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## **TIGER Working Paper Series**

**No. 116**

### **Market Reform and State Paternalism in Hungary: a Path-dependent Approach**

**István Benczes**

**Warsaw, July 2009**

# Market Reform and State Paternalism in Hungary: a Path-dependent Approach<sup>1</sup>

*István Benczes*<sup>2</sup>

## **Abstract**

Hungary is one of the worst-hit countries of the current financial crisis in Central and Eastern Europe. The deteriorating economic performance of the country is, however, not a recent phenomenon. A relatively high ratio of redistribution, a high and persistent public deficit and accelerated indebtedness characterised the country not just in the last couple of years but also well before the transformation, which also continued in the postsocialist years. The gradualist success of the country – which dates back to at least 1968 – in the field of liberalisation, marketisation and privatisation was accompanied by a constant overspending in the general government. The paper attempts to explore the reasons behind policymakers' impotence to reform public finances. By providing a path-dependent explanation, it argues that both communist and postcommunist governments used the general budget as a buffer to compensate losers of economic reforms, especially microeconomic restructuring. The ever-widening circle of net beneficiaries of welfare provisions paid from the general budget, however, has made it simply unrealistic to implement sizeable fiscal adjustment, putting the country onto a deteriorating path of economic development.

JEL codes: P26, P35

Keywords: individual-specific uncertainty, gradualism, paternalism, fiscal profligacy, Hungary

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## **1. Introduction**

Hungary has been long admired for its mild and politically calm transformation process and its apparently well-designed reform strategy, the predecessors of which dated back to the New Economic Mechanism (NEM) of 1968. The evident successes in the field of marketisation, liberalisation and microeconomic restructuring, however, masked the inaction in other fields, such as public finances. Apart from a few exceptional episodes, the general government has been left mostly untouched; thus, persistent delay and helplessness characterised the last couple of decades in this respect. Understanding such a controversial performance is, however, not an easy task. This paper attempts to explore the reasons behind policymakers' impotence to reform public finances. By providing a path-dependent explanation, the paper argues that both communist and postcommunist governments used the general budget as a buffer to compensate losers of economic and political reforms. The ever-widening circle of net beneficiaries of welfare provisions paid from the general budget made it simply unrealistic to implement sizeable fiscal adjustment, putting the country onto a deteriorating path of economic development.

The general budget has become the means for compensating people for losses, especially in the early times of microeconomic restructuring, which added strongly to transformational recession. While in other transition countries the euphoria at the time of the systemic change provided a so-called "window of opportunity" for politicians to implement severe reforms, no such opportunity emerged in Hungary. The long reform tradition of the country on the one hand and the peaceful and politically calm political change in the framework of a close collaboration between the old and the new elites on the other hand made the change evident for the people, who did not feel it necessary to pay for the costs of the change accordingly. The heavy burden of structural reform in the sphere of the micro economy was compensated by increased public provisions in the form of household transfer or public sector employment, thereby prolonging paternalism. Albeit a near-to-crisis situation triggered a fiscal stabilisation in Hungary by 1995, soon after the recovery, politicians returned to fiscal indiscipline, fuelling private consumption from public sources with the slogan of compensating people for sufferings during the austerity measures of 1995-1997.

The hypothesis of the paper is accordingly that the success of marketisation and microeconomic restructuring, a process that started well before the systemic change itself, came at the price of a deteriorated performance of public finances and a lack of fiscal discipline in general. In more technical terms: *hardening the budget constraint of firms came at the cost of maintaining the soft budget constraint of the state.*

