From “Slip” to Stagnation?
The Political Economy of Russian and Hungarian Transformations Compared

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Abstract

The pace of policy reform in Russia and Hungary is examined from a political economy perspective. has the pace of structural change in the economies of these two countries shifted over the course of transformation, and if so in what direction? Are certain political and economic conditions most suitable for the initiation and consolidation of reforms, and do these conditions evolve according to the type of reform being considered? Finally, can reform or failure to reform be explained by the same set of factors across both cases?

Continuities across periods play an important role, with factors that frustrated progress in the first stage of reform – a weak state in the case of Russia and the avoidance of macroeconomic stabilization in Hungary – continuing to inhibit further restructuring, although with different implications for their ultimate developmental path. This implies that a single framework can be employed to analyze systemic change in both cases and that a basic set of conditions favorable to the adoption, consolidation and implementation of market reforms can be identified.

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Introduction

Approaching the conclusion of the second decade of post-communist change, the relevance of the communist legacy for interpreting and analyzing contemporary political and economic developments in the two-dozen countries that once shared the same basic political and economic system is fading.[1] On the other hand, the fact that these countries began the process of systemic change at roughly the same time, from broadly similar starting points, makes comparing developments and outcomes inherently interesting. Surveys of post-communist change are undertaken with great frequency by independent scholars in social science disciplines, and regularly released assessments from international financial institutions such as the World Bank, the Organisation for Economic Co-operation and Development and the European Bank for Reconstruction and Development all serve to further support and spark interest in comparative research.

The defining feature of post-communist transformation has been its diversity of outcomes and the still evolving nature of those political and economic changes, which appear to reflect a mixture of path dependency, global developments and local economic and political conditions. The scope and limitations of that diversity is on display in the cases of Hungary and Russia, whose economic transition trajectories form the basis for the present research undertaking. In most important ways within the realm of post-communist states, Russia and Hungary differ. Hungary is a small state whose boundaries were not altered by the end of socialism. Hungary's basic commitment to implementing the market system has been politically uncontroversial and it has exhibited a far-reaching orientation towards the European Union. In contrast, Russia is a large former empire that faced a redrawing of boundaries and institutions at the outset of transformation, with the threat of additional

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[1] For the argument that with the passage of time, the relevance of the Communist legacy diminishes, see László Csaba, *The New Political Economy of Emerging Europe* (Budapest: Akadémiai Kiadó, 2007).

regional disintegration. The basic commitment to market order was controversial and the subject of great political tension in the early years of transformation in Russia, although a strong executive attempted to push through a market-oriented economic program nonetheless. Finally, there has been no external anchoring comparable to the European Union. In short, these countries differ in dramatic and important ways at the start of transformation that are expected to have a significant impact on their subsequent political and economic development. The limits to those differences are, as László Csaba noted in a comparative undertaking at the end of the last decade, that both countries started from the same basic set of conditions and employed at its most basic level a similar policy mix to implement the market order.[2]

As the back-story sketched above would suggest, the course of economic transformation in Russia and Hungary has indeed diverged dramatically. Hungary has been labeled a qualified success in its transformation – as judged by its accession to the European Union, its early and consistently high transition indicator scores and the confidence transnational corporations have expressed by their high levels of investment – while Russia's situation has been seen as precarious.[3] Much of this assessment is based on the extent to which a stable market order was implemented through the "first generation" mix of policies of stabilization, liberalization, institution building and privatization (the "slip" agenda).[4]

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[2] László Csaba, "A Decade of Transformation: Hungary and Russia Compared" in Andrzej Brzeski and Jan Winiecki eds. *A Liberating Economic Journey: Post-Communist Transition* (London: Cromwell, 2000), 99.

[3] Indeed, a recent attempt by a pair of professional economists to argue that Russia is a "normal" country at a middle level of development provoked controversy. See Andrei Shleifer and Daniel Treisman, "A Normal Country: Russia After Communism," *Journal of Economic Perspectives* 19,1 (2005), 151-174, and Peter T. Leeson and William N. Trumbull, "Comparing Apples: Normalcy, Russia and the Remaining Post-Socialist World," *Post-Soviet Affairs* 22,3 (2006), 225-248.

[4] Although in a strict sense the word "reform" does not accurately characterize these policies because by its dictionary definition it generally refers to changes *within* an existing system rather than change *of* system, this paper follows general usage within the economics and political economy field and will employ the term.

These changes were consolidated in Hungary by the mid-1990s and thus transition can be said to have been complete by then, with economic growth appearing from 1994 onward. In Russia, however, these similar policies implemented from 1992 to 1998 did not succeed in implementing a stable market order capable of generating economic growth until after the economy went through the shock of financial collapse. Developments since then have complicated the picture, however, with Russia experiencing high levels of growth and indications of a renewal of reform efforts in the aftermath of the financial crisis while in Hungary backsliding on the reform agenda has been in evidence, along with a recent slowdown in growth.

This research project employs a comparative approach that utilizes the literature on political economy of policy reform to determine some of the political and economic factors that have served to drive reforms forward and caused their postponement or reversal in Hungary and Russia. The main questions that will be addressed are: has the pace of structural change in the economies of these two countries shifted over the course of transformation, and if so in what direction? Are certain political and economic conditions most suitable for the initiation and consolidation of reforms, and do these conditions evolve according to the type of reform being considered? Finally, can reform or failure to reform be explained by the same set of factors across both cases?

