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The Centrally Planned „Invisible Hand" - The Case of Hungary

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Introduction

The development characteristic of each former socialist country at the present time may be understood and analysed in the context of the interaction a great many factors, and it is not at all surprising that divergences are observed. Each one's short and long term past, the interactive dynamics of the formal and informal institutions is partially determinative, as well as the impact and combination of external influences with all this. Continuity with the past, a kind of dependence on the route is a most essential feature, in which the customs, concepts, traditions and views of the populace play a key role (North, 2005).

It is worth reviewing the distinctive development of Hungary in the context of the above framework, as a kind of case study. In the years of market socialism introduced after 1968, this was internationally recognised as one of the best places to live within the socialist camp; it was the "happiest barracks". After the change of regime, it was a leader in the transformation during the nineties, and there were great hopes for the future and for the chances of catching up with the developed countries. Belying all these expectations, with problems heaped on problems in the first decade of the millennium, it became one of the lagging economies of the Central-Eastern European region. Not only could it not work off, or at least reduce, its disadvantage compared with the developed countries serving as an example, it also fell significantly behind its associates in the change of regime. What could be the reason why Hungary, from being in the lead and amongst the first, could change position and be among the last following the stormy period of transition?

In the final third of the 19th century, the building of belated capitalism also began in Hungary, as part of the Austro-Hungarian Monarchy. With the help of some support from the state and significant foreign capital, considerable development had occurred by the First World War. Following disintegration of the Austro-Hungarian Monarchy, within new frontiers Hungary was faced with decades of difficulty. The capitalist economy was strongly coloured with the remains of feudalism (Berend, 1998), and by the time it had recovered somewhat from the first great world conflagration, and the crisis of 1929/1933, the Second World War arrived.

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The socialist heritage

Building of the socialist system in Hungary gained full momentum from 1948, and this opposed the conventions, traditions and people's conceptions so strongly that the greatest explosion in the Soviet empire occurred here in 1956. And this, in spite of its failure, left its mark on the long period which followed afterwards. According to historians, the essence of an age or a system is determined by the circumstances of its birth. The Kádár system in Hungary was born in the wake of the Soviet tanks which quelled the 1956 Hungarian uprising. The reprisals during the first period are therefore not surprising. What is much more so is that later, from the second half of the sixties, this became the weakest dictatorship in the socialist camp. Both the oppression and the later period with a preference for prosperity were nourished by an overwhelming fear on behalf of the state party leadership and the members of the political elite that once again an elemental explosion could occur, like the one which almost swept away the foreign system in 1956. On the scale between strict dictatorship and legitimation by increasing consumption, the Kádár system shifted in the direction of the latter in the interest of securing authority and keeping the peace in society.

This was the deeper motive for the market socialism experiment, introduced in 1968 and creating a stir even at the international level, and then when this was relatively unsuccessful, for the indebtedness to foreign capital, with which the increase in consumption could be covered. This was also the root of permitting and tolerating the extensive activities of secondary economy in the 1980s. An orientation towards consumption instead of forced accumulation, the use of capitalist wealth from the enemy to maintain the system, "releasing" the activities of the population from the socialist sector, in any case inefficient, into a kind of grey economy (Muraközy, 2004). The basis for all this was a tacit "social contract", if citizens did not attack the system, the political leadership would try to increase consumption. As expressed by János Kádár's typical saying – whoever is not against us, is with us.

All of this, however, had profound effects on the conduct and concepts of the then generations:

- Legitimation of the system depended on the level of consumption granted.
- The level of consumption and personal accomplishment depended primarily on loyalty and position in the hierarchy rather than on efficiency.
- Compared with the efficiency of the economy, over-consumption was general in the country.

- Amidst the scenery of market socialism, people got used to the fact that the market was only a kind of “monopoly” game, which could not be taken seriously. You can win by clever manoeuvring, but you can’t lose.
- The extensive secondary economy in the eighties, essentially legalised and not subject to taxation, further reinforced the idea that there are no obligations towards the state.
- State provisions were more extensive than in most of the socialist countries, and this authenticated additional, often baseless promises for the future which became incorporated into people’s expectations.

In consequence of the peculiar Hungarian development, a completely different attitude to the state and the market emerged in Hungary in contrast to the other socialist countries. In spite of the necessary failure of market socialism, the “marketised” planned economy and the “weak” dictatorship of these two decades did not pass away without a trace with the collapse of the system. The large-scale paternalism was deeply ingrained in people’s consciousness, attitudes and habits. The other socialist systems also promised a great deal, but in reality gave people very little. The examples of Romania, Albania or even the Soviet Union may be considered here. In Hungary however, in a strange way, paternalism played a greater part in upholding and maintaining legitimacy of the system than elsewhere. On the one hand this legalised the system to some extent, and on the other, by means of real and not just promised benefits it was more authentic, and became better incorporated into public consciousness. The attitude of hunting for allowances became established in connection with the state.

Similarly, it also became established in Hungary that the market itself is just a popular game, a kind of “monopoly”, where the rules need not be taken seriously. In reality, on the so-called market, what was at stake was obtaining a share in state properties, but there was no great risk for the loser either, as the state would take care of everyone in one way or another. This soft character became the fixed idea with regard to the market, and the risks of the true market following the change of regime produced serious rejection and animosity in the face of this institution in broad strata of the populace. The various forms of paternalism and the false sense of security had a lasting effect on the consciousness of several generations. Naturally, this did not pass away with the historical turnaround of 1990.

The continuity was not just manifest in this, but also in the survival and endurance of the highly extensive bureaucracy due to the indirect centralisation of market socialism. The powerful continuity and the remaining in office of the former bureaucracy is a distinctive feature in the transformation of Hungary in comparison with the other countries of the region.

The decades of the overweight state with a large bureaucracy, and the paternalist, state-dependent attitude took root very deeply in generations of the Hungarian population, even in those who executed and fashioned the change of the regime in the nineties.

Hungarian "new" capitalism in broader perspective

In Hungary the market and the institutional system necessary for operation of a mixed economy was domesticated relatively soon after 1990. Privatisation was progressing, significant foreign capital was flowing into the country, and everything was apparently in place for rapid and efficient economic growth to occur, enjoying the advantages of the change of regime. After all, the history of the 20th century had proven that the modern capitalist economy is much more efficient that the centralised planned economy. In the countries of Central-Eastern Europe, all this was coupled with the establishment of the democratic political system (Kornai, 2008.). Following the initial successes, just when the transformation was largely over by the first decade of the new millennium, instead of the expected upswing Hungary displayed an increasingly worse performance, gradually lagging behind not only the developed world, but also its "fellow-sufferers", the other former socialist countries. The onetime leader had been pushed to the end of the line.

Reasons of this paradox phenomenon partly rooted in the earlier mentioned Hungarian type socialism. But after 20 years this is not enough explanation itself, we have to exam these last 2 decades as well. We can learn more, if we look Hungary in international comparison, mainly with the "colleagues", with the other former socialist countries. There are many common features, but more and more special way has rised up, mainly after the millennia. (Bohle-Greskovits, 2007)

The socialist period of Central-Eastern Europe spanned four decades and two generations. At the time of the change of regime the great majority of the active population and the bulk of those carrying out the changes had been socialised in the centralised planned economy system, where there is a sharp contrast between the level of the formal and informal institutions, but the influence is not at all just in one direction. Not only is the operation of the institutions introduced from outside modified by the attitude and approach of the population, but the latter is also constantly shaped by the socialist set-up.

The break-up of the Soviet Union also "liberated" Central-Eastern Europe, where a further change of regime commenced with tempestuous speed. It is true that this now opened the door to the mainstream of world economic development, and in contrast to the situation after the Second World War, the adoption of a successful model was on the agenda. The constant challenge of many centuries was once again on the agenda: to catch up with the most highly developed states of the continent and the world. The "conceitedness" of the centralised planned economy (Hayek, 1988) was swept away by the storm of the historical change of regime, but it is as if the states of the region and their expert consultants fell into somewhat similar illusions. Now it is not the socialist system which must be built deliberately, with centralised control, but the market economy, the modern mixed economy.

The situation was contradictory, after all, over the four decades of communism these countries had dropped out of the mainstream of development and lagged behind the majority of the world in many ways. There was no other option than rapid building of the market as directed by the state; the "visible hand" fashioned the "invisible hand" indispensable for the new system. This accelerated development, in contrast to the historical route, led from the state to the market here rather than the other way round. On the one hand the state had to build the market institutions, on the other, it had to deconstruct its previous dominance, its almost exclusive economic authority. To demolish and transform itself, and construct its own antithesis, is no everyday challenge.

Besides this, something had to be established in the region which had never existed here; this system evolved in its modern form elsewhere, and it had to be replanted here. A "living" organism had to be created by inorganic, radical intervention, which would later be capable of organic advancement. The heightened role of the state in the change of regime was not completely new in the region, after all, it was also perceptible in the transformation from feudalism to capitalism and industrialisation, particularly in the eastern centre of the region and on its edge (Gerschenkron, 1962, Berend-Ránki, 1974). In the second, socialist transformation, of course, state control was self evident and exclusive. The clarity of the situation helped to determine the pattern to be followed, and in truth, taking more or less similar steps, within a short time the countries of the region had established the framework of the new system and the most important institutions, and the importance and role of the state had been driven back or transformed.

