From Democratic Dissatisfaction to Financial Crisis

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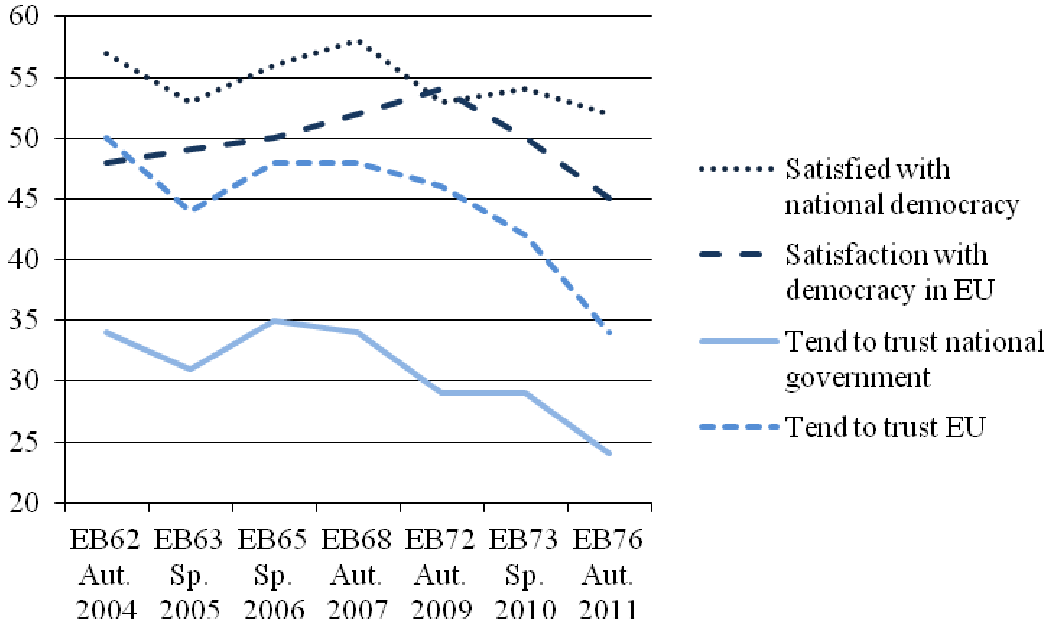
Following the financial crisis, the ideal of democracy seems to be losing attractiveness. In several countries, the populist measures, which eventually led to the crisis, were the outcome of democratic politics as electoral considerations dominated policy-making at the detriment of long-term sustainability. Excluding vote-maximizing considerations from economic decision-making thus seems to be order of the day in Europe as the reform of economic governance increases the power of European institutions over almost every aspect of economic policy.

The public does not remain unaware of decreasing national discretion. In the creditor countries there is considerable outrage over the large-scale financial help to the periphery. It appears that democratic control over tax-payers money is greatly reduced. In the periphery countries the strict conditionality, which comes from the bail-out packages, strongly constrains the discretion of democratically elected leaders over economic decisions.

Based on the above, it is unsurprising that trust in the EU and national governments is in a steady decline. Figure 1 shows the changes in the satisfaction with democracy and the level of trust towards the European Union and national governments.

Figure 1. Trust and satisfaction in EU (2004-2011)
(percent of respondents)



Data: Eurobarometer 65, 76, 77

The growing skepticism towards democracy by both elites and regular citizens raises disturbing questions about human freedom and autonomy. However its relationship to the financial crisis is almost never mentioned. In the following I will attempt to uncover the links between democratic dissatisfaction and financial imbalances. The main argument of the chapter is that by reflecting decreasing trust in the political system, democratic dissatisfaction leads to a shortening of time-horizon in society, which in turn increases the attractiveness of short-term, populist measures. Accumulating public and private indebtedness is a manifestation of this problem.

The chapter will discuss the background of indicators such as trust and satisfaction with democracy in order to understand their meaning. Then it will provide a theoretical framework showing the relationship between lack of trust and short-term thinking. The theory will be illustrated by data on indebtedness in the original euro-zone countries and new EU member states (EU-12 and CEE-10). Finally, the case of Hungary will be used to illustrate how such results come about from the policy process. The conclusion will discuss the main implications of these trends.

The Debate over Measuring Political Support

Before proceeding to discuss the consequences of declining trust in democracy, first it is important to discuss what the indicators such as trust in government and satisfaction with democracy actually mean. In the following I will provide a brief overview about the debate over these measures focusing on the meaning of satisfaction with democracy.

The focus on political support can be traced back to the work of David Easton who argues that the level of trust in government is a key factor in the functioning of the political system (Easton 1965). In assessing support he differentiates between specific support, which relates to short-term outputs, and diffuse support, which means "a reservoir of favorable attitudes or good will that helps members to accept or tolerate outputs to which they are opposed or the effect of which they see as damaging to their wants" (Easton 1965: 273). These ideas strongly resonate with the ideas of Gamson (1968: 45-46), who claims that "when the supply in the reservoir is high, authorities are able to make new commitments on the basis of it and, if successful increase such support even more. When it is low and declining, authorities may find it difficult to meet existing commitments and to govern effectively." Indicators such as 'Trust in government' or 'Satisfaction with democracy' aim to measure this kind of support.

Critics of the indicator, however, have noted that when an individual answers the question whether they trust the government or are satisfied with democracy, it is not at all clear what they mean. The most thorough critique of the indicator is given by Canache et al (2001) who claim that in the literature the satisfaction with democracy measure is used in a variety of ways. Some authors consider it as an indicator of specific support, while others as an indicator of diffuse support – these two interpretations are clearly contradictory. There is a pragmatic third way of interpreting the indicator (Clarke et al 1993) through looking at it as a summary measure of support for political community, regime, incumbent authorities – satisfaction with the existing political system. Canache et al (2001: 508) note that empirical evidence favors this interpretation. However, this also means that the measure is so ambiguous that inferences from its use become meaningless.

In response to the above criticism, Anderson (2005) claims that although it is indeed impossible to separate specific and diffuse support, it does not mean that the indicator is meaningless. He takes the pragmatic position that "in the absence of a better item [which the authors, incidentally, do not supply], the satisfaction with democracy measure is a reasonable (albeit imperfect) indicator that we can use to test our theories" (Anderson 2005: 10). He also suggests that triangulation of evidence and different methodologies are most appropriate to assess the theories.

The most recent empirical examination of the problem is a longitudinal study done by Wagner, Schneider and Halla (2009) on the determinants of the satisfaction with democracy. They find that controlling for various variables, a better rule of law, lower corruption, a smaller shadow economy, better checks and balances, and a better institutional quality generally all lead to a higher satisfaction with democracy score (Wagner, Halla and Schneider 2009: 37) .