To attempt answers to these questions, this project will unfold in the following way: a first chapter will investigate the literature on policy reform and the ways in which it has evolved over the course of the transition – including attempts to take account of surprising outcomes by employing new political economy frameworks. The subsequent three chapters form the empirical core of this undertaking. Since the post-communist transformations in Hungary and Russia proceeded within a window of two years from each other and temporal factors such as sequencing and speed of reforms have been emphasized in most of the

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literature on transition, a rough chronology of systemic change will be offered, broken into three main chapters. The first analyzes initial political and economic conditions at the outset of reform, while the next chapter examines the attempts at reform from the outset of transformation up until the Russian financial crisis in the fall of 1998, which also coincides with an election year in Hungary and a change in government. The next chapter looks at more recent developments, including the rise of Vladimir Putin and his ambitious economic reform agenda and the growth of a populist economic agenda in Hungary.

Fashioning a case study of post-communist reform in Hungary and Russia presents a number of challenges and limitations, some perhaps unavoidable. While qualitative research makes it difficult to subject hypotheses to rigorous testing, well-established problems with the availability and reliability of economic indicators at the early stages of transition and the limited number of cases available pose serious obstacles to quantitative research as well. What emerges will be a nuanced portrait of change, in which policy reform in neither case follows a steady course nor is entirely consolidated. Continuities across periods play an important role, with factors that frustrated progress in the first stage of reform – a weak state in the case of Russia and the avoidance of macroeconomic stabilization in Hungary – continuing to inhibit further restructuring, although with different implications for their ultimate developmental path. This implies that a single framework can be employed to analyze systemic change in both cases and that a basic set of conditions favorable to the adoption, consolidation and implementation of market reforms can be identified.

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Chapter 1: One Framework Fits All? The Political Economy of Policy Reform

At the start of the post-communist transformation, a near consensus on the economics of reform had emerged within the economics profession based on the "global stampede" of reform efforts undertaken by countries of diverse geographic, economic and political backgrounds in the last quarter of the 20th century.[5] No such consensus existed on the proper political conditions for the initiation and consolidation of market-oriented policies, however, and addressing this gap has been the subject of a burgeoning field of inquiry known as political economy of policy reform. The post-communist transformation has given scholars two dozen new empirical cases to analyze, and the specificities of post-communist change as well as the dramatic divergence in political and economic outcomes among these countries has provoked a process of continual reassessment of the political economy of reform.

The specific nature of post-communist transition rests in part on the scope of change that was involved, which entailed both political and economic transformation.[6] In the economic sphere, mechanisms of market coordination were introduced in economies that had been directed by the state and not merely distorted by its interventions, as in the case of many developing countries. In the political arena, a system founded on political repression gave way – in most cases – to democratic forms of governance. With the collapse of the Soviet Empire, a geographical reorientation also took place – countries in Central Europe reoriented their trade and political futures towards Western Europe and countries of the former Soviet Union (the New Independent States) grappled with how to define their political, social and cultural boundaries. Thus developing any theory of the political economy of post-communist change involves addressing a complex network of historical, institutional and political factors

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[5] John Williamson, *The Political Economy of Policy Reform* (Washington: Institute for International Economics, 1994), 3.
[6] Leszek Balcerowicz, *Socialism, Capitalism, Transformation* (Budapest: Central European University Press, 1995), 145-155.

that are linked in complex and often obscure ways that can conflict as well as compliment each other.

While the change in political system occurred rapidly in most countries even if democracy was not consolidated, a number of factors prohibited the quick implementation of economic transformation. The core set of policies that dismantle the centrally planned, socialist order, and replace it with one dominated by the market necessarily operate at different speeds. Macroeconomic stabilization – controlling inflation and correcting macroeconomic imbalances – as well as liberalization of prices and regulations in areas such as foreign trade can proceed quickly in some instances but privatization and the establishment of the institutional underpinnings of market practices and norms by their nature take time.[7] Thus the primary concern in the political economy approach to transition is to determine the political constraints that block, slow down or reverse the positive direction of transformational change.

Debates within the field of political economy of policy reform can be divided into questions of how initial political, economic and organizational factors contribute to the pace of reform, and secondly how the policies themselves can be designed to overcome political constraints. Theories have been developed to explain how initial conditions and subsequent policies impact the pace and success of transformation, and delineating the relationship between the two has been a continual goal. The ensuing analysis of systemic change in Russia and Hungary will demonstrate their complex linkages, as both initial conditions and subsequent policy choices differed dramatically between the two cases. Yet this paper will argue that the pace of reform in both cases can be explained within the same framework, even as the different policy developments increasingly pulled the two countries apart, to the point where they now face entirely different sets of economic policy considerations.

[7] Balcerowicz, *Socialism, Capitalism, Transformation*, 145.

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In terms of explaining the importance of political and economic conditions, a series of competing though not always contradictory hypotheses have emerged. Perhaps most well known of these theoretical approaches is the "crisis hypothesis" which posits a linkage between the initiation of reforms and an economic or political crisis, since such a crisis can have the power to destroy political coalitions that had blocked reform and can create the consensus on a need for change.[8] The economic and political crisis that accompanied the fall of communism fit this description, and former Polish Finance Minister Leszek Balcerowicz has developed a concept of "extraordinary politics" to capture the window of opportunity for reform opened up by the change in system.[9] Yet the divergent patterns of reform initiation among post-communist states indicate that the explanatory power of this hypothesis is limited. There are also well-known examples of reforms being initiated without an apparent crisis, and crises tend to put a premium on reforms that can be undertaken rapidly and demonstrate relatively quick results at the expense of permanent structural reforms, which can take years to implement and bring benefits in terms of economic growth only slowly.[10] Yet despite these limitations – indeed perhaps because of them – the crisis hypothesis does shed light on developments in Hungary and Russia after the end of communism. As the ensuing empirical evidence will indicate, actual and potential economic crises have played a formative role in accelerating reforms, although with a mixed legacy in terms of outcomes – in part because of the difficulties of implementing permanent structural reform measures in such conditions.

