

# Market reform and fiscal laxity in communist and postcommunist Hungary

## A path-dependent approach

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### Full Abstract

**Purpose** – The purpose of this paper is to present a conceptual framework in order to analyse and understand the twin developments of successful microeconomic reform on the one hand and failed macroeconomic stabilisation attempts on the other hand in Hungary. The case study also attempts to explore the reasons why Hungarian policymakers were willing to initiate reforms in the micro sphere, but were reluctant to initiate major changes in public finances both before and after the regime change of 1989/90.

**Design/methodology/approach** – The paper applies a path-dependent approach by carefully analysing Hungary's communist and postcommunist economic development. The study restricts itself to a positive analysis but normative statements can also be drawn accordingly.

**Findings** – The study demonstrates that the recent deteriorating economic performance of Hungary is not a recent phenomenon. By providing a path-dependent explanation, it argues that both communist and postcommunist governments used the general budget as a buffer to compensate the losers of economic reforms, especially microeconomic restructuring. The gradualist success of the country – which dates back to at least 1968 – in the field of liberalisation, marketisation and privatisation was accompanied by a constant overspending in the general government.

**Practical implications** – Hungary has been one of the worst-hit countries of the 2008/09 financial crisis, not just in Central and Eastern Europe but in the whole world. The capacity and opportunity for strengthening international investors' confidence is, however, not without doubts. The current deterioration is deeply rooted in failed past macroeconomic management. The dissolution of fiscal laxity and state paternalism in a broader context requires, therefore, an all-encompassing reform of the general government, which may trigger serious challenges to the political regime as well.

**Originality/value** – The study aims to show that a relatively high ratio of redistribution, a high and persistent public deficit and an accelerated indebtedness are not recent phenomena in Hungary. In fact, these trends characterised the country well before the transformation of 1989/90, and have continued in the postsocialist years, too. To explain such a phenomenon, the study argues that in the last couple of decades the hardening of the budget constraint of firms have come at the cost of maintaining the soft budget constraint of the state.

**Keywords** Gradualism, Paternalism, Fiscal laxity, Budget constraint, Individual-specific uncertainty, Hungary

**Paper type** Research paper

## **Benczes**

### **Introduction**

Hungary has been long admired for its smooth and politically calm transformation process and its apparently well-designed reform strategy, the predecessors of which date back to the New Economic Mechanism (NEM) of 1968. The evident successes in the fields of marketisation, liberalisation and microeconomic restructuring, however, masked the inaction in other fields, especially in public finances. Apart from a few exceptional episodes, the general government has been left mostly untouched; thus, persistent delays and helplessness have characterised the last couple of decades in this respect. Understanding such a controversial performance is, however, not an easy task. This paper attempts to explore the reasons why Hungarian policymakers were willing to initiate reforms in the micro sphere, but were reluctant to initiate major changes in public finances both before and after the regime change of 1989/90. By providing a path-dependent explanation, the paper argues that both communist and post-communist governments used the general budget as a buffer to compensate losers of (micro)economic and political reforms. The ever-widening circle of net beneficiaries of welfare provisions paid from the general budget made it simply unrealistic to implement sizeable fiscal consolidation, putting the country onto a deteriorating path of economic development.

The general budget has become the means for compensating people for losses, especially in the early times of microeconomic restructuring, which added strongly to transformational recession. While in other transition countries the euphoria at the time of the systemic change provided a so-called “window of opportunity” for politicians to implement severe reforms, no such opportunity emerged in Hungary. The established reform tradition of the country and the peaceful political change, with the active collaboration of the old and the new elites, made the systemic change a self-evident process. Accordingly, people simply refused to pay the inevitable costs of the change. The heavy burden of structural reform in the sphere of the micro economy was compensated by increased public provisions in the form of household transfer or public sector employment, thereby prolonging paternalism. By 1995, a near-crisis situation triggered a fiscal stabilisation in Hungary and soon after the recovery, politicians returned to fiscal indiscipline. Private consumption was further fuelled by public sources with the slogan of compensating people for sufferings endured during the austerity measures of 1995-1996.

The hypothesis of the paper is thus that the success of marketisation and microeconomic restructuring, a process that started well before the systemic change itself, came at the price of a deteriorated performance of public finances and a lack of fiscal discipline in general. In more technical terms: *the hardening of the budget constraint of market participants came at the cost of maintaining the soft budget constraint of the state.* This hypothesis will be verified by the path dependency theory. As the theory can establish a structural and causal relationship between past and current events, it can grasp the evolutionary profile of Hungarian economic and political change. Furthermore, the applied methodology can shed light on why Hungary’s development path has differed so much from the experiences of other Central and East European (CEE) countries.

