

Hungary: From Star Transition Student to Backsliding Member State

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Abstract

This article investigates the reasons behind the recent backsliding of Hungary in terms of economic performance. Special focus is given to its membership of the European Union's common market, the introduction of the euro, and the reform steps taken by various government administrations in recent years. The article also makes statements about Hungary in relation to the 'varieties of capitalism' debate.

Keywords

Hungary; capitalism; economic performance; eurozone; reforms; dependent competition states; privatisation; transition; Central and Eastern Europe

HUNGARY WAS HERALDED THROUGHOUT THE 1990s AS THE STAR STUDENT OF transition and was widely expected to be one of the economies amongst the new European Union (EU) member states that would come out as a clear winner of the transition to a market economy and entry into the EU. Yet lately Hungary has become one of the laggards of the region, with the economy underperforming heavily. This paper argues that the apparent backslide of Hungary is important because it took place not only due to mismanagement by the political elite of the country. Policy inadequacy and populist politics naturally did play their part, but what Hungary's recent relapse really demonstrates is the limits of the long term sustainability of what was the *sui generis* ideal type of a liberal transition economy.

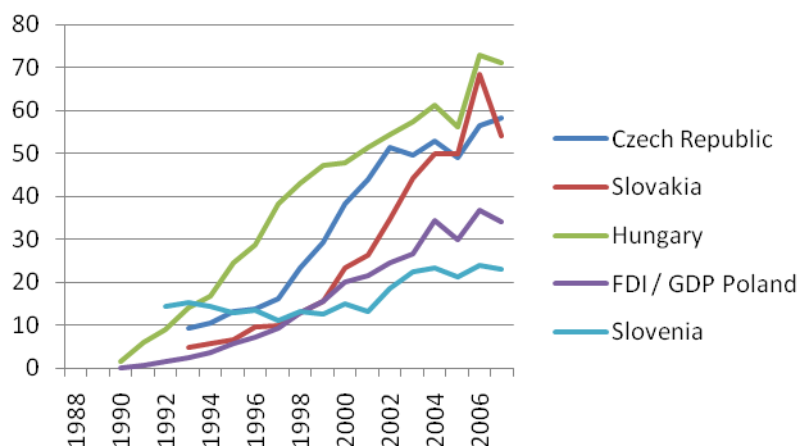
The liberal dependent competition state model of transition

The origins of the current crisis can be traced back into the dying decades of communism. Hungary was already a rather 'liberal' state prior to transition. In parallel with its relative political openness during the pre-transition communist period (famously dubbed 'goulash communism'), Hungary had already also introduced a fair degree of economic liberalism into the functioning of its essentially Soviet style economic system. After the halted New Economic Mechanism (NEM) (see Csaba 2005: pp. 273-276) of the 1970s came the loosening of economic control in the 1980s. Private enterprise was allowed in certain segments of the economy, and foreign investors were encouraged to enter into joint ventures with ailing Hungarian state owned firms. Thus by the beginning of transition Hungary was already the single economy in the region with most experience of involving outsiders in rejuvenating its industrial base (see Bruszt and Stark 1998: p. 54).

A second reason for the marked openness and strong outside orientation of Hungary was the enormous foreign debt it had accumulated in the last decades of the communist era. In contrast with some countries of the region that came out of transition with negligible foreign debt (Romania, the Baltic states, or Slovenia), and others that had a manageable foreign debt burden (Czech Republic, Poland, Slovakia), Hungary was very heavily indebted. Thus on top of the quasi bankruptcy of state owned firms in the late eighties there was also the issue of the crippling foreign debt.

These two reasons together led to Hungary become an early *de facto* model for outward oriented economic transition. While at the beginning of the nineties other states in the region were all experiencing with some inward oriented, coupon based scheme initially, Hungary never introduced such a design, and was well on its way to attracting significant amounts of foreign direct investment (FDI) through an FDI based direct privatisation strategy (Sass 2004). With the lack of domestic investment capital being the central justification, the state auctioned off assets to the highest bidder, who quickly turned out to be foreign investors. These transnational firms later went on to initiate greenfield investments in Hungary as well, which successive Hungarian governments welcomed as a reassuring sign of the attractiveness of the Hungarian economy, as well as proof of rapid, thorough and successful transition. Hungary used investment promotion systems such as heavy state subsidies (Sass 2003, 2004), tax exemptions and special industrial zones extensively to make itself more attractive, on top of its low wages and geographical proximity to the core of Europe. Trade union rights were also deliberately codified to be weak. In this light it is not surprising that by the middle of the decade ten million strong Hungary managed to attract as much foreign investments as all the other countries of the former Communist Bloc taken together – a fact much propagated by governments in Budapest.

Figure 1: FDI stock accumulation in Hungary in contrast to other countries of the region

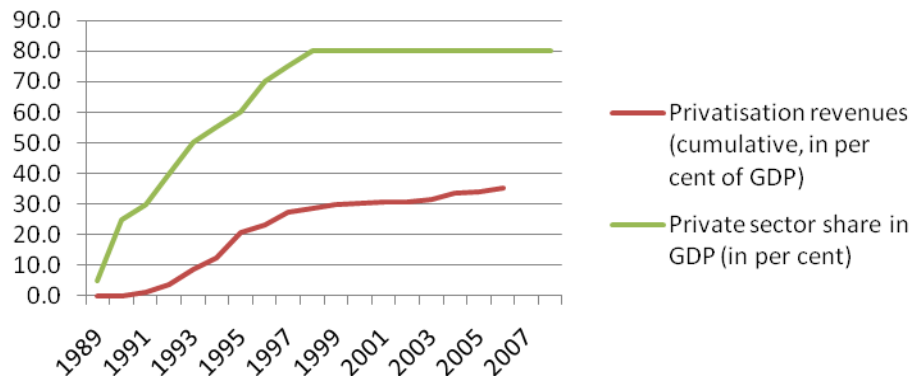


Source: UNCTAD (2008)