Beside the institutions at the macro-level, micro-level transformation was also an important step: establishment of the modern corporate sphere. The institution building by the state provided a framework for this, but it could not have implemented it by itself. The truly significant breakthrough here was represented by the adoption and inrush of foreign patterns, in which a key role was played at the regional level by a significant influx of capital. This is really no novelty in the region, as at the end of the 19th century, beginning of the 20th, foreign capital also played a prominent role in the first capitalist transformation. At the present time the most successful players in the competitive sector are in foreign hands, as is the bulk of the banking sector. At the same time a significant proportion of enterprises with domestic capital today are unable to compete on the international markets; a kind of dual corporate structure has come into being.

Three changes of regime within a century, induced from outside, provide a common lesson in one way. Transformation and reform of formal institutions is much easier than retailoring the informal institutions, customs, conventions and traditions interlacing the society and the economy, and adjusting to the new forms. In fact, it is very often these deeply influential traditions and means of behaviour which modify the newly established institutions. As Hayek wrote in the foreword to the American edition of the Road to Serfdom: "the political ideals of a people and its attitude toward authority are as much the effect as the cause of the political institutions under which it lives." (Hayek, 2007, 48)

Socialism was born in Russia, in the midst of a historical dilemma in many ways. After the Second World War this model, the "uniform" of classical socialism was pulled over countries with very different traditions and stages of development, from Mongolia to Poland, from Albania to Hungary (Kornai, 1992). The "clothes" may have been the same, but they were worn and tolerated differently by the various societies, and this rebounded on the quality and formation of socialism in the individual countries. The more developed an affected country was, the more the effects of the earlier bourgeois mentality came to the fore, and the stronger was the contrast between the levels of the formal and the informal institutions. This is why the explosions of various kinds occurred in the most developed members in the fifties. The socialist model is much more suitable, at least for a time, for the quantitative development of countries at a low developmental stage, than for the operation of moderately developed economies. Expressed another way, there is a much greater loss of efficiency resulting from the non-market system in this latter case. An increase in the relative shortfall compared with the market economies occurred specifically as a result of these losses.

Alongside much that was identical, therefore, the socialist countries also differed in many ways. One of the main reasons for this is rooted in the fact that when the change of regime occurred after the Second World War, the conventions, cultures and traditions of the Central-Eastern European countries were very divergent. Citizens who had been socialised under the earlier system had "built", fashioned, formed and of course endured the new system for decades. By the time the generations born into socialism were entering adult life in the seventies and eighties, the system was already approaching its end. More apparent aspects of the differences between the countries were, for instance, the appearance of market socialism in Hungary and Poland, and the short-lived experiment of Prague Spring in 1968.

Problems with the system appeared more sharply and more perceptibly in the western area of the eastern bloc, in the more developed countries, and in order to handle these, they had to "sacrifice" more resources than the less developed members. The way to do this, essentially due to the nature of the system, was primarily to raise the level of communal consumption, and to a lesser extent increase personal consumption. Certain possibilities for change-over presented themselves to the leaders of the system, from the application of the violent instruments of dictatorship to the increase of consumption. The Soviet Union, or for instance Romania, leaned generally towards the first pole, but this was much more difficult to apply in the more civilised countries. Partly due to the more democratic traditions, and partly because of the nearness of the west, the example of the standard of living there being perceptible in spite of closed borders.

As Yevgeni Preobrazhensky had already sketched out in the 1920s, alarmingly but with haunting foresight, the centralised planned economies (Preobrazhensky, 1926), regrouped all resources into forced industrialisation, and in this a decisive role was played by keeping wages low and the accumulation rate extremely high. At the beginning, this could be represented as a temporary sacrifice made for future abundance, "don't eat the goose that lays the golden egg", but not for ever. There was no way abundance was coming. The real situation was masked by that bogus illusion, that wages are low because the state will take care of all needs, free of charge, such as education, medication, pensions, recreation, etc.. The ideology of paternalism, mainly at the beginning, served the purpose of things being taken away from the population on the whole, rather than given to them.

In the less developed states applying a more severe dictatorship, this remained characteristic throughout the whole period of the system. At the time of the change of regime in the nineties, the socialist state was presented as the cause of oppression and deprivation. In the more developed region, naturally to varying degrees here too, the state redistributed more back to the population in the form of social benefits, and at the time of the changes this was fixed in their consciousness as a state role to be retained. Beyond this is fact, many long term promises were made on maintaining the socialist state in the future. In general, however, even in these countries the importance of consumption as a whole was low, in particular personal consumption. From the other side, of course, the efficiency of the economies was of a very poor standard, as became clear at lightning speed from the market trial performed by means of liberalisation in the nineties. As a result, the redistribution affecting the population at varying levels, and the fixing of this in the expectations of the people, created differing situations in terms of what was expected from the state in the individual economies in transition. Though important in terms of our subject, a stronger or weaker paternal attitude is of course just one consequence of the differing developmental routes taken by the counties.

Looking in the longer term at the development in the region, fragmented as it is by external shocks, a kind of interactive, dual spiral can be considered. Generations living in a given system are borne by a current which is partially determined by the framework of characteristic institutions, but also strongly influenced by traditions and conventions carried forward and inherited from earlier times. The formal institutions influence people's concepts and actions, but at the same time, the people also fashion their own institutions and their operation. If this occurs as long-term, organic evolution, then there is time for the two spheres to develop harmoniously. Over the period of the last hundred years in Central-Eastern Europe, this was not the case. At the end of the 19th century, the forms of behaviour, traditions and expectations established over the previous centuries found themselves relatively rapidly in a strange formal institutional system which had come from outside. A hard struggle by a succession of generations was needed in order to adapt, but in the meantime capitalism became something essentially different from in the leading model countries. Modernisation of the region was burdened with feudal elements even in the 20th century. A peculiar fragmentation of the dual spiral was also caused by the collapse of empires in the First World War, which involved the formation of new national boundaries. This had a significant effect not only on the formal institutions, but also on the informal. New national states came into being, old empires and national communities disintegrated.

In this situation, following a further world conflagration, the second change of regime occurred, totally inflicted from outside: the rapid and violent introduction of socialism. Conventions and behaviours in sharp contradistinction to the semi-feudal, semi-bourgeois traditions once again adapted over generations of suffering to the new system, but meanwhile they also modified it, in somewhat differing ways according to region and country. Of course, this also rebounded on these same generations, but more especially on the younger age-groups. By the time the generations growing up under the latest system could take on an active, formative role, a further change of regime had swept through the region.

Copying and domesticating the mixed economy model established by lengthy organic evolution in the developed countries became the common, but also individual task for the countries of the region. For the most part, implementation fell upon the generations socialised under the socialist system. The new system was born 20 years ago, but its children have not yet appeared on the scene, nor could they. In the coming decades they will, but these are still before us. Interestingly enough, in parallel with the new change of regime, the map of the region was once again significantly redrawn. The establishment of new states overshadowed the picture, which naturally signifies formal institutional changes, but it has at least as much effect at the deeper level of informal institutions.

A result of the dual spiral outlined above, is that by the first decade of the millennium the characteristics of the former socialist countries are increasingly diverging from one another. It also follows from this that the model is not working at all as described in the textbooks of the western model countries, or as many had expected when the change of regime occurred (Kolodko, 2002). Both the characteristics of the earlier socialism, and the more distant historical past which can be caught in the act within it, had and have an effect on the economic and social systems now established in Eastern and Central Europe. The chief vehicle is the informal institutional system, forming very slowly and under the influence of many factors, the current of customs, traditions, values, unwritten rules, beliefs and myths passed down from generation to generation, and the dynamic interaction of these with the formal institutions. A very significant part of all this is what type and character of state and what kind of market was formed in the mixed economies established from above and by external influences after the nineties, and how the relationship between these was established. And it is particularly important how the institutions are linked with the concepts, expectations, customs and traditions of the generations who live in them, considering that three changes of regime have occurred in the region within the lifetime of a total of 6-8 generations, and a number of state boundaries were changed twice in the 20th century.

Institution building in the nineties

Half full or half empty?

Through a series of great hopes, endeavours and mistakes, the foundations of the new economy were laid in most countries during the first decade, a majority of private ownership was established, the institutions of market economy were organised and in the fortunate countries all this was accompanied by the introduction of democracy. Institution building, partially at the suggestion of international institutions and consultants and partially in a spontaneous way, was based far more on the adoption of forms already established in the developed countries, rather than on their own, scarcely existent traditions, or on internal evolutionary forms. “Time’s Arrow” (Hayek, 1988, 151) played a significant role here; Hayek thus referred to the adoption of institutions formed in an evolutionary way elsewhere. This can be “time’s arrow” as it accelerates development, but at the same time the dangers of “organ transplant” can arise, in which the foreign environment may reject the institution obtained from elsewhere, or at least, it may result in dysfunctional operation. The opinion expressed by North and his co-authors in their book (North-Wallis-Weingast, 2008) essentially implies that it is more or less impossible to copy the successful institutional system of the western way.

The operation and characteristics of two institutions of key importance in the modern mixed economies, the market and the state, are investigated for the former socialist countries in this study, with particular reference to experiences in Hungary. Of course establishing here the new system is very complex process (Kornai, 2000). After two decades it can be seen more clearly what system has been established in the region, how it operates, and what its characteristics are (Csaba, 2007). In this part of the study an attempt is made to take stock of the “facts” to analyse the forms and operation of the institutions in our region. The two main institutions connected to our topic, the market and the government, and their connections. Two international databases could help us in this international comparison.

