What remains of the ideals of transition?

Examining competing theories of populism in Hungary, Latvia and Romania

PRELIMINARY DRAFT

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Abstract

With a global sentiment of gloom about the eclipse of liberal democracy and the rise of populist and authoritarian movements, the ideals of transition seem to have faded. Populism appears to be on the rise everywhere. Central and Eastern Europe is a prime venue for such tendencies given the disappointments from the transition and a value system, in which survival values dominate over self-expression. At the same time the populist trend is far from homogenous in the region, and the main question of the paper is to explain the divergence within the region through qualitative case studies. Looking at the three countries, which needed international financial assistance during the global crisis (Hungary, Latvia and Romania), the paper tries to disentangle various explanations for the rise of populism. It argues that attitudes towards the state rooted in the divergent heritage of communism provide a better explanation than economic or value-based explanations to the question why populism and illiberal democracy rose in Hungary rather than in Latvia or Romania. The paper shows how the communist heritage shaped the response to the financial crisis, which in turn strengthened the links to the West in the case of Latvia and Romania and weakened them in the case of Hungary. The main conclusion of the paper is that the ideals of the transition are still highly relevant and provide an avenue for economic success, but their survival depends on a strong commitment to limited government and a continuous improvement in the quality of governance.

1. Introduction

János Kornai recognized the disillusionment from the transition more than a decade ago (Kornai 2006). In his article on the great transformation of Central Eastern Europe he argued that in the context of world history the process had been a unique success. At the same time from the perspective of everyday life there has been widespread disappointment due to the growth of inequality and uncertainty as well as unrealistic expectations from the new system. A decade later he documented the drying up of the third wave of democracy – "for the 47 post-socialist countries, only a tenth of the population live in democracy, while autocracy or dictatorship prevails in all other countries in this group" (Kornai 2016: 547). Does this mean that the ideals of transition faded away?

The challenge to the centrist consensus on liberal democracy and market economy is not limited to the post-socialist world. The examples of China, Turkey and Russia underline the persistence of dictatorial rule in the developing world, while Brexit and the presidency of Donald Trump demonstrate the dangers of populism in advanced countries. These phenomena gave rise to a voluminous literature to explain the causes, and two dominant narratives emerged. The first narrative focuses on the impact of economic anxiety following the global financial crisis, while the second narrative emphasizes identity as an explanatory factor, and interprets populism as a cultural counter-revolution against the growing empowerment of women and minorities since the 1960s as well as a fear of immigration.

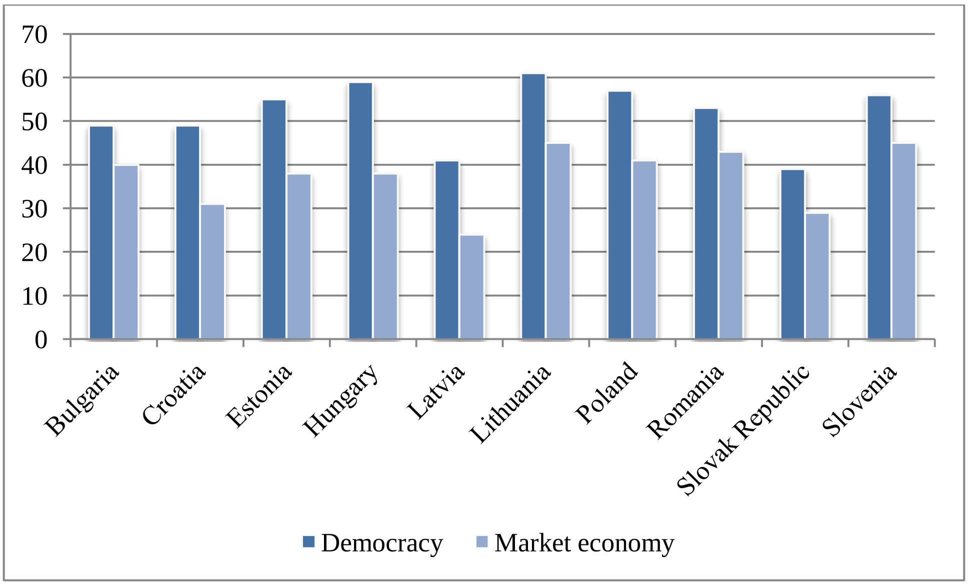
The present paper will examine the context of turning away from the ideals of transition through looking at economic developments and the landscape of values in the 11 post-socialist member states of the EU (CEE-11). It shows that neither economic nor cultural explanations seem to work to explain the divergence of populism in the region, so there must be some additional explanation. By comparing the cases of three countries, which needed international financial assistance (Hungary, Latvia and Romania) the paper points to the importance of attitudes towards the state as well as a commitment to improve the quality of governance as decisive factors in resisting domestic and foreign actors spreading populist messages.

The paper proceeds as follows. In the next section I will provide a brief overview about the economic and social outcomes of the transition and the populist trends in the CEE-11 region. The following section summarizes the main theories explaining the rise of populism. The fourth section compares the political economy of financial crisis management in Hungary, Latvia and Romania and examines the reasons for their divergent experience with populism. The final section concludes with the implications from the findings.

2. Ideals and the reality of transition in Central and Eastern Europe

At the time of transition the post-socialist countries of Central and Eastern Europe shared the ideals of building democracy, market economy and join the European Union (European Commission 2014a). In the words of Nutu and Ionita (2017a: 4) this is the "Western model, which combines democracy with the rule of law, promotes an open society with liberal and inclusive institutions, encourages transparent governance and sets limits for administrative discretion and political corruption. In economic terms, this model fosters free competition, level playing field, effective commercialization (including hard budget constraints) and the limitation of monopoly abuse." As we can see from Figure 1, the commitment to democracy and the market economy is far from undisputed in the region. In most countries of the region support for democracy fluctuates around 50 percent of the population, and there is not a single country, where the majority would consider market economy as the best economic system. Such results leave plenty of room to experiment with other arrangements if political circumstances allow.

Figure 1: Support for democracy and market economy (2016)



Source: EBRD (2016): 74-126.

Kornai (2006: 209-217) considers the ideals of building a democracy and market economy as rejoining the main direction of Western civilization. However, even at the time he realized that people might expect too much from the transition – while they truly wanted democracy, human rights, market economy, competition and security of property rights, they also expected the preferably quick fulfillment of the promises of the old regime, which never materialized under socialism (Kornai 1993: 453). The transformational recession[1] came as a massive shock as people expected that the collapse of socialism and the establishment of a market economy will lead to immediate improvements in welfare (Csaba 1995).

With the disappointments over the transition populism has been a characteristic of the region ever since the 1990s. A widespread definition of populism is "an ideology that considers society to be ultimately separated into two homogeneous and antagonistic groups, 'the pure people' versus 'the corrupt elite', and which argues that politics should be an expression of

[1] The concept of transformational recession originates from Kornai (1994), who argues that the shift from communism to a market economy initially triggers a recession for a number of reasons including the disturbances to the coordination mechanisms, the consequences of hardening the budget constraint and the weakness of the financial system. All these factors contribute to a collapse in investment and consumption leading to 10-70 percent collapse of the GDP in the post-socialist region.

the volonté générale (general will) of the people" (Mudde 2004: 543). Anti-establishment parties appeared in all CEE-11 countries on the right, the left and the center[2] even though the tasks associated with the accession to the European Union strongly limited their policy relevance. Prior to the global financial crisis, the regional discourse on populism often focused on economic policies. Macroeconomic populism was initially used for fiscal policy measures aimed at short-term improvements and buying votes – very similar to similar policies in Latin-America (Dornbush and Edwards 1991). In the 2000s a type of new macroeconomic populism emerged, which aimed at light financial regulations, low level of government redistribution and easy availability of credit leading to macroeconomic overheating (Csaba 2009: 90-91). Discourse on macroeconomic populism faded into the background in the 2010s as anti-elitist populism spread worldwide. However, Guiso et al (2017: 3) argue that they are related – by building on people's fears and insecurities populists offer short-term protection.

