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# The Rise of Populist Parties in Central Europe

## *Big Government, Corruption, and the Threat to Liberalism*

**by Marian L. Tupy**

## *Executive Summary*

Central Europe has grown freer and more prosperous since the collapse of communism. Yet liberal parties, which were responsible for bringing those advances about, are on the defensive. In the last year, liberals have suffered a number of electoral setbacks throughout the region. Some commentators saw the poor performance of the liberal parties as a sign of weakening public support for the free market, but public opinion polls in Central Europe show continued support for capitalism. Certainly, there is no widespread support for a return to economic dirigisme, which failed so spectacularly in the past.

Rather, one of the most important reasons for public discontent with the political establishment is government corruption. The pervasiveness of corruption in Central Europe is partly attributable to the underdevelopment of civil society and the concomitant paucity of effective restraints on the conduct of the political class. Moreover, despite the tremendous progress toward economic freedom that Central European countries have made since the fall of communism, the role of the state in the economy remains large. The private sector is burdened with too many regulations, and governments continue to spend some 44 percent of the region's gross domestic product. To lessen the problem of corruption, the size and the scope of the state must be reduced.

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**Central Europeans have freedom of speech, religion, and assembly, and their per capita income is higher than ever before.**

## Introduction

In many ways, Central Europe is a success story. The Czech Republic, Hungary, Poland, and Slovakia are free-market democracies. Formerly part of the Warsaw Pact, they are now members of the North Atlantic Treaty Organization and the European Union. They have freedom of speech, religion, and assembly, and their per capita income is higher than ever before. Yet liberals, who advocate the political, civil, and economic freedoms that were instrumental in bringing about those advances, are on the defensive.

Between September 2005 and June 2006, all four Central European countries held parliamentary elections. In Slovakia, a national-socialist coalition replaced Mikulas Dzurinda's liberal-conservative government. The new government put an immediate stop to new reforms and promised to reverse some of the old ones. In Poland, a coalition deal between conservatives and nationalists kept the liberal Civic Platform out of power. In the Czech Republic, the liberal Civic Democratic Party won the elections. The Social Democrats and their communist allies, however, won enough seats in Parliament to block all liberal proposals. In Hungary, the Socialists barely managed to hang onto power. They defeated their right-wing opponents mainly by concealing the truth about the state of the economy from the public prior to the elections.

The poor performance of the liberal parties in the elections has been seen as a sign of weakening public support for the free-market. In the case of Slovakia, the *Financial Times* wrote of "a popular backlash against Prime Minister Mikulas Dzurinda's sweeping free-market reforms that turned Slovakia from international pariah into a country championed by foreign investors."[1] In fact, opinion polls showed that most of Dzurinda's reforms were supported by the majority of the population. So, what went wrong?

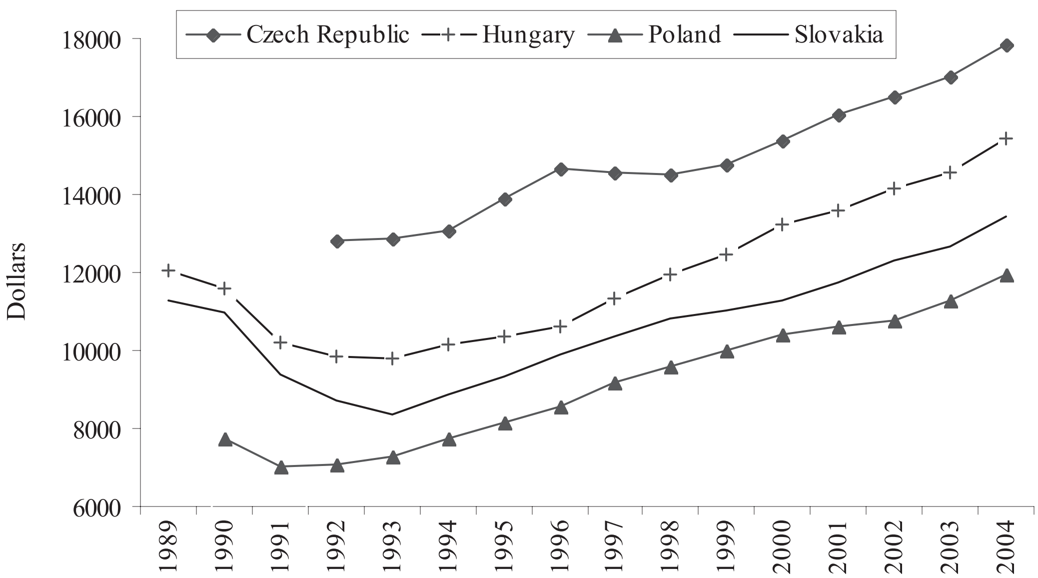
One of the most important, though largely unexplored, reasons for the rise of populist parties in the region is the scourge of corruption. Despite a dramatic rise in the region's economic freedom over the past 17 years, Central European economies remain more heavily regulated than their Western counterparts. Central European governments continue to spend, channel, and redistribute a huge percentage of each country's gross domestic product. The allocation of government contracts is seldom truly competitive. The process lacks transparency, the bidding rules are often subjected to the whims of capricious public officials, and the private sector is often forced to resort to bribing those officials. Thus, licensing and public procurement have facilitated the creation of a whole class of politicians, former politicians, and people with political connections who have made their fortunes in a dishonest way.

In a region where government transparency and accountability are relatively underdeveloped, the outraged public has exacted punishment on the ruling class by withdrawing its support from the established political parties and increasing its support for the populists, who skillfully tapped into the feeling of disenchantment with the transition process. The rise of the populists and the postponement of further economic reform will preserve the important role that the state plays in the economy. That is regrettable. The size and the scope of the state in Central Europe have to be reduced in order to lessen the problem of corruption. Ironically, the postponement of further liberalization measures and the concomitant failure to address the underlying cause of corruption in the region could undermine Central Europe's new rulers and pave the way for a liberal renewal.

## The Central European Success Story

The end of communism in Central Europe brought economic reforms that included the elimination of thousands of restrictions, the liberalization of prices and foreign trade, and the privatization of most state enterprises. It also brought increased freedom for domestic and foreign businesses to enter the market.

**Figure 1**
**Growth of GDP per Capita Adjusted for Inflation and PPP (1989–2004)**




Source: "World Development Indicators Online," World Bank, June 25, 2006, http://publications.worldbank.org/WDI.

At the end of the communist period, economic freedom in Czechoslovakia and Hungary was virtually nonexistent. In Poland, farmers enjoyed some very limited freedoms, but the economy as a whole was subjected to the same central planning as the rest of the Soviet bloc. By 2004, the Fraser Institute's *Economic Freedom of the World: 2006 Annual Report* shows, Hungary was Central Europe's freest economy and ranked 20th out of the 130 countries surveyed. Hungary was followed by the Czech Republic and Slovakia, both in 45th place, and Poland in 53rd place.[2]

Initially, Central Europe experienced economic contraction, as many of the inefficient and heavily subsidized firms were forced to shut down. By the mid-1990s, however, Central Europe was growing again. Between 1995 and 2004, GDP per capita[3] rose by 28 percent in the Czech Republic, by 49 percent in Hungary, by 46 percent in Poland and by 44 percent in Slovakia (see Figure 1).[4]

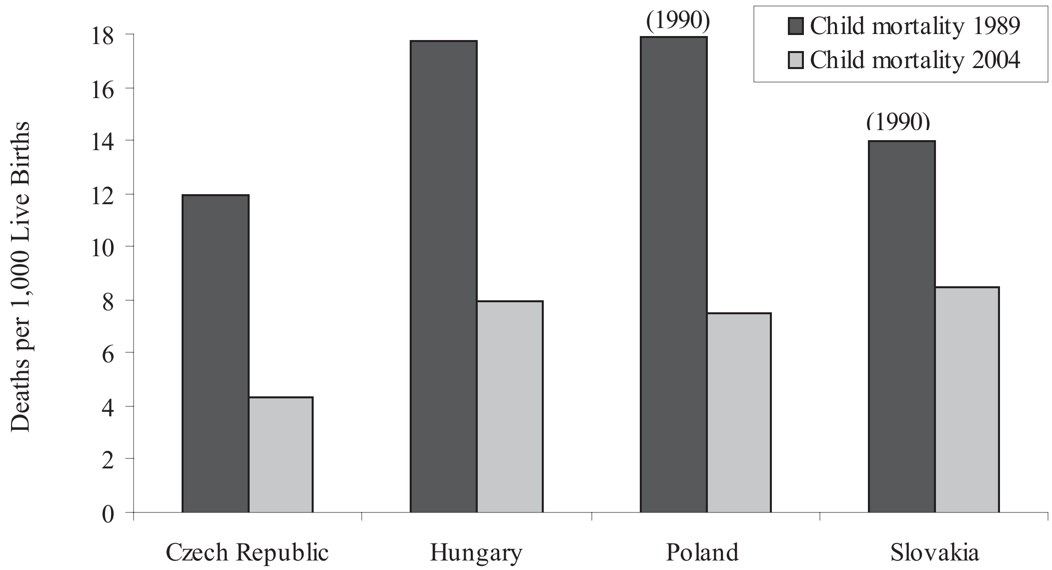
The net inflows of foreign direct investment[5] to the region substantially increased.[6] At their highest point, net FDI inflows to the Czech Republic amounted to 11.52 percent of GDP (2002). In Hungary they amounted to 10.75 percent (1995), in Poland to 5.60 percent (2000), and in Slovakia to 16.89 percent (2002).[7] Rising capital inflows were accompanied by growing productivity and low inflation, which fell from double digits (triple digits in Poland) in the 1990s to between 2 and 8 percent in 2004.[8]