Economic freedom

The market is one of the most complex institutions, and whilst it is of informal character in many of its manifestations, formal rules and institutions are indispensable for its satisfactory operation in the modern form. In today’s mixed economies, the adequacy and quality of state, legal regulation are of key importance for operation of the markets. Precisely for this reason, evaluation of market operation may and must be approached from several angles. We must examine how free the market is, how good the rules are, and how much they help, or hinder, the fulfilment of its function. In order to analyse these areas, which are difficult to measure, I have applied the Economic Freedom of the World index (Gwartney-Lawson, 2009), long used and perfected by the Fraser Institute, which spans several decades between 1970 and 2007, and which expanded its investigation from the beginning of the nineties to include the socialist countries[2].

The Economic Freedom of the World also examines several important subterritories, or produces a complex index as a derivation of these. The main territories:

- size of government, (expenditures, taxes, enterprises) (GOVERNMENT)
- legal structure and security of property rights (RULE OF LAW)
- access to sound money (SOUND MONEY)
- freedom to trade internationally (FOREIGN TRADE)
- credit market regulation (CREDIT MARKET)
- labour market regulation (LABOUR MARKET)
- business regulation (BUSINESS)

The investigation is focused on the extent to which indispensable regulation guarantees market freedom, overall or in the most important territories. How much does it restrict or promote this freedom? Figure 1 presents the average trends in the main indices in the period between 1970 and 2007, taking into account data from 53 countries. Figure 2 shows the same averages for 121 countries for a more restricted period, between 1995 and 2007. Figure 1 shows changes in the main indices over close to four decades, with respect to more than fifty countries. The first thing worthy of attention is that the period of crisis during the seventies checked the growth of economic freedom. The reduction occurred both on the credit and money markets, with a relatively high degree of freedom, and for the indices characteristic of the governmental and legal environment. Trends in the money and credit market are typical of a boom to a significant extent, whereas the other two areas indicate that more powerful state intervention than formerly has occurred in the crisis. The fallback and stagnation of economic freedom lasted right up till the second half of the eighties, and in the nineties it once again attained the level of two decades before. The turnaround occurred first of all in the credit and money markets. The upward trend begins here in the eighties, but here too, it is only in the nineties that the level of the early seventies is attained.

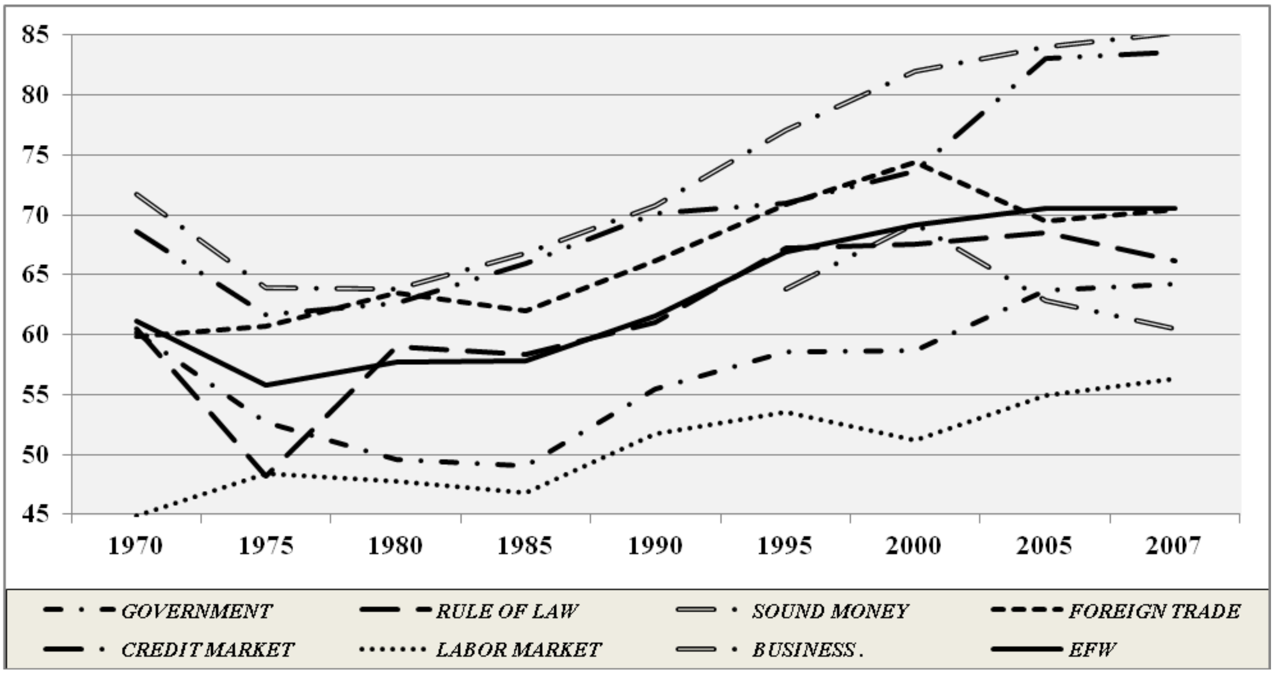
The nineties arrive with a decade of raised hopes, quiet growth and expanding globalisation. Freedom of the markets is growing, besides the money markets and foreign trade the bonds of the labour market have also been loosed, but restraints on the government and the legal system have also eased. It is further observable, however, that economic

[2] The index displays the values on a scale of 0 to 10. 10 signifies total freedom. Here in the study the indices have been transformed into values between 0 and 100, (multiplying the original value by ten), for the sake of easier comparison with the rest of the data under investigation.

freedom is relatively greater in the money and credit markets, and in the area of foreign trade, and this is served less by the role of the government, and the labour market is traditionally stiff and inflexible. These deviations appear particularly strikingly in the developed countries of Europe. This ranking according to order of magnitude is also similar in the leading overseas economies, but there, a greater economic freedom may be observed overall, and particularly in the areas of government and the labour market.

Figure 1.

Average values of the Indexes of the Economic Freedom between 1970 and 2007 (53 countries)

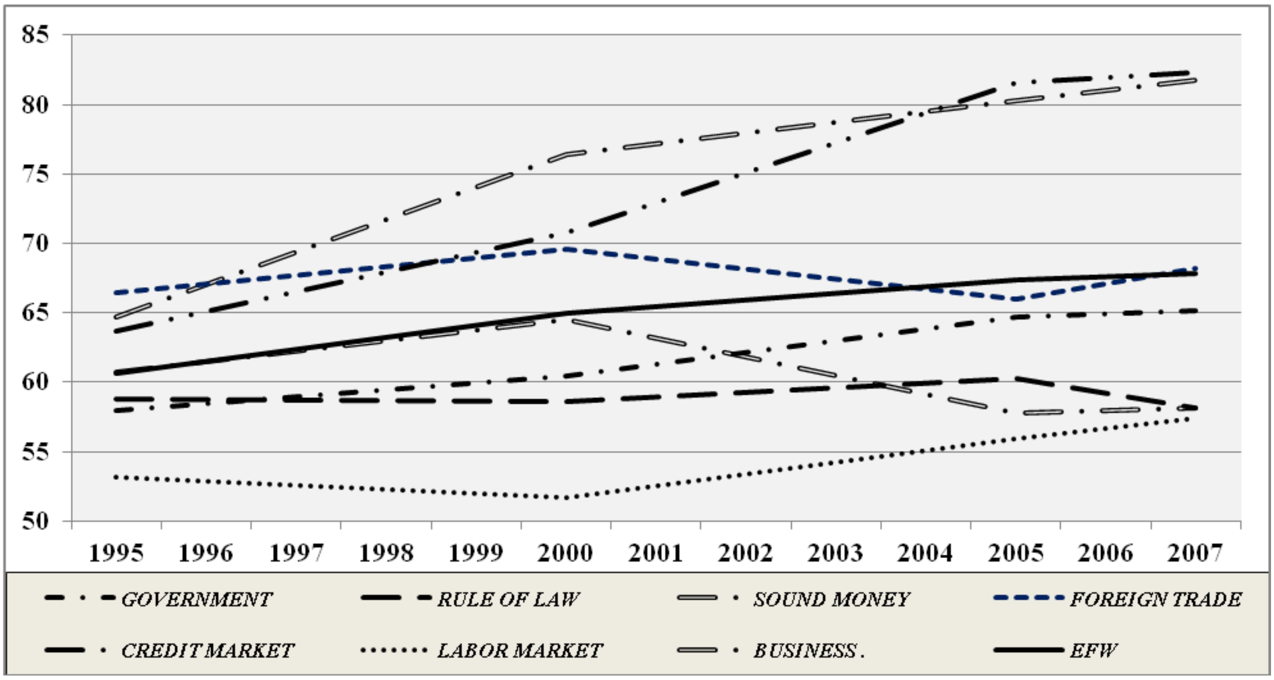


Source: Gwartney-Lawson, 2009

The final years of the nineties and the turn of the millennium mark another turnaround. Growth of economic freedom slows down, particularly in the areas of the labour market and the government. Freedom in foreign trade is restricted in the decelerating world economy after 2000, and business opportunities worsen. Interestingly, and even then as a warning sign, the greatest growth in freedom occurs in the credit markets after a more moderate rise in the nineties, and together with this, freedom of the money markets is also very high. A kind of global “runaway” in the money and credit sphere was perceptible even before the crisis of 2007/2008.

Figure 2.

Average values of the Indexes of the Economic Freedom between 1995 and 2007 (121 countries)



Source: Gwartney-Lawson, 2009

The changes occurring from the mid-nineties can be examined on a broader national pattern, as data from more countries are available from that time. In Figure 2, trends in the indices can be seen with respect to various areas of economic freedom, now extending to 121 countries. This considerably larger sample draws a broader sphere of less-developed countries into range. The main tendencies show a similar pattern to the previous sample. A striking change can be observed after the turn of the millennium: alongside the rising freedom of the money and credit markets, the freedom in foreign trade is reduced and the business freedom index worsens. A small scale improvement is perhaps perceived after 2005, but as we know, this period was the calm before the storm, as the storm of the financial and economic crisis has by now thoroughly rearranged the picture. After the turn of the millennium, therefore, the economic standstill can be felt in the real economy, but not at all in the area of the financial and credit sphere, indeed, the opposite tendency is more perceptible there.

