Why Hungary?

A political economic assessment of the Hungarian post-communist economic transition

Doctoral Dissertation Summary

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Debrecen, 2015
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1. The research question: Why Hungary?

The goal of this thesis is to provide a political economic interpretation of the Hungarian post-communist economic transition. More specifically, I am interested in the political economic explanation of institutional developments during the Hungarian transition. Being as extreme as it is, the Hungarian case can provide some generalizable observations about how countries can or cannot transit from one social, economic and political system to another. Hungary started off the transition as one of the best placed countries to attain fast and successful structural change towards liberal democracy and market economy. And indeed, Hungary had been a forerunner of transition throughout the 1990s. Yet, since the mid-2000s it is considered to be one of the most problematic countries in the region both economically and politically, and its attainment in transition both in terms of economic development and institutional stability lags behind most of its peers, demonstrating significant deterioration over time by the end of the second transition decade. Hence the question: Why Hungary?

The decline of relative performance started at the beginning of the 2000s. The rate of investment had been declining, and the role of private and government consumption had been increasing in GDP. Real GDP growth since the mid-2000s had lagged behind that of the CEE average as the 2004 EU accession, unlike in the case of most new CEE member states, did not provide any salient added growth impetus. Subsequently, the fiscal consolidation imposed in 2006 restricted economic growth.

The consumption based growth and the growing general government deficit resulted in increasing public and private indebtedness. Debt financing occurred to a large extent through external loans. In consequence, Hungary became highly vulnerable to external economic shocks and, along with Latvia, was among the first EU member states to claim official financing aid from the EU and the IMF in autumn 2008 amidst the global financial crisis.

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1 As regional peers I consider the East Central European EU members states: Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.
3 Investment as a share of GDP peaked at 24.4% in 2000. By 2012 it has declined to 17.4% but in 2013 it reached 18.1%.
Deteriorating internal and external balances resulted in the double deficit of the general government and the current account, known from the early 1990s. In 2006, just as in 1995, the center-left government was forced to impose strict budgetary stabilization. And at the top of that came the 2008 global financial crisis that led to a severe deterioration in popular perceptions on social and economic conditions. Social trust, already among the lowest ones in Europe, further deteriorated (Tóth 2009).

Unlike in most of Europe, counter-cyclical fiscal policies could not be employed because of the deteriorating fiscal stance and weakening investor commitment towards Hungary. Although the general government deficit slightly increased in percent of GDP in 2008-10, it did so to a lesser extent than the shrinkage of GDP. Hence, aggregate government demand exercised pro-cyclical impact during the crisis, exacerbating difficulties.

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Graph 2. Change in general government balance in percent of GDP in CEE, 2008-2010

Hungary’s extraordinarily pro-cyclical budgetary stance becomes more apparent if the change in general government deficit in percent of GDP in 2006-10 is assessed. In this period, Hungary was the only country in the region – and for that matter in the entire EU – that improved its general government balance.

Graph 3. Change in general government balance in percent of GDP in CEE, 2006-2010.

At the same time, the center-right parliamentary opposition mobilized the electorate, and the far-right became a major political actor. It is not difficult to explain the anti-liberal political turn
by the severe toll of the fiscal stabilization and recession. The question is, however, why Hungary had pursued such an unsustainable fiscal policy path before 2006 and became the first crisis casualty in 2008? Why the one-time reform vanguard (Andor 2010) and top performer of comparative country rankings (EBRD 1999) suffered such a spectacular backdrop in institution building towards marketization and democratization (North et al. 2009, North 1994, Acemoglu–Robinson 2012, 2006, Acemoglu 2005)?

2. The structure of the dissertation

The dissertation attempts at providing an answer by interpreting the post-1989-1990 transition process in a political economy framework using notions of institutional economics. Chapter 1 provides an introduction to the dissertation, sets the research agenda and formulates the dissertation’s hypotheses.

Chapter 2 first looks at the initial conditions of post-communist transition with particular reference to the political economy tradition inherited from the Kádár regime. This tradition sought to make sure the containment of social conflict and the compensation of losses major social actors suffered as a result of government policies or any other structural change (Kornai 2005). Based on this, an analysis of political economy cycles and related fiscal policies in the 1990-2010 period is formulated, identifying the particular political economy pattern that differentiates Hungary from other CEE countries.