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

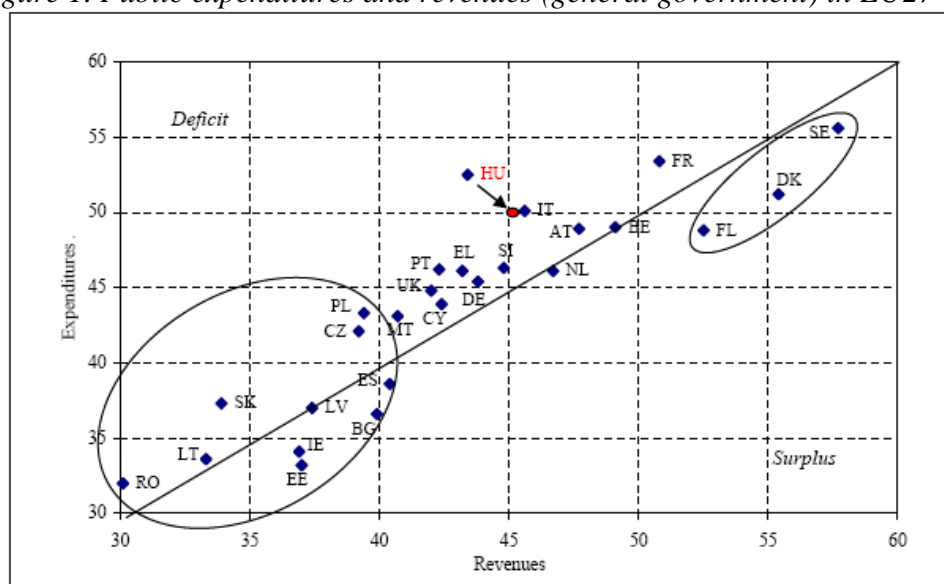
## **2. Fiscal laxity: stylised facts**

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

Hungary, a country with 60 per cent of the average income of the EU (on PPP), maintains a relatively high level of redistribution. The ratio of public spending to GDP has always been at (or beyond) 50 per cent, a ratio that is characteristic of the welfare states of Nordic countries or France – countries with at least twice as high levels of development in terms of GDP (on PPP) than Hungary. More importantly, none of the former socialist countries – with an almost same level of development – has such a sizeable state (varying from 30 to 45 per cent in GDP). Admittedly, there are substantial differences with regard to the size of states across Europe and the industrialised world.<sup>3</sup> Yet, the relatively large redistribution can make a country more vulnerable to external shocks. (Comparative data on EU countries are displayed in Figure 1.)

In Hungary, however, the high redistribution ratio has existed together with an extremely high and persistent budget deficit for the last two decades. Hungary managed to reduce its deficit below the Maastricht reference value only once; fiscal balance showed a 6 per cent deficit on average during this period. The general government deficit has been mainly due to the overruns in the primary balance, especially in current spending. Public debt has also accumulated without bounds and reached the highest level among new member states, totalling at 73 per cent of the GDP by 2008 – the CEE10 average was 26.8 per cent in the same year (EC 2009). A high and persistent deficit, together with an accelerated debt-ratio, can seriously devalue the growth potential of any country and endangers economic stability.

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



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

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

The real challenge to the country's fiscal sustainability is the unhealthy structure of the general government, especially on the expenditure side. Both the compensation of public sector employees and household transfers significantly exceed that of neighbouring countries and also most of the EU15 countries. Over-employment has become a serious problem in the

<sup>3</sup> Redistribution rates are of course not exogenous in the sense that they are strongly influenced by several political, historical and cultural patterns (see Aghion et al. 2004 for instance). Furthermore, there is no consensus at all in the literature on the optimal size of states. Both low and high redistribution ratios can deliver robust economic performance (see Sweden and Finland on the one hand and Ireland on the other hand).

Hungarian public sector: one-fourth of total employees work in the public sector, illustrating the inefficient functioning of the state administration. Structure of welfare spending suffers serious distortions, too. On the one side, spending on health care and education is slightly below that of the EU15's average, whereas household transfers – such as family and child allowances, sick pay, disability pay or early retirement payments – are more generous than in most of the old member states. The disincentive structure of welfare provisions makes non-participation in the labour market appealing. The labour force participation ratio – 56 per cent – is the lowest among OECD countries. Somewhat strangely, economic functions conducted by the state often serve the interest of households, therefore price regulations on gas, housing or pharmaceuticals should be considered as welfare payments, too.<sup>4</sup> Table 1 depicts the distorted structure of the Hungarian general budget in a comparative perspective.

*Table 1. General government spending by economic decomposition, 2005*

|   | <b>EU15</b> | <b>CEE8</b> | <b>Hungary</b> |
|---|-------------|-------------|----------------|
| Compensation of public sector employees             | 10.9        | 10.0        | 12.6           |
| Collective consumption expenditure                  | 8.1         | 8.9         | 9.9            |
| Social transfers in kind                            | 12.8        | 10.1        | 12.6           |
| Social benefits other than social transfers in kind | 16.0        | 11.8        | 14.5           |
| Subsidies   | 1.1         | 1.3         | 1.1            |
| Interest payments                                   | 2.7         | 1.6         | 3.9            |
| Other current expenditures                          | 2.2         | 2.2         | 2.5            |
| Gross fixed capital formation                       | 2.4         | 3.4         | 4.0            |

Source: EC (2006)

Note: data as per cent of the GDP

The general tendency to overruns in the fiscal balance and the unsustainable structure of the general government are, however, not new phenomena at all. They have been deeply rooted in the past development of the country. Advanced reforms in the field of micro economy and successive failures in the field of public finances are the two sides of the same coin; they are strongly related to each other. Practically, the road of liberalisation, stabilisation and privatisation was paved by compromises and compensations buffered by the general budget.

