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Drowning the Tiger

The Failure of Hungarian Economic Reform 1989 – 2009

by
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Summary
The paper explores Hungary's steady economic decline in the twenty years since the fall of the communist system. It attributes this decline to an overall failure to disengage the government from a controlling role in the economy and in social welfare, and it examines the historical and contemporary factors that led to this failure.

Introduction

In the space of 20 years, from the end of communism in 1989 to the present, Hungary has fallen from first place to last in economic terms amongst its Central European neighbours. This may not seem like a noteworthy story, given the current global economic crisis. But in fact Hungary's economy was well in decline by 2006, when neighbouring countries were experiencing notable growth and prosperity. To lose Hungary's unique story in the broader narrative of global economic downturn would be a disservice to those countries which made the painful but necessary reforms in the immediate post-communist period and which now deserve credit for their success — Estonia, Poland, the Czech Republic and Slovakia. At the same time, failure to understand Hungary's unique story would be to miss critical lessons in one of the most important debates taking place today: how do countries successfully make the transition from authoritarian rule and central planning to market democracy?

Why has Hungary's story not been told up to now? First, human nature is such that by necessity we simplify. Analysts, policymakers, and journalists, when faced with a canvas of 11 different countries (the Baltics to the Balkans — the canvas becomes much larger if one includes the countries of the former Soviet Union) can only discern so much detail. Many of the finer distinctions among the different countries are lost in the broader strokes. Second, circumstances have served to distract from the drama of Hungary's fate. Central and Eastern Europe held the eyes of the world for just under a year — from October 1989 until August 1990. Then Saddam Hussein invaded Kuwait and launched the Gulf War and attention was shifted to the Gulf. From there it was drawn to the Yugoslav War, to 9/11, then on to Afghanistan and Iraq. Even the aid agencies and the many NGOs who had committed themselves to a long-term role in assisting the democratic transition in Central and Eastern Europe, setting up local offices and hiring local staff, withdrew in the mid-1990s, having decided that they were more needed elsewhere and that the countries of this region were now successful graduates of transition. Finally, as mentioned above, the current state of the Hungarian economy is being obscured by the larger global economic crisis. Hungary's leaders are themselves the greatest proponents of this sleight of hand, hoping to raise much needed funds and deflect attention from their bad spending habits.

So in part, the Hungarian story has been lost simply because it is one story among many, and second, because of the way circumstances have transpired and drawn attention and resources away from the region. But there is a third reason as well, and it is to this reason that this paper is primarily addressed. The third reason is that at least a part of what has gone wrong in Hungary has been beyond the measure of easily quantifiable factors. With democratic peace theory at the heart of U.S. foreign policy for the past two to three decades, scholars and policy analysts have expended a great deal of effort to understand how countries become more democratic, and therefore, presumably, less of a threat to the United States and greater contributors to global peace and prosperity. Great strides have been made in this field, to be sure, particularly in understanding the importance of such factors as corruption, civil society, rates of taxation, government regulation, justice and reconciliation, and economic freedom. Progress has been possible because of the many scholars and experts who either have brought a very close scrutiny to their subject, or who have found ways to quantify and thereby measure and compare complex, previously unquantified subjects. The shortcoming is that virtually none of these studies can singly say why in 2006 Hungary saw police and demonstrators clash in the worst violence in 50 years; why in 2007 Hungary had GDP growth of 1.8%, while the smaller neighbour Slovakia had a growth rate of 8.8%, or why Hungary is today on the verge of bankruptcy.

The aim of this paper is to paint that larger picture, with the primary purpose of drawing key lessons about how countries move from stagnant and repressive centrally planned economies to prosperous free-market economies, and secondarily to suggest what Hungary needs to do today to reverse its steady downward course. Rather than provide a strictly historical narrative of Hungary in the two decades following the collapse of communism, this paper will instead highlight five reasons for the failure of Hungarian economic reforms.

None of the five reasons alone can account for the overall failure, therefore there is no effort to rank them in order of importance. Rather, the order is based on their mutability — those factors which are least impacted by human decision-making are listed first. Why approach it this way? Because there are some factors that cannot be changed, no matter how many resources or experts one might bring to bear and yet they are critical to the ultimate failure or success of a transition process. For example, if you do not have a specific individual who has both the force of personality to achieve a major leadership position (ideally prime minister or finance minister) and the education to understand the working of the free market as well as the inclination to be deeply committed to market reforms, then all the other factors necessary for transition are unlikely to come about. The development of a leader can be supported through education and scholar exchange programmes, or through translation of key works into local languages, but if the moment of transition arrives and such a person is not on the scene, he or she cannot be made. Factors such as this, which can be least effected by specific policies or decisions, are therefore listed first because while they may be of great interest to observers or historians, they are less relevant to policymakers.

Other factors central to Hungary's decline, however, are eminently mutable, and as such, they should be of great interest to policymakers who are today facing the challenges of reform. As of the publication of this paper, Hungary will have a nearly bankrupt economy and a new prime minister. He or she, whether by force or inclination, will have to take an interest in policies that can lead to stabilization and growth. At the same time, leaders and experts everywhere, not least in the United States, are still trying to find that perfect balance between the role of the state and the role of the market. A number of recent cases, notably Ireland, Botswana and El Salvador, have underscored the strong causal link between economic liberalization, with its scaling back of state regulation and spending, and subsequent high rates of growth. As such, they have warranted a good deal of scrutiny and attention.[1] Hungary, as this paper demonstrates, is further testimony to this causality — from the opposite side of the coin: its failure to scale back public sector spending and to reduce and simplify regulations and bureaucracy have led to a steady and prolonged decline in the economy.