Following the short introduction, Section 2 provides a short, stylised fact analysis of Hungary’s current deteriorated public finances. Section 3 turns to the explanation of the puzzle of persistent deficit and elaborates on the reform experience of Hungary between 1968 and 1989, showing that market reform and fiscal profligacy emerged at the same time in the country. Section 4 concentrates on the transformation years and its aftermath to date, claiming that the path-dependent character of Hungarian development prevents the country from maintaining a sustainable track of fiscal policy. Section 5 concludes.

### **Fiscal laxity: stylised facts**

After twenty years of systemic change and five years as European Union members, Hungary has successfully developed into a fully-fledged market economy. The country has been one of the most successful in the process of marketisation, liberalisation and microeconomic restructuring. However, the performance in the field of public finances is far from convincing. Fiscal profligacy has become an integral feature of the country and the reform of the general government has suffered serious delays.

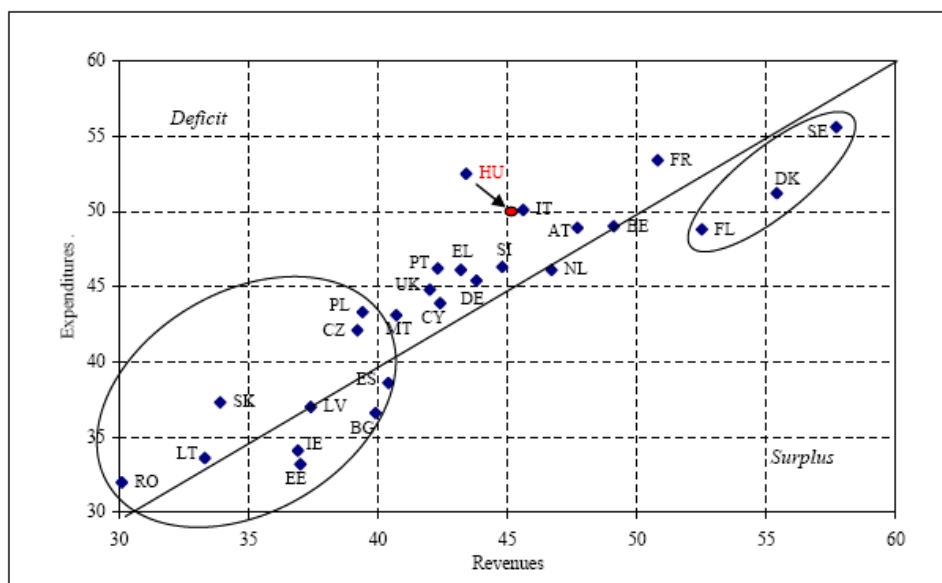
Hungary, a country with 60 per cent of the average income of the EU (on PPP), maintains a relatively high level of redistribution. The ratio of public spending to GDP has always been at (or beyond) 50 per cent, a ratio that is characteristic of the welfare states of Scandinavian countries or France – countries with at least twice as high levels of development in terms of GDP (on PPP) than Hungary. More importantly, none of the former socialist countries – with an almost same level of development – has such a sizeable state sector (varying from 30 to 45 per cent in GDP). Admittedly, there are substantial differences with regard to the size of states across Europe and the industrialised world.<sup>1</sup> However, in Hungary, the high redistribution ratio coexisted with an extremely high and persistent budget deficit, which averaged 6 per cent in the last two decades. (Comparative data on EU countries are displayed in Figure 1.) The general government deficit has been mainly due to the overruns in the primary balance, especially in current spending. Public debt has also accumulated without bounds and reached the highest level among new member states, totalling 73 per cent of GDP by 2008 – the CEE10 average was 26.8 per cent in the same year (EC 2009). A large redistribution rate, together with a persistent deficit and an accelerated debt, have made the country extremely vulnerable to external shocks. At the same time, economic growth has declined significantly, too.<sup>2</sup>

*Figure 1. Public expenditures and revenues (general government) in EU27*

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<sup>1</sup> Redistribution rates are of course not exogenous in the sense that they are strongly influenced by several political, historical and cultural patterns (see Aghion *et al.*, 2004 for instance). Furthermore, there is no consensus at all in the literature on the optimal size of states. Both low and high redistribution ratios can deliver robust economic performance (see Sweden and Finland on the one hand and Ireland on the other hand).

<sup>2</sup> The economic growth rate reached only 1.1 and 0.8 per cent in 2007 and 2008, respectively, in Hungary, whereas CEE's average was 7.1 and 2.4 per cent in the same years (EC, 2009).



