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Large-Scale Transformation of Socio-Economic Institutions - Comparative Case Studies on CEECs. Interim Report

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Large-Scale Transformation of Socio-Economic Institutions - Comparative Case Studies on CEECs

Interim Report

Working Paper no 16

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*Socio-economic Sciences and Humanities Europe
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Abstract

The general idea is to follow the Varieties-of-Capitalism literature on generating indicators on the economic systems actually implemented. However, this literature mostly concentrates on the enterprise (or micro) level in traditional OECD countries, categorizing countries between the extremes: liberal market economies and controlled market economies. It largely neglects the role of the government spending, the transition of former socialist countries and developing countries, and the political process behind the choice of an economic system.

We broaden the perspective by combining the Varieties-of-Capitalism with the Worlds-of-Welfare-States literature in order to provide a comprehensive view on government activities in transition. With the perspective of our contribution to WWFforEurope, we concentrate especially on social welfare, innovation systems, macro stability, and, of course, how these aspects work together (or not) and are explained by the political background.

We will a cluster analysis for OECD and European transition countries and comparative country studies on Slovakia and Hungary. These countries are of special relevance because they represent extreme cases (Slovakia: significant switch in transition path towards star performer, Hungary: muddling towards problem case). One part of the comparative work concentrates on the comparison of Slovakia with other new EU members that also face to challenge of state building after dissolution of one or the other sort (Czech Rep. and the Baltics). The other part of the comparative work concentrates on Hungary in comparison with the other EU-CEECs. A broad based comparison will most likely be possible on available data only. The possibility for deeper qualitative comparisons will have to be determined during the project. The comparative components will focus on the macroeconomic background (Slovakia) and the welfare state (Hungary) respectively.

Cluster analysis (initially foreseen for MS25) and comparative country studies allows us to draw conclusions for the EU by providing a first comparison of the position of CEECs with respect to the “old” EU members, most interestingly the southern crisis countries that are often categorized into a form called mixed market economies with sometimes contradicting institutional set ups. Do CEECs converge towards prototype models or do they (still) constitute own models?

Contribution to the Project

Lessons from CEECs seem to be highly relevant for the transition of the EU towards 2020 goals because of the most profound and ambitious transfer of institutions in recent history which took place in these countries at different speed. Concerning the economic and especially the welfare system, the literature on varieties of capitalism has established two prototypes of capitalism – (LME) and Coordinated Market Economies (CME), a categorization that already divides EU-15 in two groups (anglo-saxon vs. continental). MS23 provides a first set of lessons based on comparative country studies by asking if CEECs are converging towards prototypes of capitalistic systems or rather establish new types of capitalism.

Keywords: EU integration, innovation, innovation policy, institutional reforms, macroeconomic disequilibria, market economy with adjectives, social development, welfare reform, welfare state

Jel codes: P10, P51

1. Introduction

Lessons from EU member countries in Central and Eastern Europe (CEECs) are highly relevant for the transition of the EU towards 2020 goals because of the most profound and ambitious transfer of institutions in recent history which took place in these countries at different speed. Concerning the economic and especially the welfare system, the literature on Varieties of Capitalism (VoC; see, e.g., Hall/Soskice 2001) has established two prototypes of capitalism – Liberal Market Economies (LME) and Coordinated Market Economies (CME), a categorization that already divides EU-15 in two groups (anglo-saxon vs. continental). The interim report provides a first set of lessons based on comparative country studies by asking if CEECs are converging towards prototypes of capitalistic systems or rather establish new types of capitalism.

The general idea is to follow the Varieties-of-Capitalism literature on generating indicators on the economic systems actually implemented. However, the literature on VoC has largely concentrated on leading OECD countries and on micro issues like inter-company relations, corporate governance, training/education, industrial relations. This only touches issues relevant for the design of welfare states and gives rather low weight to government interventions (especially spending). The discussion in the literature on Worlds of Welfare States (WWS; e.g. Esping-Andersen 1990) is still to be integrated. As argued by Kitschelt (2006), there is also a possible or impossible trinity of welfare/equality, innovation/growth, and macro stability. Arguably, welfare/equality is often said to be neglected by liberal market economies, while fiscal stability is not given sufficient weight in coordinated market economies. In addition, the discussion mainly does not consider the context of development and transition.

We attempt to broaden the VoC perspective by a comprehensive view on government activities in transition. At the same time, with the perspective of our contribution to WWWforEurope, we concentrate especially on social welfare, innovation systems, macro stability, and, of course, how these aspects work together (or not).

In order to draw conclusions for the EU we provide a first comparison of the position of CEECs with respect to the “old” EU members, most interestingly the southern crisis countries that are often categorized into a form called mixed market economies with sometimes contradicting institutional set ups. Do CEECs move in this direction or have they avoided possible traps during transition? In Section 2, this will be done on the basis of a macro cluster analysis.

While internationally comparable data provides a solid background for the analysis of economic systems in CEECs, some aspects are to be deepened in comparative country studies. The comparative

country studies with focus on Slovakia and Hungary respectively look at two strikingly different transition paths and at the political economy of building capitalist welfare states from two angles:

- Slovakia, in a way, constitutes a case of shock therapy, disintegration, and, finally convergence, which allows analyzing a possible/impossible trinity in building up a welfare state in a (relatively) low income country. In this country study, the main focus will be on the trinity providing also comparable macro data. It will be possible to analyze to which extent the impact of transition on social indicators is stronger compared to other countries in the region and, consequently, to which extent Slovakia is a specific case.
- Hungary, to the contrary, had a rather favorable starting point as one of the most liberal socialist economies but ended up with rather strong political and economic crises. In this country study, the main focus will be on the link between polity and business, comparing the variety of explanations in the post-socialist context. While the macro trinity issue will be considered as well, the study goes more into details. Because of the qualitative content, comparisons are more restricted and based on the literature.

Section 3 provides the main results of the comparative country study on Slovakia (see also Background Paper 1). Section 4 gives the main results of the comparative country study on Hungary (see also Background Paper 2) but starts out with a discussion on a specific economic model of CEECs (details are to be found in Background Paper 3).

2. VoC and WWS in CEECs – Cluster Analysis

As described and analyzed by the Varieties-of-Capitalism (VoC) approach (see, e.g., Hall and Soskice 2001), different market regimes, i.e. capitalist variations, are characterized by different institutional matrices in the economy. These institutional environments and arrangements provide incentive structures for the behavior of firms, households and also policymakers. Moreover, these different institutional settings reflect, influenced by distinct incentive patterns, different economic and societal preferences with respect to the role of the government in the economy.

The VoC literature classifies market economies into two polar types of capitalism. In Liberal Market Economies (LMEs), coordination is primarily characterized by price signals and formal contracting in competitive markets. In contrast, Coordinated Market Economies (CMEs) are largely driven by specific non-market institutions which play critical roles and influence processes of strategic interaction. This analytical division is conceived as a bipolar continuum on which countries cluster as follows: CMEs include the Scandinavian countries, Continental European countries and Japan. LMEs comprise the USA, the UK, Ireland, Canada, New Zealand and Australia (Hall and Soskice 2001).

Despite increased international competition due to globalization processes as well as despite domestic adjustment pressure due to demographic changes, there has not been a convergence of different economic regimes towards a universal economic order (Schustereder 2010). LMEs and CMEs have adjusted, but not converged. Each regime has largely maintained its peculiarities. This confirms Hall and Soskice's (2001) hypothesis that institutional convergence will be unlikely.

