

THE DOMESTIC POLITICS OF PUBLIC DEBT: A CENTRAL AND EASTERN EUROPEAN PERSPECTIVE¹

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Abstract

According to Alesina and Tabellini (1990), persistent deficit and its consequence, debt accumulation, cannot be explained by myopia or political business cycles exclusively. Instead, there is a tendency for incumbent politicians to use both deficit and debt strategically in order to severely limit the new incoming coalition's spending capacities. Although the relevance of the model was tested in the context of advanced industrialised countries, no systematic analysis has been conducted yet on Central and Eastern European ones. The article argues accordingly that public debt did serve the strategic aims of incumbents in Hungary, Poland and, to a lesser extent, the Czech Republic, but the strategic manipulation of debt was much less straightforward in other cases. It was rather the accession to the European Union (especially its timing) that served as a strategic variable in the reform of public finances in most of the countries in the region.

Keywords: public debt, strategic behaviour, debt dynamics, Central and Eastern Europe, EU accession.

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1. The strategic use of public debt

In neoclassical theory, public debt serves as a buffer in the case of downturns in economic activity (due to war for instance). By manipulating public debt, the government can avoid costly fluctuations in tax rates (Barro, 1997). The role of public debt, therefore, is purely functional, i.e., to ensure the smooth functioning of the economy and the tax system, and is totally free from political motivations. In new political economy, however, the level of budget deficit and debt can be highly different from that of the socially desired optimum due to some sort of political bias (Persson and Tabellini, 2000). For instance, coalitions may react too slowly in case of fiscal shocks (Alesina and Drazen, 1991); differences in political regimes can also be accounted for a deficit bias due to the tendency of proportional electoral systems and parliamentary regimes to associate 'with more public goods, larger and more universalistic welfare programs, and a larger overall size of government' (Persson and Tabellini 2002, p. 2). The fragmentation of the political processes and the weakness of government (and/or the legislature) can lead to a permanent deficit and the accumulation of debt, too (Kontopoulous and Perotti, 1999). The decentralized nature of the process of annual budgeting (i.e., the drafting, the amendments, the decision and the implementation), the lack of a firm-handed finance or prime minister, the lack of a coalitional agreement, and the absence of transparency can also contribute to the prevalence of deficit bias (Hagen, 1992 or Alesina and Perotti, 1995).

Alesina and Tabellini (1990) showed that the accumulation of public debt can result from strategic behaviour, too; that is, indebtedness itself can be a strategic choice used by the alternating policymakers (or parties) in power.¹ The higher the chance to lose the next election, the more likely it is that incumbents are willing to increase spending and debt in the present. How much debt the incumbent is willing to take on is usually a question of ideological distance between the alternating parties in the various models of the literature.² Consequently, it is not just the decreasing chance of being re-elected that points towards a strategic accumulation of debt but also the strong polarisation of the party structure (Alesina and Tabellini, 1990).

Public debt as the legacy of the current government works then as an exogenous factor for the new incumbents, since by its use, the current executives are able to constrain the room for manoeuvre of their successors in future policy-making. The liabilities undertaken by the current government in the form of increased public debt can become a burden for the future cabinet and therefore the successor may find itself in

1 Importantly, for Alesina and Tabellini (1990) the reference point was still the normative theory of fiscal policy, i.e., the neoclassical tax smoothing concept. They, however, tried to create a positive theory, which can explain the non-applicability of the neoclassical explanation of budget deficit and debt under the circumstances of the empirical observations in the seventies and the eighties.

2 Assuming that it is not office motivation what matters in policy making but partisan motivation.

a strongly constrained situation in which the preferred policies cannot be pursued. In fact, the government which embarks on debt accumulation serves the interest of its own constituency, and by tying the hands of its successor it brings the electorates of the other party (the successor) in a worse situation than otherwise. Deficit and especially debt, therefore, can be interpreted as means in a struggle between policymakers with different preferences on the desired level or composition of public good(s).³

In contrast to Alesina and Tabellini (1990), Persson and Svensson (1989) focused on the different levels of spending on the *same* public good. The authors contrasted the behaviour of conservative governments (those in favour of a low level of public consumption) and left wing (assumedly expansionist) governments. Generally speaking, conservative governments prefer tax cuts. However, studying fiscal policy in the US, Persson and Svensson (1989) found that the decrease in revenues was not combined with a consecutive decline in spending under conservative cabinets; instead, deficit and debt increased. Their explanation was that conservatives used the debt strategically in order to tie the hands of their likely successors, the expansionist liberals.⁴

Aghion and Bolton (1990) confirmed the main findings of Persson and Svensson (1989). However, they also added that rational conservative voters preferred the accumulation of debt because more people would be active in the debt securities markets and thus citizens would become more cautious in monitoring and sanctioning their (misbehaving) politicians. Interestingly, the 'debt-tactics' of the Reagan Administration in the eighties seemed to verify the point of Persson and Svensson (1989), and Aghion and Bolton (1990). The reduction in taxes and the increase in military spending substantially constrained the room of policy choice of the Democrats in the first half of the nineties, who (would have) preferred an increase in social security expenditures.⁵

Following a short introduction to the political economy models of the strategic use of public debt, the debt dynamics of CEE counties is analysed within the framework

3 In another model, Tabellini and Alesina (1990) turn to the voters (instead of parties) and claim that the more polarized individuals' preferences are, the higher the deficit and the debt.

4 While in Alesina and Tabellini (1990) the current government still has a chance to get re-elected, albeit its exact chances are uncertain, in Persson and Svensson (1989) the current government is certain that it is unable to hold onto power. Moreover, the model of Alesina and Tabellini (1990) is a symmetrical one, as both parties can use debt strategically. The Persson and Svensson (1989) model is asymmetrical in the sense that it is paradoxically the conservative cabinet which may manipulate the level of indebtedness with the aim of restricting the policy options of its successor.

