

CONTINUITY OR DISRUPTION?

CHANGING ELITES AND THE EMERGENCE OF CRONYISM AFTER THE GREAT RECESSION – THE CASE OF HUNGARY

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ABSTRACT *After a short theoretical overview about the interplay between institutions and elites, the paper analyses the economic performance operationalized by the GDP and the quality of governance in Hungary in comparative perspective, considering two milestones, namely, the impact of the Great Recession, and the change of government in 2010. The role of elites and elite moves are revealed in these developments. In Hungary, the local crisis started before the Great Recession as the slide of the quality of governance and mismanagement of the economic policy can be observed since the accession to the EU. The paper elaborates the disruptive nature of the system built after 2010 with a special focus to the schemes of corruption and cronyism. Finally, the paper confronts the political elite's endeavors with some perceptions of the population.*

KEYWORDS: *institutionalism, elites, corruption, cronyism, economic development, quality of governance*

INTRODUCTION

Democratic backsliding and the rise of populism throughout Central and Eastern Europe have been subject to vast academic and policy research in the past years (e.g. Kornai 2015, Pappas 2014, Freedom House 2014, Transparency International Hungary 2017). The surge of populism and the impact of the global crisis have put at stake the democratic polity and institutions established in

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the 1990s. In several countries democracy seems to be emptying out and has become just procedural, focusing only on elections and the rule of the majority. The substance of democratic norms (i.e., the functioning of democratic checks and balances, the protection of minority rights, and the active participation of citizens) is losing ground. Some CEE societies seem to be regressing, to use Douglass North's terms, from the previously established 'free access order' towards 'closed access order' (North et al. 2009).

The 'capture' of the state by influential groups – i.e. the systematic downplaying of furtherance of commonweal in favor of making particularistic gains (Hellman et al 2000, Transparency International Hungary 2011) – has become rather the rule than the exception across Central and Eastern Europe (Innes 2014). Democratic institutions initially designed to control the government's endeavors, as well as ensure a level playing field for societal and economic actors have in many cases become the instruments of oligarchs and the ruling political elite. Informality and action is tending to overrule established formal institutions.

Having been a member of the European Union (EU) since 2004, Hungary has a nominally democratic system with institutions that were initially established to respect the separation of powers. Between 1989 and 2010 consensus among political parties and in public discourse existed that, according to the eighteenth century Montesquieu' doctrine, legislative, executive and judicial powers need to be separated, and the government should be controlled by independent institutions.

However, Viktor Orbán, a charismatic leader of the political party Fidesz, who had already governed the country between 1998 and 2002, made it clear in opposition between 2002 and 2010 that once he got back into power he wanted more than a "simple" change of government. The popularity of Fidesz in opposition started to soar from the middle of the first decade after the millennium. This can be explained partly by the political crisis that was triggered by the leaked speech of the then prime minister Ferenc Gyurcsány in 2006, after which the government's popularity started freefalling². In a speech most probably intended to be kept secret, Gyurcsány admitted to his party members that between 2004 and 2006 they had lied and done nothing to win the 2006 election³. After the landslide victory in 2010 Fidesz gained a supermajority in parliament, and Viktor Orbán declared the foundation of a new "regime", the so-called "System of National Cooperation" in which the state would play a crucial role.

2 Ferenc Gyurcsány was prime minister of Hungary (for the Hungarian Socialist Party) from 2004-2009 in a coalition with the Alliance of Free Democrats (SZDSZ, a liberal party).

3 https://en.wikipedia.org/wiki/%C5%90sz%C3%B6d_speech

Fidesz is a right-wing party that also belongs to the EU-wide European People's Party. It has used nationalist rhetoric, sometimes with an adamant anti-EU tone, although it has not questioned Hungary's EU membership so far.

Fidesz was able not only in 2010 but also after the next election in 2014 to form a government with the support of more than two-thirds of MPs who decided to re-engineer the entire public arena. For Prime Minister Orbán, the desire for elite change overwrote respect for control mechanisms. The system he has built might be called a simulated democracy (Lengyel 2014, 2017) or an autocratic hybrid regime (Kornai 2015); i.e., a polity existing somewhere between liberal democracy and dictatorship.

The concepts of liberal democracy, state capture, checks and balances, as well as democratic backsliding are normative categories and thus may be used as indicators of the deviation of political systems from the Weberian ideal type of liberal democracy that involves the impartiality of governance and a non-monopolistic market economy. The "extent" of this deviation can be estimated by proxy indicators in empirical analyses.

In this paper, after a short theoretical overview about the interplay between institutions and elites, we focus on economic performance and the quality of governance in Hungary with special regard to corruption over the last decade. We describe the role of elites and elite moves in these developments. The main question we address is whether continuity and/or disruption has prevailed in the last decade considering two milestones: namely, the impact of the Great Recession that started in 2008, and the change of government in Hungary in 2010.

VIRTUOUS AND VICIOUS 'CIRCLES' OF INSTITUTIONS AND ELITES

In the most recent three decades, the 'new institutional economics' (North 1990) that was previously influenced by economic sociology made remarkable steps in explaining durable economic development. From the initial conclusion that "institutions matter", nowadays economists and the economic policy literature echo the mainstream verdict that, besides traditional, neo-classical factors based on capital and labor accumulation, institutions play a significant, perhaps even decisive role in economic development (North 1990, Rodrik et al 2002, Acemoglu et al 2004, Acemoglu-Robinson 2013, World Bank 2002, WEF 2001-2017).