In brief, then, the five factors that have led to the failure of economic reform in Hungary over the past 20 years are as follows:

1) the introduction of "market socialism" reforms prior to the free-market stage;
2) the absence of a leader committed to free-market reform;
3) the absence of effective lustration;
4) the choice of commercial privatization over reprivatization of state assets;
5) the failure to implement fiscal and regulatory reforms.

This paper will first examine the nature of the present crisis. It will then provide some background to this crisis, exploring several historical factors which did not directly lead to the crisis but had a significant role, and finally it will explore each of these five causes of Hungary's economic crisis and in so doing point to some possible solutions.

The Nature of the Crisis

To the many who have visited Hungary over the past two decades, all would seem well on the streets of Budapest. Crime is low. Renovation and construction are steady. Food and drink and shopping are bountiful. There are no troops required to keep the peace, and no one is starving. Why, then, suggest that Hungary is in crisis? If Hungary were Romania or Albania, had it started out the democratic transition in a worse state, its position today would not be likely to garner much attention. But the fact is, in 1989, when the Berlin Wall fell, Hungary was by all accounts the country most likely to succeed. Of all the formerly communist countries, Hungary had gone the farthest in introducing market reforms prior to 1989, and the results were pronounced. It was the most prosperous country in the bloc, and its regime the least totalitarian. At the time that communism collapsed, the private sector was already generating 20% of Hungarian GDP, (compared with 4% in Czechoslovakia, for example). Hungary had the highest levels of foreign direct investment, receiving about one-third of all FDI in the region well into the 1990s, and living standards in Hungary were markedly higher than in neighbouring countries. Hungarians did not have to stand in line at dawn for milk and eggs as Romanians did. They did not have shortages of meat and bread as the Poles had.

[1] For an analysis of the link between liberalization and growth in each of these three cases, see Benjamin Powell, Ireland, Botswana, Joan Carlos Hidalgo, "El Salvador: A Central American Tiger?" *Cato Institute Development Policy Analysis*, March 9, 2009, No. 8;

Compared to their neighbours, the Hungarians were very well off. So in essence, it is not merely the fact of Hungary's decline that defines the nature of the current crisis but the scale of the decline.

Comparative prosperity, high FDI, and nearly two decades' experience with private enterprise led many to believe that Hungary would easily make the transition to market democracy after 1989. Yet within the relatively short period of 20 years, Hungary's growth rate has dropped to one of the lowest in Europe (1.7% in 2007), its debt to GDP ratio is one of the highest (109% in 2006, second only to Latvia among the European nations), and it has been steadily downgraded by the rating agencies. These are a few of the quantifiable measures of Hungary's current crisis. There is also much about it than cannot be so easily quantified — strong social and political dimensions which are difficult to measure, but impossible to ignore. Locally many speak of a moral crisis. There is a deep mistrust of government and official institutions. Corruption is high. Hungarians have cynically dubbed their country *The Land of No Consequences* because of the numerous corruption cases in which guilt has been proven, but no one is held to account. Thus while the crisis has an important economic dimension, it has other aspects to it as well which might best be described as rule-of-law and political culture issues.

Background to the Crisis

The false steps that Hungary took in its transition process can primarily be ascribed to events that took place from 1968 onwards. However, it is worth noting two factors predating the 1968 reforms that had an impact on the post-1989 reform process. The first is the attitude among Hungarians toward the free market prior to the imposition of communism. In the United States and Britain we generally think of the so-called political right as being supportive of limited government and free markets. Not so in Hungary. The Hungarian right shares some qualities traditionally associated with the right in the West, notably patriotism and conservative, Christian-based values, but on the role of government, they take the opposite stance. In the United States, the right places individual freedom over all, and the government is often perceived sceptically, as a potential threat to that freedom. The Constitution, *not* the government, is sacrosanct.

In Hungary, on the other hand, individuals can only be protected by the nation, and the nation can only be protected by the government. And indeed the enemies have been and can be vast--the Ottomon empire, the Austro-Hungarian monarchy, Soviet-backed communism, and now, American-led global capitalism. Hungary has been swallowed up many times before and many fear it being so again. Hungarians are therefore eminently willing to sacrifice individual interests or freedoms for the sake of the nation. It is an impulse rooted in their history.

Prior to 1948, the right in Hungary was deeply critical of liberalism, which the political scientist Csiky Balázs defines as "free market capitalism insensitive to social problems, rejection of authority, anticlericalism, rejection of moral limits, relativism of moral values, extreme individualism, uninhibited enforcement of interests in the economy and the arena of power, [and] aversion to Hungarian national feeling and patriotism." [2] The Hungarian right prior to 1948 condemned capitalism on the grounds that they felt interest in profit and material gain would push moral considerations and national interest into the background. Liberalism, or belief in the free market, was seen as the domain of the mercantilist Jews. This has left an enduring bias against the free market to this very day. Supporters of the free market are thought of as the radical left (and still strongly associated with Jews), while the left (former communists, socialists and technocrats), as well as the right, (defined primarily by their anti-communism) both support a strong state in the economy and in social welfare. None of the mainstream parties unequivocally advocates the principles of the free market, and those who argue that a smaller role for the government might result in a stronger economy or greater efficiency and freedom have not yet managed politically to gain a significant foothold.