5 Indeed, Bill Clinton left his office in 2000 with a huge surplus in the public budget, and the successor conservatives under Bush – copying the example of Reagan – accumulated a huge deficit and debt. Interestingly, the last 25 years in the USA seem to verify the point that conservatives behaved fiscally as non-conservatives, while Democrats were more or less fiscally prudent.

of Alesina and Tabellini's (1990) model. Since their model concentrates exclusively on the increasing tendencies in the general government gross debt, only those countries and episodes have been scrutinised in length which have convincingly demonstrated a worsening fiscal performance *over* the business cycle. The article concentrates on the period between 1994/95 and 2006/07, since the original model can be applied in normal times only. The first few years of the systemic change were evidently burdened with significant costs (not just economic but also social ones) due to the transformational recession (equalling to 12 to 50 per cent of the GDPs of the countries under analysis – see Kornai, 1994; Winiecki, 2002), which in turn considerably restricted the room for fiscal manoeuvring of the very first freely elected governments. As the analysis ends with 2007, it does not extend to the era of the current global economic and financial crisis, since governments might have decided to adopt discretionary policies not just because of electoral (or political) reasons – or at least, it would be extremely challenging if not impossible to disentangle politically-driven strategic motivations for debt-accumulation from those measures which were meant to cushion the perverse effects of the crisis.

2. Where there is no debt, there are no incentives to spend (?): the Baltic states

By and large, public debt might have played a role in constraining the fiscal space between alternating governments in several CEE countries. However, there are a few exceptions to this trend. For instance, the Baltic states were in a unique position, since the three countries inherited quite small debt stocks from the communist era. Estonia went through a severe transformational recession between 1991 and 1994, which was followed by a relatively fast recovery.⁶ The first democratically elected Pro Patria National Coalition managed to initiate major structural reforms, such as price liberalisation, monetary reform and privatisation, relatively early on from 1992 onwards. Although the 1995 elections saw a change in the composition of the ruling cabinet, the implementation of reforms (especially the establishment of a currency board, price deregulation, property rights reform, enterprise reform and trade liberalisation) did not stop under the Coalition Party and the Rural Union. In fact, Estonia experienced a strong economic take-off from 1995 onwards, which was curbed only by the Russian financial crisis in 1998 (OECD, 2011). Fiscal discipline was maintained until the end of the period under scrutiny by the centrist and social liberal Estonian Centre Party (1999 to 2007), too.

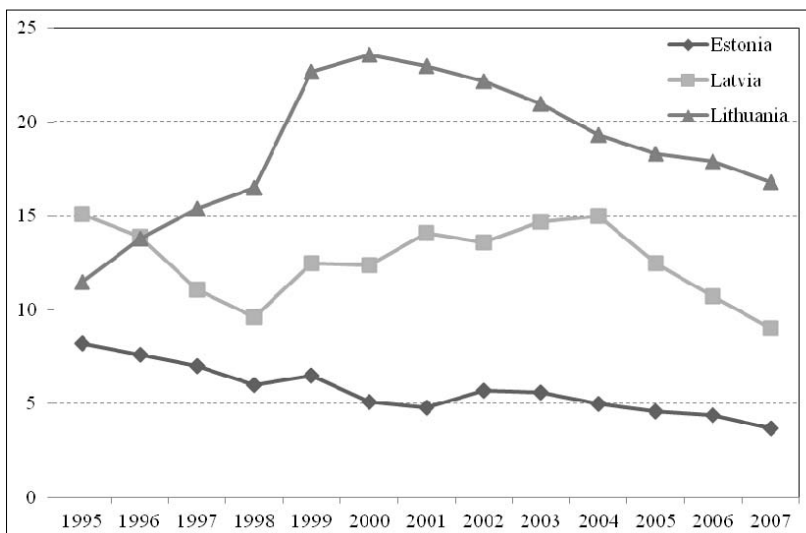
Just like Estonia, Latvia and Lithuania started economic transformation with a relatively low level of public debt (Figure 1). In Latvia, there were three occasions when the debt level increased, but none of these episodes reflected fiscal laxity or political bias. In 1999, the debt-to-GDP ratio increased due to the Russian crisis, whereas in 2001 and 2003-2004 the increase was the consequence of strong cyclical effects. Both the People's Party-dominated coalition governments (1998-2002; 2006-2010) and the

6 The drop in the Estonian GDP was -12.6, -14.2, -8.6 and -3.2 per cent in 1991, 1992, 1993 and 1994, respectively (Hansson, 1997).

New Era Party-led coalition (2002-2004) were successful in maintaining a stable fiscal position during the years of analysis.

Although the case of Estonia and Latvia seems to defy the general validity of the concept of the strategic use of debt, the third Baltic state, Lithuania may provide some food for thought. Debt increased substantially under the leadership of the centre-right Homeland Union in the second half of the nineties (Figure 1). Although in 1999 the Russian crisis hit all three Baltic states very hard, it cannot serve as an adequate and exclusive answer in the case of Lithuania for debt accumulation. In 1996, the year of the elections that resulted in the victory of the Homeland Union, the debt increased by 20 per cent, and the average increase between 1997 and 2000 was 15.07 per cent. The main reason for the acceleration of debt in the second half of the nineties was probably due to Lithuania's transformation strategy. According to the Bertelsmann Stiftung (2012), politicians attempted to avoid the huge social costs of transformation; thus, they embarked on deficit financing. In fact, a comprehensive reform process started only after the beginning of the new millennium. From 2001 onwards, the country started to reduce its debt-to-GDP ratio and managed to keep fiscal targets in spite of huge increases in health and pension expenditures (Zápal and Schneider, 2006).

As a corollary, public debt did not seem to play a systematic role as strategic variable in the Baltic. Two alternative hypotheses can be formulated to rationalise this behaviour. First, Estonia, Latvia and Lithuania – as former member states of the communist empire, the Soviet Union – wanted to break away from the communist and state paternalist past once and for all and to reorientate themselves as quickly as possible.



Note: Data are as per cent of the GDP.

Figure 1: Public debt to GDP in Estonia, Latvia and Lithuania

Source: Eurostat (2013).

Therefore, political elites actively supported a quick economic recovery and a fast catch-up to the West in order to ensure their countries reintegration into Europe. Alternatively, it can also be claimed that although these countries managed to avoid debt accumulation in the public sector, they engaged in huge debt build-up in their external balances. In lieu of public debt, private actors actively engaged in a dramatic consumption increase, financed by private debt accumulation (see Csaba, 2008; Darvas and Szapáry, 2008; and, more recently, Gyórfy, 2013).