According to a growth model of new institutional economics provided by Acemoglu et al. (2004) economic institutions define whether a country is

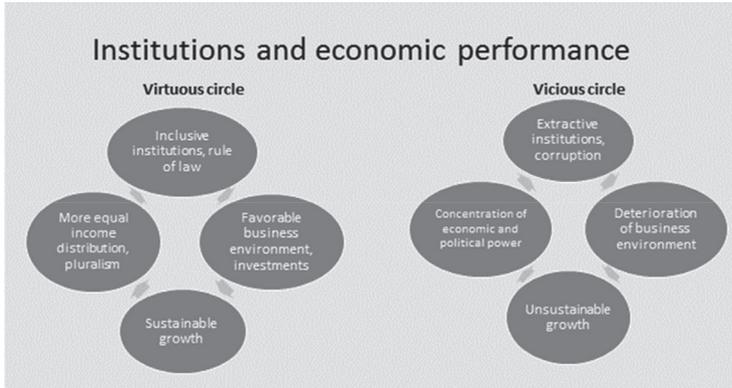
capable of developing in the long run. Economic institutions depend on the nature of political institutions. By political institutions or polity, in the first instance we mean whether the implied country is a democracy, a dictatorship, or somewhere in between; a hybrid regime. In this model the political institutions define the *de jure* distribution of political power which eventually influences the ruling elite's decisions about economic institutions. For Acemoglu et al., political power and the distribution of political resources slowly change the independent variables which ultimately determine economic performance. Political institutions do not alter too often: only in the cases when the ruling elite is forced to change.

Acemoglu and Robinson (2013), in their renowned book *Why Nations Fail*, make a distinction between virtuous and vicious 'circles'. The first are initiated by inclusive and the latter by extractive institutions. Inclusive political institutions place constraints on the elite's endeavors by fostering pluralism and rule of law which promote a level playing field and fair competition. These factors then enhance investment and increase economic performance. This eventually leads to more resources for distribution, thus more equal opportunities. The vicious circle is the opposite of the virtuous one, with a series of negative feedback loops (see *Figure 1*).

While the new institutionalism provides a notable explanation for sustainable economic development, it does not provide a coherent view of the role of elites, actors and personalities. Institutionalism is prone to attribute an occasional role to actors; consequently, in this paradigm the elites may be considered the passive executors of the institutional will. But this claim is controversial in new institutionalism: for example, North states that informal institutions such as norms and culture have effects through the perceptions (mental beliefs) of actors. And, according to Acemoglu et al., the role of the elite is primarily important during critical historical turns that induce institutional change. However, in the concept of new institutionalism the elites remain more like an abstract category, with a murky relationship between them and institutions.

The new elite paradigm (Higley-Pakulski 2000) partly opposes institutionalism by claiming that actors can overwrite rules and become game-changers. In the new elite paradigm, the most important question is how the elites relate to each other horizontally (Ilonszki-Lengyel 2014). In this concept, the trust (distrust) of the elites and cooperation with each other is logically and factually prior to institutional arrangements. Moreover, interaction among elites is considered the main method of differentiation among regimes and polities, and social changes generally originate from the elite moves that result in new configurations.

Figure 1. An interpretation of the interplay between institutions and economic performance



While institutionalism can be interpreted to mean that the elites are the passive bailiffs of institutional will, in the new elite paradigm institutions should be considered the passive subjects of the endeavors of the elite. For elite theory, only the disposition of the masses (i.e., public opinion) can constrain the elites. The new elite paradigm can thus be interpreted as getting rid of the “utopias” that some of institutionalist approaches present (Higley-Pakulski 2000).

A further elaboration of the new elite paradigm suggests that instead of speaking about causality between institutions and elites, covariance prevails. According to a typology of political regimes (Lengyel 2014, Ilonszki-Lengyel, 2014), the characteristics of political institutions are interlinked with elite configurations. This is related to the role of actors and personalities. On one end of this scale of regimes is consolidated democracy, which implies a consensus when the elites accept each other as legitimate partners, and when, in line with liberal democracy, not only the rule of the majority but also the rights of minorities prevail. This kind of democracy implies the existence of responsive and responsible leaders. At the other end of the scale we have “elected autocracy”, in which institutions serve as the instruments of central government. In these regimes the elites are ideologically homogenous and leaders are pseudo-transformative; i.e., their words and actions are not harmonized. Between the two extremes, we find simulated democracies (hybrid regimes) in which civil rights are not respected, elite consensus is weak, and leaders’ promises are often not realistic.

The configurations of elites, institutions and personalities, as described by the typology of the new elite paradigm, may influence the quality of governance (Lengyel 2017), and ultimately, economic performance. Accordingly, the

theoretical scheme is similar to the distinction of virtuous and vicious circles by Acemoglu et al. However, the game changers in the two concepts are different: they are the elites and personalities in the new elite paradigm, and the institutions in new institutionalism.

THE SLIDE OF HUNGARY: WHERE IS THE STARTING POINT?

Hungary underwent a drastic but relatively successful economic transformation in the early 1990s and became a member of the EU in 2004 as the completion of political desires (Balázs 2014), and with high hopes of economic convergence with the West. Then – in the first decade after accession – Hungary’s economic performance became the poorest among all the new CEE member states (Poland, Czech Republic, Slovakia, Slovenia, Romania, Estonia, Latvia, Lithuania, and Bulgaria). If we “fix” real GDP in 2005 at a nominal value of 100 – as a starting point – then we can observe that GDP grew faster in all the nine countries than in Hungary until 2015, independently of whether GDP/capita was initially higher (e.g. in Slovenia and Czech Republic) or lower (the other 7 countries). The differences are sometimes conspicuous: GDP in Poland rose by 50 %, and in Slovakia by 47 %. In Hungary, meanwhile, it only grew by 11 % (see Table 1).

Table 1. Cumulated GDP growth in CEE countries in 2016 (2005=100)

	2005	2016
Hungary	100,0	110,6
Poland	100,0	150,2
Czech Republic	100,0	125,9
Slovakia	100,0	147,2
Slovenia	100,0	114,5
Romania	100,0	136,5
Estonia	100,0	119,8
Latvia	100,0	118,7
Lithuania	100,0	130,1
Bulgaria	100,0	132,5

Source: Eurostat, <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tec00114&plugin=1>

A number of academic publications have tried to decipher the reason why Hungary lagged behind regional competitors after the millennium (Pogátsa

2007, Oblath 2014, Bod 2014). The crisis and the arrears of the once “eminent pupil” of the region might be linked to economic instability which may stem from policy failures and institutional factors. Economic policy serves as a means of establishing an institutional set-up suitable for durable development, although the distinction between the two is somewhat murky (Rodrik et al 2002).