Until recently, however, the VoC literature suffered from two shortcomings: It has concentrated on advanced economies (especially in an OECD context), and, although pointing at the importance of governance issues, neglected the role of the state. However, there is an increasing number of publications which seek to explain capitalist variations in less developed, emerging, or transition economies within a VoC framework (see, e.g., Ahrens and Jünemann 2007, Lane and Myant 2007). In those countries, especially formal institutions tend to change at a broader scale and a faster pace than in the OECD world, and governments have played influential roles in initiating and enforcing formal institutional change. Lewis and Lloyd-Sherlock (2009) find that, for much of the second half of the twentieth century, the economic weight of the state in middle-income Latin American countries (particularly as regards economic outreach and social policy interventions) seemed to approach that of socialist countries in Eastern Europe. At the same time, the overall growth strategies contain a mixture of liberal capitalism as well as an emphasis on state supported late industrialization. Hence, preferences for the mode of governance seem to matter but the policy mix in developing countries may not neatly fit with categorizations established in the VoC discourse.

There are also a few papers which started to focus on the role of the state. Amable and Azizi (2009) and Schustereder (2010) observe that LMEs usually exhibit more limited social protection, while CMEs and particularly social-democratic (Nordic or Scandinavian) welfare regimes are based on governance structures which provide significantly more generous social protection both in kind and monetary terms.

One explanation is provided by a direct link between labour market institutions and the welfare state as analyzed in the literature on Worlds of Welfare States (WWS; e.g. Esping-Andersen 1990). According to Amable and Azizi (2009), the competitiveness of LMEs relies on activities which require workers to acquire general skills. Because of these non-specific skills, workers are conceived to switch relatively easily between jobs. Hence, there is no specific need for protection. On the contrary, the competitiveness of CMEs is typically based on activities which favour the appropriation of firm- or sector-specific skills. In such an environment, a generous social protection system may act (ex-ante) as an incentive for workers to acquire the needed specific skills. Hence, "LMEs (...) sharpened market mechanisms, while ... (CMEs) ... tended to cushion citizens against the effects of market adjustment, moving more slowly to make changes to social protection ..." (Hall and Gingerich (2004: 36)).

There is, however, also an argument which goes well beyond a narrow focus on the welfare system and related spending for social protection. Lijphart (1999) points out that CMEs usually have a consensus-oriented political system, in which large (at times heterogeneous) coalitions ensure government support. Such regimes provide an institutional setting in which vested interest groups participate in, or indirectly influence, policy making. Thereby, interest groups help to generate a consensus between firms and unions to generate, extend, or at least maintain a developed welfare regime. On the contrary, LMEs are often based on majoritarian political regimes that favor two-party political competition as well as a pluralism of interest groups, while a relatively powerful government faces fragmented partners in the social realm. Finally, consensus-based systems with proportional representation may be conducive for a political center-left power which may be more inclined to establish and extend a welfare state regime than a centre-right wing political alliance which frequently exists in systems of majoritarian rule.

Amable and Azizi (2009:4) conclude that the "consequences for macroeconomic policy, and more particularly for social policy, can be exemplified by the 'common pool' problem (...). Indeed, in countries with coalition governments, each member of the coalition may be prone to make public expenditures in different areas towards the specific groups which are supportive of its political party. Hence the tendency to 'overspend' and to produce 'excessive' deficits because of the given levels of governments' resources (...)".

All in all, the literature on VoC has largely concentrated on leading OECD countries and on micro issues like inter-company relations, corporate governance, training/education, industrial relations. This only touches issues relevant for the design of welfare states but gives rather low weight to government interventions (especially spending). The insights of the WWS literature are still to be integrated. More specifically, , as argued by Kitschelt (2006), there is a possible or impossible trinity of welfare/equality, innovation/growth, and macro stability. Welfare/equality is often said to be neglected by liberal market economies, while fiscal stability is not given sufficient weight in coordinated market economies. In the same vein, EU enlargement criteria have also focused on competitiveness and stability in the first place, while – due to a lack of consensus – welfare and equality considerations have not been high on the list of conditions for entry into the EU nor for EU policy as such.

In this paper, we analyze the evolution of economic systems in CEECs, i.e. European transition countries, on the basis of a modified and extended VoC (Varieties-of-Capitalism) approach. Rather than focusing on the micro level, we argue that economic systems are characterized by government activity in spending and/or regulating the economy and that policy should be evaluated in the context of performance. For doing this, we employ cluster analysis for European and OECD countries using broad macro indicators for policy and performance. In addition, we acknowledge for the transition aspect by looking at cluster history, i.e. cluster analysis for different time spans.

As will be seen when discussing the results, emerging clusters are strikingly similar to the traditional ones, suggesting a high correlation between the variables used in these analyses. The use of macro data, however, allows us to include performance variables along the line suggested by Kitschelt (2006). In addition, this allows better cross-country comparisons because of data availability.

We consider three variables measuring government activity,¹

- Overall size of government incl. transfers, government enterprises, tax system, etc.,
- Transfer spending as a proxy for welfare related involvement,
- Government regulations aggregated on the basis of sectoral regulation in trade, labour, capital markets, etc.,

¹ Variables for government activity have been taken from Economic Freedom of the World Report compiled by the Frazer Institute.

As well as three sets of variables measuring whether countries succeeded in achieving²

- Equality in income as measured by the GINI index,
- Stability measured by using fiscal debt, and
- Welfare in terms of income perspectives, measured by innovation capacity.

An important issue concerning the CEECs is of course convergence. This implies that, contrary to the traditional OECD analysis, we assume that cluster patterns may change over time with CEECs either forming own clusters or integrating themselves into OECD or Western EU clusters. Hence, different to other studies, we define periods for which we average our variables and provide a cluster history by performing cluster analysis for all periods in order to reveal potential convergence. Finally, principal component analysis reveals, which variables are driving the cluster results.³

Figure 1 – Clusters of Liberal and Coordinated Market Economies, 2007-09 (period average)

