

# A Comparison of Greek and Latvian Budget Consolidation Politics

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# Abstract

This comparative case study tries to answer the question why the budget consolidation process began earlier in Latvia than in Greece after the 2008 financial crisis. The established theories predict one-party majority governments to be more decisive than coalition governments, but in this essay the opposite is the case. Theories regarding the impact of protests on budget consolidations are also tested but this causal link is deemed to be too weak to draw any conclusions from. The method used is process tracing of hypothesized explanatory variables derived from the existent theory formation in a method of difference type case situation. The explanation suggests that Latvia benefited from having several veto players in the government as no single government party could be held responsible of the stern budget consolidation politics. In contrast, the Greek politicians hesitated because of the intense framing by the opposition of the government as being economically irresponsible.

*Key words:* Budget Consolidation Politics, Fiscal Policy Decision-Making, Greece, Latvia, Political Economy

Words: 8827

# Abbreviations

AIAS	Amsterdam Institute for Advanced Labor Studies
BBC	British Broadcasting Corporation
CNN	Cable News Network
EIRO	European Industrial Relations Observatory
EJPR	European Journal of Political Research
EMU	Economic and Monetary Union
EU	European Union
GDP	Gross Domestic Product
IMF	International Monetary Fund
SGP	The Stability and Growth Program
WEO	(International Monetary Fund) World Economic Outlook

# Table of Contents

<b>Abbreviations .....</b>	<b>3</b>
<b>1 Introduction.....</b>	<b>1</b>
<b>2 Theories.....</b>	<b>3</b>
2.1 Coalitions versus One-Party Majority Governments .....	3
2.2 Political Protests and Fiscal Policy Reform .....	5
<b>3 Methods.....</b>	<b>7</b>
3.1 Comparable Cases .....	8
<b>4 Empirics.....</b>	<b>10</b>
4.1 The Latvian Case.....	10
4.2 The Greek Case .....	12
4.3 Budget Consolidation Comparison .....	13
<b>5 Explanations .....</b>	<b>15</b>
5.1 Shared Responsibility.....	15
5.2 Political Protests.....	16
<b>6 Conclusions.....</b>	<b>19</b>
<b>7 References.....</b>	<b>21</b>
<b>8 Appendix.....</b>	<b>25</b>
8.1 Latvian Governments .....	25
8.2 Greek Governments.....	26
8.3 Greek Budget Consolidations in 2009 .....	27

# 1 Introduction

The aftermath of the financial meltdown in the autumn of 2008 has been called the worst recession since the Great Depression. The economic crisis has put European leaders in a precarious situation when imbalances in current accounts<sup>1</sup> in conjunction with low or negative growth numbers and soaring social costs have put pressure on national budgets. Increasing budget deficits together with structural problems such as large non-competitive sectors, ageing populations and huge national debts, have called for reform and consolidation of national budgets.

Two European states that have experienced dramatic post crisis difficulties are Greece and Latvia. Both countries are small, open economies in Europe's periphery and both have had enormous budget deficits and structural problems. Further similarities are the legislative design – they are both parliamentary republics – and a recent history of dictatorship as well as problems with widespread corruption (Transparency International, 2011).<sup>2</sup>

However, the fiscal policy paths taken by the two countries have neither been the same in shape, nor been the same in length. In Latvia the answer to the financial crisis was a swift and extensive budget consolidation, while in Greece the budget consolidation process has been drawn out. The Latvian efforts to tackle the financial crisis have by some – especially by proponents of “inner devaluation<sup>3</sup>” – been acclaimed as a success story, whilst the Greek problems threaten to bring down the entire EMU project.

This is interesting because the Greek politicians had fewer options than the Latvian politicians. Latvia is not a member of the EMU and has its own currency – the Lat. This means that Latvia could have devalued its currency in order to boost exports and as a consequence reduce the deficit; this option was not available to the Greeks. It is reasonable to believe that with fewer options, the time needed to make decisions would be shorter, but with Greece, this was not the case.

This poses an interesting question: *Why did the Latvian decision-makers make quicker decisions than their Greek counterparts?* This is the question I try to answer in this essay.

The time period of the analysis begins with the bankruptcy of Lehman Brothers on the 15<sup>th</sup> of September 2008 and ends with the installment of the Papademos coalition government in Greece on the 11<sup>th</sup> of November 2011 (BBC,

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<sup>1</sup> Current account = (exports – imports)+(interests-dividends)+transfers

<sup>2</sup> Latvia received a score of 4.2 and Greece 3.4 in *Transparency Internationals Corruption Perception Index* 2011.

<sup>3</sup> Meaning reducing real wages in order to depreciate the effective exchange rate as a way of making the export sector more competitive and as a result improve the current account and reduce the deficit.

2011; Financial Times, 2008b). The governments in both countries had before the financial crisis broke loose acknowledged the need for reform, but the starting date for the study is nevertheless the bankruptcy of Lehman Brothers because it became obvious then that the world economy was heading in a bad direction. If budget consolidation was considered necessary before the crisis, it should be apparent that with the threat of world recession, the need for budget consolidation became even more imminent.<sup>4</sup>

The cause of the 2008 financial crisis and the wisdom of inner devaluation through budget consolidation will not be discussed in this paper.

The broad purpose of this study is to get a better understanding of fiscal policy decision making and the process of budget consolidation: what factors explain different outcomes of fiscal policy processes with similar underlying conditions? The more narrow purpose is to explain differences in fiscal policy between Latvia and Greece. In the media and on the blogosphere, the argument that Greece should have looked to Latvia for advice, is often heard. If Greece should have done what Latvia did, why didn't they?

In the next chapter the theories used in this paper are presented. The third chapter explains the methods used to gather the empirical data as well as how these data are being analyzed. This chapter also contains a motivation of the case-selection. The fourth chapter contains the essay's main empirical foundation; it describes the conducted fiscal policy in Latvia and in Greece. In the fifth chapter, the theories believed to explain the different outcomes are tested through the method of process tracing. The sixth chapter concludes the essay.