The post-communist era also saw improvements in the region's human development indicators (see Figures 2–4). The child mortality rate fell,[9] and the number of physicians rose.[10] The life expectancy increased.[11] The same was true for health expenditure as a percentage of GDP.[12]

Education spending as a percentage of GDP rose in two out of four Central European countries.[13] The region as a whole has maintained its historically high record of gross school enrollment.[14] In fact, between 1991 and 2003, the gross primary, secondary, and tertiary school enrollment ratio increased throughout Central Europe.[15] The above statistics are especially important, considering the common misper-

**One of the most important, though largely unexplored, reasons for the rise of populist parties in the region is the scourge of corruption.**

**Figure 2**
**Decline in Mortality Rate for Children under Five Years of Age per 1,000 Live Births (1989–2004)**

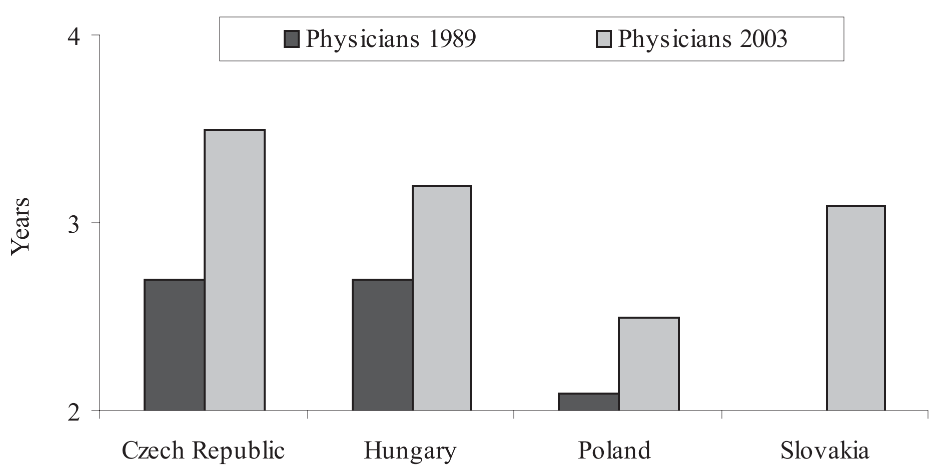



Source: "World Development Indicators Online," World Bank, June 25, 2006, http://publications.worldbank.org/WDI.

ception that education and healthcare in Central Europe are worse today than they were prior to the fall of the Berlin Wall.

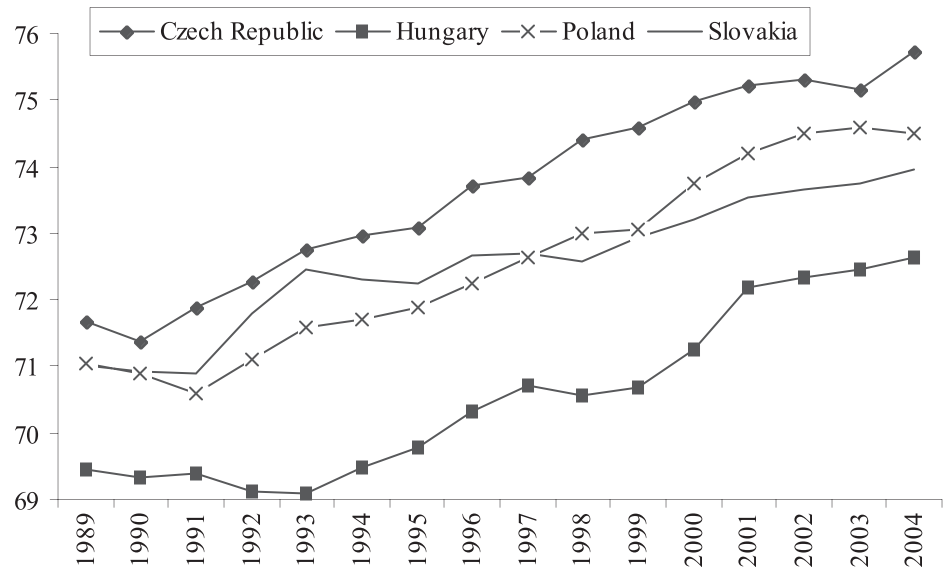
The region has experienced a number of important material gains as well. For example, car ownership increased[16] and the total network of roads expanded.[17] The number of fixed-line and mobile phone subscribers also increased,[18] as did the number of Central Europeans connected to the Internet.[19] With

**Figure 3**
**Increase in the Number of Physicians per 1,000 People (1989–2003)**




Source: "World Development Indicators Online," World Bank, June 25, 2006, http://publications.worldbank.org/WDI.

**Figure 4**
**Increase in Life Expectancy at the Time of Birth (1989–2004)**




Source: "World Development Indicators Online," World Bank, June 25, 2006, http://publications.worldbank.org/WDI.

the exception of Poland, military expenditure as a percentage of GDP declined throughout the region.[20]

Despite post-communist advances, many people in Central Europe continue to be unhappy with the progress that the region has made so far. In 2005, a poll conducted by the European Foundation for the Improvement of Living and Working Conditions found that 58 percent of Slovaks, 40 percent of Hungarians, 38 percent of Poles, and 34 percent of Czechs felt pessimistic about their lives.[21] That is a damning statistic, though it should be noted that Europeans in general tend to be more pessimistic than, for example, Americans. As a Harris Poll found in July 2005, "Fully 58 percent of Americans are very satisfied with their lives compared to the 15-country European average of 31 percent. Fifty-six percent of Americans think that their lives have improved in the last five years compared to 45 percent of Europeans. Furthermore, 65 percent of Americans expect their personal situation will improve in the next five years compared to only 44 percent of Europeans."[22]

## The Rise of Populists and the Weakness of Liberals

The populists in Central Europe have tapped into that feeling of dissatisfaction. The Slovaks, for example, have elected Robert Fico, a self-declared socialist who fumes against multinational corporations and financial interests, and promises a variety of taxes and regulations to bring them to heel. After his election win, Fico formed a coalition government with the disgraced former prime minister Vladimir Meciar and Jan Slota's Slovak Nationalists, who adhere to socialism mixed with racism and xenophobia. The words and actions of the members of the Slovak triumvirate speak for themselves. Meciar stands accused of ordering the murder of a journalist and the kidnapping of a son of a former president. Yet Meciar cannot be prosecuted because the above crimes are subject to an amnesty granted by, of all people, Meciar himself in 1998. Slota, a racist xenophobe, has raged against "mongoloid" Hungarians and "hideous" Gypsies. He has

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even called on the Slovak army to "flatten Budapest."[23] No wonder, then, that in an act of unprecedented decisiveness, the socialist members of the European Parliament expelled Fico's party from their ranks a mere 24 hours after the new Slovak governing coalition was announced.