Based on the above, in the following I will interpret the satisfaction with democracy indicator as a summary measure of institutional performance and show how it lies at the root of financial imbalances. However, knowing its limitations, I will also use a case study in order to uncover processes through which this variable contributes to outcomes.

The Relationship between Public Trust and the Time Horizon of Decision-making

When uncovering the consequences of democratic dissatisfaction and distrust in the system, first it is important to look at what trust means. In an attempt to provide a cross-disciplinary understanding of trust, Rousseau et al (1998: 395) defines trust as “a psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behavior of another.” This implies that when acting upon trust we cannot be certain that the other party will not abuse this trust.

Lack of certainty does not mean that trust implies blind faith. When accepting vulnerability the actor uses the information available on the other party. In this sens, there are rational elements of trust such as experiences from past interactions or the understanding of the motives of the other party. However, it is also important that the picture is necessarily subjective, since no one can be certain that she knows all the relevant facts about the other party’s past or motives. This makes belief an essential ingredient of trust, which facilitates action on the basis of incomplete information (Möllering 2001).

Social science literature distinguishes between particular and general trust (Uslaner 1999: 126-127). Particular trust means that people trust only those who are part of the same community – such as family members or those with the same religious faith. This kind of trust is based on personal knowledge, the necessity of repeated cooperation and shared identity, which reduce the danger of an abuse of trust. In contrast, generalized trust means that most people, including those outside one’s social group, can be trusted. As society became larger and more complex, this kind of trust gained increased significance since this makes cooperation among strangers possible. From the perspective of aggregate economic outcomes, it is generalized trust, which matters, since this form of trust makes anonymous exchange possible.

The written and unwritten rules of society contribute to generalized trust and increase the predictability of interactions among members. According to Offe (1999: 73-75) institutions can generate trust through enforcing the values of truth-telling, promise-keeping, fairness and solidarity, which contribute to trust. Such an outcome is not the result of a single institution but rather the joint effect of a set of institutions. Truth-telling and the provision of information are ensured, for example, by the freedom of the press, public court proceedings and accounting standards. Promises are enforced by contracts and independent courts. Equality before the law and equal political rights foster a sense of fairness. Finally, state redistribution towards the less fortunate generates the feeling of solidarity. The success of institutions in these endeavors can give rise to “moralistic trust”, which claims in a normative sense that most people should be trusted. This is a variety of the Golden Rule, which requires “you do unto others as you would have them do unto you” (Uslaner 2008: 103). Not attributing the intention of exploiting trust to the other party follows from this rule. According to Uslaner (2008: 117) moralistic trust is the real foundation for generalized trust.

The importance of institutions generating trust underlines the fact that in everyday life governance, which is the output side of the political system, is at least as important as the input side, elections. In the absence of good governance[1] generalized trust cannot emerge and

[1] The concept of good governance became widespread following the failure of the neoliberal agenda about minimizing the role of the state. It is generally defined in terms of respect for

the institutions cannot fulfill their role in coordinating the interactions of citizens. If the state is widely seen as corrupt, there is no equality before the law and public services increase rather than decrease life opportunities, the non-privileged groups are unlikely to have strong motives to respect the rules.[2]

The above consideration is particularly important once we recognize that in the emergence of rule-following behavior the legitimacy of norm or its creator is particularly important. In his overview about rule compliance Hurd (1999) differentiates three different motives for following the law: coercion, self-interest and the legitimacy of the rule. He claims that the most efficient is the third, when internal convictions rather than external pressure create obedience. Physical coercion is not only expensive but also leads to resentment and resistance to the law and authorities (384-385). Self-interest is somewhat better in motivating voluntary compliance, but in the long-term it is likely to fail since it encourages continuous cost-benefit analysis about following the rule – once it appears too costly, there seem to be no reason to obey.[3] In contrast, rule compliance based on legitimacy does not calculate and obedience becomes habitual – in this case breaking the rule has psychological costs and thus requires special consideration (388). If this is missing, and following the rules is not in someone’s interest, rule-avoidance becomes the norm since it is clear that the state cannot have a policeman for every citizen.

Based on the above, it is clear that institutional trust has a particularly important function in creating generalized trust. Without institutional trust the risks of cooperating with strangers increase greatly. If business partners cannot be certain that contracts are enforced, they will require much more guarantee for signing a contract than in an environment where respecting the rules is the norm. This not only increases transaction costs, but it also results in an uncertain, unpredictable environment, where long-term plans are unrealistic. It is very risky to invest in a place where contracts are not enforced by independent courts and respect for private property rights cannot be taken for granted. In such an environment short-term survival becomes the major objective for those who cannot leave, and rule-breaking and corruption become the widely accepted means towards this objective.

In a low-trust environment the evasion of rules is generally fostered by perceptions about success. This has been analyzed empirically by Csepeli et al (2004: 222), who found that in contrast to Western Europe, in Eastern Europe perceptions of success are much less associated with talent and hard work than with dishonesty. If success is associated with rule-breaking, and weak institutions are seen as unlikely to punish trespassers, people will have much less internal resistance to do the same, and a vicious cycle emerges among low trust, wide-spread rule-evasion, radical uncertainty and short-term thinking.

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democracy, human rights, rule of law as well as transparent and efficient state administration. For a more thorough overview about the concept see Weiss (2000) and Rothstein and Teorell (2008).

[2] A good example for this idea is the research by Hellman and Kaufmann (2004). Based on data from 6500 companies in 26 transition countries, they find that those firms, which feel that they have disproportionately small influence on regulations directly affecting them, have a negative view about public institutions, are less likely to pay taxes and more likely to engage in corrupt practices. Paying taxes or paying bribes appear to be substitutes.

[3] It is important to note that Hurd (1999: 386) does not accept references to enlightened self-interest, since if everthing can be considered self-interest, then the concept becomes empty. In his definition of self-interest the individual does not accept moral responsibility for others, which means that her relations are purely instrumental. This does not exclude cooperation, but it does imply that the relationship in itself is not valued only the benefits it yields.

Politicians, who expect to gain votes during elections, cannot remain impervious to the prevalence of the above cycles. Since long-term promises are not credible, in the absence of strong external pressure, they answer to the short-term objectives of citizens by short-term solutions in order to gain votes. These, however, rarely intersect with the requirements of sustainable development.

The possibilities for short-term solutions are almost endless. In the socialist system the state generally looked the other way rather than punish trespassers. The leaders of the system attempted to reduce the social stress due to shortages and the resulting low level of consumption through allowing private deals, very often involving the use of state resources. State authorities were willing to overlook these dealings and show leniency, although this was unpredictable and they could change their mind and apply the law in its full rigor at any time (Kornai 1992: 451-452). While the second economy indeed improved the standard of living, it also implied a lasting heritage about the disregard for rules shared by both citizens and authorities.