Source: own construction, data are taken from HNB (2008).

Note: data as of 2006. The arrow (and the red dot) indicates the preferred position of Hungary by 2011.

The real challenge to the country's long-term fiscal sustainability is the unhealthy structure of the general government, especially on the expenditure side. Both the compensation of public sector employees and household transfers significantly exceed that of neighbouring countries and also most of the EU15 countries. The Hungarian public sector suffers from over-employment, although the labour market participation ratio is the lowest among OECD countries (56 per cent). One-fourth of the total employees work in a highly inefficient public sector. The disincentive structure of welfare provisions makes non-participation in the labour market appealing. While spending on health care and education is slightly below that of the EU15 average, household transfers – such as family and child allowances, sick pay, disability pay or early retirement payments – are more generous than in most of the old member states. Economic functions conducted by the state often serve the interest of households, therefore price regulations on gas, housing or pharmaceuticals should be considered as welfare payments too.<sup>3</sup> Table 1 depicts the distorted structure of the Hungarian general budget in a comparative perspective.

Table 1. General government spending by economic decomposition, 2004-2008

	<b>EU15</b>	<b>CEE8</b>	<b>Hungary</b>
Compensation of public sector employees	10.6	9.9	12.1
Collective consumption expenditure	8.1	9.0	9.9
Social transfers in kind	12.7	10.0	12.2
Social benefits other than social transfers in kind	15.7	11.0	14.9
Subsidies	1.2	1.1	1.4
Interest payments	2.8	1.6	4.1
Other current expenditures	2.4	2.1	2.5
Gross fixed capital formation	2.4	3.9	3.7

<sup>3</sup> Benedek et al. (2006) estimated the welfare part of economic functions of the state to 2 per cent of GDP.

Source: EC (2009).

Note: data as per cent of GDP.

CEE8 includes the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia

The general tendency to overruns in the fiscal balance and the unsustainable structure of the general government are, however, not exclusive characteristics of the post-communist years, as such disequilibria have well predated the systemic change of 1989/90. Advanced reforms, starting in 1968 within the field of micro economy, put an unexpectedly heavy burden on public finances. The road of marketisation, liberalisation and privatisation was paved by compromises and compensations buffered by the general budget. These tendencies have proved to be integral features of Hungary in the last fifty years.

### **The New Economic Mechanism and its aftermath (1968-1989)**

The classical Stalinist regime prevailed for a relatively short period of time in Hungary. In the Stalinist regime, the maintenance of the political power of the communist party, along with Marxist-Leninist ideology, was underpinned by an almost complete nationalisation of property rights. State ownership and bureaucratic coordination – together with the massive use of political repression and terror – provided a solid ground for forced industrialisation. A rapid and extensive growth of the heavy industries was compelled at the cost of light industry and agriculture and especially individual welfare. The constant state of alertness for war and the extensive use of natural resources caused serious and constant shortages of consumer goods.<sup>4</sup>

By the mid-sixties, however, Hungary chose a different track. Instead of a blatantly repressive system, the communist party elite opted for the creation of an environment which endorsed political calm and material well-being. The historical lessons drawn from the Revolution of 1956 against the communist rulers forced political leaders to recognise the importance of meeting the material needs of the people (Kornai, 1990). Public spending was thereby redirected from physical investment to the material welfare of citizens, a shift that elicited the expression “goulash communism” as a namesake for the Hungarian system.

From 1968 onwards, reforms of varying intensities were high on the agenda of Hungarian policy-makers. In rhetoric, the main objective of the first cycle of reforms (1968-1973) was to increase the efficiency of the economy by introducing market incentives at company level. Decentralisation swept away mandatory output targets and input quotas. Economic decisions were delegated to the factory level. Managers were given more discretionary power. Indirect financial instruments were introduced in order to influence the behaviour of enterprises. Reform attempts culminated in an accelerated growth performance, which fuelled the improvement of individuals’ living standards.<sup>5</sup>

Whatever merits the New Economic Mechanism (NEM) had, the ultimate goal of the Party elite was not economic efficiency *per se*. The decision to move towards marketisation was determined solely by political considerations. Party leaders of the Hungarian Socialist Workers’ Party engaged in stabilising their political power by providing additional economic growth and prosperity for families. By learning from past mistakes, a kind of “consumption-oriented” approach to socialism evolved. Instead of forced savings and industrialisation, the emphasis was placed on people’s own relative prosperity. The NEM can be best interpreted therefore as a tacit agreement between the citizens and the Party: in exchange for a relatively

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<sup>4</sup> On the classical socialist regime, see especially Kornai (1992) and Kozminski (2008).