As Figure 2 (below) demonstrates, by 1998 Hungary had privatised 80 per cent of its economy, which is considerably higher than similar rates in Central and Eastern Europe, and even higher than the relevant rate in most Western European economies. Hungary was also unique in receiving steadily increasing revenues from privatisation right from the start of transition in 1991. Privatisation revenues only really began to trickle in from 1997 in most other transition economies. Hungary was successful in collecting an amount approximating one third of its GDP by the end of transition. (Much of this was used to pay

off some of the country's enormous foreign debt.) This rate is also considerably higher than similar rates in the region: approximately 25 per cent in the Czech Republic and Slovakia, 14 per cent in Poland, and 6 per cent in Slovenia.

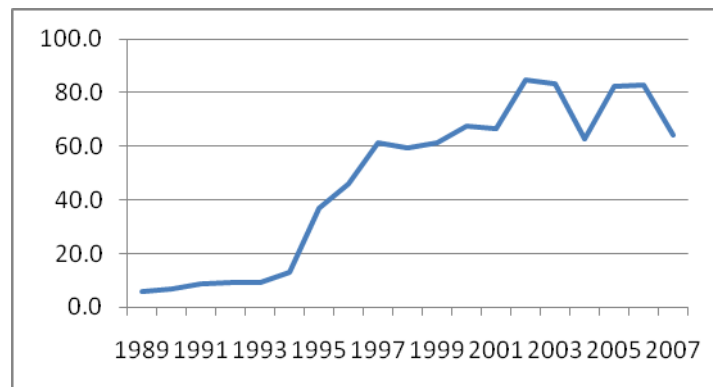
Figure 2: *Privatisation revenues and the share of the foreign sector in Hungary*



Source: EBRD (2009)

The banking sector was also quickly liberalised and made open for foreign investors, resulting in an extreme case of foreign domination in both Western and Eastern European terms. This was later emulated by other countries of the CEE region (Claessens *et al.* 1998).

Figure 3: *Asset share of foreign owned banks in the Hungarian economy, percentages*



Source: EBRD Structural Indicators (2009)

All these achievements were mirrored by institutions such as the International Monetary Fund (IMF) or the European Commission back to the region as a model case, a star student. It was being promoted (along with Poland initially) as the leading transition state by the 'Washington consensus' institutions, it was accepted to be in the first group of countries negotiating for membership by the European Commission. Even Hungary's own governmental administrations during this time period and the electorate were fully confident, based on all the positive Western feedback, that Hungary was the most daring former socialist state, fully embracing a private economy and opening up without second

thoughts to economic globalisation, while other states across the region appeared to be wasting time with domestically oriented alternatives that would not work. For example, when the Czech Republic was going through the crisis of the Klausian bank based privatisation scheme and Slovakia was struggling with the crippling political and economic conduct of Vladimir Mečiar, Hungary was proclaimed to be on a steady path to economic growth based on an almost completed transition. One glance at the so-called Transition Index of the European Bank for Reconstruction and Development (EBRD), a complex indicator of transition countries' performance in eleven key areas of transition reform, reveals how Hungary was the star student of the nineties:

Table 1: *Leading country in the EBRD's Transition Index*

Year	Leading country
1991	Poland
1992	Czechoslovakia
1993	Czech Republic
1994	Czech Republic
1995	Hungary
1996	Hungary
1997	Hungary
1998	Hungary
1999	Hungary
2000	Hungary
2001	Hungary

With the collapse of internally oriented privatisation schemes, essentially all other states (with the notable exception of Slovenia) began to follow the 'Hungarian way', the model that can retrospectively be called the sui generis 'dependent competitive state'. This model does not fit any previously identified social or economic ideal type within the 'varieties of capitalism' debate (Shonfield 1965; Moerland 1995; Hall and Soskice 2001; Amable 2003), such as Liberal Market Economies (LMEs) and Coordinated Market Economies (CMEs) (Hall and Soskice 2001); Continental, Social Democratic or Mediterranean Models (Amable 2003); Market/Managed/State Capitalism (Schmidt 2002); or Germanic/Latinic/Asiatic subgroups (Moerland 1995). The defining features of dependent capitalism are twofold. Firstly, it is dependent upon capital and firms from other regions of the world, attempting to make use of foreign direct investment, multinational production chains, portfolio capital, and a foreign owned banking system to create economic growth for the domestic population. Secondly it is a competitive state, whose long term strategy is to create the conditions necessary for accommodating foreign investments (low wages, weak trade unions, direct state support, tax breaks, infrastructure), and is not interested in developing evidence based, monitored policies per se in employment services, education, RandD, social policy and inclusion, infrastructure, or elevating the domestic part of the economy. It perceives all these policies to be the resultant of investment promotion from abroad. As a consequence the decisive industrial relations are between managers of domestic subsidiaries with top level management of the firm abroad, as well as central government officials with the same group.

The concept of the 'competition state' was developed by Philip G. Cerny (2007), who used it to describe how former Western welfare states have attempted to react to what they perceived as the challenges and 'realities' of the globalised economy. The dependent form of the competition state is one where domestic economy had not gone through previous stages of capital accumulation and the formation of domestically based transnational firms. Instead, it has relied on foreign direct investment (Hunya 1998; Kalotay and Hunya

2000), portfolio capital and a foreign owned financial system for competing in the globalised world. In addition to access to financial development capital, they have taken advantage of the know-how, technology and network-type social capital of transnational production networks (Sturgeon 2001) and their value chains (Dicken 2004: 14-16). The aspect of this outside reliance makes them 'dependent' on outside resources.