From 2001-2002 the incumbent Hungarian governments pursued an economic policy unique to Central Europe which ultimately led to turbulence even before the global financial crisis (Martin 2013). The Hungarian government was the only one in the region which had to introduce severe austerity measures as many as three times – in 1995, 2006 and in 2009 – during the 20 years between the fall of the Berlin Wall and the Great Recession. This is one of the reasons why Hungary is an outlier in the Visegrad group of Central European countries – Poland, the Czech Republic, Slovakia and Hungary – concerning economic development in the first decade of the new millennium (Martin 2014).

Hungary pursued an extremely loose fiscal policy and plunged into “fiscal alcoholism” (Kopits 2006) between 2001 and 2006 when public spending soared and the budget deficit was constantly higher than the EU ceiling of 3 %. In the two election years (2002 and 2006) the deficit rose to 9 %, by far the highest rate among the OECD countries at a time when world markets were still liquid. Because of Hungary’s dangerously growing budget deficit, the EU started an excessive deficit procedure (EDP) against the country immediately after accession which lasted nine years – until 2013.

However, the period of excessive deficit could also be considered a time of relative prosperity and convergence towards the EU. In this period the growth and increase in household income was fostered by state expenses which ultimately were covered from foreign debt. Debt rose from 52 % in 2001 to 65 % in 2006 compared to GDP. An empirical study (Oblath 2014) points out that Hungary was the only country between 2000 and 2013 among the new member states where economic growth and the budget deficit were positively correlated. In other words, growth in Hungary was induced by growing state expenditure, and thus a pro-cyclical economic policy until 2006. The danger of adopting this policy in “good times” is that no resources might be left for “bad times” – as Hungary was due to discover. In the other Visegrad countries, growth was fed by a disciplined fiscal policy (involving competition and investment) rather than public spending.

In Hungary, as the budget deficit between 2004 and 2006 was unsustainable under the pressure of the market and the EU, the government was obliged to introduce strict austerity measures in 2006. Consequently, the budget deficit decreased from 9.4 % in 2006 to 5.1 % in 2007. This drastic fall in public spending involved a drop in the growth rate. Hungary’s GDP tumbled to the

lowest level in the EU at only 1 % in 2007. Thus, the local crisis induced by the huge budget deficit preceded the Great Recession.

The Visegrad countries entered in different positions into the turbulent times of the global financial and economic crisis. This erupted in 2007-2008 in the United States and then spread to Europe and to CEE via financial products, a confidence crisis (a lack of lending) and foreign trade (European Commission 2009). It seriously affected the whole of Central and Eastern Europe, but impacts differed across countries as both the pre-crisis legacy as well as crisis management strategies were different (European Central Bank, 2010). The Baltic States plunged into a deep, double-digit recession in 2009, but rebounded very quickly. Poland, on the other hand, was the only country in the EU that was able to avoid recession in 2009. Also worth noting is that there were only three countries which did not grow in 2010-2011: Slovenia, the Czech Republic, and Hungary. However, the former two had a considerably bigger GDP/capita than Hungary for a long time. Thus, it is not surprising that in Hungary perceptions about “the state of the domestic economy” were at a historic low point in 2009. A Eurobarometer survey showed that only 5 % of the Hungarian population thought that the state of the economy was “very good” or “good” – the smallest share in CEE at that time⁴.

Because of soaring government expenditure and huge indebtedness Hungary became a target for speculation in 2008 when the global crisis hit the country. This jeopardized a fast after-crisis recovery, and explains why Hungary could not pursue an anti-cyclical fiscal policy (i.e., government expenditure did not invigorate the economy in the short run, unlike in other Visegrad countries). Hungary was the first country in the EU after the eruption of the crisis that had to turn to international organizations to ask for a bailout to prevent state default. A drastic austerity package had to be introduced to rebuild trust and prevent the collapse of the economy. The price the country had to pay was a recession of 6.6 % in 2009, which was the biggest slump among the Visegrad countries.

The Hungarian economy remained unstable after 2010 when Fidesz took power. Despite the new government’s rhetoric about reducing the budget deficit and putting an end to stop-go cycles, between 2010 and 2012 they continued: after an expansion of spending, austerity measures were introduced that pushed the country into recession. After 2012, the influx of EU funds was considerably and continuously increased, fostering economic growth. After continuous growth, in 2016 the share of EU funds reached almost 6 % of GDP⁵.

4 <http://ec.europa.eu/commfrontoffice/publicopinion/index.cfm/Chart/getChart/themeKy/27/groupKy/229>

5 http://www.portfolio.hu/unios_forrasok/gazdasagfejlesztes/meg_ket_evig_hasithat_magyarorszag_aztan_beallhat_a_foldbe.251569.html

After 2011 the new government started to respect the 3 % budget deficit ceiling, thus the rise in indebtedness came to a halt. But the new government, supported by a supermajority of MPs, pursued an “unorthodox” economic policy that countered “liberal” and “mainstream” doctrines in its interpretation. For example, the government targeted some companies, mainly service sector, and also levied significant surtaxes in three sectors – banking, retail and telecommunication. They also eliminated the private pension scheme, nationalizing most pension savings. Moreover, tailor-made legislation and the so-called strategic partnership agreements between the government and select groups of companies made clear the government’s intention to divide the private sector into “good” and “bad” companies (Transparency International Hungary 2014). The industrial sector was mostly labeled as “good”, and the service sector as “bad” – the government put the burden on the latter.

Consequently, until 2010 the main factor driving economic instability was economic policy, but after 2010 instability derived from the unpredictable and tailor-made legislative and business environment. In both cases, the norms of good governance were breached, but from different angles.

The deeper explanations of economic instability before and after the Great Recession in Hungary leads us to institutional factors and elite configurations (Martin 2016). Despite political divisions, in the 1990s the basic consensus about formal institutions (i.e., the rules of the game) prevailed. In the 2000s, however, this elite consensus started to erode. After losing the national election in 2002, Fidesz questioned the legitimacy of the new government (Ilonszki-Lengyel 2010, 2014, Fric et al. 2014, Lengyel 2017). “The homeland can’t be in opposition”, declared PM Orbán in 2002. As the government and the opposition did not recognize each other as reliable partners, the consensus concerning the formal institutions as well as the informal ones, crumbled. Hungarian politics plunged into a vicious ‘circle’ catalyzed by distrust following the leaked speech of PM Gyurcsány in 2006.