3. EU accession as a strategic variable?

The case of Slovenia, Slovakia, Romania, Bulgaria, and Croatia

Besides the Baltic states, Slovenia has often been regarded as one of the fiscally most disciplined countries among the new member states (Zápal and Schneider, 2006). Nevertheless, although the level of the general government gross debt did not even reach the half of the 60 per cent reference value for a long time, the debt-to-GDP ratio did indeed display a moderate but steady increase in the first ten years of the independent state, until 2002 (Figure 2). During this period, the Liberal Democracy of Slovenia (LDS) dominated the political arena.⁷ As EU accession became reality, the governing forces agreed on pursuing a strict fiscal policy in 2002 in order to fulfil the Maastricht convergence criteria. In spite of the successful EU accession and the effective consolidation efforts which managed to maintain economic growth, the LDS was voted out of power and the conservative Social Democratic Party formed government in 2004. The new cabinet did not seem to use public debt strategically either in the next couple of years. In fact, following the EU accession the country targeted euro-zone membership and was able to enter the zone in 2007.

Although Slovenia's EU accession was taken more-or-less for granted right from its independence, for some other CEE countries, EU accession was not evident at all. Consequently, (accession to) the European Union was evidently considered as a motivating force for reforms in public finances in Slovakia, Romania, Bulgaria, and, most recently, Croatia.

Slovakia was characterised by an intensive GDP growth and a relatively low inflation until 1997, which made the country a seemingly successful transition economy by the mid-nineties. According to the OECD (1996), the sound and credible monetary policy, the prudent and disciplined fiscal programmes and the relative openness of the country provided a solid ground for robust economic performance. Nevertheless, there were severe macroeconomic imbalances beneath the surface, which drove up fiscal deficit and debt from 1996 onwards. The problem started with the deceleration of export, which culminated in a massive 9.9 per cent deficit in the current account by 1996 (OECD 1999b). The governing coalition of the Movement for a Democratic Slovakia (MDS) and the nationalist-populist Slovak Nationalist Party (SNP) tried to

⁷ The party won the greatest share of the votes in three consecutive elections, i.e., in 1992 (23.5%), 1996 (27%) and 2000 (36.2%) (European Election Database, 2013).

lower current account deficit by tightening monetary policy, but this action placed a credit constraint on the private sector and made the financing of the state budget more challenging. As the interest burden increased, the debt-to-GDP ratio surged as well (Figure 2). Although there were other import constraining measures implemented by the Mečiar's coalition government, the current account deficit remained high, close to 10 per cent of the GDP. The 1997 Czech currency crisis triggered a strong speculation on the Slovak koruna, too, which made further monetary tightening necessary and put an extra cost on financing the budget deficit.

With the coming of the 1998 general elections, the budget deficit (especially the deficit of the central government) reached 5.3 per cent. The overrun was the result of the compensation of public sector employees (13 per cent increase) and the state's contribution to other state funds was doubled. Although election economics worked well for the Mečiar-led MDS which won the 1998 elections, it was the Slovak Democratic Coalition (a five-party coalition government also referred to as the 'Rainbow Coalition'⁸) which managed to form a new cabinet under the leadership of Mikuláš Dzurinda. The new cabinet did not hesitate to engage itself in a comprehensive reform of the economy by mid-December 1998. The new coalition decided to cut the general government deficit to 2 per cent within one year, by downsizing public infrastructure projects, freezing the public sector wage bill and increasing taxes. Despite the macroeconomic stabilization steps and substantial progress in structural reforms, the general government still required further consolidation in the new millennium. Ultimately, the increasing trend of indebtedness was turned back and the debt-to-GDP ratio started to decline in 2001 (OECD, 2002, see Figure 2). Following the parliamentary elections of 2002, the re-elected Dzurinda government continued with a comprehensive reform of the tax system, the labour market, the pension system, the health care system, the state administration and the education system (OECD, 2005). As a result, the debt-to-GDP ratio declined from 50.5 per cent in 2000 to 30.5 per cent in 2006.

In sum, under the leadership of the MDS (1992-1994 and 1994-1998), the debt-to-GDP ratio increased substantially and this was not driven purely by cyclical trends but by discretionary and politically motivated actions. By 1998 it became clear that the country, led by the Mečiar cabinet, eroded its chances of joining the European Union.⁹

8 The pro-Western opposition forces, the so-called 'Rainbow coalition', led by Mikuláš Dzurinda, comprised the Slovak Democratic Coalition, Party of the Democratic Left, Party of the Civil Understanding and Party of the Hungarian Coalition. Dzurinda had also the opportunity to form his second government after the 2002 elections. The new coalition partners were the parties of the centre-right, namely the Slovak Democratic and Christian Union, the Christian Democratic Movement, the New Citizens Alliance and the Party of the Hungarian Coalition.

9 Nevertheless, the party's social support showed stability throughout the years. In 1992, the party received 37 per cent of the votes, while two years later, the HZDS and the RSS gained 34.9 per cent.

If the country wanted to join in the first wave of CEE countries, it had to embark on a series of economic and political reforms which entailed social costs. The new right-wing cabinet, therefore, did not have any other option but to commit itself to severe reforms, which might have indeed eroded its popularity. Lamenting on the strategic behaviour of the Mečiar government, it is reasonable to assume that it was not the public debt per se that Mečiar used strategically but EU accession. Since Mečiar and his party firmly opposed EU accession, they tried to make the accession to the EU as expensive for new incumbents as possible.

Among the European transition countries, Romania had some of the worst starting conditions, except for the inherited debt-to-GDP ratio (IMF, 2004). Despite the huge poverty in the country, the former communist party's first secretary, Nicolae Ceaușescu, enforced Romania to engage in a dramatic debt-repayment programme in the eighties. It gave freely elected governments ample room for fiscal laxity following the systemic change. As a corollary, the debt-to-GDP ratio dynamically rose from 1995 onwards from its starting level of 6.6 per cent in 1995 (Figure 2). The first wave of increase was mostly due to the 1996 elections. The Democratic National Salvation Front (elected into office for the first time in 1992) practiced lax fiscal policy before the 1996 parliamentary elections and the debt-to-GDP ratio climbed above 10 per cent in just one year. Nevertheless, it still did not follow that the fiscal space of the next government (the coalition of the Democratic Convention of Romania, the Democratic Party, and the Democratic Union of Hungarians in Romania, which took office over DNSF in 1996) could have been restricted substantially. Yet, the new government faced a huge inflationary pressure, which was caused by the loosened macroeconomic policy of 1995 and 1996. The coalition, therefore, had to respond to negative tendencies by introducing administrative price controls and exchange rate controls and by returning to the further liberalisation of the economy. As far as fiscal policy is concerned, the coalition initiated adjustments mainly on the revenue side of the budget between 1997 and 1998 – without too much success, however. The general elections of 2000 triggered a further round of fiscal laxity instead, and gross public debt climbed to 22.5 per cent (IMF, 2004).