Chapter 3 focuses on structural reforms. It outlines the theoretical literature and places Hungarian reforms into international and historical context. It also sets forth a discussion of three key Hungarian structural reforms: the hardening of the soft budget constraint in the corporate sector (1990-98), the reform of the pension system (1997-2011) and the liberal healthcare reform (2006-2008). Understanding the mechanism – and in most of the times the subsequent failure – of these reforms is a crucial part of my argument. Swift, seemingly efficient but on the long run politically and socially unsustainable and/or socially excessively costly structural reforms played a large part in the Hungarian transition failure – goes my argument.

Chapter 4 is concerned with another salient characteristic of the Hungarian transition, intimately related to the rapid structural reform of the corporate sector: the conspicuously low
labor market participation rate and the comparatively high budgetary spending on welfare policies.

Chapter 5 discusses another Hungarian transition characteristic: the particularly strong institutional position of the government and the lack of competitive political actors, who could provide a counterweight to it in a highly centralized, Westminster-like political system.

Chapter 6 analyses the relation between institution building and economic development both qualitatively and quantitatively. Employing fixed effect panel regressions it argues that the relation between economic growth and key institutional variables such as the establishment of the ‘Rule of law’ and ‘Government effectiveness’ might be different across Western and Eastern Europe.

Chapter 7 summarizes the research findings and draws some policy conclusions.

3. Research methods

The dissertation is predominantly based on the qualitative analysis of economic, social and political developments during transition in Hungary and the CEE region. Yet some of my arguments are underpinned by using quantitative techniques. My approach seeks to analyze the variation in transition patterns both across CEE and throughout time. The variation in the behavior of independent variables are expected to provide a plausible explanation in the variation of dependent variables. The two major dependent variables are economic development and institutional stability throughout transition.

This is an approach mainly falling into the realm of political economy as political and economic developments are assessed in their interaction with each other. However, the operationalization of variables are often borrowed from institutional economics, and the results of the dissertation can be also seen from an economic sociology point of view, as both political and economic developments are interpreted in a social context.

The dissertation focuses on one case, the Hungarian post-communist transition in 1990-2010. Hence, it can be conceived as an extended case study, within which, however, a fair amount of comparison is made to other transition countries in CEE.
4. Hypotheses

The dissertation elaborates on four aspects of post-communist transition, sets hypotheses on each of them, and examines those. The four aspects of transition are (1) fiscal policy patterns; (2) structural reforms; (3) labor market policies and welfare spending; and (4) the institutional structure of the emerging new political system. These four aspects are interrelated and, as I argue in the dissertation, together define the distinctive characteristics of the Hungarian transition.

4.1. Fiscal policies

One of the most salient attribute of the Hungarian transition is the recurring political economy cycles of loose vs strict fiscal policies. Throughout the two decades of transition one can observe two big fiscal policy cycles, one in the 1990s and one in the 2000s. Overly loose fiscal policies culminated in the 1995 and 2006 fiscal stabilizations, whereas smaller stop-go policy cycles were present within most four-year parliamentary periods (Győrffy 2010; 2007).

Governments tried to ‘buy in’ major social groups into the transition process by providing them with extensive budgetary transfers, following the policy pattern of the pre-1989 Kádár regime (Benczes 2011). As a result of the transformation recession (Kornai 1993a) and declining employment, this led to a deterioration in general government balance and growing indebtedness. Following the international financial crisis in 1994, the center-left government of Gyula Horn was forced to implement a strict budgetary stabilization package in 1995-96. As the fiscal trajectory became sustainable, however, fiscal loosening took over in 1997-98. The subsequent right-wing government also started with stricter policies to be followed by budgetary loosening. In 1993-1994, 1996-1998, 2001-2002 and in 2002-2006 fiscal policies were typically loose, whereas in 1995-1996, 1999-2000 and in 2006-2010 typically strict as far as the change in aggregate government demand was concerned.

The strong political cycle of government demand resulted in the recurrence of unsustainable fiscal trajectories and growing indebtedness. Sustainability of the economic policy mix was
rather the exception than the rule, and growth episodes typically occurred along unsustainable fiscal policies (Oblath 2013).

**Hypothesis 1.** The political cycle of fiscal policies reflected the inheritance of the pre-1989 political regime and played a decisive role in the course of Hungarian post-communist transition. The episodes of fiscal expansion undermined the sustainability of the fiscal trajectory, and on the long run destabilized the course of transition.

**4.2. Structural reforms without sufficient popular support**

The reform consensus of the Hungarian transition believed that the economy could and should be liberated from the political cycle of fiscal policies by conducting swift, thoroughgoing structural reforms. Radical reforms were not only deemed economically beneficial but also morally superior to gradualism and political compromise.