The second factor which, though historical, should also carry some of the blame for Hungary's recent crisis, was the purge of Hungary's economists in the period 1948-9. László Szamuely and László Csaba have pointed out that while all countries of the region experienced a discontinuity between the pre-1945 period and the post-1948 period, Hungary saw a complete break with the past when Marxist-Leninist thinking was strictly imposed on the economic sciences. After a brief period of democratic rule from 1945-7, Soviet-backed communism was forcefully imposed, and with it came a "Sovietization" of academic life. Few fields were more profoundly affected than economics. All economists who had been members of the Hungarian Academy of Science lost their titles or positions, as did most professors of economics, who lost their chairs and their right to teach.[3] Some were sidelined, but many simply left the country. The result was that Hungary was left without economists with the education or the inclination to criticize shortcomings in the socialist system. However, there was one young journalist who, though a committed communist, began to see the ways in which central planning did not function. First he saw the difficulty of maintaining wage levels and production targets, one result of which was recurrent shortages. He then came to see the political abuses of communism. He heard from friends who were tortured, who suffered "shameful atrocities," and this caused him to question communism in a more fundamental way and eventually motivated him to undertake an intensive study of economics. János Kornai, originally a young journalist and committed communist, became perhaps the best known and most influential of all the region's economists who came to criticize socialism. But in one of the unfortunate ironies of Hungary's fate, Kornai did not originally embrace the free market. Kornai has acknowledged that while he saw shortcomings in central planning, he did not at first see those shortcomings as systemic.[4] As a result, in 1953, after Stalin died and opened the gates to the first wave of public criticism of Marxist-Leninist central planning, Hungary had no avowed advocate for the free market. Kornai's doctoral dissertation, *Overcentralization in Economic Administration*, published

[2] Balázs, Csiky "Topics in the Hungarian Right-Wing Press – Now and in the Past" in *Intellectual and Cultural Change in Central and Eastern Europe* (Peter Lang, 2007).
[3] Szamuely, László and László Csaba, "Economics and Systemic Changes in Hungary, 1945-1996," in *Economic Thought in Communist and Post-Communist Europe*, Wagener, Hans-Jürgen ed. (London and New York: Routledge Press, 1998) pp. 158-163.
[4] Kornai, János *By Force of Thought: Irregular Memoirs of an Intellectual Journey* (Cambridge, MA: MIT Press, 2006) p. 51.

in 1956 amidst a storm of public attention, is recognized as one of the seminal works in the literature of socialist criticism, but the book reflected Kornai's belief that the socialist economy could be reformed. The simple fact that this very bright and influential economist, who had the force of thought to gain audiences that went far beyond his home country, had not yet fully evolved in his economic thinking at a critical juncture in history, had repercussions for decades:

> I believed in the possibility of change so strongly that I had agreed in the spring of 1956 to direct a working group to summarize for the [Communist] party and government the reform proposals devised in the institute….In August, we put on the table 120 pages of material containing a proposal for introducing Hungarian "market socialism," phrased calmly and carefully, with plenty of specific detail. The material, modestly, confined itself to light industry, but its message was broader than that. It can be seen as a first rough draft of the New Economic Mechanism eventually introduced in 1968. Standing behind the proposal for reform as sources of intellectual inspiration were the articles of György Péter and my book *Overcentralization*.[5]

To be fair, Kornai was far from alone in advocating "market socialism." The drive for reform that swept through Central and Eastern in the 1960s was almost unanimously a call for market socialism—not an abandonment of socialism but merely a loosening of central control and the introduction of some market mechanisms. Economists in Czechoslovakia called for similar reforms, but the invasion of Prague by Soviet and Warsaw Pact troops on August 21st put a definitive end to such proposals, and Czechoslovakia remained one of the most comprehensively centralized economies as well as one of the most oppressive regimes up until 1989. Economists in Poland as well called for a serious rethinking of their system. But to the extent that any of these countries had economists calling for a full embrace of free-market reforms, such as Stefan Kurowski in Poland, they were isolated, and they were in the minority.

Therefore Hungary was very much in step with neighbouring countries in its call for market-socialist reforms in 1968. Where it differed was in its ability to implement those reforms. Hungary was able to move ahead with reforms and go further than any of its neighbours. And it is here, ironically, that Hungary's troubles began. In spite of the early gains brought about by the limited reforms known as the New Economic Mechanism, Hungary opened itself up to a number of hazards described below that greatly constrained its range of policy options further down the road.

Hence, prior to 1968, there were two factors that deeply impacted Hungary's subsequent reform process: a deeply held and long-standing bias against capitalism among the general population, and no one amongst economists or political leaders to dissuade them from that bias. Together, these factors formed a foundation on which it would have been difficult to build a successful economic reform programme after 1989. The tide might yet have been turned after 1968, but there were processes or decisions after 1968 that together led Hungary to the crisis it is in today.

[5] Kornai, p. 93.

Five Reasons for the Failure of Economic Reforms in Hungary 1989 – 2009
One: The Myth of Market Socialism and the New Economic Mechanism

The majority of Hungary's neighbours went through a two-step process, moving straight from central planning to free markets — in the loosest sense of that term — with 1989 as the dividing line. Hungary, on the other hand, went through a three-stage transition: 1) central planning, 1948-1968; 2) market socialism, 1968-1989; 3) free market (again, used in the loosest possible sense), 1989 to the present. The second stage began formally on January 1, 1968 with the introduction of the New Economic Mechanism [NEM]. (It is an added irony that in Hungarian the word "nem" means no.)

The NEM called for four principal reforms: to replace plan directives with market pricing, to limit central pricing, to link domestic prices of exports and imports with world market prices, and to decentralise investment decisions.[6] At the time, and for two to three decades afterwards, this appeared to have been to Hungary's advantage. In the years following the NEM's introduction, Hungary did not suffer the same degree of shortages as its neighbours did. Not only were Hungarians materially better off during the 1970 and 1980s, but the economic advantage Hungary gained from the reforms seemed to place it in the best possible position when full-scale reforms began after the collapse of communism in 1989. It was universally assumed that Hungary would do well. It had the highest FDI in the region and many of its citizens had had some experience with private enterprise. They had been free-marketeers in training—or so it was believed.

