The rise of illiberalism in Eastern Europe

With euroscepticism on the rise and Brexit catching all of Europe off guard, many investors and observers are reconsidering what the recently emerging ‘illiberal democracies’ further east may mean for the rest of the EU. In this piece, we argue that rather than ‘turning away’ from a western European model of democracy, Eastern Europe has never fully embraced it. Moreover, further democratic reversals in the region cannot be ruled out.

First of all, we argue that history is important. Both the time spent under democracy and the type of regimes seen previously will affect the current democratic track record. CEE democracies are very young, which makes them prone to setbacks.

It is also important to differentiate between political and economic illiberalism. In Hungary and Poland, similar degrees of political illiberalism involve different forms of economic populism. Separating the two may make it easier to crystallise the economic implications of democratic reversals.

Investment is the key channel through which economic populism affects long-term growth. Lower policy predictability, often a characteristic of populist regimes, will hurt investment in both physical and human capital and will also affect productivity.

Looking at Hungary’s experience with Orbanomics, we find that productivity has declined drastically since 2010, and has not caught up with unit labour costs. Investment, meanwhile, is hugely dependent on EU funding, and drops dramatically if the latter dries up. Hungary’s experience does not bode well for Poland’s prospects should the PiS remain in power for several terms.

The rise of illiberalism in Eastern Europe has political and security implications. It is incompatible with core EU values and creates conditions for greater policy gridlock within the EU and risks further contagion. In addition, it makes it more difficult for the EU to have a unified voice against external security threats stemming from Russia.

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<th>The effects of participation and non-participation in the EU</th>
<th>Political illiberalism</th>
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<td></td>
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Note: Red means strong degree of illiberalism, yellow = medium, green = largely liberal.
Source: Oxford Economics research

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The rise of illiberalism and why one should care

Populism is on the rise across the developed world, but the economics profession is struggling to gauge what it means for economic prospects. My colleague Gabriel Stein recently wrote about its rise across the developed world and the risk it poses for the global economy. While in advanced economies populism has not yet entered mainstream politics, in Eastern Europe it has. Hungary seems to have turned from a “beacon of democratisation” into a “beacon of illiberalism”. Prime Minister Victor Orban has openly referred to his vision of Hungary as one of “illiberal democracy”, quoting Russia, China and Turkey as his “role models”. Until recently Hungary was seen as the “odd one out” in a land of successful EU-led democratisation. But since Poland overwhelmingly elected the populist right-wing Law and Justice (PiS) government, which immediately embraced Orban’s “Budapest model”, Hungary has been less of an exception and a number of questions arose: Are illiberalism and state interventionism becoming a new trend across Eastern Europe? Does this risk contagion throughout the rest of the EU? What does this mean for investors? Is the region becoming less of a safe haven in the emerging world? These questions have been further reinforced by the UK’s vote to leave the EU – will Brexit fuel further euroscepticism and divergence of Eastern Europe away from ‘core’ European values? We address some of these questions here, first by looking at the causes of this drift and then offering a framework to analyse the political and economic implications.

Both Hungary and Poland were examples of radical reformers, embracing the recipe of the Washington consensus – liberalisation, macroeconomic stabilisation and structural reforms (the latter often basically meaning privatisation). The EU was a key catalyst in this transformation, providing both incentives to transform and a template through the adoption of the acquis communautaire. Hungary stood out for its far-reaching privatisation, which made it a regional hub for multinationals, while Poland transformed itself into a financial hub. Poland became something of an economic miracle, having avoided recession since 1992. Against this backdrop of apparent economic liberalism, Victor Orban’s subsequent shift towards “illiberal democracy” since 2010, and Poland’s recent slide into Orban-style populism under the newly elected PiS party, seem to have caught the international community totally off guard.

