission that such consideration will have secondary importance in assessing a country's readiness to join the EU and macroeconomic convergence – including fiscal policy – should be achieved on the medium-run. After these countries became members legally they are bound to comply with the Maastricht criteria and join the EMU as soon as possible. However weak enforcement mechanisms of the EU combined with the lack

of clear deadline for compliance meant that prospective EMU membership did not have such disciplining effect for CEE countries as for the 12 original members. The latter group had a clear deadline when the common currency area was formed, therefore those countries that indicated interest in becoming founding members had a much clearer incentive to comply with the criteria to avoid failure. It can be argued that as more and more new member states are adopting the Euro the outsider new members will have increasing incentive to comply with the criteria in order to avoid becoming “last in the class”.

When discussing the external pressure the issue of currency board needs to be addressed. When testing the findings of her research Györffy examined the connection between level of public trust in a country and its fiscal performance. In case of EMU member states she has found significant positive connection, however this was not the case when she tested the eight CEE countries. She suggested this is due to the fact that certain countries in the region have CBA in place, thus having different external incentives. According to her argument a CBA has such strong disciplining effect on fiscal policy and on the consensus regarding fiscal restraint that it is overriding even otherwise unfavorable domestic conditions (i.e. low public trust). Thus, it is implied that, in case of CEE no further investigation of domestic factors makes sense.

Existing literature is inconsistent on whether CBA automatically enhances fiscal discipline and if it does to what degree. The fact that merely a CBA is not an ultimate remedy against lax fiscal policies is demonstrated by the case of Argentina. The argument that lack of correlation between public trust and fiscal balance in CEE is due to the effect of CBA can be effectively contested if we run the same test leaving out Estonia and Lithuania – the two countries with a CBA – of the sample. Although the number of cases is even lower than before - which should warn us from making far fetched conclusions – the results still seem to be quite unequivocal, that there is no connection between public trust and budget deficit. It means that the CBA is not the ultimate problem, rather it can be suspected that public trust – at least the way it is measured by Györffy – is not such crucial determinant in the region as it could be suspected based on the theory. Nevertheless - based on the literature – it can be assumed that a CBA does have some fiscal disciplining effect due to its rather obvious implications for fiscal policy. Furthermore it has to be assumed that governments are

aware of these implications and that introduction of a CBA – if they aim to keep the arrangement in place - will limit their discretion regarding fiscal policy. In that sense we can consider the CBA as a special type of fiscal rule: consciously self imposed (thus it can not be considered as an external factor) and limiting fiscal policy.

It can be established that the two important preconditions suggested by Gyórrffy's theory, namely the significance of fiscal rules in fiscal outcomes and the similarity of external pressure/incentives are fulfilled in CEE. Therefore it can be assumed that – in line with the logic of the theory – domestic factors are key determinants of variance also across CEE countries. Thus, following chapters will focus on domestic factors and aim to identify those that are important determinants of fiscal performance. The main focus will be on comparing the cases of Estonia and Hungary the two extremes regarding fiscal performance throughout the period. The results should be then used to suggest possible directions for generalization on the region.

5. DOMESTIC FACTORS AND DIFFUSE SUPPORT

5.1. The theory's suggestions regarding domestic factors

So far all chapters of the current paper began with a detailed discussion of the framework theory's suggestions regarding that chapter's topic. We have no intention to deviate from this pattern. Since this second structural unit focuses on domestic factors we will start with an overview of the theory's suggestions regarding domestic factors. This part contains the essence, the real value of Gyórrffy's theory therefore it is particularly important to understand how these domestic factors influence – according to Gyórrffy – the fiscal performance of a country.

So far it has been established that the quality of budgeting rules is a fundamental determinant of budget balance. The real question Gyórrffy is aiming to answer in her dissertation is the following: if the connection between fiscal rules and budget balance is so clear (and the external pressure / incentive environment is similar enough) why do governments of certain countries choose to implement strict rules while others do not and once a government has created strong rule setting, why in certain countries subsequent governments respect and adhere to these rules?

Gyórrffy investigated the cases of Hungary and Sweden in order to identify the relevant domestic factors that explain the different choices of governments. Both countries needed strong fiscal adjustment in the same period around the late '80s / early '90s and while both countries attempted to deal with the problem of unsustainably high budget deficits only Sweden managed to achieve lasting success, while Hungary's fiscal adjustment attempts remained largely futile and could show forth only temporary success. Gyórrffy provides further justification for her choice of Sweden as a case to compare it with Hungary by highlighting similarities in certain important aspects: both countries are small, open economies, with large state redistribution and large public

debt. Moreover there are a number of differences that would rather presuppose that Hungary has higher chances of conducting a successful fiscal adjustment, e.g. Swedish electoral system tends to yield minority governments, Hungary is a candidate to the Euro Zone while Sweden is not, etc. (Gyórfy [2007] p. 139.) The results from the case studies were then synthesized, which provided the basis for Gyórfy's suggestions about the importance of domestic factors.

An important assumption of Gyórfy's work is that fiscal management reforms, that is changing or tightening budgeting rules, do not effect any interest groups directly, therefore it is politically less sensitive to take this step than for instance cutting pensions, public sector wages or closing hospitals, etc. (Gyórfy [2007] p. 38.) Therefore whether these rules are tightened depends primarily on the elite's willingness to do so. Consensus within the elite about the necessity of tight fiscal rules is thus the first important domestic factor. The government in power has to be sure that once tightened fiscal rules are in place - which by the way tie the government's own hands in spending - the opposition will respect these rules and will not deviate from the consensus by trying to win votes with populist promises. If there is any considerable political force that is outside of the consensus then the government has no incentive to make tight rules as it would only create a situation where the government maneuvers itself into a disadvantageous position vis-à-vis the opposition.

Having such consensus is however only the first necessary condition and the easier one to achieve: a looming crisis for instance can lead to a situation where the elites put aside their conflicts and work out a temporary consensus to avoid the worst. Lasting change in fiscal performance however can only be achieved if the consensus is persistent. The other important domestic factor, the level of diffuse support for the system in the society, determines whether a society is capable of upholding such lasting consensus. As it has been mentioned earlier in this paper Gyórfy uses for her theory David Easton's concept of diffuse support, who defined it as a certain trust of the society towards the system, wherein the members are convinced that the current system generates outputs favorable for them in the long run even if sometimes the immediate measures are unfavorable for them. (The next section will discuss the issue of diffuse support in details.) In a society where diffuse support is high – according to Gyórfy – long term thinking is more appreciated than in an environment characterized by low

diffuse support. That is, in the latter case it is easier to buy votes with populist promises that yield benefits for the electorate only on the short run, since voters do not believe anyways that the system will provide them any benefits on the long run. Such promises however are impossible to make if strict budgeting and generally strict fiscal rules are in place, therefore a low diffuse support environment provides considerable incentive for different groups of the elite to deviate from the original consensus that favored fiscal restraint.

The above suggestions of the theory regarding the importance of these two domestic factors were then tested by Gyórrffy. As first step the two factors, elite consensus and trust (Gyórrffy uses trust interchangeably with diffuse support, which is not entirely correct, as it will be explained later), had to be operationalized. In case of the former Gyórrffy's method is quite simple: she assumes that the level of average budget deficit indicates the degree of consensus within the elite about the importance of fiscal restraint. This approach can be supported by the argument that since high correlation has been detected between deficit level and quality of budgeting rules, better rule setting presupposes higher degree of consensus. The latter – diffuse support - has been measured through the results of Eurobarometer surveys regarding satisfaction with democracy: the share of population that is either “very satisfied” or “fairly satisfied” has been considered being satisfied with democracy in the respective country. For each of the 12 founding EMU member state the average level of satisfaction with democracy was calculated for the period between 1998 and 2005. These figures were then set against the average budget deficit levels of these countries for the same period and the relationship of the two datasets was investigated through a simple linear regression analysis. (For the dataset used by Gyórrffy see Appendix D.) It was found that “public trust in the system [or diffuse support] explains over 56 percent of the variation in fiscal deficits” ($Y = 0.139X - 9.234$; $R^2=0.561$, Sig. = 0.005). (Gyórrffy [2007] p. 192.) There might be different views on exactly how strong support this result provides for the hypothesis, nevertheless 56 percent indicates significant connection – even if one disagrees with the rather optimistic assessment of Gyórrffy that it provides “strong support”.

As it was discussed earlier in this paper the same test was ran on eight Central and Eastern European countries yet the analysis failed to show similar connection

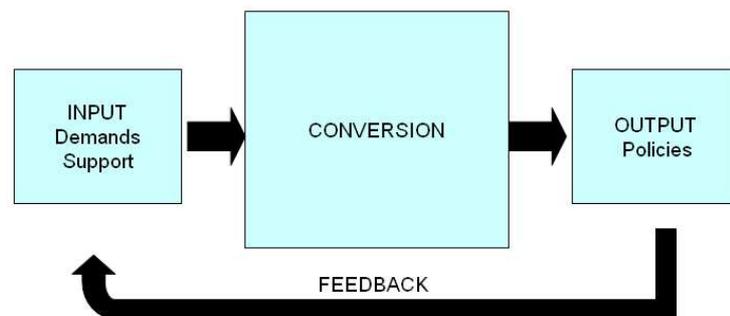
between diffuse support and budget balance. It was also mentioned that Györffy explained this discrepancy with the influence of currency board arrangements in certain countries of the region and a large section of the third chapter argues that this suggestion is invalid. Thus the question arises: if Györffy's explanation for the discrepancy is invalid does this mean that the whole theory should be dismissed as false? The current paper argues that it would not be reasonable to discredit the theory. As it will be seen in later chapters the cases of Estonia and Hungary in many ways actually support the notion. It is quite likely that the main source of problem is Györffy's way of operationalizing the relevant domestic factors. The following section investigates this issue by taking a closer look at the theory that served as a basis for Györffy's work, that is, David Easton's concept of diffuse support.

5.2. David Easton's concept

David Easton first elaborated the concept of diffuse support in his book 'A Systems Analysis of Political Life'⁷ In this work his main concern was to examine how different political systems manage to persist. According to him most of the political research "is concerned with exploring all those intricate subsidiary processes through which decisions are made and put into effect [however] theory needs to know how it comes about that any kind of system can persist long enough to continue to make such decisions". (Easton [1979] p. 31.) It is far beyond the scope of this paper to discuss Easton's entire work in detail. What is important here that Easton viewed the political life as an open and adaptive system, where all the elements are interconnected and reinforce each other. In an optimal case such a system can meet the challenges imposed by stress (disturbances) and can continue to exist. Support and within that diffuse support is only one – albeit very important – element of the system. In a brief and extremely simplified manner Easton's political system can be described as following: political systems exist in an environment with innumerable events and conditions. The inputs of the system concentrate and capture the effect of everything that is relevant from the environment as political stress. There are two major types of inputs: demands

⁷ The book was first published in 1965 however for the purpose of this research a second edition from 1979 was used: Easton [1979].

and support. Demands are channeled into the political system, where they are converted into outputs by the authorities (i.e. decisions and actions by the authorities). The outputs then influence the environment through a feedback loop influencing thus inputs (altering or creating new demands, changing support).



From the above scheme for our purpose only the suggestions regarding support are interesting, thus in the following section the focus will be on this aspect of Easton’s political system. (It can be noted here that the bulk of ‘A System’s Analysis of Political Life’ deals with the issue of support, thus it might be argued that support is the most important element of Easton’s system anyways.) A decade after the first publication of his book, due to the special attention received by the concept of support (its increased use in empirical research) and the ambiguities persisting around it, Easton further elaborated on the issue of separating diffuse from specific support in an article; Easton [1975]. These two sources will be used here to specify the concept of (diffuse) support.

5.2.1. Support, its objects, and stress on support

Support as an input variable has essential importance, since no political system can persist without at least a certain level of support. Thus decline of support is considered a major stress on the system which can threaten its persistence. Support for a political system is constituted by support for three political objects: support for the authorities, the regime and the political community. Relatively stable support for the authorities is necessary, so that some sort of continuity of decision makers /

administrators exists, otherwise demands can not be processed into outputs. Support for the regime, that is, the rules and structures of demand conversion is also essential and last but not least without maintaining some minimal cohesion within the membership of the political community, that is without support for the political community, no system can exist. A vague hierarchy of objects is implied, wherein loss of support for the political community or the regime poses a more fundamental threat for the system than decline of support merely for the authorities.