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<sup>4</sup> The option of contra-cyclical macroeconomic stimulus is not discussed simply because none of the countries chose this (except Papandreou's never realized election promise).

## 2 Theories

There exist some theories related to the subject of budget consolidation and these will naturally be applied to the case. The fit is not perfect however, and this essay therefore has theory developing ambitions. The result is a mixture between theory using and theory developing.

One theory that is often brought up when government performance in general is being discussed is the effect of the number of parties in the government. The view has long been that one-party majority governments are more decisive than “bickering” coalition governments. Since Latvia and Greece differs when it comes to the number of veto players<sup>5</sup> in the government, the relevant literature on this subject therefore are reviewed below, before they are applied to the case in chapter five.

Another factor that seems to have played an important role in the budget consolidation efforts in Greece and Latvia, at least according to media coverage, is political protests. It is likely that the expected reactions from the public and from unions have influenced decision makers and it therefore seems relevant to consult the literature on political protests. Theories regarding protest frequency and protest group strength are therefore discussed below.

Before going any further, though, it is probably a good idea to define the term budget consolidation. Budget consolidation is, in this paper, considered the process of putting the development of the national debt on a more sustainable path after an economic shock. There are basically two methods of consolidating the budget: changing incomes (e.g. increasing tax revenues) and changing spending. In democracies the government has to get support from the legislature to make changes in the national budget, and it is the process from the recognition of the necessity of budget consolidation to the decision by the legislature to make these changes that is examined in this essay.

### 2.1 Coalitions versus One-Party Majority Governments

Greece has a distinct two-party system and a history of one-party majority governments (Lijphart, 1999: 109-115). Latvia, on the other hand, is a multi-party system and has a tradition of coalition governments (Dombrovskis and Åslund,

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<sup>5</sup> i.e. a player whose agreement is required for a change of status quo

2011: 120). During the last twenty years, a lot of research has been done on what effects different constitutional designs have on the economy. One such study is Roubini's and Sachs's "Government Spending and Budget Deficits in the Industrial Countries". In this paper they explore the reasons behind the increasing government spending in industrialized countries after 1973 and factors explaining the increasing government deficits. They find that deficit reduction requires a political consensus and that "such consensus is hard to achieve in multi-party coalitions" (Roubini and Sachs, 1989: 2).

Alesina and Drazen construct in "Why Stabilization is Delayed" a model of determining the expected time of fiscal stabilization by arguing that stabilization is delayed due to "a war of attrition" between different socio-economic groups on how to share the burden of the stabilization efforts (Alesina and Drazen, 1991: 1171). A&D argues that their model is consistent with Nouriel and Roubini's findings, reaching the conclusion that "[l]arge coalitions of politically diverse parties find it particularly hard to reach agreements on how to allocate tax increases or expenditure cuts among the constituencies represented by coalition partners" (Alesina and Drazen, 1991: 1181).

Similar conclusions are drawn by Alesina and Perotti who argue that coalition governments leads to fiscal deadlocks and delayed fiscal stabilization. On the other hand, they do recognize that countries with "very polarized distribution of preferences" may gain from having a more proportional design to avoid extreme variations in fiscal policy when there is a change in government (Alesina and Perotti, 1994: 42).

Persson and Tabellini has, along this trend, shown in their pivotal book *The Economic Effects of Constitutions* (2003) that proportional representation, due to bargaining inefficiencies, raises total government expenses and, more importantly in our case, that countries with this design runs larger budget deficits (Persson and Tabellini, 2006: 732-735).

George Tsebelis, another prominent researcher, has done extensive work on the effects of the number of veto players in the government. Tsebelis (for instance 1995, 1999) argues that proportional systems create more veto players and that a larger amount of veto players in the government increases the risk of "lock ins" (Persson and Tabellini, 2006: 734).

However, the view that coalitions are less suited than one-party majority governments to stabilize the deficit has been questioned by some. Edin and Ohlsson replicate Nouriel and Roubini 1989 study with the same robust results but show that their conclusion that coalition governments are worse in reducing government deficit does not hold. They show that the relationship between coalitions and the deficit reduction disappears when controlled against minority governments (Edin and Ohlsson, 1991: 1601).

Arend Lijphart, a longtime proponent of proportional electoral systems, questions the view that one-party majority governments are more "effective" in a paper called "Constitutional Choices for New Democracies" (Lijphart, 1991). Lijphart reaches the conclusion that democracies with multi-party parliaments and proportional representation in a broad perspective performed better than alternative democratic systems both with regards to economic performance and

accommodation of ethnic minorities, which he holds as evidence that coalition governments, common in these countries, cannot be regarded as “ineffective” (Lijphart, 1991: 83). On the other hand Lijphart argues, when discussing the respective benefits of the two systems, that “[i]n the short run, one-party cabinets or presidents may be well able to formulate economic policy with greater ease and speed” (Lijphart, 1991: 83). This is contrasted with the view that “[i]n the long run, however, policies supported by a broad consensus are more likely to be successfully carried out and to remain on course than policies imposed by a ‘strong’ government against the wishes of important interest groups” (Lijphart, 1991: 1983).

To me, it is not obvious if budget consolidation is to be considered a short-run or a long-run policy reform. The consolidation measures of cutting expenditures or raising taxes are short-term decisions indeed, but the reasons for making them are to establish long-term sustainable debt levels. Therefore, it will be very interesting in the fifth chapter to see the effects of the government compilation on the outcome of the budget consolidation processes in the two cases.

## 2.2 Political Protests and Fiscal Policy Reform

Another factor that probably affects the budget consolidation process is the presence or threat of political protests such as demonstrations and strikes. Political protests are costly for the government and are therefore, if possible, avoided. If the government is planning budget consolidation measures, and if this is expected to be met with political protests, the strength of the protest groups ought to be taken into consideration by the government.