<sup>5</sup> Hare (1983) claimed accordingly that the NEM made Hungary unequivocally different from the rest of the Eastern bloc countries.

high standard of living and relative freedom (hence the term “the happiest barrack”), citizens had to remain loyal to the Party and did not question the *raison d'être* of the socialist regime itself.<sup>6</sup>

The success was, however, relatively short-lived. External shock in the form of the first oil crisis of 1973 caused severe structural tensions in the country. Internal factors, however, played a possibly even more important role in the failure of the New Economic Mechanism. As the path dependency theory suggests, the “genetic programme”<sup>7</sup> of the communist regime did not allow market reforms to push the Hungarian economy into the state of a new and stable, high-growth equilibrium. Bureaucratic intervention did not decline in practice. It was replaced by indirect bureaucratic management. The change occurred in form only, and left the intensity of economic dependence untouched.<sup>8</sup>

In spite of the economic slowdown,<sup>9</sup> political interest was adamant on preserving the relative well-being of citizens. With the objective of maintaining consumption-maximisation, Party elites turned to external financial sources. Such a change, however, culminated in foreign debt accumulation. Increased indebtedness and the oil crisis of 1979 triggered a second reform cycle in the country by 1982. The most significant elements of the reform steps were the following: informal activities (often called second economies) were legalised; small private firms (mostly in the service sector) were officially recognised; corporations could enter the financial market by issuing bonds; a two-tier banking system and a new, market-conform tax system were introduced, etc.

The official aim of the reform was to restore competitiveness. The real aim was, however, different and more practical. Party elites wanted to provide room for private initiatives on the market in order to maintain the relative well-being of families. The sixties saw a change in the incentive structure of large state enterprises and cooperatives in order to induce competition amongst them, thereby increasing national welfare. By the eighties, however, the further marketisation of state enterprises was not enough in itself to energise the economy. Instead, the private and the semiprivate sectors were allowed to spring into existence. By the mid-80s, more than 10,000 new small enterprises (“petty cooperatives” or “independent contract work associations”) existed, in contrast to fewer than 1000 state and cooperative enterprises.<sup>10</sup>

In fact, market reforms from the early eighties onwards have been adopted out of necessity, with the explicit aim of avoiding further economic deterioration. The relative share of income from work declined dramatically, as opposed to other non-work related sources (see Table 2). Since marketisation significantly increased both aggregate and individual-specific uncertainty, the state did not hesitate to embark on generous welfare programmes. Thereby, the short-sighted state elites became able to compensate the losers in the economic reforms. Generous welfare spending became an untouchable part of social rights later on, making any downsizing of such entitlements extremely difficult from a political point of view. Marketisation and economic restructuring were therefore implemented by applying measures which strengthened the winning coalition and minimised the number of losers at the same time. With market incentives and private property on the one hand and increased

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<sup>6</sup> By 1976, Hungary's collective consumption equalled 20.3 per cent of GDP. Almost 60 per cent was dedicated to welfare provisions and one quarter to health care.

<sup>7</sup> The term “genetic programme” originates from Kornai (1992).

<sup>8</sup> Quasi-market incentives were assumed to induce competitiveness among firms. In practice, however, enterprises started to bargain with the different levels of bureaucracy for additional resources. Economic agents did not negotiate over the targets anymore, but over a complex net of economic regulations (such as credit, price, tax and subsidy) instead.

<sup>9</sup> Whilst Hungary grew at an average of 3.4 per cent between 1961 and 1970, it first slowed down to 2.6 per cent (1971-80), and then to -0.1 per cent (1981-88). (Kornai, 1992)

<sup>10</sup> See especially Bauer (1988).

welfare spending on the other hand, pragmatist Party leaders provided a credible commitment to both market reform (favouring winners) and compensation schemes (placating losers).<sup>11</sup>

*Table 2. Disaggregating personal income*

	<b>Income from work</b>	<b>Social benefits in cash</b>	<b>Social benefits in kind</b>	<b>Income from other sources</b>
1960	80.4	7.0	11.4	1.2
1970	76.1	11.3	11.3	1.3
1975	71.5	15.5	11.7	1.3
1980	68.0	18.9	13.1	0.1
1985	65.6	19.9	14.1	0.4
1990	58.1	22.6	16.6	2.7

Source: Kornai (1997).