It was only the incoming left-wing coalition in 2000 which decided to seriously alter the previous regime of fiscal laxity and tried to stop the accelerating tendency of indebtedness (Figure 2). The new, reform-oriented government led by the Social Democracy Party of Romania implemented a value-added tax and profit tax reform and started to improve the revenue administration as well from 2002. Moreover, in 2003, 79 proposed amendments to the constitution were adopted in order to create an EU-conform economy and state. The coalition engaged in the much awaited structural and macroeconomic reforms as well. Consequently, the upward tendency of public debt was not only stopped but also curbed. Just like in Slovakia, fiscal and economic reforms were adopted mostly by necessity by the governing coalition, which was strongly committed to EU accession. The possible reward of becoming an EU member state kept Romania on track even after the 2004 general elections, which placed the

National Union into power. Yet, there was a loosening in fiscal policy under the new government. The level of budget deficit doubled in three years and reached 2.9 per cent of the GDP in 2007, as opposed to 1.2 per cent in 2004. The cyclically adjusted deficit of the general government reflected an even worse tendency, as the cyclically adjusted deficit without interest payments reached 4.6 per cent in 2007, in the year of the EU accession (Eurostat, 2013). That is, fiscal consolidation implemented under the former socialist coalition ensured the proper fiscal playground for the National Union.

In contrast to Romania, which started its new era under a democratic rule without substantial debt, the Bulgarian debt-to-GDP ratio was one of the highest in the whole region under scrutiny. By 1997, the debt ratio stood at 105.1 per cent. The most important factor in the build-up was the transition crisis¹⁰ and the 1996 banking crisis, accompanied by hyperinflation. The immediate cause of the banking crisis was a liquidity injection to commercial banks and the intervention of the central bank to finance the budget deficit (Gulde, 1999).¹¹ 1997 reflected, however, a major turning point in the postcommunist history of Bulgaria. The winning coalition, the Alliance of Democratic Forces had basically no other choice than to commit themselves to a severe consolidation programme built on the advice of the IMF. The government adopted a currency board and reduced the real value of the domestic debt, which had initially been very favourable to maintaining a balanced budget (the general government deficit was 8.0 and 11.2 per cent in 1995 and 1996, respectively) due to interest payments.

The reform of public finances was so successful that the debt-to-GDP ratio was reduced to less than the Maastricht reference value by 2002 and dropped below 20 per cent (!) in 2007 (Figure 2). Interestingly, the effective monetary and fiscal consolidation was not reversed even at the time of the Russian crisis. By now, it can be safely claimed that Bulgaria belongs to that group of the CEE-10 countries where there was a strong reform commitment and fiscal discipline during the studied period. Absolutely no sign of using strategically public debt could be detected during the analysed period. Nevertheless, it is worth mentioning that this was the only option for Bulgaria to join the European Union and not to lag behind the other new member states.

Croatia, the 28th member state of the European Union, is quite different from most of the other Central and Eastern European new member countries. It was run as a war economy at the time of its independence. Moreover, in spite of free parliamentary elections, the country was best characterized as an autocratic regime under Franjo

10 Bulgaria suffered roughly a one-quarter drop of its GDP by 1993. After that, however, a slow increase in economic activity started, which suddenly halted in 1995, and the country faced another 10 per centage point decline in its GDP (Fischer and Sahay, 2000).

11 The controversy measures were adopted by a left-wing coalition (its members were the Bulgarian Socialist Party, the Bulgarian National Agrarian Union and the Ecoglasnost Political Club).

Tudjman during the nineties.¹² Additionally, its former economic system was less centralised than in other states in the region (World Bank, 1997).

As the transformational recession was aggravated by the war, Croatia experienced hyper-inflation, huge fiscal and current account deficits and a substantial loss of its GDP.¹³ Although the newly elected right-wing cabinet announced a stabilisation package in 1993 which successfully moderated macroeconomic imbalances, this was followed by a substantial expansion of the state sector. Public expenditure rose from 33 per cent to 47 per cent of the GDP, and taxes were also increased in order to cover the increasing financing needs of the state (World Bank, 1997). The increase in spending was mostly related to the war and the social needs of citizens.¹⁴ Thus, Croatia became one of the most heavily taxed economies in the region,¹⁵ which considerably undermined the competitiveness of the private sector. Interestingly, the general government deficit was relatively low during the HDZ years, especially if the distorted expenditure-revenue structure of the budget is taken into account. The structural problems caused concern for politicians only at the end of 1998 and 1999, when the deficit jumped to 8 per cent of the GDP due to the recapitalisation of commercial banks as a consequence of a bank crisis in 1998 and 1999 (World Bank, 2001). Nevertheless, public debt increased substantially not only in 1998 and 1999, but well before this period as well (Figure 2). One of the major reasons for this increase was the agreement with the Paris Club in 1995 and with the London Club in 1996, according to which Croatia took over 28.5 per cent and 29.5 per cent of former Yugoslavia's debt burden, respectively. All in all, what the HDZ left for its successor in 2000 was an unsustainable government budget structure, an increasing debt level, growing expenditure needs, an over-taxed economy and an over-sized government.

Croatia's 'second transition' started in 2000 (World Bank, 2008), when a new, pro-European coalition came into power. The six-party coalition, led by the Social Democratic Party of Croatia (SDP),¹⁶ launched a dynamic deficit reduction programme in

12 The HDZ (Croatian Democratic Union) won the first election in 1990, which was followed by two other electoral successes in 1992 and 1995. The party received 41.6, 44.7 and 45.2 per cent of the votes, respectively and was able to govern the country without the need for forming a coalition (European Electoral Database, 2013).