The relationship between protest group strength and the occurrence of protests has been studied in various ways since at least the mid-1970s. Models containing *bargaining power*<sup>6</sup>, *accurate information*<sup>7</sup>, as well as studies based on *game theory*<sup>8</sup> methods, have been presented throughout the 1970s and 1980s. In a chapter called “Strikes Around the World: A Game Theoretic Approach” in the book *The Workers of Nations* George Tsebelis and Peter Lange presents a model incorporating ideas from these earlier studies and presents a whole new interpretation (Lange and Tsebelis, 1995: 101ff). Lange’s and Tsebelis’ model is derived out of the assumption of rational actors and shows a curvilinear relationship between labor power and strikes (Lange and Tsebelis, 1995: 118).

Lindvall reinterprets this model in the working paper “Pressure Group Strength and Political Protests” but uses trade union density as a proxy for mobilization power (Lindvall, 2010a: 3) Lindvall also shows that there is a curvilinear relationship between pressure group strength and the frequency of

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<sup>6</sup> Focusing on the relative bargaining power of unions and employers

<sup>7</sup> Focusing on the role of information in reaching efficient agreements

<sup>8</sup> Focusing on the interaction between bargaining parties

political protests. Lindvall argues that “protests are most likely when pressure groups are strong enough to organize protests but too weak to be confident in their own capacity for mobilization” (Lindvall, 2010a: 15). In comparison, “[w]eak pressure groups do not protest since they have no chance of success” and “[s]trong pressure groups [...] do not protest since governments prefer to preempt them by modifying their policies” (Lindvall, 2010a: 1).

The literature on the impact of political protests on fiscal policy decision making, however, is to my knowledge non-existent. It is assumed, nevertheless, that decision makers account for demonstrations and strikes when decisions regarding the economy are being made. Protests are expected to have an impeding effect on the budget consolidation process as politicians are assumed to try to meet the demands of their constituency.

### 3 Methods

This comparative case study has both within-case and cross-case elements. The empirical chapter is cross-sectional in its nature, as the purpose of it is to determine in what way the two processes differ. The empirical chapter also has within-case features as the two political processes of budget consolidation are described one at a time. In the fifth chapter the *causal mechanisms* that explain the different budget consolidation processes are being identified and described. This is done with the within-case method of *process tracing*. Causality is in this essay defined as “the outcome of flows from the convergence of several conditions, independent variables, or causal chains” (George et al., 2005: 212). Mahony defines *process tracing* as “a technique in which the analyst attempts to locate the causal mechanisms linking a hypothesized explanatory variable to an outcome” (Mahony, 2003: 360).

The comparative method (as well as the single-case method) demands the Humean causality assumptions of “constant conjunction”, i.e. that the explanatory variable is necessary for the outcome – that the outcome would not have happened if it were not for this variable. This can be compared with the method of regression analysis which adhere to probabilistic ontology traditions, i.e. that the outcome is bound to happen at a certain probability (Hall, 2003: 382). Many of the theories used in this essay have been tested in research where the causality assumptions do not fit well with Humean causality. There is hence a risk of “ontology-stretching”.

Hall presents a method he calls *Systematic Process Analysis* that tackle these kinds of problems. Good theories, Hall argues, are theories that “specify a set of causal processes associated with the operation of particular variables” (Hall, 2003: 393). If this is the case, the method these theories have been tested with is irrelevant, as their validity is determined by their capacity to identify causal processes that explain the dependent variable. In this sense, all case studies are theory testing, because every time a theory is applied, the explanatory power of it is being tested. The ontological assumptions the theories are based upon, does as a result of this not matter, as long as they are assumed to be able to trace the variable causing the outcome.

The within-case analysis also has a cross-case element, as the cases are compared in order to detect anomalies leading to rejection of the hypothesis and to identify spurious correlations.

The research design in this paper is modeled after J.S. Mill's famous ideal type<sup>9</sup> *Method of difference* and the cases are hence picked because of their similarity in independent variables and difference in dependent variables (Hall, 2003: 380). For the two cases to be comparable, it is necessary to establish the idea that both countries needed to reform their budgets in order to move to a sustainable debt development path at the beginning of the time period in this paper. This is so essential that I will devote this topic an own subchapter (3.1).

The theories chosen to analyze the empirical data have, as discussed above, been selected because of their expected predictive capacities and their ability to detect causal mechanisms given the certain context.

To avoid selection bias when it comes to data gathering, a strict selection method has been used. Effort has been made to use comparable data, preferably from the same research journal or dataset. The main bulk of the empirical data is therefore gathered from *The Political Data Yearbook* compiled by The European Journal of Political Research (EJPR) and from The European Industrial Relations Observatory Country Profiles. In addition, the Google News search engine has been used to find articles from reliable news agencies to broaden the description of the domestic political situation and as a supplement to the EJPR yearbook which does not exist for 2011. A search interval of two months was chosen for every search, starting in January 2008, and then all relevant hits on the words "Greece", "Latvia", "Greece budget", "Latvia budget", "Greece protests" and "Latvia protests" was controlled whether they included any information that could help to understand the budget consolidation process or not. In addition, a Google News search has been made on the words "Greece strike" for the time period 2000 and 2008. Furthermore, data from Eurostat, WEO, ICTWSS and OECD has been used in this essay.

The purpose of this essay is to determine why the Latvian decision makers made quicker decisions then their Greek counterparts. To be able to answer this, the term *quick* needs to be operationalized. Quick is operationalized as the time taken for the government to make the first major budget consolidation measure after the Lehman Brother's bankruptcy. Governments continuously change fiscal policies, however, and the minimum amount of budget consolidation measures taken are therefore four percent of GDP if it is to be counted as "major".

### 3.1 Comparable Cases

To pinpoint the independent variable(s) that caused the difference in budget consolidation politics, it is necessary to prove that the countries were in the same spot in the beginning of the financial crisis.

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<sup>9</sup> This word is chosen to emphasize the fact that not even Mill himself thought the methods he developed to be used in the social sciences due to their too exacting scientific standards.