But in the long run, having gone through this unique three-stage process did not work to Hungary's advantage. There were several negative outcomes as a direct result of the intermediate period of market socialism. In the first place, it allowed those who believed in market socialism to take a dominant position within the system. In the Czech Republic, advocates of market-socialist reforms lost their jobs or emigrated. In Hungary, they became ascendant. Moreover, their reform programme breathed new life into the myth of market-socialism because it did indeed result in a positive outcome, *but only relative to countries which remained fully socialist*. It prevented the type of economic collapse experienced in Poland, but it did not lead to sustained growth.[7] Yet that fine distinction was lost on subsequent generations of economists, policymakers, and voters, with the result that in Hungary the notion of market socialism has been endowed with an enduring plausibility.

A second negative outcome of Hungary's three-stage transition process is that it opened Hungary up to the pitfalls that have come to be associated with the gradualist approach to reform. Anders Aslund, in his recent book, concluded from the broader post-communist experience that rapid reform strategies produce the best results because gradual reforms are more likely to be co-opted by rent-seeking elites.[8] However, he mistakenly considers

[6] Adair, Bianca L. "Interest Articulation in Communist Regimes: The New Economic Mechanism in Hungary 1962-1980," in East European Quarterly, 37.1 (Spring 2003) p. 101.
[7] Swain, Nigel *Hungary: The Rise and Fall of Feasible Socialism* (New York, Verso Books, 1992) p. 1.
[8] Aslund, Anders *Building Capitalism* (New York, Cambridge University Press, 2002).

Hungary to be among the rapid reformers and he does not take into consideration the gradual reforms that took place *prior to 1989*. Janos Kornai, on the other hand, makes the case that Hungary's was an extreme form of gradualism:

> The process of transformation in Hungary has extended over several decades; the initial steps were taken back in the 1960s. Though a few milestones can be mentioned, the process as a whole has been notable for its gradualism. Similarly gradual development in this respect has only occurred in Slovenia. In the eyes of those who distinguish "shock therapy" or "big-bang" strategy from "gradualist" strategy, Hungary represents one extreme of the second and in many ways a special case of it: "gradualism Hungarian style."[9]

Gradualism Hungarian-style opened the door to co-option by rent-seeking elites in two distinct ways. In a later wave of reforms as a part of the New Economic Mechanism, a degree of privatisation was allowed and a new class of "entrepreneurs" emerged. It included those who worked within state factories and were allowed to use resources and equipment to produce privately in the off hours. It also included those who were allowed to establish small private businesses. According to Czech economist Jiri Schwarz, the small business owners who emerged after the 1968 reforms opposed rapid and radical privatisation and reform, since it would have put them at a disadvantage. Hence from this perspective the early reforms were no longer an advantage to Hungary after 1989 but rather acted as an internal brake on the deeper, necessary reforms.[10]

There was a second negative component of the pre-1989 reforms. As the full dismantling of central planning approached, communists maneuvered to get an early hold of assets. The Company Act, introduced in early 1989, led to the creation of 4,225 limited liability companies before the Berlin Wall even fell, so that by the time central planning was officially dismantled, the former communist elite had enacted a kind of spontaneous privatization. As a result, they were then able to drive the path of further privatisation, explained in further detail below.

The negative outcome of Hungary's experience with partial economic reforms on the way from command to market economy may seem irrelevant from the perspective of other transitioning countries. The Hungarian case might mistakenly lead one to conclude that a country would do better in the long-term to maintain a strongly centralised and authoritarian rule until the last possible moment prior to reform. On the contrary, where there is opportunity to reform, it should be taken. The standard of living of millions of Chinese, for example, has been raised by partial reforms, much as was those of the Hungarians in the 1970s and 1980s. But the Hungarian case acts as an important warning, that the new class of entrepreneurs and economic elites may very well try to control further reforms for their own advantage, to the detriment of the broader population and the nation, if and when political change makes that possible.

Two: The Absence of a Free-Market Reformer

[9] Kornai, János, "Paying the Bill for Goulash Communism: Hungarian Development and Macro Stabilization in a Political-Economy Perspective. *Social Research* 63. no. 4, Winter 1996, pp. 943.
[10] Interview with author, March 18, 2009.

The majority of studies of post-communist transition focus on institutions — the importance of getting the right economic institutions, the right government institutions, or the right civil institutions in place following the collapse of authoritarian rule. Fewer studies have looked at what transformation might need to take place within the citizens themselves — what process facilitates a transformation of individuals cowed by decades of state abuse, betrayal by family, friends and co-workers, by a system which rewarded subservience and obedience over initiative, into enterprising, responsible, trusting and trustworthy citizens of a free nation. However, two of the region's leaders did recognise the centrality of this transition. Lech Walesa made the following comment:

> Democracy is made up of two major components. One is the legal framework of freedoms and rights that accompanies the political process, what actually gives you the ability to carry out democracy. The other is the extent to which one takes advantage of it. The second component cannot be enforced. Either people take advantage of freedoms or they decide not to.[11]

And the Czech Republic's key transitional leader, Vaclav Havel, also noted this point:

> …in the 1970s and 1980s, society became morally crippled, and this was the source of people blatantly turning their backs on everything public, but the massive epidemic of looking out for Number One and indifference to others was hardly new or surprising. There is plenty of evidence to show how opportunistically a large part of society behaved in the 1950s, when it was common to sign petitions demanding the death penalty for various "enemies of socialism," or how little support from society our domestic resistance against the Nazi occupation received during the Second World War. Only a fool could believe that the nation, or the whole of humanity for that matter, would change overnight and that everyone would start to behave wisely, unselfishly, altruistically, ready to make sacrifices for a good cause.[12]

In other words, individuals themselves must undergo a significant transition in the move from a communist to a democratic society. But this aspect of transition is almost universally overlooked.