## **After the change**

### *The early years of transformation*

The first free election in May 1990 found Hungary with an almost complete price liberalisation (Csaba, 1995). The foundations for structural reforms in the micro economy were laid down a year before the elections by adopting the Company Act and the Transformation Act. In turn, spontaneous privatisation evolved. Accordingly, there was no need to apply a big bang approach in Hungary as chosen by several other CEE countries, especially Poland and Russia. Big-bangers wanted to prevent their countries from reversal (both in political and economic terms) and argued that with speedy reforms the elite of the old regime could be demolished.<sup>12</sup> In Hungary, with its long reform tradition, however, political change managed to evolve without mass demonstrations and strikes in a politically calm and peaceful environment. The so-called “round-table” negotiations, including the representatives of both the communist and the main opposition parties, consensually defined the framework and the sequence of the political shift to democracy.<sup>13</sup>

At the very start of the new regime, the freely elected political forces tried to implement a series of painful reforms with the explicit aim of hardening the budget constraint of firms and individuals in 1990 and 1991. The Hungarian bankruptcy law liquidated insolvent capacities mercilessly, causing an immediate and drastic fall in economic activity.<sup>14</sup> Hardening the budget constraint of enterprises came at a high price, however. Transformation recession totalled at 18 per cent of the GDP by 1993, and, in turn, Hungary experienced the most dramatic fall in employment in the region. Adopting the 1989 level as 100 per cent, employment declined first to 87 per cent by 1991 and then further down to 72 per cent by 1994. The numbers for the same period were 90 and 85.5 in Poland, and 93.5 and 90.5 in the

<sup>11</sup> By 1981, Hungary’s public expenditure (measured to GDP) significantly exceeded other socialist countries’ data: 63.2 versus 53.2 in Poland, 53.1 in Czechoslovakia, 47.1 in the Soviet Union, and 43.5 in Romania (Kornai, 1992).

<sup>12</sup> On the big-bang *versus* gradualism debate, see Balczerowitz (1995) and Gros and Steinherr (1995) on the one hand and Aghion and Blanchard (1994) and Dewatripont and Roland (1995) on the other.

<sup>13</sup> Furthermore, members of the previous socialist system were allowed to participate in the first free elections and became members of the new establishment.

<sup>14</sup> The liquidation of low-quality companies triggered the need for large bank consolidations too (Király, 1994).

Czech Republic. Unemployment reached double-digit numbers in the first half of the nineties; it peaked at 12 in Hungary (Basu *et al.*, 2000).<sup>15</sup>

Under socialism, guaranteed employment meant a solid safety net for families. The appearance of the second economy in the eighties also provided some extra income for citizens. After the change, the loss of jobs in both the first and the second economy in turn endangered the living standard of individuals and also the relative political calm. In principle, the transformation recession should have triggered a dramatic erosion in living standards and private consumption, which was not the case, however. Private consumption declined proportionally much less than other macroeconomic variables, thereby giving a special character to the Hungarian transformation – see Table 3.

Table 3. GDP and its components, 1989-1994

	GDP	Final consumption		Gross capital formation	
		Total	of which: total household consumption	Total	of which: fixed capital formation
1989	100	100	100	100	100
1990	96.5	97.3	96.4	95.5	93
1991	84.8	92.3	90.8	75.3	83.3
1992	82.3	92.7	90.8	60.1	81.2
1993	81.7	97.7	92.4	79.5	82.7
1994	84.2	95.4	92.4	95.1	93

Source: own calculations based on CSO (2007).

Note: The closing date is 1994, because one year later Hungary adopted an austerity package.

In order to understand such a paradoxical change, one needs to confront these numbers within the context of Hungary's past. Relative political calm was maintained after 1968 by allowing individuals to earn more on the market and to benefit from the increased welfare spending of the state. As path dependency theory claims, no current decisions can be made without taking into account the constraints of past actions and institutions.<sup>16</sup> The taxi and lorry drivers' blockade against the price increase of petrol just 4 months after the free elections made it clear to the political incumbents that people would not tolerate the decline in their personal (but not aggregate) wealth status. It was clear that reform in the micro sphere could go further only if the government *compensated* citizens. To put it differently: the new democratic leaders recognised that the price of microeconomic restructuring was accordingly the preservation of the relative well-being of citizens. Household transfers were expanded to an extent which could significantly counterbalance the negative consequences of a fall in output. The general budget was burdened by generous social entitlements in the form of unemployment benefit, family allowance, sick leave, early retirement schemes, etc., thereby preserving the pre-existing welfare state of the socialist past.<sup>17</sup> As the communists earlier purchased the loyalty of citizens by providing an unsustainably high standard of living by

<sup>15</sup> The unemployment rate was even higher in Poland; it peaked at 16 per cent. Unemployment in the Czech Republic reached only a very low level of 3.5 per cent in the early years of transformation. Nevertheless, following the 1997 Czech crisis, it climbed to 8 per cent.