In Poland, the Law and Justice Party won the parliamentary election as well as the presidency. President Lech Kaczynski appointed his identical twin brother, Jaroslaw, as prime minister. That makes Poland the only country in the world where the top two spots in the government are occupied by two genetically identical individuals. The economically dirigiste and socially conservative Law and Justice Party formed a coalition government with Andrzej Lepper's Self-Defense Party and Roman Giertych's League of Polish Families.[24] The economic program of the Self-Defense Party is based on opposition to the European Union and increased financial support for Polish farmers. The program of the League of Polish Families emphasizes the Catholic doctrine of social justice and, consequently, greater redistribution of wealth. All three parties adhere to some degree of isolationism, xenophobia, and homophobia. Like their Slovak counterparts, the Polish leaders have engaged in inflammatory and disturbing rhetoric. Lepper, for example, has made numerous anti-Semitic remarks, praised Hitler's employment policies, and accused gays of spreading disease.[25]

Although the situation in Slovakia and Poland is serious, in the Czech Republic it is almost comical. In July 2006 the Czechs delivered an electoral verdict that split the powerful Lower House of Parliament right down the middle. The market-liberal Civic Democratic Party of Mirek Topolanek won the election but cannot form a new government, because even with the support of its coalition partners, the Christian Democrats and the Green Party, it has only 100 out of 200 seats. The socialist Social Democrats and the communists have the other 100 seats. And so, four months after the election, the political situation in the Czech Republic remains unstable. Partly as a result of the economic reforms that the Czech Republic underwent in the 1990s and partly as a result of the fast-growing global economy, the Social Democrats have presided over solid economic performance. Still, toward the end of their last term in office they increasingly relied on the support of the Communist Party, which led to renationalization of the health sector and substantial tightening of the labor code. The latter is particularly damaging given the country's 8 percent unemployment rate.[26] The strength of the Social Democrats and their Communist allies in the new Parliament will likely stifle future economic reforms, including the flat tax proposal that formed the core of the Civic Democrats' election platform. It is increasingly likely that the political stalemate in the Czech Republic will have to be resolved through early election.

In Hungary, which also held an election this year, the liberals won a mere 6.5 percent of the vote. They formed a coalition with the Socialists, who won the election by lying to the electorate about the sorry state of the economy.[27] It remains to be seen how long the government will survive and how much of an impact the liberals will have on the government's economic policy. With the budget deficit predicted to top 10 percent of GDP in 2006, for example, the Socialists have produced a roadmap out of the fiscal crisis that includes substantial tax increases that may hobble economic growth. Not surprisingly, the *Financial Times* warned that Hungary risks becoming "the sick man of Europe."[28] The main opposition party, Fidesz, started off as a market-liberal party in the early 1990s, but has turned increasingly socially conservative and economically dirigiste. The party's deputy leader Istvan Mikola, for example, has recently toyed with the idea of a state-sponsored "light" corporal punishment for unruly children.[29] Fidesz's boss, Viktor Orban, made promises concerning free healthcare, lower energy prices, and the renationalization of some privatized state property. He ranted against international capital and called for greater protection of domestic producers. Though Fidesz has been kept out of power, its support is at an all-time high, having risen from around 9 percent in 1990 to 42 percent in 2006.

With the notable exception of the Czech Republic, the politicians in Central Europe have managed to combine right-wing attitudes on public and private morality with left-wing attitudes on economics. Calls for price regulations, increased taxation of the wealthy, and renationalization of privatized property have been heard throughout the region. The same goes for calls for a return to traditional family values, religion, and suppression of sexual autonomy. This combination of socialist and conservative attitudes does not fit the usual left-right divide, making accurate reporting on Central European politics complicated. The European press, for example, keeps on referring to the Slovak Nationalists as a "far-right" party, even though their economic program is as left-wing as that of the Slovak Communist Party.[30] A more helpful way to analyze the political scene in the region is by contrasting liberal with illiberal political forces, where the former generally tend to favor extension of individual autonomy in economic and social spheres, and the latter object to both.

Opponents of liberalism are not merely reactionary, of course. They offer an alternative program based on active government intervention with the stated goal of making people's lives better. The defining feature of what some European analysts call "populism" is the refusal to consider trade-offs. Some of the standard populist promises include substantial increases in welfare spending and income redistribution, tightening of the labor code, and price controls on popular goods and services, while at the same time committing the government to budget discipline, sustained high rates of economic growth, and the reduction of unemployment. Whether this new political phenomenon in Central Europe is called illiberalism or populism, the recent election outcomes clearly indicate that liberal parties are no longer as potent a political force as they used to be.

## Is Liberalism to Blame?

No doubt one of the reasons for the rise of populism in Central Europe is the dramatic social change that the region is undergoing. Despite their official commitment to "social progressivism," the Communists, who dominated Central Europe for four decades, were, in fact, socially ultraconservative. Pornography and gender equality, not to mention homosexuality, were either prohibited or discouraged. The groundswell of expressions of personal freedoms that followed the collapse of the Berlin Wall in 1989 took the stultified socialist societies of Central Europe by complete surprise. Permissive attitudes to individual freedoms, especially toward expressions of sexual autonomy, which took decades to evolve in the West, were suddenly expected in the East as well. The EU made socially liberal legislation a prerequisite for EU membership.

As long as the EU membership was being negotiated, the extremist voices were silenced or dismissed through cooperation of the political elites and the media in the region. Now that the Central European countries are part of the EU, the populists have simply reclaimed their natural political space. That partly explains the electoral success of socially conservative forces in Slovakia and Poland, as well as the relative strength of Fidesz in Hungary. Only the Czechs have so far evaded the lure of moral populism. That is in part because the Czechs have the longest and most deeply rooted liberal tradition in the region. Moreover, as a survey by the EU Commission's pollster Eurobarometer found in 2005, only 19 percent of Czechs believe in God. With 16 percent, Estonia is the only country in the EU with a lower level of religiosity. In contrast, 44 percent of Hungarians, 61 percent of Slovaks and 80 percent of Poles said they believe in God.[31]

According to the conventional wisdom, the other important reason for the rise of populism in Central Europe is the free market or, to be more precise, its alleged excesses. In Poland, for example, Leszek Balcerowicz, the head of the National Bank of Poland and the former

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**Table 1**
**Support for the Free Market and Limited Government (percentage of population)**

| | Czech Republic | | Hungary | | Poland | | Slovakia | |
|---|---|---|---|---|---|---|---|---|
| | Yes | No | Yes | No | Yes | No | Yes | No |
| State intervenes too much | 59 | 33 | 65 | 32 | 59 | 35 | 73 | 23 |
| Competition boosts growth | 63 | 15 | 47 | 39 | 63 | 22 | 65 | 20 |
| Growth should be a priority | 42 | 35 | 44 | 32 | 37 | 27 | 38 | 37 |

Source: Eurobarometer, *Identities and Values in the Acceding and Candidate Countries: Full Report* (Brussels: European Commission, 2005).

finance minister who presided over the initial wave of liberalization of the Polish economy in the early 1990s, is the focal point of the government's fury.[32] When asked why he named his party Self-Defense, Andrzej Lepper responded that Poland needed defending from people like Balcerowicz.

> He represents all the evil. It is not true that Poland has no money. There is money in the banks and the reserves are deposited in banks in the West. . . . It is untenable that Poland's central bank be a state within a state . . . . Both right and the left kept him on, because they're really one band.[33]

Similarly, Viktor Orban has declared his opposition to "wild capitalism" and Robert Fico has called for "capitalism with a human face."[34]

**Central Europeans continue to accept the superiority of the free market over socialism.**

Yet there is evidence that, whatever their misgivings about the transition process, Central Europeans continue to accept the superiority of the free market over socialism. For example, at the end of 2003, the Gallup Organization, in cooperation with Eurobarometer, conducted a comprehensive survey of public opinion in the EU accession countries. They polled over 12,000 people about their "identities and values." The respondents were asked to agree or disagree with the following statements, "the state intervenes too much in our lives," "free competition is the best guarantee for economic prosperity," and "economic growth must be a priority [for our country], even if it affects the environment." All three statements had the support of the majority (or at least a plurality) of the respondents in all four countries (see Table 1).[35]

### It's the Corruption, Stupid

More recently, an opinion poll by the Institute for Public Questions in Bratislava found public support for many of the reforms that Mikulas Dzurinda, the liberal Slovak prime minister, implemented in Slovakia. The flat tax reform, for example, was broadly supported by 58 percent of the Slovak citizens a mere two months before the 2006 parliamentary election. Only 31 percent of the respondents wanted to abolish it. The partial privatization of the pension system enjoyed the broad support of 53 percent of the public, with 37 percent opposed. The reform of the welfare system had broad support of 47 percent of the public, with 46 percent opposed. Conversely, only 25 percent of the respondents supported the reforms of the healthcare system that included, among other things, the introduction of small payments for hospital visits, while 72 percent were opposed.[36]

My personal experience when visiting Slovakia at the time of the 2006 parliamentary election also suggests that economic reforms were not the primary reason for the rise of the populists. Without exception, every person I spoke to complained about one thing more than anything else—widespread corruption among public officials.