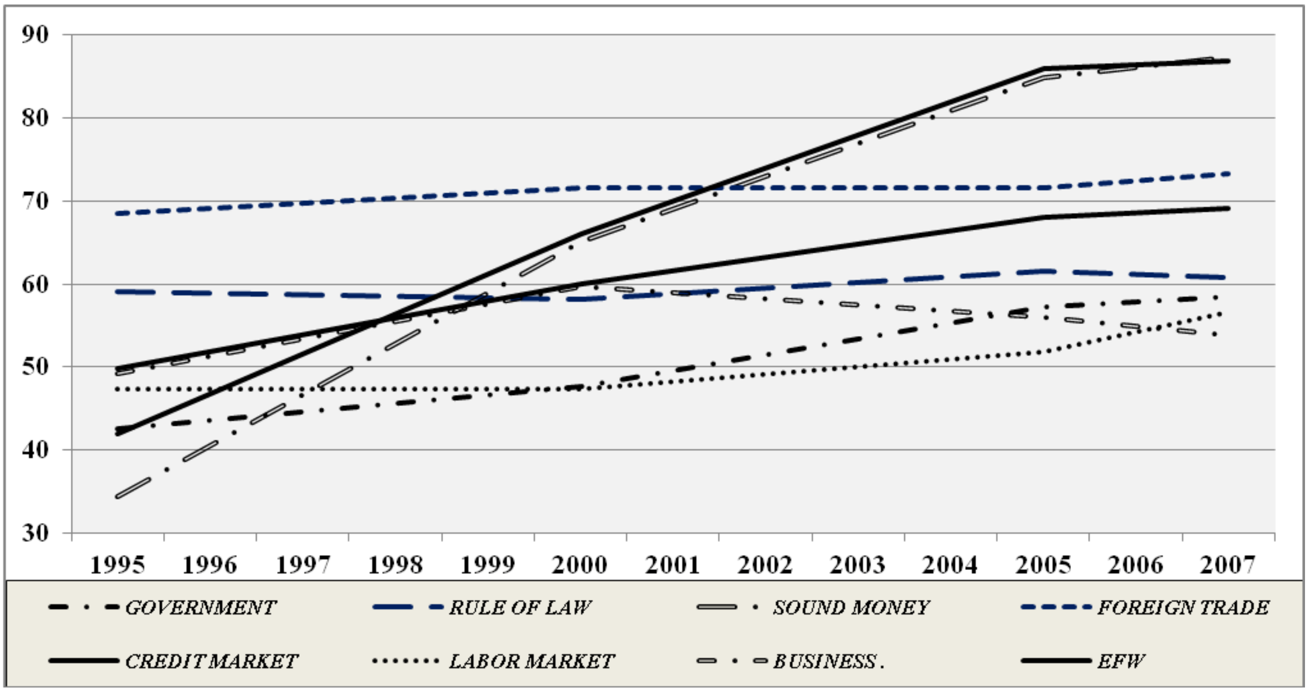
In terms of our subject it is particularly important to see how the various elements of market freedom developed in the former socialist countries during the period of transformation and institution building, which occurred incredibly rapidly from a historical perspective. Figure 3 shows the trends in the economic freedom indices in the period between

1995 and 2007 for 15 widely differing former socialist countries[3]. These countries, with very different historical, developmental and cultural features, were facing similar challenges during this period, to build the market and establish the basic institutions of a mixed economy.

Figure 3.

Average values of the Indexes of the Economic Freedom between 1995 and 2007

(15 former socialist countries)



Source: Gwartney-Lawson, 2009

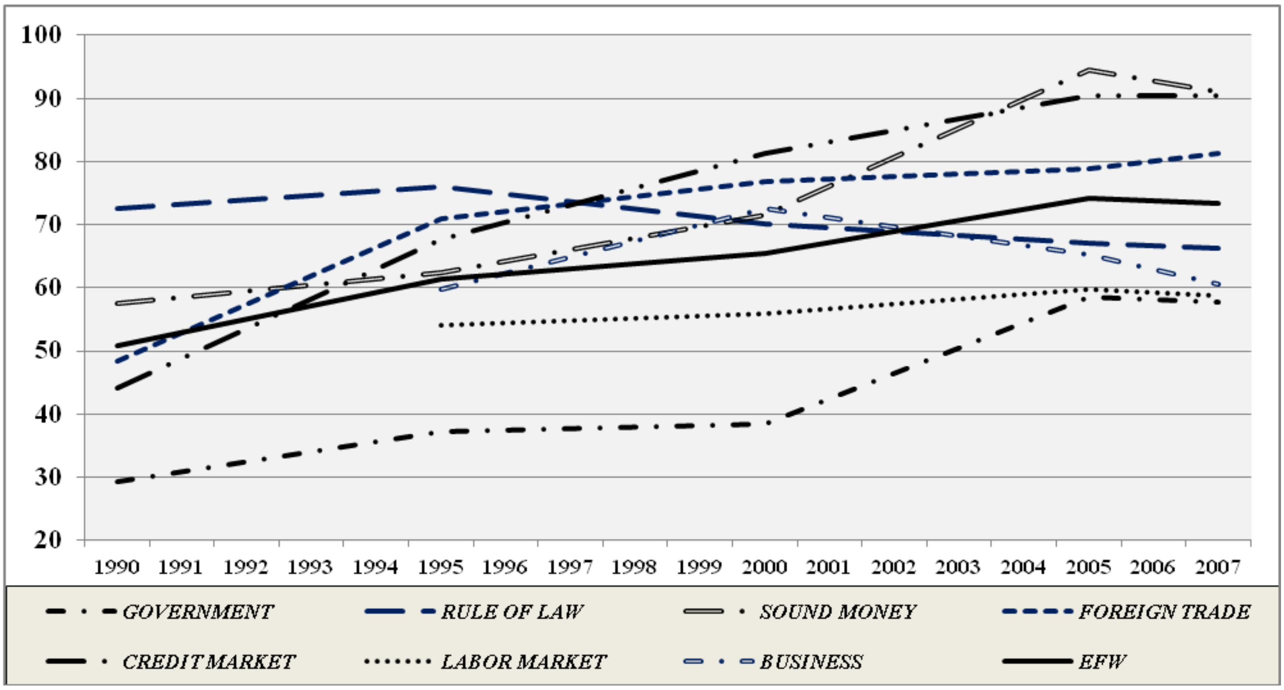
The most dynamic, even tempestuous changes for the economies under transformation are shown by the freedom index of the money and credit market. From a 30-40 percent value, in a decade they attained values close to 90 percent of that of the developed European economies, in fact, the Baltic States even exceeded this. Foreign trade and the legal system remain largely on the same level in this period, the freedom of the labour market and the government index climb slowly. Business freedom rises until the turn of the millennium and afterwards slowly decreases, similarly to the developed countries. The aggregate freedom index does in fact rise, but a deciding factor in this is a jump in the increase in freedom of the credit and money market. In truth the change between 1995 and 2007 is surprisingly small, if the credit and money market indices are disregarded.

[3] The Visegrad Group, with Slovenia also listed here, the Baltic States, in the southern group Croatia, Romania, Bulgaria, Albania and two CIS countries, Russia and Ukraine, as well as China.

Of the individual groups of economies in transformation, the economic freedom index is largest for the Baltic States, almost identical to that of the developed European countries. The state is also the freest here, distancing itself perhaps excessively from economic issues, though the price for this was paid in the crisis. (László Csaba, 2009) The Visegrad Group comes next, in this study including Slovenia, which is similar in many ways. The southern states come next, with China and Russia at the end. It can be stated, therefore, that the most developed groups of the former socialist countries, the Baltic States and the Visegrad Group, in respect of the economic freedom index had largely fallen into line with the developed European economies by the middle of the first decade of the third millennium. The development of Hungary also fits in with this trend, as can be sensed from Figure 4.

Figure 4.

Indexes of the Economic Freedom in Hungary between 1990 and 2007



Source: Gwartney-Lawson, 2009

The average index of economic freedom rose continuously in Hungary between 1990 and 2007, but here too the money market and the credit market is the decisive driving force, in particular between 1990 and 1995, as well as between 2000 and 2005. It appears peculiar, however, that the freedom index for the legal requirements system has been falling since 1995. Remission of the business freedom index after 2000, on the other hand, follows international tendencies. The government index is very low in the nineties, though this improved somewhat in the decade from 2000. 2005 shows a break in the case of Hungary, growth of almost all the indices came to a halt.

The forms of the market institutions, with emphasis on the word forms, were more or less established in the Visegrad and Baltic States. According to experience, however, these did not operate anywhere near as well as in the developed countries. It is worth taking a good look at the quality of operation, in order to obtain a more subtle picture of the transformation process.