<sup>16</sup> See for instance David (2001).

<sup>17</sup> While the economically active population declined from 5.22 million in 1989 to 4.54 million by 1994, the total number of pensioners and other beneficiaries increased from 2.42 million to 2.95 million. The monthly average number of families receiving family allowance increased from 1.37 million to 1.50 million in the same period of time (CSO, 2007).



maximising current consumption at the expense of the future, the government at the time of transformation followed a similar attitude. By providing relatively generous social protection, individual-specific uncertainty was reduced substantially in times of a severe transformational fall. In turn, individuals considered increased welfare payments as rightful compensations for the loss of their jobs, making it rather hard to cut back on them later on. That is, there was a strong tendency for a high level of redistribution and overspending at a time when one of the major challenges of the country was to deconstruct the old and inefficient state structure and to promote a shift towards getting incentives right that are compatible with market economies.

From such a perspective, it is reasonable to claim that the gradualist character of the Hungarian transformation was not the result of a conscious decision of the freely elected government, but a historically determined path dependent outcome of a two-decade long reform process which culminated in the political change of 1989. Applying the term “gradualist” with regard to Hungary is therefore misleading. Originally, the theorists of gradual reforms favoured a sequenced and embedded reform process and argued against the total suspension of past capacities, since it would have triggered an unnecessary fall in supply, ending up in impoverishing and frustrating citizens. The early years of the Hungarian transformation, however, were burdened with ambiguity and a lack of coherence in policy decisions.<sup>18</sup>

#### *Stabilisation first and a return to paternalism later*

The artificially high level of aggregate demand caused serious imbalances in both the internal and external positions of Hungary. With the re-emergence of a twin-deficit, in 1994-95 a financial crisis threatened the country. The inaction of the Hungarian authorities on the one hand and the Mexican financial crisis of 1994-95 on the other made international financial investors reluctant to finance Hungary. In order to avert a crisis, a stabilisation package was adopted by 1995. The fundamental goal of the surprise package was to remedy the disequilibria in both the foreign and the internal balances, thereby stopping the dangerous spiral of indebtedness, and consequently regaining the trust of foreign investors. While preserving the political calm was an eminent objective of both socialist and post-socialist governments between 1968 and 1995, the austerity package reneged on it and made the restoration of economic stability the only valid goal.<sup>19</sup>

The package aimed at enforcing short-term stabilisation and long-term sustainability at the same time. Besides the strict measures of demand contraction, it also tried to break down the pre-existing paternalist welfare state. It restored the competitiveness of the economy by reducing real wages in the economy by 12 per cent and by significantly accelerating the privatisation process. The consumption-oriented character of Hungary’s reform cycles could be replaced by an investment-oriented one only because of two factors: the real threat of a financial crisis and the availability of a “technopol”, the finance minister.<sup>20</sup>

However, the change in orientation did not last too long. As soon as the direct threat of an economic collapse diminished, Hungarian politics regained its pre-crisis character. By 1999, the growth rate of private consumption exceeded once again the increase of overall economic activity, which was further deepened by the world-wide economic slowdown in 2001 and the rebirth of a political business cycle in 2002 (Figure 2.). Election economics

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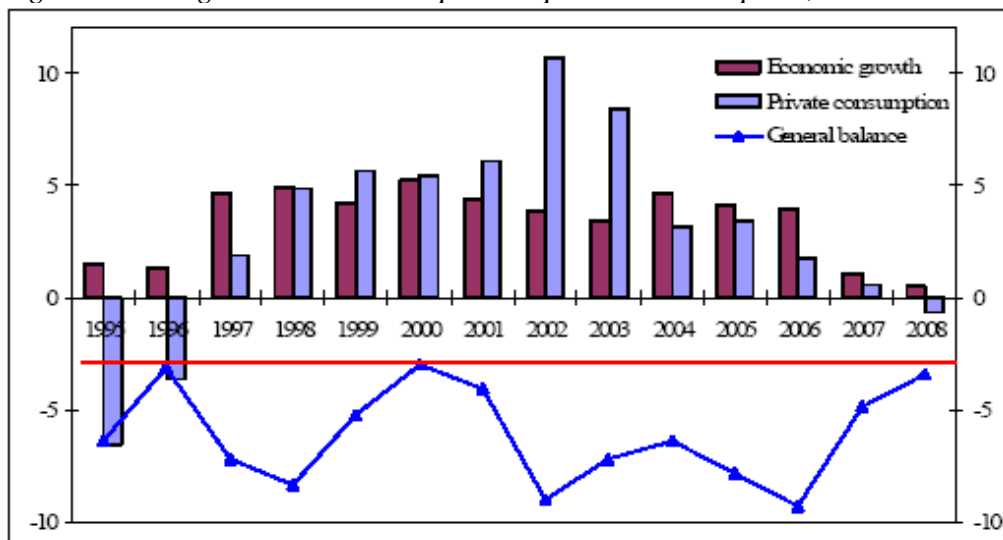
<sup>18</sup> For an elaboration, see Csaba (1995).