The disruption of elite consensus and the atmosphere of a “cold civil war” implied that the power game had to be played at any price, both in government and opposition. This is a logical explanation for why extensive fiscal policy until 2010 and the “unorthodoxy” after 2010 were pursued, despite their economic irrationality. The manipulation and “purchasing” of voters using populist measures emerged as a legitimate means of keeping or obtaining power. For example, the excessive public spending between 2001 and 2011 was green-lighted by the Hungarian elites, unlike in Poland where the implicit elite consensus and a pragmatic economic policy created good conditions for economic growth (Győrffy, 2012).

In Hungary, economic policy and the institutional system have become dependent on elite struggles since EU accession. Party politics has gradually

violated economic rationality, thus the erosion of elite consensus has led to the erosion of governance.

THE QUALITY OF GOVERNANCE AND CRONYISM

Deteriorating governance

By quality of governance we mean a set of formal and informal institutions which enables the creation of an environment appropriate for a functioning democracy and market economy (Rodrik 1999, Kaufman et al. 2010, Rothstein 2011). A clearly delineated system of property rights, the rule of law, a clean government, apparatus suitable for curbing corruption, the capacity of government to effectively formulate and implement sound policies, and trust and social cooperation are usually listed among the factors of good governance. The quality of governance concerns the exercise of, not access to, power. Respect for the rule of law and the control of corruption may be the two most important factors of good governance. Rule of law first of all means the impartiality of law enforcement. By corruption, we refer to the abuse of entrusted power or public office for private gain (World Bank 1997, OECD 2012) – this extends beyond the notion of corruption in criminal cases.

The operationalization of good governance is mainly possible using proxies. A widely used set of proxies in which the assessments of experts and businesses are applied is the World Governance Indicators (WGI) of the World Bank. The WGIs are: rule of law, control of corruption, government effectiveness, accountability, quality of regulation and political stability. An empirical study by Bo Rothstein (2011) based on WGIs shows a 90 % correlation between rule of law, control of corruption and effectiveness of a government.

For measuring the quality of government through proxies in Hungary using a comparative perspective we use the WGIs (*see Table 2*). Most of the indicators indicate that performance has deteriorated for more than a decade. Both in terms of rule of law and control of corruption, Hungary's positions were the worst among the Visegrad countries in 2016. The contrast between the trends is eye-catching when we compare Poland and Hungary. Moreover, the stagnating Czech and Slovak proxies are also different from the declining Hungarian one. These proxies of governance for Hungary indicate no major rupture or even shift due to the global crisis, nor to the change of government in 2010, and the milestones do not affect the generally downward trend. The rule of law indicators indicate a worsening situation since 2007 (a decrease from 81 in 2007 to 67 in

2015), while the corruption proxy indicates deterioration since 2004 (from 76 in 2004 to 61 in 2015). This continuous bad governance may be explained by the durable lack of economic stability elaborated on in the previous chapter.

The trend of the WGI indicator for control of corruption for Hungary looks similar to Transparency International's Corruption Perception Index (CPI)⁶ which detects public sector corruption according to an assessment of businesses and experts. In 2016, the CPI for Hungary dropped seven places in the rankings, landing at 57. The country achieved 48 points, three points below the previous year's score. The perception of Hungary's situation in terms of corruption has been deteriorating for years. The decline is even more striking in comparison with the EU and CEE countries. Hungary currently lags in 24-25th place out of the 28 member states of the EU, tied with Romania. With the exception of Greece, Italy, and the most corruption-infected Bulgaria, this proxy shows that every EU member state performs better than Hungary. According to this data, corruption in Hungary has been increasing since its EU accession. For a number of years Hungary's scores were some of the best after Estonia and Slovenia, but now only Bulgaria is behind Hungary among the CEE countries.

Other surveys also underpin perceptions about Hungary's slide in terms of transparency. Economic actors rate the Hungarian government's measures against corruption as insufficient. According to the survey of the World Economic Forum (WEF, 2001-2017) which appraises competitiveness each year, Hungary's competitiveness has been nosediving for more than a decade. Hungary was the 28th most competitive economy in the world in 2001, but it only ranked 69th on the competitiveness list last year. The perception of institutional efficiency and transparency is outstandingly bad: from 26th place in 2001, the country had slipped to 114th by 2016. Businessmen in Hungary named unpredictability and corruption as the main obstacles to running a successful business. The main trigger for the slide in competitiveness is the poor performance of institutions. Hungary's competitiveness as well as institutional performance deviates not only from the EU but also from the CEE average⁷. Competitiveness as a kind of long-term growth potential may be operationalized using 12 pillars, one of which is institutional. The institutional factor as the bottom element of a pyramid may determine the others (Vakhal 2012) such as capital and labor accumulation, or education and innovation.

6 https://www.transparency.org/news/feature/corruption_perceptions_index_2016

7 For these charts, see Slides 14-15.: <https://transparency.hu/wp-content/uploads/2017/01/CPI-2016-prezentacio.pdf>

Table 2. Selected quality of governance proxies in the Visegrad countries*

HUNGARY							
	2004	2006	2008	2010	2012	2014	2015
Rule of law	78	80	80	72	68	72	67
Corruption	76	73	68	65	65	61	61
Accountability	86	79	76	75	70	67	66
Quality of regulation	84	86	86	81	78	75	74
Government effectiveness	79	78	75	72	71	72	71
POLAND							
	2004	2006	2008	2010	2012	2014	2015
Rule of law	63	61	66	68	72	77	76
Corruption	59	62	67	70	72	71	71
Accountability	81	72	75	80	81	82	80
Quality of regulation	76	72	75	80	79	81	80
Government effectiveness	71	67	68	71	72	75	75
CZECH REPUBLIC							
	2004	2006	2008	2010	2012	2014	2015
Rule of law	72	73	77	80	82	85	83
Corruption	69	66	65	65	64	65	67
Accountability	79	76	78	77	77	78	78
Quality of regulation	80	84	85	86	81	81	81
Government effectiveness	79	82	81	78	77	80	82
SLOVAKIA							
	2004	2006	2008	2010	2012	2014	2015
Rule of law	65	65	68	65	64	69	70
Corruption	69	69	66	64	61	60	62
Accountability	80	76	74	74	77	76	75
Quality of regulation	83	85	83	81	81	79	75
Government effectiveness	80	79	78	76	74	75	75