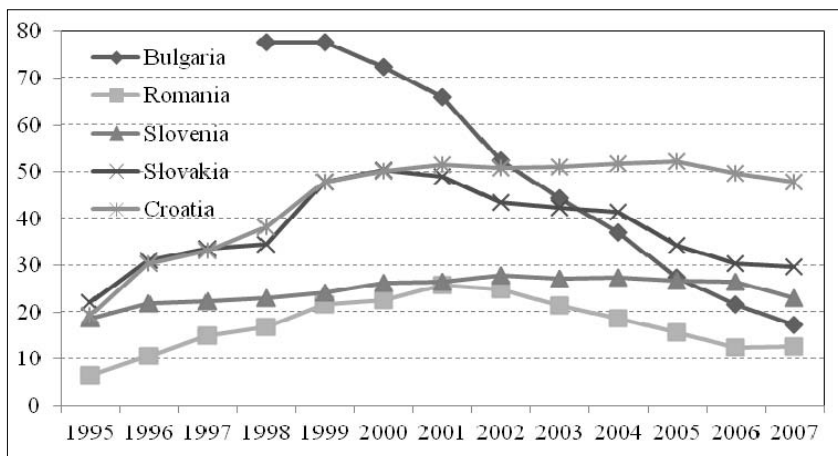
13 Between 1990 and 1993 the GDP fell by almost 30 per cent and the industrial output decreased by 50 per cent.

14 One of the most sensitive parts of the expenditure side was welfare expenditure. Pension payments rose from 7 to 10 per cent of the GDP between 1993 and 1996; health expenditures increased from 7 to 9 per cent in the same period (World Bank, 1997).

15 By the end of the decade the tax-to-GDP ratio was beyond 41 per cent of the GDP (World Bank, 2001).

16 The coalition consisted of the Social Democratic Party of Croatia, the Croatian Social Liberal Party, the Croatian People's Party, the Croatian Peasant Party, The Istrian Democratic Assembly and the Liberal Party (European Election Database, 2013).

cooperation with the IMF. The coalition committed itself to the reduction of the expenditure side of the budget – mostly by cutting back public sector wages and the number of public sector employees, by the rationalisation of social transfers and by the moderation of state subsidies and other transfers (IMF, 2001a). The implementation, however, suffered from serious delays due to fierce parliamentary debates (IMF, 2001b). As a result, the coalition broke up and new elections were called for in 2003, which saw the comeback of the HDZ – this time, however, without Tjudman and with a more pro-European character. Neither deficit, nor debt increased substantially in the years of the new millennium. Nevertheless, according to the World Bank (2008), the right-wing government had to face the fiscal challenges which were rooted in the failed policy decisions of the former decade: the huge and ever-increasing public sector, the high level of debt and the enormous tax burdens. In sum, public debt accelerated in Croatia mostly due to factors that are not considered to be strategic in this study (i.e., the Balkan war, bank recapitalization, debt takeover from former Yugoslavia).



Note: Data are as per cent of the GDP.

Figure 2: Public debt to GDP in Bulgaria, Croatia, Romania, Slovakia and Slovenia

Source: Eurostat (2013) and World Bank (2011).

4. 'Matured' democracies with a tendency for using public debt strategically: Hungary, Poland and the Czech Republic

Whereas the previously analysed eight countries were less inclined to use public debt in a strategic way as predicted by Alesina and Tabellini (1990), the most advanced transition economies such as Hungary and Poland and to a lesser degree, the Czech Republic, did not refrain from engaging in the manipulation of public debt.

Generally speaking, the transformation of the Hungarian economy was a success story in several respects. However, it was heavily burdened with alarming features as well, especially the large external and internal indebtedness, which the first freely

elected conservative coalition was not able and not willing to tackle at all. In fact, due to the advances in market reform, Hungary postponed the needed structural reforms of public finances until the escalation of the macroeconomic instability in 1994-1995. The first freely elected right-wing coalition (1990-1994) thus manoeuvred the new incoming socialist-liberal government into a situation where the Hungarian Socialist Party and the Alliance of Free Democrats had simply no other chance than to embark on a severe austerity programme to prevent Hungary to become the next Mexico in 1995.¹⁷ The austerity package was adopted in March 1995, and in consequence primary expenditures were reduced from almost 52 per cent to 41.6 per cent of the GDP in just one year. Primary revenues fell somewhat also, but to a much smaller extent than expenditures, which helped to improve both the primary and the general balance (OECD, 1999a). Public debt was above 80 per cent in 1995, but four years later it was brought down to the Maastricht reference value of 60 per cent, mostly financed from privatisation proceeds (Figure 3). The budget deficit was also reduced mostly by cutting back household transfers and the public sector wage bill.

Despite the strong economic recovery, the socialist-liberal coalition lost the next elections in 1998, giving an opportunity to the right wing forces to consolidate the results of the reform.¹⁸ The leading coalition party, Fidesz, however, tried to distance itself from the socialist-liberal government's legacy of austerity and reform and declared itself as the party which aimed at increasing the standard of living of people, targeting especially its voter base, the middle class. Nevertheless, during the first two years in power, the Fidesz-led cabinet did not threaten fiscal stability. The economy showed a robust growth in any comparison, which provided enough room for the government to achieve its objectives without undermining fiscal sustainability. Yet, the stable internal and external conditions and the strong economic growth would have made it possible for the right-wing coalition in the first two years to go ahead with the still awaited structural reforms, especially in the sphere of education, health care and public administration.

The run-up to the 2002 elections, however, dramatically accelerated public spending. While Fidesz and its allies were almost sure until the end of 2001 that the forth-

17 The Hungarian Socialist Party (HSP) won 54 per cent of the total seats in the parliament, while the Alliance of Free Democrats (AFD) received 18 per cent of the seats in Spring 1994. The incoming new coalition government, comprising the HSP and the AFD, was not willing at first to admit that without a radical change, Hungary was heading towards a catastrophe. Instead of using its two-third majority in the parliament to embark on a firm set of actions in order to regain credibility and restore equilibrium in external and internal positions, the coalition attempted to create wide-scale social agreements which, however, were never realised.