While for a considerable period there was a belief that once populist come to power they behave in a responsible manner and consider the long-term consequences of their action, this belief was clearly invalidated by the advance of illiberal democracies in Central Europe but also elsewhere. The term was first used by Fareed Zakaria (1997), who defined it in opposition to liberal constitutionalism – weak protection for human rights, an absence of checks and balances, weak rule of law, insecurity of property rights and repression of civil society. In 2014 Viktor Orbán proclaimed the building of illiberal democracy as a positive objective in order to be competitive in the post-crisis global landscape[3]. The rise of illiberalism as a form of government point to an important element of populism – antipluralism. According to Müller (2016: 3) "populists claim that they, and they alone represent the people. … The populist logic claims that whoever does not support populist parties might not be a proper part of the people." The illiberal alternative to the Western model is "grounded in nationalism and economic populism, with a strong anti-globalization (i.e. anti-Western) discourse. It favors opaque decision-making, clientelistic, preferential rules for certain well-connected players, it makes room for corruption, including through soft budget constraints, and it goes against the principles of a free competitive market. In its softer version, it is a pro-status quo regime informally protecting incumbent economic agents against natural change; harsher versions of illiberalism drift towards "revenge" nationalizations and active protectionist measures" (Nutu and Ionita 2017a: 4).

The perception that Central and Eastern Europe is a hotbed of populism is certainly not unjustified. The region still has not converged with the old member states of the EU, disillusionment from the transition is widespread, and civil society is generally weak. According to Ágh (2014: 22) trust in these countries is low because "(1) instead of *economic* cohesion, dual economies have emerged, (2) instead of *social* cohesion, social polarization has deepened and (3) instead of *territorial* cohesion, the ECE countries have split into two –

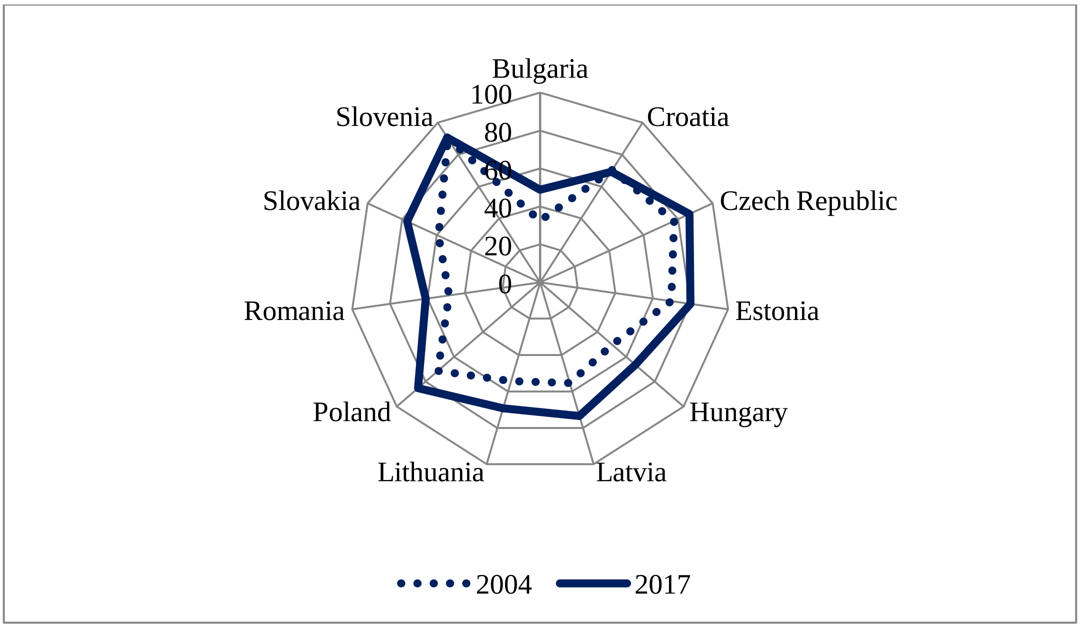
[2] Stanley (2017) provides an extensive overview of these parties in the region.
[3] For a thorough review of the speech see: https://freedomhouse.org/report/modern-authoritarianism-illiberal-democracies. Accessed: 30 January, 2018.

developed and underdeveloped – parts (western East vs. eastern East).” Such trends are clearly favorable for the emergence of populism.

Although the current discourse on populism would make us believe that populism is an irresistible force on the Eastern periphery of the EU, one of the most important conclusions of Stanley (2017) is that populism is far from a decisive electoral force. In several countries, such as Estonia, Romania or Slovenia its impact remained rather muted. There was no linear trend in the rise of populist parties in other countries in the region either – between 1990 and 2014 their total vote share remained well below 40% with the exception of Bulgaria, Hungary and Slovakia. Populism led to a constitutional change only in Hungary. A similar skepticism is voiced also by Kriesi and Pappas (2015: 318), who show that “despite a perception among the general public, the media and even academics to the opposite, populism has not been uniformly strong in the CEE countries.” In order to explain this, the authors point to former attempts at populist rule in Slovakia, which took away the novelty of effort. It is also important that even when in power, populists in the Czech Republic and Slovakia tuned down their populism (Ibid 2015: 320). Part of the reason might be that in spite of a widespread discourse on the failure of transition there has been considerable progress in the region in terms of satisfaction with life (Figure 2.). In the words of EBRD (2016: 11): “the life satisfaction gap between the transition region and western European comparator countries has finally closed.” The question – what causes populism? – still remains open.

Figure 2. Changes in life satisfaction 2004-2016

(% of those responding satisfied or very satisfied with their lives)



Data: Eurobarometer online

3. The roots of populism – literature review

The rise of populist tendencies is certainly not limited to the post-Socialist world. The shock of Brexit and the presidency of Donald Trump led to the emergence of a significant literature on the causes of populism.

Most analyses give an economics-based explanation for the populist trend in the West. This is most clearly elaborated by Rodrik (2017: 5), who claims that while globalization reduces inequalities among countries, it increases inequality within countries – while high-skilled workers gain, low-skilled workers are "unambiguously worse off." The enormous growth in inequalities in advanced countries as a result of globalization has been emphasized by Piketty (2014) as well as Milanovic (2016), who argue that these developments provide a fertile ground for populists. Based on European individual-level data Guiso et al (2017) show how economic insecurity fuels distrust and increases the probability for either abstaining from voting or voting for a non-mainstream party. Algan et al. (2017) provide evidence how the global financial crisis exacerbated these tendencies and led to the strengthening of populist parties all across Europe – they find a strong relationship between unemployment and voting for non-mainstream parties. The impact of crisis-driven austerity on populist gains is also emphasized by Mudde (2016).

A rival theory to explain rise of populism focuses on values. A widely-cited article by Inglehart and Norris (2017) contrasts economic- and value-driven explanations for the rise of populism. They argue that we are observing a cultural backlash against the progressive developments that have taken place from the 1960s regarding human rights, gender equality and environmental protection. Based on individual data from 31 European countries they show that the older generation, the lesser educated and men are most likely to vote for populist parties, while evidence on economic insecurity is more mixed – populists are strongest among the petty bourgeoisie rather than unskilled workers and those who live on welfare protection. Their research points to the importance of status loss in the vote for populist parties. Gidron and Hall (2017) elaborate on this finding and show how a person's subjective social status influences the rise of populist sentiments such as hostility to outgroups (S63). They provide the long-term trends in the growth of populist parties – from 1980s onward their voting share increased across European democracies (Ibid S60). Interestingly there is a dip, rather than a peak between 2010 and 2014 indicating the limits of explanations, which focus on the financial crisis as a factor exacerbating the trend. They also show how economic insecurity and loss of subjective social status are combined for low-educated men especially in the rural areas as decent jobs for them slowly disappeared while women entered into the labor market in increasing numbers (Ibid S66).