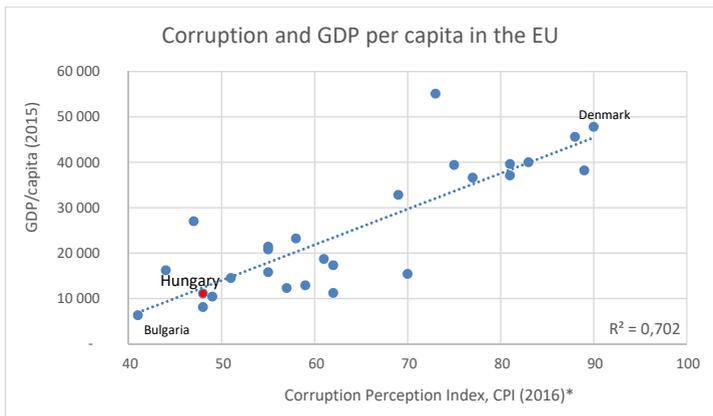
* On a scale between 1 and 100, where 1 is the poorest and 100 the best performance

Source: World Bank WGI; <http://info.worldbank.org/governance/wgi/#reports>

Corruption as an institutional factor and one of the main obstacles to good governance affects economic performance. A piece of research by OECD (2012) shows significant correlation between the WGI's control of corruption indicator and GDP per capita. For the EU, the correlation is even more striking (*see Chart 1*). The causal relationship, however, between the governance indicators, including corruption and economic performance, is vague (Rothstein 2011). Still, empirical research finds no evidence of a positive correlation between sustainable growth and a high level of corruption in Western countries. The inclusiveness of the institutions do matter for long-term competitiveness. However, Asia seems to be an outlier in terms of the worldwide trend; i.e. in a number of Asian countries a high level of corruption and economic prosperity appear to go hand in hand (OECD 2012).

The business climate may serve as a channel through which corruption and breaches of rule of law affect economic performance. A hard indicator of the business climate is the investment rate (the share of gross capital formation in GDP). The link between rule of law and investment rates is significantly correlated in Hungary (*see Chart 2*); i.e., in the period after the accession the decline in rule of law performance may have impacted the value of investment. If we look at only private and household investment, Hungary's figure was quite low in CEE in 2015 (see Table 3).

Chart 1. Perceived corruption and economic performance in the EU

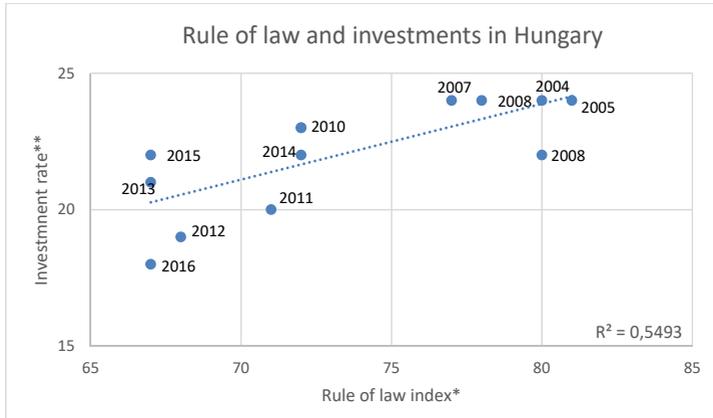


*The higher the CPI, the less the perceived exposure to corruption

Source: Eurostat, Transparency International

<http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tec00001&plugin=1>

https://www.transparency.org/news/feature/corruption_perceptions_index_2016

Chart 2. Correlation between rule of law and investment rate in Hungary

* On a scale ranging between 1 and 100, where 1 is the weakest and 100 the best performance

** Share of gross capital formation in GDP

Source: World Bank, Eurostat

<http://info.worldbank.org/governance/wgi/#reports>

<http://ec.europa.eu/eurostat/tgm/refreshTableAction.do?tab=table&plugin=1&pcode=tec00011&language=en>

In sum, proxies indicate a continuous decline in governance quality in Hungary after EU accession. However, other qualitative research such as institutional analyses or case studies about the nature of the political system and corruption might generate more sophisticated conclusions.

Table 3. Investment rates in CEE

	Private investment rates* in CEE (2015) (%)
Czech Republic	21,2
Estonia	20,2
Romania	19,9
Latvia	18,5
Bulgaria	17,2
Slovakia	17,2
Hungary	16,1
Lithuania	15,4
Poland	15,2
Slovenia	14,5

*Sum of business and household investment compared to GDP

Source: Eurostat

<http://ec.europa.eu/eurostat/tgm/refreshTableAction.do?tab=table&plugin=1&pcode=tec00011&language=en>

Centralization and systemic corruption

When the government of Fidesz party took office in 2010, it created a completely new institutional framework. After 2010 the government extended its power to an extent that is unusual in liberal democracies, for example, by nominating loyal-to-government persons as heads of state institutions. As a result, many of these bodies have become instruments of the government's power, rather than of control (Martin-Ligeti 2017)⁸. The determination of the government to weaken the capacity of independent institutions entailed their taking an instrumental approach towards formal institutions, including the constitution. Between 2010 and the entry into force of the Fundamental Law in 2012, Hungary's old constitution was amended 12 times. The country's newly adopted Fundamental Law has been amended six times since it came into force. The Council of Europe's Venice Commission concluded in its opinion that frequent constitutional amendments "are a worrying sign of an instrumental attitude towards the constitution."⁹

The quality of democracy has deteriorated across the whole CEE region (Freedom House 2014); moreover, the growth in the interlinkage of oligarchs and politicians is a worldwide phenomenon. However, Hungary is unique in the region for its U-turn (Kornai, 2015). Hungary, from all the countries in CEE, has deviated most spectacularly from the Western concept of democracy. The new Hungarian system has challenged the fundamental principles of good governance and capitalism (the rule of law and property rights), and has started a campaign to curtail the freedom of civil society¹⁰. Close-to-the-government oligarchs have bought themselves into the media sector using public money¹¹. Moreover, the "obsession" with centralization, not only in politics but also in the economy, has reached an unprecedentedly high level, both in the EU and in terms of the post-1990 Hungarian history. The central government has now got tremendous regulatory and operational power and undue influence.

