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Hungary: The Janus-faced Success Story

László Csaba*

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Abstract

This paper offers a broad overview of the Hungarian development strategy over the past two decades. Combining historical and functional analysis, some major strengths and weaknesses are identified, with special emphasis on the country's open-door policies and the role played by the European Union. The paper investigates why the impetus of institutional and financial integration was lost by about 2004 when policy drifting took over the role of strategies. Some ideas on how to remedy the situation are being offered. Paradoxically, the Hungarian success and failure both testify to the relevance of a neo-institutionalist/political economy approach to sustainable development. It also examines the limitations of external anchoring by the EU as well as of the spontaneous bottom-up evolution of institutions when policy drifting continues.

Keywords: structural reform, sustainability, EU accession, regulation, FDI, trust

JEL classification: P21, P26, F15, F59

* Central European University, Budapest, email: csabal@ceu.hu

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UNU World Institute for Development Economics Research (UNU-WIDER)
Katajanokanlaituri 6 B, 00160 Helsinki, Finland

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1 Introduction

In this paper we refrain from presenting a very long-term statistical analysis, for no other reason than the fact that Hungarian political and economic structures have undergone truly fundamental changes in the past 90 years, i.e., since the disintegration of the Habsburg Monarchy. Each event, but most recently the collapse of the Soviet empire in 1989/90, and the related economic and power structures have created new circumstances. In the following we attempt to summarize the post-1989 era, a period of two decades when basically everything has undergone a change in the process of Europeanization and globalization.

In general, we also refrain from the detailed, and by its nature ephemeral, analysis of the ups and downs of specific years, as descriptions of such individual phases and their related analyses are available from a number of regional overviews. Instead, we adopt a developmental perspective, i.e., the long view, and therefore approach the Hungarian experience from the perspective of global political economy of reforms, focusing on facts that could be of relevance for other countries in managing their institutional and structural change. This is a unique, and in some way, a narrow perspective, but it follows the themes of the UNU-WIDER Development Conference on 'Country Role Models for Development Success'.

2 Is Hungary to be considered a success at all?

Hungary is a country with a population of ten million people and a per capita GDP of €15,800.[1] GDP grew 4.0 per cent per annum during the years 1996-2000; 4.3 per cent in 2001-05, but dropped to 3.9 per cent in 2006. In 2007, growth decelerated partly because of the harsh fiscal adjustment measures included in the Convergence Programme of August 2006 adopted for the 2007-09 period,[2] but did not come to a halt. In 2007, GDP grew by 1.3 per cent and, according to the consensus of analysts, a slow recovery to 1.6-2.0 and 2.5-3.0 per cent is expected for 2008-09. In short, almost similarly to the delayed and forced adjustment of the previous decade (Kornai 1997; Antal 1998), major fiscal adjustment has taken place without a recession, albeit the expansionary effects that many had hoped for on the basis of more theoretical literature, also failed to materialize.

But this is not why Hungary can be considered a success story. During the period under review, growth tended to be significantly above the eurozone average: 2.7 per cent in 1996-2000 and 1.4 per cent in 2001-05. Exports, a major component of sustainable external finance and thus lasting growth, expanded rapidly. Starting from a mere US$9 billion in 1989, exports had grown to US$15.7 billion by 1996, 30.5 billion by 2001, expanding to 89.7 billion by 2007 and forecasted to reach US$101.6 billion by 2008 (EIU 2008). With regard to foreign direct investment (FDI), Hungary has long been the champion in per capita terms as far as stocks are concerned, although the inflow peaked in 2005 at €6.8 billion; the figure for 2007 is around €5 billion, while the

1 Data source, unless otherwise indicated, is the *ECB Statistics Pocket Book*, August (ECB 2008).

2 Various versions of the programme, most recently updated in December 2007 and approved by the Commission in January 2008, are available at the website of the ministry of finance: www.pm.gov.hu

2008 projection is €5.6 billion.[3] Still, foreign ownership accounts for approximately 40 per cent of Hungarian assets and 80 per cent of its exports. Dynamic inward FDI has contributed to a major upgrading of Hungarian exports, with machinery and equipment accounting for 61.7 per cent (ibid.), or double the Spanish or Italian equivalent.