<sup>19</sup> The austerity measures were worked out in full discretion without the involvement of the parliamentary parties or social partners. This was the only time from 1968 onwards when stabilisation was initiated without any compromise.

<sup>20</sup> The term “technopol” was originally coined by Williamson (1994). It refers to a person who behaves as if s/he was a social welfare planner.

along with the old reflexes of compensating losers of the austerity package have re-emerged.<sup>21</sup> The consequent deterioration of fiscal balance again put Hungary on an unsustainable path of development. Apart from a short period of necessarily exerted fiscal discipline, Hungary continued its previous regime of consumption-maximisation. It meant the regression to an expansionist state paternalism, financed by increased public liabilities. Politicians were yet again unwilling to embark on the radical and necessary macroeconomic policy changes, especially in the field of public finances (Antal *et al.*, 2005). The budget constraint of the state weakened dramatically and the general budget itself again became a buffer in order to compensate losers.

Figure 2. Change in economic output and private consumption, 1995-2008



Source: data are taken from the EC (2006 and 2009).

Note: red line: 3 per cent reference value of the EU.

As the main element of fiscal profligacy was the compensation of losers of macroeconomic stabilisation and microeconomic reforms, the two main sources of fiscal overruns in the early years of the new millennium were increased public sector wages<sup>22</sup> and increased household transfers. On average, employees in the public sector received a fifty per cent hike in total between 2001 and 2003. The share of compensation of public sector employees to total outlays climbed to 25 per cent by 2003 from the initial 20 per cent in 2000 (OECD, 2004). As far as household transfers are concerned, family-related benefits proliferated substantially both in scope and size (i.e., family allowance, maternity allowance, child-bearing benefit and childcare benefit, child raising support and childcare allowance). Generous housing subsidies can also be considered as welfare provisions.<sup>23</sup> For pensioners, the so-called 13th month premium was introduced by 2002 in a country where 90 per cent of the employees have been eligible to retire years earlier than the official retirement age.

<sup>21</sup> In 2002, the new governing coalition explicitly announced the initiation of a “systemic change in welfare politics” which meant a radical shift away from fiscal sustainability to increased welfare spending in order to redistribute the fruits of the stabilisation measures of 1995-1997 to as many people as possible.

<sup>22</sup> The statutory minimum wage also increased dramatically (in real terms it equalled 65 per cent). Kertesi and Köllő (2004) found that the wage rise triggered a significant fall in employment opportunities, especially in the small- and medium-sized sector. They estimated a 3.5 per cent decrease of employment in companies employing 5-20 persons. The most seriously hit sectors were the labour-intensive ones.

<sup>23</sup> Between 2001 and 2004 mortgage lending was actively supported by housing subsidy schemes of alternating governments, providing a negative real interest rate for borrowers. Furthermore, the monthly mortgage payment became tax-deductible.

Hungary has also been the country with the highest share of disability benefit recipients, and the amount of social benefit paid to this group has increased drastically over the past decade. The number of disability benefit recipients increased from the starting level of 250,000 in the early nineties to 450,000 in 2005 which is more than 11 per cent of employees.<sup>24</sup> Sick pay, on the other hand, has been used by many as an extension of unemployment benefit after the termination of the employment contract. In the mid-2000s, unemployment insurance benefit was paid to around 100,000-130,000 people, supplemented by an incredibly high number of 80,000 people receiving sick pay. The generous welfare system, along with an outstandingly high tax wedge on employment, provides serious disincentives to work: only (a bit less than) four million out of the total seven million active people are registered employees in Hungary. The real challenge to welfare benefits is that such fiscal expenditures are always considered as entitlements. Once people become entitled to receive them, they show strong political resistance to any change in the system – a phenomenon that was well-known in the socialist past, too. The continuation between the communist and the post-communist era is demonstrated by the time series on household income and consumption between 1960 and 2005 (see Table 4). The data reveal that a dramatic gap emerged between real wages on the one hand and real income (wage plus welfare payments and subsidies) and consumption on the other hand – both before 1989 and after.<sup>25</sup>

*Table 4. Real wage, real income and consumption, 1960-2005*

	<b>Real wage per wage-earner</b>	<b>Real income per capita</b>	<b>Consumption per capita</b>
1960	100	100	100
1965	109	123	115
1970	129	159	150
1975	152	199	185
1980	158	216	208
1985	151	236	220
1990	142	245	238
1995	118	215	205
2000	127	234	236
2005	176	296	319

Source: CSO (2007).