The key lesson that both Orban and Jaroslaw Kaczynski (the leader and ideological father of PiS) learned from their previous terms in power (1998-2002 and 2005-07 respectively) was that cultural shifts were insufficient. In order to be successful, they needed to be accompanied by a capture of key institutions to eliminate checks and balances, particularly in the judiciary and the media, which is precisely what both did when coming back to power. But the speed at which PiS did so was truly remarkable, triggering fierce criticism from EU institutions, street protests and a credit rating downgrade from S&P. As Annex 1 shows, it took Orban about a year to reform the media to make it loyal to the state and 20 months to curb the powers of the judiciary. PiS did the same in a matter of weeks. These shifts have been all the more puzzling given that Hungary and Poland are among the largest recipients of EU funding, the scale of which as a share of GDP has exceeded the Marshall Plan to post-war Europe and significantly boosted their growth in the past two decades.

Causes of illiberal drift

Post-2008 downturn and the immigration crisis have undoubtedly contributed to the rise of populism across the world. As data from Swedish think tank Timbro shows, however, support for populist authoritarian parties in Eastern Europe has been on the rise from the

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early-2000s and on a much larger scale than in Western Europe. Populists have been particularly strong in Hungary and Poland. The refugee crisis boosted populism in Poland and Slovakia, but less so in other countries. It therefore seems that reasons other than the global financial or refugee crises have been behind the rise of illiberalism in Eastern Europe since the early-2000s.

- **Democratic capital**: the notion of democratic capital suggests the less time a country has spent as a democracy, the more likely regime switch is to happen.\(^1\) Eastern Europe’s track record of democracy is very short, mostly dating back to post-communist times, which makes it less entrenched and prone to reversal.

- **Pre-communist history**: if one looks at the region in the context of modern state-building, Hungary was never truly a democracy. Following the end of WWI, it was stripped of two-thirds of its population and three-quarters of its territory and left with a sentiment of injustice surpassing that of Germany. Following only one year as a republic (in 1918), it slipped into left- and right-wing dictatorships, and then into an openly anti-Semitic and authoritarian monarchy (which later allied with Nazi Germany). Elsewhere in the region, most of the newly-established democracies crumbled in the next 10-15 years, mainly through military takeovers.\(^2\) Czechoslovakia was the exception, managing to preserve broadly democratic institutions throughout this period.

- **Suppressed identity and nationalist revival**: some 43 years under communism only strengthened the feeling of lost national identity across Eastern Europe, and did nothing to help build a responsible civil society or a culture of checks and balances. The democratic revival in the early-1990s across the region was therefore marked by a rise of widespread nationalist, ethno-religious and revanchist sentiments, seen as part and parcel of the process of rebuilding an independent nation-state.

- **Technocratic liberals versus rent-seeking elites**: technocratic liberals, who established key economic and political institutions, have also accommodated the forces and interests of rent-seeking elites and cultural conservatism. Meanwhile, the civil society – a key but often underestimated democratic institution – remained under-developed. This configuration generated a mirage of liberal-

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\(^1\) Persson and Tabelini (2009)

\(^2\) Democracy in Poland and Lithuania ended in 1926, giving rise to fascist-populist regimes, while in Yugoslavia it ended in 1929, and in Estonia and Latvia in 1934, while in Romania it never really took hold and reverted back to monarchic dictatorship in 1920.

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democratic progress and mainstream moderate politics, obscuring a deeply running elite collusion and limits to cultural change.\(^3\)

- **Nationalism versus ownership**: the above two points are inter-related. Although transition economies regained independence following the fall of the Berlin wall, the speed of required reforms meant that they did not have full ownership of the process, largely following the Washington consensus recipe. This put the liberals in a weaker position in terms of national ideologies.

- **Inequality**: inequality has often been quoted as one of the key reasons for the PiS coming to power, with the country’s eastern regions feeling left behind. Poland’s Gini coefficient, at 32.4, is higher than that of the Czech Republic and Slovakia (at 26.1) and Hungary (30.6), but is not far from Italy and lower than the EU average. In fact, globally, no consistent relationship has been found between inequality and social unrest or radicalisation. The perception of inequality (what Amartya Sen called relative deprivation) may matter more, particularly its evolution over time. If we look at this year’s Happiness Report, Poland indeed scores much lower than many of its CEE peers (apart from Hungary\(^4\)), and the degree of “unhappiness” has increased since 2012. Among the countries where “happiness” has declined one can also spot the UK, Greece, Italy, the US, Spain and France – all countries where support for populism has surged recently.