Political conditions and their impact on the initiation of reform are linked with the crisis hypothesis, since deteriorating economic conditions often lead to changes in government. New governments, with "honeymoon effects" and the ability to place blame for

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8 Williamson, *The Political Economy of Policy Reform*, 472.
9 Balcerowicz, *Socialism, Capitalism, Transformation*, 160-162.
10 Williamson, *The Political Economy of Policy Reform*, 473.

economic problems and social hardships on predecessor governments are said to be in better positions to initiate reform.[11] In terms of the structure of the political system, a focus on regime type reflecting the popular view that authoritarian governments are better suited to the initiation of economic reform gave way at the start of transformation to a focus on the benefits of a strong state with concentrated executive power that is able to delegate power over economic policy to insulated technocrats and has the administrative capacity to undertake reform.[12] This view has undergone a continual reassessment, however, as different outcomes are observed.

With respect to policies, the scholarly and policy community during the first years of post-communist transformation focused much attention on the proper speed and sequencing of market oriented reforms to ensure their success against political constraints, a debate that also shifted after the initial outcomes of post-communist change became discernable. At first discourse was dominated by questions of whether reforms should be gradual in nature or radical and fast-paced.[13] This question was tied to concerns over how to compensate reform "losers" and thus minimize ex post and ex ante resistance against reform stemming from time inconsistency (the temporal gap between when the costs and benefits of reform are felt) and collective action problems (benefits from reform were seen as dispersed while costs were concentrated in certain industries associated with socialist production).

The evidence from the initial years of transformation shifted this debate by offering the insight that those new democracies that had succeeded in implementing radical and far-

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[11] Robert H. Bates and Anne O. Krueger eds. *Political and Economic Interactions in Economic Policy Reform: Evidence from Eight Countries* (Cambridge, Mass. and Oxford: Blackwell, 1993), 124.
[12] John Williamson's concept of the "technopol" fits this description. Williamson, *The Political Economy of Policy Reform*, 11-28.
[13] Examples of either end of this debate include: Mathias Dewatripont and Gerard Roland, "The Virtues of Gradualism and the Legitimacy in the Transition to a Market Economy" *The Economic Journal* 102 (2000), 291-300, and David Lipton and Jeffrey D. Sachs, "Creating a market economy: the case of Poland" *Brookings Papers on Economic Activity* (1990), 75-147.

reaching reforms sooner had done better in terms of output recovery and GDP growth than countries that implemented only partial reforms or delayed implementation altogether.[14] Meanwhile, the course of economic reform in these countries was not substantially reversed by reform losers, even in cases where reform-oriented coalitions were voted out of office. These findings were all the more relevant because striking patterns of divergence could be observed in the first few years of transition, with Central European countries, including Hungary, emerging as leaders in terms of development indicators and NIS countries, including Russia, showing stifled economic indicators including output levels that were stuck far below their pre-crisis levels.[15] These differences were brought into stark relief with the 1998 financial collapse in Russia, which triggered a major reassessment of mainstream thought about transition.

Competing explanations for these developments had different implications for the literature on policy reform. Former World Bank Chief Economist Joseph Stiglitz has perhaps gone the furthest in his reassessment by critiquing the economic underpinnings of the policy mix advocated by international financial institutions and other external advisors who he argues did not adopt a broader goal with respect to market reforms nor aim at building support within society.[16] Although this view has not come to dominate the discipline, it has coincided with a shift to focusing on the relationship between economic success in transition and the institutional framework in which the economic reforms are embedded.[17]

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[14] Summarized in Charles Wyplosz, "Ten Years of Transformation: Macroeconomic Lessons," World Bank Policy Research Paper 2288, (Washington: World Bank, 2000), 11.
[15] Anders Aslund, "Possible Future Directions for Economies in Transition," in Joan M. Nelson, Charles Tilly and Lee Walker eds. *Transforming Post-Communist Political Economies* (Washington: National Academy Press, 1997), 462.
[16] Joseph E. Stiglitz "Whither Reform? Ten Years of the Transition" in Boris Plesovic and Stiglitz eds. *World Bank Annual Conference on Development Economics* (Washington: World Bank, 1999).
[17] John Williamson, "What Should the World Bank Think of the Washington Consensus?" *The World Bank Research Observer* 15,2 (2000), 261.

Stiglitz's critique was in part aimed at a school of theorizing about transformation failures represented by Anders Aslund – an advisor to the first Russian government – who argued that the differences in post-transformation performance could be explained by rent seeking behavior on the part of connected elites who took advantage of the limited pace of reforms in areas such as energy price subsidies to reap massive profits on foreign trade markets.[18] Had reform been more radical and fast, according to this reading, the opportunities for rent seeking behavior would have been more limited and economic recovery made easier.

The emphasis on rent seeking also implied a switch from concern with reform "losers" as the main obstacles to enacting market reform and called into question the notion that a state well insulated from voters was best suited to implementing reforms. This new focus was outlined in an influential article by Joel Hellman of the European Bank for Reconstruction and Development, who argued precisely that those beneficiaries from "partial reform" – rent seeking commodity traders, commercial bankers – were the main obstacles to implementing full liberalization and stabilization measures.[19] Hellman's model suggested that political institutions most conducive to sustained progress in economic reforms are those associated with participatory democracy, and that more competitive systems were better able to adopt and maintain economic reforms in the first years of transition.