Improved living standards can also be achieved by increasing public or private debt. In order to improve their popularity, democratic governments can increase spending or cut taxes – both leading to budgetary imbalances; but while the first option generally benefits the poor, the second option benefits the tax-payers. If the rise in deficits is not feasible for some reason, loose financial regulation makes it possible to increase present consumption at the cost of the future without directly influencing state finances.

The likely failure of the above strategies already at the medium-term further increases the distrust towards the institutions and strengthens the short-term orientation in society. If external pressure forces policy-makers to consolidate finances, the short-term sacrifices further increase dissatisfaction. There is thus no easy way out of the vicious cycle regardless of whether a responsible or irresponsible path is taken.

Institutional Trust and Indebtedness in the European Union

On the basis of theoretical considerations we can hypothesize that lack of trust towards the government or the political system will manifest itself in increased debt levels, which reflects a strong preference for the present over the future.[4] In the following, I will illustrate this hypothesis in the old and new member states of the European Union. Institutional trust in the analysis is measured by the satisfaction of democracy indicator. While this is not a perfect measure, as discussed above, I view it in a pragmatic sense as an approximate measure of the level of satisfaction with the political system. Although it is clearly sensitive to daily politics and scandals, looking at longer periods can smooth out these factors.

Figure 2 shows the relationship between satisfaction with democracy and fiscal balance during the period 1998-2007. Both measures signal averages during the 10 years. This period is particularly good for examining the hypothesis of this chapter because in order to qualify for the euro deficit was below 3 percent by 1998 in every country.[5] Following the introduction of the euro there was no external force to discipline these countries – risk premiums converged to Germany.[6] At the same time, the Stability and Growth Pact also failed to discipline euro-zone members following the no-vote in the ECOFIN to the fining of Germany and France in 2003. This means that neither market nor bureaucratic discipline

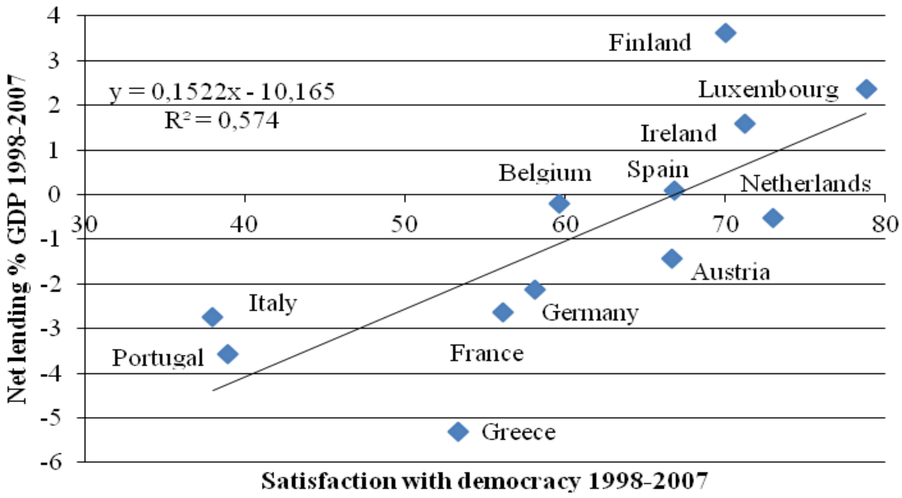
[4] Naturally I do not mean to imply that other factors, most importantly investment, do not drive tendencies of indebtedness. The hypothesis is that other things (such as investment needs) being equal, countries with low level of trust will be more likely to accumulate debt than high-trust countries.

[5] With the exception of Greece, which introduced the euro in 2001.

[6] Between 2002 and 2007 there was less than 1 percentage point difference in long-term interest rates within the euro-zone (European Commission 2012: 126).

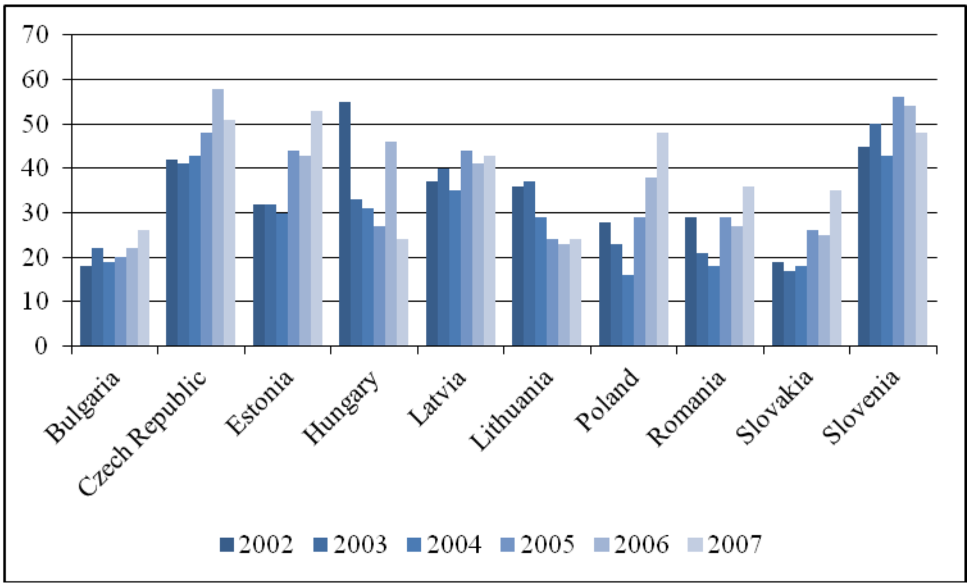
worked in this period, which means that internal factors were decisive in the trends in fiscal balance. Figure 3 supports this hypothesis and shows a strong relationship between satisfaction with democracy and fiscal position.