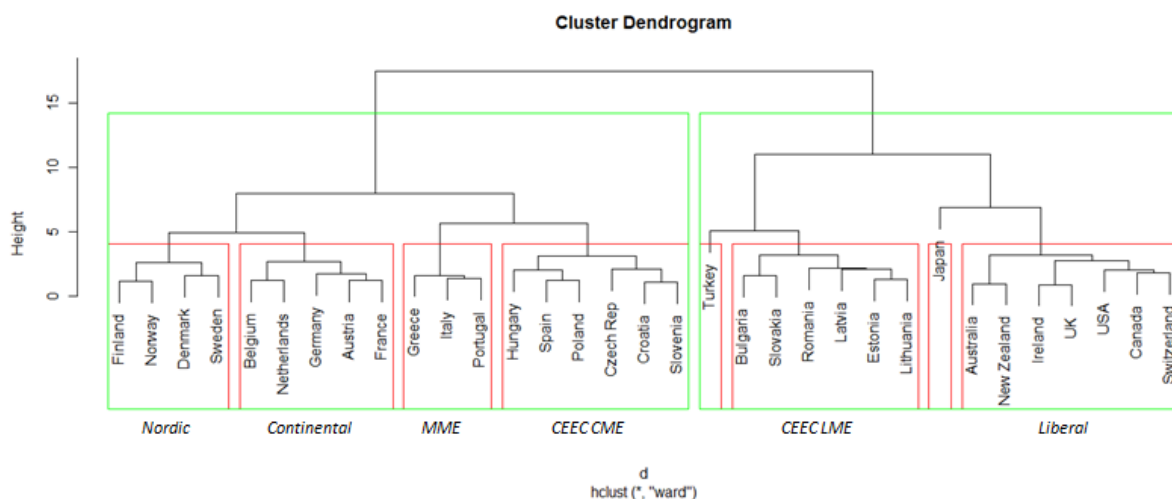


Figure 1 shows the result of the cluster analysis for the most recent period, for which a full set of data was available. A first answer to the question whether or not there is a specific economic model for the CEECs is that it depends. If one allows for a level of heterogeneity where different varieties of coordinated market economies are to be distinguished, CEECs still form separate groups and are not integrated into the traditional OECD clusters. It is interesting to note that the macro level analysis is able to reveal the clusters highlighted in VoC and WWS literatures. Hence, there is a distinction

² Data for performance variables is taken from World Bank (World Development Indicators in case of GINI index; KAM database in case of innovation variable).

³ Concerning the Cluster Methodology 'Euclidian Distance' and the 'Ward Method' were chosen as dissimilarity measure and clustering algorithm.

between three “traditional” groups of CEECs: Nordic, Continental, and MME, i.e. the Southern Europeans (except Spain). These groups are distinct from the Liberal group of LME countries.

The macro analysis also reveals, however, that there are two distinct groups of CEECs, which cluster either with the CME-groups or with the LME-group. The fact that CEECs form two groups is also robust to the use of alternative performance variables but the distinction between a coordinated and a liberal group is most pronounced when using a forward looking measure of performance, i.e. innovation capacity. At the same time, and this is the second answer to the question about a separate CEEC-model, moving up the cluster tree shows the integration of CEEC-groups with traditional groups. Hence, on a level of heterogeneity at which the traditional OECD world is divided into only two groups - CME and LME – CEECs become integrated (see Background Paper 3 for a more detailed discussion).

Table 1 – Cluster History, 1995-2009

	07-09	04-06	00-03	95
Australia	Liberal	Liberal	Liberal	Liberal
Canada	Liberal	Liberal	Liberal	Liberal
Ireland	Liberal	Liberal	Continental	Liberal
New Zealand	Liberal	Liberal	Liberal	Liberal
Switzerland	Liberal	Liberal	Liberal	Liberal
UK	Liberal	Liberal	Liberal	Liberal
USA	Liberal	Liberal	Liberal	Liberal
Japan	Outlier 1	Outlier 1	Outlier 1	Outlier
Austria	Continental	Conti/MEEC	Continental	Conti/Nordic
Belgium	Continental	Conti/MEEC	Continental	MME 2
France	Continental	Conti/MEEC	Continental	Conti/Nordic
Germany	Continental	Conti/MEEC	Continental	Conti/Nordic
Netherlands	Continental	Nordic	Continental	Conti/Nordic
Denmark	Nordic	Nordic	Nordic	Conti/Nordic
Finland	Nordic	Nordic	Nordic	Conti/Nordic
Norway	Nordic	Conti/MEEC	Nordic	Conti/Nordic
Sweden	Nordic	Nordic	Nordic	Conti/Nordic
Czech Republic	CEEC CME	Conti/MEEC	CEEC CME	CEEC CME
Slovenia	CEEC CME	Conti/MEEC	CEEC CME	CEEC CME
Croatia	CEEC CME	Conti/MEEC	MEEC LME	
Hungary	CEEC CME	Conti/MEEC	Nordic	Conti/Nordic
Poland	CEEC CME	MME	CEEC CME	CEEC CME
Slovakia	CEEC LME	CEEC LME	CEEC CME	CEEC CME
Estonia	CEEC LME	CEEC LME	Baltics/ESP/PT	CEEC LME
Latvia	CEEC LME	CEEC LME	Baltics/ESP/PT	CEEC LME
Lithuania	CEEC LME	CEEC LME	Baltics/ESP/PT	CEEC LME
Romania	CEEC LME	CEEC LME	CEEC LME	CEEC LME
Bulgaria	CEEC LME	CEEC LME	CEEC LME	MME
Greece	MME	MME	MME	MME
Italy	MME	MME	MME	MME2
Portugal	MME	MME	Baltics/ESP/PT	MME
Spain	MEEC CME	MME	Baltics/ESP/PT	MME
Turkey	Outlier 2	Outlier 2	Outlier 2	

As mentioned above, convergence is an important topic when talking about CEECs. Hence, cluster analysis was performed for the periods 2004-06, 2000-03, and for the year 1995 representing the first data available for our government variables. Table 1 reveals some rather stable groups but also convergence as well as divergence. The most stable groups are the Liberals, both traditional LME countries and the more liberal CEECs, mainly the Baltic countries. This also applies to a core group of Continental countries – Austria, France, Germany, and, to some extent, Belgium and the Netherlands, and, for most of the time, for the MME group consisting of Southern European countries.

Interestingly, and consistent with reform efforts in the region, the Nordic group diverged from a joint cluster with Continentals after 1995. For the group of CEECs, which tends towards a coordinated economic system, some convergence towards the Continental group happened in the context of accession. After the period 2004-06, however, these CEECs separated forming an own cluster. Overall, it seems that the distribution into clusters seems to be stabilizing somewhat but it is still too early to conclude that CEEC clusters will remain stable.

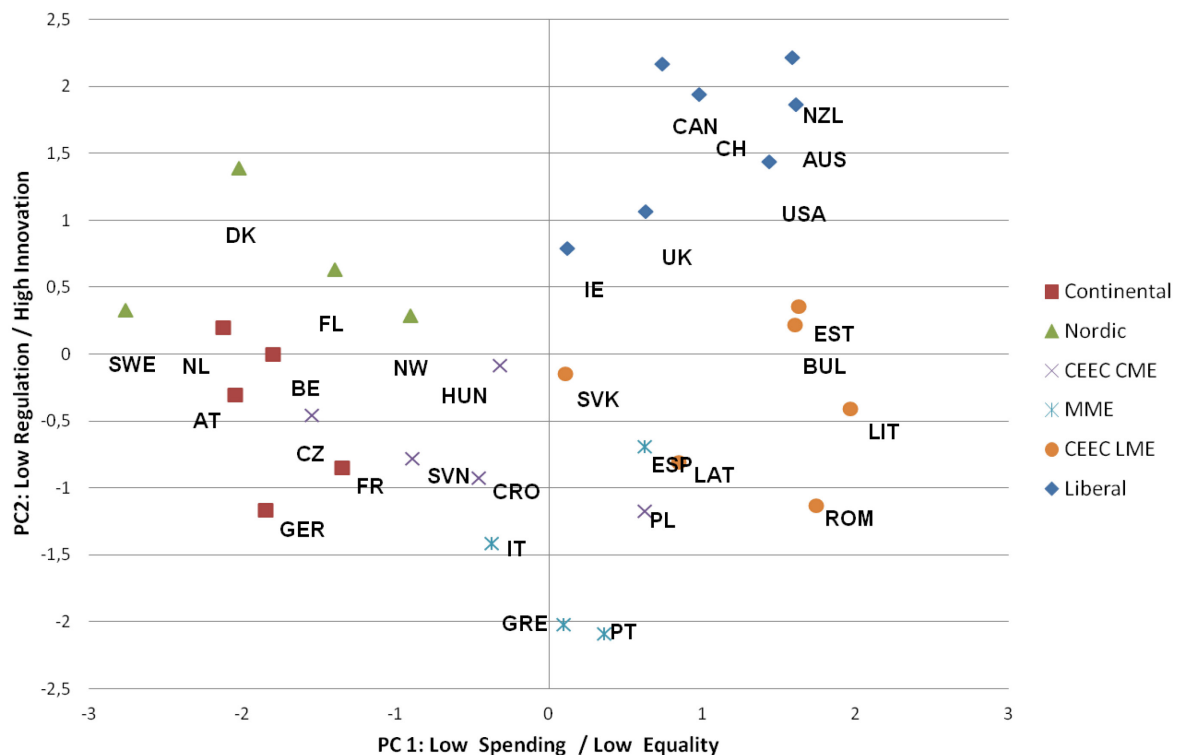
The analysis of the driving variables for the cluster results reveals some additional insights. There are two main principal components:

- PC1 is negatively correlated with government spending (overall and transfers) and equality
- PC2 is positively correlated with innovation but negatively correlated with regulation

Figure 2 sorts the clusters revealed in Figure 1 into the a PC1/PC2-space. This reveals some interesting insights:

- There are two “worlds of redistribution”: the traditional LMEs joined by the more liberal CEECs, which spent less and have a higher degree of inequality compared to all the other groups. This confirms a positive interdependence between spending and distribution. Some groups of countries have a preference for equality and others do not.
- At the same time, there is also a distinction according to a regulation/innovation mix within these two “worlds of redistribution”. Clearly, the Nordic countries are distinct from the other CMEs by revealing a rather low degree of regulation going together with a high degree of innovation. While this is not an analysis of causality, it fits to the argument made by Kitschelt that it is especially the Continental group of CMEs facing a problem of inefficiency. Regulation and spending constitute rather complements than substitutes. On the contrary, Nordic countries are running large (redistributive) welfare states but increasingly liberal regulation regimes.

Figure 2 – Principal Components Analysis, 2007-09 (period averages)



- If we assume some causality for lower regulation allowing for higher innovative capacity, comparing Nordic and Liberal groups in Figure 2 seems to reveal some kind of “unavoidable trade-off” involved in having (efficient) redistribution by a welfare state.
- While the CEEC countries on the left hand side are distributed somewhere in the area of the Continental group, the Southern Europeans again are quite distinct. Except Spain, the MMEs seem to represent the worst mix of high regulation/low innovation together with a rather undetermined spending/equality mix. As was revealed by the cluster analysis in general, CEECs do not mix up in such a scenario.

Concerning the countries, we focus on in the following comparative country studies, Slovakia and Hungary, it is interesting to note that they reveal a rather similar almost average performance with respect to the innovation/regulation-equality/spending mix. This is remarkable because, as indicated above and detailed below, the countries are coming from very different backgrounds and experiences. Similarity implies that the two countries are not quite average countries within their clusters. However, it also exemplifies the fact that Slovakia has made substantial progress compared to its starting position as a low income country which had to cope with nation building and a lagged transition process.

3. Comparative Country Study Slovakia

Contrary to Western Europe, where market oriented economic systems developed over several centuries, transition in CEECs from centrally planned economies to market economies took place in considerably shorter time. Some CEECs started to introduce economic reforms towards a market economy already from the early 1980s (Poland, Hungary, Yugoslavia). However, in other countries no reforms were undertaken at this stage. After the fall of the Iron Curtain, some nations (the Baltic States, Slovakia, Slovenia) used the opportunity for regaining their independent statehood. Hence, these countries faced a double challenge: 1. to introduce economic reforms leading to a market economy, 2. to build the basic economic institutions needed for managing an independent state economy. There was a belief that it is possible to implement capitalist institutions in CEECs from above and in a relatively short period of time. However, reality proves to be much more complicated – transition took a longer time and it was much more difficult and complex. Given the legacy of central planning, economic transition of CEECs was path-dependent and the old institutions were combined with the new ones.

Although joining the EU as soon as possible became the key external factor of accelerating transition of the CEECs, discrepancies arose in each country as regards the priorities and pace of the reforms to be undertaken. In some of the CEECs including Slovakia, the supporters of more radical reforms (the so-called “shock therapy”) enforced this approach despite its big negative impact in the short-term (output fall, unemployment and recession). Other countries (e.g. Hungary, Slovenia) took a more “gradualist” approach, in which reformers implemented step-by-step reforms, with the aim to avoid drastic changes in output, employment and welfare.

Similar to OECD countries, instead of one variety of capitalism several varieties developed in CEECs. However, legacy of central planning constituted different starting points and different challenges for CEECs compared to countries in Western Europe. The heritage of the communist pasts, lower levels of development and various informal institutions mean that there is no close fit with the ideal types used for analysing and comparing mature market economies (Lane-Myant 2006).

Hence, the VoC approach can only be restrictively, flexibly and sensitively applied to post-communist countries, the mechanical application of the VoC can be misleading. Although some features may already be clear, these countries are still undergoing changes leading to a variety of capitalism with the shape difficult to predict. In addition, institutions can be changed more easily in transition economies because of weaker enforcement compared to developed economies. Hence, more alternatives for capitalist trajectories exist in transition countries, which can develop towards LME, CME or a mixed form of both (Mendelski 2008).

Slovakia was labelled *late comer* at the beginning of transition; however, it seemed to become a kind of *star performer* in the first decade of the 21st century. Although the pace of reforms has slowed down few years ago, the Slovak economy provides a good example of a relatively successful transition. In Slovakia a local variety of capitalism with specific features of capital control and with lower productivity level developed. Dual economy and reliance on bank finance are other specific features of capitalism in this country. Dual economy includes a) on one side economy represented by highly effective, export oriented and technologically advanced branches of multinational companies and by international banks, and b) on the other side several large companies and many small and medium enterprises (SME) in domestic ownership, with SME having lower efficiency and limited personal, technological and financial sources. R&D system is underfinanced in Slovakia and the role of the business sector is relatively weak. From this point of view, Slovakia would fit into the Mediterranean model.

During the socialist era, Leninist type of social policy, universally oriented at a wide group of working people and their families, was conducted in CEECs. Nowadays welfare state in CEECs is a combination of more types of welfare states, depending on the sector examined. According to Farkas (2011), CEECs cannot be put into one single welfare system, social protection in Poland, Hungary and Slovenia fits the Continental model, and the others have the characteristics of the Anglo-Saxon model.