Good governance

The international study examining the expansion of economic freedom as analysed in the previous section primarily compares the formation and developmental state of the institutional frameworks. More information on the nature and quality of their operation can be obtained from the World Bank Worldwide Governance Indicators (WGI) project, which has already extended its survey to 212 countries (Kaufmann – Kraay – Mastruzzi, 2009). Those who produced the material have summarised their approach as follows: “We define governance broadly as the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them.” (Kaufmann – Kraay – Mastruzzi, 2009, p. 5)

The six dimensions of governance that they measure corresponding to their definition are:

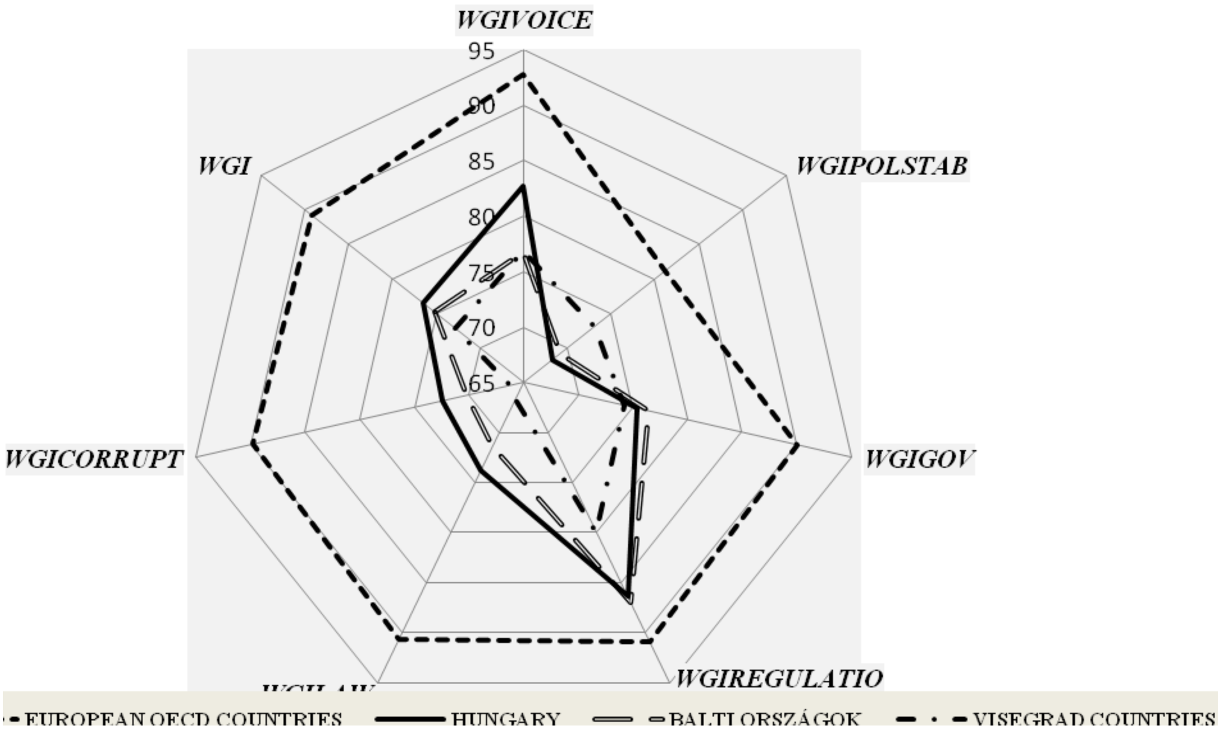
- Voice and Accountability (WGIVOICE)
- Political Stability and Absence of Violence (WGIPOLSTAB)
- Government Effectiveness (WGIGOV)
- Regulatory Quality (WGIREGULATION)
- Rule of Law (WGILAW)
- Control of Corruption (WGICORRUPT)

As can be seen, the study attempts to grasp the correct operation of the institutions in these six dimensions[4]. Data from this study with respect to 2007 are presented in Figure 5 for a number of country groups and for Hungary.

It can be clearly perceived from Figure 5 that compared with the developed European market economies, even the most developed countries in transition are lagging behind to a much more significant extent than in the case of the economic freedom indices examined above. The Visegrad and the Baltic States are on a closely similar level, but a much larger divergence is seen for the rest of the former socialist countries. This indicates that though the institutional forms may be similar in many ways to those in the model countries, the efficiency and quality of their operation lag significantly behind.

Figure 5.

Indexes of the World Governance Indicators – 2007



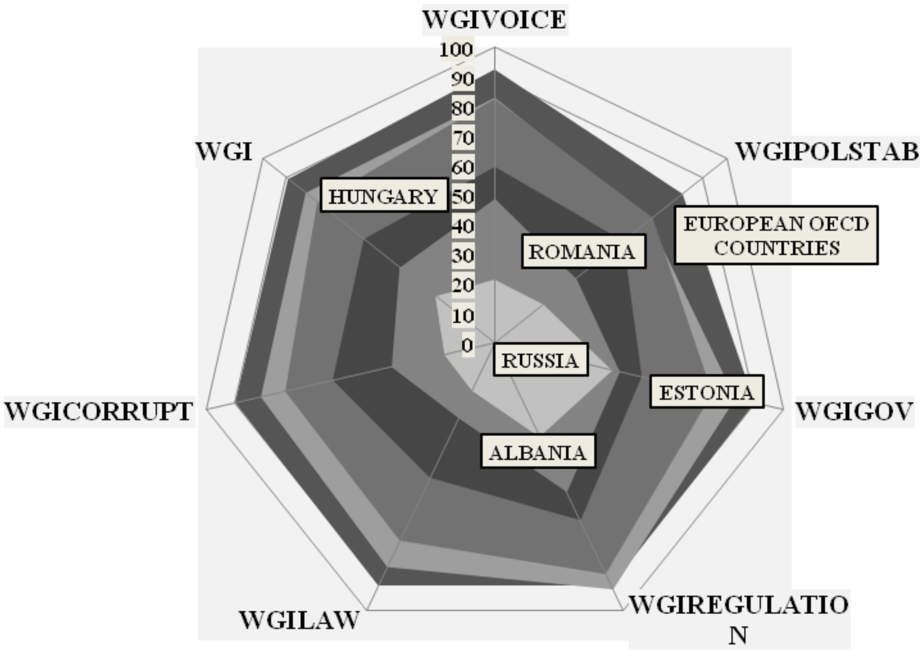
Source: Kaufmann – Kraay – Mastruzzi, 2009

[4] A methodological description of the World Governance Indicators may be found in: Kaufmann – Kraay – Mastruzzi, 2009. In the individual areas, the indices show the ranking of the individual countries by percentage. In contrast to the Economic Freedom of the World test, experts of the World Bank do not use a single, totalised WGI index, aggregated from the six indices, taking into account the differences between the areas, which are clearly very diverse in character. In this study I regard the average of the 6 aggregated indices as the WGI index, but I also place more emphasis on the individual territories.

The WGI indices for one country from each of the groups of former socialist states mentioned above are shown in Figure 6. Of these, Hungary and Estonia lie closest to the developed European countries, Russia and Albania the furthest away, and Romania occupies an intermediate position. In general, the divergence is smaller in the indices for regulation and democratic forms, and is the largest in the area of corruption and the rule of law.

Figure 6.

Indexes of the World Governance Indicators in some former socialist countries – 2007

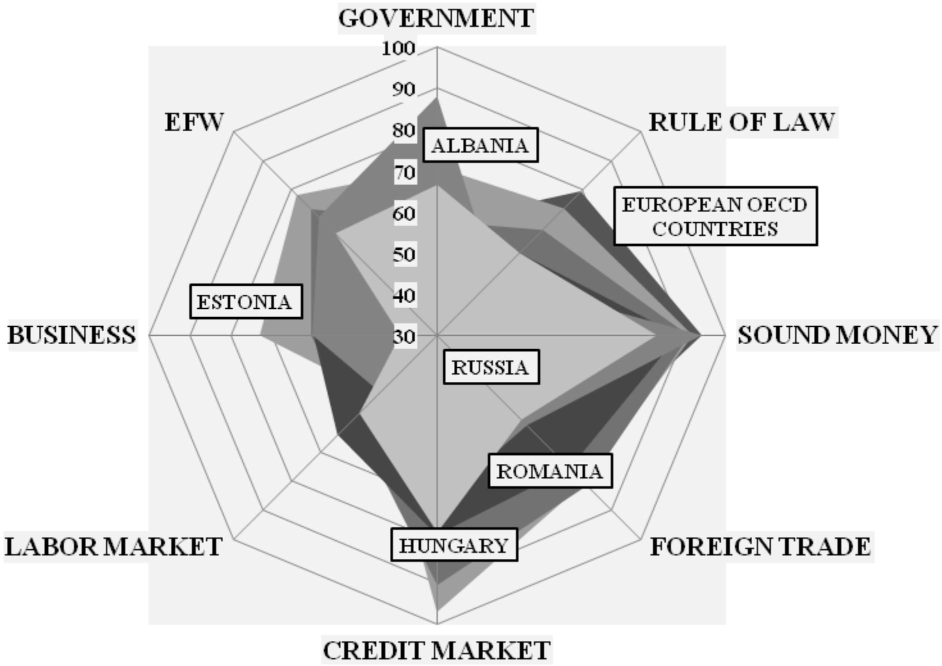


Source: Kaufmann – Kraay – Mastruzzi, 2009

The values of the Economic Freedom of the World index with respect to 2007 are shown in Figure 7 for these same countries. A comparison of the two figures speaks for itself. In contrast to the WGI indices, the EFW indices of the countries under investigation are much closer to one another, and it is not at all certain that the economic freedom measured here is greater in a more developed country. The government, for instance, is the freest in Albania, the labour market in Romania, the business sphere and credit market in Estonia, though in fact everything is very free everywhere, just like the money market. In the developed Western European countries, on the other hand, the rule of law is higher than in the former socialist states featured here.

Figure 7.