- **Macroeconomic instability**: Hungary’s much earlier shift to illiberalism is also reminiscent of Latin America in 1990s, where neoliberal populists came into power on the back of financial and debt crises, setting out to restore financial and fiscal stability (e.g. Argentina’s Carlos Menem, Peru’s Alberto Fujimori or Brazil’s Fernando Collor). As Hungary narrowly avoided default in 2008, following years of fiscal profligacy that swelled the fiscal deficit to 10% of GDP by 2006, Orban won in 2010 on a platform of macroeconomic stabilisation which he achieved, albeit by populist measures such as nationalisation of private pensions and distortive sectoral taxes targeting foreign capital.

This complexity of causes goes some way to explain why populism gained popularity much earlier in Eastern Europe than in the West, and why it’s been much stronger. The fact that these causes are systemic and not unique to Poland and Hungary suggests that more democratic reversals in the region cannot be ruled out.

### Economic consequence of populism

Before discussing the economic impact, it is worth drawing a distinction between political and economic illiberalism and populism.

- **Political illiberalism**: liberalism is associated with free political institutions, religious tolerance, and prioritises freedom and rights of individuals over those of the state. In illiberal democracies, such as Victor Orban’s Hungary or Vladimir Putin’s Russia, elections still take place but checks and balances are significantly eroded and the opposition is often suppressed. Democratic illiberalism may or may not be accompanied by outright economic populism.

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\(^3\) Dawson and Hanley (2016)

\(^4\) Interestingly, Hungary, which scores among the most “unhappy” countries in Europe, appears to have become “happier” since Victor Orban has been in power, climbing twenty places from 110\(^th\) to the 91\(^st\) “happiest” country between 2013 and 2016. Poland, meanwhile, slid from 51\(^st\) to 60\(^th\).

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• **Economic populism**: traditionally, populism has been associated with left-wing economic policies – protectionism and fiscal expansion, to maintain voter support, and reduced independence for central banks, hence often inflationary.

• **Neoliberal populism**: but Latin America in the 1980s and even Russia under Boris Yeltsin have shown that political illiberalism can also be based on neoliberal (right-wing) economics, market reforms and fiscal consolidation. Victor Orban’s economic policies are not neo-liberal, but the focus on fiscal consolidation means they are not left-wing populist either. We prefer to refer to them as “conservative populism”.

As an example of this left-right schism, Figure 2 shows how broadly equally illiberal governments of Hungary, Poland, Bulgaria and Romania (albeit in their different ways) have very different attitudes to fiscal discipline. While Orban came to power on a platform of aggressive fiscal consolidation (narrowing the fiscal deficit by 3.3% of GDP since taking office in 2010), Poland’s PiS came to office on a much more fiscally expansive platform, which risks expanding the budget deficit by more than 1% of GDP in 2017-18, despite already pushing the 3% threshold.

![Figure 2](image)

While left-wing populism is known to compromise macroeconomic stability in the medium-to long-run, the impact of neoliberal or conservative populism is less straightforward, making it harder for investors to assess the longer-term growth implications and hence the risk premium that needs to be charged.

Broadly speaking, the economic impact of populism is an old question of whether democracy facilitates growth.

• **Democracy and growth**: although cross-country studies struggled to find conclusive evidence on the impact of democracy on growth, when measured over time democracy has been found to be strongly associated with growth.\(^5\)

• **Regime change**: regime changes matter.\(^6\) Democracy was found to be more strongly associated with growth in newer countries; and regime change from

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7 Sylwester (2015)

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autocracy democracy also boost growth. This typically happens with a delay, and results in GDP being 16-49% higher in 25 years after democratisation.  

- **Risk of reversal**: beyond a certain level of democratic and economic development, as the room for catch-up narrows there are incentives for de-democratization in order to boost short-run growth at the cost of higher sustained long-run growth. 

- **Expectations of reversal**: investor confidence tends to depend heavily on the expectation of a stable democracy and no regime change, and therefore a risk of an exit from democracy has been found to hurt investment and thus growth.

All of the above is of particular importance for Eastern Europe’s relatively young democracies. As we discussed in our [recent research](#), regime change towards democracy and market economy, further boosted by EU accession, was initially accompanied by a sharp rise in productivity and potential growth. As both of the latter receded in the wake of the crisis, populism is on the rise again.