Moving forward a decade, a further shift can be seen to be emerging in some strands of the recent literature on policy reform. This shift has been influenced by the considerable progress made in many of the transition countries that had lagged behind in the 1990s with respect to economic growth and structural reform. At the same time, the Central European countries which had been at the forefront of transformation in the 1990s have been experiencing slower growth and, to a certain extent, stagnation with respect to structural

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[18] Anders Aslund. "Russia's Collapse" *Foreign Affairs* 78,5 (1999), 64-77.
[19] Joel Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions" *World Politics* 50, 2 (1998), 203-234.

reforms. Observing this trend, research by Aslund suggests a link between reduction in government expenditures and economic growth.[20] The key turning point, according to this analysis, is the 1998 financial collapse which forced governments to reduce budget deficits as external financing disappeared, resulting in steep expenditure reductions and subsidy cuts which helped kill rent seeking behavior. Remarkably, Aslund argues that while democracy and growth were positively correlated in the 1990s because democratic accountability helped to reign in rent seeking behavior, the positive impact has diminished because the financial crisis forced a hardening of budget constraints and reductions in subsidies that had been fertile ground for rent seekers. Similarly, while proximity to the European Union is correlated with growth of the transition economies during the 1990s, Aslund's analysis suggests a reversal from that pattern in time period after 1998.[21] Another recent theory which has developed on the basis of an apparent reversal in trends of reform implementation over a similar time period links progress in second-generation reforms to "underinstitutionalization" of party system which insulate the state from voter preferences.[22] This is essentially the opposite of what Hellman and others argue leads to success, the argument implies that the ideal configuration of political institutions for building a market economy – the goal of the first-generation of reforms – differs from the institutional setup most conducive to the adoption of second-generation reforms such as the flat tax.

The thrust of the above discussion was to illustrate the evolving concerns and the interactions between theoretical literature, policy practice and observed outcomes. The implication of some of the literature cited is that success in first generation reforms does not

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[20] Anders Aslund and Nazgul Jenish, "The Eurasian Growth Paradox," Institute for International Economics Working Paper 6-05, (Washington: IIE, 2006).
[21] Proximity to the EU is measured by distance from Brussels. Aslund suggests that the reversal can be explained by the pro-market orientation of the first phase of EU accession
[22] Conor O'Dwyer and Branislav Kovalcik, "And the Last Shall be First: Party System Institutionalization and Second-Generation Economic Reform in Postcommunist Europe" *Studies in Comparative International Development* 41, 4 (2007), 3-26.

necessarily translate into higher economic growth than initial reform failures or greater progress with subsequent levels of structural reforms. The near consensus view has evolved, however, that a positive correlation between progress in market-oriented reforms and cumulative economic growth can be observed, with progress in one stage of market reform having an effect on growth in the subsequent period which in turn acts to propel further structural reforms.[23] This study uses the cases of Hungary and Russia to examine this assertion further.

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[23] Elisabetta Falcetti, Tatiana Lysenko and Peter Sanfey, "Reforms and growth in transition: Re-examining the evidence," *Journal of Comparative Economics* 34 (2006), 421-445.

Chapter 2: Destined to Diverge? Initial Political and Economic Conditions

Russia and Hungary began the transition under different economic and political circumstances, even with the common heritage of the Soviet system that was characterized at its most basic level by centralized control of the economy and political repression. These differences are often highlighted by scholars who emphasis the importance of path dependency as factors explaining the divergence in reform trends during the transition. This chapter will argue that the different legacies of economic reform under socialism and the political conditions under which it collapsed yielded a vastly different institutional framework in which the subsequent economic transformation would unfold.

2.1 – Economic Reform Under Communism

Reform efforts in the direction of market conditions had started in Hungary as far back as the late 1960s with the beginning of the "New Economic Mechanism," whereas in Russia under the Soviet Union, market reform efforts were quite limited even in Gorbachev's final years. A detailed analysis of the Hungarian economic reform agenda under Socialism lies outside the scope of this paper, but key reform developments include Hungary's first steps towards price liberalization in 1968 and increasingly radical institutional reforms of the 1980s. Those steps included the 1986 bankruptcy law, the introduction of a two-tiered banking system in 1987, the 1988 corporate law as well as the institution of a value-added tax system and personal income tax in 1988, followed by the liberalization of trade in 1989.[24] These measures meant that the economic system of Hungary at the outset of transition was far less distorted than in Russia, but also had much broader sociological and political implications.

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[24] Frank Bönker, *The Political Economy of Fiscal Reform in Central-Eastern Europe* (Cheltenham, UK: Elgar, 2006), 71.