Development of social policy in Slovakia has been turbulent after 1989 and represents still not sufficiently investigated area. According to classification of Korpi and Palme (1997) and based on analyses of institutional development, labour market policy in Slovakia could be placed between the *encompassing model* and the *targeted model*, since the principle of definition of unemployment benefits is uniform for all people; active searching for a job (or participation in labour market programs) is condition for registration and help from the state; and help is targeted and temporary (Gerbery and Kvapilová 2006). The current pension system in Slovakia shifts a big part of responsibility from state (Social Insurance Company) to the market (private pension funds management companies) and individuals. The pension system is supposed to develop towards the combination of the *encompassing model*, conditioned by participation in the labour market and by compulsory membership in the system; and the *basic security model*. The system of social aid is very close to the *targeted model*, with some features of the *basic security model*. Although it is very difficult to identify which out of the welfare state models Slovakia belongs to, in general, we can conclude that during transition the Slovak welfare state moved from universalism towards minimum social security and targeted measures. Significance of passive policy has decreased relatively -

benefits were minimized, criteria for receiving benefits were tightened, their real value decreased and the period of receiving them was shortened.

The political pressures for neo-liberal restructuring could be observed all around Eastern Europe, however, election of a right-wing party representing these groups was one of the pre-conditions for neo-liberal restructuring to take place. These conditions were fulfilled in Slovakia after 2002, which became an emblematic case of neo-liberal restructuring and corresponds to the 'minimal welfare state'. However, the neo-liberal restructuring took place only after the imbalances of the old systems had been reduced and stabilized in 1998 - 2002. Further development could be either towards the 'European' social model or could continue in the neo-liberal direction (Myant-Drahokoupil 2010).

From the perspective of capitalism development in Slovakia, the federal transition strategy (first stage of transition – 1990-1992) focused on implementation of liberal market oriented measures. However, their negative effects on the Slovak economy resulted in favourable conditions for creation of the so called "own way of transition". This was implemented in the second period (1993-1998), which is difficult to classify in terms of standard VoC categories. The experiment with the own way of transition failed and led to significant macroeconomic imbalances. The privatisation process was highly influenced by political decisions, with the objective to create the so called "Slovak capital stratum", composed of enterprises owned solely by the Slovak entrepreneurs. However, the majority of enterprises under control of these entrepreneurs were knowingly led into bankruptcy (so called "tunnelling"). The lack of relevant legal procedures and laws, the existing links between politicians and entrepreneurs made this behaviour possible, without any significant legal sanctions. As a result, the low inflow of FDI, international isolation of the Slovak Republic, expansive fiscal policy and restrictive monetary policy created significant macroeconomic imbalances.⁴

The economic policy in the third stage of transition (1998-2002) implemented large number of market oriented reforms, which created the foundation for even more market oriented reforms in the following period. Despite the composition of the government parties (left–centre–right coalition), the main principles of the reforms pushed the Slovak economy closer to liberal market economies. This tendency was intensified in the fourth transition period (2002-2006) under the new centre-right government. The reform and principles of the social system, the tax reform, privatisation of state owned enterprises and the generally negative attitude toward state interventions and state ownership were the most prominent features of economic policy. Despite the liberal market

⁴ While the first and partially the second stage of transition were managed by the IMF and the World Bank, the European Commission played the key role in the following stages, given integration efforts of the Slovak Republic. After EU accession, the Slovak government had relatively free hands when deciding on further progress of economic development.

orientation, the importance of attracting FDI and competition among the CEEC countries in this area forced the government to provide substantial investment subsidies.

In 2006, a new centre-left government was appointed, which basically accepted and only slightly amended the social-economic reforms implemented by the previous government. However, these reforms have been more significantly modified after the appointment of the new left-wing government in 2012. The present development suggests that the effects of the reforms conducted in 1998–2006 are fading. The future development of the Slovak economy will depend also on a new set of reforms aimed at changes in the education system, R&D and innovation support, domestic SME support and implementation of extensive reforms in the public sector. Despite the recently implemented changes in economic policy, Slovakia still seems to be closer to LME than to CME and the future development will be again strongly dependent on the political cycle. According to Baláž (2006), as it is not possible to say which variety of capitalism is better than the others, it is also not possible to say whether the current variety of capitalism in Slovakia has good long term perspectives or not.

To put the performance of Slovakia into the CEEC perspective, two analyses have been conducted comparing ten CEECs (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia) with three benchmark countries (Germany as the case of CME, UK as LME and Italy as MME):

- Analysis of selected policy variables (transfers and subsidies, size of government, regulation) and performance variables (Gini coefficient, innovation, fiscal debt), on which the cluster study has been based. Using a different method, this analysis allows for an alternative view on the cluster data.
- Analysis of selected indicators representing the trinity of welfare/equality, innovation/growth/competitiveness and macroeconomic stability, based on available time series and data from the Eurostat database.⁵ This analysis is based on a broader set of indicators in order to provide a more detailed picture of performance in the CEECs.

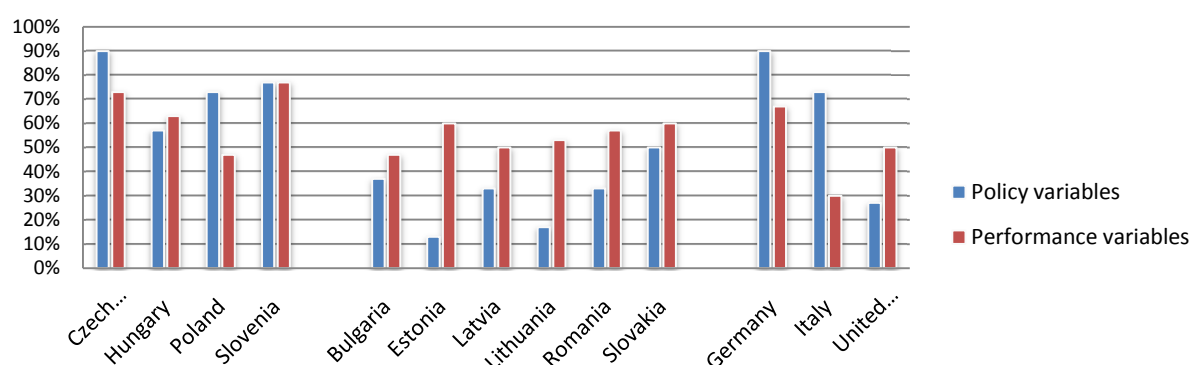
Overall, these variations in method and data allows for a kind of robustness check for the results of the cluster analysis and, at the same time, deeper insights into the transition. For both analyses, a scoring model has been developed, based on the average values of the respective indicators for all

⁵ Welfare/equality: employment rate, unemployment rate, long-term unemployment, Gini coefficient, COFOG - Social protection (% GDP), expenditure on social protection per inhabitant, in-work at-risk-of-poverty rate; Innovation/growth/competitiveness: gross domestic expenditure on R&D (% of GDP), patent applications to the European Patent Office per million inhabitants, GDP growth rate (Y-o-Y change), labour productivity per hour worked vs. EU average. Macroeconomic stability: current account balance (% of GDP), government deficit/surplus (% of GDP), general government gross debt (% of GDP), private debt (% of GDP), HICP inflation. Apart from the data sources of the cluster analysis presented in Section 2, data comes from Eurostat.

13 countries. The model has the following specifications: The average values of individual indicators have been statistically distributed into 10 percentiles, which provided the necessary intervals for assigning points to countries. The points have been assigned to countries in descending order from 10 to 1 (i.e. the country with best performance in the respective indicator receiving 10 points and the worst receiving 1 point).⁶ The total score for each country for the sets of policy and performance variables (first analysis) or for individual dimensions of the trinity (second analysis) has been calculated as the sum of the points assigned to the country for indicators in the respective set of variables or in the respective dimension of the trinity.