True, the kind of grand larceny that took place in Slovakia under Meciar is a thing of the past. Government ministers no longer steal on as grand a scale as they did in the 1990s. Back then, Meciar simply distributed state assets to his friends and political supporters with reckless abandon. For instance, a steelmaking giant in Eastern Slovakia (VSZ) was "sold" to one of Meciar's cronies, Alexander Rezes. Prior to the sale, Rezes received a heavily discounted loan from Meciar's government—a loan he used to buy the company. Rezes then dutifully channeled some of the profit back to Meciar, who used much of it for political campaigning.[37]

Today, individual acts of corruption in Central Europe have become smaller but more sophisticated and more widespread. They tend to coalesce around government procurement.[38] Government officials go through the motions of competitive bidding but then select winners based on criteria other than quality and price. Often, they do so in order to benefit domestic producers or firms owned by friends and families.

Consider the following example. In 2006, the Czech Parliament decided to buy 220 laptop computers. Four companies competed for a contract that was, in the end, awarded to a Czech firm called Autocont. Dell, a U.S. company, offered the best deal. Dell met all the technical specifications and offered to pay the highest late-delivery fee. The company also offered the lowest price of $160,000. In contrast, Autocont's price tag was more than twice as high. What made the difference between the losing and winning bids? On the Dell laptops, wireless connection to the Internet was to be activated with a button, Autocont's with a lever. The public official in charge of the deal argued that pulling the lever was more difficult than pressing the button, which would prevent the MPs from accidentally accessing the Internet and inadvertently disseminating sensitive information. The bids were evaluated on a point scale that was suspiciously skewed in favor of Autocont. For example, the higher processing speed of Dell's computers was worth 1 point, whereas Autocont's lever was worth 15 points.[39]

Sometimes, government officials award contracts to companies that offer financial or nonmonetary "kickbacks." Subsidies, highway building, IT upgrades, and unnecessary consulting assignments at government ministries are particularly popular sources of personal riches for government officials, their families, and their friends, many of whom use their ill-gotten wealth to buy expensive houses and cars. The combination of ostentatious spending that far exceeds the salaries of the officials in question, freedom of the press, and increasingly sophisticated investigative journalists who expose such scandals can be explosive.

Take Ludovit Kanik, who was minister of employment in the market-friendly government of Mikulas Dzurinda (2002–06). Among Kanik's many duties was the streamlining of the Slovak welfare state. In 2005, however, he resigned after a newspaper reported that his brother and business partner was about to benefit from a large state subsidy.[40] Or take Pavol Rusko, Dzurinda's minister of economics (2003–05) and leader of a small liberal party called ANO. Rusko issued personal promissory notes worth $3.4 million. He said that he had paid them off, but refused to explain how he managed to do so, considering that his monthly salary amounted to $3,250. He resigned.[41]

Similarly, the Social Democrat prime minister of the Czech Republic, Stanislav Gross (2004–05), resigned after being unable to explain how he came to possess a luxury apartment the price of which was clearly far in excess of his official income.[42] Another socialist prime minister, Milos Zeman (1998–2002), fired his minister of finance when the police began investigating the latter's shady financial dealings. Ivo Svoboda, it turned out, borrowed $273,000 on behalf of a company called Liberta, then used the loan to repay the debt of his own firm, Omnia. Svoboda was charged with fraud and sentenced to five years in jail.[43]

Peter Medgyessy, the socialist prime minister of Hungary (2002–04), came under investigation for corruption as well. The prosecutor alleged that Medgyessy pressured the Budapest city government to agree to the 1998 sale of the Gresham Palace, one of the city's landmarks, to a property developer called Gresco. Even though Medgyessy's consulting firm

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received a $143,000 "consultancy fee" from Gresco, the police dropped the charges.[44]

Viktor Orban's Fidesz-dominated government of Hungary (1998–2002) had its share of corruption scandals as well. In 2001, Zoltan Szekely, who served as chairman of the Public Procurement Committee in the Hungarian Parliament, came under investigation for accepting a bag containing $107,000 from a businessman who previously applied for a government contract. Similarly, Attila Varhegyi, chairman of Fidesz's Executive Board, state secretary at the Ministry of National Cultural Heritage, and mayor of Szolnok, came under investigation for bribery of a senior official and misappropriation of funds. Allegedly, Varhegyi tried to cover up fictitious invoices related to his political campaign and made money out of a real estate sale, the terms of which were disadvantageous to the municipality.[45]

**In Central Europe, the state remains the most important economic actor.**

In 2001, the police arrested Zbigniew Farmus, who served as an assistant to the Polish deputy minister of defense Romuald Szeremietiew, for soliciting bribes from bidders in an arms deal intended to supply the Polish air force with new fighter aircraft. The estimated value of the contract in question was between $2.5 and $3.5 billion. The newspapers alleged that Szeremietiew was involved in the scam. Jerzy Buzek, the center-right Polish prime minister (1997–2001), fired him.[46]

The above examples aside, evidence suggests that public perception of corruption among public officials is widespread throughout Central Europe. The Corruption Perception Index, which is published by the German nongovernmental organization Transparency International, confirms that, some 17 years after the end of communist rule, corruption remains a serious problem in the region. The CPI is measured on a scale from 0 to 10.[47] The higher the number, the lower the corruption. Between 1996 and 2005, the Czech CPI went from 5.4 to 4.3 and the Polish from 5.6 to 3.4. Over the same period, it went from 4.9 to 5 in Hungary. The Slovak CPI improved from 3.9 in 1998 to 4.3 in 2005. (That slight improvement did not save Dzurinda's government from punishment in the polls.)[48]

## Private Sector and Big Government

In Central Europe, the state remains the most important economic actor. According to the Eurostat, the EU's statistical arm, between 1995 and 2005, government spending as a percentage of GDP fell from 54.38 percent to 44.08 percent in the Czech Republic. It fell from 47.72 percent to 42.77 percent in Poland and from 54.12 percent to 36.83 percent in Slovakia. In Hungary, it rose from 49.92 percent in 1999 (the first year for which the data is available) to 50.61 percent in 2005.[49]

In fact, much of the reduction of government spending in Slovakia can be attributed to changes in the methodology for measuring Slovak spending. As Martin Chren of the Hayek Foundation in Bratislava explains:

> The Slovak budget was not "consolidated" prior to 2001. That meant that when the Minister of Finance transferred 10 billion Slovak crowns to the Minister of Economics in order to pay for farming subsidies, the money appeared twice in government accounts. First, it appeared as an expenditure of the finance ministry and second as an expenditure of the economics ministry. That means that government statistics before and after 2000 are not comparable.

Still, Chren admits, there has been a real reduction in state spending of between 2 percent and 4 percent of GDP between the end of the Meciar era in 1998 and his return in 2006.[50]

Considering the size of the public sector under communism, it is not surprising that the state played a major role in the economy at the start of the transition process. In 1989, the European Bank for Reconstruction and Development estimates, the private sector in the Czech Republic, Slovakia, and Hungary generated 5 percent of GDP in each of those countries and 30 percent in Poland. By 2005, the private sector generated 80 percent of GDP in the Czech Republic, Slovakia, and Hungary and 75 percent in Poland.[51] Yet Central European governments continue to spend 44 percent of the region's GDP.

Businessmen in the region have reacted to the continuously high government spending in a rational and predictable way. They started to finance political parties in order to secure the future flow of public contracts. Major financial groups, like ING in the Czech Republic and the Penta group in Slovakia, bankroll the political establishment, which includes all mainstream political parties on both center-right and center-left. Private sector donations to political parties are not unique to Central Europe, of course. In the United States, for example, both major parties receive financial donations from people associated with companies as well as trade unions. Yet the influence of business on political decisionmaking has a more corrupting effect on the democratic process in Central Europe. That is because government transparency, parliamentary oversight, judicial independence and the strength of civil society—all of which provide a useful (though imperfect) check on the power of special interests in the United States—are still relatively underdeveloped.