Central European economies are not Liberal Market Economies, primarily because they lack the substantial autonomous domestic sectors that would make decisions based on market mechanisms. In addition, most subsidiaries are manufacturing and assembly bases for re-export to the parent company, who will sell the final products abroad. Therefore the key management decisions and functions do not take place within the economy, but abroad.

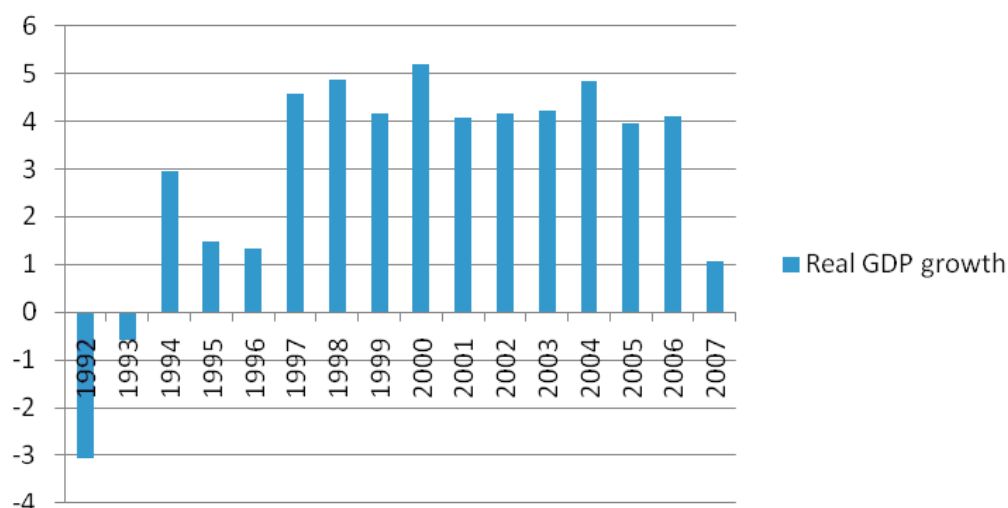
CEE economies are also not Co-ordinated Market Economies. In spite of the geographical and cultural proximity of Germany and Austria they have not established the distinctive institutional arrangements of a CME. Associations of both employees and employers are weak, trade unions are at a firm level, and there is no industry level bargaining or *mitbestimmung*. Groups of companies are not created, given their essentially foreign origin. Banks are also dominantly foreign owned, and therefore do not play a role as investors and stakeholders in company development. Central and subnational levels of government also do not think it should be their function to hold a stake in private enterprises.

Central European economies (with the single exception of tiny Slovenia) can best be described as dependent competition states, and Hungary was the early forerunner of this strategy from the middle of the 1990s, as a neoliberal transition state (Drahokoupil 2008: 36). After brief attempts at domestically oriented privatisation, based mostly on voucher schemes, all states of the region abandoned these alternatives and turned to towards the Hungarian model, which seemed to them to be outstandingly successful at the time. Central European reforms have always been understood by both the countries of the region themselves, as well as the international institutions as a sort of race. Which country will attract most FDI? Which one will complete its transition before all others? Which one will reach its 1989 GDP levels first? Who will be a European Union member state and who will be left out? Which countries will introduce the euro before everyone else, and which ones will lag behind and be symbolically shamed and exposed to the mistrust of the international financial markets? The Hungarian model offered a chance for rapid and efficient transition that many leaderships in the region have embraced in the region, perhaps most successfully Slovakia after 1998 and Bulgaria after 2007, but also for the Czech governments after Klaus and various others across the region. The model offered a chance for governments to demonstrate visible economic success, measured in terms of macroindicators such as GDP growth or FDI inflow itself (with other crucial indicators such as real wages or employment levels being represented as 'long term' ones). The model also represented a vindication of very goals that Washington consensus institutions promoted: privatisation, deregulation and opening up to free trade. While these institutions played a very positive role in serving as anchors of fiscal stability in a high debt country with a political elite bent on fiscal irresponsibility, some other economic issues were clearly ignored by them. The IMF and the World Bank have repeatedly declared that domestic economic structure (the weakness of the domestic part of the dual economy, low employment, the low value added presence of FDI) and integration into the global economy (as a low value added periphery) were matters of domestic policy that the international financial institutions will not be concerned with. They also made it clear that they will not be drivers of internal structural adjustment, and have tended to accept suboptimal proposals for this from governments, as long as their declared goals of fiscal stability, deregulation and privatisation were adhered to. Theoretically the European

Commission did have the mandate of assessing whether the new Eastern European entrants had a 'competitive economy that could withstand the pressures of the internal market' according to the Copenhagen entry criteria, and was not simply to negotiate on the *acquis communautaire* of the EU. However, the Commission represented the governments of Western, Northern and Southern European states, whose corporate sectors were pressing for an opening up of Eastern Europe for free trade and the free movement of capital, seeing it as an opportunity to create a low wage re-export production platform. Therefore, the Commission never concerned itself with a more balanced economic development model, and accepted the FDI based model as the muster. And the muster was indeed implemented more or less everywhere, with the possible exceptions of Poland, which was simply too large geographically, with Western interest limited to its Western regions only, and Slovenia definitively, which deliberately opted for a different development model. As we shall attempt to demonstrate at the end of this paper, a possible failure of the Hungarian model must therefore serve as a warning sign for all of the other states in the central and Eastern European region.

The model produced tangible results at first. Enterprise restructuring was fast, as the theory suggested. Growth began to pick up, and there was some job creation as well in the late nineties. All in all, the model produced a certain degree of economic recovery, based on extensive exports mainly to the single internal market, chiefly by the local subsidiaries of the multinational firms. Hungary managed to achieve an 80 per cent exports to GDP ratio, making it a very export oriented country. In 2007, approximately 79 per cent of exports went to EU27 states.