### **3. Reform socialism (1968-1989): marketisation along with paternalism**

The classical Stalinist regime prevailed for a relatively short period of time in Hungary. In the Stalinist regime, the maintenance of the political power of the Party, along with Marxist-Leninist ideology, was underpinned by an almost complete nationalisation of property rights. State ownership and bureaucratic coordination – together with the massive use of political repression and terror – provided a solid ground for forced industrialisation. A rapid and extensive growth of the heavy industries was compelled at the cost of the light industry and agriculture. The constant state of alertness for war and the extensive use of natural resources caused serious and constant shortages of consumer goods.<sup>5</sup>

<sup>4</sup> Benedek et al. (2006) estimated the welfare part of economic functions of the state to 2 per cent of GDP.

<sup>5</sup> On the classical socialist regime, see especially Kornai (1992) and Kozminski (2008).

By the mid-sixties, however, Hungary chose a different track. Instead of a blatantly repressive system, the communist party elite opted for the creation of an environment which endorsed political calm and material well-being. The historical lessons drawn from the Revolution of 1956 forced political leaders to recognise the importance of meeting the material satisfaction of the people (Kornai 1990 and 1997). Public spending was thereby redirected from physical investment to the material welfare of the citizens, a shift that elicited the expression “goulash communism” as a namesake for the Hungarian system.

From 1968 onwards, reforms with varying intensities were high on the agenda of Hungarian policy-makers. In rhetoric, the main objective of the first cycle of reforms (1968-1973) was to increase the efficiency of the economy by introducing market incentives on the level of firms. Decentralisation swept mandatory output targets and input quotas away; economic decisions were delegated onto the level of factories, thereby giving more discretionary power to the managers. Indirect financial instruments were introduced in order to influence the behaviour of enterprises. Reform attempts culminated in an accelerated growth performance, which fuelled the improvement of individuals’ living standards.<sup>6</sup>

Whatever merits the New Economic Mechanism had, the ultimate goal of the Party elite was not economic efficiency *per se*. The decision to move towards marketisation was determined solely by political considerations. Party leaders of the Hungarian Socialist Workers’ Party engaged in stabilising their political power by providing additional economic growth and prosperity for families. Learning from past mistakes, a kind of “consumption-oriented” approach to socialism evolved, where the emphasis was put on people’s own relative prosperity, instead of forced savings and industrialisation. The NEM can be best interpreted therefore as a tacit agreement between the citizens and the Party: in exchange for the relatively high standard of living and the relative freedom (hence the term “the happiest barrack”), citizens had to remain loyal to Party leaders and did not question the *raison d’être* of the socialist regime itself.<sup>7</sup>

The success was, however, relatively short-lived. On the one hand, external shock in the form of the first oil crisis caused severe structural tensions in the country. Internal factors, however, played a possibly even more important role in the failure of the New Economic Mechanism. The “genetic programme” of the communist regime made it basically impossible for market reforms to achieve a new and stable equilibrium (Kornai 1992). Bureaucratic intervention did not decline in practice; it was replaced by indirect bureaucratic management. The change occurred in form only, and left the intensity of economic dependence untouched.<sup>8</sup>

In spite of economic slowdown, political interest was strong in preserving the relative well-being of citizens; the objective of consumption-maximisation did not change accordingly. The base for such a regime was not increased productivity anymore but foreign resources. The accumulation of foreign debt and the structural crisis of the world economy made it unavoidable for Hungary to start on its second reform cycle by 1982.<sup>9</sup> The most significant elements of the reform steps were the following: informal activities (often called second economies) were legalised; small private firms (mostly in the service sector) were officially recognised; corporations could enter the financial market by issuing bonds; a two-tier banking system and a new, market-conform tax system were introduced, etc.

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<sup>6</sup> Hare (1983) claimed accordingly that the NEM made Hungary unequivocally different from the rest of the Eastern bloc countries.