In short, Hungary has been a success on a number of accounts. First, the country managed the transition from communism to democracy peacefully without any of the political turmoil witnessed in a number of countries in east and southeast Europe. Second, it managed its accession to the European Union in 2004 in a gradual and organized manner. Adoption of policies and institutions has been gradual, whereas opening up the domestic market was swift and irreversible. In so doing, Hungary was able to benefit from competition and structural adjustment and around 1996 inward investors were already factoring in the impacts of EU membership, including improved regulatory framework. Third, Europeanization speeded up and shaped institution building, and lent credibility to new institutions, such as the competition agency, the financial supervisory agency, or environmental agencies. Fourth, global processes had an impact in terms of IT revolution and deregulation. In terms of mobile use, Hungary ranks among the first in Europe. In terms of liberalization, e.g., airlines, insurance business and any other trades, the global processes have fostered change for the better and created sizable consumer surplus, as prices started to come down to single-digit levels during a number of years since 2001. All in all, Europeanization has been working both top-down—by setting up new organizations—and bottom-up through inter-firm contacts, massive movements of students as well as business executives and tourists. Stagnation of the formal institutional level of the EU has, by no means, slowed down the growing interaction at the microlevel.

One of the toughest challenges is to define to what extent the above mentioned outcomes are the result of conscious policy that could be described with the term ‘strategy’, as has become customary in the political economy of policy reforms. More probably than not, conscious and forward-looking decisions at some critical juncture were needed and these, indeed, were taken. But at other times, particularly since membership in the European Union in 2004, drifting and improvisation have prevailed over any conscious conduct of policy.

The first major conscious decision was taken in 1989 when the communist government adopted a three-year liberalization plan and legislated for various forms of privatization (Szamuely 1990). The second major decision was taken by the newly elected conservative government, which, in fact, continued with liberalization. Moreover, ongoing legislative and political processes had culminated by 1992 in the adoption of a series of laws that made life for corporations much harsher. These four laws, concerning central banking, financial institutions, bankruptcies and corporate taxes, actually included most of what was by 1992 known as ‘second generation reforms’. This accounted for an institutional shock therapy (Bokros 1994) which contrasted these measures with radical liberalization, as practised in Poland and Russia at the time.

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3 These figures are from the ministry of national economic development. Actual numbers tend to vary. For example, in terms of per capita stock over the 1993-2007 period, UNCTAD’s *World Investment Report 2007* puts Hungary with €4,567 in third place, after Estonia (€5,660) and the Czech Republic (€5,306). Regional assessment by Ernst and Young, on the other hand, ranks Hungary as the frontrunner in a draw with the Czech Republic, both with €6,612 per capita for the decade, 1998-2008 (reported in *Világgazdaság*, 26 June 2008).

Finally in March 1995, fiscal adjustment and reform measures were introduced, with major expenditure cuts, surprise inflation and the introduction of a crawling devaluation of the currency.

No further radical measures have been taken since then. However, it is beyond any doubt that until December 2002 when the enlargement decision of the EU was taken at the Copenhagen Council, a fair degree of consensus existed across the various fractions of the ruling elite on the need to comply with all or most of the Union's entry requirements. These entry criteria covered political freedom, legal harmonization, institution building and introduction of policies that were not high on the domestic agenda, but which had been prioritized by the EU. The latter included issues on environmental protection, gender equity, cooperation with neighbouring states, or the improved transparency of legal and political decisionmaking processes. Thus there can perhaps be justification in considering the entire 1989-2004 period as a single continuum, as the commonalities obviously outpaced the dissimilarities. As a consequence, improved economic performance and solidification of democratic arrangements allow Hungary to be classified as a success story for the period under review.

3 The changing interface of external and internal factors

The strategy of global and European integration has evolved through trial and error during the socialist reform period. Hungary stands out among the communist countries of the period with respect to a few unique factors.

3.1 Classical socialist system

The classical socialist system as described by Kornai (1992) lasted for a mere four-year period (1949-53). Previously it had been commonly expected that with reunification with Austria (and eventually with Germany which actually happened in 1955 but which had been anticipated as early as 1947),[4] Hungary would become 'Finlandized'. Thus, it was believed that a non-communist government majority as well as the equally important dominant private sector would create a path to development comparable to that in Italy, Britain or France. In these countries, despite the financial sector being curtailed and state management extended, economic and political pluralism was sustained. Finlandization, in this perspective, would have implied security guarantees to the Soviet Union as well as a tolerance of Russian interference in various domestic affairs in exchange for economic liberties at large.

The outbreak of the cold war thwarted these hopes, but the pluralist system was maintained until mid-1949. Already by June 1953, with a 'new course' initiated by Stalin's heirs in Moscow, the reformist government under the leadership of Imre Nagy launched a series of changes, phasing out the command economy over a decade and a half.[5]

4 See Fülöp and Sipos (1998) for more details.

5 For more details, see Berend (1988).

3.2 Limited pluralism

The second oddity of the country was triggered by the fact that liberalization in Hungary, similar to Poland, went out of control and culminated in the revolution of 1956. Despite the presence of occupation forces, the totalitarian system collapsed in twelve hours, and this signalled that it could be replicated any time. Therefore the new communist regime of János Kádár, installed in two weeks by the Soviets after crushing the revolution, made every effort to find a *modus vivendi* with the population, who had also learned that geopolitics limited freedom.