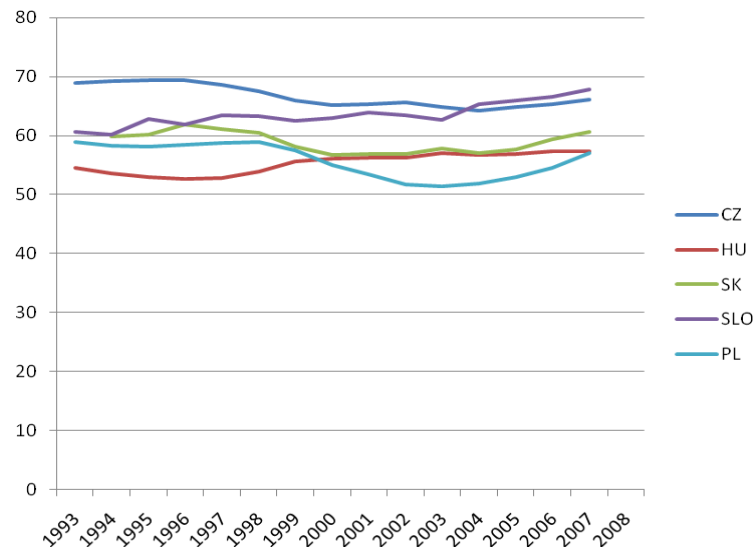
Figure 4: *Real GDP growth in Hungary*



Source: OECD (2009)

Employment in Hungary was at a lower level than elsewhere at the time of transition, but this particular feature of the Hungarian economy was not considered to be important and was rather overlooked. It was believed that statistical data collection in the first phase of the transition was inaccurate and unreliable, and that employment would eventually pick up with the inflow of FDI, as firms would resolve operation.

Figure 5: *Employment rates in Central and Eastern European countries after transition*

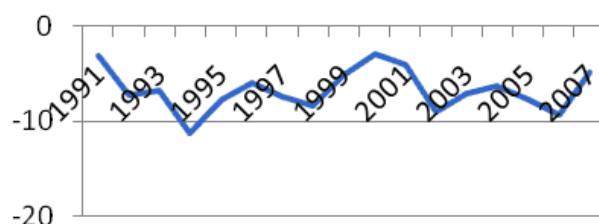


Source: OECD (2009)

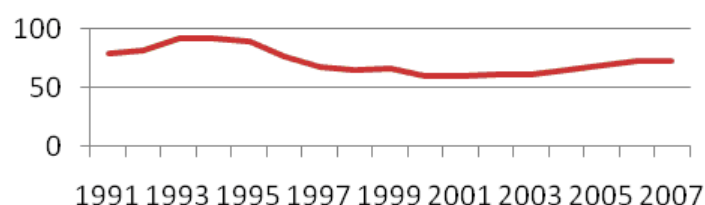
These beliefs were initially confirmed, as the employment loss of the first few years was recovered in the following years. Incidentally, employment never really increased thereafter, and remained significantly lower than elsewhere in the region. This fact was once again overlooked, due mostly to the favourable unemployment rate of Hungary in this period at 5-6 per cent, much lower than the EU average. In terms of the complete picture on the labour market, the low unemployment rate of course concealed the very high ratio of dependent population. (It is also interesting to notice that the U-shaped shredding-reabsorption curve in employment was repeated elsewhere in the region at later stages, when the other countries eventually also opted for FDI based transition á la Hungary. Poland and Slovakia clearly illustrate this trend.)

The euro and the global financial crisis: The breakdown of the model

Hungary was feeling comfortable at the head of the pack around the turn of the millennia, with its prospects for high economic growth about to be enhanced by certain EU membership by 2004. Then suddenly something began to go wrong. The post accession commitment of entry into the eurozone made it obvious for the Hungarian elite that there are certain problems with the stability and the sustainability of the Hungarian model. The first target year specified for the adoption of the euro had been 2006. This would have meant immediate entry into ERM2 after accession in 2004. However, with the passage of time this target date began to be considered unrealistic. It was revised over and over, pushed back in time continuously as the country began to find itself in a continued state of macroeconomic instability. With the arrival of the global financial crisis Hungary was swept into such deep economic difficulties that the government (and market analysts) stopped speculating about possible target dates. Hungary, once the leader in economic reforms in the region, found itself very deep economic difficulties. The criteria of the stability pact seemed further and further:

Figure 6a: Budget deficit in Hungary during the post-transition period (% of GDP)

Source: OECD (2009)

Figure 6b: Budget deficit in Hungary during the post-transition period (% of GDP)

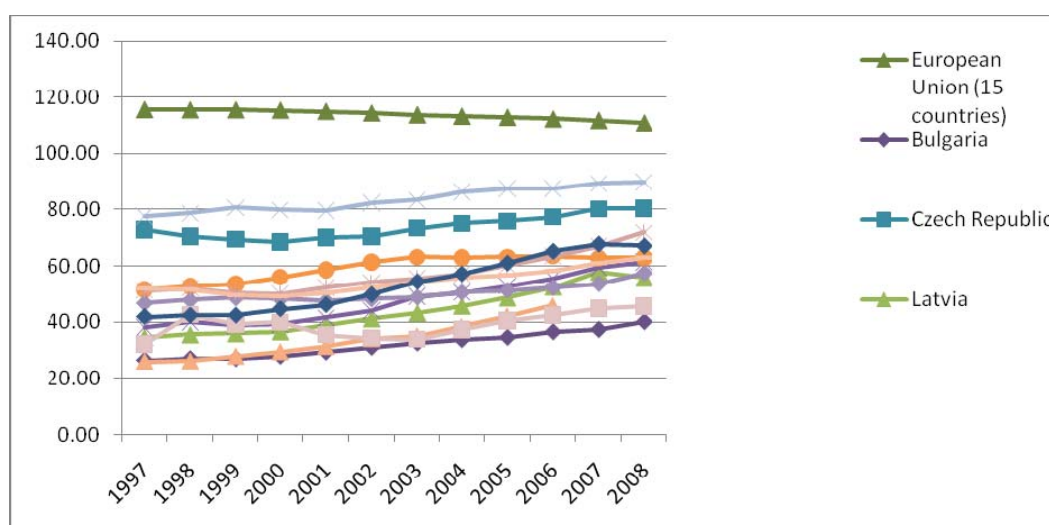
Source: OECD (2009)