Private sector funding of mainstream political parties provides for a degree of predictability and stability. Both the business and the political actors know the "rules of the game." They have an implicit, and sometimes explicit, understanding that funding of political parties will be rewarded by government contracts and vice versa. The trouble comes when a particular group of businessmen feels left out. Some of the past political crises in the region have resulted from decisions by groups of disgruntled businessmen to throw their financial support behind political "upstarts." In such cases, the clash between established special interests and usurpers contributed to political destabilization and the rise of populist parties. The rise of Smer, the party of the Slovak prime minister Robert Fico, can be in part attributed to massive financial support that the party was given by a number of wealthy Slovak businessmen, such as Juraj Siroky and Vladimir Poor, who felt that they were kept from getting their "fair" share of public contracts. As the *Slovak Spectator* reported:

> While the Smer party has consistently denied any connection to either man, both the names on Smer's candidates list for the June 17 elections, as well as among the party's nominees for ministerial posts, contain people with business ties to Poor and Siroky. For starters, the new Telecom and Transport Minister, Lubomir Vazny, served as a board member and supervisory board chairman of the Biotika Slovenska Lupca pharma firm from 1997 to 2003, where Vladimir Poor also had a board role. Vazny also served on the board of Nafta with Juraj Siroky. The Telecom and Transport Ministry is a key player in the economy, such as in regulating the telecom market and deciding how highway infrastructure funding gets divided up. Economy Minister Lubomir Jahnatek, meanwhile, was the director of plastics maker Plastika Nitra for over a decade and on its board of directors from 1992 to 2005. The firm is currently controlled by Siroky, who has been on its board since 1996. . . . The Economy Ministry also wields enormous economic clout, governing the issue of business permits and licenses for everything from shoe imports to arms exports, and administering the state's energy assets.

The *Slovak Spectator* also found extensive previous business connections between Poor and Miroslav Jurena, the minister of agriculture.[52]

In Hungary, the socialist-liberal coalition government under the leadership of Gyula Horn (1994–98) got enmeshed in a party-funding scandal as well. In 1996, the state privatization and holding company APV hired a lawyer named Marta Tocsik to nego-

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**Enterprising mayors and city councilors have turned regional politics into a gold mine.**

tiate financial compensation that APV owed to the local municipalities for privatizing real estate that was formerly in their ownership. A public scandal broke out over the fee paid to Tocsik, 50 percent of which she transferred to companies owned by two politicians—Laszlo Boldvai, a treasurer of the governing Socialists, and Gyorgy Budai, a businessman close to the liberals. Tocsik transferred $1.2 million to Boldvai and $613,000 to firms controlled by Budai. Those financial transfers raised suspicion that Tocsik's contract was part of a deal to clandestinely finance the two coalition partners. In 2002, Tocsik received a 4-year prison sentence. Similarly, Csaba Schlecht, the former treasurer of Viktor Orban's Fidesz, sold 17 companies to two foreigners who later claimed total ignorance of the sales. The proceeds from the sales were used to channel money that fueled Fidesz's reelection campaign.[53]

One of the first major corruption scandals in the Czech Republic after the collapse of communism involved the funding of the governing Civic Democratic Party (ODS). In 1995, a businessman named Milan Srejbr donated $400,000 to the ODS. As Srejbr was about to "privatize" a steel mill, someone in the ODS decided to cover up the donation by attributing it to a number of fake sponsors. Alas, some of the fake sponsors had been dead for some time. The prosecutor charged Libor Novak, the deputy chairman of the ODS, with tax fraud. Under Czech law, donations to political parties are tax free up to a certain amount. Srejbr's donation would have been liable for taxation, but when divided up between multiple sponsors it was not. The court found that although a crime had been committed, it could not be attributed to anyone in particular, and Novak walked free. As a result of that scandal, however, the ODS split and Vaclav Klaus's liberal government collapsed.[54]

Government spending is not the only problem, of course. As the following example shows, regulation remains an important source of corruption. In the summer of 2002, the newspapers reported, Lew Rywin, who produced Roman Polanski's Oscar-winning movie *The Pianist*, solicited a bribe of $17.5 million from a former dissident and editor of a Polish daily newspaper *Gazeta Wyborcza*, Adam Michnik. In exchange for the money, Rywin promised to get the socialist government to amend the media legislation so that Gazeta's parent company, Agora, could enter the protected TV market dominated by the Polish state broadcaster. Rywin claimed to speak for the ruling Alliance of the Democratic Left. The media also reported that Prime Minister Leszek Miller (2001–04), who was a friend of Rywin, and Aleksander Kwasniewski, the ex-communist president of Poland (1995–2005), were aware of the shakedown. Miller resigned and the Polish left was obliterated in the 2005 election, which brought the Kaczynski brothers to power.[55]

As can be seen, state intervention in the economy remains a serious problem in Central Europe. As long as the state remains large in size and scope, there will be plenty of opportunities for corruption. In order to minimize corruption, therefore, the role of the state in the economy must be reduced.

## Communist Involvement in Business and Politics

One of the disappointments of the transition process in Central Europe is the continued involvement of former communists and former members of the communist secret police in the top echelons of politics. The persistence of communist involvement in politics is not surprising, considering that no Central European country, with the exception of the Czech Republic in the 1990s, excluded communists from public office. (The new Polish government, for all its shortcomings, is stridently anti-communist and may succeed in purging the former communists from public life.)

Thus, in Slovakia, 11 out of 16 members of Fico's government, including Fico himself, were members of the Slovak Communist Party before communism ended in 1989.[56]

Sometimes, the politicians in the region try to hide their previous political associations. When that happens, crises ensue. In 2002, for example, a Hungarian newspaper called *Magyar Nemzet* revealed that Prime Minister Peter Medgyessy worked at the Ministry of the Interior prior to the end of communism in 1989. Medgyessy argued that he worked there to protect Hungary from interference by the Soviet KGB, but few believed him. Throughout Central Europe, ministries of the interior were crucial to communist control over the populace. Consequently, their employees tended to be loyal communists, many of whom were directly approved by Moscow. Medgyessy resigned.[57]

In 1996, Gromoslaw Czempinski, the Polish minister of internal affairs, shocked the nation by revealing the identity of a KGB agent with the code name "Olin." Czempinski alleged that Olin was none other than the socialist prime minister Jozef Oleksy. Oleksy resigned.[58] Similarly, Janusz Tomaszewski, the Polish deputy prime minister, was dismissed from Jerzy Buzek's center-right government (1997–2001) after being accused of collaborating with the communist secret police.[59]

Former communists continue to have a large presence in Central Europe's economic life. A vast majority of the bureaucrats who ran the centrally planned economies in the region before 1989, including managers of state enterprises, directors of banks, and import-export specialists, were members of the communist parties or agents of the secret police. Many knew each other and were friends. They were often indebted to one another through past favoritism, which enabled the former communists to get around the inconveniences of daily life under communism, such as, for example, material scarcity. By the time communism fell, the "Red Mafia" was well prepared to take advantage of the changing times ahead. Consequently, the people with access to pertinent financial information that included the relative profitability of various state enterprises were the ex-communist managers. The managers then turned to the ex-communist bankers, who provided discounted loans needed for privatization of the most lucrative state enterprises. Former members of the communist secret police played an important role in this asset grab by using phone tapping, surveillance, and—occasionally—assassination, to undermine or to eliminate potential competitors.

Take Vladimir Lexa, one of Slovakia's rich movers and shakers. He and his son, Ivan Lexa, do business together. Fabulously wealthy, they were among Slovakia's first billionaires. In a recent interview Vladimir Lexa said, "If you combine common sense with hard work, detachment, understanding and seriousness, you have to succeed." A cursory look at their background suggests that much more than "hard work" and "detachment" were behind their amassed fortune. Ivan Lexa, for example, used to head the Slovak Intelligence Service. He was one of the men pardoned by Meciar in 1998. His father, Vladimir, was the undersecretary of the Slovak Communist Party prior to 1989. In the early 1990s, Vladimir Lexa "privatized" a government-owned mill. Though the mill was valued at about $34 million, Lexa purchased it for $1 million. He then made a fortune by processing grain that he bought from the state for $120 per ton though the market price at the time was over $166 per ton.[60]

## Corruption Undermines Democracy and Capitalism

Corruption in Central Europe involves more than just national politicians. After the collapse of the Berlin Wall, communist centralization was gradually replaced with devolution, partly as a result of pressure from Brussels. The EU is increasingly organized along subnational lines, because of the prevailing opinion that the centralized nation-state was responsible for the horrors of World War II. But devolution was also driven by the desire of national politicians to bring decisionmaking closer to the people and give citizens more control over the quality of public services they receive. Regrettably, the strength of family and business ties, and the virtual nonexistence of local civil society

**The lack of the rule of law is now recognized as a major barrier to a speedy and successful economic transition.**

**Future reformers should focus on tackling the underlying causes of corruption, such as the size and scope of the state.**

groups in Central Europe, allowed corruption to metastasize at the local level, where enterprising mayors and city councilors have turned regional politics into a gold mine.