Indexes of the Economic Freedom in some former socialist countries - 2007



Source: Gwartney-Lawson, 2009

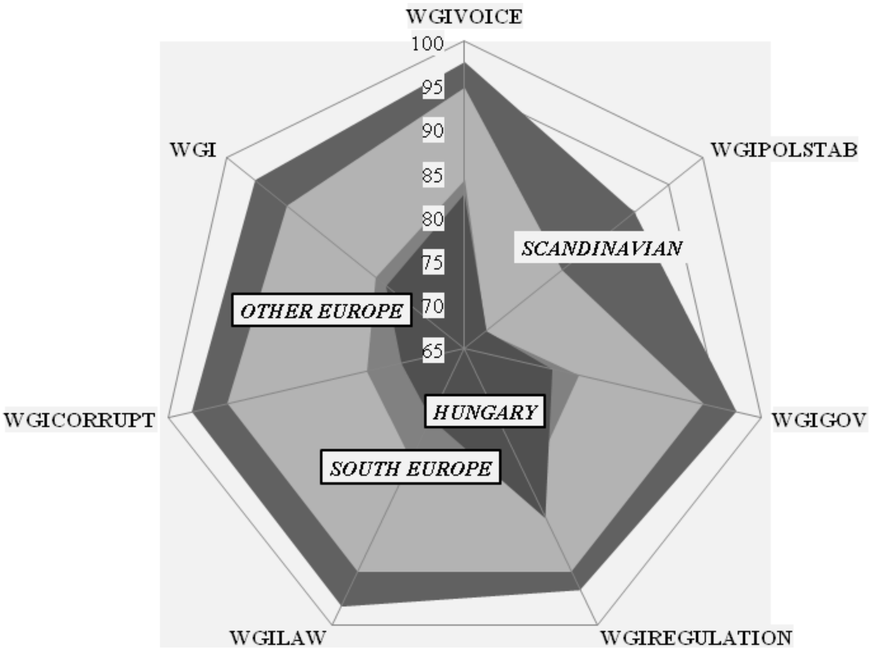
It can be experienced from a comparison of the two extended international studies, and by taking broader contexts into account, that the international expansion of institutional forms may be rapid, but at the same time this does not mean that after their adoption and domestication they will work in a similar way to where they have been present for a long time. Good institutional operation depends on a huge number of factors, and in the developed countries many decades were needed for their evolution and for concerted operation. The WGI indices have only been available for just over a decade, but during this period the values in the developed countries have shown great stability, the ranking, index and positions of the individual countries with respect to one another have not changed much. This also indicates that the nature and quality of operation of the institutions is a result of complex factors and to a large extent is based on historic, traditional considerations, which themselves are slow to change. In the decade in question, the political stability index worsened in general in the developed countries, whilst that of regulation improved in most cases; the rest, on the other hand, display a large degree of stability.

Differing levels of quality are also found between the developed European countries with regard to operation of the institutions, as modelled by Figure 8. The highest level is observed in the Scandinavian countries, the lowest in the states of Southern Europe. The other European countries are positioned between these two extreme cases.

In spite of the fact that Hungary occupies a relatively good position among the former socialist countries in terms of the WGI survey, it does lag behind the values of the Southern European countries, apart from the case of the regulation index. The shortfall is the greatest with regard to corruption and the rule of law, in comparison with all three groups of European countries. The institutes of political democracy and market regulation, as also seen on Figure 5, are the two "strongest" territories both in Hungary and in the rest of the former socialist countries.

Figure 8.

Indexes of the World Governance Indicators in Europe and in Hungary - 2007



Source: Kaufmann – Kraay – Mastruzzi, 2009

According to the evidence of the two international studies examined, the former socialist countries established the forms of the market institutional system relatively quickly, but the operation and quality of these lagged significantly behind those of the developed countries.[5] The formation of this latter, though, is a very slow and complex process, and no

[5] In international comparative studies, the magnitude and extend of corruption is also used as a kind of gauge or "mirror" of the operation of institutions High corruption can also be a kind of index number of the low level of efficiency in operation of the state and the administration of justice. If we include these aspects, we can get very similar results as above. (Keren-Ofer, 2007).

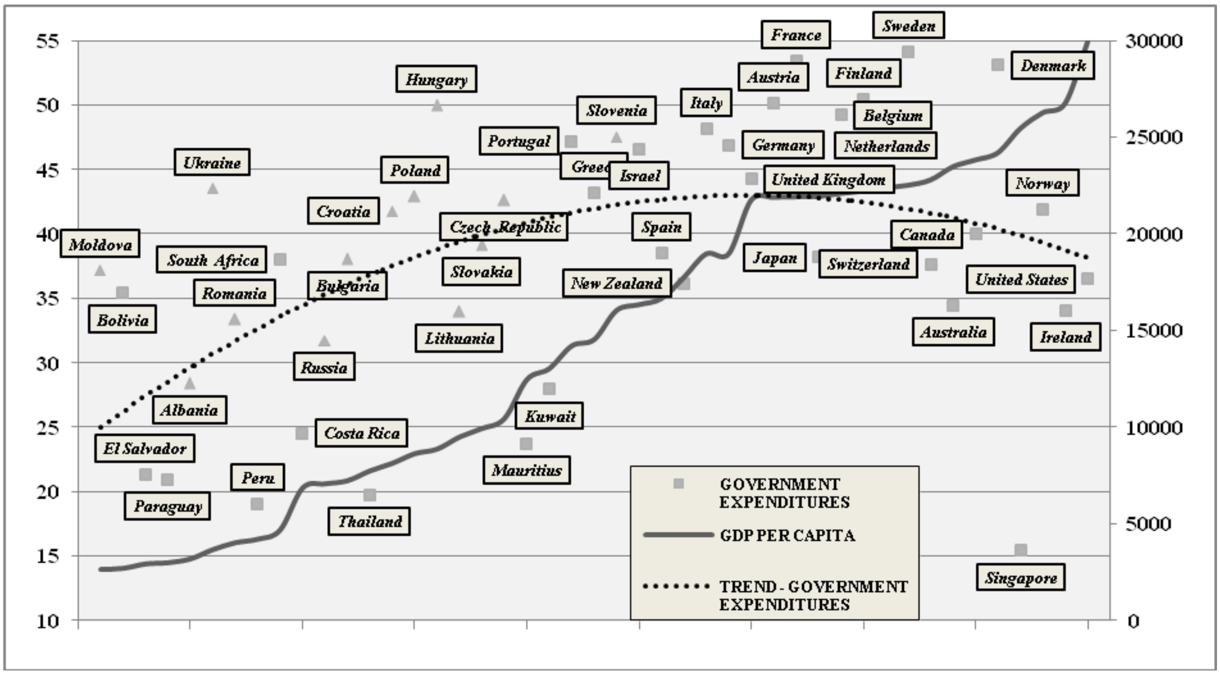
abrupt change could or did occur in this from the mid nineties. In the following, besides the market, the development of the role and operation of the other important institution, the state, is investigated separately. This is particularly important in the case of the former socialist countries, as here a centralised planned economy, a society dominated by the state, was replaced by the idea and practice of the dominant mixed economy. The main player in this transformation process in Central and Eastern Europe was, paradoxically, the totalitarian state which was to be deconstructed and transformed.

The size, freedom and efficiency of the government

The importance of the state may most frequently be estimated by its magnitude, by its size compared with the GDP. This is a very important index or characteristic, even if it clearly provides a quantitative and not qualitative approach to an estimation of the state (Tanzi-Schuknecht, 2000.). International comparisons here are of course made more difficult, in that we cannot speak of unified tendencies or unequivocal trends even in countries of the developed world; very different countries and types are encountered in this area too.

Figure 9.

General government expenditures in 45 countries in the % of GDP - 2005



Source: Government Finance Statistics, 2007, Maddison, 2003.

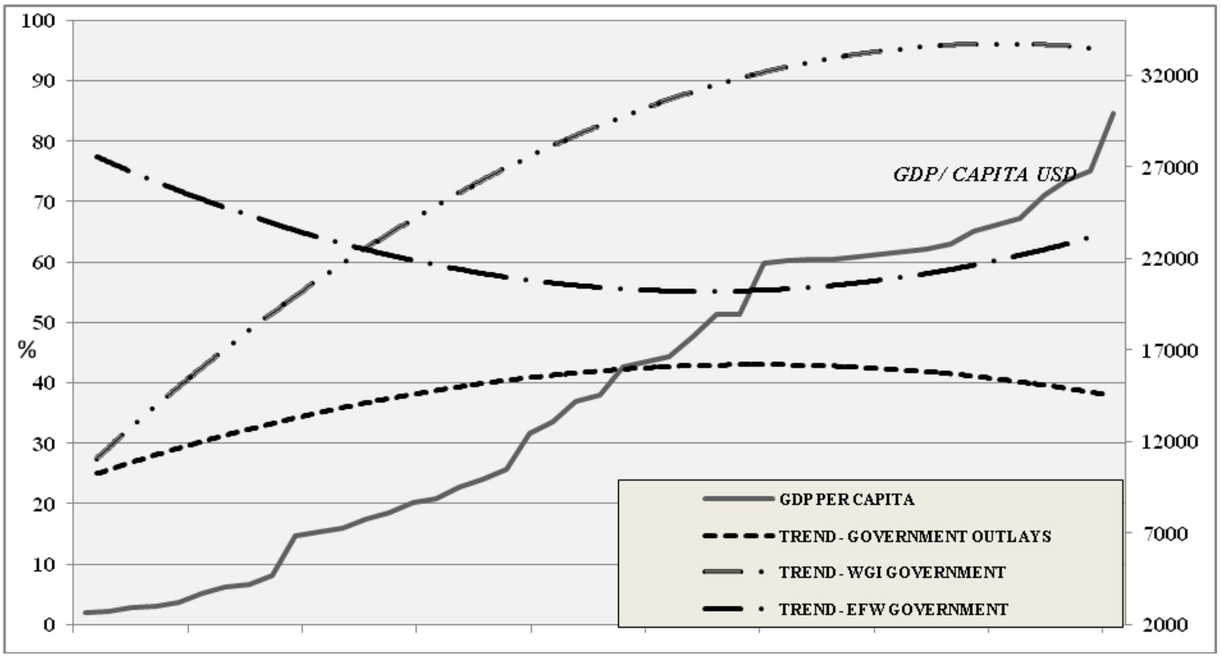
This is clearly perceived in Figure 9 too, where based on data from Government Finance Statistics, the magnitude of national expenditure in comparison with the GDP can be seen for 2005, for countries listed in increasing order according to GDP per capita. The highest value is observed for the developed states of Europe, for the leading overseas economies it is lower than this. At the higher developmental level the governmental importance is generally greater, but the scatter is very large at every level. Of the former socialist countries the value for Hungary is very high, and this is followed by Slovenia.