<sup>7</sup> Importantly, in stark contrast to the Czech attempts of 1968, the Hungarian leaders never refuted the leading role of the Soviet Union.

<sup>8</sup> Originally, it was assumed that quasi market incentives should have induced competitiveness among firms. In practice, however, enterprises started to bargain with the different levels of bureaucracy for additional resources, a phenomenon that was called as “plan bargaining” (Kornai 1992). Economic agents did not negotiate over the targets anymore, instead over a complex net of economic regulations (such as credit, price, tax and subsidy).

<sup>9</sup> See especially Bauer (1988).

The official aim was to restore the competitiveness of the Hungarian economy, but the real aim was to give room for individuals to earn a decent income in order to maintain the relative well-being of families or at least to avoid a further deterioration. The sixties saw the change of the incentive structure of large state enterprises and cooperatives, in order to induce competition amongst them. The eighties, however, gave a chance for private and semiprivate sectors to spring into existence.<sup>10</sup>

As market reforms from the early eighties onwards have been adopted by necessity since the driving force for market reform was to avoid further deterioration in economic activity and individuals' wealth status, the state also embarked on generous welfare programmes. The relative share of income from work declined substantially, as opposed to other non-work related sources (see Table 2). Since marketisation unavoidably increased uncertainty, the state compensated the losers of the reforms by more generous welfare spending, which was directly built into the state budget (thereby becoming untouchable social rights).<sup>11</sup> Marketisation and economic restructuring were therefore implemented by applying measures which strengthened the winning coalition and minimised the number of losers at the same time. With market incentives and private property on the one hand and increased welfare spending on the other hand, pragmatist Party-leaders provided a credible commitment to both market reform (favouring winners) and compensation schemes (placating losers).<sup>12</sup>

*Table 2. Disaggregating personal income*

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

Source: Kornai (1997)

## **4. After the change**

### **4.1. Big bang versus gradualism**

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

<sup>10</sup> By the mid-80s more than 10,000 small new enterprises ("petty cooperatives" or "independent contract work associations") existed, in contrast to less than 1000 state and cooperative enterprises.

<sup>11</sup> On individual-specific uncertainty, from a purely theoretical point of view, see Fernandez and Rodrik (1991).

<sup>12</sup> These are basically the methods of a (successful) gradualist approach (Roland 2002).

<sup>13</sup> On the big-bang versus gradualism debate, see Balczerowitz (1995) and Gros and Steinherr (1995) on the one hand and Aghion and Blanchard (1994), Dewatripont and Roland (1995) or Roland and Verdier (1999) on the other hand.



environment. The so-called “round-table” negotiations defined the framework and the sequence of the political shift to democracy with the consent of the communists.<sup>14</sup>

The reform tradition and the relative successes did not prevent Hungary from implementing a series of painful reforms with the explicit aim of hardening the budget constraint of firms and individuals in 1990 and 1991. The Hungarian bankruptcy law liquidated insolvent capacities mercilessly, causing an immediate and drastic fall in economic activity.<sup>15</sup> Hardening the budget constraint of enterprises came at a high price, however. Transformation recession totalled at 18 per cent of the GDP by 1993, and Hungary experienced the most dramatic fall in employment in turn in the region. From its 1989 level, employment declined first to 87 per cent by 1991 and then further down to 72 by 1994. The numbers for the same period were 90 and 85.5 in Poland and 93.5 and 90.5 in the Czech Republic. Unemployment reached double-digit numbers in the first half of the nineties; it peaked at 12 in Hungary.<sup>16</sup> (Basu et al. 2000)

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

*Table 3. GDP and its components, 1989-1994*

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

Source: own calculations based on CSO (2007).

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

The taxi and lorry drivers’ blockade against the price increase of petrol just after 4 months of the free elections made it overt for incumbents that Hungarians did not tolerate the decline in their wealth status. It was clear that reform in the micro sphere could go further only if the government *compensated* citizens. To put it differently: the new democratic leaders recognised that the price for microeconomic restructuring was accordingly the preservation of the relative well-being of citizens – a phenomenon that was nothing new indeed in Hungary. Economic development in Hungary, therefore, showed a strong path-dependent character, which narrowed down the array of policy options substantially. Household transfers were

<sup>14</sup> In fact, members of the previous system were allowed to participate in the first free elections and became members of the new establishment.

<sup>15</sup> The liquidation of low-quality companies triggered the need for large bank consolidations, too (Király 1994).