8 For further analyses of the Hungarian government's manoeuvres to systemically weaken democratic checks and balances, see TI Hungary's report attached to Hungary's Self-Assessment Survey on the United Nations Convention against Corruption: http://transparency.hu/uploads/docs/Civil_society_review_report.pdf

9 See: Opinion on the Fourth Amendment to the Fundamental Law of Hungary, CDL-AD(2013)012, Strasbourg, Council of Europe, 17 June 2013, www.venice.coe.int/webforms/documents/?pdf=CDL-AD%282013%29012-e.

10 See the new NGO law that discriminates against "foreign funded" organisations; in force since June 2017: <https://www.theatlantic.com/news/archive/2017/06/hungarys-anti-foreign-ngo-law/530121/>

11 In: Transparency International 2017 (pp. 10-11.) Some other violations of property rights are elaborated in the next sub-sections.

The nature of corruption has significantly changed from that which existed before 2010. According to Transparency International, corruption was already substantial and institutionalized by 2008 (TI-H, 2008); i.e., the central and local governments regularly abused power for private gain in the form of fraud and bribery. But the level of centralized, top-down corruption reached new heights after 2010, parallel to democratic backsliding and major setbacks to the rule of law. The elimination of control institutions *per se* increased corruption risks. Complete systems of corruption have been intentionally built to reallocate resources and/or channel public money to the insiders.

On the other hand, according to the Transparency International Global Corruption Barometer released in 2016, petty or street corruption in Hungary, apart from bribery in the healthcare sector, has decreased. The share of those who said that they had paid bribes to the police dropped from 10 % in 2012 to 3 % in 2016¹². There has also been some whitening in some sectors of the economy that can be detected in the significant rise in VAT income¹³. However, these phenomena do not contradict but rather reinforce the interpretation that in Hungary corruption has become extremely centralized.

Some examples of centralized and systemic corruption are illustrated in the case studies described below¹⁴.

The case of tobacco kiosk licenses

The government, by adopting the Tobacco Retailing Act in 2012, redefined the tobacco retailing market by first introducing a government monopoly and then distributing new concessions to tobacco kiosk owners under the pretext of preserving the health of Hungarian youth. The concept, as declared, was to decrease smoking by restricting the number of tobacco shops and denying the entry of young people into them. At the end of this process, the number of licensed tobacco kiosks had dropped from 40,000 to less than 6,000, damaging the property rights of several thousand kiosk owners.

12 <https://transparency.hu/wp-content/uploads/2016/11/Global-Corruption-Barometer-2016-Europe-and-Central-Asia.pdf>

13 http://www.portfolio.hu/gazdasag/adozas/brutalis_feheredes_az_afaban.214671.htm 1

14 In the case studies the author relies heavily on the work of Transparency International Hungary, and would like to thank his colleagues Miklós Ligeti, Head of Legal, and Gabriella Nagy, Head of Public Finance Programs for their initial descriptions.

Investigative journalists¹⁵ found that an early version of the Tobacco Retailing Act, submitted to the European Commission in 2013, had been drafted on a computer belonging to János Sánta, CEO of the Hungarian tobacco company Continental and chair of the Federation of Hungarian Tobacco Investors, thus an influential representative of the tobacco industry. Both the government and János Sánta admitted the involvement of the CEO in the adoption of the Tobacco Retailing Act. Reporters also revealed that some 500 tobacco kiosk licenses had been distributed to companies connected to the same CEO or belonging to his interest group of Continental Tobacco¹⁶. The reshaping of the tobacco market showcased favoritism, illustrating the government's determination to employ its regulatory power to promote the business interests of political loyalists.

Government residency bond scheme

Taking the number of residency bonds into account, intermediary companies may have received a total of more than 136 million euros from the Hungarian state, a major contribution to their profit – without having to offer any service in exchange. Thus the net loss to the Hungarian taxpayers from this scheme might be in the order of 136 million euros. The sum of 300,000 euros, the price of a Hungarian residency bond with five-year tenure, buys unhindered and permanent access to the Schengen-zone of the European Union for any non-EU citizen. Neither further investment nor personal presence in Hungary is required. Together with family members, approximately 16,000 third country nationals have thus been granted the right of free movement in the EU.

The purchase of residency bonds channels large sums of Hungarian taxpayers' money into the pockets of beneficiaries. Though issued by Hungary's state debt management agency, applicants can only invest through intermediary companies. These companies are licensed – or deprived of their licenses – by the Hungarian Parliament's Economic Committee in a procedure that falls outside the normal rules, and offers no recourse to legal remedy.

The proprietary structure of the intermediary companies remains unclear. All but one of them have seats in offshore havens, such as the Cayman Islands, Liechtenstein, Malta or Cyprus. This, on the one hand, makes it possible to allocate public funds to non-transparent recipients, a practice which is banned by Hungary's

15 E.g. see http://hvg.hu/itthon/20120227_lazar_dohanylobbi .

16 E.g. see http://www.napi.hu/magyar_vallalatok/minden_tizedik_dohanybolt_continental-kozeli_lehet.557230.html

Fundamental Law. On the other hand, it reveals that the Parliament Economic Committee, authorized by law to certify these companies, has either been outwitted or has willfully contributed to the selection of non-transparent companies.

Intermediary companies have been enriched at the expense of Hungarian taxpayers. According to an estimation of Transparency International Hungary, since the program started in 2013 they have presumably generated revenues of more than 320 million euros. A significant portion of the intermediary companies' revenue comes from Hungarian public sources, as the government offers a 29,000 euro discount on every 300,000 euro package of bonds. Taking the number of residency bonds into account (approximately 6200 until November 2017) intermediary companies may have received a total of more than 190 million euros from the Hungarian state, a major contribution to their profit – without having to offer any service in exchange. Thus the net loss to the Hungarian taxpayers from this scheme might be in the order of 190 million euros.