At the same time, because there was such an overwhelming desire to get away from the authoritarian model of leadership, where one distinct individual stood at the helm dictating policy, the role of individual leaders tends to be overlooked as well, with emphasis again placed on institutions instead. But if one looks at the best performers today, Estonia, the Czech Republic, Poland, and Slovakia, one can clearly indentify key leaders who strenuously advocated and helped bring about free market reforms: Mart Laar in Estonia, Vaclav Klaus in the Czech Republic, Leszek Balcerowicz in Poland, and Mikuláš Dzurinda and Ivan Miklos in Slovakia.

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[11] "Democracy: The Never-Ending Battle, A Conversation with Lech Walesa," Worldviews for the 21st Century (Global Connections Foundation, Orlando, FL 2006) Vol. 4, No. 1, Spring 2006, p. 5.
[12] Havel, Vaclav *To the Castle and Back*, Paul Wilson, trans. (New York, Vintage Books, 2008), pp. 58-9.

Two points need stressing here. First, in each case, these individuals had a deeply held commitment to the free market as well as a solid knowledge base (except perhaps for Mart Laar, who, by his own admission, had only read Milton Friedman's *Free to Choose* before becoming prime minister in 1992. But he also had the benefit of a background as an accomplished historian as well as the policy advice of German economist Herbert B. Schmidt). Second, each of these committed free-market reformers had a sufficient power base from which to enact reforms, holding the position either of prime minister, finance or privatisation minister. Hungary did not have such an individual.

The first post-communist, democratically elected government in Hungary was a centre-right coalition, led by Prime Minister József Antall. Antall was a medical historian and librarian, and although he gained political experience in the negotiation process that led to the fall of communism in Hungary, he never received an education in economics, and perhaps for that reason, he was in the social-market camp rather than in the free-market camp. His objective, according to one source, was to set up a "real, free, social market economy."[13]

In dismantling the communist regime, Antall called for a gradual transition: one which would maintain much of the welfare state, while gradually privatising state-owned corporate assets. The type of privatisation he advocated was also a significant factor, but that will be discussed in further detail below. For now, let it suffice to say that because Antall believed in the possibility of a social-market state, he did not scale back the size and cost of the government. Béla Greskovits, in his study of the post-1990 leadership in Hungary and its impact on policy, argues that of Antall's four principal policy advisors, only Ferenc Rabár was in favor of radical reforms (reforms that János Kornai also advocated, under the banner of "macro-economic surgery"): budget cuts, sharp devaluations, fast liberalisation of prices and trade, and a rapid transition to currency convertability.[14] The other three key advisors (György Matolcsy, Bélá Kádár, and Péter Ákos Bod) advocated a more moderate approach to reforms based in part on political considerations (which, to be fair, probably meant concern about the social cost, rather than the cost in votes). But Greskovits also makes clear that Antall was intensely ambitious and tended to surround himself with people who *a priori* supported him, so it is unlikely he would have tolerated this leaning toward moderate reforms had he not embraced that position himself.

The end result of this moderated pace of reform was that the state maintained extensive control of the economy through regulation, taxation and bureaucratic controls. Additionally, the state maintained extensive welfare programmes and also maintained its dominant presence in education, health, culture, and sports. This naturally translated into a high state budget and high employment by the state, resulting in both high taxes and a growing budget deficit. By 1993, public sector share of GDP was still 48%, and public

[13] http://www.aja.hu/download/ajaeng.pdf, p. 5, accessed 3/30/2009.

[14] Greskovits, Bélá "Brothers-in-Arms or Rivals in Politics? Top Politicians and Top Policy Makers in the Hungarian Transformation," in *Reforming the State: Fiscal and Welfare Reform in Post-Socialist Countries*, János Kornai, Stephan Haggard, Robert R. Kaufman eds. (Cambridge University Press, 2001) pp. 119-120.

sector employment actually rose during this period, rather than declined, contrary to what one should expect from a country ostensibly dismantling a socialist state:

Public sector employment (as a percentage of total employment):

1990	1991	1992	1993	1995	1995
19.0%	19.9	21	23.1	24	24.1

The result was that by the end of Antall's term (he died of cancer 6 months short of the full term), although much of the Hungarian economy had been privatised, the country was in a declining state. Antall had missed a critical window for implementing reforms, and the door was opened for the former communists to come back into power. Hungary's second post-communist government, voted into power in 1994, was led by Gyula Horn, former Central Committee member and foreign minister under the communist regime.

Three: Choosing commercial privatization over reprivatization of state assets

When 1989 came around and 41 years of oppressive, totalitarian rule came to an end, two key questions should have been asked: how do you heal a deep feeling of injustice that has been engendered over four decades, and how do you put assets or property of sufficient worth into the hands of the citizens in order to make them feel that they are stakeholders in the new system and therefore willing to fight for their rights?

One aspect of the injustice of communism is political, which can in part be answered by lustration, discussed further below. The other side of communism's injustice is economic, which can only be answered by the twin processes of restitution and privatisation. Communism, it must be remembered, enforced a system that was unjust not only in political terms, with its absence of free elections, totalitarian controls, secret police, imprisonments, executions, and torture. But it was also unjust in economic terms. The communists took away people's houses, their land, their factories, their businesses. It forced them into jobs they did not want and ruined careers. It squandered skills, intelligence, and innovation. It paid wages that were insufficient. It took away farms and turned them into collectives. Privatisation needed to address all these issues. Some countries came closer than others in doing so.