Reform policies have had a longstanding tradition going back to ‘reform-Communism’ (Pető–Szakács 1985; Kornai 1993b) and were in line with the dominant international policy discourse of the ‘Washington consensus’ (Aslund 2013, Williamson 1994). Structural reforms were not only expected to enhance economic performance but also to alter social behavioral patterns, reducing dependency on the state and strengthening civic values (Tárki és Kopint-Tárki 2009). Economic growth, on the long run should also make up for the losses in jobs and production facilities occurred during transformational recession. Reform thinking placed little emphasis on the social internalization of structural changes (Gelbach–Malesky 2010), and assumed that social adjustment would occur automatically. As this had not happened, however, reforms on the long run destabilized and became subjects of political mobilization against liberal policies.

**Hypothesis 2.** Rapid, radical structural reforms played an important role in the destabilization of institutional underpinnings of Hungarian post-communist transition in the second part of the 2000s. The lack of social internalization of reforms became an institutional hurdle when economic transition lost popular support in relation to fiscal stabilization and the recession of
the late 2000s. Once a major component of the successful Hungarian post-communist transition of the 1990s, radical reforms turned out to be a liability amidst deteriorating social and economic conditions towards the end of the second transition decade.

**4.3. Welfare policies and labor market participation**

Extensive welfare policies inherited from the pre-1989 regime had always been a distinctive feature of the Hungarian transition. Until the end of the 2000s, Hungarian welfare spending in percent of GDP was typically above the CEE average and in some respects approached the average of old EU member states. This was the result of compromise-seeking social policies that tried to compensate all major social groups for their losses in transition. One of the most widely used form of compensation were generous retirement schemes, including early age and disabled pensions (Tóth 2009).

In the early 1990s employment shrank in all CEE countries, but Hungary was among the most extreme cases both in terms of the size of the drop in employment and the lack of subsequent labor market recovery. The hardening of the soft corporate budget constraint resulted in the elimination of about 20% of formal jobs, and the recovery of the labor market had never really taken place. In consequence, the dependency on government transfers increased and the demand for populist fiscal policies grew.

According to comparative data, higher employment rates are typically associated with a more balanced fiscal stance in EU member states under normal economic circumstances. Low employment rates, on the other hand, are associated with weaker fiscal balances, both because of larger expenditures and smaller revenues.

**Hypothesis 3.** The Hungarian transition trajectory had been characterized by particularly low labor market participation rates in a regional comparison. Government transfers played a major role in maintaining social stability and in compensating for losses in transition. However, once the reform compromise became unsustainable and transfers had to be cut, political and economic institutions destabilized and the course of transition derailed.
4.4. Highly centralized political power

The fourth unique characteristic of the Hungarian transition is the over-centralization of the political institutional system. Hungary had been known for its spectacular political stability until 2006. No snap election were held, and effectively all parliamentary majorities persisted throughout four years.

This had to do with comparatively high entry barriers into the political system and the dominance of single-member electoral districts that gave advantage to strong parties. The political system was organized around a unicameral parliament and the dominance of the national executive, headed by the prime minister, who is protected by the so called constructive no-confidence vote.\(^5\)

The power of the prime minister is unrivalled in the Hungarian constitutional system. The president of the republic is elected by parliament and has limited political role. There are no nationally important regional governments. The only local politician playing a significant national role is the mayor of Budapest, whose authority, however, is limited by those of district mayors.

The Hungarian political institutional system is highly centralized and hierarchical. Decision making follows a top-down pattern as political resources are centralized and controlled by party leaders. Centralized institutional authority is underpinned by exclusionary ideologies that gradually spilled over to society and led to an internationally high degree of popular ideological identification (Körösényi 2012, Karácsony 2006). Meaningful political discourse between government and opposition became increasingly difficult and rare. Political competition was increasingly organized around zero-sum games, while cooperative games lost their appeal (Ádám 2013).

It was not by chance that the founding fathers of the 1989-90 republic decided to create a centralized political system with high levels of entry. They thought that political destabilization was a major threat to transition. Hence, they secured the competitive institutional positions of the executive and its leader, and reduced the voice of the opposition and any other

\(^5\) So that the prime minister can be dismissed, the majority of parliament has to agree on a new prime minister.
institutionalized political counterbalance. This arrangement worked well in terms of political stability until the second part of the 2000s, but effectively made power exclusionary and did not bring enough social internalization of the democratic discourse.

**Hypothesis 4.** The character of the Hungarian political institutional system played a decisive role in transition. The overly strong and stable executive power pushed a large part of interest representation outside the institutionalized political discourse. Meanwhile political interactions got to be organized around zero-sum games and an increasing ideological differentiation took place. Strong executives with under-institutionalized political counterbalances were at times prepared to back unpopular reforms. Exclusionary political institutions were used to pursue exclusionary social and economic policies – often with good intentions but bad consequences.