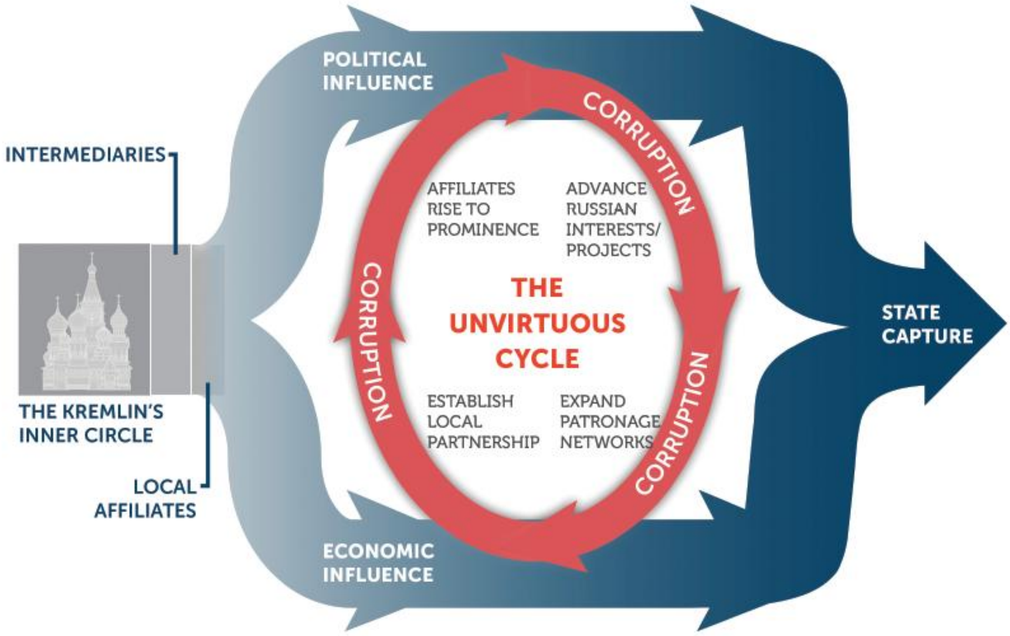
Economic and cultural theories of populism are regularly contrasted, and Gidron and Hall (2017) is one example of how they can be reconciled with one another through their use of the subjective social status variable. The above analyses usually use individual-level survey data. This is very helpful in addressing the question what type of individual is likely to vote for a populist party. However, it is much less useful to explain why some crisis countries proved resistance to populism while others did not. Such questions are critical for understanding Central and Eastern European countries since wide-ranging constitutional changes took place only in Hungary and not elsewhere. This shows that some other macro-level factors are also at work.

A different literature, which is unaddressed in the above debate, considers the influence of Russia in supporting populism and the importance of institutions in resisting that influence.

After a decade of weakness Russia has taken a more assertive stance in its former sphere of influence (Nutu and Ionita 2017a). Weakening democracy in the CEE region serves as a guard against regime-change at home by precluding the emergence of an attractive alternative to Putin's corrupt rule (US Senate... 2018: 1). As explained by Conely et al. (2016: X) the primary objective is "to break the internal coherence of the enemy system – and not about its integral annihilation."

According to Braghiroli and Makarychev (2016: 218) Russia's strategy in the region is based on four pillars: a rejection of liberal values in favor of traditional Christian-conservative values; return to the Westphalian system of state-to-state relations without supranational forces; increasing distance from the US and NATO; acceptance of Russian concerns about neo-fascism in the Baltic States and Ukraine. In order to spread various combinations of these messages, Russia has built up relationships with the far left and far right parties within the EU[4]. It is also conducting international media campaigns through its state-owned media network in a range of languages (RT and Sputnik) as well as utilizes the social media to influence public opinion (Oliker 2017: 18)[5].

Figure 3. The unvirtuous cycle of Russian influence



Source: Conely et al (2016): 3

According to Conely et al (2016) as well as US Senate (2018) countries with stronger institutions and lower corruption are less vulnerable to malignant Russian influence than others. Conely et al. (2016) use the symbol of a virus as a metaphor to describe the link between institutions, corruption and the rise of populism and illiberalism. Corrupt business transactions in strategic sectors (such as energy or finance) and/or buying individual

[4] For an extensive overview of these relationships see Klapsis (2015)

[5] According to Veebel (2016: 16) such campaigns have the following objectives: "demonize the adversary, deter and demoralize the adversary, legitimize one's own activities to the general public, mobilize target populations, promote one's own political elites."

politicians produces an 'unvirtuous cycle' of Russian influence (Figure 3): compromised local agents grow a network of corruption and advance Russian interests – if they resist, they get busted by Russia, which also weakens the system and spreads cynicism thus Russia wins either way. This leads to the conclusion that less corrupt systems have a stronger chance of averting Russia influence operations than countries with weak institutions. While Conely et al (2016) have found no clear quantitative evidence to support the relationship between institutional strength and Russian influence, qualitative cases indicate the relevance of their narrative.

4. The political economy of financial crisis management in Latvia, Hungary and Romania

Economic insecurity, value changes, institutions and foreign influence all potentially contribute to the disillusionment from the ideals of the transition. However, in section 2 it was also noted that not all CEE countries are equally susceptible to populist tendencies. It is particularly worth examining why some countries, which fell victim to the financial crisis avoided a populist breakthrough, while others did not. The cases of Hungary, Latvia and Romania are particularly helpful to address this question. In the following first I list the similarities among the three cases from the perspective of populism theories. Then I consider their different heritage from the Communist years followed by an assessment of the impact of this heritage on choosing the methods of crisis management. The politics of crisis management are discussed next, leading to a causal explanation about the difference concerning populism among the three countries.

4.1. Similarities among Hungary, Latvia and Romania

From the perspective of theories and populism Hungary, Latvia and Romania share a lot of similarities, which make them vulnerable to populism. Still, illiberal democracy was established only in Hungary. Populism is a weak force in Latvia – as Balcere (2014) explains, although there have been efforts at devising populist messages, these have been electorally unsuccessful. A similar narrative can be said of Romania, where Corbu et al (2017: 331) argue that although populism has been a constant presence in Romania since the transition, populist parties have been in decline – partly because some elements of their programs such as anti-corruption has been picked up by mainstream parties.

All three countries faced a severe financial crisis, and needed international financial assistance. Hungary signed an agreement with international institutions in October 2008, Latvia in December 2008, and Romania in May 2009[6]. During the negotiations of these programs all three agreed to implement substantial fiscal adjustment and by 2013 all of them recorded fiscal deficit below 3 percent (European Commission 2017: 160-161).

[6] For a detailed overview about the origins and management of the financial crisis in the three countries see Győrffy (2018): 147-190. In the following discussion about the crisis I strongly rely on this earlier work.

The source of the crisis was macroeconomic populism in all three countries indicating the vulnerability to the phenomenon. Hungary conducted classical old-type populist policies with enormous fiscal deficits, which led to a sharp increase in public debt. As fiscal consolidation became inevitable, policy-makers allowed the accumulation of private debt in foreign currency through easy credit conditions (Győrffy 2013: 132-134). Loose credit conditions were the main source of the crisis in Latvia and Romania, which is the new type of macroeconomic populism conceptualized by Csaba (2009). In Latvia it was a way to address the dissatisfaction due to highly constrained social spending (Bohle 2010: 8-9). In Romania the combination of "low flat taxes, generous real estate and corporate tax breaks, opportunits – as opposed to coordinated – wage and pension rises" were the main elements of pre-crisis populist macroeconomic policy (Ban 2016: 210).