Interaction between the leaders and the population created a continuously evolving set of interrelationships and change that developed into a model of limited pluralism in all walks of life.[6] The economy was only one dimension of this gradual change, which, of course, fortified the regime as long as the geopolitical predetermination lasted. But simultaneously, obviously at odds with official creed, it undermined its legitimacy by allowing for a series of practical options, such as existence of the irregular economy from the late 1960s, particularly its large-scale forms after 1982.

The limited but continuously expanding liberalization created the training ground for various forms of market activity. Moreover it helped the Weberian 'commercial spirit' to survive at the grassroots levels, i.e., millions working in small businesses, household plots, auxiliary and servicing activities outside the state controlled large-scale operations in trade, farming, industry, banking and even intellectual activity. The emergence of a 'second society', second publicity, second value set, second career path, coexisting with formal/official structures of communism, obviously eroded the old regime.

3.3 Social learning in matters of the economy

Most important from our perspective, this long trial-and-error period (when the concept of how capitalism could be restored without capitalists) promoted large-scale social learning in economic matters. As this paper is not the place to replicate these intriguing details,[7] a summary should suffice at this point: social learning implied that much of what later became known as the Washington consensus, had been emerging through learning by doing, and through local dialog on the controversial reasons for the minimal success of the limited reforms. From a long-run perspective it is particularly relevant to note that a broad professional consensus emerged over the need to reorient trade from the east to the west, to conduct an open door policy vis-à-vis FDI, and to support private property as it emerged in an organic process rather than through legislative action. It became a deep and shared professional conviction that individuals assuming governmental responsibility observe a kind of professional minimalism, and that experimentation in general be avoided (Kádár 1994).

This applied *a fortiori* to the wholesale transformation projects proposed by the offices or academic departments of various agencies. Using the parlance of the Wolfensohn presidency of the World Bank, the 'domestic ownership of reforms has never been in

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6 Cf., the collection of papers by Szabó and Majtényi (2008).

7 More on these issues in Csaba (2003) which provides broad references and an historical account of the elements of the entire subject matter.

doubt'. For this reason, a fair degree of continuity in terms of policy could indeed be observed and maintained, despite recurring pressures from democratic political processes that could have easily derailed the overall operation, especially during the push for immediate redistributory justice and other populist measures. This is a well-known phenomenon in any established multiparty democracy not applying rules-based fiscal policy.

3.4 Sustaining policies on structural reforms

Continuing policies on structural reforms, mainly of the second, and in part of the third generation, had thus become politically feasible. As long as successive governments modified only the emphasis of the overall strategic direction, not the strategy itself, these measures had time to be internalized, applied and to produce results. For instance, it goes without saying that privatization, although vitally necessary, is by no means sufficient for improving efficiency, allocative and static alike. But if time and other scope conditions (competition, trustbusting, adjustment of administrative pricing and ensuring market entry for new participants) are secure, privatization can become effective. Present examples abound; from mobile phones to airline and insurance markets, not to mention the food industry or tourist services. However, this required time and patience, as the first results—as also with liberalization—were painful in terms of prices and redistribution.

The above observation can also be validated through indirect reasoning. In some areas where such policies have not been sustained, outcomes have been less convincing. For instance, Hungary was among the first in terms of introducing a partially funded pension scheme in order to overcome the problems of an ageing society and a massive evasion of public dues (partly caused by the tax system supporting small businesses). However, the 1997 privatization scheme was gradually phased out and cancelled by successive governments over the years 2001-08 in efforts to court current pensioners who are among the most active participants in national and municipal electoral processes. Consequently, due to modifications to the system, much of the gain in terms of implicit debt reduction was undone, without resorting to an even partial nationalization of the pension funds (Orbán and Szapáry 2006). In turn, the fiscal burden of the pension system alone has increased to about 2.5 per cent of GDP per annum and is likely to grow despite timid measures introduced in 2007-08 to curtail early retirement and disability pensions.

Similarly, the decrease of market capitalization and the increase of governmental intervention and spending during 2001-08 have clearly been at the root of the recent overall structural slowdown of economic growth. No new entries can be observed on the Budapest Stock Exchange, and all major privatization efforts (such as Budapest Airport in 2005 or Malév Hungarian Airlines in 2006) have evaded capital market deals in favour of policymakers hand-picking strategic investors. As a result, it is perhaps realistic to say that the local capital market has already lost its window of opportunity. Supporters of this line of thought (Pálosi-Németh 2008) note that large multinationals are already in the habit of funding themselves through global capital markets in New York or London, while small- and medium-sized businesses, due to their inherent features, tend not to be suitable for floating on the capital markets.