In the years before the financial crisis, both the Latvian and Greek economy boomed as a result of credit inflow from the EU (Hellenic Republic Ministry of Finance, 2010a: 5; Karnite, 2009: 2). After the markets crashed in the autumn of 2008 the world economy plunged into deep recession, which of course affected both Greece and Latvia. In 2007, the Latvian economy grew with incredible ten percent, and in 2008 the economy shrunk with almost half that number. The Greek slowdown was less severe: the growth shrank with three percentage points. The Greek economy is focused on services and it consists to a large extent of flexible small business enterprises, which has the effect that the economic business cycles lags (Tikos, 2009: 3). It is reasonable to assume that the Greek government thought of this and expected a contraction in 2009.

### 3-1 Comparison of cases

Source	Description	Latvia		Greece	
		2007	2008	2007	2008
WEO	GDP, constant prices, % y-o-y change	10	-4.2	4.3	1.0
WEO	Current account balance, % of GDP	-22.3	-13.0	-14.4	-14.7
Eurostats	Government deficit/surplus, % of GDP	-0.4	-4.2	-6.5	-9.8
WEO	General government gross debt, % of GDP	7.8	17.0	105	110.3

Both countries had large imbalances in their current accounts, implying that they were living above their means. The Latvian current account improved in 2008, possibly because of decreasing demand as an effect of the layoffs by the Karamanlis government. The current account deficit, however, was larger than ten percent in both countries.

Furthermore, the budget deficit was on the rise in both countries. The deficit increase in Latvia was larger than in Greece, but it started from a lower level. The same goes for the national debt – the increase in Latvia was bigger than in Greece, but it started from a lower level; the difference between the sizes of the two countries' national debt is huge.

In conclusion did the Latvian economy contract more, but Greece had a larger deficit and a debt already at high levels. It is not a perfect fit, but with this data at hand, it should be obvious that the two countries needed budget reform measures.

It must however be said that the data on Greece is highly unreliable. Eurostat have several times revised the data coming from the Greek finance department (which the IMF data comes from). The Greek finance ministry's accounting methods had serious flaws and the economic downturn was underestimated (European Economy, 2010: 25).<sup>10</sup>

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<sup>10</sup> For a discussion regarding arbitrary national accounting and GDP manipulation see (Klarin, 2010: 12).

## 4 Empirics

The purpose of this chapter is to find out in what way the two budget consolidation processes differ in order to trace the processes leading up to the divergence in outcomes in the next chapter. To accomplish this, the fiscal policies in Greece and Latvia are described and compared below.

### 4.1 The Latvian Case

As discussed in 3.1, the Latvian economy was hit hard by the 2008 financial crisis following the bankruptcy of Lehman Brothers. How severe the bust was going to be was however unknown initially. The uncertainty however, was short-lived, as the country's largest locally owned bank PAREX soon had to be rescued by the government. The decision to rescue PAREX worsened Latvia's liquidity and accelerated its need to gain outside funding (Ikstens, 2009: 1020). This fueled speculations whether the centre-right Godmanis government was going to devalue the Lat in order to boost export or whether they were to stick to the Euro peg and forego large cuts in public sector wages and state spending.

Many prominent economists such as Nobel laureate Paul Krugman advocated a devaluation of the Lat but the support for "inner devaluation" turned out to be strong both from the Godmanis government and from Latvia's neighboring economies (Krugman, 2008; Financial Times, 2008a). The option to devalue was actually recommended by a majority of the IMF staffers in the December 2008 IMF-meeting, but the support amongst the Godmanis government for this option was very slim (Dombrovskis and Åslund, 2011: 42).<sup>11</sup>

An emergency loan package of 7.5 billion Euro was granted in December 2008 by the IMF, the EU, the World Bank and other countries with the requirement that Latvia proceeded with the "exceptionally strong domestic policies" the government intended to implement (BBC, 2008; IMF, 2008). The government's attitude is expressed in the IMF staff report that followed the loan agreement: "[t]he program is centered on maintaining Latvia's exchange rate peg through strong domestic policies and substantial international financial assistance" and furthermore that "key elements" include: "[f]iscal measures to limit the substantial widening in the budget deficit, and prepare for early fulfillment of the

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<sup>11</sup> The reasons for doing this are not discussed further as it falls out of the limits of this essay. For those interested, I refer to the chapter "To Devalue or Not to Devalue" in Valdis Dombrovskis book "How Latvia Came Through the Financial Crisis" (co-written with Anders Åslund).

Maastricht criteria” (IMF, 2009: 4). The “strong domestic policies” were conditions Latvia needed to fulfill to get the loan package (Ikstens, 2010: 1052).

The 2009 budget was approved by the Saeima the 14<sup>th</sup> of November. It contained spending cuts in order to stabilize the budget. As the economic crisis developed and the government needed to lend money from the EU and the IMF, it became apparent that the 2009 budget needed revision. On the 12<sup>th</sup> of December the parliament adopted an amended budget with further cuts in public sector, e.g. wage cuts of 15 percent (Republic of Latvia Ministry of Finance, 2009: 22)

In 2009 elections were held which resulted in a new government; on the 12<sup>th</sup> of March 2009 the current Prime Minister, Valdis Dombrovskis<sup>12</sup>, took office. The new five-party cabinet (appendix) was like its predecessor a center-right government, and consisted of roughly the same parties, but it was more outspoken regarding the needs to diminish the Latvian budget (Ikstens, 2010: 1052). On the topic of consolidating Latvia's budget, Dombrovskis said in a speech in the Saeima before the final vote on the new Prime Minister was cast that the government was going to need “the support, advice and full participation from civil society, businesses and all residents” (Seattle Times, 2009).