Disturbances in the environment or in the system itself that threaten the persistence of a system are called stress by Easton. Stress on support in this sense is the decline of support below a critical level. An important source of decline in support is output failure. Output failure occurs when the authorities either fail to take action to meet the demands of members or their actions are incompatible with demands. This is important for us because Easton identifies cleavages, or the lack of consensus as major drivers of output failure. Thus consensus appears as an important factor not only in Gyórfy's work, but also in Easton's system theory. What is missing from Gyórfy's work is that consensus can influence the level of support, insofar as the level of consensus influences the potential danger of stress on support. Easton does not suggest that social diversity or group conflicts necessarily have negative consequences on output. Nevertheless there is a danger that "cleavages may so divide the relevant members that they find themselves unable to cooperate, negotiate, or compromise their differences even to the minimal extent necessary so as to discover some kind of acceptable output resolution". (Easton [1979] p. 233)

5.2.2. Specific and diffuse support

It is necessary to differentiate between two types of support: specific and diffuse. The need for such differentiation arises from the fact that often, even though members of a political system are dissatisfied with certain policies or their life (generally with the outputs), this political discontent does not necessarily lead to fundamental political changes, as confidence in the regime or the political community is unharmed. Such phenomenon is the manifestation of the existence of two types, two levels of support. In

short: specific support is directly related to what the authorities do and how they do it, while diffuse support is more fundamental in character, directed to basic aspects of the system. The source of specific support on one hand is the membership's ability to directly link outputs to their demands, thus emphasis is on specific actions. On the other hand specific support is also based on the authorities' perceived general performance. Even if direct causal relation between the actions of the authorities and the outcomes is harder to establish the members of the system might blame or praise the authorities, the government for their present conditions. Whereas diffuse support is a broad political good will, a diffuse attachment to the regime and community that makes members tolerating outputs that are perceived to run contrary to one's wants and demands. "It consists of a reserve of support that enables a system to weather the many storms when outputs cannot be balanced against inputs of demands. It is a kind of support that a system does not have to buy with more or less direct benefits for the obligations and responsibilities the member incurs." (Easton [1979] p. 273.)

Without diffuse support and based solely on specific support no system can persist, it is however possible that a system temporarily survives on specific support alone, which in an optimal case will breed – after a while - diffuse support as well. Differentiating between the two types of supports has another important aspect for the current research. In countries where the political system has changed recently, governments usually face the problem that the level of output is inadequate, it does not meet demands. This is usually due to the inexperience of new authorities and/or the chaotic political/economic circumstances usually surrounding political system change. As a consequence specific support for the new system is usually low however this is offset - in an optimal case - by the high diffuse support, large reservoir of good will towards the new system. Indeed it is quite logical to assume that around its birth a new system enjoys such diffuse support – the amount of this sort of diffuse support is however highly dependent on the circumstances surrounding the birth of the new system.

5.2.3. Dimensions of diffuse support

It is not explicitly stated, but from Easton's works it seems that the object of specific support is mostly the authorities, whereas the objects of diffuse support are both the offices and their occupants, but especially the regime and the political community. In the first chapter of this paper it was mentioned that Györffy equates diffuse support with trust. This is not uncommon among other scholars either however this is not entirely in line with Easton's concept. Trust – according to Easton - is only a dimension of diffuse support, a form of diffuse support for the authorities and the regime. In the presence of trust “members feel that their own interests would be attended to even if the authorities were exposed to little supervision or scrutiny. For the regime, such trust would reveal itself as symbolic satisfaction with the processes by which the country is run.” (Easton [1975] p. 447) The other form of diffuse support for the authorities and the regime is belief in their legitimacy or “the conviction on the part of the member that it is right and proper for him to accept and obey the authorities and to abide by the requirements of the regime.” (Easton [1979] p. 278) Thus trust and belief in legitimacy are two forms of diffuse support for the authorities and the regime. Diffuse support for the third (and most fundamental) political object - the political community – may appear as a sense of “we-feeling”, common consciousness or group identification. In order to be able to operationalize diffuse support understanding of these dimensions is essential, as “the political object will govern the mode of expression of diffuse support.” (Easton [1975] p. 447)

The above summary might have been somewhat dense nevertheless it is important to have at least an overview of Easton's theory and where in it the concept of support has its place. This is important because – as it was mentioned before – the suspicion arose that Györffy's choice of indicator for diffuse support, the way she operationalized it is not in line with Easton's suggestions therefore it is inappropriate for measuring diffuse support. In order to highlight the problems associated with Györffy's operationalization, below the most important properties of diffuse support were synthesized from Easton's works:

- Diffuse support is independent of the effects of daily outputs - at least in the short and medium run.
- It is not easily depleted through disappointment with outputs.
- It is more stable and less fluctuating/volatile than specific support - although there might be cases where a sudden frustration results in dramatic drop in diffuse support.
- It is a sentiment. While specific support is given for returns (direct link to outputs or at least perceived outputs) diffuse support is offered because of affective ties to an object in and of itself.

This last point implies that capturing diffuse support through opinion polls is particularly problematic. If a question inquires about how the members assess a certain institution or the system itself (as it happens for instance in the eurobarometer question used by Gyórrffy) it is quite inevitable that the answer will be to a large extent based on the perceived outputs of that object (institution, the entire system, etc.). It can happen that public opinion polls reflect low trust in parliament, political parties, government, etc. but still maintain diffuse support towards the system. An additional problem with Gyórrffy's way of measurement is that it does not fulfill the requirement of sufficient stability. In the few years' data presented by Gyórrffy there can be quite substantial changes in the values from year to year in CEE (see Appendix D), which suggests that this indicator is rather connected to specific outputs of certain years, than to the deeper diffuse support.

Even though Gyórrffy's explanation about the importance of CBA does not seem to hold, it is still a fact that the connection between trust and deficit can not be detected in CEE, at least not the way Gyórrffy measures it. Thus the question arises: does this mean the entire theory is wrong or does the problem lie elsewhere? As it was mentioned before, this paper argues that the latter is the case: the main suggestions of the theory are relevant also in CEE, that is successful, lasting fiscal adjustment through strengthening fiscal rules requires elite consensus and high diffuse support in a society. However it seems that Gyórrffy's way of measuring diffuse support is incorrect. The following chapter will compare the cases of Estonia and Hungary. On one hand these

cases support the theory on the other hand they can be useful for identifying new ways to operationalize diffuse support.

6. DOMESTIC FACTORS IN ESTONIA AND HUNGARY

6.1. Overview of the past two decades

In the first section of this chapter a brief overview will be taken of fiscal developments in Estonia and Hungary since the beginning of transition. Estonia is the simpler case. Since the introduction of the national currency, the Kroon, in June 1992 and the choice of currency board arrangement, Estonia has been characterized by fiscal discipline exceptional among transition countries and rare even in whole Europe. As data shows the general government's budget exhibited surplus in most years, while deficit remained marginal in other years. (See Appendix A) The only exception is 1999, when deficit reached a slightly higher level due to the 1998 Russian crisis which had hit Baltic economies particularly strongly. The remarkable determination of Estonian governments towards fiscal discipline has also been reflected in the budget balances during the years of the current economic crisis. Despite the huge economic contraction experienced by Estonia the country managed to keep its budget balance within the 3% limit set by the Maastricht criteria – almost unparalleled in the EU - both in 2008 and 2009. Considering that Estonia still has the lowest level of sovereign debt among all EU member states one can imagine the constraint this fiscal discipline has put on the country in recent years.

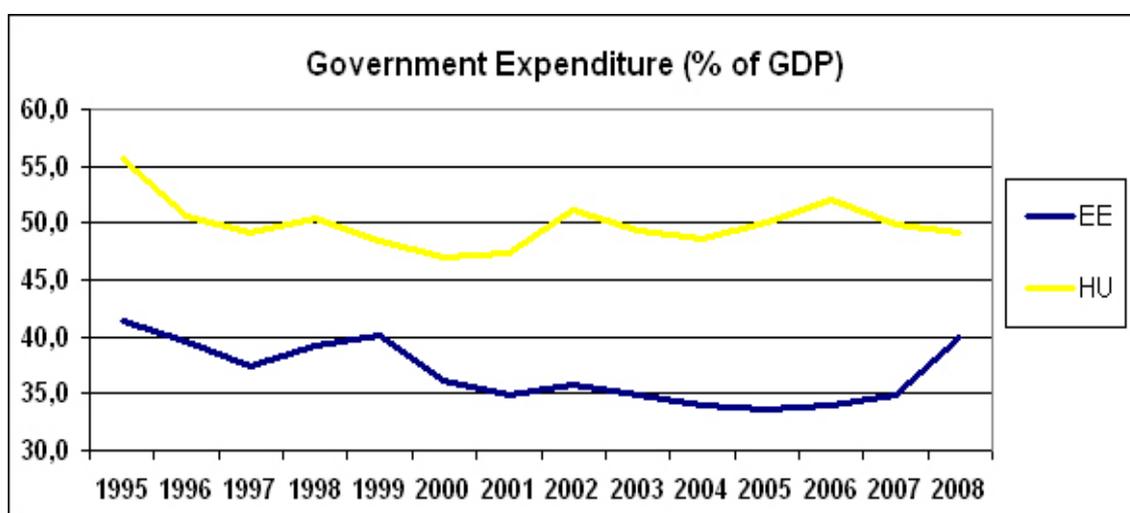
The picture is very different in Hungary⁸. When discussing recent fiscal issues in the Hungarian economy one needs to go back a few decades in time since the inertia of certain developments during the communist period still seems to exist and determines the current situation. It is widely known that since the early '60s Hungary had been a frontrunner in economic reforms among countries of the soviet block. The main reason behind this had been the effects of the 1956 uprising, more precisely the regime's fear

⁸ A substantial part of this section is based on the chapter in Györffy's work concerning Hungarian developments (Györffy [2007] p. 111-137) When other source was used it is indicated by reference.

that such event might happen again. Therefore from the '60s on constant raise of living standards became the main aim of the regime. (Kornai [1995]) It was hoped that economic reforms will secure the necessary resources however when the first oil price shock hit the soviet block economies and demand decreased for their low-quality export the leadership decided to keep financing the system by borrowing from foreign creditors. (Muraközy [2004] p. 15) Increase in wealth of the masses in a socialist system was of course only possible through high state redistribution. This strategy of high redistribution and financing wealth or consumption through accumulation of debt continued for the rest of the communist period. These tendencies were reflected in the fast increase in social expenditure. While in 1980 they amounted to 15% of the GDP a decade later they exceeded 25% which was 25% higher than the OECD average and equaled the levels of Austria, Denmark and Germany! (Muraközy [2008] p. 156-157) As a consequence, at the time of the changes the new democratic Hungary had an enormous sovereign debt burden (73% of the GDP in 1989 – OECD) and high level of redistribution (Government expenditure was over 63% in 1989 – OECD). This legacy has undoubtedly put a huge burden on the new governments and limited their space of maneuvering in fiscal policy.

Since the beginning of transition one of the weakest spots of Hungarian economic policy has constantly been fiscal policy. Subsequent governments were unable to reach lasting success in deficit reduction. Out of the 15 years where we have trustworthy, comparable data, Hungary exhibited the worst deficit seven times and in most other years the country was among the worst performers. (See Appendix A). The new democratically elected government first attempted to take measures in order to reduce the deficit however it quickly backed off in face of social resistance. The most famous manifestation was the blockade of the cab drivers in October 1990 who paralyzed Budapest as a response to drastic rise in petrol prices. (Romsics [2005] p. 561) After 1990 the economic situation worsened, by 1992 the economy contracted by 20% and the government decided not to take measures that would put additional burden on the population. This policy seemed to prevail under the subsequent governments even though substantial reduction in social expenditures would have been necessary in order to balance the budget. Yet even during the second decade after the regime change level of state redistribution and social expenditure remained well above OECD and the

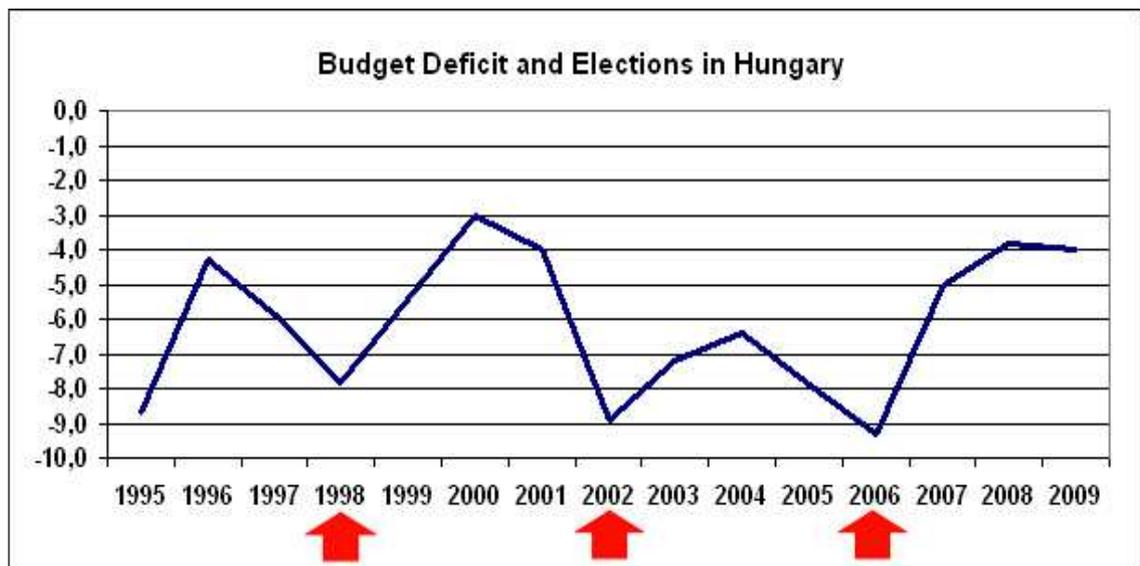
region's average. (See for instance Muraközy [2008] p. 164; Barabás et al [2008] p. 14) Muraközy [2008] labeled Hungary as an “early born welfare state”, wherein the level and structure of redistribution, social benefits, etc. resembles that of the most developed European welfare states while the actual level of economic development corresponds that of developing countries. The chart below shows the wide gap between Estonia and Hungary concerning the level of redistribution (level of government expenditure). While high level of redistribution does not necessarily mean higher deficit (as the example of Sweden shows) the chart certainly reflects the difference in economic policy approach in the two countries.