The early experimentation in Hungary brought with it greater familiarity and understanding of the market economy on the part of the populace, and the partial economic liberalization already in place allowed further reforms to be seen as further evolution along a previously established trajectory.[25] In contrast, in Russia the lack of consequential economic liberalization during the Soviet period masked the underlying decay of the system and market reforms were seen by the public as both radical and destructive. The result is that in a broad sense, while a societal consensus existed in Hungary on instituting a market economy and a multiparty democracy, such a consensus was notably absent in Russia at the start of transition.[26]

The different experiences with market coordination under socialism also had a direct impact on the nature of economic elites that emerged during the transition, which in turn impacted the reform process. In Hungary, the decade preceding the transition was characterized by a partial "dissolution" of the socialist power structure and the emergence of a new technocratic elite that had been promoted on the basis of educational and professional credentials and shared a market economy orientation.[27] According to one theory, this group emerged in Hungary as its new political and economic elite after the transition.[28] Meanwhile, the economy of the Soviet Union at its twilight was still dominated by a politically connected business elite, a club whose members had attained their status on the basis of relationships and connections.[29] The partial liberalization under Gorbachev – allowing limited numbers of businesses to engage in foreign trade – helped contribute to rent seeking as state enterprise

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[25] Csaba, "A Decade of Transformation: Hungary and Russia Compared," 128-129.
[26] And indeed, as subsequent analysis will demonstrate, Russia remains no closer to achieving such consensus and it may be further out of reach after the reform experience of the 1990s.
[27] Erzsebét Szalai, "The Power Structure in Hungary After the Transition" in Christopher G. A. Bryant and Edmund Mokrzycki eds. *The New Great Transformation? Change and Continuity in East-Central Europe* (London: Routledge, 1994).
[28] Ibid.
[29] Arkady Vaksberg, *The Soviet Mafia* (New York: St. Martin's Press, 1991), 24.

managers took advantage of low fixed prices of commodities and reaped enormous wealth selling those goods on the open market.[30] This same group emerged as the economic elite in post-Communist Russia, with their control over businesses based on those same political connections rather than an effective track record under the market system; indeed, many of these managers would became opposed to further liberalization as it threatened their ability to engage in rent seeking behavior.[31] These contrasting features help explain the predominance of rent seeking in post-Soviet Russia, which scholars argue had a significant negative impact on the effectiveness of economic reforms there. The stylized comparison to be drawn is that while in Hungary there existed a modicum of understanding on the part of the populace and elite as to how the basic rules of the market system might function, basic knowledge of market economics was for all purposes absent.

To be sure, scholars have also suggested that continuities between Hungary's long period of socialist reform and the period of its transition to market economy hampered its transformation—particularly in the realm of fiscal policy. János Kornai argues that the overriding concern of Hungary's political leadership from the 1960s, under the regime of János Kádár, was maximizing economic welfare, security and political calm as a way of courting popularity in the aftermath of the 1956 revolution and avoiding subsequent conflict.[32] Economic policies aimed at increasing consumption accomplished this at the price of escalating foreign debt, as these pro-consumption policies continued even in the worsening economic climate of the 1970s. Measures that would have achieved macroeconomic balance but reduced consumption were avoided—part of a pattern of what Kornai calls "muddling

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[30] Anders Aslund, "Russia's Collapse," 65-66.
[31] Serguey Braguinsky and Roger Myerson, "A Macroeconomic Model of Russian Transition: the role of oligarchic property rights" *Economics of Transition* 15,1 (2007), 82.
[32] Kornai, "Paying the Bill for Goulash-Communism: Hungarian Development and Macro Stabilization in a Political-Economy Perspective" in *Struggle and Hope: Essays on Stabilization and Reform in a Post-Socialist Economy* (Cheltenham, UK: Edward Elgar, 1997), 121-179.

through" in which aims of short-term welfare maximization prevailed over longer-term economic considerations. He argues that the end of socialism brought no change to this pattern of economic policy, and that radical measures were postponed as long as was feasible.

2.2 – Initial Political Conditions

Hungary's transition to democracy was the product of negotiations between the government and opposition forces, and was characterized by few demonstrations or outbreaks of violence. In the first competitive multiparty elections held in the spring of 1990, the conservative Hungarian Democratic Forum emerged as the strongest party and its leader Jószef Antall was made Prime Minister of a centre-right governing coalition. The successor to the communist party, the Hungarian Socialist Party, competed in the 1990 elections but attracted only about 10 percent of the votes.[33] Yet the Democratic Forum had not campaigned on a sweeping reform platform, indicating a preference for evolutionary change—at least at the level of political rhetoric. The institutional setup in post-Communist Hungary was settled early in a constitutional deal between the largest parliamentary factions in the spring of 1990, establishing a unicameral system with a weak president. The position of the Prime Minister was relatively strong, however, with the power to appoint cabinet members and a requirement for a constructive no-confidence vote making early elections unlikely. The Constitutional Court was also granted a strong role resembling an upper chamber, with veto power over legislation regardless of whether a case had been brought against it.

Russia's political institutions were shaped by the final years of the Soviet system and characterized by intense tensions between parliament and executive, and between reformers and communists that resulted in a fragmented and weak state. A series of changes initiated by Gorbachev in the late 1980s were intended to give an institutional base to his policy of open political communication (*glasnost)* and included the creation of an unwieldy but

[33] Frank Bönker, *The Political Economy of Fiscal Reform*, 71.

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representative parliamentary body elected in 1989. Equivalents at the level of the union republics were also established and elections were held for those positions in 1990. In Russia the result was nearly equal factions of staunch defenders of the old system and market-oriented reformers.[34] Without the institutional features designed to assist decision-making and with its main factions at an impasse over reforms, the USSR parliament delegated extensive authority to Gorbachev. This development was also mirrored at the republic level, where in Russia Boris Yeltsin—a leader whose power base resided with radical democrats and Russian nationalists in parliament—first won a campaign in parliament to create a powerful, directly elected President and subsequently gained election to that position in June 1991.[35] In the aftermath of that election, a contest between the legislative and executive branches broke out, with Yeltsin's position strengthened after a failed coup attempt against Gorbachev in August 1991 and a series of measures Yeltsin put in place that included decrees outlawing the activities of the Communist Party. It was in this heated atmosphere that in the final months of 1991 an independent Russia emerged—with the Soviet Union formally ceasing to exist on December 31, 1991.