As budget deficits began to reach outstandingly high levels in an EU comparison, the country began to accumulate foreign debt again. Having once decreased its exceptionally high levels of foreign debt in the transition period from privatisation revenues, the high budget deficits run by the governments after 2001 led to the re-accumulation of outside debt. Together with high inflation and interest rates, this led to Hungary becoming the only country in the region which did not fulfil any of the four criteria of the Stability Pact. While Slovenia and Slovakia were already introducing the euro in 2007 and 2009 respectively, and other states were well on their way, Hungary was left in the uncomfortable position of a laggard. In addition, the government was unable to meet even its own Convergence Plan for a number of years after EU accession. This left the European Commission in the difficult position of having to consider putting Cohesion Fund resources on hold for Hungary. The disciplinary measure was eventually never initiated, as the Commission went into extensive length to negotiate with the Hungarian government and to restore confidence in the member state on the markets. The Convergence Plan has therefore served as an important anchor to help facilitate fiscal stability in a new member state which otherwise is likely to have been even more imprudent. It is important to mention in this respect that the government was re-elected in 2006 after what *The Economist* called "...the worst mismanagement of public finances anywhere in post-communist Europe" (*The Economist* 2006). This indicated to the political elite that the electorate was not a hard constraint to fiscal imprudence. Another duress could have been a collapse of the national currency, however as long as there was an oversupply in global liquidity on the international financial markets, the Hungarian forint also remained strong. Thus the disciplinary stance of the European Commission remained the only significant force for member states politicians to reckon with.

The re-accumulation of outside debt was coupled with the slowdown of growth. While the initial years (1996-2003) after privatisation and restructuring had produced remarkable

economic growth, and therefore catch up, from 2003 on Hungary became the only country in the region not in the process of narrowing its GDP gap vis-à-vis the European Union average. In fact it has been drifting further and further away from it in recent years, with a number of countries such as Estonia and Slovakia overtaking Hungary in terms of GDP per capita. This has clearly been a disappointment for society in general, who voted overwhelmingly in favour of EU accession in the hope of rapid economic convergence. The slow economic growth also helped exacerbate problems with the 'debt to GDP ratio' criterion for eurozone accession, where the GDP level serves as the denominator.

Figure 6: GDP per capita as a percentage of the EU average (=100%) in the new member states of the European Union, PPS, EU27



Source: Eurostat (2009)

The leading intellectual elite found it difficult to believe that anything could be wrong with the eminent economy of the region that had so often been praised in the past. It was clear that the central budget was heavily out of balance. At first this was believed to be simply due to the populist bargaining of the two political parties that dominate the scene in the country. This was definitely a contributing factor. As can be observed in Figure , budget deficits rose to record high levels in and around election years (1998, 2002, 2006). This essentially means that the political elite has been attempting to buy the votes of the electorate in elections to the detriment of fiscal sustainability in a country where high indebtedness has been a defining feature of economic problems for decades. Perhaps the most glaring example of this high degree of irresponsibility can be found in the institution of the "13th month pension", introduced by Prime Minister Péter Medgyessy in 2002 before the local elections in the fall of that year. The pay as you go state pension system is in fact unable to finance even the 11th and the 12th months of pensions due to a low level of inward payments, and has to be complemented from the state budget. In spite of this, it took some seven years for the government to scrap this clearly unsustainable and politically motivated institution altogether. The leader of the leading opposition Fidesz Party, Viktor Orbán, even proposed the introduction of a 14th month pension in the 2006 parliamentary election¹, taking populism to new extremes. This competition in demagoguery between the parliamentary parties led to a continuation of high fiscal deficits throughout the period, dubbed by domestic economic commentators as "fiscal alcoholism". Naturally amidst conditions of fiscal irresponsibility the monetary side of economic policy was very

¹ "Orbán 14. Havi nyugdíjat ígér" Hungarian News Agency, 2006.01.20.

limited in its options. Since there was no agreement on the right fiscal-monetary mix between the government and the central bank, monetary policy was drawn into the political arena, with a protracted battle waged between the two sides that drew attention away from the more important issues of fiscal responsibility and structural reforms.

Later it had to be accepted that the problems went deeper. The entire functioning of the state needed a revision. Economists and business analysts began to talk about the need for a 'state reform'. It began to be acknowledged that the state was still functioning at the level of efficiency of the 1970s, while trying to meet the global challenges of the post-2000 era. Yet it was maintained that there was nothing wrong with 'the economy' itself. As if the functioning of the economy could be separated from that of the state. In the modern world, where half of GDP is redistributed by the state, and where governments essentially macromanage economic life through fiscal and monetary policy, the two domains have a relationship like milk and coffee in a latte. As an example, public procurement and large scale public investments are amongst the most problematic elements of the economies of new democracies in Eastern Europe from a public efficiency point of view. However, there were obviously serious problems with the non-state part of the Hungarian economy as well. The surest sign of this was the strikingly low unemployment rate, one of the lowest in the OECD. How could an economy be doing fine if it was not providing enough work for society?