Source: EuroStat

There were two exceptions during the past 20 years when serious and promising attempt were made for fiscal adjustment. In March 1995 a fiscal stabilization package was introduced by the finance minister Lajos Bokros (hence the popular name: “Bokros-package”). The package included devaluation of the currency, an 8% import surcharge, strict restriction of wages and an aim to redesign welfare spending. (Kornai [1995]) All of these measures affected the population strongly. Even though some of the proposed measures did not pass the constitutional court a large part of the package was introduced and the economy was eventually stabilized. The stabilization however came with a price: Bokros was hugely unpopular and in 1996 had to resign from the position of finance minister. In 1998 the socialist-liberal coalition that governed the country in 1994-98 was defeated by the conservative FIDESZ not least because the unpopular

Bokros-package could be well used against the socialists in the campaign. Still, for a few years it seemed that this adjustment was enough to put the country on the right track: economic growth picked up after the first shock and budget deficit started to decrease. Before the 2002 elections however growing number of signs showed that the old reflexes are returning. Real wages started to increase by an incredible pace due to doubling minimum wage in 2001-2002 and massive salary increases in the public sector. (Antal [2004] p. 7-9)⁹ These tendencies continued after the elections. (Further 50% wage increase in the public sector!) The lesson that parties learned from earlier experiences was that short term promises to the electorate can buy votes and unpopular measures should be avoided by all means. This tendency of “vote purchase” particularly before elections is illustrated well by the following chart:



Source: EuroStat

The main reason behind the socialist-liberal government’s final decision to give green light to the stabilization package lies in the growing international pressure. In 1994 Mexico was hit by a crisis and by this time the twin deficit (fiscal and current account deficits) reached such a level that in the financial world Hungary suddenly moved to the center of attention as potentially the next country to be hit by a crisis. (Kornai [1995] p. 16) The government acted unilaterally. As later developments showed, no wider consensus with the opposition existed about the necessity of the stabilization package.

⁹ Györfly quoting Antal [2004]

This why fiscal responsibility could not be institutionalized and the Bokros-package could only have temporary impact.

The next serious attempt for fiscal adjustment was also connected to external factors namely the current financial and economic crisis. Due to the traditionally lax fiscal policy pursued by Hungarian governments and the continuously high sovereign debt, Hungary was exceptionally vulnerable when the crisis unfolded and was among the first countries having to apply for IMF bailout. In return and to avoid the fate of Greece the government had to accept the terms set by the IMF, which above all included sharp reduction of deficit. As a result Hungary has been praised for its determination and visible improvement of fiscal position. It is still too early to say whether the current adjustment brings about lasting changes in Hungarian fiscal policy, nevertheless the signs are not necessarily good. Once again wide consensus is absent and the new government taking office in May 2010 announced its intention to renegotiate terms with the IMF in order to substantially increase deficit target for coming years.

It is true that the circumstances of the two countries were in many ways very different in the beginning of transition (first and foremost the heavy indebtedness inherited by the new democratic government of Hungary should be mentioned here) moreover this paper certainly does not suggest that one mere factor determines fiscal balance of a country. Nevertheless it is still remarkable that throughout the two decades of transition these strong differences in the fiscal balance so stubbornly persisted. It is widely accepted that fiscal issues are strongly connected to politics and the above overview, particularly the overview of Hungarian developments, seems to support this notion. In her theory Györffy attempted to reveal the mechanism of how this connection works between politics, society and fiscal policy. In the following section Estonian and Hungarian developments will be discussed in connection to consensus the first major domestic factor suggested by Györffy's theory.

6.2. Elite Consensus

A minimum level of consensus within the elite about the general direction of economic policy including fiscal policy is a crucial (although not sufficient) condition for

successful and persistent fiscal consolidation. Moreover - as it has been mentioned earlier - according to Easton, consensus is not merely a dependent variable influenced by diffuse support, but the connection works to both directions: lack of consensus or cleavages in the society can have negative impacts that hinder the emergence of diffuse support towards the system. Therefore, when investigating the state of elite consensus in Estonia and Hungary, attention should be also devoted to the existing cleavages within these societies as they are the two sides of the same coin. In line with Györffy's theory, the hypothesis here should be that while Estonia enjoys strong elite consensus regarding economic policy, enabling persistent fiscal restraint, the Hungarian elite is disrupted and serious cleavages are in the way of necessary consensus.

6.2.1. Consensus in Estonia

At first glance the suggestion that the Estonian society is substantially less affected by serious cleavages than the Hungarian seems odd. Indeed while Hungary is ethnically relatively homogenous, quite the opposite is true for Estonia, where the share of the titular ethnic group is the second lowest in Europe. Moreover it is clear that the issues arising due to this ethnic division pose just as serious and complex challenges for the Estonia as any other current social problem potentially can for the Hungarian society. Nevertheless it should not be forgotten that according to Easton's concept only politically relevant members matter in issues that concern the political system, for instance regarding cleavages or diffuse support. The issue of the non-Estonian (mostly Russian-speaking) population will be discussed later more in details. For now it should be accepted that this share of the population – strictly from the perspective of the current paper - does not constitute a politically highly relevant group, therefore the ethnic division by itself does not exclude the possibility that Estonia has a cleavage structure more favorable than that of Hungary.

In their 2004 analysis of Estonian politics Mikko Lagerspetz and Henri Vogt focus exactly on the issue of cleavages within the society which makes that paper extremely useful for our purposes. Their main point is in line with the diagnosis of 26 Estonian thinkers that was elaborated in an open letter in 2001, namely that the most

important cleavage in Estonia is a horizontal one, which separates the elite from the rest of the population. The letter accuses the elite – and not just the government in power – of being alienated from the masses and being indifferent to the problems of ordinary people.¹⁰ Without intending to objectively evaluate the validity of the above criticism the current paper agrees that such horizontal cleavage exists within the Estonian society and more importantly for the current research: no impenetrable division exist within the elite itself. Lagerspetz and Vogt emphasise two basic characteristics of the Estonian political landscape: the monolithic nature of the political elite and the distorted spectrum of politics that tilts towards the political right. It seems temptingly easy to measure political stability of countries through the stability of governments or how often governments are changed in a given period. Based on the large number of governments since regaining independence one could indeed have the impression of relative political instability in Estonia compared to other countries in the region. However, as Lagerspetz and Vogt pointed out: “in economic policy Estonia has followed a straight course despite the regular changes of government”. (Lagerspetz and Vogt [2004] p. 74) This is exactly what needs to be understood under the “monolithic nature” of the Estonian politics: there is no real polarization of parties, which - at the same time - means that there is a consensus among the elite in key areas, first and foremost in economic policy. The unbalance of the political spectrum on one hand means that right wing parties have been overrepresented in the Riigikogu since regaining independence (see for instance Mikkel [2006]), that substantially more Estonians identify themselves with the political right than with the left (Vihalemm et al [1997] p. 208). On the other hand it also means that the prevailing economic policy, which enjoyed hegemony under any government during the past 20 years, is essentially a right-wing policy, favoring market liberalism or laissez-fair capitalism. (Lauristin and Vihalemm [2010]) It goes without saying that such economic policy that promotes a small state and low level of redistribution is much more favorable for pursuing strict fiscal policy than a more socially sensitive, more “left-wing” policy, where more emphasis is put on easing inequalities, protecting the “losers of transition” through large social transfers. (It has to be noted here that the framework theory presumes a more or less stable consensus among economists about the superiority of government wage and

¹⁰ Lagerspetz and Vogt quoting the open letter published in Postimees on April 23, 2001.

social transfer decrease, as most promising way for sustainable financing of deficit – Gyórrfy [2007] p. 20; also Alesina and Perotti [1996]) Moreover this is not simply a situation where the political right outbalances the left, as “even the ‘left’ options have been clearly market-economy and nationally oriented – to the extent, in fact, that in many countries these parties might qualify as steadfast right-wingers”. (Lagerspetz and Vogt [2004] p. 67) The results of the 1995 parliamentary elections (that resulted in a coalition government led by the winner of the election the Estonian Coalition Party) were dubbed by contemporary observers¹¹ as a turn to the left. It could be observed in many transition countries – including Hungary – that in the second election after the political changes the dissatisfied voters brought back the post-communists into power. (It can be of course argued to what extent this Estonian coalition can be considered as “post-communist”) In Estonia however this change in the government did not bring along any change in economic policy and the liberal, market-oriented policies were continued. (Lauristin and Vihalemm [1997] p. 114)

The monolithic nature, the lack of polarization of Estonian politics manifests itself in the party structure. Until 2003 there were five significant parties dominating politics: Pro Patria, Reform Party, the Moderates, the Center Party and the People’s Union. (In 2003 the Res Publica as a newcomer criticized all other parties for their corruption however they quickly failed politically – Lauristin and Vihalemm [2010] p. 15) Among these only the Center Party looked like that it could potentially offer an alternative as it was the only party left out of any government coalition between 1995 and 2002. Moreover the party has been considered as a more left-wing oriented formation, that is, the voice of ordinary people, who do not belong to the winners of the new market-capitalism. This illusion was however blown to pieces when in January 2002 the Center Party and the Reform Party (the biggest advocate of market-liberalism) formed an unlikely coalition. Thus it became clear that seeming ideological barriers are of secondary importance, each party can step into coalition with any other party therefore we can speak of no real alternative in the political scene as far as economic policy is concerned. (Lagerspetz and Vogt [2004] p. 64-67) Further empirical evidence in support of this notion can be cited looking at voter behavior, more precisely electoral volatility. Electoral volatility refers to the share of voters who vote for a different party

¹¹ Lauristin and Vihalemm refer to Laar [1996] and Nelson [1996]

than in the previous election. The Estonian political system is characterized by high electoral volatility. (Mikkel [2006] p. 43; at the same time an index created by Powell and Tucker [2009] indicates, that while Estonian electoral volatility is among the higher ones, it is by no means exceptional in the region.) This is a logical development in a system where no major vertical cleavage exists between significant political parties, none of whom questions the fundamentals of the prevailing consensus and where in consequence long-term electoral loyalty has no importance.

At this point it is also timely to return to the issue of the mainly Russian-speaking non-Estonian population. Why does the undoubtedly existing and important ethnic cleavage not pose a serious threat to the current consensus of the elite? Why does the Russian-speaking population not form a politically relevant group? It is not implied that Russian-speakers as individuals are not politically significant, they might be (provided they have the right to vote). However Russian speakers did not emerge in the political scene as a distinct group. There is no significant Russian party that effectively articulates specific Russian demands characteristically different from that of Estonian parties, thus challenging the current consensus. One reason is undoubtedly the low number of citizens among Russian-speakers. Nowadays roughly a third of the population that immigrated to Estonia during the Soviet times holds Estonian citizenship. (Foreign Ministry of Estonia) The rest has either no citizenship or chose to become (mainly) Russian citizens. In the early '90s this share was obviously even smaller. Since only Estonian citizens are allowed to vote in parliamentary elections this factor has obviously influenced negatively the chances of any potential Russian party for gaining significant amount of votes. It can be argued however that since the 1995 parliamentary elections there were enough Russian-speaking citizens who - with electoral discipline (i.e. high turnout and electoral loyalty) - could manage to secure a firm and significant position for at least one Russian party in Estonian politics. After a promising start in the 1995 (and to a lesser extent in the 1999) elections this scenario never became reality. (Estonian National Electoral Committee) In fact the bulk of Russian speaking citizens votes for mainstream Estonian parties. Although there is a clearly recognizable pattern, that the share of the Russian speakers is the highest among the supporters of the Center Party (Lagerspetz and Vogt [2004] p. 64), this does not make the Center Party a vessel through which the ethnic cleavage could seriously

threaten the prevailing consensus. For one thing – as it has been described above – the Center Party itself is part of this consensus, this way the Center Party rather integrates the Russian-speaking citizens in the Estonian consensus not the other way around. Moreover Russian-speakers still constitute a minority of the supporters of the Center Party and – although to a lesser degree – they can be found among the supporters of other Estonian parties as well. (Lagerspetz and Vogt [2004] p. 64)

In conclusion: analysts of Estonian politics agree, and empirical evidence (election results, electoral volatility) supports that strong consensus exists within the political elite regarding economic policy. As a result of this consensus during the past almost two decades subsequent Estonian governments followed a straight path of market-liberalism, which is particularly favorable for pursuing tight fiscal policies.