The analysis of the three policy variables and the three performance variables has revealed that while the countries in the CEEC CME group (labelled according to the results of the cluster study) reached higher/the same scores in the policy variables than in the performance variables, with Hungary being a slight exception; in the CEEC LME group, the score in the performance variables is higher than that in the policy variables in all countries included (figure 3). Basically, the results of the CEEC CME countries are closer to those of Germany and Italy and the CEEC LME are comparable with the UK. It can be concluded that the analysis provides support for the results achieved in the cluster study. Interestingly, the scores of Slovakia and Hungary are also very similar. In order to compare their performance in a more depth, the analysis of a broader set of indicators of the trinity has been accomplished.

Figure 3 – Policy and performance variables in CEEC groups and benchmark countries (percent of maximum values in total sample)



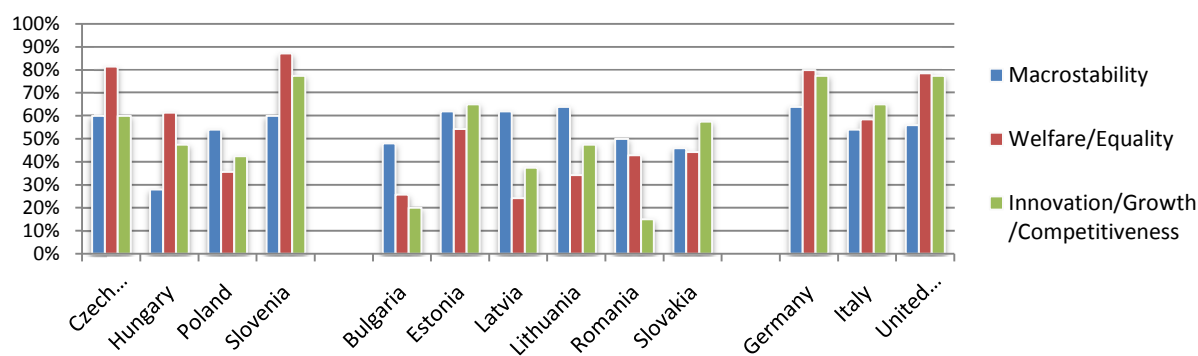
Based on the data and methodology used in the second analysis, Slovenia and the Czech Republic, followed by Estonia are the most successful countries among the CEECs in terms of performance with respect to all three dimensions of the trinity, with Estonia lagging in terms of welfare (figure 4). In

⁶ In case of the policy variables, assigning 10 points means the most transfers and subsidies, the biggest government, the most regulation.

general, the Baltic States are rather unequal and socially exclusive, Slovenia represents the opposite extreme and the Visegrad countries are between these two extremes. By many authors, Slovenia (CME) and Estonia (LME) are considered the most successful transition countries with two diverse but coherent institutional systems. Slovenia achieved balance between macroeconomic stability, competitiveness and welfare. One of the factors of the success of Slovenia is its exceptional legacy, as the country inherited from the former Yugoslavia a unique enterprise ownership structure.

Estonia and other two Baltic States reveal the best results in terms of macroeconomic stability among the CEECs, Latvia and Lithuania only before the crisis. The goal of national independence can explain why macroeconomic stability became a priority for these states. They have enjoyed strong political support for reforms towards the market economy in contrast with many other countries, as radical economic reforms were crucial for the defence of national independence. The Czech Republic is also often considered one of the most successful socialist countries to have transited to capitalism, which was confirmed by the results of our analysis. A very important factor for the relative success of the transformation process in the Czech Republic was the early rejection of a “third way” between socialism and market economy. As regards R&D, Slovenia, Estonia and the Czech Republic represents slight exceptions from underfinanced systems in the CEECs.

Figure 4 – Performance in CEEC groups and benchmark countries (percent of maximum values in total sample)



When compared to the benchmark countries, the results for Slovenia mostly fit those of Germany and surprisingly also those of the UK. In less extent, the same is the case of the Czech Republic (with the most evident difference in dimension of innovation and competitiveness) and Estonia (with worse performance in welfare dimension). Other CEECs are closer to Italy, with Slovakia lagging behind mostly in welfare. Hungary has performed better than Slovakia only in welfare/equality dimension but lags behind Slovakia mostly in terms of macroeconomic stability.

The results of the Slovak economy in the respective dimensions of the trinity are mixed, which implies that Slovakia performs about average within the CEEC countries, with the following strengths: private debt, general government gross debt, GDP growth, labour productivity and Gini coefficient. A still high unemployment rate (in particular long term unemployment and unemployment of young people) and low gross domestic expenditure on R&D represent serious weaknesses.

As can be seen from Figure 4, the results of the trinity in Slovakia are closer to those of Estonia (LME) than those of Slovenia (CME), which represent two extreme cases in the literature. This is in line with the results of the cluster analysis, where Slovakia and Estonia belong to the group of CEEC LME. According to the analysis of the trinity, both countries have focused less on welfare/equality than on other two dimensions of the trinity. On the contrary, the results of Hungary fit more those of Slovenia, with a stronger emphasis on welfare dimension. These economies belong to the group of CEEC CME according to results of the cluster analysis. However, as regards the trinity, the overall results of Hungary are significantly worse than those of Slovenia, which is not the case of Slovakia, when compared with Estonia.

Based on the analysis of the selected indicators, Slovakia does not seem to be a special case. However, comparisons between countries using quantitative indicators reveal only part of the story. From the view of the institutional developments and in particular the pace of the liberal reforms implemented in the beginning of this millennium, Slovakia has been labelled a *star performer*. However, the way of managing transition in Slovakia is characterised by several mistakes which resulted in economic losses as well as decreasing confidence in transition process. In the first stages of transition, mistakes and shortcomings include:

- *The speed of transition.* The shock therapy proved to be appropriate for few reforms (price liberalisation), however, in some areas this approach was not feasible (privatisation, restructuring the enterprise sector) or it was even damaging (liberalisation of foreign trade relations). Liberalisation of foreign trade was conducted at once and in an asymmetric way. Privatization process, focusing on speed and range, suffered from several weaknesses; legal environment and institutional framework for business activities was insufficient.
- *A late start of building institutional framework of the market economy.* The neoclassical conception, which minimized the role of institutions in the economy, dominated in Slovakia in the first stage of transition. Later economists supporting radical reforms enriched their approach by institutional issues of transition. However, it took more than a decade to build at least the basic elements of a new system of formal institutions in Slovakia.
- *Misunderstanding of the role of the state in the market economy in general and in transition process in particular.* The change of the role of the state became a strategic task of transition.

However, many functions of the state were underestimated and it took a rather long time to define the new tasks of the state in the market economy.

Overall, the transition process, coupled with continued legislative and institutional changes and political controversies, has created foundations of the market economy in Slovakia. However, its design is still not satisfactory. Although the transition of Slovakia and other CEECs countries towards market economies represents a unique process, identification of its successful sides as well as problems and shortcomings may be useful for other transition processes. As the Slovak experience with transition shows, it is crucial to build well-functioning institutions, in particular the formal ones, already in the initial stage of any transition. Further, both too slow and too fast implementation of reforms can result in a slowdown or even stoppage of the transition process. At the same time, a high pace of reforms should not be achieved at the expense of their quality and long term sustainability, since numerous additional changes of institutions can decrease confidence in the authors of respective reforms. Moreover, the experience of Slovakia shows how reform strategies and the parameters of adopted reforms are linked to the political cycle. In the periods of right-wing or centre-right governments, liberal policy direction tends to be significant. However, the change of the government to the left-wing one or centre-left one usually results in more or less significant changes in the policy direction, which slow down, stop or even return the economy from the way towards a liberal market economy.