As oversight of these offshore companies and verification of their financial statements are entirely lacking, intermediary companies' revenues remain untaxed in Hungary (with the exception of one company with domestic registration). Thus the Hungarian residency bond program is a non-transparent gateway to the European Union with no benefit to the Hungarian economy, but most probably contributing to private enrichment.

Undue spending of the central bank

One of 2016's most significant cases involved the undue allocation of public funds worth approximately 900 million euros, equivalent to almost one percent of Hungary's GDP, by the National Bank of Hungary to six foundations established in 2013 and 2014 by the central bank itself. In March 2016 the parliament adopted a retroactive law to prevent the central bank foundations' expenses and operations from becoming public¹⁷. After opposition parties and anticorruption watchdogs heavily criticized the bill, President János Áder refused to sign it and referred it to the Constitutional Court for review. Then, one day prior to the Constitutional Court ruling, Hungary's supreme law court, the Curia, ordered the Central Bank to publish data on how its six foundations had spent the assets. The data exposed the extensive conflicts of interest on Central Bank foundations' boards, favoritism in Central Bank

17 <https://www.bloomberg.com/news/articles/2016-05-22/a-1-billion-central-bank-guide-for-enriching-friends-and-family>

foundations' investment, and possible infringement of EU monetary financing rules as approximately two-thirds of the total sum was spent on the purchase of state bonds. Documents released by the foundations also showed that they had not issued public tenders for purchases as was required by the public procurement act.

Eventually, the Constitutional Court of Hungary ruled that the law intended to hide these expenses was unconstitutional, and determined that, as the Central Bank serves public duties and manages public money, details about the foundations' activities must remain publicly available.

NGOs alluded to a connection between the reluctance of the prosecution service to investigate Central Bank funding issues and the fact that the wife of the prosecutor general, besides serving as the Central Bank's head of human resources, was also a supervisory board member at two of the Central Bank's foundations. On April 2016, Transparency International Hungary filed a criminal complaint against a non-specified person for misappropriation of public funds and abuse of public office on the Central Bank's behalf. But the Prosecutor General's Office declined to investigate. The Public Procurement Arbitration Board, a special state organization empowered to rule in public procurement cases, found that 66 out of 112 contracts involving the Central Bank's foundations violated the law because no bids were invited, and fined the foundations 280 000 euros, a moderate sanction in light of the assets involved.

System of public procurement

The functioning of the Hungarian public procurement system also shows signs of partial governance. Competition has been very limited in this field for a number of years. Proceedings without prior notification (i.e. those negotiated with a value above the EU threshold)¹⁸ accounted for 13 % of total public procurement market value in 2015, while the EU average was only 4 %. The local public procurement market accounted for 5.7 % of Hungarian GDP last year. In 2016, the proportion of tenders without prior publication decreased to 9 % but still remained above the EU average. In 2016 there was only one tenderer in 36 % of public procurements, while the EU average was only 21 %. The

18 This threshold for the procurements of goods and services is 135 000 euros but this amount can deviate according to some parameters. See details about thresholds here: https://ec.europa.eu/growth/single-market/public-procurement/rules-implementation/thresholds_en

Hungarian share of single-tenderer applicants is thus the fifth greatest among the member states¹⁹.

Considering those procurements which are valued below the EU threshold, the gap between the Hungarian and EU figures has become even wider. According to the national data²⁰, in 2013 70 % of the total number and 40 % of the value of public procurement procedures under the threshold were realized without prior notification, meaning that approximately 1 billion euros were allocated without any competition.

A qualitative study of Transparency International Hungary (TI-H 2015) revealed the corrupt nature of the distribution of EU funds. According to this research, EU projects are overpriced on average by 25 % compared to market prices. Sixty per cent of EU funds are redistributed by public procurement, which has been distorted in the ways mentioned above.

The partiality of the state in fund allocation, including EU funds, can be detected in the splendid enrichment of some of the oligarchs operating close to the government. The most obvious example of this is the case of Lőrinc Mészáros, a former gas-fitter and mayor of a small municipality, Felcsút, which happens to be the home town of PM Orbán. According to expert estimations, the wealth of Lőrinc Mészáros in 2017 accounted to around 380 million euros, more than five times that of 2016, placing him fifth on the list of the wealthiest Hungarians²¹. This might be the fastest enrichment in the course of Hungarian economic history²².

An extensive analysis of public procurement data shows that friendship with Prime Minister Orbán pays off when it comes to winning tenders. According to the Corruption Research Center Budapest, a think tank five oligarchs around PM Orbán (either friends or relatives), including Lőrinc Mészáros, won 4.5 % of the total value of public procurements between 2009 and 2016. What is more notable is that when PM Orbán had a falling-out with a former longtime ally (Lajos Simicska) in 2015, the share of this oligarch's winning tenders fell from 11 % of the total in 2013 to 0.1 % in 2015²³.

19 See: https://ec.europa.eu/info/sites/info/files/cr_hungary_2016_en.pdf, p. 53., and https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-report-hungary-en_1.pdf, p. 35.

20 See <http://www.parlament.hu/irom40/00147/00147.pdf>. pp. 94-95.

21 http://www.napi.hu/magyar_gazdasag/itt_az_uj_lista_ok_a_leggazdagabbak_es_a_legbefolyasosabbak_magyarorszagon.635525.html

22 See details about the enrichment of Lőrinc Mészáros: <https://www.bloomberg.com/news/articles/2017-07-25/what-s-boosting-the-world-s-best-performing-stock>

23 CRCB states that its researchers analyzed 150,000 instances of public procurement between 2009 and 2015: <http://www.crcb.eu/?p=1111>

These issues might have contributed to the negative perceptions of domestic economic actors about the public procurement system: 81 % of businesses say that corruption is widespread in this field (the EU average is 71 %²⁴).