6.2.2. Consensus in Hungary

In Hungary the situation is exactly the opposite. A major problem of Hungarian politics is precisely the extreme polarization of the political scene, the dominance of party politics in almost every sphere of life. Instead of the horizontal cleavage of Estonia that divides the elite from the rest of the society, Hungary as an important vertical cleavage, which not only splits the political elite but also the society. After the change of the political system step by step two big political camps emerged from the political scene antagonistically opposing each other. There were signs already in the beginning of the transition period but the pattern became clear during the 1998 parliamentary elections. In 1990 six parties gained mandates in the parliament and no extreme concentration of seats could be observed at this point: there were larger parties, medium parties and small parties, yet none of them had extremely large weight in parliament. What could be observed in subsequent elections was the gradual decrease of parties: by 2010 only two of the original six remained in parliament. Moreover until the 2010 elections only once did it happen that a new party, outside the original six, managed to get a seat in the parliament. (In 1998 the right radical Party of Hungarian Justice and Life received slightly more than 5% of the votes, their presence however lasted only for one term.) At the same time among the remaining parliamentary parties

an extreme concentration took place: the two biggest parties, the leading forces of the two political camps received 83% and 85% of the votes in the election of 2002 and 2006 respectively. (For detailed results see Appendix E) The 2010 elections, which brought about major changes, will be discussed later. If we take a look at the electoral volatility also in Hungary we can see – again - exactly the opposite of Estonian developments. In line with notion of two opposing political camps the electoral volatility has decreased steadily and it has the lowest level in the entire region. (See Powell and Tucker [2009])

A two-party system by itself should not necessary bring along such extreme antagonism, however the specific problem of Hungary is the lack of any kind of value consensus. The main basis of orientation is relation to the previous (communist) political system, thus a kind of background consensus is missing, wherein the parties at least accept each other's legitimacy. The fact that party politics has penetrated such spheres of life that in an optimal case should be politics free makes the problem worse. Parties have infiltrated in cultural, educational, health care institutions, science (including economics) and more importantly also the lower levels of public administration¹². Individual voters are not entirely free of party influence either: as it has been mentioned above the system in Hungary is characterized by low electoral volatility and strong party loyalty. In an environment, where even basic consensus is absent, this has an affect, where people tend to use double standard when assessing political performance: abuse of power is only condemned only if the other camp's politicians are involved. The result of this deep vertical cleavage is that the political discourse is dominated by symbols instead of specific policy issues. (Körösényi [2009] p. 60-66; Györffy [2006] p. 252-254) It has been mentioned that the basis of conflict is relation to the communist system. This would imply a post-communist / reformist conflict and some sort of left-right ideological split between the two camps. To some extent this is indeed true, at least on the level of official communication (although it has to be stated that both political camps have many figures from the "old guard", for instance economic experts of both large parties are recruited from this circle – Szalai [1999] p. 43-45.), however this does not mean that there would exist two well definable, characteristically different specific policy set alternatives (e.g. in economic policy).

¹² To illustrate this Györffy refers to Fricz [2004] p. 125-129, where exact data can be found on personnel turnover in public sector after elections.

While in Estonia the lack of alternatives means that one, well defined direction prevails in economic policy, the antagonism in Hungary does not produce two alternatives instead no clear direction is defined. Labeling the economic policy pursued by one or the other political camp along traditional left-right divide is also problematic in Hungary: the political left at times appears to be more market friendly than the right while economic populism is practiced in both sides. This was particularly clear in the elections of 2002 and 2006. (Körösényi [2006])

The way how the two political blocks exploited every opportunity when the other was in government to win support with populism reflects well the above described lack of minimum consensus in Hungary. In 1990 when the cabdrivers blockaded Budapest in wake of sharply raising petrol prices, the opposition sided with the protesters against the newly elected government. (Romsics [2005] p. 562) After the blockade that government had never dared to take any measures that could trigger mass protests. Still people felt the harsh negative effects of transition and in 1994 voted the post-communists (in a coalition with the liberals) back in power in hope that the former reform communists will keep their promises and make transition less painful. Oddly enough it was this government that introduced in 1995 the tough economic adjustment measures. The hugely unpopular minister of finance who conducted the whole process had to resign soon and the opposition did not miss the chance to keep the issue alive until the next elections, which was won by the right-wing FIDESZ to a large extent because of the lively memory of the adjustment package in people's minds. By the next election in 2002 both blocks have learned the lesson and the campaign both in 2002 and 2006 became practically a competition of who can promise more to the electorate. (Kornai [1995]; Györffy [2006]; Körösényi [2006] and [2009])

In this section the issue of elite consensus has been investigated in Estonia and Hungary. It was found that in line with the suggestion of Györffy's theory the country with persistently low deficit (Estonia) enjoys a stable consensus over economic policy, while at the other extreme the country with permanently high deficit (Hungary) lacks even basic consensus. Moreover the case studies have revealed that there is direct connection between the existence/lack of consensus and policy choices that are favorable or unfavorable for fiscal discipline. Now that we have this result the following question arouses: how is it possible that Estonia managed to sustain the prevailing

consensus and it has not been challenged by any significant political force? Moreover why did Hungary not manage to follow the Estonian path and did not build stable consensus at least in basic economic policy issues?

It was seen in the case studies that the Hungarian government in power has always been intensely attentive of people's attitude, not least because the opposition has never been reluctant exploiting the public's dissatisfaction with harsh (albeit often necessary) measures. Political forces in Hungary did find a promising political market segment as both camps tried to gain support by playing on the dissatisfaction of the citizens with unfavorable measures accompanying the undeniably difficult economic transition. The fact that it didn't happen in Estonia could logically be explained by two factors: either the dimensions of hardships in Estonia were smaller than in Hungary or the Estonian society reacts differently to these hardships than the Hungarian. The first option can be easily dismissed. A great number of figures and indicators could be cited here to support that economically speaking Hungary was in an incomparably better situation than Estonia around the beginning of transition. At this point however it is enough to highlight two indicators that strongly and directly affect the population: real wages and inequality.

János Kornai compared real wage decrease in five Central European countries (Hungary, Czech Republic, Poland, Slovakia and Slovenia) between 1989 and 1993. Real wages decreased by far the least in Hungary: by 1993 to 85% of the 1989 level, while Poland and Slovenia experienced almost 30% decrease. (Kornai [1995] p. 1105) Yet Estonians suffered even more drastic drop: in less than two years between 1989 and 1991 real wages fell by more than half! (Iwaskiw [1995]) As far as inequality is concerned the most plausible way to measure it is the widely used Gini-coefficient, wherein higher value means larger inequalities within the society. In Estonia the figure rose from 28 in 1989 to 39.3 in 2002 (the highest among the eight CEE countries that joined the EU in 2004), which reflects a 40% increase in inequality, while Hungary exhibited one of the smallest inequality increase in the region (19%) and with its 26.7 points the Hungarian society is among the most equal ones in the region and Europe. (Kornai [2005] p. 923)¹³ Still it seems that the Estonian public was able to bear hardships more than the Hungarian and seems less receptive to economic populism.

¹³ Kornai quoting data from UNICEF data base.

This does not mean however that equality is less important for Estonians than for Hungarians. Based on the results of the European Social Survey, in 2007¹⁴, although larger proportion of the Hungarian (85%) than the Estonian (77%) respondents thought that the government should reduce inequalities, yet the difference is not very significant especially if it is put into a European context. (In a number of western European countries it is around 60%, while in Denmark it is below 40%.) (Lelkes [2009] p. 20)¹⁵ As it has been discussed earlier such difference in consensus are ascribed by the framework theory to differences in diffuse support. In the following section we will look at the different explanations that are suggested by the existing literature and see whether these explanations can be identified as manifestations of diffuse support. If they are then this means that the cases of Hungary and Estonia support the validity of the theory.

6.3. The background of consensus

A number of interrelated factors and circumstances are brought up in the existing literature as explanations for the above elaborated state of consensus in the two countries. Synthesizing and ordering them in a logical chain will be attempted in this section nevertheless due to their complex interrelation it is not an easy task.

Towards the end of their analysis of Estonian politics Lagerspetz and Vogt mention the important and often quoted term ‘period of extraordinary politics’, which has been introduced by the Polish economist (deputy prime minister and minister of finance) Leszek Balcerowicz. They paraphrase Balcerowicz’s definition as following: “great changes in a country’s history create a reserve of political capital at the disposal of the government in charge. This reserve enables the government to apply radical and drastic measures of economic reform, if concentrated in the period of extraordinary politics shortly after this historical change.” (Lagerspetz and Vogt [2004] p. 80)¹⁶ The

¹⁴ The results reflect values of the respondents. Since it is assumed that values do not change in the short-run, we can assume that results of the 2007 survey also reflect by and large the attitude of Estonians and Hungarians regarding inequality in the beginning of transition.

¹⁵ Lelkes quoting results from ESS third wave.

¹⁶ Lagerspetz and Vogt paraphrasing Balcerowicz [1993]

striking similarities between Balczerowicz's concept of extraordinary politics and Easton's – earlier quoted - definition of diffuse support can not go unnoticed.

A major point of Lagerspetz and Vogt is that this period of extraordinary politics still exists in Estonia to some extent. "Large parts of the population are still ready to accept such decisions by the government that they would otherwise basically resist, provided that these decisions seem to strengthen the country's independence." (Lagerspetz and Vogt [2004] p. 80) A major source – they continue – of the persistence of this period is the perceived Russian threat, the deep-seated historical lesson that independence can not be taken for granted and it is best to be dependent on Russia as little as possible. This factor was presumably even stronger in the early period of transition, prior to 1994, the withdrawal of Russian troops from Estonian soil. First of all the issue of troop withdrawal was kept open until the very last moment by the Kremlin and this uncertainty definitely did not help in easing the threat felt by many Estonians. (Galbreath [2005]) Moreover the early '90s was still generally a quite uncertain period in CEE. The former Yugoslavia descended into a bloody ethnic conflict and in Moldova the Transnistrian separatists were openly backed by the Russian troops stationed in the region. Statements of certain Russian officials also did not help to ease the tensions. A member of Vladimir Zhirinovsky's infamous Liberal Democratic Party, Petr Rozhok, for instance openly encouraged veterans of the Soviet army staying in Estonia to form armed militias. (Galbreath [2005]) p. 194) After the troop-withdrawal Estonian fears of direct military threat might eased somewhat, however they were far from disappearing. According to a poll conducted in 1996 most Estonians – although to a varying degree – still believed Russia is a threat to Estonia. (Kirch [1997] p. 152) One major reason behind this is that the external Russian threat is inseparable from the issue of the large number of Russian-speaking population within the borders of Estonia. Again, opinions of ethnic Estonians surely vary on a wide scale concerning the threat level the Russian-speaking population presumably poses to Estonia, nevertheless according to a 2000 poll only 37% of ethnic Estonians is fully convinced about the loyalty of Russian-speakers to Estonia. (Budryte [2005] p. 91) Lagerspetz and Vogt assumed that the NATO-accession of Estonia will render the Russian threat irrelevant and this will end the period of extraordinary politics in Estonia.

As it is known the 2007 bronze soldier incident had an opposite affect and reminded the Estonian society of the seriousness of the ethnic cleavage.

Besides the extension of the period of extraordinary politics the perceived Russian threat has had another major consequence for the Estonian transition. An external enemy usually tends to strengthen the cohesion of a group. The fact that there is a “them” and an “us”, that the two groups are well defined and easily separable, feeds the “we feeling” of the threatened group. Identity politics has had great importance in Estonian transition. “The foundational myth of Estonia is based on unanimity, on ‘One Estonia’ against outside oppressors, a small community of people surrounded by great powers.” (Lagerspetz and Vogt [2004] p. 74) Even after the mythological stage of transition (Vihalemm et al [1997]) ended and public trust in political institutions (parliament, political parties, etc.) deteriorated this notion continues to be important. (Lagerspetz and Vogt [2004] p. 74-75) Such strong “we-feeling” – as it has been mentioned already in connection with Easton’s concept – is a manifestation of diffuse support for the political community, the most fundamental of the three objects of diffuse support. (The other two are: the authorities and the regime.)

In Hungary no similar external factor was present during the transition. It is true that Soviet troops stationed in the country and their withdrawal was the essential interest of the new democracy, however – unlike in Estonia – the issue was solved quite early. Actual withdrawal started already in early 1989 and agreement about the exact timetable was signed in March 1990, finally by June 1991 the last soviet soldier (and all family members) left the country. (Romsics [2005] p. 577) In 1991 with the dissolution of the Warsaw Pact, the Council for Mutual Economic Assistance and finally the Soviet Union itself the Kremlin’s influence disappeared in Hungary and its neighborhood practically overnight. This development also meant that no external threat factor was present to strengthen the cohesion of Hungarian society or to prolong the period of extraordinary politics, both of which make a society more likely to endure temporary economic hardships.