Populist economic policies can affect potential growth in a number of ways:

- **Investment and policy predictability**: this is by far the key channel of transmission. Risk of policy reversals or tax changes, often characteristics of populist regimes, will hurt investment in both physical and human capital, and thus also cut productivity.

- **Fiscal expansion**: populism depends on the persistence of popular support, which is often achieved by excessive wage, pensions and benefits increases. If not offset by tax hikes, government debt will keep rising; beyond a certain threshold it will also start suppressing growth. When income growth outpaces productivity, it erodes competitiveness.

- **Populist fiscal consolidation**: even when setting out to correct macroeconomic imbalances, as was the case in Hungary or in 1990s Latin America, conservative or neoliberal populists still tend to “over-promise” income increases to the electorate to maximise their hold on power. Such conflicting goals of fiscal consolidation and generous spending promises result in an even more distortive redistribution of wealth away from the corporate sector to households than would be the case in a classical left-wing populism.

- **Quality of investment**: this can also go down as wrong incentives prevail and it becomes more profitable to invest in short-term projects like housing than in productivity-enhancing physical or human capital.

- **Cronyism and corruption**: these undermine property rights, also hurting long-term investment.

- **Distortive price signals**: accumulation of strategic sectors in the hands of rent-seeking elites, often in the form of monopolies or oligopolies, distorts price signals, thus making resource allocation less efficient, also hurting productivity.

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8 [Nax and Schorr (2015)](#)

9 [Nax and Schorr (2015)](#). This effectively addresses the inconclusive results of cross-country studies, which fail to find faster growth for rich democratised economies.

10 [Persson and Tabellini (2009)](#)

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Based on the above, one can see that populism involves both economic and political levers to consolidate and maximise power. We follow the approach that Kaufman and Stallings (1990) applied to analyse the political economy of Latin American populism, and construct our own typology of illiberal policy measures pursued by East European governments.

### Typology of illiberal policies in Eastern Europe

#### Figure 3

<table>
<thead>
<tr>
<th>Political illiberalism</th>
<th>Economic illiberalism</th>
</tr>
</thead>
<tbody>
<tr>
<td>Judiciary</td>
<td>Media freedom</td>
</tr>
<tr>
<td>Hungary, Fidesz (2010)</td>
<td></td>
</tr>
<tr>
<td>Poland, PiS (2015)</td>
<td></td>
</tr>
<tr>
<td>Slovakia, SMER-SD (2012)</td>
<td></td>
</tr>
<tr>
<td>Romania, PSD (2012)</td>
<td></td>
</tr>
<tr>
<td>Czech Republic, SDP (2014)</td>
<td></td>
</tr>
</tbody>
</table>

Note: Red means strong degree of illiberalism, yellow = medium, green = largely liberal.

Source: Oxford Economics, drawing on Kaufman and Stallings (1990)

As Figure 3 shows, despite fiscal consolidation Orban’s economic policies have been populist across the board: generous wage and pension increases financed by distortive sectoral taxes; preferential ownership by vested interests of some strategic assets; and loss of independence for the central bank. In order to maintain power, Orban applied a range of politically illiberal measures: scaling back media and judicial freedom; mobilising nationalist sentiments, including through the use of an external threat such as migration; and maintaining a culture of deeply entrenched cronyism.

Poland’s PiS is also following the populist playbook, albeit a more classically left-leaning one: generous spending promises, partially financed by distortive sectoral taxes (largely targeting foreign capital) and (most likely) partial pension nationalisation. However, central bank independence has so far been preserved and the degree of business collusion is also less than in Hungary.

While Hungary and Poland have stolen the spotlight, one can see that Slovakia and the Czech Republic also share some of these illiberal policies, in particular the degree of state capture by vested interests. This makes them ripe for further democratic retrenchment down the line.11

All of these channels usually take several years to manifest themselves in headline growth numbers. While in Poland it is too soon to judge, in Hungary after six years of Orbanomics there are already clear signs of an economic impact.