18 After the May 1998 elections, Fidesz formed a new government with the Hungarian Democratic Forum and the Independent Smallholders' Party. The coalition had a 54 per cent majority in the parliament.

coming election would be won by the right-wing forces, the trend changed at the very beginning of 2002 – just three months before the general elections. The incumbent parties had to react quickly in order to change the unpleasant trends and embarked once again on generous spending programmes and promises. This time the main elements of the increased spending included a public sector and a minimum wage rise and an increase in household transfers – targeting voters directly.¹⁹ The government also accelerated motorway construction and provided extra funds for small- and medium-size enterprises.

In the election race, the Hungarian Socialist Party, the main opposition force, responded in a similar tone, by promising several welfare-improving measures in advance, especially in the form of tax cuts and wage and transfer increases. On the one hand, the socialists tried to differentiate themselves from Fidesz by claiming that extra revenues should be channelled back to the people in the form of tax reductions, instead of spending the money on white elephants. On the other hand, the HSP also wished to make it clear that the party was devoted to increasing the standard of living, especially that of teachers, health care workers and young couples, and that the party did not wish to ever return to the era of austerity. As a corollary, the two sides of the political arena mutually hounded each other into a vicious circle of untenable promises.

The election campaign of April 2002 saw the victory of the Hungarian Socialist Party, though only with a slight majority. The HSP formed a new cabinet along with the Alliance of Free Democrats. Although it was evident that the economy had already veered onto the road of sustainable economic growth, the unusually narrow majority, the oppressive political atmosphere (as for instance the questioning of the election results), and the load of election campaign promises made it politically difficult for the new incumbents to embark on serious fiscal adjustments. As a result, the long-awaited reforms were postponed, and the government instead declared a ‘systemic change in the welfare regime’, which meant an extraordinary increase in public sector salaries and the rise of family allowances and housing subsidies.

By the end of 2005, just a couple of months before the next general elections, according to Antal (2005), the direct threats of a crisis did not (yet) emerge in the economy – as opposed to the year of 1995 –, however, there was an immense lack of political commitment concerning adjustment and reform. Budget deficit climbed up to 9.2 per cent in 2006, which also saw the victory of the governing socialist-liberal coalition. Antal, Csillag and Mihályi (2005) accordingly pointed to the rebirth of late socialist sentiments. They saw the return of an expansionist state paternalism, financed by increased deficit and debt, and the unwillingness of politicians to embark on radical

¹⁹ For instance, pension payments were raised by 9.7 per cent. The government prepared a new proposal by which taxpayers would have been allowed to transfer part of their income tax to their retired parents. Additionally, an interest-free loan was made available for farmers (EIU, 2002, p. 17).

and necessary policy changes, especially in the field of public finances. That is, from the very beginning of the new millennium, political rationality seemed to override economic considerations in the extreme within a regional comparison.²⁰ Nevertheless, Hungary might not have been that much different from many other CEE countries in the post EU accession era. Csaba (2011, p. 239) rightly claimed that 'When the accession agreement was signed in December 2002 in Copenhagen, the stimulus for change has weakened, often simply disappeared. Lacking domestic ownership reforms were bound to fall prey to domestic politics, myopic manoeuvring and fishing for votes in the simplest possible manner.'

Similarly to Hungary, Poland started the process of transformation with a huge debt, which seriously constrained the policy space of alternating governments. Although Poland managed to reduce its debt level already in the nineties (Figure 3), when most of the countries struggled with the negative consequences of transformational recession, its success was mostly due to the successful combination of accelerated economic growth, appreciation of the real exchange rate and external debt relief; that is, no real efforts were made in order to initiate a comprehensive reform of the general government (OECD, 1998a). Although no deliberate actions were enacted to strengthen fiscal discipline until the second half of the nineties, the ruling left-wing coalition (the Alliance of the Democratic Left, 1993-1997) adopted a new constitution, which made a debt brake effective in Poland.²¹

The real turn, however, arrived in late 1997, when the Solidarity Electoral Action formed a coalition with the market-oriented Freedom Union. The new right-wing cabinet put an immediate stop on the further increase of public sector wage bill, which showed an unprecedented acceleration during the previous cabinet in 1996 and 1997. The new incumbents also decided to halt the further escalation of pension expenditures by initiating wide-scale structural reforms in the sector from 1999 onwards. Structural reforms also targeted public administration and social welfare programmes. As a consequence of the restrictive approach of the new coalition, both deficit and debt started to decline between 1997 and 1999. Albeit the downward trend of the debt and budget deficit was moderated somewhat by an economic slowdown in 1998 and 1999 (OECD, 2008), the tendency remained clear: a decline which stopped

20 Later on, Mihályi (2008) gave a more detailed analysis on the cause-effect relationship between the past (i.e., the pre-systemic change period) and the present.

21 A public debt ceiling was set by the Constitution at 60 per cent of the GDP and the President was deprived of the power to veto the budget. Furthermore, direct central bank lending to the general government was prohibited from 1998, and the Monetary Policy Council, chaired by the governor of the National Bank of Poland and nine other members, was set up in order to ensure the independence of monetary policy. The supervision of banks was also strengthened. The new rules showed the streamlining efforts of the country with the European standards, however, the 60 per cent debt ceiling provided a comfortably large playground for fiscal manoeuvres (Rutkowski, 2007).

only in the year of the following parliamentary elections, which brought the victory of the opposition forces, i.e., the Alliance of the Democratic Left-Labour Union (ADL-LU), which gained 41 per cent of the votes. Citizens punished the governing coalition for two major reasons: reduction in public welfare transfers and programmes, and corruption scandals.

During the term of office of the Alliance of the Democratic Left-Labour Union (2001 to 2005), the debt level substantially increased (from a starting level of 37.6 per cent of the GDP in 2001 to 47.1 per cent by 2005 – see OECD, 2008). The increase was more visible in the election year of 2005, which was preceded by a moderate fall of the debt level in 2004 as a result of a robust economic growth (Figure 3). Importantly, the cyclically adjusted deficit data also confirms that fiscal laxity prevailed in the country between 2001 and 2005. The permanent increase in the deficit and thus the repeated budgetary overruns which continued under the return of the centre-left coalition from 2001 resulted in the increasing indebtedness of the country (OECD, 2004a).