4. Comparative Country Study Hungary

The VoC literature has developed a rather substantial knowledge base in the frames of comparative economics. For various countries and country groups important institutions were checked for similarity (Hall and Soskice 2001, Amable 2003, Sapir 2006). The most frequently analyzed areas were capital and labour markets, product markets, welfare institutions/social protection, innovation systems, political stability/democracy, shadow economy/corruption. There is a far reaching consensus among the scholars concerning the four basic types of capitalist models in Europe: The Nordic, the Liberal, the Continental and the Mediterranean (MME) models, which have also been confirmed by the macro cluster analysis in Section 2.

After the transition of Central and Eastern Europe from central planning to market economy these countries also became targets of research in the frames of the VoC literature. Many papers tried to fit the individual transition economies into one or another existing models of capitalism (Bohle and Greskovits 2007, Csaba 2007, Lane 2007, King 2007). Research results were rather contradictory and problematic. Not only the lack of coinciding classifications for the single countries is embarrassing,

but also the fact, that every single country shows up very unique mixtures of the elements of the four classic models. The appearance of conflicting institutional solutions made transition especially difficult in some countries, since the lack of consistency frequently destroyed the effects of one or another institution. Hence, institutions became and remained rather weak allowing rent seeking and other perverse behaviour rather large room in transition economies.

Those scholars intending to classify transition economies into the existing modelling frames frequently came to the conclusion that due to the lack of consistency among the investigated institutions a unique Eastern European model of capitalism could also be existing (EC 2008; Rodrigues, 2009). While some researchers restricted their work on one or few important aspects of capitalist models, up till now there was one comprehensive paper that analyzed the complex network of 5 important systemic elements of the models that could be captured by hard data in the 10 new EU member states (see Farkas 2011). Nevertheless, this paper was also based on the common assumption that basic feature and institutions should be by definition the same in the specific Central and Eastern European model then in the classic models. This paper also concluded that the various countries had established different institutional mixes. Hence the question of a specific CEEC model is a rather controversial one.

Besides the traditional institutions and linkages, also many transition specific features may play important role in the special arrangements of capitalism in CEECs that are usually not covered in the literature. Such features may be special geographic location between East and West, the legacies of the five decades long Soviet rule in the countries (in terms of social behaviour, economic structure and others), the strong role of FDI in creating competitive structures while development from local sources was much slower, dual structure of the economies, serious problems with job creation in the competitive sectors, the survival of state paternalism or the strong frictions in welfare institutions.

The study on Hungary, therefore, focuses on the welfare state, the most important systemic element of capitalist models according to Sapir (2006). Research on the services of the welfare state provides valuable systemic information not only on the levels of social cohesion and fiscal discipline, but also on how social institutions work and on the relationship of polity and economy. In this regard, the analysis of the history of the past 30 years of Hungarian welfare system also clearly shows the weaknesses of social-economic institutions, the ongoing presence of state paternalism and the continuous shuttling of polity between two poles: the more authoritarian, Eastern type of capitalism, and the more democratic and controlled Western type.

The formation and development of the welfare state in the Central European region has brought much attention. However, there are studies that claim that the post-socialist welfare state does not

follow a single pattern, Deacon (1992), for instance, has predicted that Eastern European countries will develop their social policies in the future into distinct regimes that may even lie outside the three worlds of welfare capitalism described by Esping-Andersen. The question of whether or not a specific CEEC model exists has been on the agenda for a long time. The transformation of the post-communist welfare states involves communist legacies and strong elements of path-dependency as well as innovations and path-departing changes (Cook 2010).

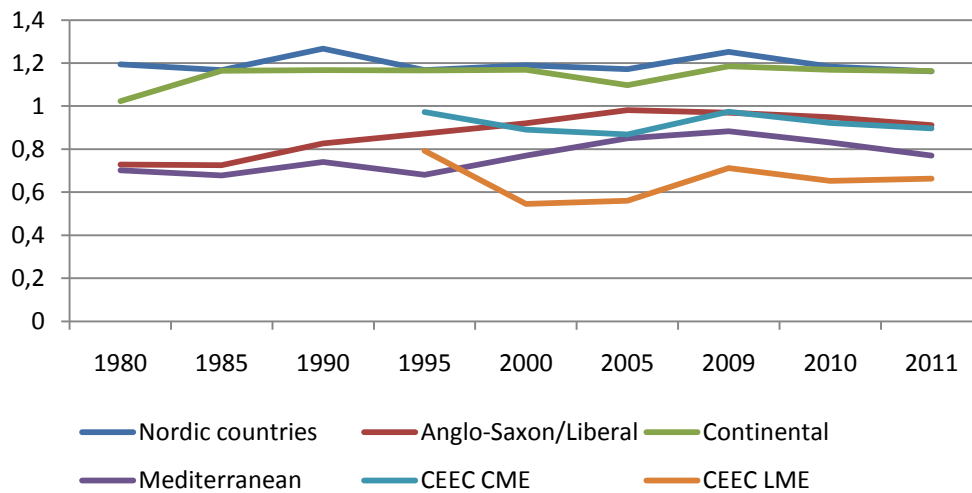
According to the performance of Hungary during the transition it has been presumed that it is easier to form market economy from reform socialism. Reform socialism's adherent hope was this combination would unite all the real (or perceived) advantages of socialism and capitalism. The collapse of the communist regime was followed by rapid and radical changes, institutions of parliamentary democracy have emerged and produced laws to harmonize with the new system, at the end a market-conform legal infrastructure has been installed. While rapid development of the private sector can be observed, the reform of the pension system, medical care and social assistance systems has been laid aside for several years (Korna 1997). The Hungarian welfare state is often characterised by the term 'premature' welfare state, coined by Kornai (1993, 1997) by calling the attention to the fact that the socialist regime did not result in a mature system, but a system with significant distortions.

From the point of view of the welfare state, transition is not yet completed. A fundamental feature of transition is its destructive nature (Csaba 1990, 1994) and the time horizon for transition was underestimated for the CEECs. While the institutional setup is compatible with market economies despite structural dissimilarities, the current crisis is an indicator of the incompleteness of institutional and regulatory change. Welfare systems in general and pension systems in particular are far from being sustainable (Csaba 2011).

Welfare state generosity ratios put Hungary and the CEEC region on the map of the worlds of welfare states and allows to compare welfare state policies of the country groups (Figure 5).⁷ It can be concluded that the generosity ratio of them all have converged. By 2010, the Continental and the Nordic model have reached the same generosity level, meaning a significant cut and a salient increase respectively. The mean value of generosity for the Nordic countries went through significant decrease because Sweden and Norway radically cut back these types of expenditures, while for other Nordic countries this ratio has been increased. Coefficient variation of the Nordic generosity level is around 6 per cent compared to the overall 20 per cent value, generosity level in the Nordic countries is almost identical for 2011.

⁷ Own calculations have been based on OECD SOCX dataset and World Bank data.