**Competitiveness:** unit labour costs in Hungary have been consistently outpacing productivity growth, unlike in the Czech Republic where the two are broadly in line, or in Poland, where productivity appears to outpace labour costs, eroding Hungary’s competitiveness.

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11 E.g. the Czech Finance minister, an oligarch who also appropriated most of the mainstream media, may become a Prime Minister after next year’s general elections; the Czech and Slovak presidents Milos Zeman and Robert Fico are both outspoken supporters of Putin and his “strong” model of governance, which suggests Victor Orban may not be the last European leader to emulate Russia’s illiberal model.

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Financial intermediation: punitive taxes on banks and a compulsory FX mortgage conversion have hit credit growth, which has been in decline since 2010. Although most large corporates preserved access to finance by channelling their borrowing through parent banks, a structural decline in credit also hurts productivity and budget revenues.

Investment: broken financial intermediation channels and unpredictable policy environments have affected private sector investment. While very strong in recent years, fixed investment is mainly dependent on EU funding, as first half of 2016 has shown (when investment slumped 20% on the previous year) clearly demonstrated (seen in figure 5).

Productivity: as a result, productivity growth has been around zero since 2009. Although some scope for improved productivity remains (e.g. from repairing relations with banks, and hence credit growth), the latter is set to remain among the lowest in the region. We therefore see potential growth averaging only 1.8% in the next 5-10 years.

Poland’s starting point is very different from that of Hungary – while Hungary was on the verge of an economic collapse when Orban took power, Jaroslav Kaczynski found Poland in a much better shape, with solid growth and strong macroeconomic fundamentals. Orban had to combine populist spending promises with fiscal consolidation. Poland does not need radical fiscal consolidation, but PiS’ spending promises are much more generous than those in Hungary. Hence, the Polish economy has a bigger “cushion” against populism, and it may take longer for Polish macroeconomic balances to unwind. However, the Hungarian experience suggests that the trajectory of Poland’s long-term growth may decline should PiS stay in power for several terms.

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Political and security implications

While Orban has successfully modified institutions and solidified voter support, one of the key questions now is how long will PiS stay in power.

**Upside risks:** on the one hand, Poland’s track record with right-wing parties is much shorter than that of Hungary; its civil society and opposition are stronger; popular opinion is strongly in favour of the EU (indeed at 72% it is the strongest in the EU).

**Downside risks:** but the arguments for longer PiS rule may eventually outweigh the upside risks. Populist spending tends to mobilise voter support in the initial years in office, while in the meantime the ruling party is modifying political institutions in such a way that may make the return of the opposition impossible. The general drift to the right across Europe may continue to provide support to PiS and even reinforce other right and far-right parties in the region and Europe more broadly. Moreover, unlike in other European economies, where illiberalism tends to correlate with euroscepticism, in Eastern Europe it does not. According to opinion polls, Hungary is the second most pro-EU member state (with 61% support) after Poland. This does not preclude Hungarians from giving two-thirds of their votes to the right and far-right parties (Fidesz and Jobbik).

The relatively short democratic track record leaves the region exposed to the influence of Russia. Even when openly pro-NATO, many conservative East European leaders gravitate towards Putin’s style of governance, expressing scepticism towards western values. This trend has further strengthened as the global financial crisis has undermined the European model that CEE economies sought to emulate. Capitalising on this, Russia has fostered direct links with right-wing parties across Europe and has used East European media for its information war. The leaked tapes that brought down Civic Platform in Poland were reportedly recorded by someone with links to both Russia and PiS. The unified EU response to Russia’s threats to democracy has also become more complicated, as Hungarian, Slovak and Czech political leaders all strongly oppose sanctions on Russia.

As we wrote recently, despite being the largest beneficiaries of the EU funding programme, many of the countries in the region have been emboldened by the Brexit vote and are calling for less integration (despite paradoxically showing very strong pro-EU opinion polls). The Brexit process may reinforce this sentiment, particularly as the CEE has a sizeable voice in the Brexit debate given the number of their citizens in the UK.