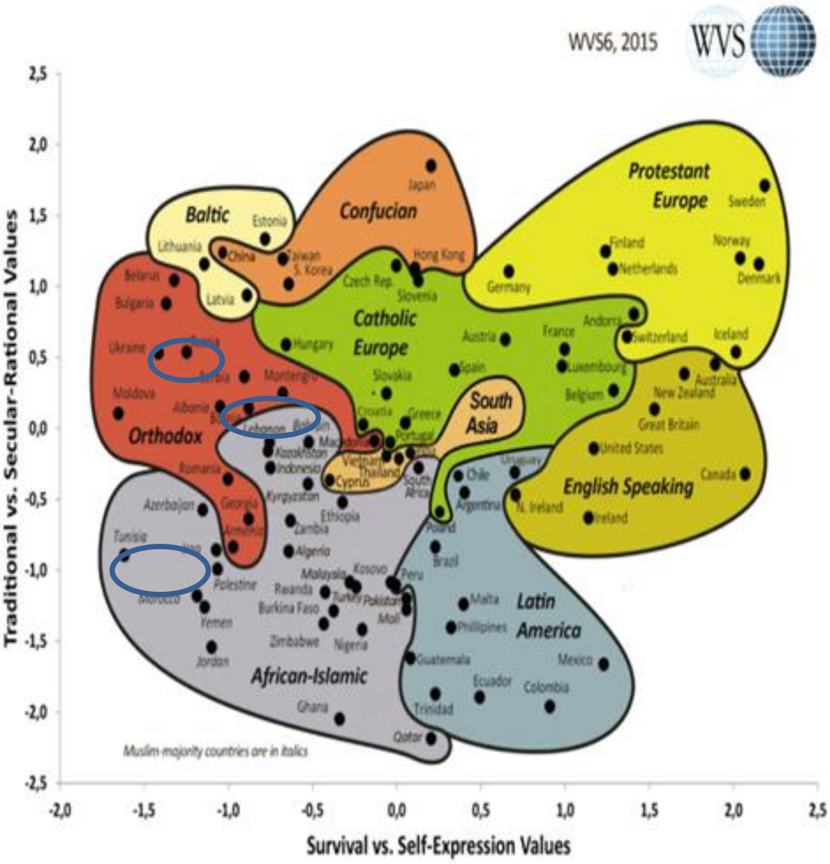
Social indicators would suggest that it is Latvia and Romania rather than Hungary, which are susceptible to populism. In 2016 the Gini index of inequality was 34,5 and 34,7 in Latvia and Romania respectively, and 28,2 in Hungary[7]. Emigration is a problem in all the three countries - while the exact numbers are very difficult to obtain, accourding to the calculations of Hárs (2016: 44) over 12 percent of Romanians, 8 percent of Latvians live in the EU-15 in contrast to only 3 percent of Hungarians. However, migration has been increasing steadily in Hungary as well since the crisis – according to Gödri (2014) while prior to the crisis the number of emigrants were below 30 000 annually, their number reached 60 000 in 2011 and 80 000 in 2012. Even more striking is the fact that in 2013, 33 percent of the 18-40 year-old population considered migration with 47 percent of those aged 18–24. These plans indicate considerable pessimism towards remaining in the country – not dissimilar to the pessimism of people living in Latvia or Romania.

Cultural theories are similarly incapable at explaining the differences in the three countries. As shown by the Inglehart-Welzel cultural map, Latvia and Romania are even further from Protestant (Western) Europe than Hungary (Figure 4). The map places countries along two dimensions. The vertical axis shows the traditional vs. rational/secular cleavage, which measures the importance of religion, reference to authority and traditional family values. The horizontal axis shows the survival vs. self-expression cleavage – while the first gives priority to economic and physical security, the latter refers to the dominance of post-material values such as environmental protection, tolerance and gender equality. In their book Inglehart and Welzel (2005) argue that the rise of self-expression values creates the basis for aspirations for democracy. Most countries in the CEE region fall into the upper left quadrant, where secular values and survival instinct dominates. Such value system implies that if there is a tradeoff between order and freedom or prosperity and freedom, the choice is very rarely for freedom. Hungary, Latvia and Romania are circled on the figure – as we can see self-expression values are strongest in Hungary among the three countries. Still, it is Hungary and not Latvia or Romania, where illiberal democracy was created. This implies that there is more to the story than the value system. Figure 1. earlier also showed that support for democracy is actually the highest in Hungary, and Latvia scores lowest on both support for democracy and market economy.

[7] Data is from Eurostat online: http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=ilc_di12.

Overall given the above difference neither economic, nor cultural theories of populism seem to be able to explain why Hungary fell for populism while Latvia and Romania did not.

Figure 4. Inglehart-Welzel cultural map (2015)



Source: World Values Survey online
http://www.worldvaluessurvey.org/WVSContents.jsp?CMSID=Findings

4.2. Divergent Communist heritage and transition experiences

The major difference among the three countries lies in their communist past. Latvia was part of the Soviet Union, Romania suffered greatly under the Ceaucescu regime, while Hungary was the country of goulash communism. Such past implies very different attitudes towards communism and towards the state. Romania and Latvia have long been among the countries, which feel the least nostalgia towards the old regime, while in Hungary over 60% believed that the old regime was better even in 2004 (Rose 2006: 39).

Due to the revolution in 1956, under the leadership of János Kádár Hungary became the country of goulash communism, where market reforms started as early as 1968, and in spite of periodic reversals, they were continued up until the transition[8]. As a consequence of the reforms, the standard of living was somewhat higher than in other countries of the Soviet block, and by retreating into their private sphere, people could find a sense of security. While

[8] The following discussion on the path to crisis relies on Győrffy (2013): 128-137. See also Benczes (2016).

this was an undisputed benefit for the generations in the Kádár regime, for the transition it implied a heavy burden: the relatively high standard of living was financed by debt, and following the unavoidable difficulties of the transition, people became nostalgic about the old regime. Furthermore a number of inherited features of the previous system survived, most importantly the expectation of the population for welfare benefits and the weak culture of rule of law, which was the result of the extensive second economy under Socialism.

Latvia started transition from a very different point than Hungary. Following independence in 1991, it faced the triple task of political and economic transition as well as state-building. Unlike in Hungary, there was no desire to preserve elements of the old system and there was no inherited debt either. The total rejection of the Soviet past guided the transition, which meant a strong commitment to market economy and European integration. The rejection of the past was symbolized by the exit from the rouble zone, the setting up of an independent central bank modelled on the German Bundesbank and a strict peg to the IMF special drawing rights (Bohle and Greskovits 2012: 108-109). Beyond the strict exchange rate arrangement Latvia followed the example of Estonia in introducing wide-raging market reforms during the early 1990s. This included strict fiscal policy, a flat tax system and complete trade liberalization (Aslund and Dombrovskis 2011: 9-10). Such neoliberal policies became a central pillar of the new Latvian identity.

Romania also turned towards neoliberalism although for a rather different reason. For over a decade it was considered as a laggard during the transition and it implemented the transition agenda significantly later than Hungary or Latvia. An important reason for the Romanian style gradualism is that early during the transition there seemed to be no need for radical reforms. The country started out with no public debt, which was a legacy from Ceausescu's drive to repay all public debt even at the cost of unimaginable suffering for the population. After the fall of Ceausescu, human capital was lacking for building a market economy – Romanians had no experience with enterprise during communism, and there was not even a sizable diaspora to help like in the Baltics (Papadimitriu 2006: 219). After the elections in 2004 the new center-right Tariceanu government pushed the country into the Baltic direction. Romania introduced a flat tax of 16 percent for personal income tax and corporate tax as well as established an inflation-targeting regime for monetary policy. In the interpretation of Bohle and Greskovits (2012: 208) a "weak state is unable to devise and enforce clear and stable rules of the game." This also implies difficulties in designing and enforcing complex regulations and collecting taxes. For such countries the flat tax system reduces "public agencies' enforcement activities to a minimum at which they could appear efficient" (Bohle and Greskovits 2012: 221).

In spite of their different transition experiences all three countries aimed at joining the EU. With its relatively stronger institutions, Hungary was among the leaders in the process and joined in 2004. Latvia faced a rockier path - in the 1997 opinion of the Commission on Latvia's request for accession to the EU the quality of governance featured prominently in a second-round accession recommendation (European Commission 1997). Latvia still succeeded in starting the negotiations in 1999, and was able to join the EU in 2004. Its efforts to do so comprised a large set of institution-building measures including a strong anti-corruption bureau (Kuris 2012). Romania had to wait another 3 years, and during this period it faced significantly stricter conditionality than countries joining in 2004 (Papadimitriou and Gateva 2009: 14-15).