An important question is, how do the governments of various sizes and the general government expenditures relate to development of the economic freedom indices examined earlier, and also with the index estimating the quality of "good governance"? In Figure 10, the index with respect to the government is highlighted and presented from among all the EFW and the WGI indices, and compared with the magnitude of government expenditures. These indices are presented with the countries arranged as a function of their state of development.

Figure 10.

General government expenditures and WGI Government indexes - 2005

(45 countries)

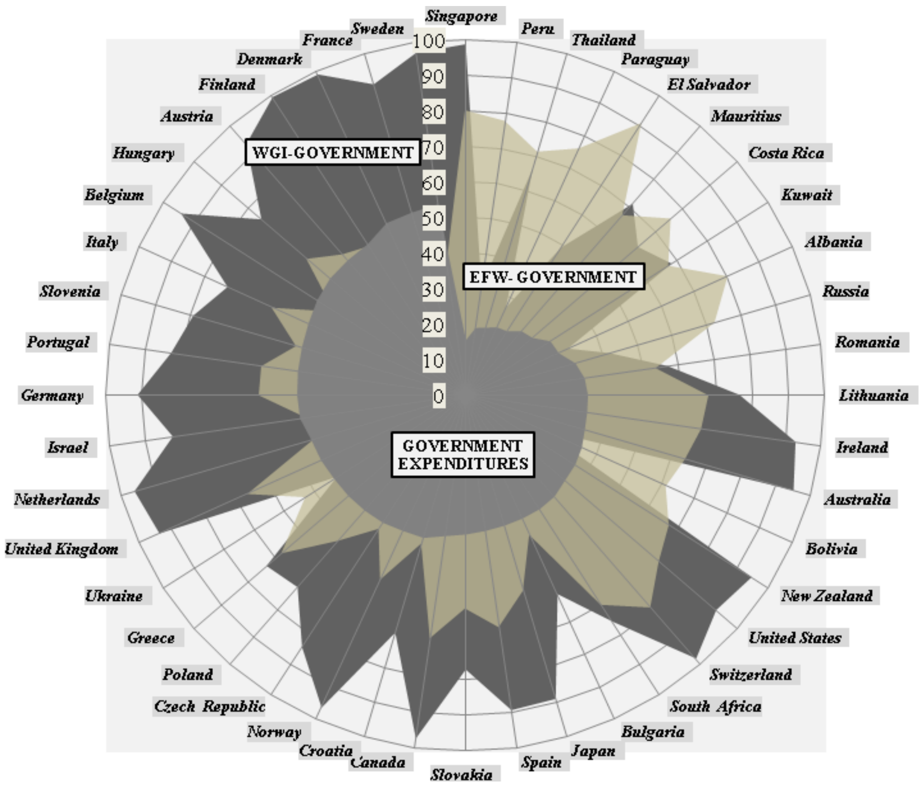


Source: Government Finance Statistics, 2007, Maddison, 2003, Gwartney-Lawson, 2009, Kaufmann – Kraay – Mastruzzi, 2009

It can be seen that a greater governmental importance generally reduces the measure of economic freedom, but, and this is a very important lesson, the quality of government does not depend on its size, but much more on the developmental state of the country's economy and institutions. There is a close correlation between the WGI index related to government and the developmental state. More detailed analyses also show that the quality of governmental activity in closely related to the level of economic development. The varying extent of the role played by the state could also involve similar effects. It is clearly perceived how many different things are meant and how many diverse concepts are covered by the frequently mentioned expressions "major" state or "strong" state. Analysis of the data for the countries show, that on the WGI scale, the most developed countries have attained such a high level in the governmental operation index that in the very highest "class" the value of every single member is similarly outstanding. This is indicated in the figure by the flattening of the WGI governmental index at the level of the highest developmental state.

Figure 11.

General government expenditures, EFW and WGI Government indexes - 2005 (45 countries)

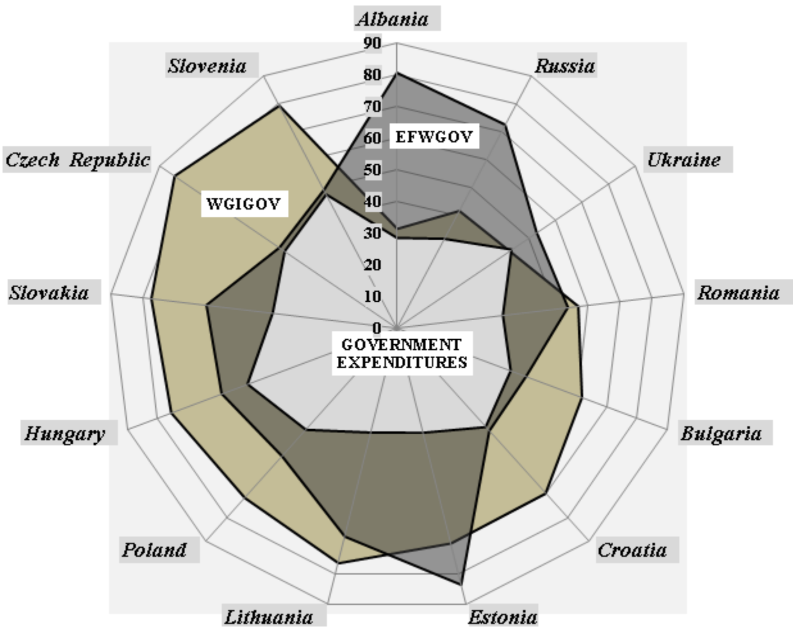


Source: Government Finance Statistics, 2007, Maddison, 2003, Gwartney-Lawson, 2009, Kaufmann – Kraay – Mastruzzi, 2009

In Figure 11, the countries are featured in order of the magnitude of general government expenditure rather than developmental state in comparison with the GDP. Also in this case it is experienced that there is no close connection between size and the WGI governmental index, the latter are scattered to a large extent, as seen on the Figure. The connection between the extent of the state and the freedom index with regard to the government is all the stronger, and not surprisingly inverted. This is a clear and close correlation; it is no coincidence that, as has been seen earlier, of the former socialist countries it is Albania which has the greatest governmental freedom, which in reality often signifies the weak and powerless effect of the role played by the state. With a chart reminiscent of a flower, Figure 11 summarises the lessons learnt so far from the comparative analyses carried out in this section. The 45 countries included in the study can be seen in the figure in the order of significance of general government expenditure, this is shown by the diagram in the middle. The governmental index of economic freedom is the next on the figure, which is larger for the smaller states, and much smaller for those with extensive general government expenditure. The outermost, irregular "flower petal" is the index estimating governmental efficiency.

Figure 12.

Government expenditures, EFW and WGI Government indexes – Former socialist countries - 2005



Source: Government Finance Statistics, 2007, Maddison, 2003, Gwartney-Lawson, 2009, Kaufmann – Kraay – Mastruzzi, 2009

We have already seen that in spite of the twenty year transformation process, the overall lag behind the developed countries is rather large. If the general government expenditure, the EFW and the WGI governmental indices are also compared in more detail in the other half of Europe, in the former socialist lands, even in the leading countries, characteristics similar to the southern group of the more developed European states are found. A similar conclusion could be reached earlier for the indices showing governmental quality on Figure 5. Values for 13 economies in transformation are presented on Figure 12.

Due to data restrictions, only these economies in transition could be analysed now, but even so, groups with differing characteristics can be outlined. 9 countries, the majority of the 13 examined, are members of the European Union, 4 are not. With regard to their developmental state, Albania is to be found at the end of the line, as well as the two successor states of the former Soviet Union, Russia and Ukraine. In these countries the value of the index measuring the quality of government is very low, besides this the magnitude of general government expenditure in Albania and Russia is low, around 30%, and the state is very "free". A small but powerless state is found here. In Ukraine, on the other hand, the general government expenditure encapsulates 43-44% of the GDP, so it sits more firmly on the economy than in the two countries mentioned previously, and allows less freedom. Its efficiency, however, is similarly low. Here a large but powerless state is seen.