5. Research findings

With respect to the above four hypothesis, I found the followings in my research.

1. Hungarian welfare spending in the period under investigation exceeded the regional average and in some respects even surpassed that of old EU members. High welfare spending impacted negatively on the general government and the current account, and increased indebtedness. Deteriorating balance positions and the following fiscal consolidation episodes were not the only reason for the destabilization of the transition trajectory, but they are likely to have played an important role in that process.

2. Structural reforms yielded mixed results and often proved unsustainable. Although the reform of the corporate sector in the early 1990s brought about lasting changes and a large improvement in corporate efficiency, it also triggered a large number of job losses that had later never recovered. The reform of the pension system and the healthcare system yielded less success. Although the 1997-98 pension system reform had initially enjoyed widespread popularity, efficiency enhancement remained questionable and after 2010 the private pension system was abolished. The 2006-08 reform of the healthcare system did not result in sustainable structural changes and the reform of healthcare finance did not even take place. Importantly, the healthcare reform was highly unpopular and provided a major platform for the anti-reform mobilization that culminated in the March 2008 referendum.
3. Hungary had been characterized by a comparatively large drop in employment in the early 1990s and low employment rates throughout transition. Under normal economic circumstances, these are associated with relatively higher general government deficits in the EU. Low employment rates are also likely to be associated with populist economic policies. Yet, the statistically persuasive demonstration of this relationship requires further research.

4. It seems to be self-explanatory that institutionally strong, exclusive political institutions are inclined to employ exclusive economic policies that, in turn, need to be compensated by inclusive social policies so that the political economy of transition becomes manageable. However, statistically speaking it is difficult to prove such a relationship. Nevertheless, it is plausible to argue that institutionally weaker (i.e. politically more vulnerable) and more inclusive (i.e. more accessible) political institutions had been associated with slower reforms and longer social adjustment periods in CEE during transition. Such concessions had for long been viewed as unnecessary compromises that entail high social costs. In retrospect, however, slower reforms and longer social adjustment periods seem to result in politically more stable and socially more sustainable transition trajectories, whereas the long term social costs of the U-turn in Hungarian transition are likely to be enormous.

6. A caveat

There is one more aspect of transition I examined in my dissertation, the relation between institutional development and economic growth. I tested the thesis of Glaeser et al. (2004) that economic growth at the beginning of modern, capitalist development is typically not based on democratic political institutions but takes place under authoritarian rule. I run fixed effect panel regressions, regressing annual real GDP growth on institutional variables as well as standard macroeconomic variables such as budget balance, export performance and a crisis dummy for 2009. Because of data limitations, I examined the period of 1996-2012.

What I found was that in Central and Eastern Europe both government effectiveness and the rule of law, as defined by the World Bank (Kaufmann et al. 2002), turned out to be significant independent variables in explaining the variation in economic growth. Yet, whereas government effectiveness had a positive significant coefficient, rule of law had a negative one. In contrast, in the old EU member states, regulatory quality and political stability were the two main institutional variables carrying significant positive coefficients, whereas both government
effectiveness and the rule of law played a secondary role, while both were positively related to growth.

This suggests that Glaeser et al.’s hypothesis may to some extent hold in CEE, and the pathway to development might not always lead towards the democratic control of the executive. In this context, the lack of social internalization of structural reforms might not in itself be a problem in the course of transition, but against the background of a fairly democratic political system, in which governments are in fact replaced through elections, and the costs of being out of power may get excessively high.

7. Policy conclusions

The policy conclusions of my dissertation can be summarized as ‘inclusivity matters.’ Exclusively organized, institutionally strong executives may carry out vigorous structural reforms that for some time may appear technically successful and politically viable. However, such a policy course typically comes with a price tag of economic populism under democratic conditions. So that those who are excluded from the process of economic development can be kept on board, welfare transfers must remain high. When economic conditions deteriorate and transfers have to be cut, either due to domestic imbalances or to external shocks or both, the transition trajectory may destabilize. This suggests that even institutionally strong, cohesive executives should consider objections to radical reforms and leave sufficient time for people to adjust to structural changes.

When it comes to the design of political institutions, inclusivity matters again. Authoritarian governments may get along with exclusive policies and organizational principles, but democratic polities must have inclusive institutions so that interest representation can be institutionalized and social and political sustainability maintained.

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07 May, 2015