4 On the role of professional and social consensus

4.1 Social roots and broad-based approval

The short summary above provides some (albeit partial) answers to rather intriguing questions in the search for the reasons for success. In short, no simple single-factor explanations can apply.

It would be difficult to attribute success to policies and institutions only. This is, of course, the customary, textbook answer provided by analysts in the first instance. We have already alluded to what competing interpretations in political science have called 'embedded neoliberalism' (Greskovits and Bohle 2007). This denotes to the social roots and broad approval of most of the major measures that have not only been contemplated, but also implemented. However, it is also true that over the past two decades of economic reform, a series of structural and policy measures were attempted or contemplated, but could not be implemented or sustained.

For instance, among the better-known samples, we could cite the following:

– introduction of local taxes (*teho*) in 1987;
– the attempts to introduce a value-based property tax in 1996 and 2007;
– experimentation with a wholesale introduction of tuition fees in 1995 and 2007; and
– centralization of the management of all public finance funds through the introduction of the treasury office in 1997.

While there was a rather sound economic rationale behind each of the measures, they were all somewhat contrary to the implicit 'social contract'. It is hard not to describe the 2006-07 period as a series of attempts at reform despite the recognized characteristics of social contract and the ensuing resistance to these, especially in health care and reorganization of territorial administration. The landslide victory of the opposition in the referendum of 9 March 2008 and the ensuing split of the ruling coalition left the minority socialists without room for manoeuvre. One of the most palpable consequences of this was the ongoing lack of consensus with respect to the size and nature of reforming public dues. As noted by an insightful analysis by the Chair of the Round Table on Competition, a government convened expert body: the lack of professional consensus and adversarial political climate in 2005-08 mutually reinforced the debilitating outcome (Török 2008), i.e., that Hungary was the only new EU member where no serious tax and expenditure reform had been attempted during the years 2000-08. This had a dampening effect on growth, particularly from 2004,[8] however, the impact was much less on the country's competitiveness due to the predominance of transnational corporations.

[8] According to conservative estimates, fiscal expansion during 2004-06 must have contributed at least one percentage point to the growth rate of 4.3 per cent per annum. But such an expansion was obviously unsustainable in Hungary, as in any small open economy.

4.2 Behaviour of foreign investors

A second major component, usually overlooked by macro-scene analysts, is the behaviour of foreign investors. These are not always impressed by the changing moods of the rating agencies, the quality press, or even of the international institutions and academic fashions. Foreign investors have tended to qualify Hungary as a fundamentally good location, despite its well-known and publicized shortcomings in terms of policy incalculability, legal imprecision, or red tape and non-transparency. While the complaints on these accounts seem endless—and many are well founded—major investors have generally considered Hungary and its environment in a broad sense as hospitable and profitable. The first had to do with the continuing insight, namely that the paucity of foreign savings and investment lowers current consumption, and that only a much slower pace of modernization is attainable. Thus, successive governments have maintained lavish investment incentives, and the low corporate tax rate (currently only 16 per cent) is also an incentive to realize profits locally for reinvestment rather than repatriation abroad through transfer pricing. Moreover, outward investment during the current decade started to grow, reaching the US$3 billion margin in 2007, highlighting the gradual maturing of the country as an investment locality.

4.3 The structural upgrading of production and exports

A related consequence of the former two factors has been the structural upgrading of production and exports. As more foreign and domestic investors increasingly adapt a long-term perspective, the more they invest in R+D, in their organizations, training, marketing and linking with international production and sales network across the board. The predominance of intermediary manufacturing, intra-industry and even intra-firm trade in Hungarian exports made it resistant to cyclical fluctuations and made possible the tenfold increase (from US$9 billion to 101 billion) already noted for the period 1989-2008. This laid the foundation for a solid external position, based, according to central bank estimates, on an external financing requirement of no more than 2 to 3.5 per cent of GDP for the period 2008-10.[9] This is a major difference to the decades of the 1970s, 1980s and even the 1990s when external financial disequilibria was a recurring event among the major, but mostly unexpected, constraints that dominated all aspects of economic policymaking.

4.4 Cumulative processes

Last but not least, the role of cumulative processes needs to be underlined. This means that instead of applying the usual analysis of comparative statics, longer-term developments may be understood better through multiple causalities. Interaction among various market players and regulators may turn out to be crucial, because such interactions can solidify, modify or even correct the outcomes and/or its unintended side-effects.