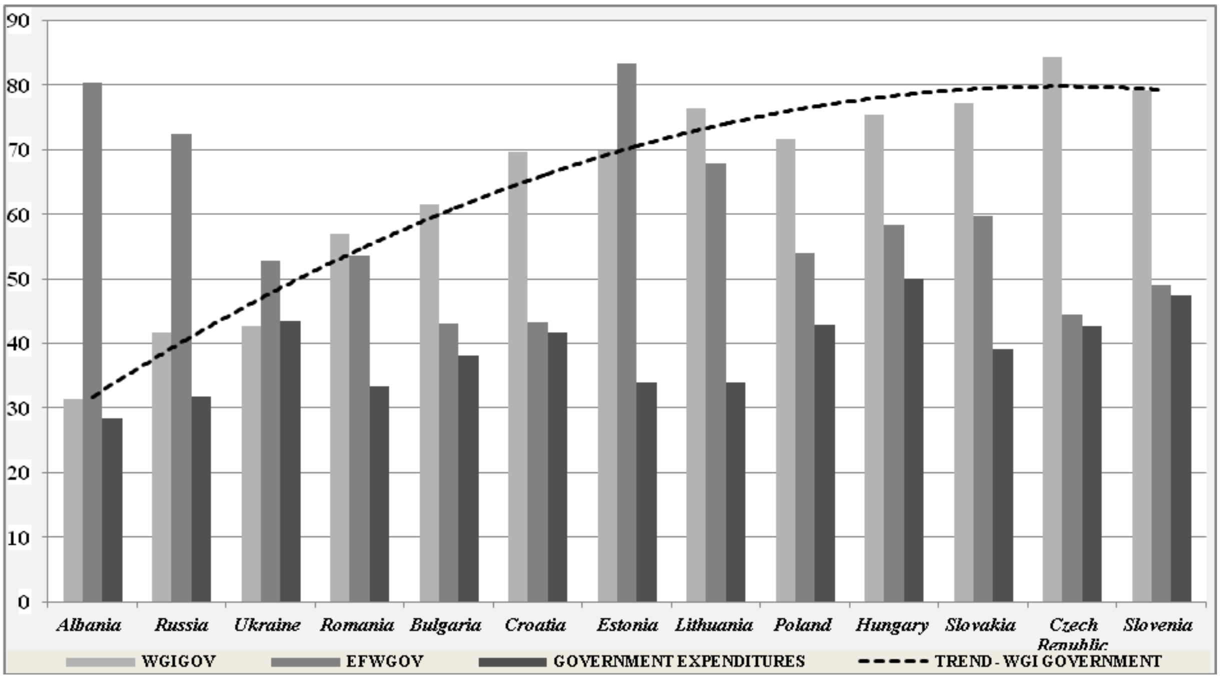
The fourth non-EU country is Croatia, though it is supposedly close to joining. According to the phenomena examined here it appears ripe for accession, as it is economically more developed and the operation of the state more efficient than in Romania or Bulgaria. Of the EU member states, the two countries which joined later, Bulgaria and Romania, are at a lower level of development than the states of the first cycle, and their governmental efficiency is also lower. The proportion of general government expenditure is somewhat higher in Bulgaria than in Romania, and the governmental freedom index here is the lowest of all the 12 countries examined. All of the Visegrad States are featured in the sample, including Slovenia too. With regard to the general government expenditures Slovakia has "left" this group, having managed to reduce the formerly high level to under 40 percent, thus approaching the Baltic States. At the same time, the governmental efficiency index is the second highest here after the Czech Republic and Slovenia, and the governmental freedom index is the largest of all the Visegrad Group. In all these characteristics, it displays similarity with the Baltic States featured here, Lithuania and Estonia. The Czech Republic, Poland, Hungary and Slovenia can be listed in the “remnant” Visegrad Group. In these the governmental efficiency index is high, but so is the magnitude of general government expenditure compared to the GDP. The governmental freedom index, however, is relatively low.

From an examination of the former socialist countries, it can be seen that by the first decade of the millennium the overweight state of the previous period has lost ground everywhere, but the magnitude is diverse even now. The general government expenditure centralisation is the highest in the Visegrad States, with values between 42 and 50%. It has fallen below 40% in Slovakia, and is around the same in Croatia. In the Baltic States it is around 35%. In the less developed countries under investigation the magnitude of general government expenditure centralisation is very scattered, 43-44% in Ukraine, and less than 30% in Albania.

Figure 13.

Government expenditures, EFW and WGI Government indexes –

Former socialist countries - 2005



Source: Government Finance Statistics, 2007, Maddison, 2003, Gwartney-Lawson, 2009, Kaufmann – Kraay – Mastruzzi, 2009

The GWI index for governmental efficiency, however, shows a close correlation with the developmental state of the countries studied, as can be seen in Figure 13. It is the highest in the Czech Republic, Slovenia and Slovakia, and the lowest in Ukraine, Russia and Albania.

The governmental freedom index shows a diversified picture. Similarly to the experiences in the broader international study, on the one hand the value is high for the largely undeveloped countries, and also for more developed economies which have a state with less weight but greater efficiency. Russia and Albania can be listed with the former, perhaps the Baltic States with the latter. Estonia has the highest EFW governmental index, greater than 80%, and Lithuania is the third highest with only Albania (!) between them. For the Baltic States, however, as indicated earlier, this could also signify a powerless state in a certain sense. (László, 2009)

The measure of the centralisation of general government expenditure is displayed on Figures 9, and here it can be seen that in Hungary this value is the highest for the economies in transition, and this is also prominent in a broader sense, in particular with respect to the moderate developmental stage of the country. Higher values are only found for the traditionally developed states of western and northern Europe. It can be perceived from Figure 11, however, that at the same time, the WGI governmental index shows a much lower efficiency than in those countries.

The values for Hungary can be compared with those of the other former socialist countries on Figures 12, with regard to the middle of the decade following the turn of the millennium. But we can find in Hungary the highest general government expenditure ratio, and the same time relatively high here the freedom of the state. But this could be the sign of the weakness.

Conclusions

Institution building occurred relatively rapidly and successfully in the region of Central-Eastern Europe, and the more developed was the country in transition, the more successful was the adoption of the institutional patterns fashioned in the developed countries, as least at far as the forms are concerned. This has been seen earlier in the international comparative study for the case of the Visegrad and Baltic States. At the same time it has also been seen, and reinforced by much additional experience, that the efficiency of operation of these institutions lags considerably behind those observed in the model states. In fact, according to our investigations, during the period from the rapid transformation in the nineties until today, after domestication of the new system, this efficiency has not improved further. It has more or less stabilised at a relatively low level, in fact, a fall is observed in certain places.

With regard to the form and framework for domestication of the institutions, Hungary was more or less similar to the other Visegrad States. The reasons must be sought elsewhere. The fashioning of the institutions of the market economy, as has been mentioned, fell upon the state in these countries; the processes were directed from here. This governing state was distinctively extensive in Hungarian, with a great many staff, and a bureaucracy which represented its own interests well. It has preserved its extended role until today.

A significant proportion of the former elite and interest groups also preserved their roles after the change of regime and in many areas also became intertwined with the state. In many respects Hungary has exemplified a state dominated by interest groups as characterised by Olson (Olson, 1982) during the period of the last two decades (Muraközy, 2008). In the other countries under transformation, the former interest groups and a significant proportion of the earlier elite were generally swept away by the change of regime, even if the transition was peaceful.

In the new political system, under democratic circumstances, the Kádár system survived strongly in that legitimation and the support of the citizens have to be "bought", so before elections those in power tried to gain votes by an increase in state benefits and expenditures, and the opposition by promises of the same. Of course, democracy in general has a tendency to election cycles, and overspending (Buchanan – Wagner, 1977) but this took on extreme forms in Hungary (Győrffy, 2007). In election years, a deficit amounting to one tenth of the GDP has been typical in the last two decades.

The intertwining power of the state, state bureaucracy, interest groups and the political elite has significantly hindered the efficient operation of the consolidating market economy, and has continuously provided a breeding ground for the perpetuation of substantial corruption. The extended state, and irresponsible politicians making promises, understandably could not change the inherent mistrust of the populace towards the state authorities, which has deep historical roots, and which attitude was just further reinforced during the Kádár period. Indeed, this tendency has continued during recent decades, and what is particularly regrettable, this is often extended to an evaluation of democracy[6].

The Hungarian population is possessed of a distinctive dual psyche. It has got used to paternalism, and expects the state to provide, but at the same time it does not trust this same institution, or its representatives, from which the care is received. It was typically like this during the last decades of the Kádár period, but it has remained, and been remanufactured in

[6] The interaction of the institutions, politics and culture really important both in short as well as long run. (Kolodko, 2009. 283-305 pp.)

the new social and economic milieu. This vicious circle is also manifest in that, the non-payment and avoidance of taxes which would provide a cover for this extended state provision, in this atmosphere is accepted and preferred by a broad section of society. Instead of following rules, the rule of law, the avoidance and infraction of these becomes determinative. The result of this situation is that the country regularly has to depend on foreign loans, and just as in the eighties, the state debt here is once again the largest in the region.

After being taken on, the market institutional system forms began to operate in a milieu like this. The intertwined spheres of the overweight state, the strong interest groups and the populist politicians settled over the operation of the market, thus deforming it. The state is the largest employer, places the most orders, makes and changes the rules, and even avoids them. The state of public procurement is a good example of this distorted situation. From the other side, however, during the years of market socialism as sketched out, the market players on the one hand got used to it as a kind of “monopoly” game, where clever manoeuvring is needed rather than accomplishment and competition. On the other hand if things get serious, the market selects, determines and differentiates, the players immediately cling onto the state.

In the midst of the formal institutions of the new system, whilst carrying deeply rooted old habits, customs and traditions, the players have fashioned these “in their own image” during recent decades. The interactive spiral of the formal and informal institutions has set Hungary on a downward track. The onetime leading country of Central-Eastern Europe is now constantly lagging behind. Changing this may be a slow and complex process, but without it there is no chance for a lasting recovery.

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