The emergence of the Russian Federation did not change the basic conflict between Yeltsin and the legislative branch. Control over the state administration was by no means assured during Yelstin's initial tenure, which was also characterized by the delegation of extensive powers to Russia's regions in order to avert further territorial breakdown. Russian politics in its first year was consumed by the battle to adopt a constitution, leading to a sequence of events that included a nearly successful impeachment effort and culminating in an armed conflict in October 1993, in which Yeltsin shut down the parliament and set up a national referendum for adopting a constitution, which succeeded in December 1993. The

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[34] Thomas F. Remington, "Parliamentary Politics in Russia" in Stephen White, Zvi Gitelman and Richard Sakwa eds. *Developments in Russian Politics* (Durham: Duke University Press, 2005), 42.
[35] Ibid. 44.

document — still in force today — established a strong presidency aimed at ensuring the executive branch adequate power to drive reform, with the ability to issue decrees with the force of law and veto laws passed by parliament relatively easy. Although fundamentally a liberal document, its vision of extensive executive authority remains controversial to this day.[36]

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[36] Richard Sakwa "Politics in Russia" in White, Gitelman and Sakwa eds. *Developments in Russian Politics* (Durham: Duke University Press, 2005), 42.

Chapter 3: Radical Change? Economic Reform Trends up to 1999

For Russia, Hungary and nearly all the New Independent States, the decade of the 1990s was a period of political transformation and economic reform that saw the emergence of democratic rule and the basic workings of a market economy. These changes were accompanied by a steep output collapse, which contemporary observers dubbed the "transformational recession" for its association with systemic change.[37] It was in this atmosphere of transformation and economic crisis provoked by the collapse of the old system, then, that the policies instituting the new policies and rules of the market economy were enacted.

This chapter will examine the evolution of those major reforms in Hungary and Russia from a comparative perspective informed by the literature on political economy of policy reform. Hungary was better equipped during this period to consolidate and effectively implement the reforms of this initial phase of transition, which were aimed at macroeconomic stabilization, liberalization of the economy and privatization of state assets. Yet the transformation of Russia's economy during this period was equally staggering, although perceptions of the outcome of these reforms have been clouded by the country's financial crisis in 1998 and the vast scale and concentration of wealth created by the two-phased mass privatization program.

At the point at which this chapter concludes, Russia was mired in a deep, though ultimately short-lived, economic crisis, while Hungary had experienced a recovery in growth following the implementation of a package of stabilization measures in 1995. For nearly the entirety of this time period, Hungary was seen as a model for successful implementation of a market economy, while Russia was a poster-child for transformation gone awry. While a

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[37] Janos Kornai, "Transformational Recession: the main causes" *Journal of Comparative Economics* 19,1 (1994), 37-52. A more recent perspective is offered in Jan Winiecki, "An inquiry into the drastic fall in output in post-Communist transition: an unresolved puzzle" *Post-Communist Economics*, 14,1 (2002), 5-30.

popular explanation for Russia's economic failure during this time period was that reforms were too radical and quickly paced, this chapter will argue that the pace of reform was not as fast in Russia as in Hungary nor were the measures as radical because they were ultimately not capable of being implemented by the weak state that had developed as a result of the collapse of the Soviet Union and the protracted period of consolidation that ensued.

Hungary's reform trajectory during this period was far from optimal and not without setbacks, reversals and policy failures, but the changes implemented brought radical transformation to the economy – particularly at the microeconomic level. Meanwhile, macroeconomic policy remained a weakness – postponement of fiscal reforms and mistakes in the arenas of fiscal and monetary policy such as inaccurate budgetary forecasts proved costly and contributed to a budget and balance of payments crisis in 1994-1995.

3.1 – Initial Reform Packages

Macroeconomic stabilization was the focus of initial reform efforts, and fiscal policy was the principle area where Hungary's legacy of reform under communism was felt negatively. As discussed in the previous section, the democratic government that assumed power in the spring of 1990 had not campaigned on a specific economic reform platform. With macroeconomic conditions perceived as stable in the short-term and price liberalization effectively in place, there was no need for the kind of "shock therapy" policy—combining rapid price liberalization with measures to bring inflation under control quickly—which Poland had engaged in during the previous year.[38] Instead, the initial year of transition in Hungary was characterized by policy drift.[39] Economic policymaking was enfeebled by

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[38] Paul Marer, "Economic Transformation, 1990-1998" in Aurel Braun and Zoltan Barany eds. *Dilemmas of Transformation: The Hungarian Experience* (New York: Roman and Littlefield, 1999), 164-165.
[39] Csaba, "Macroeconomic Policy in Hungary: Poetry versus Reality," *Soviet Studies* 44,6 (1992), 951-952.

internal rivalries in the Antall government and fragmentation of decision-making.[40] A standby agreement had been concluded with the International Monetary Fund by the outgoing regime in early 1990, triggering some mid-year stabilization measures that improved the fiscal and current account balance.[41] But a draft economic plan was only released by the new government in September 1990, and a subsequent mass protest by Budapest taxi drivers against a fuel price increase caused the government to reduce the subsidy cuts in a subsequent November proposal and postpone measures that could elicit opposition such as cuts in welfare benefits.[42]