Within this perspective, the strategic role of foreign investors, especially in the banking sector and in the process of Europeanization, which is perceived as a two-way social

9 For details and supportive quantitative analysis, cf. MNB (2008).

learning process, might have been decisive. Ultimately, the decisive transnationalization—or according to its critics, extreme transnationalization—of financial intermediation might have anchored the rest of the process. Privatization of the banking sector already in the mid 1990s was a bold step, given the ongoing protectionist practices in much of continental Europe, France, Spain, Italy and Germany included. Furthermore, the practice of multinational corporations relying on parent-company financing or directly tapping the global capital markets has had two major ramifications. First, it helped to bridge the novel and largely inexperienced domestic banking and financial services industry and to iron out the shortcomings that could have easily become a major bottleneck to industrial restructuring and economic expansion in general. Second, it substantially constrained the ability of the government to pick winners along the more traditional lines, as in east Asia or France. Thus it enhanced the role of capital market financing and diminished the role of government-inspired allocational decisions. This helped to sustain a market-led line of restructuring, which is, by no means, the one-shot event in the contemporary world economy, but rather a process of continuous adjustment and renewal.

5 Strategies, learning and unlearning

As we have tried to sketch above, foreign actors—as the result of strategic options—have had a major lasting influence in shaping decisions. However, it would be wrong to neglect the role of local policies and regulations, both in terms of their favourable and unfavourable implications.

5.1 The role of local policies and regulations

Domestic policies have fallen short of providing a truly sound macroeconomic policy environment during the entire period under scrutiny. Despite recurring attempts to streamline public finances, general government deficits, when adjusted for cyclical items and occasional creative accounting, tend to be around 6 per cent of GDP. In comparative terms (Bönker 2006), this seems to be a peculiarity of Hungary and should not be attributed to general trends in transition or to various one-off effects relating to EU accession.

It would perhaps require a separate study to decipher how and why recurring budget deficits continue to emerge. In the 1990s most analysts would have attributed the recurrence to the ongoing dominance of state administration, extension of the welfare state and changing forms of redistribution stemming from social contract (Antal 2007; Muraközy 2008), but the 2000s obviously mark a new era. In this period, the anchor role of the EU has been lost, while ‘normal politics’—understood in most continental OECD countries in terms of myopic policy stances and refraining from major restructuring of the welfare state—have become the defining feature. This general trend is influenced by a level of extreme distrust among major political agents that translates into ever-shorter horizons and the tendency to inflate populist promises (Györffy 2007b). Expectations of basic improvement, i.e., swift alignment with the eurozone, were widely shared by both investors and analysts alike, but the derailment, which in theory could have happened any time after 2004, has not materialized. However, in the longer run, crowding-out and the ensuing insufficient investment in all areas except manufacturing have led to a deceleration of growth.

Similarly, according to ECB (2008: 37), Hungary's inflation record has been dismal. Inflation reached a high of 15.1 per cent during 1996-2000, dropped to 5.8 per cent by 2001-05, to 4 per cent in 2006, but reverted to 7.9 per cent by 2007 and 7 per cent by 2008. According to the central bank forecast, the 3 per cent inflation target is to be approximated only by 2010, and inflation is unlikely to come down to the inflation target before late 2010.[8]

4.2 External borrowing

The role of external borrowing has changed politics. Whereas external finance in the communist period served primarily to bridge imbalances triggered by macroeconomic policies, the majority of financing since 1995 has gone to the private sector and investment. Hungarian growth remains export and investment led. For this reason, even the softening of policies during the current decade has not translated into serious external financing difficulties, as robust export growth and the continuous inflow of direct and portfolio investment have helped to overcome this problem. The overall picture, however, is modified if we consider that much of the portfolio investment in the 2000s was used to cover fiscal deficits. Once the exchange rate[10] stabilized and started to appreciate by an additional 8 per cent by mid-July 2008, the high nominal interest rate on *forint* claims translated into a real rate of interest for foreign investors. In other words, external financing came at a considerable cost (Erdös 2008). To put it differently, the room for manoeuvre could well have been utilized for launching third generation reforms because entry in the EU, particularly in the EMU, could have created an anchor for social forces and for expectations. This opportunity, however, seems to have been wasted.

5.3 Joining the Euro-Atlantic structures

Joining the Euro-Atlantic structures in 1999-2004 has had a stabilizing influence. Alignment with NATO at a time when it was at war with Yugoslavia on the borders of Hungary was a bold step, and put an end to a decade of uncertainty with regard to military strategy and neighbourhood policies. Membership in the EU also played a predominantly favourable role already during the accession process by anchoring expectations, shaping institutional change and lending credibility to the newly established, or even directly duplicated, regulatory agencies. However, it is equally obvious (Györffy 2007a) that EU membership and the prospect of a swift introduction of the single currency was loaded with moral hazard. While markets expected politicians to act in the best interest of the market, politicians took advantage of the advances in trust and credibility, misusing these for their own party policy games.