The Czech Republic, Poland and Estonia did a better job of meeting this broader goal because they at least made a plausible show of restoring the property (or its value) that had been stolen under communism, and they put assets directly into people's hands through a voucher system of privatisation. In spite of the shortcomings of both restitution and voucher privatisation in Poland, the Czech Republic and Estonia, these policies at least conveyed an acknowledgment that injustice had been suffered. A broad swath of citizens was able to feel it had been reenfranchised. That was not the case in Hungary. Hungary did not transfer assets through free distribution to the public, or through reprivatisation, but rather pursued a route of *commercial privatisation,* that is, the sale of state assets, and this kept both shares and assets in a limited number of hands, most often the former communist managers. These efforts were successful in purely statistical terms: private sector share in GDP rose from 20% in 1990, to 33% in 1991, to 44% in 1992, to 52% in 1993. Yet while ownership was shifted from the state into private hands, the question arose: "into whose hands?" There was a growing feeling among the population that the economy had gone straight into the hands of the former elite.

It was argued above that Hungary's experience with gradual reforms prior to 1989 may have been the cause for this set of policies. Two classes had emerged under the early reforms: the entrepreneurs who had found room to operate under the loosening of restrictions on private enterprise, and the managers who gained a stake through the Company Law of 1989. As Ákos Róna-Tas argues, "managers had grown into a powerful force under state socialism, and a private entrepreneurial class also began to emerge, limiting the policy options of the political elite."[15] Managers predictably opposed reprivatisation or voucher schemes because they wanted ownership for themselves. The Antall government ultimately facilitated this for them, making available government loans for buying state companies as well as preferential leasing arrangements, whereby managers could "lease" the company and later buy it at a discounted price. This form of privatisation was carried out in a way that favored both managers and entrepreneurs, who, argues Róna-Tas, "had accumulated sufficient capital in the private sector under socialism to believe that they could bid successfully on state enterprises."[16]

The influence of this class on post-communist privatisation policy is confirmed in Béla Greskovits' study of economic decision-making in the 1990s:

> …the WGES [Working Group on Economic Strategy] programme also included the government's new philosophy of privatization, and this more or less remained in place. Reflecting the prime minister's and MDF's [the majority party, the Hungarian Democratic Forum] wish to accommodate the interests of public firm managers in privatization, the WGES document said, "We have to learn to accept politically that the main force of the new Hungarian bourgeoisie will be the 'nomenclature-bourgeoisie".[17]

The direction of the privatisation process by the former communists to their own advantage can be attributed to the general phenomenon of co-option by rent-seekers under a gradualist system of reforms. In other words, any time gradual reforms are introduced, those who make gains from it early on will use their power, whether economic or political, to shape further reforms to their advantage. However, in Hungary, more sinister causes for the course of reform are widely suspected. In what is referred to as the Rose Hill Pact, it is commonly believed that József Antall and the Hungarian Democratic Forum made a secret agreement with the last communist government of Miklós Németh and the Alliance of Free Democrats (SZDSZ) that a peaceful transition to democratic rule would be permitted as long as communists were not persecuted and that

[15] Ákos Róna-Tas, "Social Engineering and Historical Legacies: Privatization and the Business Elite in Hungary and the Czech Republic,"
[16] Ibid. p. 132
[17] Greskovits, Bélá "Brothers-in-Arms or Rivals in Politics? Top Politicians and Top Policy Makers in the Hungarian Transformation," in *Reforming the State: Fiscal and Welfare Reform in Post-Socialist Countries*, János Kornai, Stephan Haggard, Robert R. Kaufman eds. (Cambridge University Press, 2001) p. 127.

privatisation went through the hands of the communists and the SZDSZ. The theory has never been adequately substantiated. But in a sense, that does not matter. It is widely believed and discussed and therefore regardless of whether it is true or not, it still manages to undermine public confidence in the ruling parties and in the transition process itself. It has led to a deep divisiveness in the population and has kept too much of the attention of political leaders on the challenges of reelection rather than on the challenges of reform. Finally, it has also led to a further disenchantment with capitalism and rejection of post-1989 "market democracy." Few can see that Hungary has been in the thrall of a uniquely unhealthy blend of oligarchy and market socialism. Hungarians now wrongly believe that what they have experienced for the past twenty years was market democracy, or capitalism, and based on that experience, they criticise it on the grounds that it benefits only a few corrupt elite.

Four: The Absence of Lustration

The word "lustration" derives from the Latin *lustrum*, a religious act intended to cleanse and free one from sin, guilt or defilement. Webster's defines it as "*a sacrifice, or ceremony, by which cities, fields, armies, or people, defiled by crimes, pestilence, or other cause of uncleanness, were purified.*" A good definition even in the modern political context of regime change. The idea of lustration in Central and Eastern Europe has been to shed light on the past, both in order to heal society and also in order to keep former communists, secret police, and informers, out of key positions.[18] Following the events of 1989, its relevance to the success of political transition has been extensively explored; its relevance to economic transition hardly at all.

The successful functioning of a market economy depends on respect for private property. Respect for private property is dependent on the rule of law, and the rule of law is dependent in its turn on a specific value set that includes honesty, integrity, honouring contracts, and respect for the rights and property of others. That set of values was utterly gutted under communism and needed to be restored in order for the free market to function properly. Lustration is the process that resets that moral compass. In a concrete sense it serves to keep former communists or informers from key positions within a democracy. But this is not its real value, because ultimately they are able to exert extensive control through formal and informal channels. The real value of lustration is that it makes a clear statement that what happened under totalitarian rule was morally wrong—that it was wrong to nationalise private property, wrong to torture or imprison people for their beliefs, wrong for the communist elite to steal from the state. Without that clear statement being made on a national, political and very public level, the behavioural patterns of communism live on, even if its institutions are formally dead.