One of the main reasons for the absence of fiscal discipline during the first half of the 2000s was the sharp political tensions between the coalition parties (European Electoral Database, 2013). The ADL-LU and the Polish Labour Party (PLP) were not able to reach a compromise on several policy issues, which led to the exclusion of the PLP from the government in 2003. The minority government, however, did not prove to be more effective either, and its popularity deteriorated relatively soon. In consequence, the ADL lost the next general elections of 2005 by only 11.31 per cent of the votes. The Law and Justice managed to form a minority government led by Prime Minister Kazimierz Marcinkiewicz. In the following years, not only the annual budget deficit, but also the cyclically adjusted balance and the debt-to-GDP ratio showed a declining trend.

In summary, the left-wing coalition governments (i.e., between 1993 and 1997 and during 2001 and 2005) showed a significant political bias towards fiscal indiscipline, accumulating deficit and debt – although during their first government cycle the strong economic performance of the country hid this feature away. Although the right-wing government managed to introduce strong legal insurances for the elimination of deficit bias and debt increase, it could not prevent the left from engaging in debt increase, since even after the constitutional limits, a substantial room for laxity was provided for the new incoming forces.

If Poland was the example of intense conflicts and frequent changes in government, the Czech Republic can be regarded as the other extreme with relative political calm and stability. More importantly, as opposed to most of the CEE countries, the Czech Republic experienced a strong economic growth right after the systemic change, mostly due to the devaluation of the Czech national currency, the koruna, by nearly 50 per cent. Practically it also meant that the Czechs were simply not willing to call for the necessary structural reforms which could have put the country on a sustainable track of economic development. Consequently, real wages increased and inflation started to accelerate, too. As the export performance deteriorated and was

not followed by a decline in domestic demand, the current account displayed huge deficits and placed the exchange rate under serious pressure. The deteriorating trends culminated in a currency crisis in 1997 which, in turn, triggered a severe slowdown of economic activity (OECD, 1998b).

The 1996 parliamentary elections proved to be unique in the CEE region: the unwillingness of the right-wing cabinet to engage in comprehensive and painful stabilisation measures – along with lax fiscal policy which resulted in an unavoidable widening of the deficit in the structural balance between 1994 and 1996 (Burns and Yoo, 2002) – ensured that the Civic Democratic Party remained in power – albeit it was only a fragile minority coalition.

The currency crisis of 1997, coupled with financial scandals concerning the activity of the incumbents, led to early elections in 1998. The elections brought the victory of the Czech Social Democratic Party (CSDP), which repeated its success in the next elections as well in 2002. The change in government, however, did not mean a turn towards fiscal discipline. The debt-to-GDP ratio continued to climb until 2004 (Figure 3). The balance of the general government substantially deteriorated in 2000 and 2001 as a consequence of discretionary fiscal decisions (Burns and Yoo, 2002), which, however, kept the governing party in power in 2002.

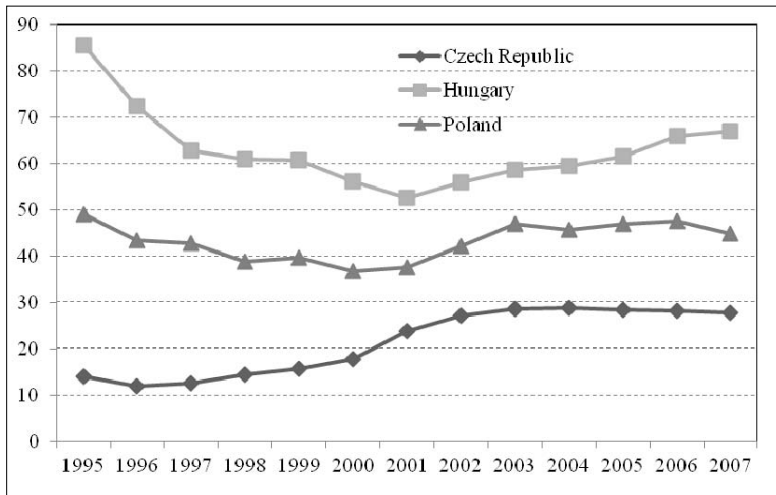
Interestingly, while the ratio of public spending was stabilized on a near-constant level between 1993 and 1999 at around 42-44 per cent, it suddenly rose to 48.4 per cent of the GDP in 2000. Revenues also increased, but at a much slower pace. Within the general budget, the share of the mandatory expenditures (social transfers, health insurance and debt service payments) and the quasi mandatory items (military spending and wage expenses in public administration) reached nearly 80 per cent of total spending in 2002-2003 (OECD, 2003). All these measures reflected the CSSD's intention to keep its lead position in the political arena.²²

It was only in 2003, that is, one year after their second victory, when the coalition government introduced a fiscal and public expenditure reform. The fiscal deficit started to decline after its peak in 2003 (6.7 of the GDP) and dropped to 2.8 per cent in 2004. The first reform package contained both tax- and expenditure-related measures. The second round targeted the structural reform of the pension and health care system (OECD, 2004b). Although right before the elections of 2006 government expenditures were on the rise once again, which secured the repetition of the previous election results (the CSDP gained 32.3 per cent of the votes), the centre-right Civic Democratic Party (led by Mirek Topolánek) outperformed the CSDP with 35.38 per cent of the votes and could form a new coalition accordingly.

In sum, the Czech political and fiscal performance reflected a rather strange character in the period under scrutiny. No real measures were taken during the first term

22 The CSSD received 32.3 per cent of the total votes in 1998. In 2002, there was only a slight deterioration, when it gained only 30.2 per cent of the votes (European Election Database, 2013).

of the Civic Democratic Party (between 1992 and 1996), which prevented the country from facing a serious transition recession; however, the country could not avoid a crisis in 1997, which made it overt that without structural reforms even such a relatively developed country could not survive for long. Sadly enough, the new incoming (leftist) parties did not learn much from past mistakes and did not embark on wide-scale reforms right after the crisis either. The CSSD was reluctant to commit itself to fiscal discipline between 1998 and 2002. It was only due to external pressure from the approaching EU accession that induced the governing socialist coalition to change its previous mentality and to launch a comprehensive reform programme.



Note: Data are as per cent of the GDP.

Figure 3: Public debt to GDP in the Czech Republic, Hungary and Poland

Source: Eurostat (2013).

5. Conclusion

One of the most significant (if not the most significant) analytical values of Alesina and Tabellini's (1990) classic model is that myopia in itself can hardly be the main explanatory factor for persistent deficit and debt. Instead, public debt can be used strategically by incumbents in order to constrain the choices of future governments – even when such a strategic use of deficit and debt can eventually culminate in a socially sub-optimal equilibrium.