Since then, the EU has been faced with its worst implementation crisis—large member countries flouting the Stability and Growth Pact and two founding members rejecting the Constitutional Treaty—consequently, existing procedures cannot ensure compliance in public finance. This is not an attempt to shift the blame on external factors instead of internal issues. However, it goes without saying that any country outside the perceived safe haven of the EU would have been severely punished by global capital markets for such continued misbehaviour, as was witnessed in Hungary in 2002-08.

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10 Exchange stabilized around 250-260 *forits* per euro for the entire 2003-07 period.

5.4 Open economy and open society

Lastly, we have repeatedly referred to the favourable conditions created by an open economy and open society for sustaining and deep rooting modernization. In short, it is not just the question of substantial inflows of FDI and portfolio investment, nor is it only about formal membership in the EU. What really matters is what could be justifiably termed the ‘microfoundations’ of change. These include broad access to information, the spread and ever-cheaper use of internet facilities, large numbers of students being involved in exchange programmes like Erasmus and Socrates, faculty mobility programmes, as well as the spread of mass tourism, all of which constitute a form of on-the-spot training of how other societies work on a daily basis. Large-scale employment of foreigners in local firms and of Hungarians working in international firms and institutions also contributes to this experience. In short, ‘Europeanization’ and globalization (terms which we apply for convenience) have become factors of life that shape expectations (e.g., of earnings, discipline, quality of services), career paths as well as geographical mobility. The exchange of academics, businessmen and students creates an environment conducive to adaptive strategies on all layers of the economy and society.

6 Causes and consequences of post-EU derailment

Sustainability is a pet notion of modern economics and for good reason. Borrowed from biological sciences, it addresses a point often missed in earlier economics analyses fixed on maximizing attitudes, i.e., that maximum at a given point of time can lead to loss or even damages later. Furthermore, success should be measured in a continuum rather than through a comparison of discrete points in time.

This consideration is obviously relevant to our assessment of the Hungarian development strategy. As could be forecasted years ago (Csaba 2007), EU membership created only the option—but not the certainty—of further reforms and institution building. As the EU increasingly stagnates in terms of institutional and policy renewal, immediate incentives fade for the political class to introduce the reforms that are needed for sustaining high growth rates and for achieving a real convergence to the EU-15 average in terms of per capita GDP. In 2006, per capita GDP in Hungary was only 54 per cent of the EU-15 average and only 63 per cent with regard to the average of the EU-27 (ECB 2008: 39).

Even the rudimentary data cited at the beginning of this paper indicate that Hungary has entered a low-growth phase, because of repeatedly missed opportunities to consolidate public finances, and the ensuing impact of crowding-out of deficits. The level of public debt is a synthetic indicator[11] of the mismatch between growth and financing: public debt has gone up from 52 to 66 per cent over the years 2001-07, and peaked at 67.5 per cent by the end of 2008 despite a major fiscal consolidation effort in 2006-08, while growth was close to 4 per cent, declining to 3.9, 1.3 and 2.0-2.2 per cent over the same period. Furthermore this also implies that the annual burden of amortizing public debt is about 4.5-5.0 per cent of GDP. In other words, the scope necessary to tackle structural

11 MNB (2008) and OECD (2008).

reforms such as privatizing pensions, supporting infrastructural development, financing the streamlining of the overblown public administration,[12] is already restricted by the need to pay for the costs of yesterday's party, an issue known only too well in Europe.

Other factors of growth also seem to be in poor shape. With real wages stagnant, personal savings are unlikely to grow while capital markets, as we have indicated, remain sluggish. According to a recent expertise report (OECD 2008), governmental savings are contingent on tough implementation of additional reforms, while the administration remains reserved on the probability of these, except for minor advances in severing early retirement. Finally, the corporate sector, a net saver during several years of the decade, may not be in such a position once the economy expands.

Enhancing labour market participation to align with the EU's Lisbon Agenda would certainly be a possibility. When people work instead of collecting various social transfers, they are also contributing to social security rather than merely drawing on its services. The Scandinavian example is quite convincing for ensuring higher participation rates and a subsequent steady, sustainable decline in public spending and deficits. By contrast, analyses by the ministry of finance (Ohnsorge-Szabó and Romhányi 2007: 265) have shown that measures triggered by purely electoral politics, such as reduced tax rates to low- and lower-middle income stratas or discretionary pension increases above the statutory levels, contributed to about half of the 2006 deficit of 9.2 per cent. Reversal of these measures, yet to materialize, is not sufficient for improvement. According to official 2008-10 projections by the ministry of social affairs, family and employment (reported in *Magyar Hírlap* 4 January 2008) that are aligned with the latest convergence programme, a mere 1.2 per cent increase is forecasted in labour market participation, bringing it slightly over 58 per cent, a figure that falls short of the Lisbon target by 12 per cent.