EU accession provided the clearest incentive for the countries to improve their institutions. Most of the improvement took place during this period (Bruszt and Vukov 2017). Once accession was accomplished, the incentive to improve institutions further deteriorated. As Romania was not included into Schengen, its situation was somewhat different – through CVM process it still faced conditionality with relation to institution-building – independent judiciary and fighting corruption in particular (Spendzharova and Vachudova 2012).

4.3. Negotiations of financial assistance

Such pre-crisis trends proved to be crucial in the different political paths these three countries took with regard to their political system. With their tradition of neoliberalism, Romania and Latvia had no difficulty agreeing to IMF conditionality for their bailout packages.

The negotiations with Latvia were characterized by high level of cooperation where open discussion and persuasion were the main methods, which shaped the outcome (Dahan 2012) – in spite of several contentious issues among participants. One of the most critical questions of the program was whether to give up the peg. Latvians insisted to the peg because over 90 percent of their loans were in euro, and they considered accession to the euro-zone as an exit from this situation (Bakker and Klingen 2012: 115). In order to maintain the peg, they were aware of the need for internal devaluation and severe fiscal consolidation. During the negotiations the European participants supported the Latvian strategy given the fear of losses from the banking system as well as the possible regional spill over effects. On the other hand the IMF was not convinced that Latvia can execute the tough measures needed to maintain the peg, and they even suggested the unilateral adoption of the euro, which was strongly opposed by the EU (Lütz and Kranke 2014: 320). Seeing the firm stance of the Europeans, the IMF was finally willing to agree to the Latvian strategy and signed the package without devaluation. In sum, Latvia succeed in convincing the IMF about their commitment to a much tougher austerity program than they thought was politically feasible.

Romania approached the IMF for financial assistance on 29 March 2009, and by 6 May the country received a € 20 billion package. The fast negotiations reflected the government's willingness to implement serious measures to fight the crisis. The radical approach of the government seemed to take even the IMF by surprise. As Ban (2016: 210) describes: „It is not everyday that one hears the managing director of the IMF charged with being an ideologue of the left and a proponent of 'state capitalism' whose fondness for it was deemed traceable to his communist youth. Yet this is exactly what happened in Romania in 2010 when Dominique Strauss Kahn asked the Romanian government to spread the costs of austerity more equitably."

In order to curb fiscal imbalances the government used simple and radical measures – not unlike during the pre-crisis period (Ban 2016: 213). They aimed to signal their commitment to an expenditure-based consolidation. The IMF mission chief, Jeffrey Franks emphasized that it was the IMF, which called attention to the importance of defending the most vulnerable members of the population from the impact of austerity: “given that the authorities wanted to rely on heavy expenditure cuts in adjusting their budget, we asked that they put in place some protection for the most vulnerable” (Andersen 2010).

The cooperation with the IMF continued even after a change in government in 2012. Although in opposition the Social-Democrats were against the severe austerity of the Boc government, eventually the slogan became “high-quality fiscal consolidation” (Ban 2016: 238). Their continued adherence to the program was also signaled by the fact that in June 2012 the new Ponta government signed a supplemental memorandum of understanding with the Troika, and in 2013 a third balance of payment program was agreed for pre-cautionary assistance.

Hungary also completed the negotiations very fast during 2008 Fall. The authorities asked for assistance on October 9, after a failed government bond auction, weakening exchange rate and falling stock market price for the largest domestic bank, OTP (Bakker and Clingen 2012: 93). An IMF team flew to Budapest two days later, and a stand-by-agreement was signed on 6 November.

The negotiations were smooth, and there were no differences of opinion between the IMF and the European Commission, which was also involved (Lütz and Kranke 2014: 319). In return for the € 20 billion support package, Hungary had to implement a front-loaded expenditure-based consolidation, which included the abolition of the 13th month pension. Following a decade of resistance by the political elite, in the context of the program, the parliament also 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. As emphasized by the IMF ex post program review (IMF 2011: 12) the program was based on a blueprint presented by the Hungarian authorities at the beginning of the negotiations.

The 2010 elections changed the relationship between the Hungarian government, the IMF and the European Commission. Viktor Orbán was handed a two thirds majority in the Hungarian parliament by voters based on the promise to end austerity, cut taxes and implement an unorthodox adjustment program. The early elements of the program such as the special taxes on multinationals, the de facto nationalization of private pensions or the possibility to repay mortgages early at preferential rates[9] were not taken well by the markets especially given the turbulance within the euro-zone. Given the weakening of exchange rate, the country had to turn to the IMF again in November 2011. A second stand-by-agreement however was never signed – the government negotiated for over a year before stating in December 2013 that it does not want to sign a new program.

Ex post it appears that the Orbán government had no serious intention to enter into a stand-by-agreement as the negotiations in themselves were sufficient to stop speculations against the forint. As the financial markets calmed and the current account was in surplus, by the end of

[9] These steps will be discussed in greater detail in the next section on the implementation of the program.

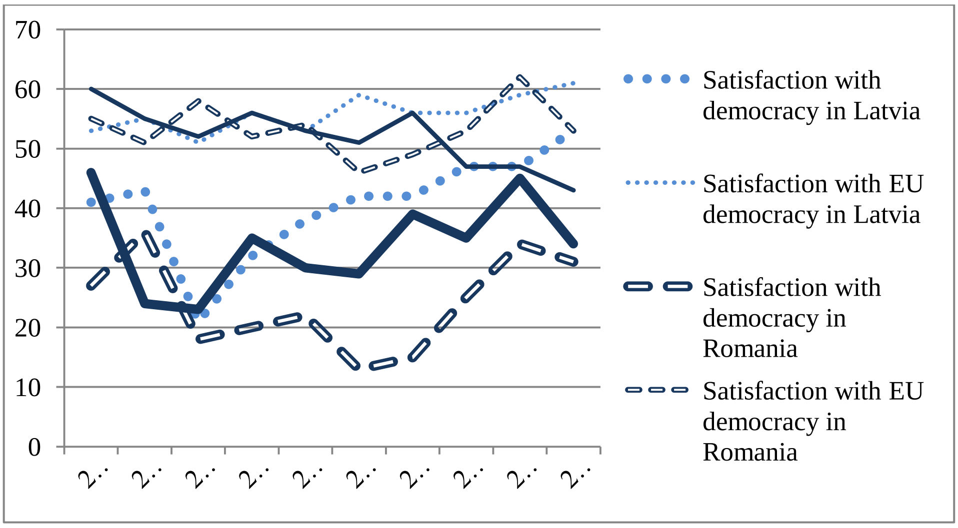
2013 it became clear that there would be no new agreement. During the extended negotiations the government was able to conduct a public campaign listing all the measures presumably asked by the IMF, which it was not willing to introduce such as the introduction of property tax and the cutting of pensions. Although the IMF continuously denied the presence of such list of mandatory conditions, the government could sustain its image of fighting against austerity (Farkas 2014: 255-259). Naturally, such techniques were not conducive to fruitful exchange of views for a new program. Still, the government succeeded both in stopping the speculation against the forint and avoiding the potentially harsh conditionality of a new agreement.

The negotiations of the program indicate that Latvia and Romania were willing to negotiate with lenders and were generally more neoliberal than even the IMF. In contrast Orbán gained a constitutional majority with the promise of no more austerity, which resonated particularly well in the country of goulash communism. This led him to tax foreigners as well as increasingly to turn to other supporters than the EU and the IMF.

4.4. The politics of crisis management

While the atmosphere of negotiations differed, Hungary, Latvia and Romania are rather similar in terms of the political difficulties associated with the implementation of the program. As Figure 5. shows, in all three countries, with over 50 percent satisfaction rate, EU democracy is judged much more favorably than national democracy. Satisfaction with the latter was well below 50 percent in 2006, and it fell close to 20 percent by 2009 signaling considerable disillusionment with the system. The collapse of systemic confidence was paralleled with political turmoil in all three countries causing substantial difficulties in implementing the terms of the program. The various performances of the three countries are signaled by the differences in the recovery of trust in the system.