In early June the Dombrovskis government revised the 2009 budget and dramatically cut spending and raised taxes (Reuters, 2009b). This was done due to the fact that the Latvian economy had contracted considerably more than expected in 2008– 18 percent in the first quarter – and this made the Latvian GDP fall the biggest in the EU (Bloomberg, 2009b) The spending cuts of about four percent of GDP secured the next payment from the 7.5 billion euro bailout package (Reuters, 2009a). The cuts included a 20 percent wage cut in the public sector, 10-30 percent reduction of pensions and spending cuts in health care (Ikstens, 2010: 1057). The 2009 consolidations further entailed the sacking of 20 percent of central state institution employees and the reduction of the number of government agencies from 79 to 25 (Republic of Latvia Ministry of Finance, 2010: 16)

In March the IMF cancelled its payments to Latvia because of the lawmakers' inability to further cut spending due to fear of losing upcoming local elections (Bloomberg, 2009b). Therefore it was of utmost importance, if Latvia not were to go bankrupt, that the June votes were passed in Parliament, according to Dombrovskis (Reuters, 2009b).

The 2010 budget was adopted by the Saeima on the first of December 2009. It contained more expenditure cuts and revenue enhancements, 507.5 million Lats in total (Republic of Latvia Ministry of Finance, 2010: 18).

In 2010, the first signs of economic recovery came and were framed as a result of the government's fiscal policy measures (Ikstens, 2011: 1040), which helped the Dombrovskis government to get reelected in the autumn of 2010 (Ikstens, 2011: 1042).

In the spring of 2011, the Latvian government stated that budget consolidation measures of one percent of GDP were necessary if the goal of a deficit no bigger than 2.5 percent in 2012 was to be reached (Bloomberg, 2011). In the autumn,

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<sup>12</sup> of *New Era* (later *Unity*).

however, Latvia stated, because of the quick recovery, that there was no need for further IMF/EU payments and ended the “bailout”-program before the planned end date.

## 4.2 The Greek Case

In the annual Stability and Growth Program (SGP) report to the EU, the Greek Finance Ministry have throughout the mid- to late-2000s stated that budget reforms are necessary to bring the deficit down (e.g. (Hellenic Republic Ministry of Finance, 2006: 3; Hellenic Republic Ministry of Finance, 2007: 3). The Greek government has been struggling to meet the Stability Pact conditions since the entrance into the EMU in 2001, but little progress has been made. In the spring of 2008, the pension system was however reformed, although to a lesser degree than first planned (Mavrogordatos, 2009: 969).

On September 6<sup>th</sup> 2008 – 19 days *before* the Lehman Brothers bankruptcy – Prime Minister Kostas Karamanlis said that the “financial crisis is deep” and that he stood by the planned tax increases that had been announced in August. He also promised to curb spending (Bloomberg, 2008a).

Shortly after the Lehman Brother’s bankruptcy, George Provopoulos – governor of the Bank of Greece and a member of the ECB:s Governing Council – expressed deep concerns about the ongoing financial turmoil and said that he believed the impact to be worse than the experts expected. Provopoulos said that the Greek economy could expect slower growth, higher inflation and increasing pressure upon financial and credit markets (Reuters, 2008b).

The year and a half between the highly unpopular pension reform in 2008 and the late 2009 EU/IMF/ECB fiscal consolidation program (see below) little happened with regards to budget consolidation. In January 2009, however, the parliament passed a small bill to cut spending and increase taxes in order to keep the budget deficit below an European ceiling (Bloomberg, 2008b). Papandreou and the opposition were against the “austerity” plan; they meant that the conducted fiscal policy was the very reason Greece had such grave economic problems (CNN, 2008).

Further measures were also taken in mid-March 2009 when the Greek government decided to freeze public sector wages and to introduce a new tax hitting the highest income earners (Forbes, 2009).

The government was from then on occupied with political scandals, political protests, riots and the June election to the European parliament and the election to the Greek parliament in September of 2009 which resulted in a change in government from *New Democracy* to *PASOK* (Mavrogordatos, 2009: 961) (Mavrogordatos and Marantzidis, 2010: 996-998).

On Christmas Eve 2009, the new Papandreou government, in response to recent week’s lack of trust with regards to Greece possibilities to pay off its debt, passed a package in the parliament which aimed at consolidating the budget with eight percent through spending cuts and tax increases (Bloomberg, 2009a). At this

point Greece was very near a default on the public debt which many feared would have thrown the world economy in another world recession.<sup>13</sup> At this point Papandreou saw no other possibility than to request an ECB/EU/IMF rescue package<sup>14</sup> (Mavrogordatos and Mylonas, 2011: 985-986).

In May 2010 the requested rescue package had taken form. It consisted of 30 billion Euros from the IMF and 80 billion Euros from the ECB over three years. The money was to be paid in several installments after the implementation of budget consolidation measures and structural reform (Mavrogordatos and Mylonas, 2011: 986). The package was ratified by the parliament on the 6<sup>th</sup> of May by 172 votes (Mavrogordatos and Mylonas, 2011: 986).

The European Commission explains the late recognition of the Greek economic deterioration with the Greek financial ministry's incorrect accounting measures; the 2009 budget deficit was initially set to two percent but was in October 2009 revised to over 12 percent (European Economy, 2010: 6)

The original 2011 budget, set in 2010, proved to be too optimistic with regards to GDP growth and the Greek government consolidated it in 2011 (Hellenic Republic Ministry of Finance, 2011: 6-7).

### 4.3 Budget Consolidation Comparison

Table 4-1 consists of data from the Latvian ministry of finance who has put together a summary of the measures taken. The first year of major budget consolidations for Latvia was 2009 when tax increases raised the Latvian revenues with 2.8 percent of GDP and expenditure cuts decreased spending with 6.7 percent.