Figure 2. Satisfaction with democracy and fiscal balance in the EU-12 (1998-2007)



Data: Eurobarometer No. 49, 51, 53, 56, 58, 59, 61, 63. 65, 68, European Commission (2012): 180

Figure 3. Satisfaction with democracy in the CEE-10 (2002-2007)

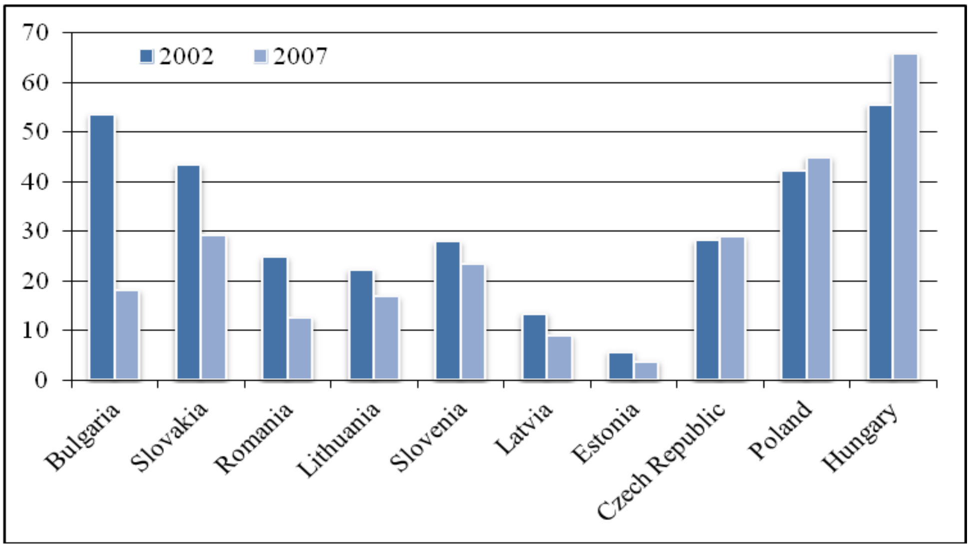


Data: Candidate Countries Eurobarometer 2002.2, 2003.4, 2004.1 as well as Eurobarometer 63, 65, 68

The relationship between institutional trust and indebtedness is much less evident in Eastern- and Central Europe (EU-10). Given the inheritance from the Communist period trust is notoriously low in these countries – as shown by Figure 3 satisfaction with democracy rarely reached 50 percent even in those countries, which have the highest level of satisfaction such as Slovenia or the Czech Republic. This implies that the majority of the population in not satisfied with the political system in these countries.[7] In the 10 year period examined in the euro-zone, only Italy and Portugal showed similar tendencies.

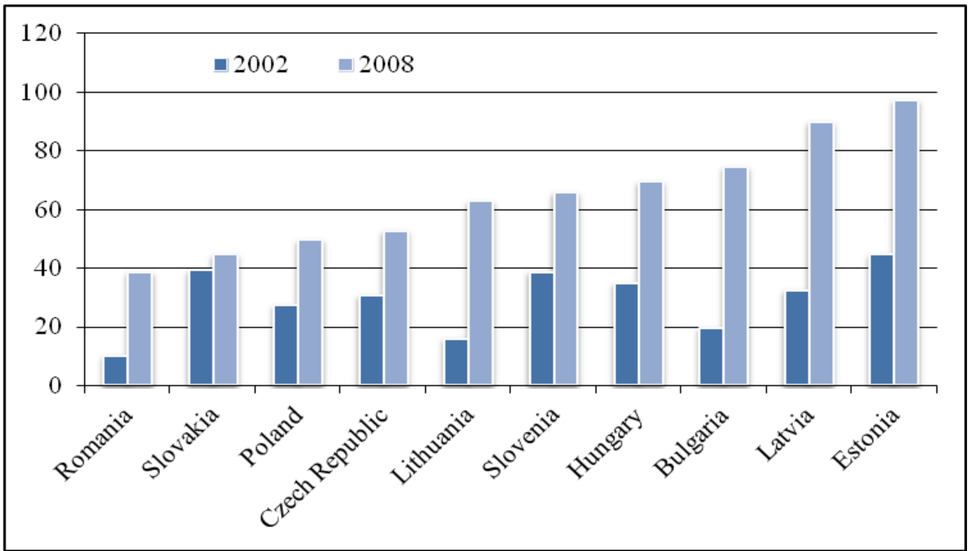
In spite of low levels of trust we can observe a declining trend in the level of public debt (Figure 4), which is surprising in light of the theory. One potential explanation for this contradiction is that unlike in the old member states of the EU, market forces worked for the CEE10 countries and fiscal processes were influenced by other factors than internal pressures. This is especially true for those countries, such as the Baltic States and Bulgaria, which had a currency board arrangement, which can be undermined by irresponsible fiscal policy.

Figure 4. Public debt in the CEE-10 2002-2007 (% of GDP)



Data: European Commission (2012): 184-185

Figure 5. Credit to private sector in the CEE-10 2002-2008 (% of GDP)



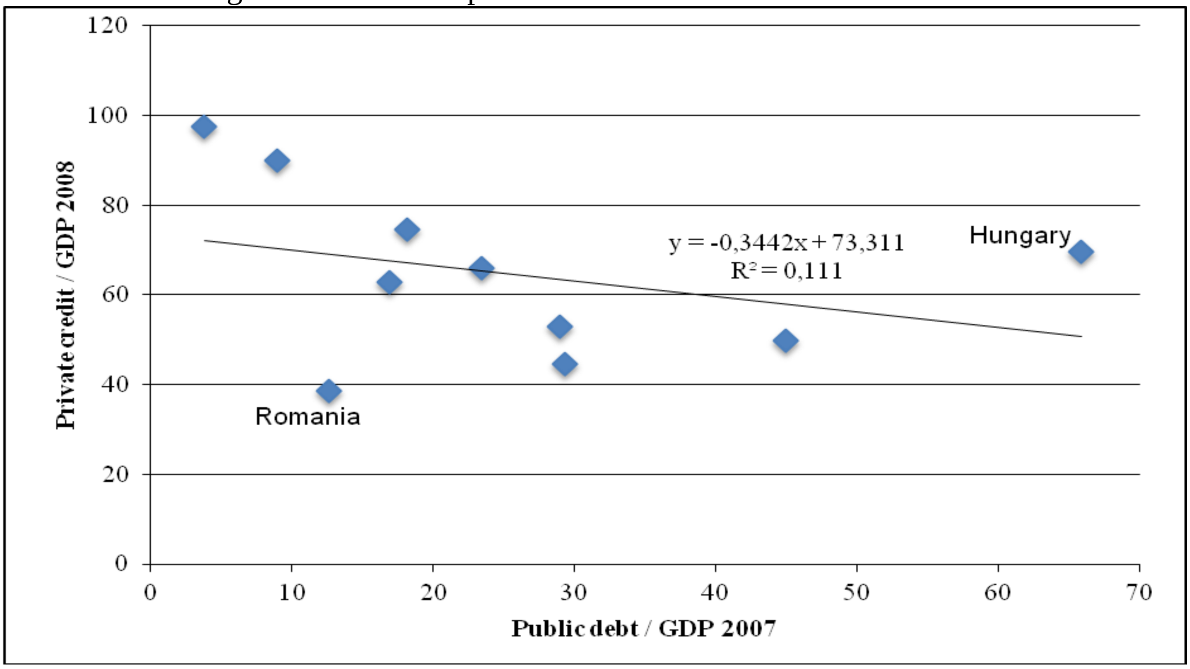
Data: World Bank Data Catalog[8]

[7] Rose (2009) provides an excellent discussion of the subject.
[8] Available: http://data.worldbank.org/indicator/FS.AST.PRVT.GD.ZS

While external disciplinary forces clearly worked, there still seemed to be a way to appease a dissatisfied electorate through increasing present consumption. If we take a look at the trends in private sector lending (Figure 5), we can observe a clear rise in debt especially in those countries that conducted the strictest fiscal policy.