The above discussion leads us to another important factor that influences the length and intensity of the period of extraordinary politics: the degree to which the transition fulfilled the society’s expectations. It has been discussed earlier that outputs of a system, that is, specific decisions and measures taken by the authorities, feed

specific support. In case of a system change however the output level of the new authorities is quite low or dissatisfactory for various reasons (inexperience, general economic/political/social chaos often surrounding system changes, etc.). Therefore political good will or diffuse support towards the new system is crucial in its survival until the new system is able to generate favorable outputs and gather sufficient specific support as well. As we know diffuse support is largely based on a sentiment. It is a positive attitude towards the political community, a strong sense of community, of belonging together. It is moreover a belief in the legitimacy of the authorities and the regime that they are in the common interest of the nation, of “our people”. The level of diffuse support for a new regime depends on how much it is able to evoke such sentiments in the members. (Easton [1979]) It is therefore very important to investigate whether such expectations of the Estonian and Hungarian societies were fulfilled by the new systems or not. Fulfilling certain expectations might remind us to the mechanism of policy outputs feeding specific support and indeed in a way it can be said that diffuse support is fed by certain psychic or symbolic outputs. (Easton [1979] p. 273)

When comparing the circumstances of the Estonian and Hungarian transition an obvious and very important difference presents itself: while in Hungary the system change meant major changes in economic, political and social system in Estonia the whole transition has had an additional layer, namely, regaining national independence. As it has been highlighted by Vihalemm et al [1997] the first stage or the “mythological stage” of Estonian transition was dominated by the issue of independence from Moscow. Practically all Estonians were for total national independence. The period was characterized by large, emotionally loaded mass demonstrations, manifestations of national unity (song festivals, Baltic chain, etc.). Generally hopes were very high and the demand for national independence from the vast majority of ethnic Estonians was clear. Obviously independence was not the only aim: democratic political system and end of the soviet style command economy were all implied in the idea of an independent Estonian state. Yet it was clear: in order to reach these goals the first step is to reach independence. The fact that it did happen and that the new system was able to provide the most elemental demand of the political community certainly gave it an enormous boost of diffuse support. According to Vihalemm et al [1997] the mythical stage faded away soon after gaining independence and gave way to the disillusionment during the

institutional stage of transition. Still the reservoir of good will stemming from the realization of independence did not disappear. The first few years of independence were dedicated to the enormous task of building up a state from scratches, including the economy. As it has been described already in economic policy “the Estonian government chose the path of maximum liberalization: no tariffs, no subsidies, no regulated prices [...], no progressive taxes, no quotas and no extensive transfer of income”. (Lauristin and Vihalemm [1997] p. 107) This approach undoubtedly put enormous burdens on the population. While disillusionment increased fast the fact that public sentiment did still not give rise to an alternative political force that would have exploited negative attitudes through populist promises signals the presence of still considerable diffuse support for the prevailing system and conduct of economic policy. An excellent example of how diffuse support - originating from positive sentiments – for independence did help the new regime overcome difficult economic decisions is the introduction of the new currency, the Kroon. Its pragmatic necessity could be well combined with its strong symbolic meaning: the introduction of the own currency was certainly regarded as an important element of independent statehood at the same time a useful tool of securing independence from the inflation plagued Ruble-zone, thus securing further Estonia’s independence from Moscow. In order to create a strong national currency achieving credibility was crucial, this is the reason why the Estonian leadership eventually decided for the currency board arrangement despite warnings from the IMF that requirements for such a monetary regime might put too much strain on the Estonian economy. A harsh fiscal adjustment was conducted by the government, amounting to 5-6% of the GDP, in order to meet the requirements for the currency board arrangement (including VAT increase from 10 to 18%). (Knöbl et al [2002] p. 16)

In Hungary the aim for independent statehood was obviously absent from the circumstances of transition. Hungary however differed in yet another aspect from other post-communist transition countries, also from those Central European ones that retained their statehood during Soviet times. A number of scholars (see for instance Kornai [1995] and [2005]; Inotai [2004] and Muraközy [2004] have pointed out that the main expectation of Hungarians from the system change was mostly materialistic, first and foremost an immediate improvement in standard of living and material well-being. After the 1956 uprising (the most severe incident against Soviet rule in the Eastern

Block) and the subsequent retaliation both the communist authorities and the public longed for peace and calm. During the following decades the authorities aimed to keep the population calm by constantly raising living standards. As it has been already partly discussed this meant that Hungary started experimenting with alternative policies in the economy before any other socialist country: abandoned central command in the '60s, allowed small private enterprise like entities in the '80s, etc. When these concessions proved insufficient in keeping up the pace of development the government was willing to finance higher living standards from foreign loans. Quite short-sited policy indeed, yet the regime was afraid of the consequences of falling living standards more than anything. Besides the economy concessions were also made in politics. The doctrine of the regime was "who is not against us is with us", which was a great improvement compared to the more oppressive, totalitarian regime doctrine of the early '50s: "who is not with us is against us". Of course this was not even remotely a liberal democracy, but at least the regime did not demand open commitment of the citizens for the system and if they did not "rock the boat" people could enjoy small benefits like for instance passport to the west every 3rd year. (Romsics [2005]) In summary, for about 25 years the Hungarian society lived in relative peace and material well-being unparalleled in the soviet block. As a consequence an illusion started to spread in the society that the Hungarians who managed to create the "happiest barrack" of the soviet camp are the most innovative, smartest, most flexible among the socialist societies. Even though the actual performance of the Hungarian economy was not better than that of other CEE countries, still instead of Czechoslovakia or Poland, Hungarians compared themselves to Austria and Germany. When, by the late '80s the crisis and the unsustainability of the system became apparent the main expectation from the new system was to elevate standard of living to that western European level many Hungarians experienced during their trips to the west. (Inotai [2004]). This does not mean that changes in Hungary were not accompanied by mass demonstrations, reemergence of national symbols and a general positive emotional charge, yet these were less intense than in Estonia or any other transition country in the region. (We will return to this issue in the next section, when the extreme gradual nature of the Hungarian transition will be compared to the swift and radical Estonian changes.) As János Kornai has put it the Hungarian population has already got used to the easing of repression, felt that extension of

political rights is natural and did not become particularly euphoric about political changes rather accepted it with silent satisfaction. This lack of euphoria which was visible even compared to Czechoslovakia or Poland had the consequence that the period of extraordinary politics in Hungary was much shorter than anywhere else – if existed at all – which was reflected in the first democratically elected government's reluctance to take harsh measures. (Kornai [1995] p. 10) Later, as people realized that the standard of living is rather decreasing than increasing the major basis of support for the new system eroded very fast. Unlike in Estonia there was no other major expectation from the new system and once this fell, the loss in diffuse support became significant enough that in the subsequent two decades no government could ask the population for substantial sacrifices, unless was willing to risk a major political defeat. It goes without saying that Estonians also expected strong improvement in their living standards. Especially in Northern Estonia due to Finnish TV broadcasting people had an idea about gap that existed between the west and Eastern Europe. However this was not the only, and not even the most important expectation from the system change. The aim of independent statehood stood above everything else and when this goal was reached the euphoric historic momentum, the period of extraordinary politics or reservoir of diffuse support was there for the Estonian government to seize the opportunity and take measures that were painful yet necessary.

The relationship between expectations and reality in the two societies manifests itself in the difference in attitudes towards the old and the new regime. According to a poll conducted in 1993, out of the 10 CEE countries only in Hungary did more respondents think positively of the previous system than about the current one: 58% rated the communist system positively whereas only 50% gave positive rating to the current system. (New Democracies Barometer III.) In the same year only 32% of ethnic Estonian respondents evaluated the communist system positively, while 58% gave positive evaluation to the current system. These ratios improved further in the following years and in 2006 Estonians gave the best rating for the current system in the whole region, while Hungarians remained the most pessimistic about the current system. Perhaps the best illustration to this Hungarian attitude is two state funerals in 1989. On June 16. Imre Nagy, the central figure of the 1956 uprising, who was executed in 1958 by János Kádár the communist leader of Hungary between 1956 and 1989, was

reburied. About 300 thousand people appeared in the event which was one of the most illustrious momentum of transition. A few days later János Kádár himself died, nevertheless his coffin also drew tens of thousands of supportive people. Even more noteworthy that according to a contemporary poll 75% of people thought that with his death Hungarian politics lost one of its greatest figures. (Kurtán et al [1990] p. 454) The positive opinion about Kádár did not change over the years: a poll in 2005 revealed that he is the most popular historic figure in Hungary. (Vásárhelyi [2005])

The third very important aspect in the circumstances of transition is the speed and quality of political changes. It has been discussed that in Hungary regarding political changes there was a lack of euphoria even compared to states – like Czechoslovakia or Poland - where regaining statehood was not part of the agenda. This was partly due to the different expectations of the Hungarian society but also because of the smooth – according to some too smooth – political changes, that deprived the Hungarian society from the sensation that a true change is occurring. According to Körösényi [2009] one of the main pathologic property of Hungarian transition is its extreme smoothness, that – in a certain way - no symbolic political change occurred, on the basis of which a new political community could have emerged. It is reflected on one hand in the incomplete (or in some aspects totally absent) elite change on the other hand in the sense of continuity which was a consequence of the consensual nature of political change, wherein the “old guard” and representatives of the democratic opposition agreed about the entire political transition in roundtable talks. Kornai [1995] also notes that an important characteristic of the Hungarian authorities since the ‘60s has been the intention to avoid conflicts and secure social peace. Hence the possibility of “roundtable talks” that enabled for the old elite to save its positions and even gave the old system some sort of legitimacy in retrospective. (Körösényi [2009]) The fact that wide scale political changes could be conducted at through round table talks and the lack of real elite change has had two consequences. (1) It fed the feeling that ordinary people were left out of changes, that the elite in the top quietly settled everything among each other (2) the lack of any upheaval, the overly structured, consensual nature of changes suggested some sort of legal continuity with the previous system and did definitely not help to create the impression that great, fundamental changes are occurring. These effects were strengthened by the extremely gradual nature of Hungarian transition, that

is, reforms in the economy started as early as the '60s and to a lesser extent but oppression eased substantially also in the political sphere after 1956. By 1989 the Hungarian society has been through decades of waves of different reforms therefore changes around 1989 did not have such elemental affect on the society. According to Kornai [1995] this gradual change can be only compared to the Slovenian experience.

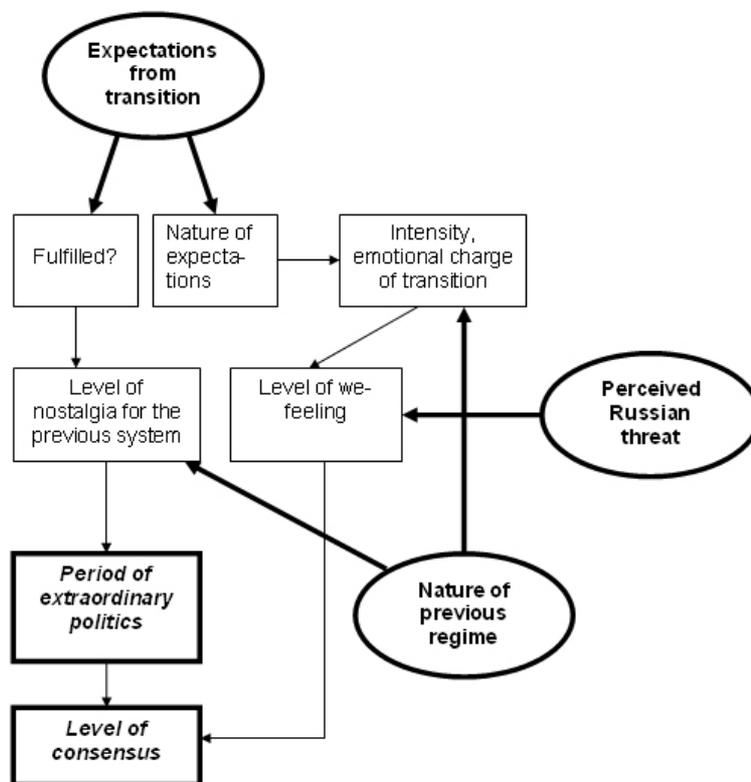
At the time of the changes the above discussed qualities of the Hungarian transition seemed like a great advantage that secure Hungary's leading position in CEE in the historic process of returning to Europe. However nowadays it is more often questioned in Hungary whether such smooth transition was indeed in the best interest of the country. These developments worked against a symbolic transition that could have created a strong we-feeling in the political community, which in turn could have contributed to a more intense, more lasting period of extraordinary politics. Instead the materialistic expectations remained the strongest basis of support for transition and when due to obvious reasons the new system could not live up to these expectations diffuse support eroded very quickly. The first democratically elected prime minister of Hungary, József Antall, realized this quite early on. When his fellow party members criticized him for not being radical enough in conducting reforms, he replied with the often quoted line: "You should have done a revolution!" (Homepage dedicated to József Antall)

The Estonian transition was the exact opposite in both of the above discussed major aspects. Although the transition was calmer than in Latvia or Lithuania, where soviet troops killed several demonstrators it was obviously much more emotionally loaded than in Hungary. Actual, specific changes were reflected in a great deal of symbolic changes that every Estonian could understand and almost every Estonian agreed with. After the changes occurred everyone could feel that something fundamentally different started. As opposed to the gradual changes in Hungary, in Estonia shock therapy was applied not only in the economy but also in the political sphere insofar as during the transition the more radical program of the Estonian Congress prevailed over the program of the People's Front, the original leader of reforms. As far as change of the nomenclatura is concerned Estonia went furthest in it among the three Baltic countries and the entire region. (Lauristin and Vihalemm [1997])

p. 106-107) Panagiotou [2001] also highlights this when investigating the factors contributing to Estonia's transition success compared to Latvia and Lithuania.

6.4. Summary of findings

The following chart summarizes the findings of the case comparison. The arrows represent direction of influence:



As it can be seen there are three independent variables that influence other characteristics of the transitions (the expectations from transition, presence/absence of perceived external threat and the nature of the previous regime). The expectations from transition can be divided into two elements: (a) Nature of the expectation or what was exactly the expectation (b) whether this expectation was fulfilled or not by transition? In case of Estonia the fact that the main expectation – independence from Moscow – was achieved had two major consequences: it strengthened support, political good will for the new regime/system and parallel with this decreased chances of nostalgia for the

previous system. The latter outcome was also supported by another independent variable, the nature of previous regime. That is in Estonia there was much less reason to feel nostalgic about soviet times than in Hungary due to lack of independent statehood, higher political repression and lower material well-being than in communist Hungary. As the new regime appeared more advantageous relative to the previous regime and since there was considerable political good will towards the new regime the period of extraordinary politics was stronger and lasted longer in Estonia than in Hungary, where the most important expectation – improving living standard – was not fulfilled, moreover in many respects the gap between the old and the new regime wasn't as wide as in Estonia (i.e. relatively high living standard, easing political repression).