**4-1 Latvian Budget Consolidation**

<b>Latvia</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
Revenue increase, % of GDP	-	2.8	2.1	1.7
Expenditure decrease, % of GDP	0.5	6.7	1.9	0.8
Total, % of GDP	0.5	9.5	4	2.6
Cumulative total, % of GDP	0.5	10	14	16.6

*Source: Latvian Finance Ministry*

In Greece on the other hand, the budget consolidations began later, as can be seen in table 4-2. The data in table 4-2 comes from two different sources. The source of the 2009 data is the Greek ministry of finance and the source for 2010

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<sup>13</sup> The fear was based on fact that the debt to a great extent was held by private banks and if they were unable to handle such a large credit loss, the liquidity problems could have spread to other financial institutes around the globe who had assets in the Greek banks. This process is called contagion (European Economy, 2010: 11).

<sup>14</sup> The package was melodramatically announced as “a new Odyssey for Hellenism”.

and 2011 is the OECD report *Restoring Public Finances* (OECD, 2011: 124; Hellenic Republic Ministry of Finance, 2010b) .

#### 4-2 Greek Budget Consolidation

<b>Greece</b>	<b>2008</b>	<b>2009<sup>15</sup></b>	<b>2010</b>	<b>2011</b>
Revenue increase, % of GDP	N/A	0.3	2.6	3.6
Expenditure decrease, % of GDP	N/A	1.4	5.2	2.9
Total, % of GDP	N/A	1.7	7.8	6.5
Cumulative total, % of GDP	N/A	1.7	9.5	16

Source: Greek Finance Ministry (2010b) and OECD

Something should, first of all, be said about the data these tables are based on, before they are compared. Table 4-2 shows fiscal policy that the Latvian ministry of finance reports has already been implemented; they are with other words *ex post*. The data for 2010 and 2011 in table 4-2 on the other hand, is based on OECD estimates, and are therefore *ex ante*. The reason for only including *ex ante* data for 2009 was to avoid double counting. This means that the Greek budget consolidation efforts might be less (or more for that matter) than expressed in this table. For this essay, however, this does not matter as it is fiscal policy decision making, and not fiscal policy implementation, that is examined.<sup>16</sup>

If we compare the two tables, we quickly observe that the budget measures has been roughly the same in magnitude, but the measures were carried out quicker in Latvia and they were more focused on expenditure cuts than their Greek late awoken and revenue raising counterpart. The majority of the consolidation measures in Latvia were done in a single year (2009) and has thereafter gradually diminished (probably as growth returned), while the Greek government made large consolidations in 2010, and then again in 2011. These consolidations were large indeed, yet smaller than the Latvian government's efforts in 2009.

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<sup>15</sup> See appendix

<sup>16</sup> The reason for this is that no *ex post* data has been found for Greece.

# 5 Explanations

## 5.1 Shared Responsibility

The theories on the effects of veto players in the government suggest that coalition governments are badly suited for budget consolidation politics. Bearing the theoretical formation in mind, a reasonable hypothesis would be that Latvia's budget consolidation process should have been slower than the one in Greece.

The stylized causal mechanism to explain the speed of the budget consolidation process in Latvia was expected, if we allow ourselves to mentally travel to the autumn of 2008 and contemplate a counterfactual outcome, to look as follows. The Latvian government has several veto players with different preferences. This causes friction within the government which in turn causes the decision making processes to be inefficient and therefore the budget consolidation process to be slow. The Greek government on the other hand has only one veto player. Therefore, the process was expected to look like this: due to the fact that the Greek government has only one veto player, the government should be unanimous in their decision making. This should cause the budget consolidation process to be swift.

The empirical part of this paper, however, tells us otherwise; the budget consolidation efforts began earlier in Latvia. In the Latvian case, the veto players in the government seems to have been largely unanimous in their opinions on first of all to consolidate the budget in the first part (and not to devalue), and secondly to do it in the fashion it was done. In other words, the large number of veto players did not slow down the decision making process because they shared the same preferences on this particular issue.

Valdis Dombrovskis, two times reelected Latvian prime minister (appendix), mentions the benefits of Latvia's parliamentary system with elections with proportional representation as one of nine lessons from Latvia's financial crisis experience. He argues that Latvia benefited from the possibility to quickly change government amidst the crisis as "a precrisis government is rarely a suitable anticrisis government" (Dombrovskis and Åslund, 2011: 120). With regards to the similarities in preferences, Dombrovskis state that since all Latvians had faced the same post-Soviet dilemmas, "almost all political parties could be described as free-market and center-right" and that Dombrovskis and his political rival, the previous prime minister Godmanis, "had very similar views on economic policy" (Dombrovskis and Åslund, 2011: 117). If all Latvians had the same preferences, as astonishing as that would be, it would not have been the fact that the government had several veto players that would have caused the quick decision making. If this was the case, the number of veto players would have been

irrelevant. However, the government's harsh budget consolidation measures were not supported by all. For example the government was criticized both from the right (For Good Latvia) and from the left (Harmony Center) for its economic politics in the 2010 elections, but still managed a narrow win the election (Dombrovskis and Åslund, 2011: 97).

In Greece the budget consolidation process started later despite the fact that the government consisted of only one veto player. Even though the Karamanlis government early stated that the budget needed to be reformed, it was not until the succeeding government (Papandreou I) was faced with increasing rent costs due to downgraded credit worthiness and lender demands that the budget consolidation process began. In the year before the 2009 elections, little was done with regards to budget consolidation policy. Both ND and PASOK instead tried not to get blamed by the bribe scandal involving the German company Siemens and both ND and PASOK governments in the early 2000s (Mavrogordatos and Marantzidis, 2010: 996).

In Latvia, the large number of veto players helped the government to be decisive in the budget consolidation program as no single party could be blamed for unpopular politics. The risk of losing veto power for every given government party is therefore less than in the case with Greece, where unpopular policies are more dangerous as they are more easily framed by the opposition.