In Hungary, between 1990 and 2002, there were ten different legislative initiatives to institute some form of vetting and/or exclusion from certain public offices, but most of these never went into effect, and those that did had no teeth. In 1994 an independent lustration court was established. The judges had access to the relevant files in order to investigate all members of parliament, the cabinet, state secretaries and the heads of the

[18] Gorka, Sebastian (ref)

most important media organs. They were to determine whether an individual had worked for or collaborated with just one department of the Communist Interior Ministry, the III/III, or if due to their position as a former communist they had had access to the classified reports of the III/III (The Directorate for Protection of the State from Reactionary Forces). If the individual was found to have been compromised then he or she would be presented in private with the evidence and asked to quietly resign from their position within 30 days. If the person refused, the evidence would be made public in the *Hungarian Gazette*. The principal problem with this process is that the court lacked any real sanctioning power. Few people read the Gazette, which carried news of governmental regulations and legislation, therefore the pressure that could be exerted was minimal compared with publication in one of the bigger newspapers. Secondly, the system relied upon moral pressure to bring the result. The court had no powers to punish or fire. Hence the famous reply of Gyula Horn, prime minister from 1994-98, when faced with his long list of posts under the communist regime — “So What?”[19]

Five: The Failure to Implement Fiscal and Budgetary Reforms

Of course, the real failure of economic reform in the period from 1989 to 2009 was simply enough the failure to implement economic reform. Up to this point, this paper has examined a number of factors around that failure, but the failure itself is worth looking at as well.

As mentioned already, the first key factor was the failure to cut back the size of the government. Indeed it grew rather than shrank. By the end of 1993, inflation was at 22%, unemployment 12%, and discontent with what was considered the social cost of transition was growing

> A paternalist "welfare state" covering the entire population was developed over several decades. Hungary can vie with the most developed Scandinavian countries in the range of codified entitlements to benefits and in the proportion of GDP laid out on social spending, whereas per capita production is only a small fraction of theirs. Although similar tendencies arose at the time in all Eastern European countries, Hungary went furthest by, far and in this respect stands alone in the region.[20]

In the second elections after the fall of communism, Hungarian voters followed a path similar to many in the region — they switched their support from anti-communists to former communists. The party of former communists (Hungarian Socialist Party) won the election, and Gyula Horn, known for his role as a para-military in suppressing the revolution of 1956 and with a long career as a high-ranking communist, became prime minister. An unsustainable external imbalance as well as the overall negative state of the Hungarian economy led to the introduction of the Bokros Plan in 1995 (named for its

[19] Gorka, Sebastian

[20] Kornai, János “Paying the bill for goulash communism: Hungarian development and macro stabilization in a political-economy perspective. *Social Research* 63.n4 (Winter 1996): pp943(98).

author, then Minister of Finance Lajos Bokros), which cut welfare spending, increased taxation, devalued the forint, and introduced an 8% levy on imports.

The plan did introduce some necessary austerity measures, but it met with great social resistance — the day the plan was introduced is now referred to as Black Sunday, and Bokros was forced eventually to resign (though due as well to allegations of corruption). The Horn government moved ahead with privatisation so that by the end of its term in 1998, the private sector accounted for approximately 80% of GDP. Yet the continued failure to dismantle the heavily paternalistic state and to cut back on the fiscal and bureaucratic restraints on business meant the economy remained largely stagnant. The true economic and political health of the country were further impaired by a series of corruption scandals.

Continuing discontent with the difficult social environment along with government corruption again caused the electoral pendulum to swing. The ostensibly right-wing or centre-right government of Viktor Orban came into power with policies the Wall Street Journal called "an improbable hybrid of interventionism and liberalism."[21] Fidesz, the ruling party led by its charismatic young prime minister Viktor Orbán, promised to help the economy grow by giving the state an active role and at the same time to reverse many of the Horn's governments cuts in social spending, most notably, by abolishing university tuition fees, reversing the Horn governments cuts to child support, and introducing policies designed to rekindle the desire among Hungarians to have more children.

The Orbán government faced a difficult situation. On the one hand, they saw that a significant portion of state assets had been captured by former communists, and that their economic power was now translating into political power. Orbán therefore wanted to regain control of the privatisation process. On the other hand, the Orbán government was and remains firmly entrenched in the belief that the state is the most important engine for economic growth. Orbán stated: "It's obvious that after the Second World War, the major source of economic development in many countries was the state. We also looked at the experience from the beginning of the 1980s, of how Finland, Ireland, Catalonia were modernized through global capital and the attraction of foreign investors. We have to combine the role of the state in providing infrastructure for business life and at the same time attract as many as possible foreign investors to Hungary."[22]

In keeping with this belief, the Orbán government introduced the Széchényi Plan, which supplemented private sector investment for entrepreneurial initiatives. Free-market proponents criticised the Plan as a Keynesian redistributionist scheme. Indeed the Orbán government grew increasingly anti-market as more time passed. Starting around 2000, the relative economic growth that had characterised the 1990s slowed: inflation remained high (down from 15% in 1998, although remaining high at 10% in 1999 and 9.5% in 2000), and growth fell from 5% in 1998 to 4% in 1999.

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[21] *The Wall Street Journal*, April 4, 2002.