This is a problem in its own right, but even more so for the public coffers, as substantial portions of the population are supported through transfers, rather than being converted into employees, either as self-employed or parttime workers. By contrast, as estimates of the independent research team CEMI (2006) have shown, a 10 per cent increase in the activity rate could by itself eliminate half of the deficit. Likewise, the suggestion to broaden the taxbase from the current 2.1 million fulltime taxpayers to 4 million (the total employed)[13] would result in an improvement of an additional 3-4 percentage points at the macrolevel in terms of GDP. In sum, the combination of better enforcement and more employment could create the opportunity for further employment and lower tax burden. And, as of yet, we have not mentioned the option of cutting expenditures, which currently run at around 51 per cent of GDP, second only to

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12 While labour market participation declined from 5.5 to 3.9 million over the 1989-2007 period, the number of individuals earning from public-sector payrolls has remained around one million, with another three million receiving pensions. According to conservative estimates, any streamlining would free at least 200,000-300,000 individuals. The rate of unemployment has risen by two percentage points to 7.5 per cent over the years 2001-07, and to 7.7 per cent by July 2008, exceeding the EU average of 6.7 per cent for the same period (ECB 2008: 43).

13 In 2007, an individual earning more than 1.6 million *forints* was taxed according to the highest rate, 38 per cent. In contrast, one million people, registered as small-scale farmers, are tax exempt for earnings up to six million *forints* per annum (this is the income level when no tax refunds and reclaims can be instituted). Further, 600,000 people earn, at least on paper, the statutory minimum wage, about double the estimate of the labour market agency.

Sweden. In a way, what is needed is not a brand new strategy, but a correction of the derailments of 2004-08, i.e., in other words, going back to basic strategy could work miracles. The latter could include deregulating and simplifying the current non-transparent system of public dues, improving the rule of law, enforcing existing laws of disclosure, and introducing rules-based fiscal arrangements in line with international experience (Kopits 2004).

7 Lessons for global political economy of reforms

From a global policy reform perspective, perhaps the most pertinent lesson from the experience of Hungary is the importance of sustained and conceptually anchored strategic interchange between governmental policy/institution building and spontaneous development/learning by doing. The Hungarian experience underscores the limitations of 'pragmatic' and 'non-ideological' approaches in managing longer-term processes, given that the number of tasks to be managed is infinite, and the pros and cons of each option are value loaded, and tend to be contradictory at any moment of time.

At certain critical junctures of time, no orchestra, not even the best and smallest chamber orchestra, can play a complex piece by Bach, Mozart or Bartók, without the guidance of at least an informal chamber master. On the one hand, at certain points of time, public choices—for example, with regard to solidarity and incentives, fiscal sustainability, or adhering to the rules of international agreements—need to be institutionalized. On the other hand, it is at least as important for longer-term development as well as process management that the cooperation of millions of players, both domestic and foreign, be ensured with persuasion, transparency and internalization of these objectives and merits of the goals to be attained. This seems to have worked in the 1988-2004 period when stabilization, liberalization and EU accession were on the agenda. In contrast, failure in 2006-08 has largely been attributable to the misconceived attempt to introduce structural reforms through *putsch* (cf., Martin 2008; Szakolczai 2008).

It would be wrong to deny that under even normal times without any imminent crisis scenarios, it could be politically difficult and require more innovative solutions than customary to orchestrate a professional and social consensus around a few well-defined objectives. Adopting the single currency could perhaps be one such intermediary objective. Creating sustainable pensions is perhaps another. And providing acceptable livelihoods for regions outside the political centres might be a third objective, environmental sustainability the fourth.

The quality of education at primary, secondary and university level needs to be mentioned. It is highly unlikely that without additional efforts and targeted development of skills, life-long learning can become nothing more than a slogan. As practical skills tend to become devalued in 5-10 years' time in all walks of life, except perhaps the infamous hamburger job, action is needed even though the outcome will not be obvious for a decade or more. Traditional arrangements, such as universities and standardized secondary schools, have proven inadequate to combat the number-one problem of entire 1980-2005 period in continental Europe. Thus Hungary's current educational policy of copying existing arrangements from other countries with reference to EU standards might prove to be a dead alley.

It is perhaps an inevitable byproduct of the FDI-led strategy that a substantial degree of dualism has emerged in economics, but even more so in social structures. The transnationalized sector is booming, its benefits multiple, and the trickle-down effect is palpable. However, in social terms, a large part of the small business sector, partly intertwined with the irregular economy, continues to stagnate under a backward system. Since the transnationalized sector, with its western-type wages and lifestyles, offers employment to only 15 per cent, social inequality manifests. Also, the three million pensioners out of a population of ten million tend to benefit little, if anything, from the dynamic components[14] of these processes, even though members of this age-group are the 'kingmakers' of any election. Therefore social conservatism, well known from the continental welfare model, is likely to be sustained.