Figure 5. Satisfaction with democracy in Hungary, Latvia and Romania 2006-2016



Data: Eurobarometer online

In *Hungary* the political difficulties started well before the crisis: following reelection in 2006 the center-left government was forced to implement substantial fiscal consolidation due to high fiscal deficits and growing debt. This became especially difficult after the so-called Őszöd speech, when prime minister Ferenc Gyurcsány admitted following irresponsible policies and lying day and night in order to win the 2006 elections. After a leaked tape about his admission, protests against the government became widespread and efforts at fiscal adjustment aroused widespread resistance. The level of dissatisfaction increased even further after Hungary had to turn to the IMF in October 2008. Gyurcsány finally resigned in March 2009, and it was left to his successor, Gordon Bajnai to implement the IMF program.

The technocratic government led by Bajnai implemented the conditions to the letter. As emphasized by the IMF (2011: 16) "despite difficult and evolving circumstances, program conditionality was met throughout the program – all the quantitative performance criteria were met at each review." During the program an implicit grand coalition took shape as the main opposition party, Fidesz, was criticizing only certain elements of the program such as family leave policies and the wealth tax. Even during the campaign it did not promise any further change to the adjustment; there was no promise of the reintroduction of the 13th month pension for example. After he came to power, Viktor Orbán praised the performance of the Bajnai government – although more during negotiations with foreign partners than in the election campaign (Farkas 2014: 154). However, all this did not change the fact that the electorate was furious with the Socialists. In 2009 austerity was paralleled with a significant drop in GDP of 6,6 percent, and the public blamed Gyurcsány and the center-left government for both. This atmosphere opened the way for a two-third Fidesz majority led by Viktor Orbán.

Orbán's original plan for the new government and his promise to the electorate was to implement tax cuts to stimulate the economy and negotiate higher deficit target for 2010. In the context of the Greek crisis however, Brussels was unwilling to allow the 6,8 percent deficit hoped by the new government (Farkas 2014: 148-149). However this failure did not lead to the reconsideration of Orbán's plans to cut taxes and push the burden to multinational companies and into the future. As one of the first measures of the new government a 16 percent flat-tax system was introduced with substantial benefits to families. Further tax cuts included a 10 percent corporate tax for small and medium size enterprises. The total costs of these measures were HUF 444bn or about 1,5 percent of GDP annually (Tóth and Virovácz 2013). Since expenditures were not cut in a parallel manner, counter-measures were necessary to reach the deficit target. Such measures included the levying of special taxes on the financial sector, energy suppliers, telecommunication and retail companies (Government.. 2011: 66-67), which were primarily dominated by multinationals. Although these were announced as temporary crisis taxes, they were made permanent once it became evident that the reduction in income taxes did not have the expected impact on growth. The government also gained substantial revenue by the de facto nationalizing the second pillar of the pension system in November 2010, which amounted to around HUF 3000bn or 10 percent of GDP as well as the reorientation of pension contributions to the budget amounting to around 1,5 percent of GDP (Government of the Republic of Hungary 2011: 47).

The agreement with the IMF expired in October 2010. However, the program lapsed even before that time – Orbán's approach to fiscal consolidation raised substantial doubts in the

IMF as they viewed them as risks to growth and sustainability (IMF 2011: 23). The IMF was in a precarious position as it was an active coordinator in the so-called Vienna Initiative, which was signed in May 2009 ensuring that Western banks do not leave the Central and Eastern European region in response to the crisis. There was an implicit expectation in the agreement that the IMF and EU protect the interests of foreign banks in the financial assistance programs (Mabbet and Schelke 2015: 516). Orbán's bank levy clearly went against this agreement.

The continuing crisis in the European Union and Orbán's attempt to make multinationals pay for the costs of the crisis management led a fall in market confidence and the substantial weakening of the forint – from HUF/€ 263 in April 2010 to 316 by November 2011. This development was not against the wishes of the government as they strongly believed in the role of exchange rate policy to stimulate exports. However, the weakening of the forint also meant that the problem of foreign currency loans had to be addressed as non-performing loans accumulated in the banking sector[10]. This was done through a long moratorium on evictions as well as the possibility to repay the foreign currency loans at an exchange rate well below the market rate through an early repayment scheme between September and December 2011. These measures implied substantial further costs for the banks amounting to a net loss of 1 percent of GDP (European Commission 2014b: 32).

The management of the crisis was used as an excuse to centralize power and lay the foundations of an illiberal democracy. The unconcealed desire of the government for increasing its discretion over policy-making was signalled by the systematic cut down on institutional checks and balances. Steps towards this objective included the nomination of party members to head independent institutions such as the posts of the President, the head of the State Audit Office, and from 2013 the National Bank of Hungary. The independent fiscal council, which was established in 2009, was abolished in 2010. The power of the Constitutional Court was also curbed following its resistance to a retroactive law on severance payments. While in the new Constitution apparently strict fiscal rules and a powerful fiscal council were included, the formally strict rules have little constraining influence on the Orbán government but might become debilitating on a future government[11]. These steps fit well with other measures for cementing Orbán's power including the restrictive media law in 2010 and the new electoral law in 2011[12], which allowed Fidesz to gain another two thirds supermajority in 2014 even though it received almost 8 percentage points less votes, which means it lost close to 500 000 voters. These developments are called a U-turn by Kornai

[10] The ratio of non-performing foreign currency loans increased from 7,5 percent in 2010 to 18 percent by 2013 (European Commission 2014b: 32).

[11] Under the debt rule public debt cannot be higher than 50 percent of GDP, and above this threshold the Parliament has to adopt a budget, which contributes to the decline of the debt rate. The task of the new fiscal council is to evaluate the conformity of the budget plan to this rule with veto power over its adoption if it does not conform to the rule. This power is particularly problematic as out of the three members of the fiscal council two are clearly political appointees as the Head of the National Bank of Hungary and the Head of the State Audit Office.

[12] The new law cut the number of parliamentary representatives from 399 to 199 with 100 elected from single-member districts and 99 through proportional party lists. The second round of voting was abolished in the districts, which was extremely advantageous for Fidesz as it was facing a highly fragmented opposition.

(2015) as they reverse the trend of liberalization, which had been characterizing Hungary since 1968.

The re-election of the Orbán government however, was not only due to the change in the electoral law. As Figure 5. shows, satisfaction with democracy steadily improved after 2009, and it surpassed 40 percent by 2015. The continued popularity of the government was not necessarily due to its aggressive stance against the IMF or the EU – the latter's support remained over 50 percent until 2014 (Figure 5.). Instead, the main factors contributing to Orbán's re-election were probably the 3.2 percent real increase in old age pensions in 2013 and the administrative cut in utilities' prices from the second part of 2012, which brought down the inflation rate and provided tangible fall in costs for Hungarian households at the expense of foreign multinationals. Benczes (2016) aptly notes that through these steps Hungary made the journey from goulash communism to 'goulash populism.' As a result, the government was successful in presenting itself as the lesser evil during the 2014 elections, and won again against the opposition, which included the exact same leaders, who were held responsible for the crisis. However, the example of Latvia shows that Fidesz' unorthodox approach to crisis management was not the only way to rebalance the economy and preserve political power.

Similarly to Hungary, in *Latvia* the crisis started before the collapse of Lehman Brothers. At the end of 2007, the slowdown of the economy coincided with the fall of the prime minister, Aigar Kalvitis, after the dismissal of the head of the anti-corruption bureau. His follower, Ivars Godmanis had considerable reputation as the first prime minister of Latvia. However, even during the Fall 2008 there was sizeable opposition to the plans for fiscal stabilization. Support for radical measures started increasing as the collapse of the economy became evident, and the maintenance of the peg came to be questioned (Aslund and Dombrovskis 2011: 33-34). The budget for 2009 was harshly criticized by the opposition for not being radical enough and trying to protect certain interest groups from the effect of cuts (Aslund and Dombrovskis 2011: 38-40). In response to widespread protests, Godmanis resigned in February 2009, and the president nominated the former minister of finance, Valdis Dombrovskis as the new prime minister.