What was impossible to swallow for the elite in Hungary was the fact that there was a fault with the entire economic model of transition. Hungary had embraced economic globalisation at such a speed that the reflexive capabilities of the state were unable to follow the developments. In fact there was even a high level of consensus that there was no need to develop such capabilities. After the collapse of communism, disillusioned intellectuals switched from believing in the omnipotence of the state to the omnipotence of the markets. There was, and still is, a very strong neoliberal underlying consensus in the political elite of Hungary. The logic was that Hungarian state owned firms had neither the capital, nor the know how to re-emerge in a Baron Münchhausen fashion from the economic collapse of the eighties. Foreign ownership was seen as highly beneficial, resulting in a swift and thorough transition.

The Socialist-Liberal coalition led by Ferenc Gyurcsány (2004-2009) attempted to carry out certain reforms of the state. It is difficult to summarise these reforms, as there wasn't a single political or policy document summarising the steps to be taken during this period. As critics have observed (*HVG* 2008.), some eight different action programmes were compiled during Gyurcsány's two half terms as Prime Minister. These policy drafts ranged from neoliberal reformist through third way social democrat to purely populist. The period can best be characterised as governance through public relations. A well selected team of experts in the Prime Minister's Office monitored public opinion for possible policy steps, and the prime minister constantly went public claiming that reformist measures cannot be introduced due to "a lack of popular support". An institutional centre within the central government for the coordination of these reform programmes was also never found. Perhaps the best summary of the most important steps taken can be found in the Convergence Plan submitted to the European Commission, which became the de facto key policy document in a rather turbulent period of governance. The Plan is a rather incoherent document containing small scale and large scale reforms alike, without a real overarching narrative. Parametric changes included for instance the introduction of hospital visit fees (at roughly one euro per visit), as well as the school fee for university students. The most important of all paradigmatic changes was to take place in the health sector, which was to be partially privatised in the domain of insurance firms. It never became entirely clear why the governing coalition chose this particular sector of the operation of the state to initiate the first major, truly paradigmatic reforms. Unlike the tax

system, labour market institutions, or education, healthcare is a residual area of central budget expenditure that only very indirectly influences the competitiveness and the performance of an economy. Yet it was in this area where the coalition threw in its weight and passed an Act in Parliament. However, the main opposition party Fidesz ran a successful referendum campaign in the spring of 2008 against these changes and reform, and even the above mentioned steps had to be revoked.

The main problem with the reforms during the Gyurcsány period was that they never came together into a complete and coherent strategy. Secondly, they failed to touch upon the central weaknesses of the Hungarian model. The Hungarian economy can be characterised as a dual one, with a weak domestic sector and a strong and dynamic multinational one. The inflow of foreign direct investment had made Hungarian transition smoother than it would otherwise have been. However, this multinational sector has been providing overwhelmingly low value added jobs, forcing Hungary to compete with low wages in the global economy. With EU accession the country became a cheap re-export base for Western European multinationals. Thus we take an alternative view to Greskovits (2005) and Greskovits and Bohle (2006) who prefer to look at the sectors in which integration into global production chains took place. Greskovits for instance is then prompted to differentiate in the region between a Visegrád semi-core, and a Baltic and Balkans semi-periphery. Exports statistics can be misleading. It is much more the value added within the host economy that matters, rather than the final exports, and this can empirically be demonstrated (Németh *et al.* 2007) to be low in the case of Hungary.

Due mostly to the weak language skills, the deteriorating educational system, tragic health situation and low mobility, Hungary has not been able to upgrade itself and move into higher value added sectors. An additional problem has been the low employment potential of the Hungarian model. As can be observed from Figure 5, Hungary came out of communism already with a lower employment potential than the rest of the pack, and although the inflow of FDI helped create some additional jobs, the country has since never really managed to catch up even with the level of other economies in the region. It is also very far from the average level of employment in the EU, which is itself behind the considerably higher US level, as the analysis behind the Lisbon strategy outlines. Thus Hungary has been amongst those member states who have contributed the least to the success of the Lisbon strategy. In spite of spending roughly €1.5 million annually on job creation from the European Social Fund and domestic sources (on top of the educational budget), Hungary has not produced any significant result in job creation, and the situation has even deteriorated with the arrival of the financial crisis.

The low employment potential of the Hungarian economy means that the tax base for personal income tax (one of the key forms of taxation) is very narrow. Thus the tax wedge has had to be very high, reducing Hungary's price competitiveness abroad. Hungary also supports foreign multinationals through tax exemptions and direct government subsidies to an extent that is greater than the amount of corporate tax collected from foreign owned firms. This has placed extra burden on personal income tax payments.

Interestingly enough, economic reform programmes during the Gyurcsány period were initiated from outside the government. One was a much discussed document by the consultancy firm ORIENS (ORIENS 2008.), which correctly identified low employment as the key predicament of the Hungarian economy. The other major set of recommendations came from a civic organisation of reform minded researchers and public figures, known as the Reform Union (*Reformszövetség*) (Reform Union 2009.).