A simple correlation between public debt and private debt in Figure 6 provides some evidence for the presence of a substitution effect. However, the relationship is rather weak given two outliers: Romania and Hungary. Credit growth in Romania was much smaller than could have been expected based on its low public debt, while in Hungary both public and private debt soared during the period under examination. In the case of Romania, weak institutions and lack of a currency board providing credibility constrained access to the international financial markets and thus placed limits on becoming indebted. Still, in anticipation of its EU accession, there was a lending boom but given the very low base and a later start, the expansion could not reach the proportions it did in other countries of the region.[9] The Hungarian case is the reverse – as a former leader of the transition, the country had access to international financial markets, and both the public and private sector made use of this opportunity. As will be shown in the next section, the case is an extreme illustration of the theory of trust and economic policy. In the regional context, howeve, the total lack of restraint makes it an outlier.

Figure 6. Public and private debt in the CEE-10 in 2007/2008

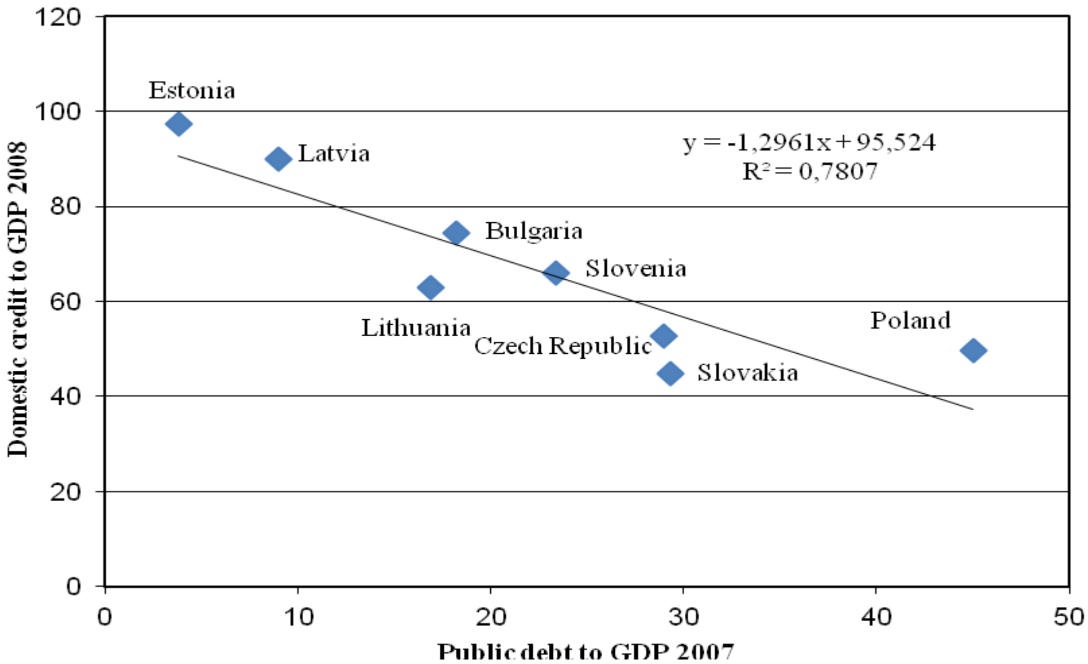


Data: see Figures 4 and 5.

Removing the two outliers from the sample yields a very strong correlation between public and private debt as shown by Figure 7. This provides some evidence for the hypothesis about the substitutability of welfare spending and credit.

[9] For a detailed overview of Romanian credit developments see Hudecz (2012): 372-380.

Figure 7. Public and private debt in the CEE-8 in 2007/2008



Data: see Figures 4 and 5.

The hypothesis that access to cheap private credit can substitute for excessive welfare spending is also supported by the findings of Hilbers, Ötker-Robe and Pazarbasioglu (2007), who provide a thorough overview about the policy responses to rapid credit growth in the post-communist region, and conclude that they were inadequate with a few exceptions such as Poland. For the case of Latvia, which shows the largest reduction in welfare spending and the largest increase in private credit, Bohle (2010: 8-9) suggests clear political motives in encouraging private indebtedness. Based on the assessment of Darvas and Kostyleva (2011: 29) the country also had the weakest financial regulation framework in the region, and between 2003 and 2007 it became even weaker.

Based on the above, we can conclude that in the absence of external pressures in the euro-zone between 1998 and 2007 the satisfaction with democracy shows a strong correlation to fiscal performance that provides illustration to the theoretical considerations. In the CEE-10 countries this relationship is much less evident partly because of the much stronger market discipline in these countries. However, a possible reason for the parallel rise in private sector credit is the popularity considerations of governments[10].

While the above correlations illustrate the predictions of the theory, they say nothing about the causal mechanisms. For this purpose case studies are particularly valuable. In the next section I will examine the case of Hungary, which can be considered as an extreme illustration of the theory given the parallel rise in public and private indebtedness.

Distrust and the Dominance of Short-term Policies in Hungary

The roots of distrust

[10] Csaba (2009) calls these trends as the new macroeconomic populism.

Distrust has been prevalent in Hungary for many decades. Under communism both interpersonal and institutional trust were eroded. Given the all-pervasive nature of bureaucratic coordination, the system was essentially built on distrust: neither fellow citizens (who might be agents of the regime), nor the state (operating without checks and balances) could be trusted (Kornai, 1992). Following the collapse of communism, transition resulted in new grievances that perpetuated distrust. While a thorough overview would require a separate analysis, four major reasons can be mentioned for this outcome.[11]

The first important factor relates to the "material losses" due to the transformational recession. The loss of output between 1989 and 1993 amounted to 18 percent (UN ECE 2003: 112) leading to decreasing consumption and rising unemployment. Real total consumption expenditure reached its pre-transition levels only in 2000 (UN ECE 2003: 113). By 1996, employment decreased to 69.8 percent of the 1989-level although the unemployment rate fluctuated around 10 percent (UN ECE 2003: 115 and 117). Rising inequality accompanied these processes: over the transition the Gini-index rose by 19 percent (Kornai 2006: 229).

"Subjective feelings of injustice" aggravated the objective losses. The old elite were generally perceived to have fared much better during the transition than the population as a whole. While the dominance of incumbents in the privatization process is only partially true, it remains a widespread perception (Laki and Szalai 2006).