Conclusions

- With both Poland and Hungary now in the “illiberal camp”, Eastern Europe is emerging as a strong antagonist to the EU’s core values and principles.
- Illiberalism could spread across the rest of the CEE and Europe (Austria, on course for a far-right president in a re-run of elections in October, may be the next in line).
- These trends may contribute to further discord and greater policy gridlock within the EU.
- The EU’s liberal set-up – the need for all countries to agree to penalise any member state – has made it institutionally incapable of confronting illiberalism. Despite the EU’s attempts to prevent Hungary’s slide into illiberalism, Orban’s tactics of “two steps forward – one step back” allowed him to succeed in retrenching democracy in Hungary.

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- As long as the EU does not use its strongest levers (budget and migration), the continuation of generous financial support and liberal migration policies will continue to validate euroscepticism across the rest of the EU. This, in itself, may be the greatest risk to the unity of the EU going forward.
- As far as economic and financial implications are concerned, illiberal and populist policies may boost short-term growth through higher consumption, but tend to hurt longer-term growth as underlying private sector confidence is eroded. Besides, given the region’s huge dependence on the EU investment funds and one major industry (the automotive supply chain with Germany), investors are better served by looking at a longer-term picture than the short-term headline numbers.

### Annex 1

#### Timeline of key reforms by Fidesz and Hungary and PiS in Poland

<table>
<thead>
<tr>
<th>Political / Institutional reforms</th>
<th>Date</th>
<th>Nr. of months since election</th>
<th>Victor Orban’s agenda</th>
<th>Date</th>
<th>Nr. of months since election</th>
<th>Poland’s PiS’ agenda</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electoral law</td>
<td>Dec-11</td>
<td>20</td>
<td>New electoral law favours the incumbent party</td>
<td></td>
<td></td>
<td>N/A</td>
</tr>
<tr>
<td>Judiciary</td>
<td>Jul-05</td>
<td>21</td>
<td>Constitutional reform curtailing power of the judiciary.</td>
<td>Dec-16</td>
<td>2</td>
<td>Replaced five judges with loyal judges loyal to PiS; Imposed a chronological order for reviewing cases.</td>
</tr>
<tr>
<td>Media control</td>
<td>Feb-11</td>
<td>10</td>
<td>Amending media law, imposing strict regulation on all media outlets. Eased after EU intervention, but ‘soft censorship’ persists.</td>
<td>Jan-16</td>
<td>3</td>
<td>New media law. Replaced the leadership at all major channels; Subordinates major media outlets to the govt.</td>
</tr>
<tr>
<td>Migration</td>
<td>Jul-16</td>
<td></td>
<td>Referendum on EU plans to relocate migrants to be held on 2 October 2016</td>
<td></td>
<td></td>
<td>N/A</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Economic reforms</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking sector</td>
<td>Jul-10</td>
<td>2</td>
<td>0.53% asset tax imposed on banks</td>
<td>Feb-16</td>
<td>3</td>
<td>0.44% asset tax imposed on banks</td>
</tr>
<tr>
<td></td>
<td>Nov-11</td>
<td>29</td>
<td>Early repayment scheme for FX-denominated mortgages at favourable exchange rates, followed by compulsory conversion from 2014</td>
<td>Aug-16</td>
<td>8</td>
<td>Plan proposes voluntary conversion of CHF mortgages into PLN. Less severe than feared.</td>
</tr>
<tr>
<td></td>
<td>2013-2016</td>
<td></td>
<td>Subsidised mortgage and small business lending</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pension reforms</td>
<td>Dec-11</td>
<td>19</td>
<td>Nationalisation of mandatory private pension savings (about $14bn)</td>
<td>Jul-Aug 2016</td>
<td>7</td>
<td>Partial nationalisation of the mandatory private pension savings (25% of total, or $8.8bn). Govt approves lowering retirement age from 67 for both to 65 for women and 65 for men. Fiscal expansion</td>
</tr>
<tr>
<td>Fiscal policy</td>
<td></td>
<td></td>
<td>Fiscal consolidation along with aggressive redistribution</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real economy</td>
<td></td>
<td></td>
<td>Increasing the role of the state / nationalisations in several sectors, primarily energy and banking. Vested interests gained preferential ownership in certain sectors (tobacco, alcohol)</td>
<td></td>
<td></td>
<td>Intention to increase ownership of the banking sector from about 30% to 70% in two decades</td>
</tr>
</tbody>
</table>