In the autumn of 2008 the global economic crisis hit Hungary on top of the already prevailing domestically manufactured economic hardships. As we have already

mentioned, Hungarian policymakers could continue their imprudent fiscal policy as long as there was enough liquidity in global financial markets for Hungary to borrow. The amounts thus raised were used to pay incurring interest on state debt, to renew the debt, and to finance open market intervention in defence of the Hungarian forint by the National Bank. As late as the 6 October session of the Hungarian Parliament, Prime Minister Gyurcsány was reaffirming that Hungary would only be affected by “side winds of the global crisis”, and accused those more concerned of being “prophets of the crisis” (Gyurcsány 6 October 2008). However, only a few weeks later global liquidity did eventually dry up. It became more and more difficult to sell Hungarian state bonds to investors, with the interest rate on 12 month bonds rising to 12.76 per cent by the auction day of the 13 November 2008 (Hungarian National Bank 2008). Thus raising financing from the market became impossible, and Hungary had to turn to the International Monetary Fund (IMF) for help. The IMF, together with the World Bank and the EU, offered a 17 month stand-by loan of €20 billion, as part of its package to help states hurt by the global financial crises. The loan enables the rollover of debt in this period, but it is tied to strict criteria such as a sharp reduction of government expenditure, the restraint of wages and pensions, and a recapitalisation of eligible banks to ensure domestic liquidity. Hungary was the first European Union country to receive such assistance from the IMF and the EU, putting the country into same basket as economies such as Serbia and the Ukraine. Romania, another EU member state later also received such assistance. The IMF loan thus enabled Hungary to survive the immediate effects of the credibility crisis created by the Gyurcsány government, but at an enormous cost to taxpayers. The loan has increased Hungary’s debt burden to well over the 60 per cent margin vis-à-vis its GDP required for eurozone entry, pushing the introduction date of the euro even further away. The European Commission and the Central Bank have repeatedly emphasised that an early entry of new member states under the security umbrella of the euro by relaxing the rules is out of the question.

Gyurcsány eventually stepped down in the spring of 2009 after a long and enduring government crisis, in which the liberal coalition partner, SZDSZ (Alliance of Free Democrats - *Szabad Demokraták Szövetsége – a Magyar Liberális Párt*) left the government, albeit continuing to support it from outside. The position of Prime Minister was taken over by former minister for the economy, Gordon Bajnai. He defined himself as the head of a quasi-caretaker government, and pledged not to run as a candidate in the upcoming 2010 parliamentary elections. Thus his term is limited to barely more than a year, in which he has set out to implement a stabilisation package. His leadership skills surpassed that of his predecessors, and he managed to pass a series of important changes through Parliament. These included the freezing of public sector wages for two years; the elimination of 13th month pensions and wages; a decrease in maternity leave from three years to two; a review of the personal income tax system; and the introduction of the long awaited real estate tax. These are just the most important measures taken in a long line of measures aimed at fiscal stabilisation and compliance with the conditions of the IMF loan.

By being able to push these reforms through a parliamentary majority composed essentially of the same MPs as Gyurcsány’s, Bajnai has in fact provided proof of the immobility and the lack of leadership during the Gyurcsány era. It is important to note, however, that in the midst of sending mixed signals about the measures accepted, the opposition Fidesz party has in fact pledged itself to revoke most of the measures achieved by Bajnai. It is unclear what economic policy Fidesz would follow once in government, which, based on a constant and sizeable lead in polls, is extremely likely to happen after the 2010 elections. The official key policy document of the party, a text entitled ‘Strong Hungary’ is very poor guide to the future policy of the party, once in power. Its leader, Viktor Orbán simultaneously denounces neoliberal capitalism in his political speeches, and at the same time places a reduction of taxes on labour in the centre of his future economic policy for recovery in Hungary.

It is now well recognised by most that the two major political parties, the Socialists and Fidesz have been engaged in symbolic political struggles at a very low intellectual level in the past, preferring power to policy. The inability of the current mainstream political elite to confront real policy issues, and to engineer a major shift in the social and economic situation has led to a very strong showing of the far right in the 2009 European parliamentary elections (15 per cent). On top of their racism and political radicalism, these extremists have successfully portrayed themselves as an anti-establishment party that is willing to face 'the real issues of the population'. Their arguments have been further strengthened by a clear and present prevalence of corruption at various levels of society. According to Transparency International, Hungary is in the middle range of countries in the world in terms of corruption. Its 2008 Corruption Perception Index (Transparency International, 2008) places Hungary in 47th position, down from 36th the previous year, with a grade of 5.1 on a scale of 10. Perceived corruption was increasing in the context of a perceived decrease in the Central and Eastern European context. The Global Corruption Barometer of the same organisation, which relies on representative opinion surveys (Transparency International, 2009), identifies the proximity of political parties, as well as public procurement as the key areas of corruption. 64 per cent of respondents have expressed scepticism about the efficiency of government in tackling corruption, cases of which dominate Hungarian printed and online media.

The sustainability of the 'dependent competition state' model

Even though many Hungarian intellectuals are still not quite ready to accept it, the crisis reveals more than merely the inadequacy and populism of the political elite. It is also a culmination of the weaknesses of the dependent competition state model of transition, of which Hungary has been the pioneering example. The Achilles heel of this model is its dependence on foreign investors, which creates a dual economy of foreign owned and domestically owned sectors. The foreign owned sectors are dynamic, efficient with an enormous export potential, but continue to compete with very low wages in the global economy. The domestic sector continues to be less efficient, and it has demonstrated a limited capacity to take advantage of the increased markets of the European Union's single internal market, the central advantage of membership in the organisation. The dependent competition state model has also demonstrated very limited employment potential beyond soaking up the unemployment created during the economic restructuring process. Hungary was unique in the region in having the lowest employment rate at the time of transition. This was partly due to the unfavourable demographics of the country, partly due to a deliberate strategy of shifting a large section of the population into early retirement and special unemployment benefits (Vanhuyse 2006). Part of the reason was to hide a sharp increase in unemployment due to economic breakdown and restructuring, and move it instead into the less visible and less scrutinised category of inactive, dependent population. Equally important was the desire to reduce the collective protest potential of labour in a very crucial period. This process went hand in hand with the weakening of trade union rights for those were left on the labour market. As a contrast, in the same period the domestically oriented Slovak and Czech governments provided soft credit and subsidies to state owned and privatised firms equally, in order to maintain employment (Drahokoupil 2008: 42.). This domestically oriented strategy failed conspicuously, but it did maintain a high level of employment, as well as the employability of large segments of society. Thus when later Czech and Slovak governments turned towards FDI oriented privatisation and restructuring, it was labour that was freshly shed that was being soaked up by the increase in output during the growth years following FDI based restructuring. As is clear from Figure 5, FDI based transition countries created almost no extra employment above those who had already been employed during the