Still, momentum for reform increased after Antall reshuffled his government and nominated Mihály Kupa as the new Minister of Finance.[43] Kupa was a technocrat who had led 1988-1989 tax reform efforts under the previous regime. He presented a three-year plan, which proposed to eliminate remaining subsidies along with further price and trade liberalization. The program envisioned a decline in real GDP by 4 percent in 1991, followed by a resumption of growth in 1992. But the output decline turned out to be much steeper than anticipated, with the collapse of Comecon trade in particular and oil price rises associated with the Persian Gulf War contributing to a much worsened fiscal stance and heightened inflation.[44] In the fall of 1992, Kupa proposed a package of revenue raising measures such as adjustments to the value-added tax (VAT) along with a freeze of public expenditures. Yet resistance to these austerity measures within the governing coalition proved fatal, and the government ultimately did not act on Kupa's proposals but negotiated a pact with unions that

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[40] Béla Greskovits, "Brothers-in-Arms or Rivals in Politics? Top Politicians and Top Policy Makers in the Hungarian Transformation" in János Kornai, Stephan Haggard and Robert R. Kaufman eds. *Reforming the State: Fiscal and Welfare Reform in Post-Socialist Countries* (Cambridge: Cambridge University Press, 2001), 119-123.
[41] Bönker, *The Political Economy of Fiscal Reform*, 71-72.
[42] Ibid.
[43] Greskovits, "Brothers in-Arms or Rivals in Politics?" 123-135.
[44] Bönker, *The Political Economy of Fiscal Reform*, 99.

fell short of what was needed to correct the deepening imbalances.[45] This proved to be the last opportunity to enact tough stabilization measures before the 1994 election.

Stabilization efforts in Russia during the initial transition followed a starkly different path. In contrast to Hungary, Russia was in a deep economic crisis when transition began. The Soviet budget deficit had risen to at least 20 percent of GDP and the USSR had defaulted on its international debts in December 1991. The Soviet command economy was characterized by an excessive supply of money combined with predominately fixed prices, which contributed to extraordinary levels of repressed inflation. Unlike in Hungary, however, the incoming government had prepared the populace for painful measures and thus enjoyed a mandate for radical reform, although it would prove limited and short-lived. During the first years of transition, stabilization efforts would proceed in waves and suffer frequent setbacks and reversals, the victim to institutional weaknesses and lack of political consolidation.

The main reform package was launched at the beginning of 1992, and involved price liberalization and balancing the state budget. In January of that year some 90 percent of retail and 80 percent of producer prices were freed, although energy prices, basic food stuffs and some raw materials were excepted.[46] These measures were accompanied by dramatic cuts in federal spending in areas such as defense procurement, which had been a major expenditure category under the Soviet system and indeed the dominant category of industrial production. The old government administration was dramatically scaled back during its merger with the newly established Russian government.[47] Yet this initial reform push began to unravel as early as April, when mounting pressure from parliament pushed the government to issue

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[45] Stephan Haggard, Robert R. Kaufman and Matthew S. Shugart, "Politics, Institutions and Macroeconomic Adjustment: Hungarian Fiscal Policy Making in Comparative Perspective" in in Kornai, Haggard and Kaufman eds. *Reforming the State*, 92.
[46] Rudiger Ahrend and William Tompson. "Fifteen Years of Economic Reform in Russia." OECD Economics Department Working Paper No. 430. 13 May 2005, 6-7.
[47] Anders Aslund, *How Russia Became a Market Economy* (Washington: Brookings Institution Press, 1995), 187.

subsidized credits to agriculture and industry. A period of destabilization ensued, with a flood of money from the Central Bank bringing Russia close to hyperinflation. Efforts would not regain momentum until the following year, when a new economic team led by Boris Federov managed to avert hyperinflation and make progress in laying the groundwork for stabilization by placing controls on credits from the Central Bank, reducing import subsidies and raising or liberalizing energy prices.[48] More far-reaching measures were put in place in the aftermath of Yeltsin's dissolution of parliament, when a brief window was opened up in which subsidized credits were abolished and agriculture was essentially deregulated—resulting in further price liberalization of foodstuffs. Yet the December 1993 parliamentary elections delivered a staggering blow to the reformist wing of the Russian government, amounting to a vote of no-confidence in their policies, which had been constantly frustrated but had nevertheless failed to deliver anything approaching stabilization. Policy in 1994 was characterized by stalemate but the radical policies implemented in the last quarter of 1993 did result in some progress toward stabilization. The failure in retrospect seems to have been assured on the basis of the complete policy disconnect between the Central Bank and reformers in Yeltsin's government as well as the continued existence of the ruble zone in the former Soviet Union made gaining control of the money supply fruitless. Csaba labels this period one of redefining "power, borders, political and economic structures" with the evolution of those structures only appearing in 1994.[49]

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3.2 – Development of the Private Sector

Reforms intended to boost private sector activity involved both the establishment of legal frameworks for private ownership and economic activities outside the state-controlled sphere, and the actual mechanisms through which state-owned enterprises were transferred to private ownership. Policies in this sphere were thus aimed not only at the privatization of

[48] Ibid. 195-196.
[49] Csaba, *The New Political Economy of Emerging Europe*, 267.

state assets but also at fostering the creation of new enterprises. Hungary enacted some of the most far-reaching reforms of any post-socialist state in this area – with the passage of a radical bankruptcy law and early bank consolidation fundamentally transforming the business environment. In Russia, although the privatization process proceeded quickly and without the same pattern of policy reversals that characterized stabilization efforts, its impact on fundamentally changing the business environment was more limited because of the absence of the type of structural reforms Hungary had enacted.[50]