One event, speaking in favor of this thesis, is when a spokesperson for the Greek finance minister in March 2009 said that Greece had absolutely no need for a euro rescue in response to a German lawmaker who said that the Eurozone members had agreed upon a rescue package for the Greek economy (Forbes, 2009). This was only a couple of months before the election to the European Parliament. Furthermore, in the election campaign before the October 2009 parliamentary election, the opposition (PASOK) contrasted the budget consolidation politics offered by the government with a stimulus package to boost demand, despite the state of the economy and the public deficit, and consequently won the election with a landslide (Mavrogordatos and Marantzidis, 2010: 998). It is ironic, to say the least, that it was Papandreou who just a couple of months after being inaugurated went forth with the budget consolidation process.

## 5.2 Political Protests

The theories suggest that the frequency of political protests is highest in societies where protest groups are "medium strong". The reason for this higher frequency is that governments in these cases consider the unions to be too small to take into account when the policies are being constructed, but the groups are strong enough to think protest behavior might have an impact and hence worth trying. Greece and Latvia are, as table 5-1 shows, representatives of these two different situations; the labor union strength in Latvia is very weak and the Greek labor unions are either very weak or "medium" strong.

The Latvian union density is remarkably low and has been declining in recent years. The trade unions are strongest in state sectors such as education and lowest in retail industries and small businesses (Karnite, 2009: 3). The Greek union density is higher, but nowhere near the high levels common in Scandinavia. The Greek union density is also fractionalized as it is relatively high in state sectors, reaching about 60 percent, and in the private sector as low as 18 percent. Much of this can be explained by the fact that the private sector is dominated by small enterprises with fewer than 20 employees (Tikos, 2009: 2).

#### 5-1 Union Strength Proxy

<b>Country</b>	<b>Description</b>	<b>2008</b>
Greece	Union Density, % of employed	24
Latvia	Union Density, % of employed	14,8

Source: AIAS

Based on the assumptions made in chapter three, this implies that the budget consolidation process in Greece should be slower than the process in Latvia.

The empirics show that Latvia began their major consolidation efforts approximately one year before the Greek government decided to do the same, and, in accordance with theory, protests have been more frequent in Greece than in Latvia. The question is whether this is a causal connection or a mere correlation.

The Latvian fiscal policy reforms in late 2008 were met with fierce and violent protests. These protests were the biggest in Latvia since its independence in 1991 and were organized by the political opposition, by trade unions and by non-governmental organizations (BBC, 2009; Bloomberg, 2009c). The peaceful demonstrations turned into riots when some dozen protesters started to throw rocks and blocks of ice towards the police and tried to storm the parliament building (BBC, 2009).

The reactions to the second round of budget consolidations by the Dombrovskis government in mid-2009 were notably milder and more stoic than the December/January riots. Some of the associations the government had support from were dissatisfied with the cuts but agreed to them anyway. The head of the Pensioners Federation for example said that the cuts were unlawful but that they did not plan any protests as they would be pointless (Reuters, 2009c).

This can be interpreted as the weak protest groups for ideological reasons felt compelled to react to the rather extreme fiscal policies whether they thought that this would help or not. After they had stated their opinion in January of 2009, further protests was considered too costly as the likeliness of success was judged to be too slim. When the unions stopped organizing protests, the public also stopped showing their discontent in public protests.

Greece has a long history of strikes and protests. In fact, of 85 general strikes in Western Europe since 1980, 38 have taken place in Greece (Kelly and Hamann, 2009: 4). There had been protests and demonstrations in Athens and in other cities in the Hellenic peninsula throughout the 2000's (BBC, 2002; BBC, 2005; BBC, 2006) and when the Karamanlis government tried to reform the pension system six months before the financial meltdown in September 2008, the streets of

Greece's capitol were flooded with upset Athenians scolding anti-government slogans (Reuters, 2008a).

In Greece, the protests to a great extent were led by the unions and the extreme left parties, and they increased in scale as the discontent public took to the streets. They were, as stated above, common before the government announced the plans to consolidate the budget but increased for various reasons, such as an upswing in anarchism and political scandals, in the following years. The protests clearly impeded the consolidation process, as Papandreou tried to balance the demands of the EU, the IMF and the ECB on the one hand, and the demands of the indignant domestic public on the other.

The protests and public discontent increased the magnitude of the risks of being the sole veto player about to introduce unpopular fiscal reforms. If voters are keen to show their malcontent in public, the voices condemning the harsh policies are stronger, which has the effect that politicians are more cautious to make major policy decisions (especially in election years). Therefore, it is probable that the protests delayed the necessary budget consolidations in Greece. But with David Hume's strict demands on causality, probability is not good enough. As the causal link between protests and the later decision to make major budget consolidations has not been able to be traced to *with necessity* be the cause, it is not honorable to assume this. To be certain that the protests had an effect on the fiscal policy decision-making, further research with different methods are required.

## 6 Conclusions

The research question stated in the introduction was: *Why did the Latvian decision-makers make quicker decisions than their Greek counterparts?* The multitude of factors that to a varying degree explains the difference in decision making are vast (possible alternative explanations are discussed in short below). The factors believed to have the highest explanation power should be clear from the previous chapter, but are nevertheless summarized in this chapter.

The fact that Latvia had coalition governments actually helped the government to make the tough fiscal policy decisions necessary to put Latvia's national debt development on a sustainable path.<sup>17</sup> This is interesting because it contradicts the established theoretical view. The Latvian coalition governments were able to be decisive because the parties in them had a chance of remaining veto players in the future. Even if a party in the government lost mandates in an election, it could remain a government party in the future, e.g. if new parties were included. In contrast with this, the Greek one-party majority governments were prevented to make the unpopular fiscal policy decisions by the high risk of losing their veto power. The opposition did not hesitate to take advantage of this and frame the consolidation measures as economic mismanagement.

In Greece, the risk of losing the veto power was probably amplified by the high frequency of strikes and public protests. In Latvia, the strikes had no, or limited, effect.