Note: Numbers are index, 1960=100.

Political myopia also strengthened an extremely sloppy planning of both public expenditures and revenues. The finance ministry overestimated revenues and the potential for economic growth and underestimated expenditures in the annual budget in every single year between 2001 and 2006 (OECD, 2006).<sup>26</sup> Hungary – due to the lack of action and ill-conceived policy choices – has found itself in the crossfire of swelling criticism: international rating agencies have downgraded the country, and even the European Committee has blamed Hungary several times, thereby making the loss of credibility of the Hungarian economic

<sup>24</sup> An additional 350,000 people receive disability benefit, although they have already passed the retirement age. In total, 9 per cent of the population within the 20 to 64 age group is entitled to a disability benefit in Hungary, which is in strong contrast with that of other CEE countries or the neighbouring Austria for instance, where the ratio is only around 6 per cent (OECD, 2004:76).

<sup>25</sup> A more elaborated scrutiny of the expenditure side of the Hungarian general budget between 1995 and 2006 is provided by Benczes (2008).

<sup>26</sup> The gap between revenues and expenditures reached 9.2 per cent (!) of GDP by 2006.

policy (and policy makers) fully overt. The period between 2001 and 2006 can be best characterised as an irresponsible and permanent election campaign where both the incumbents and the opposition tried to outperform their rivals by promising more spending from the budget without keeping an eye on the financing constraint of their populist measures. Despite the fact that since autumn 2006 the government has initiated some changes and fiscal discipline has been strengthened somewhat, essential reform measures are still waiting to be adopted. As Csaba (2009:95) accurately stated: “the stagnation of reforms and the deepening of mutual distrust among and across all players of the political scene have created a *paralysis*.”

The crisis of 2008-2009 left Hungary in an extremely weak structural and financial position. The country embarked on an irresponsible deficit-financing policy throughout the heydays of the 2000s. Due to short-sighted policy activity, the country accumulated debt, lost competitiveness and severely reduced the potential of economic growth at a time when other countries in the CEE region experienced just the opposite tendencies. The pro-cyclical character of Hungarian fiscal policy did not leave ample room for policy makers to tackle the crisis by fuelling aggregate demand. Hungary was amongst the very first countries, in fact, to be severely hit by the crisis. Once again, external forces pushed the country into changing its lax fiscal regime into a more restrictive one in order to revert the perverse effects of the crisis. The adopted measures have only concentrated, however, on short-term adjustment needs and lacked the long-term perspective of a comprehensive restructuring of the general budget. Past experience has shown that missing such an opportunity can cost too much in this small and extremely open, but at the same time strongly paternalistic, country.

## **Conclusion**

Hungary is one of the worst-hit countries of the current financial crisis in Central and Eastern Europe. The deteriorating economic performance of the country is, however, not a recent phenomenon, as the paper has documented. A high ratio of redistribution, a high and persistent deficit and accelerated indebtedness are not new phenomena in Hungary, but elements of both the communist and the post-communist history of the country.

By providing a path-dependent explanation, the paper argued that starting with the marketisation attempts in the socialist era, that is, well before the systemic change of 1989-90, politicians used the general budget as a buffer to compensate losers of economic and political reforms. This attitude did not change with alternating governments after the first free elections either, and it has been re-emerging from time to time in the last twenty years.

In fact, individual-specific uncertainty and the heavy burden of structural reform of the (micro) economy have been compensated by increased public provisions in the form of increased employment in the public sector and increased welfare transfers. It seems that the success of marketisation and microeconomic restructuring, which once made Hungary the most advanced transition economy in the region, came at the price of deteriorated fiscal discipline. Political forces managed to harden the budget constraint of enterprises on the one hand and to maintain a relatively large supportive winning coalition of restructuring on the other, only at the cost of softening the budget constraint of the state. In turn, paternalism has survived systemic change and it now endangers the healthy and sustainable development of the country – a country which had a remarkable reform history but which has dramatically devalued its future prospects.

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