Building permits are an especially attractive source of extra income. Local businessmen who want to build a factory or a warehouse, for example, have to petition the city officials for a building permit. As a consequence, building sites are much more expensive than land designated for farming. The change in designation is in the hands of city councilors. In such circumstances, entrepreneurs sometime intervene in the political process by "buying" the mayor or the majority of the city councilors. That way, they may buy agricultural land and have it re-designated for building purposes.

Consider the following example. Under the terms of the 2005 investment deal between Slovakia and KIA, the South Korean car maker, the Slovak government agreed to a large financial subsidy that included spending $17.6 million on housing for the South Korean factory managers. Seeing an interesting investment opportunity, a Slovak businessman named Vladimir Duris bought land in the village of Krasnany, next to the KIA factory building site. The ostensible goal of the investment was agro-tourism—a new form of business that involves tourists visiting eco-farms, eating homegrown products, and learning about the countryside. Since agro-tourism does not qualify as real estate development, Duris was able to purchase the land for $5 per square meter. (In contrast, land for real-estate development in the Krasnany area sells for between $12 and $17.) In doing so, he received assistance from the mayor of Krasnany, Jozef Trnka, who helped Duris to convince the villagers of the buyout's financial advantages. After the purchase, Trnka managed to get the land designation changed. That change enabled Duris to use the acquired land to build a housing compound for the South Koreans and pocket the difference between the value of the land before and after the change in designation.

Another scandal concerns the Polish municipality of Starachowice, where the local political and business elites were tightly linked by family and business ties. Local politicians, it turned out, were protected by some members of the Polish government, including Zbigniew Sobotka, the deputy minister of internal affairs in the socialist governments of Jozef Oleksy (1995–1996) and Wlodzimierz Cimoszewicz (1996–1997), who warned them about pending police actions.[61]

The widespread nature of corruption in Central Europe makes "clean" government immensely difficult to achieve. For example, Slovak voters perceived Dzurinda's government as corrupt, but the new Slovak government is likely to be even more so. After all, Meciar is a part of it. Similarly, in the Czech Republic, the fall of the liberal government in 1997 did not end political corruption. If anything, corruption under the Social Democrats, the CPI for the Czech Republic suggests, increased.

Kicking out the incumbent is the most readily available punishment the electorate can exercise over its corrupt leadership. Then the game of political musical chairs begins anew. That is the main reason why only two prime ministers have been returned to power in the region since the collapse of the Berlin Wall. One was Slovakia's Dzurinda, who was reelected in 2002, partly because Meciar's excesses were so large and still fresh in people's memory, and partly because Dzurinda presided over a brand new coalition government with little resemblance to the previous one. The other was Hungary's Ferenc Gyurcsany in 2006.

Corruption scandals do not lead to public fury and cynicism toward the democratic process alone. They also undermine the values that are beneficial to the nation as a whole. In particular, those values include honesty, trust, thrift, self-reliance and a faith in the benefits of hard work. All of those attitudes, it should be mentioned, are very important for the smooth functioning of the free market. It is tragic that many of the ostensibly liberal politicians in the region have not lived up to the principles they espoused. They have helped to discredit liberal parties through their actions in a way that was similar to the corrupt practices of nominally liberal politicians in Latin America in the 1990s.

## Transition Was Imperfect, but Necessary

Corruption has long been one of the region's characteristics. As a rule of thumb, corruption increases and government transparency declines the further east and south in Europe one travels. Nineteenth century commentators, for example, saw the quality of government in the Austro-Hungarian Empire as inferior to that of Germany, and Russia's as thoroughly hopeless. Unfortunately, four decades of communism have exacerbated that problem. The famous Czech saying, "If you don't steal from the state, you steal from your family," existed for a reason.[62]

The lack of the rule of law, which facilitates corruption, is now recognized as a major barrier to a speedy and successful economic transition. With the benefit of hindsight, some economists have argued that liberalization should have been slowed down, because of institutional weaknesses in post-communist countries. As the Nobel Prize–winning economist Joseph Stiglitz wrote in 1999:

> Privatization is no great achievement—it can occur whenever one wants—if only by giving away property to one's friends. Achieving a private, competitive market economy, on the other hand, is a great achievement, but this requires an institutional framework, a set of credible and enforced laws and regulations.[63]

The trouble is that there is no simple way to "promote" the rule of law.[64] As Vaclav Klaus, the economic reformer and now the president of the Czech Republic, has written:

> Calls to postpone the beginning of transformation until the economic institutions and the rule of law were perfect (and they never are) were . . . wrongheaded. We knew that institutions and legislation are endogenous rather than exogenous. We knew, therefore, that they would have to evolve gradually. We recognized that the faster that happened, the better, but we also recognized that institutions and the rule of law cannot be created in the offices of a few reformers.[65]

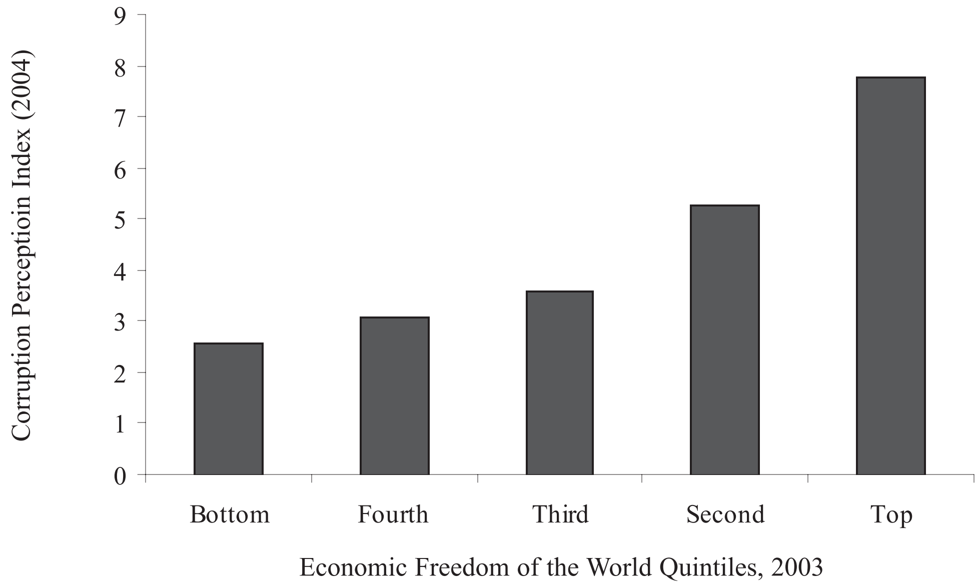
Because there is no easy fix to a weak rule of law, future reformers should focus on tackling the underlying causes of corruption, such as the size and scope of the state. Empirical evidence suggests that corruption and economic freedom are inversely related. For example, the Fraser Institute's *Economic Freedom of the World: 2005 Annual Report* found that "with fewer regulations, taxes, and tariffs, economic freedom reduces the opportunities for corruption on the part of the public officials."[66] Indeed, as Figure 5 shows, countries with the highest degree of economic freedom experienced the lowest levels of corruption, whereas countries with the least economic freedom experienced the highest levels of corruption.

Other researchers have come to similar conclusions. For example, the World Bank's *Doing Business* report found that lighter business regulation and lower levels of corruption were related.[67] Vito Tanzi from the Carnegie Endowment for International Peace found that growth in the size of the public sector provides public officials with more discretion in the allocation of goods and services. That, in turn, increases the likelihood of corruption.[68] Alberto Ades from Goldman Sachs and Rafael Di Tella from the Harvard Business School found that increased competition reduces corruption. Consequently, they found that more open economies are less corrupt.[69] Shang-Jin Wei from the Brookings Institution and Yi Wu from the International Monetary Fund found that countries with capital controls have higher corruption.[70]

Evidence points to a general link between big government and higher rates of corruption, but there are (partial) exceptions to the rule. Sweden, for example, is famous for high government spending and a low level of cor-

**Rigged privatization deals have undermined the values that form the moral underpinning of capitalism, including hard work and entrepreneurship.**

**Figure 5**
**Relationship between Economic Freedom and Corruption Worldwide**




Source: James Gwartney and Robert Lawson, *Economic Freedom of the World: 2005 Annual Report* (Vancouver: Fraser Institute, 2005), p. 26.

**The "big-bang" countries of Central Europe performed significantly better than most of their eastern neighbors who took the gradualist approach to reform.**

ruption. In 2005, the Swedish government spent almost 54 percent of GDP.[71] Also in 2005, Sweden was rated as the 9th least corrupt country in the world.[72] That lack of corruption is partly attributable to the relatively light regulation of the economy, for, as the World Bank found, Sweden is the 14th easiest country to do business in.[73] Also, the Swedes, like citizens of most other developed nations, benefit from a well-entrenched rule of law. The government's activities are subjected to thorough judicial and parliamentary oversight. Moreover, should the usual checks and balances fail, the government can be held to account by a strong and vibrant civil society.