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

expanded to an extent which could significantly counterbalance the negative consequences of output fall. The general budget was burdened by generous social entitlements in the form of unemployment benefits, family allowances, sick leaves, early retirement schemes, etc., preserving thereby the pre-born welfare state of the socialist past.<sup>17</sup>

The expansion of social entitlements paid by the government was, however, not a well-grounded decision of the political elite. Instead, it was a reaction to the negative economic tendencies, the fear of otherwise a definite denial of reforms. As the communists purchased the loyalty of citizens by providing an unsustainably high standard of living by maximising current consumption at the expense of the future, the government at the time of transformation followed a similar attitude. By providing a relatively generous social protection, individual-specific uncertainty could be reduced substantially in times of a severe economic fall. Individuals in turn considered increased welfare payments as rightful compensations for the loss of their jobs, making it rather hard to cut back on them later on. Paradoxically, there was a strong tendency for a high level of redistribution and overspending at a time when one of the major challenges of the country was to deconstruct the old and inefficient state structure and to promote a shift towards getting incentives right that are compatible with market economies.

In fact, the gradualist character of the economic transformation was not the result of a conscious decision of the first freely elected government, but a historically determined outcome of a two-decade long reform process, which culminated in the political change of 1989. Applying the term “gradualist” with regard to Hungary is therefore misleading. Originally, the theorists of gradual reforms favoured a sequenced and embedded reform process and argued against the total suspension of past capacities, since it would have triggered an unnecessary fall in supply, ending up in impoverishing and frustrating citizens. The early years of the Hungarian transformation, however, according to Csaba (1995), were burdened with ambiguity in policy decisions and a lack of coherence.

#### **4.2 Stabilisation and a return to paternalism**

The artificially high level of aggregate demand caused serious imbalances in both the internal and external positions of Hungary. With the re-emergence of a twin-deficit, a financial crisis threatened in 1994-95. The inaction of the Hungarian authorities on the one hand and the Mexican financial crisis of 1994-95 on the other hand made international financial investors reluctant to finance Hungary. In order to avert a crisis, a stabilisation package was adopted by 1995. The fundamental goal of the surprise package was to remedy the disequilibria in both the foreign and the internal balances, thereby stopping the dangerous spiral of indebtedness, and consequently regaining the trust of foreign investors. While preserving the political calm was an eminent objective of both socialist and postsocialist governments between 1968 and 1995, the austerity package reneged on it and made the restoration of economic stability the only valid goal.<sup>18</sup>

The package aimed at enforcing short-term stabilisation and long-term sustainability at the same time. Besides the strict measures of demand contraction, it also tried to break down the pre-born paternalist welfare state. While in adjustment it was successful, its more

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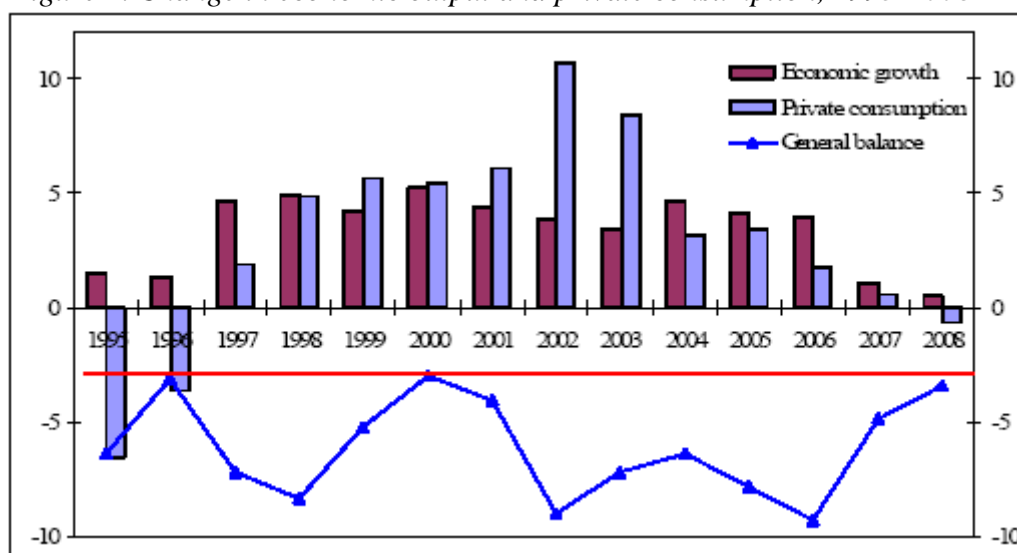
<sup>17</sup> While the economically active population declined from 5.22 million in 1989 to 4.54 million by 1994, the total number of pensioners and other beneficiaries increased from 2.42 million to 2.95 million. The monthly average number of families receiving family allowance increased from 1.37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