[22] Orban quote

The election of 2002 proved to be the most emotional and heated of the post-communist period with a record-high turnout of 74.5%, in which voters again reversed course and turned back to the former communists. The former communists had run on a platform built on growing discontent with the cost of transition. Calling for an "eco-socialist market economy," they too promised to improve prosperity through largely statist measures: increased public sector investment and increased pensions. But the government of Péter Medgyessy was distracted early on by political troubles — two months into office it was revealed that Medgyessy had been an officer of the secret police during the communist era. The opposition called for a parliamentary investigation to look into these charges, and the ruling party set up a counter committee to investigate the backgrounds of everyone who had served as a minister or state secretary in the previous 12 years.

When they were able finally to focus on economic policy, the government of Péter Medgyessy failed to make the necessary reforms: reduction of employment in the public sector, reduction of spending on healthcare, pensions and social benefits. As a result, government debt started creeping back up:

General government balance:	1999	2000	2001	2002	2003	2004
	-3.7%	-3.6	-3.0	-10.0	-7.3*	-6.6*

(*adjusted for pension reform)

In May 2003 the International Monetary Fund (IMF) warned, "Rising wages and increased government spending will further inflate the current account deficit and will undermine Hungary's competitiveness on world markets." The declining economic situation and subsequent loss of confidence led to Medgyessy's early resignation two years into his term of office. He was replaced by Ferenc Gyurcsány. The New York Times called Ferenc Gyurcsány a communist outsider, but in fact he has a solid communist pedigree, having been vice president of the Organization of Communist Youth for Pécs from 1984 to 1988 and the president of their Central Committee in 1988-89. He quickly became one of the country's most successful red capitalists. Within ten years he was the 50th richest man in Hungary. In becoming prime minister, Gyurcsány promoted the same vision of a social-market democracy as those who went before him—a system with the social guarantees of socialism, but with the prosperity of capitalism. In his re-election campaign, the MSzP's party platform, "New Hungary 2006-2010," called for "Progress, success and victory. Not for a select few, but for everyone — there can be no other objective for us." Again, the outcome was predictable. Since 2003 Hungary has been one of the worst performers in the region. The current budget deficit is expected to reach 10.1% in 2006, the highest in the EU, and Hungary's debt will stand at 71.5% of GDP by 2007. Outgoing U.S. Ambassador George Herbert Walker III called the budget deficit "monstrous" and the size of government "appalling."

Western analysts are starting to speak of an economic emergency in Hungary. In June of this year Standard and Poor's downgraded Hungary's debt and the forint fell. The same month, Gyurcsany introduced a fiscal rescue plan which emphasised hefty tax increases, rather than spending cuts, and, not surprisingly, the plan has been widely criticised. It would raise the VAT from 15 to 20%, corporate profits tax from16 to 20%, it would introduce a property tax starting in 2008, and drastically reduce subsidies of gas and electricity prices (gas prices have been raised 30% already and will again be raised another 30% in January.) Hungary has been sharply chastised by most Western financial institutions, from the IMF to the World Bank to the European Union. Perhaps more importantly, there is growing concern that many Hungarians will simply not be able to withstand the worsening economic conditions.

Conclusions

What can be learned then from the Hungarian experience that might be relevant to Hungary itself as well as to other countries in the process of transition? First, market socialism is a myth. Enough said. The corollary is that rapid transition, rather than gradual transition (or an intermediate phase of market socialism), seems to do a better job of precluding cooption, rent-seeking and clientalism, in spite of the higher short-term social costs. There is also a limited window of opportunity, so reforms are best implemented quickly, while political capital remains high.

Second, successful transition is dependent on a key leader who is educated in free market economics. It is interesting to note how little it can take to shape the sensibility of such a leader. Sometimes it takes years of education. But sometimes it takes only one book. And if one truly believes in the force of the free market argument, that should not seem so implausible. Vaclav Klaus, who is credited with the Czech Republic's successful economic reform programme, once said his worldview was shaped by one summer exchange programme in Italy. Mart Laar, as mentioned already, only had to read Milton Friedman's *Free to Choose* to become a believer. Krassen Stanchev, a leading figure in Bulgaria's reform process, says his views were changed when he happened to come across a copy of Hayek's *Road to Serfdom* in a library in the University of St Petersburg, then Leningrad where he was a student, in the 1970s. Therefore, academic exchanges and provision of materials (including book donation programmes and translation programmes) are among the most effective means for supporting eventual reform.

Third, privatisation has to be understood not merely as an economic process, but one with deep personal and political ramifications. In planning a privatisation programme, policymakers therefore need to take into account the degree of past injustice and the necessity for a programme that is widely inclusive. Even if commercial privatisation may seem to have economic benefits, the political costs are detrimental to the overall success of reform.

Fourth, in countries simultaneously making the transition from command economy and authoritarian control (an inevitable linkage), a cleansing of the past is necessary for both economic as well as political health. In spite of obvious hazards and pitfalls, lustration is necessary in order to re-establish a moral foundation on which democracy and a market economy can stand, and it should be carried out sooner rather than later in order to preclude the corruption of evidence.

Both left and right in Hungary have cited Ireland as the example they look to as the way for their future, yet they mistakenly attribute Ireland's economic turn-around to political cohesion in supporting reforms and to a strong state role in supporting industry. As Benjamin Powell has demonstrated in his article, "Economic Freedom and Growth: The Case of the Celtic Tiger," Ireland's turn-around came about because of a convergence of factors that necessitated a radical cutback in the size and role of government. Hungary represents the very opposite. Because of the lack of economic freedom, its economy has stagnated. Not surprisingly, those countries in the region that have performed best have all reduced the role and size of the state, simplified rules and regulations, lowered taxes, and generally created an environment that is more conducive for business and innovation. Hungary may yet go the way of Ireland, introducing reforms resulting in greater economic freedom not out of any deep-seated commitment to free market principles, but rather out of dire necessity in order to avoid a complete collapse of the economy.