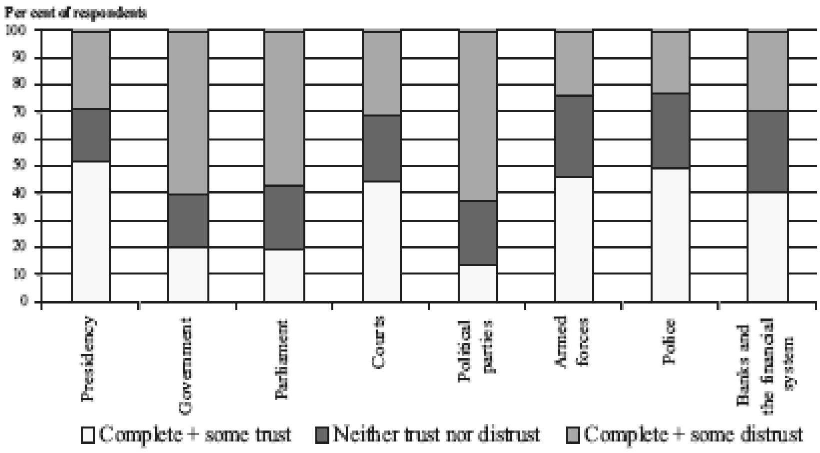
"Unrealistic expectations" of the new system can similarly contribute to the general disillusionment. Transformation was originally perceived as a way to close the gap in living standards with the advanced West. As this did not materialize, disappointment was coded into the system. In spite of the considerable increase in living standards, as measured by the availability of various consumer goods (EBRD 2007: 6), nostalgia for the previous regime has remained widespread - even in 2004 60% of Hungarians though that the old regime was better (Rose 2006: 39)

"Failures of the new system" are also a source of justified disillusionment. Endemic corruption, policy and institutional failures contribute to a sense of skepticism regarding the new system. Over 70 percent in Hungary believe that there is more corruption in the new system than in the old regime (EBRD 2007: 51). The strong general distrust towards the new regime and especially towards the representative institutions such as the parliament and the political parties is shown by Figure 8.

Overall given the above factors, the distrust that characterized the old Socialist regime did not disappear with transition. In the following, I will show how such dissatisfaction showed up in Hungarian policy-making especially following accession to the EU.

Figure 8. Trust in public institutions in Hungary (2006)

[11] In the following I rely substantially on Kornai (2006): 227-237.



Source: EBRD (2007): 51

The early phase of Hungarian transition

During the early phase of transition lack of trust did not seem to influence policy. In the 1990s Hungary was among the leaders of post-communist transition – it signed an association agreement with the EU already in 1991 and was the first country to submit its membership application in 1994. This early period was characterized by a widespread consensus among the major political actors over the main tasks of transformation – the establishment of democracy and market economy that would eventually lead the country into the European Union. Furthermore, the idea that for a small, open economy, export-led growth is the way to sustainable development was also widely shared. This consensus was also supported by the public – while in 1991 only 23 percent of the population expressed satisfaction with the economic situation, 72 percent was positively hopeful for the future (Rose 2005: 31-33).

Thee factors proved to be very important in the transformation of the economy especially in the decisions over privatization and the hardening of the budget constraints for companies. Given the high level of inherited debt, which was 73 percent of the GDP in 1989, the major objective of privatization was to generate revenue for the state and additional capital for enterprises. This practically meant the sale of enterprises to foreign investors and thus helped the country to step on the path of export-led growth (Mihályi 2001). Hungary's experience stands in sharp contrast with the experiences of most other transition countries where various public distribution schemes were tried before selling to foreigners. Besides the creation of real owners, the hardening of budget constraints was also seen as essential for the functioning of a market economy. The measures to reach this objective amounted to a microeconomic shock therapy for the economy (Csaba 1998: 1382). In January 1992 four major laws were introduced which aimed at hardening the budget constraints for all actors in the economy and end the situation of circular indebtedness in the economy[12].

Foreign-dominated privatization and the hardening of budget constraints in the economy were very successful in bringing about the fast adjustment of domestic production. Hungary was the major beneficiary from foreign direct investment among the transition

[12] The law on the central bank prohibited the monetary financing of the budget deficit. The law on financial institutions introduced the prudential, safety, transparency and disclosure requirements of the Basle Convention. The law on accounting required companies to comply with international accounting standards. Finally, the bankruptcy law introduced an automatic trigger, which obliged debtors under criminal law to initiate bankruptcy procedures if they were in default for than 90 days.

countries until 1995 (UN ECE 2003: 127). At the same time, the radical measures also had costs. During the early-1990s over 30,000 companies went through some form of bankruptcy procedures (Ábel-Szakadát 1997: 640), which had far-reaching consequences. As discussed in the previous section, during this period employment dropped by 30 percent, unemployment rose to over 12 percent and the loss in GDP was close to 20 percent. The wave of bankruptcies affected the banking sector as well, and the share of non-performing loans reached 32 percent of total company loans by 1993 (Ábel-Szakadát 1997: 643).

The transformational recession resulted in fast disillusionment from the transition and soon led to the collapse of the elite consensus. The loss of employment opportunities and rising popular dissatisfaction placed increasing demands on the welfare system of the country. In response to these pressures the government considerably eased regulations regarding disability pensions, early retirement and maternity benefits thus sowing the seeds for future problems in the economy. The pressure to consolidate the banking system further contributed to the erosion of the earlier commitment for lowering state redistribution. By 1994 consolidated expenditures reached 60.8 percent of the GDP up from 55.8 percent in 1991 (László 2001: 846). The upcoming elections were not favorable for fiscal restraint either and gave a further reason for the government to postpone fiscal consolidation. Massive overspending, however, did not save the government: the Hungarian Democratic Forum still suffered a devastating defeat at the elections, which were won by the Hungarian Socialist Party.

While a large fiscal deficit and the accompanying current account deficit due to foreign financing required immediate action, the government postponed harsh measures in order to prepare for the municipal elections that were held in October that year. The problems were addressed only in March 1995 after financial crisis hit Mexico, and it was feared that Hungary would be the next to fall. The surprise package implemented by the new minister of finance, Lajos Bokros, relied on monetary, fiscal and incomes policy to stabilize the economy.[13]. The main elements were a one-off devaluation, the introduction of a crawling peg exchange rate, the levying of an 8 percent import surcharge and nominal wage freeze in the public sector. Structural reforms played only a marginal role and instead there was an across-the-board type cut reducing primary expenditures from 51.9 to 41.6 percent of GDP. After the package, the process of privatization, which was stopped before the elections, was resumed in order to generate revenue to cover the debt burden. Similarly to the earlier years, the privileging of foreign strategic investors for the buying of banks and other large enterprises was an explicit governmental policy.