<sup>18</sup> The austerity measures were worked out in full discretion without the involvement of the parliamentary parties or social partners. This was the only time from 1968 onwards when stabilisation was initiated without any compromise.

ambitious reform measures proved to be doubtful. It restored competitiveness of the economy by reducing real wages in the economy by 12 per cent and by speeding up privatisation, but the structural reform of the general government came to a halt relatively soon. Admittedly, it tried to do so, but most of the reforms were classified as unconstitutional by the Constitutional Court or were suspended by the time of the upcoming elections in 1998, which saw electoral economics reborn.<sup>19</sup>

By 1999, the growth rate of private consumption exceeded once again the increase of overall economic activity, which was further deepened by the world-wide economic slowdown in 2001 and the fierce competition at the next parliamentary elections of 2002 (Figure 2.). Election economics along with the old reflexes of compensating losers of the austerity package have re-emerged.<sup>20</sup> The consequent deterioration of fiscal balance put Hungary again on an unsustainable path of development. Apart from a short period of fiscal discipline, Hungary has returned to consumption-maximisation, characterised by an expansionist state paternalism, financed by increased public liabilities. It also referred to the unwillingness of politicians to embark on the radical and necessary policy changes, especially in the field of public finances.<sup>21</sup>

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



Source: data are taken from the EC (2006 and 2008).

Note: red line: 3 per cent reference value of Maastricht.

<sup>19</sup> A 0.5 per cent surplus in the primary balance in 1997 was changed to a deficit (2.2 per cent) in 1998 (OECD 2000). With the approach of elections, pension payments were increased by 22 per cent (in nominal terms), while public sector salaries experienced an increase of 13 to 16 per cent. The health care sector also benefited from election-year economics. The increase of extra spending did not stop after the 1998 elections. The incoming conservative government generously bailed out two banks, and also the State Privatisation and Holding Corporation received a substantial subsidy. One-off measures increased the deficit well above the planned targets (EIU 1999:26).

<sup>20</sup> In 2002, the governing socialist-liberal coalition announced explicitly the initiation of a “systemic change in welfare politics” which meant a radical shift away from fiscal discipline to increased welfare spending in order to redistribute the fruits of the stabilisation measures of 1995-1997 to as many people as possible.

<sup>21</sup> See for instance Antal, Csillag and Mihályi (2005).

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

Hungary has also been the country with the highest share of disability benefit recipients, and the amount of social benefit paid to this group has increased drastically over the past decade. The number of disability benefit recipients increased from the starting level of 250,000 in the early nineties to 450,000 in 2004 which is more than 11 per cent of the employees.<sup>24</sup> Sick pay on the other hand has been used by many as an extension of unemployment benefit after the termination of the employment contract. In the mid-2000s, unemployment insurance benefit was paid to around 100-130,000 people, supplemented by an incredibly high number of 80,000 people receiving sick pay. The generous welfare system, along with an outstandingly high tax wedge on employment, provides serious disincentives to work: only (a bit less than) four million out of the total seven million active people are registered employees in Hungary. Furthermore, welfare benefits are considered to be entitlements. Once people have become entitled to receive them, they show strong political resistance to any change in the system.<sup>25</sup>

The post-2000 years have been heavily burdened with fiscal profligacy, irrespective of the political makeup of the governing coalition. Hungary – due to the lack of action and ill-conceived policy choices – has found itself in the crossfire of swelling criticism: international rating agencies have downgraded the country, and even Brussels has blamed Hungary several times, thereby making the loss of credibility of the Hungarian economic policy (and policy makers) fully overt. The period between 2001 and 2006 can be best characterised as a permanent election campaign where both the incumbents and the opposition tried to outperform their rivals by promising more spending from the budget without keeping an eye on the financing constraint of their populist measures. Albeit from autumn 2006 the government initiated some changes and fiscal discipline has been strengthened somewhat, essential reform measures are still waiting to be adopted. As Csaba (2009:95) accurately stated: “the stagnation of reforms and the deepening of mutual distrust among and across all players of the political scene have created a *paralysis*.”

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

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

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

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

## 5. Conclusion

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

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

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

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