The difference in the nature of expectations influenced the emotional intensity, emotional charge of the changes. In Estonia – where national independence was at stake - it was much more euphoric, elemental than in Hungary where aims were much more materialistic. The emotional intensity was also influenced by the nature of the previous regime insofar as the more reformist, softer Hungarian regime enabled a much smoother, gradual transition which lowered the emotional charge and decreased the sensation of symbolic changes. As a result the lower emotional charge of the changes in Hungary meant weaker basis for strong we-feeling, the build-up of a new political community. The opposite happened in Estonia and this was further supported by the perceived Russian threat (which factor was obviously totally absent in Hungary). The latter also contributed to the extension of the period of extraordinary politics in Estonia, as even after independence was achieved its persistence could not be taken for granted therefore in order to secure independence the population was willing to endure a great deal of difficulties.

As it can be seen all factors in this complex system have worked towards a long period of extraordinary politics in Estonia, while exactly the opposite tendency can be observed in the case of Hungary. Furthermore the literature clearly suggests that this prolonged period of extraordinary politics is the main reason of the persistent consensus in Estonia regarding economic policy but also in other political areas. The stronger sense of community or we-feeling in Estonia in addition has certainly been advantageous for the prevailing consensus. Thus advocating alternatives, “claims for social justice and solidarity sounded ‘too socialist’ in the context of the dominating

transition culture” (Lauristin and Vihalemm [2010] p. 20), that is, the prevailing market-liberalism. It goes without saying that consensus about small state, low level of redistribution is favorable environment for fiscal discipline. Moreover pursuing lax fiscal policies in Estonia would also mean jeopardizing the stability of the currency a major tool and symbol of economic independence and more recently jeopardizing the introduction of the Euro the final element of transition from the soviet past to Estonia’s European future.

Again, the situation is very different in Hungary. There was no common basis of consensus upon which all major groups of the society could have agreed. In fact it is even questioned lately in the common discourse whether real transition indeed take place in Hungary. A major element of the main opposition party’s campaign before the 2010 elections was exactly the need for a true regime change. In such environment where the society is characterized by the total lack of any consensus, where no taboos exist, political populism, the aim to win votes with short sighted promises will inevitably emerge. It is important to see that the difference is not in the sense of responsibility of politicians. The difference lies in the social and political environment insofar as it is politically advantageous in Hungary for any force not in power to come forth with populist promises, while such move is much less tempting in the Estonian social and political environment.

6.5. Suggestions for operationalization

The findings of the case comparison are in line with Györffy’s suggestion that consensus is crucial for fiscal discipline. It could be also seen that certain aspects of the Estonian transition, their lasting effects work towards stability, the persistence of this consensus. The only remaining question is whether these aspects or factors mentioned above can be identified as manifestations of diffuse support, as Györffy’s theory would suggest? This paper argues that it is possible. The definition of the period of extraordinary politics by itself is almost identical to Easton’s description of what diffuse support is. Indeed its effects suggest that it should be regarded as sign of strong diffuse support: the period of extraordinary politics secures necessary support for the system

until outputs can be generated that boost also specific support. Moreover the basis of it – as it could be seen in the Estonian case – is a certain emotional attachment, which corresponds the nature of diffuse support. The other important outcome of transition, the sense of community, the level of we-feeling can also be interpreted as a manifestation of diffuse support. While the period of extraordinary politics can be identified as diffuse support for the political system, the “we-feeling” – according to Easton – is the manifestation of diffuse support for the political community, which is one element of the political system. Thus, the cases of Estonia and Hungary clearly support Gyórrffy’s suggestions. However - as it was discussed earlier in chapter five – Gyórrffy failed to operationalize her suggestions correctly and her testing on the CEE region failed. Therefore – based on our results – suggestions will be given on how to measure diffuse support.

If the aim is to follow Gyórrffy’s footsteps than an independent variable needs to be found that explain variation among countries in the dependent variable (average budget balance). Immediately we face two major problems. The first one concerns the dependent variable: while the performance of Estonia and Hungary regarding budget balance has been quite steady and predictable (that is predictably good for Estonia and predictably bad for Hungary) most other countries in the region have shown more varying performance (see chapter one). This means that average values of deficit might be less useful in measuring their overall performance. A solution could be to use every years data (increasing thus the number of cases), however that would create problem on the independent variable side as a major property of diffuse support is exactly its low volatility over short periods of time. Thus, even if the right indicator was found to measure diffuse support this problem is with the dependent variables questions the validity of the model. The other problem concerns the independent variable: since the societies observed here have gone through ground shaking changes during the past two decades of transition, the period in our focus is extremely hectic compared to other periods in history or compared to the same period of other countries. This means that it is quite hard to find indicators that have reflected fairly similar values in the same society throughout the period. This by the way could be one explanation why Gyórrffy’s way of measuring diffuse support seemed to work in Western Europe, proved to be false when applied to CEE. The above problems already suggest that the task of

operationalizing diffuse support is extremely challenging. Nevertheless if we wish to proceed we need to take a look at the results of the case studies.

It is obvious that the only element that appears to be adequately measurable is the level of nostalgia for the previous regime, or the attitude towards the old regime as compared to the new one. Neither the length of the period of extraordinary politics, nor the level of we-feeling, nor the emotional charge of changes can be easily measured. It is worth mentioning that our suggestion of measurement is actually in line with the findings of the research by Mishler and Rose, who investigated the origins of political trust. They have found that “the largest single influence on trust in the model is the extent to which people think the new regime treats citizens more or less fairly than the old regime”. (Mishler and Rose [2001] p. 52) Since trust is a form of diffuse support, more precisely it is diffuse support towards the authorities and the regime (see chapter five) the above result supports the suggestion of the current paper.

In order to measure attitudes towards the new regime in relation to the old regime, obviously the results of opinion polls can be well utilized. It has been discussed earlier that opinion polls are most often not appropriate for measuring diffuse support as these opinions are largely influenced by most recent outputs, thus they tend to reflect views on specific support. The question thus arises why opinion polls about the assessment of the old and new regimes are suggested here to be used? Besides the above quoted result by Mishler and Rose [2001] the theoretical explanation could be the following: In conventional poll questions (that is, where opinion about a single object is asked without any further frame of reference) it is very hard to detach oneself from the daily/immediate outputs of the object in question. Yet comparison with the old regime puts the question into perspective, forces the respondent to consider a longer period, to view developments and the new system from a more general perspective. Obviously the opinion about the previous regime will be very subjective, yet this is not a problem as we are essentially interested in the assessment of the current regime, through inquiring about the attitude towards the old regime. Thus, even if the condemnation or praise of the previous regime is very much based on subjective assessment which corresponds very little with the reality, it still tells us a lot about the real level of diffuse support for the current regime. Estonia is a good case for illustrating the difference between the two polls: “although people may criticize the present parliament and laugh

at the parties, only a very few Estonians are willing to return to anything reminiscent of communism”. (Lagerspetz and Vogt [2004] p. 73) It has to be noted that if we want to learn about diffuse support then the question should concern comparison from a political and not from an economic aspect. In the latter case (for instance when opinion about current economic situation is asked compared to the economic situation under the old system) answers will be again very much connected to specific outputs.

It seems thus justified that operationalization proceeds along these lines. At this point however further problems arise concerning mostly the available data. Unlike in the case of satisfaction with democracy, where uniform Eurobarometer data is available on every country at least for the past 10 years, there is no comparable, yearly collected data available on this issue. The most promising attempt has been the New Europe Barometers/New Democracies Barometers and New Baltic Barometers compiled by the University of Aberdeen under the supervision of Richard Rose. During the past 20 years six or seven rounds have been completed in each country of the region. The questions in the individual rounds are however not entirely identical, in some years certain questions - crucially important from the perspective of this paper – have not been asked, moreover no round has been completed during the past six years, therefore the data even from these surveys is quite fragmented.

Three different datasets will be used here to create an aggregate index, which will be then used as independent variable set. It needs to be emphasized that this index is created merely to see whether operationalization based on attitudes towards the old regime displays any promising perspective. Even if connection can be detected between this index and budget balance, for the above described shortcomings extensive further research is necessary to adequately operationalize diffuse support this way. The three datasets are the results of the New Democracies and the New Baltic Barometers that provide data on the ratings of the communist and current regimes by respondents in 1993 (in some cases 1994) moreover the results of the 2006 EBRD survey “Life in Transition”. From the first two surveys those results are selected that show the percentage of respondents who gave positive evaluation for the communist regime. In the third source the question was put differently and respondents could either agree, disagree or give neutral answer to the statement that the political situation today is better than around 1989. Here, the percentage of disagreeing respondents is considered.

Positive evaluation of previous political system*							
	1993/94	2006					Aggregate index
		18-34	35-49	50-64	65+	Average 2006	
BG	51	40	49	57	59	51,25	51,13
CZ	23	22	32	51	58	40,75	31,88
EE	32	12	23	27	18	20,00	26,00
HU	58	70	70	77	80	74,25	66,13
LV	36	21	34	34	35	31,00	33,50
LT	46	19	43	48	42	38,00	42,00
PL	38	37	45	49	42	43,25	40,63
RO	33	44	38	42	42	41,50	37,25
SK	50	24	38	40	44	36,50	43,25
SI	32	22	36	43	42	35,75	33,88

*In the 2006 survey: percentage of respondents who disagree with the statement "The political situation in this country is better today than around 1989." Sources: New Democracies Barometer, New Baltic Barometer¹⁷, EBRD 'Life in Transition' 2006 Survey.

The second problem arises from this difference in questions. Although in all three surveys the question is directed towards essentially the same issue in the first two polls respondents could give positive evaluation to both systems while in the EBRD survey the agreement/disagreement dichotomy excluded such option. It means that the data from 1993/94 includes also those who would have not given positive evaluation to the communist regime if they had the choice to give positive rating only to one of the systems. This fact already distorts the picture, since it is assumed in our model that those who give positive ratings to the communist regime have such negative attitude towards the new system that we can speak of lack of diffuse support. If the focus was on positive evaluation of the current system then danger is substantially higher that specific outputs will be the basis of assessment even if the current system needs to be compared to the previous one.

The third problem concerns the 2006 EBRD survey. Results here are broken down to four different age groups in each country, yet no single national average is given. It was therefore calculated as the average of the four age groups, wherein all groups had equal weights. The distortion here stems from the fact that we don't know what weight to assign to each group as the age structure of the pool is not known.

The fourth problem concerns the surveys in the Baltic countries, particularly Estonia and Latvia. These surveys include the large Russian-speaking populations who

¹⁷ Data is presented in Rose et al [1998] and Lauristin et al [1997]

– for obvious reasons – have somewhat different criteria than the titular nationalities to evaluate the current and the previous regimes. As it was discussed in chapter six the Russian speaking population in Estonia (and in Latvia) is not relevant as a group for diffuse support and certainly not to the extent that would correspond their share of the population. Thus, it can be assumed that in Estonia and Latvia the surveys somewhat overestimate the support for communist system among the politically relevant members.

Despite the above problems there is one strongly positive aspect of the available data. The three surveys basically provide data on 10 countries from two different times: 1993/94 and 2006. When the two datasets are compared it can be seen that changes over these hectic 12-13 years have been relatively modest. There are of course differences yet the position of most countries in relation to each other is quite stable. If it is assumed that the two datasets are comparable and measure essentially the same thing then perhaps the only surprising difference is the growing nostalgia in the Czech Republic for the previous system: from the least approving country it moved to the lower-middle group, where the previous system has substantial support.

The aggregate index is simply the average of the values from 1993/94 and 2006 for each country. For the reasons described in chapter three, that is, the presence of exceptional external factors, Bulgaria will be left out. On the remaining nine countries – following Györffy’s method – a simple linear regression will be used to estimate the connection between support for the previous system and fiscal:

	Aggregate index (independent var.)	Average deficit (dependent var.)
Estonia	26,00	0,29%
Latvia	33,50	-1,92%
Slovenia	33,88	-2,82%
Lithuania	42,00	-3,22%
Romania	37,25	-3,36%
Poland	40,63	-4,40%
Czech Rep.	31,88	-4,69%
Slovakia	43,25	-5,45%
Hungary	66,13	-6,11%

Results:

X = Aggregate index of positive evaluation of the previous system; Y = Average deficit

$$Y = 1.495 - 0.127X$$

$$\text{Sig.} = 0.021$$

$$N = 9; R^2 = 0.56$$

The results suggest significant connection. As it can be seen many difficulties accompany the operationalization of diffuse support. Even our suggestion for measurement is surrounded with ambiguities, at this point however this seems to be the most promising direction for further research.

7. CONCLUDING REMARKS

The case studies have shown that the main suggestions of Gyórrffy's theory are valid: indeed elite consensus is a major precondition of an economic policy that requires long-term commitment (i.e. persistent fiscal discipline). Moreover Estonian and Hungarian developments seem to support the notion that certain preconditions, which can be seen as the manifestations of diffuse support, are necessary for keeping up that consensus.