The model of the strategic use of public debt has already been applied in the context of advanced industrialised countries (especially the USA), but there has been hardly any attempt to test its relevance in the case of transition or emerging economies. Therefore, this article presented a case study analysis of the public debt performance of CEE countries between 1995 and 2007. It has been demonstrated that some political parties and coalitions did in fact use public debt as a strategic variable, as was the case in Hungary and Poland, and to a lesser extent even in the Czech Republic. The Baltic

states or Bulgaria, on the other hand, did not embark on such activities during the period under scrutiny. Most interestingly, in some other countries, such as Slovakia, Romania or more recently, Croatia, fiscal policy and fiscal aggregates were not considered as factors that incumbents could have used for their own benefit. Instead, fiscal policy was driven by the expectations of EU accession, which consequently shaped politicians' decisions on deficit and debt.

By conceptualising the behaviour of political decision-makers in Central and Eastern Europe, this article did not reflect upon regional tendencies with regard to private debt accumulation, which can be, however, a shortcoming of the current analysis. According to Gyórfy (2013), there was a trade-off between public debt accumulation on the one hand and the acceleration of private debt on the other hand in the region. The Baltic states and the Balkan countries engaged heavily in excessive private consumption financed by external sources. Countries such as Hungary, Poland, the Czech Republic or Slovakia, however, had a more active public sector, and, in turn, they were faced with an acceleration of their public debt. Moreover, the most recent developments throughout the region have demonstrated that as former accession countries have become full member states, the EU is not capable anymore of disciplining these nations. These new tendencies call for further investigations. A summary of the main findings of the study are presented in Annex 1.

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Annex 1

Table 1: The strategic use of public debt: a summary

| Country | Timing of debt acceleration | Political orientation of incumbent(s) | Election results | Size of debt increase (in GDP) | Length of debt accumulation (in years) | External or internal effects | Debt used as strategic variable? |
|----------------|-----------------------------|---------------------------------------|--|--------------------------------|--|---|---|
| Croatia | 1996-2001 | centre-right | HDZ after three electoral victories lost the elections in 2000 (received 27.03% of the votes) SDP+HLSLS pre-electoral coalition received 39.24% of the votes; SDP lost next elections in 2003 (received only 22.61%) | 18.62 | 5 | war, debt take-over, bank crisis in 1998-1999 | yes (combined with lack of political commitment to reforms) |
| Croatia | 2001 | centre-left | | 2.79 | 1 | | not |
| Czech Republic | 1997-1998 | centre-right | Civic Democratic Party-led coalition government won in 1996 (CDP: 29.62%) | 10.48 | 2 | currency crisis (1997) | no |
| Czech Republic | 1999-2004 | centre-left | Czech Social Democratic Party won in 1998 (32.31%), re-elected in 2002 (30.21%) | 12.65 | 6 | | yes |
| Estonia | 1999 | centre | Coalition Party and Rural Union, the former centre-right government, lost the 1999 elections and the Estonian Centre Party won with 23.41% | 8.33 | 1 | Russian crisis | not |
| Estonia | 2002 | centre | Estonian Centre Party won in 1999 and was re-elected in 2003 with 25.4% | 18.57 | 1 | | yes |
| Hungary | 2002 | centre-right | Fidesz lost elections in 2002 (41.07%) | 6.07 | 1 | | yes |
| Hungary | 2003-2007 | centre-left | Hungarian Socialist Party won the elections in 2002 (42.05%), re-elected in 2006 (43.21%) | 3.71 | 5 | strong cyclical effects (2003-2004) | yes |
| Latvia | 1999 | centre-right | People's Party-led coalition (elected in 1998 with 21.3%) | 30.21 | 1 | Russian crisis | not |
| Latvia | 2001 | centre-right | People's Party dominated the coalition government between 1998-2002 but was not in the governing coalition from next year's elections (2002) | 13.71 | 1 | cyclical trends | not |
| Latvia | 2003-2004 | centre-right | The New Era Party (won elections in 2002 with 23.98%) led the coalition government and lost the elections against the returning People's Party in 2006 with 16.48% | 5.1 | 2 | cyclical trends | not |

| Country | Timing of debt acceleration | Political orientation of incumbent(s) | Election results | Size of debt increase (in GDP) | Length of debt accumulation (in years) | External or internal effects | Debt used as strategic variable? |
|----------|-----------------------------|--|--|--------------------------------|--|---|----------------------------------|
| Poland | 1999 | centre-right | Electoral Action - Solidarity and Freedom Union formed a coalition government in 1997 (33.8 % and 13.4 %, respectively) | 1.8 | 1 | cyclical trends (1998-1999) | no |
| Poland | 2001-2003 | centre-left | Alliance of the Democratic Left-Labour Union won in 2001 (41.04%) | 8.67 | 3 | | yes |
| Poland | 2005-2006 | centre-right | Law and Justice won the elections in 2005 (26.99%) | 2.17 | 2 | strong cyclical trends (2005 and 2006) | perhaps |
| Romania | 1996-1999 | centre and centre-right | Democratic Convention of Romania received in 1996 (30.17%) | 35.82 | 4 | incoherent macroeconomic policies | perhaps |
| Romania | 2000-2001 | centre-left | Social Democracy Party of Romania won in 2000 (36.61%) | 8.96 | 2 | | not |
| Romania | 2007 | centre-right | Justice and Truth Alliance won in 2004 (31.33%) in 2004; but not re-elected in 2008 | 3.23 | 1 | | yes |
| Slovakia | 1996-1998 | centre | Movement for a Democratic Slovakia (MDS)-led coalition won in 1994 (coalition received 40.37%) | 17.15 | 3 | effects of internal distortions from 1997 + speculative attack on the Slovak koruna | yes |
| Slovakia | 1999-2000 | broad coalition including parties with different political positions | The 'Rainbow coalition' won in 1999 with 58.14% | 21.89 | 2 | Russian crisis and the European economic slowdown | not |
| Slovenia | 1996-2002 | centre-left | Liberal Democracy of Slovenia three times re-elected: 1992 (23.46%); 1996 (27.01%); 2000 (36.21%); 2004: lost general elections with 22.8% | 5.26 | 7 | | yes |