Finally, it is perhaps important to acknowledge the need for continuous reform, which is likely to take the shape of reform waves. As one of the eldest insight in politics confirms, one electoral cycle is usually sufficient for a major reform agenda to be implemented, if managed by fervent reformers like Margaret Thatcher, Leszek Balcerowicz or Domingo Cavallo. Thus it may make sense to work out a strategy of reforms and to update these continually with feasibility studies, cost estimates and the introduction of sequencing propositions, as is done in large corporations. Given that the two unique events of the recent past—collapse of communism and membership in the EU—are history, normal politics, interest-group politics included, allows only for piecemeal progress. But if we take labour market reforms, for example, that were successfully managed by such diverse countries as Ireland and Denmark adopting different strategies, this might be a tall order, as it cuts across society. Likewise, pension reforms may require a decade or longer. Health care reforms may need more trial-and-error, while sustaining the calculability and access of citizens.

This suggestion is justified by the need to set up and actively re-organize reform coalitions on a regular bias. This observation radicalizes the age-old insights of the political economy of policy reforms: without social, political, ideological and media support, structural reforms and institutional change are unlikely to endure long enough to produce palpable outcomes, even in the 'single issue areas'. Furthermore it goes without saying that pro- and anti-reform interests, dispositions and convictions may vary among citizens of different generations, levels of education, or even places of residence, just to name a few of the more trivial components. Therefore, none of overarching broad coalitions, which means most of the democratic parties, qualify as agents of change par excellence. The more the traditional left-wing parties are being penetrated by business interests and the conservative parties with petty *bourgeoisie*, the less relevant the traditional assumptions about pro and anti-reform forces may prove to be.

The experience of Hungary also highlights the limitations of external anchoring. As long as the stick-and-carrot influence of EU membership was present, it helped to form and sustain the needed political and professional consensus around all major strategic issues, regardless of the issues concerned (disinflation, respect for minority rights or longer-term environmental concerns). Once such leverage is gone, lack of internal

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[14] In terms of consumer benefit, better availability and quality of services, improved quality of regulation (e.g., of financial services) or lower prices induced by competition, pensioners may also be among the beneficiaries.

commitment could lead to perverse outcomes. This means the misuse of soft external financing to fund non-reforms and old style populist policies,[15] rather than financing the transition to sustainable pension and fiscal systems. The grandfatherly approach of international markets has allowed nonsensical policies to survive much longer than the theory of efficient financial markets would have assumed. In reality, soft external financing, although by no means the trigger of misconceived policies in 2001-08, certainly contributed to their coverup, just as much as was the case in 1972-78, specifically EU membership and the prospect of a fast adoption of the euro, which could indeed have been rational for several reasons. Still, the introduction of the euro has not materialized, but in reality it has added to a disorientation of the markets. Furthermore, EU's current implementation crisis has prevented this being rectified through direct fiscal surveillance mechanisms.

In summary, Hungary can provide samples of both well-timed reforms (i.e., advantages of early bird action, as witnessed during the years 1989-96) and poorly sequenced, haphazard measures (of the 2004-08 period). In particular, the 2006-08 period indicates how radical projects can be thwarted, *inter alia*, by poor preparation and design. But more importantly, the experience of this period underscores the need to separate and sequence different reforms according to the length of time needed and the technical difficulty and complexity of social implications. While it is a relatively straightforward procedure for a government to attempt to streamline taxation or fiscal affairs, it is an entirely different matter with the more elaborate, value-loaded issues, such as the socially and intellectually divisive areas of health care[16] or environmental protection. Frontloading the health care and regional reforms, each with a time span in excess of 15 years, must be seen as a major conceptual and sequencing error that immediately led to the reversal of most reforms planned by the socialist government, irrespective of their merits. The consensus from policy reform literature about the relevance of sequencing measures, or frontloading these with immediate returns and improvements, was confirmed once again.

In short, the final lesson is the need for an integrated intellectual and analytical framework, a vision-cum-operational strategy that could be combined with tactical skills, persuasive power and coalition building—the vital ingredients of any reform policy for surviving under a democratic and pluralistic environment for one or two election cycles. Trust and social consensus are the most essential ingredients, albeit the most difficult to accomplish in practice.[17]

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15 These policies are truly unique from a regional as well as a broader European perspective. More on this topic in Csaba (2009).

16 For an enlightening account of why these failed, see Mihályi (2008).

17 As one of the practitioners rightly noted recently with respect to the broad social consensus in rejecting a reform introduced by the socialist government: 'the patient may well be unwilling to take even the best medicine from a physician who is to blame for the deterioration of his health' (Bokros 2008). In other words, achieving a consensus—any consensus—is not the issue; instead what is needed is an agreement on the proper principles and professionally sound platforms.

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