domestically oriented period prior to opening up towards multinational production chains. Hungary, by contrast, remained unable to increase its employment rate after the end of the transition period. The main reason for this was the lack of employability amongst broad segments of the population who had been allowed to exit the labour market at the beginning and the middle of the 1990s. Unfortunately, most mainstream proposals to overcome the economic difficulties of the country in recent years have focused on tax cuts as their central prescription, referring to an oversized tax wedge on labour as the main reason behind what they correctly identified as being the central weakness of the Hungarian economy: low employment. They have refused to face the fact that an even more serious factor might lie behind this central weakness, namely the low employment potential of the dependent competition state model. The main lesson for the region, therefore, is that a tax race towards the bottom is a short term strategy with questionable effects in the longer run. With the single exception of the Czech Republic, the former Eastern Bloc continues to be a region of lower than average employment within the European Union.

The FDI based liberal transition model is often criticised by the political extreme left as 'selling out to capitalism' and the extreme right as the 'selling out of family silver'. In fact the failure of domestically oriented privatisation strategies ranging from Klaus's Czech Republic (Myant 2003) through Mečiar's Slovakia (Marcincin and Beblavy 2000; MESA10 1999, 1999; Pogatsa 2010) to Tudjman's Croatia, as well as coupon based privatisation elsewhere in the region demonstrate how there was a lack of a realistic alternative during transition. Inferior technology, overreliance on Soviet and Comecon markets, inadequate know how in management and marketing, as well as political reluctance to allow a thorough restructuring have all contributed to domestically oriented attempts to fail. Governments have tended to interfere in the affairs of domestically owned firms by securing them financing from state owned financial systems for restructuring and reorientation strategies that were not always viable. This in turn led to the accumulation of bad debt in the economy. There was also a temptation for clientalism. The only contrafactual, an economy where a domestically oriented privatisation strategy has proved to be sustainable and successful, has been two million strong Slovenia. There the economy has shown solid growth, amidst stable monetary and fiscal conditions, with relatively high wages in regional comparison, and a constantly increasing rate of employment. However, Slovenia is a very special case. It was not part of the Soviet Bloc. Economic transition started decades prior to 1989, with the establishment of a two tier banking system and quasi market conditions. Slovenian firms had been exporting heavily to the West even during Yugoslav times, and were not dependent on their Eastern markets (Piroska and Lindstrom 2007; see also: Damijan and Majcen 2000; Silva-Jáuregui 2004; Simoneti *et al.* 2004; Vodopivec 2004).

Most transition countries found that the involvement of foreign investors was a necessary element of successful transition. Thus privatisation to the outside can be considered a necessary first step. It ensured a more thorough transformation process, provided immediate technology, know-how and marketing by embedding East European firms in the global production networks of transnational corporations. It provided the capital needed for investment. It ensured the revival of collapsed production and provided some work in the economy. Therefore it enabled a much smoother transition to what it otherwise would have been, as many hardships as it caused for millions across the region.

However, the recent economic backsliding of Hungary (and elsewhere) has cast doubt sustainability of FDI based transition. The dependent competition state paradigm has focused on FDI promotion for economic development, and has relied on the same process for traditional roles of the welfare state, such as job creation, social policy and investment into technology. However, it has conspicuously failed in this strategy. With the onset of the

economic crisis, not only portfolio capital and the liquidity of international financial markets dried up, but also the inflow of FDI.

If we conceive of FDI based transition as a first step in transition, we can identify the need for a second one. Rather than reducing the size of the state (expressed in terms of the rate of redistribution within GDP), as is often proposed without any reference to its capabilities, there is a need to increase the efficiency of the state in Central and Eastern Europe. In some policy areas this might result in the withdrawal of the state, in others it might also necessitate a broader role, according to societal necessities as evidenced by policy data. Unfortunately, in contrast to legal harmonisation and capacity building specific to the application of the *aquis communautaire*, the European Union had not initiated efforts to increase the policy capacities of Central and Eastern European would be member states in the period of accession. This lack of transfer in know how related to state capacity was one of the great weaknesses of Eastern enlargement. Thus these states entered the EU with very weak states that are at present incapable of carrying out the great shift that would enable them to upgrade their economies. Such an effort would be targeted at shifting from a low employment / low value added / low wage economy to a high employment / higher value added one with well paid jobs. In order to do this, the state needs to increase its capacity in areas such as employment creation, education, infrastructure and local governance. Such a strategic leap would therefore decidedly overlap with the Lisbon strategy of high employment competitiveness based on ICT society.

At the moment Hungary is the economic laggard of the region. From key economic data it might seem like it is an exceptional case in the region, which in terms of its fiscal alcoholism and the irresponsibility of its governing elite it probably is. However, the global economic crisis is beginning to highlight the weaknesses of the FDI based dependent competitiveness model elsewhere in the region as well. Among the states that have followed similar strategic and are experiencing serious economic difficulties arising from their exposed economic structure are Slovakia, Romania and the Baltic states. Would these states be unable to take the next step forward to a higher value added Western or Southern European style capitalist economy, recent optimistic posterior assessments of Eastern enlargements by European leaders and the Commission could easily prove to be premature.

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