Emergence of cronyism

Crony capitalism refers to an economic system which is nominally free-market but allows for preferential regulations and other state intervention based on favoritism, personal relationships and rent-seeking behavior (Salter 2014). If rent-seeking behavior prevails, money-making becomes possible based not just (or not primarily) on the basis of market performance, but on political loyalty. Economic actors are prone to seek the grace of the state (government) instead of competing on a regulated market. Rent-seekers may get privileges in terms of legislation such as direct subsidies, tax breaks, preferred access to credit, and protection from prosecution, etc. Cronyism is not necessarily linked to state ownership; private companies and entrepreneurs can also be the subjects of rent-seeking. Rent-seeking distorts the market and undermines a level playing field, thus eventuates in suboptimal transactions through misallocation of resources (Murphy et al. 1993). Rent-seeking behavior is enhanced by the extractive institution that provides the ground for the abuse of power for private gain.

In one interpretation, cronyism is antithetical to the notion of capitalism, thus can be considered a separate system that may be positioned between the market and competition-driven capitalism and state-controlled socialism (Karam 2017). While capitalism is seen as an economic system that exchanges value in a relatively neutral way through merit-based market allocation and which is fostered by a level playing field, cronyism benefits only those who are close to central power.

Cases of open and legalized corruption in Hungary show the government's intention to grant privileges to certain economic actors by legal means (for example, nationalization and subsequent redistribution of assets to players close to governments). In these cases the regulations are often tailor-made, hurting market incumbents and favoring new players with tighter or looser links to the government.

After 2010, the extreme centralization and the reshaping and instrumentalization of formal institutions in the government's interests, on the

24 European Commission's Country Report 2016: https://ec.europa.eu/info/sites/info/files/cr_hungary_2016_en.pdf p. 53

one hand, and the systemic and in some cases open and legalized corruption on the other, resulted in a system of state capture combined with cronyism. The Hungarian type of state capture is not ‘corporate’ or ‘oligarchical’ (Innes 2014) but is closer to the ‘reverse’ type (Kornai 2015) in which the final word is given by government politicians and some grey eminences and oligarchs around the executive power. One example of an obscure consultant is Árpád Habony, a mysterious speechwriter and advisor of PM Orbán who is considered to be one of the most influential oligarchs in terms of public decision-making around the PM, albeit lacking any formal position²⁵.

The regime at large operates using an unusual and informal network and a non-static combination of politicians and oligarchs. Public decision-makers and oligarchs extract public money from the system through intentionally designed and professionally managed channels (Jancsics-Jávör 2012). Under this system, corruption happens not primarily in the traditional form of graft, fraud or bribery, but through the endeavors of the elite to distort the political and economic system in its favor. Compared to the situation before 2010, we may say that corruption after the beginning of the decade has become part of the system, while in the past, despite its partly institutionalized character, it rather involved system disfunction.

As shown by the above examples, Hungary is heading towards a situation when players close to the government will extract a growing share of society’s wealth for themselves and their associates. The collusion of officials and the business elite provides both groups with undue benefits. This very collusion, labeled cronyism, is undermining both democracy and business competition, and thus economic performance.

SOME CONCLUDING REMARKS: A FUTURE CLASH BETWEEN ELITES AND POPULATION?

In this paper I have elaborated on the question whether continuity or disruption prevail when it comes to political-economic developments in Hungary after 2010. After having discussed the interplay between institutions and elites, I pointed out that the quality of governance measured by proxies has continuously deteriorated in Hungary since 2004 when the country joined the European Union. The diagnosis suggests that perception-based indicators, as well as some hard data about the economy, show no major shift or deviation from this general

25 See e.g.: <http://hungarianspectrum.org/2013/03/04/orbans-chief-adviser-arpad-habony-and-his-encounter-with-the-law/>

rule either due to the eruption of the global crisis in 2008, or due to the change of government in 2010.

However, besides continuity, signs of disruption also prevail. The new regime and change of elite constructed by Fidesz after 2010 gave primary importance to the instrumentalization of formal institutions. Hungary has become vulnerable to a special kind of state capture (an informal network of public officials and businesspersons re-politicizing the state in pursuit of political monopoly and private gains). This form of capturing the state entails open and systemic corruption, and in a number of cases – some elaborated in this paper – even takes a legalized shape. Moreover, cronyism evolved, an economic system that undermines the level playing field, distorts the market, and favors loyal-to-government players. The need for the establishment of a “new national bourgeoisie and middle class”²⁶ is a frequently heard ideological argument of government stakeholders for explaining income and asset redistribution. However, according to empirical studies (e.g. Rothstein 2011, WEF 2001-2017), the systematic abuse of public office undermines good governance and competitiveness.

How might these trends change? The new elite paradigm suggests that it is mainly public opinion that can constrain and counter the elite’s endeavors. In a more indirect way, institutionalism comes to the same conclusion. In 2017, some of the population’s attitudes indicate resistance to the ruling regime. Although Fidesz still enjoys the support of a large majority of the voting population according to the recent polls²⁷, and would win an election if held “today” (September 2017), on some issues the government’s stances clearly go against the popular will. The adamant anti-EU rhetoric of the government – mainly that of PM Orbán – for example, has not got through to the population (Martin 2016). Three-quarters of Hungarians support Hungary’s membership of the EU²⁸, and even ‘soft Euroscepticism’ based on pragmatic revulsion has declined.

Despite Fidesz’s popularity, a rise in dissatisfaction can be detected in public opinion. According to a Eurobarometer survey, dissatisfaction with “national democracy” has become the highest in Hungary in 2016 among the Visegrad countries²⁹ (56 % of Hungarians say that they are “not or not at all”

26 See e.g. <http://hungarianspectrum.org/2011/12/26/the-ministry-of-national-development-and-the-building-of-a-national-bourgeoisie/>

27 See: <http://hungarianspectrum.org/tag/public-opinion-polls/>

28 See: http://index.hu/belfold/2017/03/24/granitszilardsagu_a_magyarok_elkotelezettsge_az_eu_tagsag_mellett/

29 <http://ec.europa.eu/comfrontoffice/publicopinion/index.cfm/Chart/getChart/themeKy/45/groupKy/226>

satisfied with the current state of democracy). In another survey conducted by the European Bank for Reconstruction and Development (EBRD)³⁰, only slightly more than half of the population think that elections are free (53%) or that freedom of speech prevails (55%), and as few as 37% of Hungarians say that the judicial system works properly. These trends indicate that the system may be challenged, not only by economic sustainability but also by public discontent.

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³⁰ <http://litsonline-ebd.com/countries/hungary/>

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