The package achieved its main objective and Hungary avoided a financial crisis without entering into a recession or suffering further employment losses. The devaluation of the exchange rate and the nominal wage freeze greatly improved the competitiveness of the economy and kept the country on an export-led growth-path – the value of merchandise exports doubled between 1995 and 1999 (UN ECE 2003: 121). As a result, by 1997 growth resumed and Hungary was second only to Poland in recovering its industrial output to reach its pre-transition level by 1998 (UN ECE 2003: 114).[14] The country also maintained its reputation as one of the leaders of the transition signaled by the highly positive evaluations from international institutions from the EBRD to the European Commission.

These results, however, came at a serious social and political cost. Inflation jumped to 28 percent eroding real wages, which fell by a total of 18 percent in 1995 and 1996. The reduction of entitlements, such as introducing needs-based family allowances or tuition fees in higher education, aimed to signal the importance of individual responsibility in the new

[13] For the description of the Bokros package I rely on Kornai (1996)

[14] No other transition country achieved this before 2000.

regime but their main result was the triggering of a serious resistance to the package. The opposition denied that such harsh measures were necessary, and Bokros soon became the least popular figure in the country. After the crisis was over he was forced to resign from his post in 1996. While a three-pillar pension system was introduced by his successor in 1997, no further major reforms took place for a decade.

The shock administered by the Bokros package had long-lasting influence on Hungarian economic policy-making and strongly contributed to the dominance of short-term decision-making during the next decade. First, the country avoided a financial crisis and thus Hungarian policy-makers never learnt the dangers of irresponsibility in the age of capital mobility. Instead, the unpopularity of the package and the loss of the following elections in 1998 made them extremely reluctant to introduce fiscal restrictions. Promising material benefits to buy support became the norm for all parties before the subsequent elections. Second, as the opposition took advantage of the difficult situation of the government and exploited the resistance to the measures, the consensual policy-making characterizing the early phase of transition turned into open hostility among the major forces. These developments eventually eroded the results of the package.

Governance without trust

Following the turn of the Millennium, the consequences of low trust became manifest in Hungarian policy-making. While the early consensus regarding economic transformation broke down already in the 1990s, the closure of EU accession negotiations in 2002 meant that an important external anchor also disappeared. The period after 2000 can be characterized by the permanent election campaign and the lack of any major reform. The dominance of political factors in budgetary decision-making is well documented by Ohnsorge-Szabó and Romhányi (2007: 265). They calculated that in the absence of politically motivated spending[15] since 2000, public debt would have been 36.9 percent of the GDP in 2006 instead of 66 percent. During this period the fiscal deficit fluctuated between 6,5 and 9,4 percent (European Commission 2012: 181).

On the surface the persistence of electoral considerations after 2000 is due to two factors: the large number of elections and referenda in this period[16] and the intensifying antagonism between the major political parties after the close outcome of the 2002 elections that brought the Hungarian Socialist Party back to power. However, if we look deeper three factors can be identified that contributed to the dominance of election cycles in economic policy-making. First, in line with the theoretical considerations, in a low-trust environment support can be bought only through short-term material benefits and, therefore, regardless of the ideological leaning of the parties, overspending was the norm rather than the exception. This phenomenon also implies that the public remained unaware of the consequences of irresponsible fiscal policy, and fiscal illusion was rampant. [17] Second, the institutional structure provided ample opportunity for the political class to manipulate the budget

[15] Among others these include subsidized credit for housing, increase in the public sector wage bill, increase in pensions and other social security benefits.

[16] These include municipal elections in the autumn of 2002, referendum on accession to the European Union in May 2003, European parliamentary elections in May 2004, referendum on dual citizenship and hospital privatization in December 2004 followed by the parliamentary elections in 2006.

[17] This was manifested in a Gallup survey between the two rounds of parliamentary elections in 2006, which showed that only 18 percent of the voters of the winning party considered the high fiscal deficit [close to 10 percent that year] a serious economic problem.

according to electoral considerations[18] as well as contributed to the fiscal illusions of the electorate[19]. Policy-makers had no incentive to strengthen these institutions as that would only make vote-buying more difficult for them. Finally, during this period there were no external factors to enforce discipline and the international financial markets provided ample financing to cover imbalances.

The period between 2000 and 2008 in Hungary demonstrates the difficulties of long-term oriented economic policy in a low-trust environment. The imbalances, which were due to populist electoral politics, were temporarily reduced in mid-term through sub-optimal revenue-increasing measures that led to a worsening business environment. The increase in taxes and the administrative measures to fight the informal economy substantially increased administrative costs and created an unfavorable environment for investment. Small and medium-size enterprises were particularly hard hit since they did not have the means to lobby individual exemptions from taxes or regulations (OECD 2008: 147). As this sector employs 69 percent of the labor force in Hungary, it is unsurprising that after Malta and Poland, Hungary had the third lowest employment rate in the European Union at 57,3 percent in 2007. Low employment in turn affects both growth and the fiscal balance. As labor is underutilized, growth prospects of the country decline. Low legal employment also means low contribution to the budget while at the same time entrenches demand for high welfare provisions. These provisions then have to be financed by high taxes on those who work, which provides considerable incentives for tax evasion and little incentive to work legally. These developments undermined public trust in the state even further and thus created a vicious cycle between lack of trust and low growth.

The situation was further worsened by rapid credit growth, which took place mostly in foreign currency.[20] The major reason for foreign indebtedness was the large interest rate differential between loans in domestic currency and in euro. Given the weak credibility of Hungarian economic policy due to the above reasons, domestic interest rates remained steadily high – as a result between 2004 and 2007 the difference between euro loans were cheaper by 6,5 percent for housing and 15,5 percent for consumption goods (Darvas and Szapáry 2008: 40). The high interest rate influenced foreign currency lending through the exchange rate channel as well – the forint remained strong and stable in relation to the euro, which contributed to the underestimation of exchange rate risk by borrowers. As the credit boom created the illusion of prosperity it is unsurprising that the sharp increase in foreign currency borrowing was not countered by effective policy measures.[21] The growing

[18] The major problems of the institutional framework concern the overly optimistic planning of the budget, the lack of restrictions during the adoption phase to increase spending, the discretion of the government to change the budget during the execution phase as well as the lack of transparency. The extreme weakness of the Hungarian institutional framework for budgeting even in a Central European comparison has been noted by a number of observers. See Gleich (2003) or Kraan et al (2007).

[19] The attempts in 2004 and 2005 to hide the budget deficit through creative accounting are examples of this relation. For these measures see Kraan et al (2007): 12.

[20] By 2008 the share of foreign currency lending approached 70 percent of total household loans. For a detailed overview about the buildup of these loans see Hudecz (2012): 381-386. I rely primarily on his assessment in the following discussion of the main causes of foreign currency lending in Hungary.