These results have revealed a major new aspect in explaining why Hungary has been unable to pursue more prudent, more disciplined fiscal policy – like Estonia. Moreover the findings have two major consequences for Gyórrffy's theory: in contrary to its suggestions, the mechanisms described regarding EMU member states seem to be valid also in Central and Eastern Europe (as far as they are valid in Estonian and Hungarian relation), thus the area of applicability can be widened. At the same time a major part of the theory – its operationalization of diffuse support – seems to be invalid. Based on the results of the case comparison this paper has suggested an alternative way to measure diffuse support: quantified differences in attitude towards the old and new political systems. Although this alternative way of operationalization is only applicable in case of a specific groups of countries (post-communist transition states) it is suspected that based on the results of qualitative analysis of further cases it should be possible to suggest other alternatives that are applicable to a wider group of countries.

At this point however still even the results of the current paper require further refining. On one hand data on attitudes towards the systems should be collected more systematically and on a wider basis, that is, attitudes should be inquired through a set of different questions and these questions should be the same in all countries. Moreover, based on our results further qualitative comparative analysis should be conducted, involving more countries from the region, in order to solidify the validity of findings. Due to limited space this could not be accomplished within the frame of this paper. The first part of the paper (chapter 2 and 3) prepared ground for such further research as it has been proved that important preconditions exist in the region for the examination of

domestic factors suggested by the theory. That is, quality of fiscal rules are important determinants of fiscal performance and the countries have faced similar external factors (with the exception of Bulgaria).

As it has been mentioned in the beginning, the goal of this paper has not been to provide a holistic explanation for differences in fiscal performance of countries. There are obviously a great number of other factors that also influence budget balance. The current paper however highlights the importance of this additional aspect, the importance of diffuse support in fiscal policy, which therefore should be considered in models that aim to provide a holistic explanation to the phenomenon of difference in budget balance. Moreover the goal has not simply been to explain differences, but to explain persistent differences, like the one observed in the case of Estonia and Hungary. Neoclassical economics is less successful in explaining such permanent differences while it is implied in the model that the importance of diffuse support as explanatory factor is growing as the period, over which persistent difference needs to be explained, is expanding.

BIBLIOGRAPHY

Secondary Sources

Alberola, Enrique and Luis Molina [2000]: Fiscal Discipline and Exchange Rate Regime. A Case for Currency Boards? Bank of Spain Working Paper No. 6.

Alesina, Alberto and Roberto Perotti [1994]: The Political Economy of Budget Deficits. IMF Working Paper No. 94/85

Alesina, Alberto and Roberto Perotti [1996]: Fiscal Adjustments in OECD countries: Composition and Macroeconomic Effects. NBER Working Paper No. 5730

Antal, László [2004]: Hol Volt, Hol Nem Volt. [Once Upon a Time.] In: *Mozgó Világ*. Vol. 34 (8)

Balczerowicz, Leszek [1993]: Common Fallcies in the Debate on the Economic Transition in Central and Eastern Europe. EBRD Working Paper No. 11.

Barabás, Gyula, Péter Holtzer, Krisztián Orbán and Tamás Vojnits [2008]: Recovery. A Program for Economic Revival in Hungary. Oriens.

Berg-Schlosser, Dirk and Gisele De Meur [2009]: Comparative Research Design. In: Benoit Rihoux and Charles C. Ragin eds. *Configurational Comparative Methods*. London: Sage. pp. 20-33.

Berger, Helge, George Kopits and István P. Székely [2004]: Fiscal Indulgence in Central Europe: Loss of the External Anchor? IMF Working Paper No. 04/62.

Buchanan, James M. And Richard E. Wagner [1977]: Democracy in Deficit: The Political Legacy of Lord Keynes. San Diego and London: Academic Press Inc.

Budryte, Dovile [2005]: Taming Nationalism? Political Community Building in the Post-Soviet Baltic States. In: Post-Soviet Politics. Burlington: Ashgate.

Calvo, Guillermo A. and Frederic S. Mishkin [2003]: The Mirage of Exchange Rate Regimes for Emerging Market Countries. In: *The Journal of Economic Perspectives*. Vol. 17. (4) pp. 99-118.

Easton, David [1979]: A Systems Analysis of Political Life. New York: Wiley.

Easton, David [1975]: A Re-Assessment of the Concept of Political Support. In: *British Journal of Political Science*. Vol. 5 (4) pp. 435-457.

European Commission: Public Finances in EMU 2002. No. 3.

Fabrizio, Stefania and Ashoka Mody [2006]: Can Budget Institutions Counteract Political Indiscipline? IMF Working Paper No. 06/123.

Fatas, Antonio and Andrew K. Rose [2001]: Do Monetary Handcuffs Restrain Leviathan? Fiscal Policy in Extreme Exchange Rate Regimes. CEPR Discussion Papers No. 2692.

Fricz, Tamás [2004]: Kormányváltások vagy Rendszerváltások? [Government Changes or Regime Changes?] In: *Magyarország Politikai Évkönyve 2004*. [Political Yearbook of Hungary 2004.] pp. 122-139.

Galbreath, David J. [2005]: Nation-building and Minority Politics in Post-Socialist States. Stuttgart: Ibidem Verlag

Gilson, Marie-Thérèse Camilleri [2002]: Policy Pre-Commitment and Institutional Design. A Synthetic Indicator Applied to Currency Boards. OECD Working papers No. 330.

Gleich, Holger [2003]: Budget Institutions and Fiscal Performance in Central and Eastern European Countries. ECB Working Papers No. 215.

Goldschmidt, Nils (2006): Culture and Economics. In: *Intereconomics*. Vol. 41 (4), pp. 176-182.

Grigonyté, Dalia [2003]: Impact of Currency Boards on Fiscal Policy in Central and Eastern European Countries. In: *Economics of Planning*. Vol. 36 (2) pp. 111-133.

Grimm, Oliver [2007]: Fiscal Discipline and Stability under Currency Board Systems. CER-ETH Working Paper No. 07/66.

Gyórfy, Dóra [2006]: Governance in a Low-Trust Environment: The Difficulties of Fiscal Adjustment in Hungary. In: *Europe-Asia Studies*. Vol. 58 (2) pp. 239-259.

Gyórfy, Dóra [2007]: Democracy and Deficits. The New Political Economy of Fiscal Management Reforms in the European Union. Budapest: Akadémiai Kiadó.

Hallerberg, Mark and Jürgen von Hagen [1997]: Electoral Institutions, Cabinet Negotiations, and Budget Deficits in the European Union. NBER Working Paper No. 6341.

Hallerberg, Mark and Sami Yläoutinen [2008]: Fiscal Governance in Central and Eastern Europe Before and After European Union Accession: What Role Europeanisation? Hertie School of Governance Working Paper No. 37.

Hanke, Steve and Kurt Schuler [2002]: What Went Wrong in Argentina? In: Central Banking. Vol.12. (3) pp. 43-48.

Iwaskiw, Walter R. [1995] Estonia: A Country Study. Washington: GPO for the Library of Congress.

Kallas, Siim and Mart Sõrg [1994]: Currency Reform in Estonia. Tallinn: Estonian Academy of Sciences

Kirch, Aksel [1997]: The Integration of Non-Estonians into Estonian Society: History, Problems and Trends. Tallinn: Estonian Academy Publishers.

Knöbl, Adalbert, Andres Sutt, and Basil Zavoico [2002]: The Estonian Currency Board: Its Introduction and Role in the Early Success of Estonia's Transition to a Market Economy. IMF Working Paper No. 02/96.

Kopits, George and Steven Symansky [1998]: Fiscal Policy Rules. IMF Occasional Paper No. 162.

Kopits, George [2001]: Fiscal Rules: Useful Policy Framework or Unnecessary Ornament? IMF Working Paper No. 01/145

Kornai, János [1995]: Négy jellegzetesség: A Magyar Fejlődés Politikai Gazdaságtani Megközelítésben. [Four Characteristics: Hungarian Development from a Political Economic Perspective.] In: *Közgazdasági Szemle*. Vol. 42 (12) pp. 1097-1117

Kornai, János [2005]: Közép-Kelet-Európa Nagy Átalakulása – Siker és Csalódás. [The Great Transformation of Central and Eastern Europe – Success and Disappointment.] In: *Közgazdasági szemle*. Vol. 52 (12) pp. 907-936.

Körösényi, András [2009]: A Magyar Demokrácia Patologikus Vonásai. [Pathologic Properties of the Hungarian Democracy.] In: *Kommentár*. Vol. 4 (5) pp. 60-68.

Kraan, Dirk-Jan, Joachim Wehner and Kirsten Richter [2008]: Budgeting in Estonia. OECD Journal on Budgeting. Vol. 8 No. 2.

Krogstrup, Signe and Sébastien Wälti [2009]: A Culture of Budget Deficits. (Preliminary version- Not published)

Kurtán, Sándor, Péter Sándor and László Vass eds. [1990]: Magyarország Politikai Évkönyve 1990. [Political Yearbook of Hungary 1990.] Budapest: Aula.

Laar, Mart [1996]: Estonia's Success Story. In: *Journal of Democracy*. Vol. 7 (1) pp. 96-101.

Lauristin, Marju and Peter Vihalemm [1997]: Recent Historical Developments in Estonia: Three Stages of Transition (1987-1997). In: Marju Lauristin and Peter

Vihalemm eds. *Return to the Western World: Cultural and Political Perspectives on the Estonian Transition*. Tartu University Press. pp. 73-126.

Lauristin, Marju and Peter Vihalemm [2010]: The Political Agenda During Different Periods of Estonian Transformation: External and Internal Factors. In: *Journal of Baltic Studies*. Vol. 40 (1) pp. 1-28.

Lelkes, Orsolya [2009]: Az Egyenlőtlenség Nagyságának Megítélése. [Assessing the dimension of inequality] In: *TÁRKI Európai Társadalmi Jelentés*. [TÁRKI European Social Report] pp. 19-32. TÁRKI

Mikkel, Evald [2006]: Patterns of Party Formation in Estonia: Consolidation Unaccomplished. In: Susanne Jungerstam-Mulders ed. *Post-Communist EU Member States: Parties and Party Systems*. Aldershot: Ashgate.

Mishler, William and Richard Rose [2001]: What Are the Origins of Political Trust? Testing Institutional and Cultural Theories in Post-communist Societies. In: *Comparative Political Studies*. Vol. 34 (1) pp. 30-62.

Mishler, William and Richard Rose [2005]: What Are the Political Consequences of Trust?: A Test of Cultural and Institutional Theories in Russia. In: *Comparative Political Studies*. Vol. 38 (9) pp. 1050-1078.

Molander, Per [2001]: Budgeting Procedures and Democratic Outcomes. In: *Journal of Public Policy*. Vol. 21 (1) pp. 23-52.

Muraközy, László [2004]: Yet Another Change of System: What Can Be Learnt from History and What Cannot. University of Debrecen: Debrecen.

Muraközy, László [2008]: Magyarország Felemelkedése és Bukása. [The Rise and Fall of Hungary] In: *Közgazdasági Szemle*. Vol. 55. (2) pp. 149-168.

Nelson, Daniel N. [1996]: Civil Society Endangered. In: *Social Research*. Vol. 63 (2) pp. 345-368.

Norkus, Zenonas [2007]: Why did Estonia Perform Best? The North-south Gap in the Post-socialist Economic Transition of the Baltic States. In: *Journal of Baltic Studies* Vol. 38 (1), pp. 21-42.

North, Douglass C. [2005]: *Understanding the Process of Economic Change*. Princeton University Press.

Panagiotou, R. A. [2001]: Estonia's Success: Prescription or Legacy? In: *Communist and Post-Communist Studies*. Vol. 34 (2), pp. 261-277.

Pejovich, Svetozar [2006]: The Uneven Results of Institutional Changes in Central and Eastern Europe. In: *Social Philosophy and Policy*. Vol. 23 (1) pp. 231-254.

Perotti, Roberto, Rolf Strauch and Jürgen von Hagen [1998]: Sustainability of Public Finances. London. ZEI and CEPR.

Pikkani, Rasmus [2000]: The Monetary Sector under a Currency Board Arrangement: Specification and Estimation of a Model with Estonian Data. Bank of Estonia Working Papers No. 2000-4.

Powell, Eleanor Neff and Joshua A. Tucker [2009]: New Approaches to Electoral Volatility: Evidence from Postcommunist Countries. Paper for the American Political Science Association 2009 Toronto Meeting

Romsics, Ignác [2005]: Magyarország Története a XX. Században. [History of Hungary in the 20th Century.] Budapest: Osiris.

Rose, Richard, William Mishler and Christian Haerpfer [1998]: Democracy and its Alternatives: Understanding Post-Communist Societies. Johns Hopkins University Press

Roubini, Nouriel and Jeffrey Sachs [1988]: Political and Economic Determinants of Budget Deficits in the Industrial Democracies. NBER Working Paper No. 2682.

Roussenova, Lena [2002]: The 1996-1997 Financial Crisis in Bulgaria. Seminar paper for: International Seminar on Comparative Experiences in Confronting Banking Sector Problems in Central/Eastern Europe and Central Asia. April 22-24, 2002. Warsaw, Poland

Soós, Károly A. [2005]: Választási Gazdaságpolitika és a Folyó Fizetési Mérleg Alakulása Közép-Kelet-Európában. [Election-oriented economic policy and the current account balance in Central and Eastern Europe] In: *Közgazdasági Szemle*. Vol. 52 (12) pp. 960-990.