Dombrovskis implemented radical fiscal adjustment even by the standards of the IMF, which continued to raise doubt about the "quality, composition and sustainability of the adjustment measures" as well as their adverse social impact (IMF 2013: 23). On the revenue side consumption taxes were increased substantially, although as noted by Comite et al (2012: 82) compliance dropped sharply afterwards thus overall taxes as share of GDP did not rise. The increase in consumption taxes were partially offset by a 2 percent cut in personal income taxes. On the expenditure side major savings came from cuts in public sector wages as well as reforms in health care, education and public administration. The measures included the closure of half of the 75 state agencies, the decrease of territorial units from 548 to 119, cuts in the health and education budget by 26 and 27 percent respectively. In discussing these steps Comite et al (2012: 82-83) emphasize that in these sectors reforms had been long overdue, plans were available and the financial crisis provided the window of opportunity to implement them. It is also important that social protection and social assistance programs were enhanced during the crisis including the extended duration of unemployment insurance benefits, the expansion of the Guaranteed Minimum Income Program and the introduction of a public works program (Harrold, Santos and Sinnot 2012: 123-126).

In paralell to fiscal consolidation structural reforms also took place in order to improve the ease of doing business and productivity. As a result of changes, by early 2010 wages fell by 27 percent in the public sector and 6 percent in the private sector along with a steep rise in unemployment (IMF 2013: 19). The adjustment contributed to sharp reversal of the current account balance, which improved from -21,1 percent in 2007 to -0,8 percent by 2015[13]. This way the currency board system could be maintained, thus Latvia averted the problem of debt explosion, which would have occurred in the case of devaluation given the level of foreign currency loans. This problem in Latvia was handled through the introduction of the euro in January, 2014.

The harsh measures did not lead to a collapse of government popularity, and in October 2010 Dombrovskis was re-elected with an even greater majority. The anti-austerity campaign of the opposition – led by Harmony – failed. The government continued to implement the program, and by 2012 Latvia achieved the 3 percent deficit target of the Maastricht criteria. Throughout the effort confidence in the system continued to improve (Figure 5.) showing people's willingness to accept considerable economic hardship for the sake of euro-zone accession.

The population was less understanding of radical reformers in *Romania*.

The 2008 elections were won by the Democrat-Liberal Party (PDL) led by Emil Boc. In order to form a majority for the handling of the economic crisis, the Social Democrats (PDS) gave them temporary support, while a convincing conservative majority could be formed only in 2009. The changes in the composition of the government however did not influence the commitment to implement the program, which had the full support of the president and the central bank as well. The commitment to the program from the government came from a deeply held commitment to free market and an aversion to state redistribution. Ban (2016: 232) cites an interview with Emil Boc saying that "if we want to redistribute more than we do, we should wait until we reach German output levels and civil service quality."

The radicalism was reflected in the policies of the government. Fiscal consolidation was expenditure-based and front-loaded – the structural deficit narrowed by 6 percentage points during the 2009-2011 program (IMF 2012: 11). When it became clear that the initial actions will not be sufficient to achieve the program objectives, aggressive actions were taken in June 2010 including the above mentioned 25 percent cut in public sector wages, 15 percent cuts in social transfer and 5 percent increase in the VAT rate.

The government also took a radical approach on structural reforms. In 2010 a new fiscal responsibility framework was introduced with medium-term budgetary planning, fiscal rules and the establishment of a fiscal council. The new institution became a strong voice for enforcing the agreements with the Troika (Ban 2016: 225). The labor market was also

[13] Data: European Commission (2017): 96

liberalized in 2011: hiring and firing labor became easier and the scope of collective bargaining was narrowed resulting in a reduced influence of trade unions (Trift 2013).

The Boc government eventually collapsed after the violent protests during the winter in 2011-2012 in response to a new health care legislation, which tried to reduce health care services, privatize hospitals and insurance. Emil Boc resigned, and his successor also failed to survive a motion of non-confidence in the Romanian Parliament. The government was taken over by the opposition led by Victor Ponta. The December elections that year yielded an absolute majority to Ponta's Social Liberal Union. However, the low turnout of around 40 percent reflected the apathy of the population in the middle of austerity.

During the Ponta governments some reversals took place in the margins such as increasing public sector wages and reducing VAT for food, but the repeal of the labor code or the introduction of progressive tax system did not take place (Ban 2016: 239). Still, the IMF (2014: 7) notes that "political turmoil and local and parliamentary elections held in the second half of 2012 complicated the implementation of the reform agenda."

Although even the Ponta government respected fiscal conditionality, and the country achieved the 3 percent deficit threshold, deeper structural reforms were less successful. The evaluation of the third assistance program also notes that even previously adopted laws are not implemented in a proper manner. The review of the European Commission mentions the effectiveness of application of the Fiscal Responsibility Law as well as the new laws on the governance of SOEs (European Commission 2015: 2).

One key concept coming up in implementation reports is the issue of capacity. Initially Romanian authorities had no problems with commitment, and even the IMF program report applauded "strong program ownership by the authorities" (IMF 2012: 21). At the same time the report also highlighted implementation capacity both in the discussion of reducing arrears and EU funds absorption.

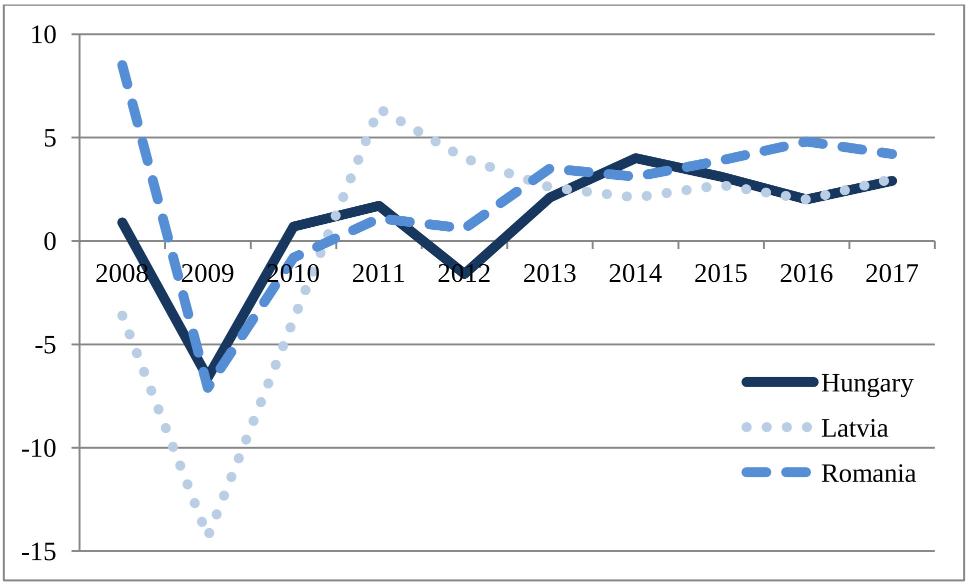
Overall Romania shows a mixed record in terms of compliance. While simple tasks such as fiscal consolidation and the adoption of new legislation were implemented vigorously, progress on more complex tasks was limited given the capacity constraint of the government. As the programs included ever more detailed structural reforms, compliance performance worsened. Essentially Romania's overall performance reflects a pragmatic recognition of realities – they implemented the reforms, which were necessary to regain access to the financial markets, but other considerations became dominant once they achieved this objective. However, an open confrontation, which happened in Hungary, did not take place.

Eventually all three countries returned to a path of growth (Figure 8) – Latvia and Romania through following the advice of international institutions and in accordance of their neoliberal past, while Hungary through its unorthodox policies, which fit well with its earlier history of goulash communism[14]. The narrative of crisis management allows us to establish a causal

[14] The sources of growth are not discussed here as for the argument about populism it is not relevant. Elsewhere I show the importance of EU funds for Hungarian growth and the weakening of institutions as a possible reason for the sub-par performance vis-à-vis the other two countries (Győrffy 2018: 178-180).

mechanism explaining the rise of illiberal democracy in Hungary and its avoidance in Latvia and Romania.