Figure 5 – Welfare State Generosity Ratios for Different Welfare State



Since 2009, CEECs converging towards the Continental countries and the Liberal countries show similar generosity trends, slightly below 1.0, while the Mediterranean countries after significant improvement (as a consequence of the EU accession) started to cut back welfare expenditures enforced by the crisis. Liberal CEECs have the lowest level of generosity and the reduction of generosity was the most radical among them between 1995 and 2000, however afterwards they have started to increase generosity again.

It is surprising that, since the 1990s, the coefficient variation has become significantly lower for all groups, except the CEECs. It can be understood as CEECs implement different policies in tackling the current crisis, while the other groups seem to be resistant to the crisis in perspective of the welfare state reforms. Among Continental CEECs, Hungary has reduced its generosity level to the greatest extent, having the lowest level within its group in 2011. The level of social protection has been still in sharp contradiction with the general level of development, resulted in too generous welfare system at the time of the transition and afterwards. In order to solve the above mentioned mismatch as a consequence of the inherited premature nature of the Hungarian welfare state, radical welfare reforms are needed. Looking more closely into the specific features of the Hungarian welfare system exhibits a large extent of path-dependency with the period before transition providing the background and the most recent years (since 2011) being characterized by proposals rather than implementations.

In case of Hungary path-dependency means that whatever change of the system took place, the country's historical experiences are inseparable from the evolved model of the 'Hungarian'

capitalism. The Hungarian reform in 1968 can be considered as the most significant, despite all of its controversies leading to an increase of production and a rising standard of living (Muraközy 2008). The market reforms from the early eighties led to marketization which significantly increased both aggregate and individual-specific uncertainty; as compensation, the state did not hesitate to embark on generous welfare programmes. Welfare services became tools of the short-sighted state elites for compensating the losers of the economic reforms. As a consequence of these reform programmes, generous welfare spending became and is still an untouchable part of social rights, making the implementation of necessary reforms even more difficult from a political point of view (Benczes 2011).

From the **problems** and **shortcomings** of the Hungarian transition, which still influence the economic performance today, a few concluding remarks can be drawn:

The speed of transition in Hungary is often picked up as an example of gradualism. Although, e.g., the bankruptcy law of 1992 may represent a classic case of a big bang approach, even this reform contained some sort of gradualism (Carmignani 2003) and is often cited as a prime example of gradualism (Condon and Dervis 1993) based on the lack of shock therapy compared to countries like Poland, Bulgaria or Russia. In the context of post-socialist transition gradualism was applied to avoid political conflict, it was equalled to timidity and unwillingness to change (Csaba 2011). The overall unique feature of the Hungarian transformation can be described as “transformation without stabilisation” (Csaba 1995: 195). To link Hungary’s experience to the debate on the speed of the transition, Benczes (2011) claim that the gradualist character of the Hungarian transformation was not the result of a conscious decision of the freely elected government, but a historically determined path dependent outcome of a two-decade long reform process which culminated in the political change of 1989. The early years of the Hungarian transformation, however, were burdened with ambiguity and a lack of coherence in policy decisions. Finally, the culture and routine of gradualism à la Hungary led to the resistance to shock-therapy. Consequently, welfare expenditures are still very high and above OECD average, although the gap has started to close since 2010. The citizens perceive worsening quality of public services despite the high costs. Creating welfare state generosity ratio, it can be concluded that Hungary ranks in the middle, however in general generosity has been significantly decreased. In addition, there is a lack of systematic comprehensive reform of the big allocation systems which has been accompanied with hectic changes of the taxation system.

In case of Hungary the role of the local governmental system and the gender dimension are to be highlighted as special features. As far as the social insurance system is concerned, the local governments are responsible for the provision of the services which resulted in the indebtedness problem of the local tier. In 2011, a reform of the local governmental system took place to handle

this process. The problem of the welfare system is the fulfilment of public services in a better quality and different structure, e.g. the share of education is considerably lower in Hungary than the OECD average. Equal access to public services has to be ensured, however the fragmented local governmental structure hinders implementation. Without change in the financing system, the current system remains unsustainable.

To dampen the negative labour market consequences of transition, government-supported pension policies were intended to mitigate the effects of declining labour demand. Most people leaving the labour market became eligible to some social provision, such as old age pension, disability pension, or maternity allowance. By 1995, the share of benefit recipients among the working age population reached 31 per cent. Pension schemes were used to reduce open unemployment since the mid-1980s and after the transition this practice was expanded. This compensation process carried out by the extension of pension schemes could dampen the negative effects of the transition, however in the long run it has become the cause for the unsustainability of the pension system. By socio-economic transition the long-run evaluation of any compensation scheme is a key issue for managing sustainability in the long run.

Transition had a specific impact on women. One of the most crucial elements of these changes are the gender specific differences of labour market participation. As a consequence of the transition, high unemployment and economic insecurity have affected women more, undermining the previous dual breadwinner model. Women's labour market employment rates have fallen dramatically. Labour market participation is a key measure of gender inequality, employment among women dropped dramatically in all CEECs. However, gender-specific discrepancy in employment rates is lower in all CEECs (except the Czech Republic) than in the Western EU countries. Hungary's situation (beside Poland) is special because female employment is the lowest. In general we can conclude that in the CEE countries the end of state socialism has brought diminishing support for women's labour market participation (Pascall and Kwak 2010: 117).

The following general findings can be drawn from the analysis of welfare state reform in Hungary:

- The temporary cut in the affluent welfare expenditures, without any notable structural changes, are counter-incentives of the successful long-run stabilization.
- The initial favourable starting point is no guarantee for success in the long run. There are path-dependent trajectories.
- The welfare system can/could not help to solve the worsening social and income problems following the change of the political system.

- Hungary is one of the worst-hit countries of the current financial crisis among the CEECs. The deteriorating economic performance of the country has its historical roots. A high ratio of redistribution, a high and persistent deficit and accelerated indebtedness are the consequences of the communist and the post-communist period.
- Building up a modern and efficient market-driven welfare state in post-communist economies requires decades for reaching political consensus in different approaches (health, housing, education, research, etc.) and developing institutional and legal framework. Even the most advanced CEECs are at the very beginning of this process, and low quality of political debates and weak political elites can be described as the major obstacles on this way. In general at any socio-economic transition the correct configuration of the time frame is a key factor in order to avoid unrealistic expectations and growing resistance in the long run.

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Project Information

Welfare, Wealth and Work for Europe

A European research consortium is working on the analytical foundations for a socio-ecological transition

Abstract

Europe needs a change: The financial crisis has exposed long neglected deficiencies in the present growth path, most visibly in unemployment and public debt. At the same time Europe has to cope with new challenges ranging from globalisation and demographic shifts to new technologies and ecological challenges. Under the title of Welfare, Wealth and Work for Europe – WWWforEurope – a European research consortium is laying the analytical foundations for a new development strategy that enables a socio-ecological transition to high levels of employment, social inclusion, gender equity and environmental sustainability. The four year research project within the 7th Framework Programme funded by the European Commission started in April 2012. The consortium brings together researchers from 33 scientific institutions in 12 European countries and is coordinated by the Austrian Institute of Economic Research (WIFO). Project coordinator is Karl Aiginger, director of WIFO.

For details on WWWforEurope see: www.foreurope.eu

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