Regrettably, the situation in Central Europe is quite different. Not only do the governments spend a lot of money, but the regulatory burden remains relatively heavy. For example, the 2006 *Doing Business* report found that Slovakia had the most welcoming business environment in Central Europe, coming in at 37 out of 155 countries surveyed. Slovakia was followed by the Czech Republic in 41st place, Hungary in 52nd place and Poland in 54th place.[74] In contrast, most Western European and Anglosphere countries are less regulated.[75] A comparison of the 2005 *Doing Business* Report with the 2005 CPI suggests that light regulation and low levels of corruption are indeed related. For example, 15 out of 20 least-regulated economies were also among the 20 least corrupt countries in the world.[76]

The rule of law, which was undermined by four decades of communism, will need more time to recover. According to the *Economic Freedom of the World: 2006 Annual Report*, most indicators of economic freedom in Central Europe, including the overall size of government, access to sound money, freedom to trade internationally, and regulatory burden, have improved between 1995 and 2004. Unfortunately, the integrity of the legal system and protection of private property rights has declined over the last decade.[77] Moreover, the judicial and parliamentary oversight over politicians in Central Europe lacks effectiveness, and civil society, though stronger than before, remains weak relative to Western countries.

It was under those difficult conditions, therefore, that one of history's most dramatic social experiments—the political and economic transformation from communist repression to democratic capitalism—took place. The challenge was enormous. Moreover, there were no detailed blueprints for the reforms that could guide the region. The reformers knew where they wanted to go but did not know how to get there. Not surprisingly, transformation was not all clear sailing. For example, rigged privatization deals channeled unearned wealth to crooked government officials and their cronies. Today, those who partook in that privatization bonanza continue to enjoy their ill-gotten wealth, which generates much resentment among the populace. Rigged privatization deals have also undermined the values that form the moral underpinning of capitalism, including hard work and entrepreneurship.

Instead of auctioning them off to the highest bidder, Central European governments often "sold" state assets at heavily discounted prices to their political supporters, friends, and families. The forgone revenue could have been used in a variety of ways ranging from tax cuts to paying off the region's debt. Moreover, the early privatization deals proved quite "sticky." Many of the new owners of the privatized enterprises did not try to resell them to more competent entrepreneurs. Instead, they either "tunneled them out" (a term for asset-stripping used in the Czech Republic and Slovakia) or drove them to bankruptcy. Regrettably, the resale of privatized enterprises in Central Europe continues to be delayed by bureaucratic hindrances, which forces the new buyers to resort to bribes.

Does that mean that Central European countries should have waited before dismantling their socialist economies? The answer is an emphatic no. The cost of postponing reforms, in terms of subsidies to inefficient producers and foregone economic growth, would have been immense. Moreover, Oleh Havrylyshyn, an International Monetary Fund economist, shows that on virtually all the relevant criteria ranging from economic growth rates to corruption, the "big-bang" countries of Central Europe performed significantly better than most of their eastern neighbors who took the gradualist approach.[78] His conclusions are overwhelmingly supported by the academic literature.[79]

**The real problem with the transition process in Central Europe is not that it was too fast, but that it was not fast enough.**

## Estonia: An Example Worth Emulating

The success or failure of the transformation process in Central Europe can only be judged in relation to other countries and regions. Central Europe has performed much better than, say, Russia and Ukraine, whose approach to reform was haphazard at best. However, in comparison to Estonia, the most fervent liberalizer in the post-communist world, Central Europe looks much less impressive.

Estonia began to liberalize at the end of 1992. The government eliminated import tariffs and instituted a flat income tax. Corporate taxes on reinvested profits fell to zero. To arrest inflation, the government established a currency board. State enterprises underwent privatization. As was the case with all former communist countries, initially the Estonian economy went into a recession as many inefficient firms folded. By 1995, however, the economy was growing again. Between 1995 and 2004, Estonian GDP per capita rose by 96 percent.[80] That rise was 47 percentage points higher than that of Hungary, the best performing Central European country.[81]

According to the Fraser Institute's *Economic Freedom of the World: 2006 Annual Report*, Estonia was the 12th economically freest country in the world and the freest country in the post-communist world.[82] The smaller role that the state plays in the lives of the Estonian people is reflected in the surveys of Estonian public opinion. For example, only 38 percent of Estonians felt that the state's role in their lives was overbearing. The score in Poland, a

EU membership is likely to contribute to perpetuating the culture of corruption in Central Europe.

country whose citizens felt government interference the least, was 21 percentage points higher. Similarly, 70 percent of Estonians favored free competition. (That was 5 percentage points more than in Slovakia, whose citizens were the keenest supporters of free competition in Central Europe.) That may be because lower state interference in the Estonian economy resulted in economic performance superior to the performance of the economies in Central Europe.[83]

Yet another striking difference between Estonia and Central Europe concerns the measure of people's contentment with their lives. As was shown above, Central Europeans tend to be very pessimistic about their lives. In contrast, only 28 percent of Estonians were found to be pessimistic.[84]

Estonia's Corruption Perception Index has improved from 5.7 in 1998 (the first year for which the data is available) to 6.3 in 2005. In 2005, the Estonian level of corruption was the lowest in the post-communist world. It was also significantly lower than that of the runner up—Hungary—with 5 points out of 10.[85] That finding is consistent with the argument advanced in this paper, which is that the size of government and corruption in the post-communist world tend to be related.

The above contrast between post-communist developments in Central Europe and Estonia suggests that the real problem with the transition process in Central Europe is not that it was too fast, but that it was not fast enough. For example, the level of expenditures of Central European governments some 17 years after the fall of communism continues to astonish. On average, those governments spent about 44 percent of the region's GDP in 2005.[86] In comparison, Estonian government spending was about 36 percent of GDP. Moreover, Estonia's regulatory burden was much lower than that in Central Europe. According to the 2006 *Doing Business* report, Estonia had the world's 16th most welcoming business environment.[87] Simply put, the Central European economies are much freer than they were under communism, but they have a long way to go.

## The EU May Make Future Reform More Difficult

The road ahead will not be easy. To tackle corruption, Central European countries will have to further deregulate their economies and reduce government spending. In doing so, they will face opposition from special interests at home. Unfortunately, those special interests will be aided by a powerful new ally—the EU.

There are a number of areas where EU membership will have negative consequences on attempts to reduce the size of government in Central Europe. First, the number of EU rules regulating everything from environmental standards to labor relations shows no sign of lessening. In fact, despite EU Commission president Jose Manuel Barroso's declared intention to cut EU regulations by 25 percent, the flow of new regulations from Brussels is actually increasing. Of the 22,000 pieces of legislation on the EU statute books, approximately 12,000 have been added in the eight years between 1997 and 2005. In contrast, "only" 10,000 EU regulations were created between the signing of the Treaty of Rome in 1957 and 1997.[88] In the words of John Egan, the former president of the Confederation of British Industries, "Look closely at what the European Commission's 'war on red tape' really means and the sad answer is: not very much."[89] He should know—EU regulations account for up to 80 percent of all regulations adopted annually by the British Parliament.[90]

Second, financial transfers from rich to poor members of the EU will contribute to keeping government spending large in Central Europe. Between 2007 and 2013, the Czech Republic is scheduled to receive $30.8 billion from Brussels. Hungary, Poland, and Slovakia will receive $29.2 billion, $77.6 billion, and $13.3 billion, respectively.[91] The primary purpose of those financial transfers or "structural and cohesion funds" is to address the unequal speed of economic growth in the EU by financing various projects ranging from roads and bridges to information technology and education. Since many of the EU development projects require domestic co-financing (i.e., 40 percent of the money for new highways has to come from domestic sources), the European financial transfers may necessitate tax increases and contribute to the general misallocation of resources.

Third, European trade policy, with its complex system of tariffs, quotas, and subsidies encourages rent-seeking behavior among European producers. Those producers, be they Italian shoemakers or French farmers, then tend to defend their protected status and the subsidies they receive by voting for economically illiberal political parties. That can make economic reform all the more difficult. Estonian consumers, for example, had benefited from a free trade regime prior to the country's accession to the EU. EU membership could change the dynamics of Estonia's political economy by creating a voting bloc opposed to future reforms.