Figure 6. Growth in Hungary, Latvia and Romania (2008-2017)



Source: World Economic Outlook database

4.5. *Crisis management, foreign influence and populist trends*

The comparison of the three countries show how nostalgia for the Communist past made a difference in attitudes towards state redistribution in Hungary, Latvia and Romania. As the crisis hit all three, the latter two was able to implement an orthodox adjustment, which turned out to be successful. In contrast harsh austerity would have undermined the power of Orbán's government, so he turned towards unorthodox measures. A constitutional majority allowed him to implement policies, which would have been judged unconstitutional earlier. As these steps led to a confidence crisis both at home and in the West, Orbán won the 2014 elections through a program of cutting utility prices. This was partly facilitated by major concessions from Gasprom (Deák et al. 2017: 79-80) and allowed Russian influence to grow in the country.

Turning towards Russia was not very difficult for Orbán. Although only 37% of the Hungarian population views Russia positively (Eurobarometer 2016: 70), and it is strongly committed to the EU, there was little political challenge for Orbán to cultivate closer relations with Russia. The former Socialist government also tried to establish friendlier relations with Russia, while on the right, Jobbik was even closer and for a long time probably financed by Russian sources (Deák et al. 2017: 85). Russia in turn was eager to cultivate these relationships and gained an ally within the EU and the NATO at a time when he was shunned by Western countries following the occupation of the Crimea. Deák et al. (2017) consider four crucial steps in building up the relationship between Orbán and Russia: Orbán's advocacy for the South Stream pipeline, the emergence of gas trader MET, gas price concession, which made the utility rate cut possible prior to the 2014 elections and the Paks nuclear extension contract. While the first and the last elements are in the interest of Russia, the second strongly benefitted Orbán's clientele (possibly even himself) and the third allowed him to keep his power in 2014. As Deák et al. (2017: 70) conclude the Hungarian – Russian relationship reflect a "strong quid quo pro logic", when the short-term political (and personal) interest drive the decisions on the part of Hungary, while Russia is probably thinking for the long-term. Still, as a result of these steps and even short of vetoing Western sanctions for example, Viktor Orbán came to be widely seen as "the most supportive leader of Vladimir Putin, his style of leadership and his worldview" (US Senate… 2018: 94). Under his leadership and eroding institutional checks and balances "Russian malign influence is able to spread with little resistance" (Ibid 96).

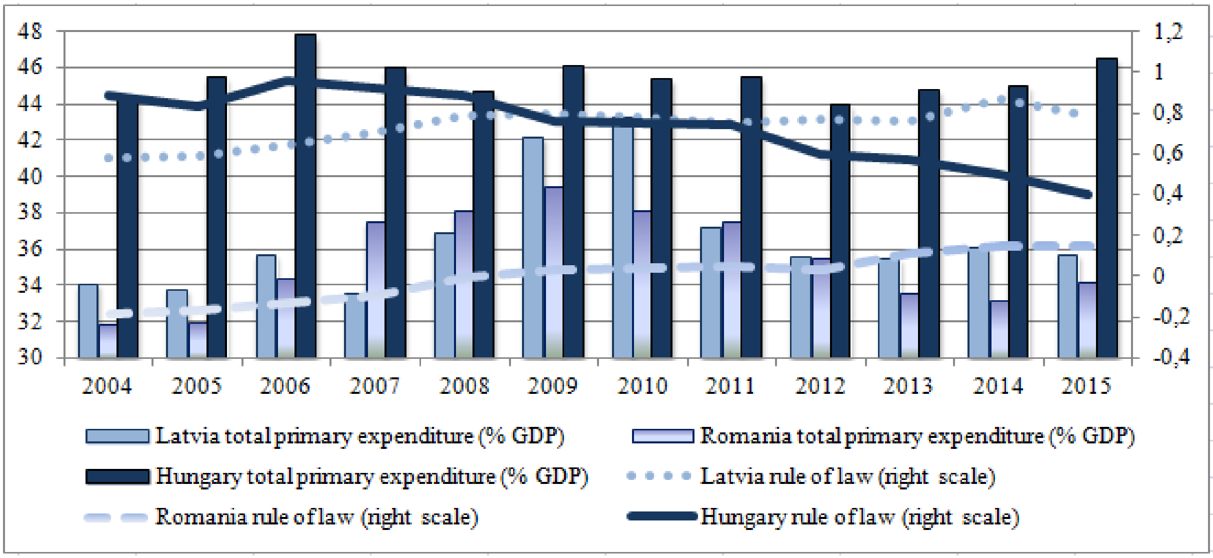
A similar turn was much less likely in Latvia or Romania. Part of the reason probably is that both countries have shown considerable success in recovering from the crisis through orthodox policies. However, it is also significant that there is a strong animosity towards Russia in both countries. Awareness of the Russian threat is naturally high in Latvia. With its significant Russian population, the country is keenly aware of the dangers presented by Russian meddling – especially after the annexation of Crimae. Conely et al. (2016: 49) also emphasize the importance of continuously improving institutions especially the independent judiciary and the KNAB – Latvia's Corruption Prevention and Combating Bureau, which reduces the country's vulnerability to corrupt business deals with Russia, which could be to influence policies[15]. Romania is also historically anti-Russia – even during the Cold War the country disengaged from the Warsaw Pact during the invasion of Czechoslovakia. Unlike Hungary and Latvia the country is independent of energy imports from Russia (Nutu and Iionita 2017b: 91). Furthermore, similarly to Latvia, they also have a strong and successful anti-corruption bureau, which makes shady business deals with Russia more risky (Ibid 103). The public is highly supportive of efforts of anti-corruption in both cases – attempted political meddling into the affairs of the anti-corruption bureau resulted in the fall of the prime minister in 2007 in Latvia and led to hundreds of thousands of people protesting in Romania in 2017 and 2018 – the largest protests since the fall of Ceausescu[16].

Based on the comparison of the three cases we can now answer the initial question of the paper. The Communist heritage in Latvia and Romania allowed these countries to manage the financial crisis in an orthodox manner without a populist breakthrough. Their commitment to small government and improving the rule of law is shown by Figure 7. In contrast, the heritage of goulash communism made such a strategy politically risky in Hungary and resulted in an adjustment, which combined welfare paternalism, nationalism and short-term solutions – large tax cuts for families financed partly by taxing multinationals and nationalizing the mandatory private pension system. Together with the parallel cuts of checks and balances on the government, Hungary distanced itself from the West and moved toward Russia for both practical and ideological reasons. Its populism is a manifestation of these

[15] The Latvian anti-corruption agency is widely lauded as a model of success. For a thorough overview of its history and the underlying reasons for its success see Kuris (2012).
[16] For an extensive overview on the 2017 protests and the background see Adi and Lilleker (2017).

moves. Figure 7. shows the stark difference between redistribution rates and rule of law trends in Hungary and the other two countries.

Figure 7. Rule of law and total primary expenditures (% of GDP) in Hungary, Latvia and Romania



Notes: Rule of law scores express relative placement of countries and range between -2,5 and 2,5. Data: World Governance Indicators at www.govindicators.org; total primary expenditures. European Commission's Ameco database.

5. Conclusions

Populism is a global rather than a CEE phenomenon. Still, based on individual-level attributes, the region is clearly vulnerable to political messages, which promise protection from the uncertainties of globalization. However, it is also important to refrain from treating the region as a homogenous entity. Populism led to the building of an illiberal democracy only in Hungary, while other countries, such as Latvia and Romania have been successful in avoiding the populist surge. Their examples provide a lesson that adherence to the market economy and a commitment to strengthen the rule of law is still a successful strategy 25 years after the transition started. Sticking with Western ideals, especially anti-corruption, also limits the malign influence of Russia, which has been more assertive in its efforts to regain its former sphere of influence.

The main implication of these findings is that the ideals of transition remain valid but they need to be defended. Anti-market measures and the resignation about the region's value-system are not the answers to the populist threat. Strengthening domestic institutions, especially the rule of law and fighting corruption seem to be the keys for making the system resistant to populist and foreign threats.

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