Szalai, Erzsébet [1999]: Oroszlánok és Globalizáció. [Lions and Globalization.] Budapest: Új Mandátum.

Talpos, Ioan, Bogdan Dima, Mihai Mutascu, and Cosmin Enache [2007]: A New Approach of the Budget Deficit: An Empirical Analysis. In: *Theoretical and applied economics*. Vol. 14 (11) pp. 15-36.

Vásárhelyi, Mária [2005]: Csalódások Kora. Rendszerváltás Alulnézetben. [Age of Disappointments. Regime Change from Below.] Budapest: MTA.

Vihalemm, Peter, Marju Lauristin and Ivar Tallo [1997]: Development of Political Culture in Estonia. In: Marju Lauristin and Peter Vihalemm eds. *Return to the Western World: Cultural and Political Perspectives on the Estonian Transition*. Tartu University Press. pp. 197-210.

Winiiecki, Jan [2004]: Determinants of Catching or Falling Behind: Interaction of Formal and Informal Institutions. In: *Post-Communist Economies*. Vol. 16 (2), pp. 137-152.

Zweynert, Joachim and Nils Goldschmidt [2005]: The Two Transitions in Central and Eastern Europe and the Relation between Path Dependent and Politically Implemented Institutional Change. *HWWA Discussion Paper 314*. Hamburg Institute of International Economics.

Primary Sources

Constitution of the Republic of Poland
<http://www.sejm.gov.pl/prawo/konst/angielski/kon1.htm>
Accessed on May 12, 2010.

EBRD “Life in Transition 2006” Survey
<http://www.ebrd.com/pages/research/analysis/publications/transition/data.shtml>
Accessed on July 29, 2010.

Estonian National Electoral Committee (Vabariigi Valimiskomisjon)
<http://www.vvk.ee/>
Accessed on July 20, 2010.

Eurostat
<http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/>

Foreign Ministry of Estonia
http://www.vm.ee/estonia/kat_399/pea_172/4518.html
Accessed on April 29, 2009.

Homepage dedicated to József Antall.
<http://antalljozsef.hu/>
Accessed on 29 July, 2010.

Homepage of the Fiscal Council of Hungary
<http://www.mkkt.hu/en/>
Accessed on May 13, 2010.

Law on State Budget 1999 (Estonia)
<http://www1.worldbank.org/publicsector/pe/BudgetLaws/EstoniaStateBudgetLaw1999.pdf>
Accessed on May 12, 2010.

National Election Office of Hungary (Országos Választási Iroda)
<https://www.valasztas.hu/>
Accessed on July 20, 2010.

Presentation by Andrus Säälük (Ministry of Finance of Estonia)

www.jvi.org/fileadmin/jvi_files/DG.../Andrus_Saalik_presentation.pdf

Accessed on May 4, 2010.

World Bank Databank

<http://databank.worldbank.org/ddp/home.do>

APPENDIX A

General Government Budget Deficit/Surplus															
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Bulgaria	-5,10	-15,2	-0,4	1,4	0,2	-0,3	0,6	-0,8	-0,3	1,6	1,9	3,0	0,1	1,8	-3,9
Czech Rep.	-13,4	-3,3	-3,8	-5,0	-3,7	-3,7	-5,6	-6,8	-6,6	-3,0	-3,6	-2,6	-0,7	-2,7	-5,9
Estonia	1,1	-0,3	2,2	-0,7	-3,5	-0,2	-0,1	0,3	1,7	1,6	1,6	2,5	2,6	-2,7	-1,7
Latvia	-1,6	-0,4	1,2	0,0	-3,9	-2,8	-2,1	-2,3	-1,6	-1,0	-0,4	-0,5	-0,3	-4,1	-9,0
Lithuania	-1,6	-3,3	-11,9	-3,1	-2,8	-3,2	-3,6	-1,9	-1,3	-1,5	-0,5	-0,4	-1,0	-3,3	-8,9
Hungary	-8,7	-4,3	-5,9	-7,8	-5,4	-3,0	-4,0	-8,9	-7,2	-6,4	-7,9	-9,3	-5,0	-3,8	-4,0
Poland	-4,4	-4,9	-4,6	-4,3	-2,3	-3,0	-5,1	-5,0	-6,3	-5,7	-4,1	-3,6	-1,9	-3,7	-7,1
Romania	-2,1	-3,7	-4,5	-3,2	-4,4	-4,7	-3,5	-2,0	-1,5	-1,2	-1,2	-2,2	-2,5	-5,4	-8,3
Slovenia	-8,4	-1,1	-2,4	-2,4	-3,0	-3,7	-4,0	-2,5	-2,7	-2,2	-1,4	-1,3	0,0	-1,7	-5,5
Slovakia	-3,4	-9,9	-6,3	-5,3	-7,4	-12,3	-6,5	-8,2	-2,8	-2,4	-2,8	-3,5	-1,9	-2,3	-6,8

Source: Eurostat, World Bank

APPENDIX B

The Structure of Gleich's (Fabrizio and Mody's) Index

I. PREPARATION

1. *Existence of statutorily mandated fiscal rules*
 - a. Balanced budget rule
 - b. Limits on public borrowing
 - c. No legal limits on borrowing
2. *Sequence of budgetary decision-making*
 - a. MF sets forth aggregate and specific budget targets in initial budget circular
 - b. MF proposes, cabinet decides on targets for budget aggregates and spending limits are assigned to each ministry before spending ministries develop budget requests
 - c. MF proposes, cabinet decides on targets for budget aggregates before spending ministries develop budget requests
 - d. Budgetary targets are set on the basis of preliminary budget requests
 - e. No budget targets are determined
3. *Compilation of the draft budget*
 - a. Finance ministry holds bilateral negotiations with each spending ministry
 - b. Finance ministry only collects budget requests and compiles summary for cabinet session
4. *Members of executive responsible for reconciling conflicts over budget bids*
 - a. MF or PM can veto or overrule cabinet decision
 - b. Senior cabinet committee, then whole council of ministers or cabinet
 - c. Executive collectively (e.g. council of ministers or cabinet)

II. LEGISLATION

5. *Relative power of the upper house vis-a-vis the lower house (not included in Fabrizio and Mody's index)*
 - a. No budgetary power vested in upper house or unicameral parliament
 - b. Lower house has prerogatives
 - c. Both houses have equal rights (e.g. joint sittings)
6. *Constraints on the legislature to amend the government's draft budget*
 - a. Deficit provided in the draft budget cannot be exceeded, or individual amendments have to indicate offsetting changes
 - b. No restrictions

7. *Sequence of votes*
 - a. Initial vote on total budget revenues, expenditures, and the deficit
 - b. Final vote on budget aggregates
8. *Relative power of the executive vis-a-vis the parliament*
 - a. Cabinet can combine a vote of confidence with a vote on the budget
 - b. Draft budget is executed if parliament fails to adopt the budget before the start of the fiscal year
 - c. Parliament can be dissolved if it fails to adopt the budget in due time
9. *Authority of the national president in the budget procedure*
 - a. No special authority
 - b. President has veto right (president elected by parliament)
 - c. President has veto right (president directly elected by citizens)
 - d. President has veto right (qualified majority required to override veto)

III. IMPLEMENTATION

10. *Flexibility to change budget aggregates during execution*
 - a. Any increase in total revenues, expenditures and the deficit needs to be approved by the parliament in a supplementary budget
 - b. Revenue windfalls can be used to increase expenditure without the approval of the parliament as long as the deficit is not increased
 - c. Simultaneous changes in revenues and expenditures allowed without approval of parliament if budget balance is not changed
 - d. At discretion of government
11. *Transfers of expenditures between chapters (i.e. ministries' budgets)*
 - a. Require approval of parliament
 - b. FM or cabinet can authorize transfers between chapters
 - c. Limited
 - d. Unrestricted
12. *Carry-over of unused funds to next fiscal year*
 - a. Not permitted
 - b. Only if provided for in initial budget or with finance ministry approval
 - c. Limited
 - d. Unlimited
13. *Procedure to react to a deterioration of the budget deficit (due to unforeseen revenue shortfalls or expenditure increases)*
 - a. MF can block expenditures
 - b. The cabinet can block expenditures
 - c. Approval of the parliament necessary to block expenditures
 - d. No action is taken

APPENDIX C

The Constituents of Hallerberg and Yläoutinen's Index

“CONTRACTS” INDEX (PLURALITY ELECTORAL SYSTEMS)

Long-term Planning Constraint

- a. Is there a multi-annual target in place?
- b. Length of time-horizon
- c. Nature of budget forecasts
- d. Degree of commitment to multi-annual fiscal targets

“DELEGATION” INDEX (PROPORTIONAL ELECTORAL SYSTEMS)

Structure of negotiations in cabinet

- a. Is there general constraint on the budget?
- b. Agenda setting power of finance minister
- c. Broadness of the budget norms (Are there more specific targets in addition to general ones?)
- d. Structure of budget negotiations

Strength of Finance Minister

- a. Does the finance minister have special power in budgetary issues?

Structure of the parliamentary process

- a. Are amendment possibilities by the parliament limited?
- b. What consequence has losing budget vote? (e.g. vote of confidence?)
- c. Can amendments cause the fall of the government?
- d. Sequence of vote on budget in parliament (first voting on total size or not?)

Flexibility of budget execution

- a. Can the fin. min. block expenditure?
- b. Can the fin. min. impose cash limits?
- c. Disbursements must be approved before spent?
- d. Possibility of transferring funds between chapters
- e. Possibility of carrying over unused funds to next year
- f. Are changes to budget law allowed during execution stage?

APPENDIX D

Data used by Dóra Gyórfy in the framework theory

Satisfaction with democracy*								
	1998	1999	2000	2001	2002	2003	2004	2005
Austria	60	64	56	63	72	65	64	68
Belgium	28	49	60	63	70	65	62	65
Finland	50	67	64	62	71	77	77	77
France	39	59	60	58	59	68	55	53
Germany	50	66	54	61	66	59	51	53
Greece	33	62	53	48	53	49	64	53
Ireland	75	74	70	73	69	66	70	71
Italy	28	34	36	38	34	38	35	44
Luxembourg	79	83	74	75	79	80	80	82
Portugal	35	57	50	37	35	37	31	41
Spain	50	71	75	64	70	58	65	67
Netherlands	75	78	80	71	66	70	64	71

Satisfaction with democracy*				
	2002	2003	2004	2005
Czech Rep	42	41	43	48
Estonia	32	32	30	44
Hungary	55	33	31	27
Latvia	37	40	35	44
Lithuania	36	37	29	24
Poland	28	23	16	29
Slovakia	19	17	18	26
Slovenia	45	50	43	56

* Share of respondents that is either “very satisfied” or “fairly satisfied” with democracy.
 Source: Gyórfy [2007] quoting Eurobarometer survey results from the corresponding years.

APPENDIX E

Results of Parliamentary Elections

ESTONIA

1992	
Party	% of Votes
Isamaa	22
Kindel Kodu	13,6
Rahvarinne	12,25
Möödukad	9,73
ERSP	8,79
Eesti Kodanik	6,89
Sõltumatud Kuningriiklased	7,12
Eesti Ettevõtjate Erakond	2,39
Rohelised	2,62

1995	
Party	% of Votes
Koonderakonna ja Maarahva Liidu Ühendus	32,23
Reformierakond	16,19
Keskerakond	14,17
Isamaa ja ERSP	7,86
Möödukad	5,99
Meie Kodu On Eestimaa	5,87
Parempoolsed	5

1999	
Party	% of Votes
Keskerakond	23,41
Reformierakond	15,92
Isamaa	16,09
Möödukad	15,21
Eesti Maarahva Erakond	7,27
Koonderakond	7,58
Eesti Ühendatud Rahvapartei	6,13

2003	
Party	% of Votes
Keskerakond	25,4
ResPublica	24,6
Reformierakond	17,7
Rahvaliit	13
Isamaa	7,3
Möödukad	7

2007	
Party	% of Votes
Reformierakond	27,8
Keskerakond	26,1
Pro Patria and Res Publica	17,9
Estonian Social Democratic Party	10,6
Rohelised	7,1
Rahvaliit	7,1

HUNGARY

1990	
Party	% of Votes
MDF	24,73
SZDSZ	21,39
FKGP	11,73
MSZP	10,89
FIDESZ	8,95
KDNP	6,46

1994	
Party	% of Votes
MSZP	32,99
SZDSZ	19,73
MDF	11,73
FKGP	8,82
KDNP	7,03
FIDESZ	7,01

1998	
Party	% of Votes
MSZP	32,92
FIDESZ	29,48
FKGP	13,15
SZDSZ	7,57
MIÉP	5,47

2002	
Party	% of Votes
MSZP	42,05
FIDESZ-MDF	41,07
SZDSZ	5,57

2006	
Party	% of Votes
MSZP	43,21
FIDESZ-KDNP	42,03
SZDSZ	6,5
MDF	5,04

2010	
Party	% of Votes
FIDESZ-KDNP	52,73
MSZP	19,3
Jobbik	16,67
LMP	7,48

Source: Vabariigi Valimiskomisjon; Országos Választási Iroda