There are many possible alternative explanations that may have caused the difference in the dependent variables. My argument is that these alternative explanations may be able to explain the difference to some degree, but in that case to a lesser degree than the explanation above. One such possible factor is what is commonly referred to as *Europeanization*. Latvia, and the other Baltic nations as well as other former Soviet republics, are keen to become EMU-members. This endeavor to become a part of the European core might have made it easier to rapidly ask the EU/IMF for help and acknowledge the troublesome situation the country was in. On the contrary, Greece was already an EMU-member and considered itself – and was considered by other nations as well, for that matter – a self-evident European core nation.<sup>18</sup> This might have made it easier for Greek politicians to avoid making the hurtful fiscal alterations it so badly needed, thinking that the might of the EU would protect them. The consequence of this explanation speaks against it as it to some degree implies that the Latvian decision

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<sup>17</sup> This conclusion is influenced by assumptions made in an unpublished paper by Lindvall (2010b) called "Reform Power of Coalition Governments"

<sup>18</sup> Democracy was after all invented in Greece.

makers framed the need for fiscal adjustments to become more integrated with Europe. This is a conspiracy hard to sell.

Another possibility is that governments in general take action when it realizes that the risk of bankruptcy is so real that it has no other alternative then to adhere to the demands of international lenders. In other words, when all other options are exhausted, the budget consolidation begins. This would be a rather cynical explanation. If politicians only act when they do not have the option not to act, it would be the same as to assume that all politicians are incompetent. This I do not believe.

It is of course possible that the explanation presented in this essay is a result of case specific circumstances and it is therefore difficult to generalize from the results. Further research is necessary if the view of coalition governments in budget consolidations is to be altered. I will therefore conclude this essay by looking forward and ponder what future studies on this subject might entail. The most obvious way forward is to examine other similar cases – perhaps the other Baltic nations compared with other South-European countries. Another possibility is to increase N and switch to different methods. A third option might be to consider other historical cases of budget consolidation politics.

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# 8 Appendix

## 8.1 Latvian Governments

Before the 2010 election the Latvian political landscape changed as several parties entered into alliances and changed names and some just changed names. Dombrovskis *New Era* joined with *Civic Union* and founded *Unity*. *LNNK* became *National Alliance* (Ikstens, 2011: 1038-1042). For further details see Ikstens (2011).

### 8-1 The party composition of Godmanis I

Date of investiture: 20 December 2007

Party	Number and percentage of parliamentary seats	Number and percentage of cabinet post
<i>Tautas partija – People’s Party (TP)</i>	21 (21.0)	7 (36.8)
<i>Latvijas Pirma partija – First Party of Latvia (LPP)</i>	17 (17.0)	4 (21.1)
<i>Zalo un zemnieku savieniba – Union of Greens and Farmers (ZZS)</i>	10 (10.0)	5 (26.3)
<i>Tevezemei un Brivibai/LNNK – For Fatherland and Freedom/LNNK</i>	7 (7.0)	3 (15.8)

Source: Ikstens (2008)

### 8-2 The party composition of Dombrovskis I

Date of investiture: 12 March 2009

Party	Number and percentage of parliamentary seats	Number and percentage of cabinet post
<i>Tautas partija – People’s Party (TP)</i>	19 (19.0)	5 (33.3)
<i>‘Jaunais laiks’ – ‘New Era’ (JL)</i>	15 (15.0)	4 (26.7)
<i>Zalo un zemnieku savieniba – Union of Greens and Farmers (ZZS)</i>	17 (17.0)	4 (26.7)
<i>Pilsoniska savieniba – Civic Union (PS)</i>	6 (6.0)	1 (6.7)
<i>Tevezemei un Brivibai/LNNK – For Fatherland and Freedom/LNNK</i>	5 (5.0)	1 (6.7)

Source: Ikstens (2010)

### 8-3 The party composition of Dombrovskis II

Date of investiture: 2 November 2010

Party	Number and percentage of parliamentary seats	Number and percentage of cabinet post
<i>Vienotība – Unity (V)</i>	33 (33)	8 (57)
<i>Zaļo un zemnieku savienība – Union of Greens and Farmers (ZZS)</i>	22 (22)	6 (43)

Source: Ikstens (2011)

### 8-4 The party composition of Dombrovskis III

Date of investiture: 25 October 2011

Party	Number and percentage of parliamentary seats	Number and percentage of cabinet post
<i>Vienotība – Unity (V)</i>	20 (20)	5 (36)
<i>Zatler's Reform Party (ZRP)</i>	22 (22)	4 (29)
<i>National Alliance</i>	14 (14)	2 (14)
<i>Party unaffiliated</i>	6 (6)	3 (21)

Source: U.S. Department of State (2011)

## 8.2 Greek Governments

### 8-4 Party Composition of Karamanlis II

Date of investiture: 1 October 2007

Party	Number and percentage of parliamentary seats	Number and percentage of cabinet post
<i>Nea Dimokratia – New Democracy (ND)</i>	152 (50.7)	18 (100)

Source: Mavrogordatos (2008)

### 8-5 Party composition of G. Papandreou I

Date of investiture: 19 October 2009

Party	Number and percentage of parliamentary seats	Number and percentage of cabinet post
<i>Panellinio Sosialistiko Kinima – Pan-Hellenic Socialist Movement (PASOK)</i>	160 (53.3)	17 (100.0)

Source: Mavrogordatos and Marantzidis (2010)

## 8.3 Greek Budget Consolidations in 2009

Because of the unreliable data from the Greek statistical institute, this data is *very* crude. It is to be considered more of a sketch than anything else.

### 8-6 Greek Budget Consolidations in 2009

#### Expenditure cuts

Salaries and pensions	203 M €
Grants to public sector entities	394 M €
Consumption expenditures	541 M €
Election expenditures	194 M €
Other	55 M €
In total	1387 M €
% of GDP	<b>1.4 percent</b>

#### Revenue increases

Taxes to incomes € 60.000+	300 M €
Tax settlements	350 M €
Revenue from bank	55 M €
In total	705 M €
% of GDP	<b>0.3 percent</b>

Source: Hellenic Republic Ministry of Finance 2011a and 2011 revised Eurostats data (for 2009 GDP)