The above consequences of EU membership are likely to contribute to perpetuating the culture of corruption in Central Europe. After all, it is mostly due to concerns over corruption that the European Court of Auditors, which oversees European spending, routinely refuses to certify EU accounts. In its 1999 report, the EU auditors found that fraud cost the EU about 5 percent of its total budget. For example, "farmers claimed subsidies for olive trees that did not exist and companies claimed [payments] for food deliveries to the poor which never arrived." In addition to farm fraud, the auditors discovered "badly managed regional aid and foreign policy programs, as well as misuse of research project funds."[92] Four years later, the Court found that the EU "is failing to keep track of huge annual subsidies, and 91 per cent of its budget is riddled with errors or cannot be verified." The Court found that agricultural subsidies were the biggest contributor to corruption. Accordingly, "Checks on subsidy claims for suckler cows found that 50.2 percent of animals in Portugal and 31.2 percent in Italy were false. The 'error rate' in forage and crop acreage was 89.7 percent in Luxembourg, 42.9 percent in Sweden, 34.5 percent in France, and 19.2 percent in Britain, despite increased use of satellite photography to spot fraud."[93]

## Conclusion

The relationship between the rise of populist parties on the one hand, and corruption, government spending, and overregulation on the other, is complex. Many factors need to be taken into consideration in order to properly interpret recent developments in Central Europe. This paper offers one interpretation: the spread of corruption in Central Europe is linked to government interference in the economy, which, in turn, has led to the discrediting of the ruling class and the rise of populist politics.

Economic liberalization in Central Europe remains unfinished. The business sector has reacted to the distortions caused by excessive government spending and regulation by adjusting its behavior. Since the regulatory environment is too complex and costly, businessmen get around it by resorting to corruption. Since governments in the region spend a lot of money and crowd out private investment, businessmen have begun to cater to their needs and started to compete for government contracts. In doing so, they found willing collaborators among thousands of powerful bureaucrats, many of whom pursue careers in public administration in expectation of unearned monetary benefits.

The public, which bears the heaviest burden of a corrupt, inefficient, and overbearing state, has exacted the only available punishment on their rulers—kicking them out of office. Since many of those disgraced politicians publicly espoused the virtues of liberalism and of the free market, liberal parties have suffered some loss of popularity as well.

That does not mean that liberalism is dead, however. In time, the public in Central Europe may well come to find that their new rulers are just as corrupt as those who preceded them. Since the populists are unlikely

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**The new generation of liberal politicians in the region will have to be humbler and more honest. They will need to live by the principles they preach.**

to reduce the size and role of government in their economies, they will be unable to address the underlying causes of corruption. That will, in turn, undermine their own popularity and electoral support.

In time, liberal parties will come back, with new and younger leaders. When the liberals do come to power, they will need to finish the job their predecessors started after the fall of the Berlin Wall. The discretion and regulatory power of the national, regional, and local governments will have to be substantially reduced, and so will the number of bureaucrats. Public administration will have to be simplified and made more transparent. Importantly, the state will have to substantially reduce its spending. Those measures should go a long way toward reducing corruption in the region. But the new generation of liberal politicians in the region will have to be humbler and more honest. They will need to live by the principles they preach. Perhaps then the bright future of liberalism in Central Europe will truly be secured.

## Notes

1. Robert Anderson, "Leftwinger Looks Set to Be Slovakia Leader," *Financial Times*, June 18, 2006, http://www.ft.com/cms/s/3bd2f28a-feee-11da-84f3-0000779e2340.html.

2. On a scale from 0 to 10, where 0 represents the lowest measured level of economic freedom and 10 represents the highest, Hungary rated 7.4. The Czech Republic and Slovakia rated 6.9, and Poland rated 6.7. See James Gwartney and Robert Lawson, *Economic Freedom of the World: 2006 Annual Report* (Vancouver: Fraser Institute, 2006).

3. Constant 2000 international dollars adjusted for purchasing power parity (PPP).

4. The Czech GDP per capita in constant 2000 international dollars adjusted for PPP rose from $12,817 in 1992 to $17,837 in 2004. Between 1989 and 2004, the Slovak income per capita rose from $11,300 to $13,438 and Hungarian from $12,045 to $15,453. The Polish income per capita rose from $7,743 in 1990 to $11,924 in 2004. See World Bank, "World Development Indicators Online," June 25, 2006, http://publications.worldbank.org/WDI.

5. "Foreign direct investment is the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. . . . Data are in current U.S. dollars." See "World Development Indicators," University of Michigan Library, May 28, 1999, www.lib.umich.edu/govdocs/wdi/wdivar/wdivar6.html.

6. The Czech Republic received $42.5 billion in foreign direct investment between 1990 and 2004, Hungary $42.7 billion (1989–2004), Poland $67.3 billion (1989–2004), and Slovakia $11.5 billion (1993–2004). (Figures are not adjusted for inflation.) World Bank, "World Development Indicators Online."

7. Ibid.

8. Czech inflation fell from a high of 10.62 percent in 1998 to a low of 0.1 percent in 2003. Hungarian inflation fell from a high of 28.97 percent in 1990 to a low of 4.63 percent in 2003. Polish inflation declined from a high of 555 percent in 1990 to a low of 0.78 percent in 2003, and Slovak inflation declined from a high of 13.4 percent in 1994 to a low of 3.32 percent in 2002. In 2004, Czech inflation was 2.83 percent, Hungarian 6.78 percent, Polish 3.57 percent, and Slovak 7.54 percent. Ibid.

9. The Czech mortality rate for children under five years of age fell from 12 per 1,000 live births in 1989 to 4.4 in 2004. In Hungary it fell from 17.8 to 8. Between 1990 and 2004, it fell from 17.9 to 7.5 in Poland and from 14 to 8.5 in Slovakia. Ibid.

10. The number of physicians per 1,000 people in the Czech Republic rose from 2.7 in 1989 to 3.5 in 2003. In Hungary it rose from 2.7 to 3.2 and in Poland from 2.1 to 2.5. There is no comparable data for the Slovak Republic, but there were 3.1 physicians per 1,000 people in 2003. Ibid.

11. The life expectancy at the time of birth in the Czech Republic, Hungary, Poland, and Slovakia was 71.67 years, 69.46 years, 71.04 years, and 71.02 years, respectively, in 1989. By 2004, it rose to 75.72 years, 72.64 years, 74.48 years, and 73.95 years, respectively. Ibid.

12. Between 1998 and 2003 (the only time period available), Czech spending on healthcare rose from 6.6 percent to 7.5 percent (of which public spending rose from 6.05 percent to 6.75 percent), Hungarian from 7.3 percent to 8.4 percent (5.46 percent to 6.08 percent), Polish from 6 percent to 6.5 percent (3.92 percent to 4.54 percent), and Slovak from 5.7 percent to 5.9 percent. Slovakia was the only country where public spending on healthcare declined from 5.22 percent of GDP to 5.20 percent. Ibid.

13. Between 1991 and 2003, Polish education spending as a percentage of GDP rose from 5.18 percent to 5.60 percent. In the Czech Republic it rose from 4.04 percent in 1999 (the first year for which the data is available) to 4.41 percent in 2003. In contrast, between 1991 and 2003, Slovak education spending declined from 5.55 percent to 4.34 percent. Similarly, Hungarian spending declined from 6.11 percent to 5.50 percent. (It should be noted, however, that the birth rate in Central Europe declined in the post-communist period.) Ibid.

14. Gross enrollment ratio is the ratio of total enrollment, regardless of age, to the population of the age group that officially corresponds to the level of education shown. See "World Development Indicators," University of Michigan Library.

15. Gross primary school enrollment ratio increased in the Czech Republic from 96.37 percent in 1991 to 102.15 percent in 2003. In Hungary and Poland it increased from 94.54 percent to 98.55 percent and from 98.36 percent to 99.50 percent, respectively. There is no comparable data for the Slovak Republic, but the gross primary school enrollment ratio in 2003 was 100.24 percent. Between 1991 and 2003, the gross secondary school enrollment ratio in the Czech Republic, Hungary, and Poland rose from 91.15 percent to 96.89 percent, from 78.55 percent to 103.41 percent, and from 81.47 percent to 104.51 percent, respectively. In Slovakia it was 91.73 percent in 2003. Between 1991 and 2003, the Czech gross tertiary enrollment ratio increased from 16 percent to 36.88 percent, Hungarian rose from 14 percent to 51.88 percent and Polish increased from 21.74 percent to 59.47 percent. In Slovakia it was 33.99 percent in 2003. (Unfortunately, no comparable data exists for the Slovak Republic.) World Bank, "World Development Indicators Online."

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