[21] The complete lack of response to the growth of foreign currency lending is unique in the CEE region as shown by Bethlendi (2011:211). Based on interviews with the participants, the reluctance of the government to constrain the credit boom is documented by Szentkirályi (2011). This was especially important, since financial supervision in Hungary is separate from

indebtedness in foreign currency made the country extremely vulnerable to any change in market sentiment and the volatility of the currency.

Overall the unhindered manifestation of short-term policy-making as a consequence of low levels of trust led to the emergence of large fiscal imbalances, high public and private debt as well as a high share of foreign currency loans. Under these conditions it is unsurprising that following the collapse of Lehman Brothers in September 2008, the subsequent freeze of the global financial markets and the sharp devaluation of its currency, Hungary was the first EU country, which had to turn to the IMF for help. As a consequence the country had to implement significant fiscal cuts in the midst of the subprime crisis,[22] deepening the collapse of output, which reached -6.3 percent in 2009. Following a decade of resistance by the political elite, in the context of the bailout package the parliament adopted strict fiscal rules constraining the growth of debt and established a fiscal council to provide independent assessment of budgetary policy and evaluate legislative proposals based on their budgetary impact.

The political consequence of distrust: the majoritarian turn under Viktor Orbán

The mismanagement of the economy and the subsequent pain of adjustment during the financial crisis swept away the Socialist government in the 2010 elections. The center-right Fidesz in coalition with the Christian Democrats received a two third majority in the Parliament on the bases of promises of an alternative economic policy, which involves no further restrictive measures but promotes growth instead. While they promised a radical turnaround, the short-termism of the earlier period only intensified as checks and balances in the institutional framework were removed.

The program of the new government relied on a mix of conservative and nationalistic elements. During its first year in office, it introduced the flat tax, substantially increased benefits to families with children, as well as loosened labor market regulations and welfare benefits in order to encourage employment. While these measures copied the earlier Slovak reform program, [23] they did not produce the same results given the parallel measures, which aimed to compensate for the loss of state revenues. Unlike in Slovakia, the reduction of taxes on labor was not matched by similar cuts in state expenditure. Instead the government de facto nationalized the second pillar of the pension system and special taxes were introduced for banks and multinational companies. The problem of foreign currency indebtedness was addressed through a long moratorium on evictions as well as the possibility of repaying the

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the independent central bank, and the supervisory body (PSZAF) is under the authority of the Ministry of Finance.

[22] The measures included "(i) a nominal wage freeze and the elimination of the 13th monthly salary for all public sector employees; (ii) the elimination of the 13th monthly pension for all early retirees and a cap of the 13th monthly pension to HUF 80,000 for other pensioners; (iii) postponement or elimination of indexation of selected social benefits; and (iv) across-the-board cuts in other spending allocations to ministries (0.5 percent of GDP). Within the capital expenditure envelope, priority will be given to investment projects co-financed by EU structural funds. On the revenue side, the authorities have already announced that tax cuts previously envisaged for 2009 will be postponed until sufficient fiscal space has been created through expenditure restraint. Under the program, the authorities will also not make any changes in the tax code that could lead to a net revenue loss." IMF (2008): 10.

[23] For an overview of these reforms see Győrffy (2009).

foreign currency loans at an exchange rate well below the market rate.[24] The method of implementation aggravated the negative impact of these steps as they were mostly introduced in an ad hoc manner without consultations or impact studies.

Many of the measures were deemed unconstitutional and thus the government also took step to eliminate institutional checks and balances and thus increase its discretion over policy-making. Steps towards this objective included the nomination of party members to the posts of President and the head of the State Audit Office, as well as the elimination of the newly established Fiscal Council. The power of the Constitutional Court was also curbed following its resistance to retroactively endorse laws. While the inclusion of a 50 percent debt rule in the new Constitution could seem like a step towards rules-based fiscal policy, in reality the government made sure that the rule applies only to future governments[25].

The impromptu decision-making and the weakening of institutional checks and balances greatly increased uncertainty for all actors and undermined confidence in the rule of law. So although the government was able to reduce debt from 81.4 (2010) to 78.5 percent (2011) and maintain a deficit below 3 percent,[26] growth remains way below the regional peers, below 1 percent in 2012 and 2013. An important reason for this is the lack of confidence from global and domestic investors, which is manifested in the country's downgrade into speculative category, a weakening exchange rate, outflow of foreign capital, increasing risk premium and growing difficulties in obtaining credit for both companies and households.[27]

Overall, Hungary can be considered a primary example of how lack of institutional trust makes short-turn decision-making a constant feature regardless of who is in power. While lack of trust could be compensated by elite consensus and an external anchor during the early years of transition, following the disappearance of these factors distrust manifested itself in growing financial imbalances. As the global financial crisis made the continuation of such policies impossible, short-termism assumed a new form and manifested itself in attacks against multinational companies and banks. The sad consequence is the continuation of a vicious cycle between distrust and economic performance.

Conclusions

This chapter attempted to show how dissatisfaction with democracy lies at the root of the present crisis. The relationship to fiscal performance was most evident in the original member states in the euro-zone, where lack of external discipline implied that internal factors were dominant in determining outcomes. Although this was not the case in the new member states of the EU, there is some indication that in countries which faced strong external pressure to conduct responsible fiscal policy, private lending played a substitute role to public lending. By examining more closely the case of Hungary, I attempted to show how these outcomes emerge from the policy process. The case is particularly illuminating given the variety of short-term measures to appease the electorate – reckless spending, loose financial

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[24] For a detailed overview of the efforts to fight foreign currency indebtedness see Hudecz (2012): 400-407.

[25] The Law on Financial Stability postponed the obligations under the debt rule to 2016.

[26] Data on Hungarian economic developments is from European Commission (2012): 49 and 210.

[27] Gross fixed capital formation has been declining since 2009 and is expected to decline even in 2013, when it is forecasted to recover in all the other countries in the region (European Commission 2012: 69).

regulations, tax cuts and finally attacks on banks and multinationals were all popular and all extremely harmful to the long-term prospects of the country.

The major implication of this study is that democratic dissatisfaction is an important root of the crisis. This means that in managing the crisis and building more resilient economies this factor cannot be neglected. While stronger external discipline takes a central role in managing the crisis especially in the EU, this is unlikely to be sufficient to bring about discipline given the wide variety of shapes short-term populist measures can take. As we could see in the case of Hungary rule of law and considerations of procedures are very easily dismissed in the name of urgent crisis management. Such measures however can easily become counterproductive as they further undermine confidence and thus make recovery slower.

As the world struggles to resolve the financial crisis, governance reforms should be on the forefront of the agenda. Only a high quality government can tackle the financial crisis effectively and contribute to lengthening the time horizon of thinking in society thus precluding the need to gain votes through destructive, short-term measures.

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