If the market economy is to function, a legal framework needs to be put in place for enterprises to fail and be restructured – something typically accomplished through bankruptcy proceedings. The enactment of a revised bankruptcy law in Hungary in 1992 proved to be one of the most significant reforms adopted by the Antall government, fundamentally transforming the legal environment for Hungarian enterprises. A bankruptcy law had been introduced in 1985, but the logic of market socialism discouraged its practical use as creditors were confident that the state would ultimately cover interenterprise arrears. As a result, the first bankruptcy law had essentially no effect: only ten bankruptcy requests were submitted from 1986 to 1989.[51] As it became obvious that existing legislation was ineffective at reducing growing payment arrears and overdue tax claims after the transition, a new approach was instituted in September 1991 that became effective in January 1992. Although it would prove to have dramatic consequences, the law provoked little controversy and was passed unanimously – indicative of the government's reliance on state

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[50] For Hungary, see Organisation for Economic Co-operation and Development *Hungary 1993*, OECD Economic Surveys (Paris: OECD, 1993), 67-87, and Keith Crane "Privatization Policies" in Braun and Barany eds. *Dilemmas of Transformation*, 203-223. For Russia, see Aslund, *How Russia Became a Market Economy*, 223-271 and Ahrend and Thompson "Fifteen Years of Economic Reform in Russia."
[51] OECD, *Hungary 1993*, 81.

administration for economic policy reform.[52] The main feature of the new law was that it automatically triggered bankruptcy proceedings involving reorganization or liquidation for any debtor in default for more than 90 days. This was primarily aimed at overcoming the creditor passivity that characterized the socialist system. The impact was dramatic. In the first quarter of 1992 there were as many bankruptcies and liquidations initiated as in the entirety of the previous year, and throughout the whole year there were more than 4,200 bankruptcy filings and more than 10,000 liquidations.[53] The pace of filings overwhelmed the court system, and amendments to the law were introduced that softened the trigger mechanism. Yet even with the adjustments it is clear that over the long term the law substantially reshaped the operating environment for enterprises in Hungary by putting pressure on managers to restore loss-making companies to profitability, reallocating resources for better uses and making the economy more flexible.[54]

In Russia, although there were efforts to adopt a bankruptcy law in the final year of the Soviet Union, resistance from the industrial lobby – fearful about widespread closing of enterprises – prevented parliament from acting on it.[55] Ultimately Yeltsin went around the parliament and used his powers of presidential decree to institute bankruptcy procedures in June 1992, but the system suffered from some of the same fundamental problems that inhibited efforts in Hungary under socialism – namely, a lack of institutional incentive to force an enterprise into bankruptcy because of the persistence of soft budget constraints. Until March 1994, only 10 enterprises were declared bankrupt.[56] This is symptomatic of a

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[52] David Bartlett, *The Political Economy of Dual Transformations: Market Reform and Democratization in Hungary* (Ann Arbor: University of Michigan Press, 1997), 233-234.
[53] OECD, *Hungary 1993*, 83-84.
[54] Bartlett, *The Political Economy of Dual Transformations*, 235, and Marer, "Economic Transformation, 1990-1998" 167.
[55] Aslund, *How Russia Became a Market Economy*, 264-265.
[56] Aslund, *How Russia Became a Market Economy*, 264-265.

stalled process of enterprise restructuring, associated with the persistence of low levels of corporate governance that would continually plague Russia.

Crucially connected to the restructuring of the business environment is the development of the financial sector, with a large body of evidence indicating a link between banking sector development and economic growth.[57] In Hungary a consolidation of the state-owned banking sector was essentially forced upon the government by the eruption of a massive banking crisis in 1993-1994. The crisis unfolded in tandem with the enterprise restructuring associated with the output collapse and accelerated by the bankruptcy law – as the insolvency of firms meant that some of the state-owned banks lost their entire capital.[58] In Russia the persistence of soft budget constraints masked the vulnerabilities of the emerging banking sector and contributed to its continued underdevelopment. Whereas Hungary had adopted international accounting standards and gradually strengthened its regulatory bodies' supervisory capacity as part of the European Union accession process, in Russia there was practically no effective supervision of banking. Evidence for this comes from the truly startling number of operating banks– some 2,457 at the end of 1994 – a result of loose licensing criteria and initial confusion over which governmental body had the authority to issue bank licenses.[59]

Privatization strategies differed drastically in the countries as well. The strategy that developed in Hungary was to privatize state enterprises through sales or initial public offerings, whereas in Russia privatization took place by distribution – known as voucher privatization – except for a few large, mostly resource-based enterprises whose fates were

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[57] Moshin S. Khan and Abdelhak S. Senhadji, "Financial Development and Economic Growth: An Overview," IMF Working Paper 00/209, (Washington: International Monetary Fund, 2000).
[58] György Szapáry, "Banking Sector Reform in Hungary: What Have We Learned and What are the Prospects?" *Comparative Economic Studies* 44, 2 (2002), 103-124.
[59] David O. Robinson, "Banking Crisis and Recovery," in David Owen and David O. Robinson eds. *Russia Rebounds* (Washington: International Monetary Fund, 2003), 124.

postponed. While the process of privatization unfolded more slowly in Hungary, in part because anticipated bidders did not materialize, the goal of transferring enterprises to "real owners" who would take an active role in managing the firms and put their own capital at risk and the inclusion of foreign investors tended to promote restructuring.[60] In contrast privatization through distribution in Russia tended to result in dispersed ownership that is not considered economically efficient.[61] Also, because of concessions made to enterprise managers, voucher privatization tended to be insider-dominated, with these managers well positioned to acquire control. Given the continued presence of soft budget constraints, there was little incentive to engage in restructuring or investment and managers instead engaged in massive asset stripping and capital flight. Thus, while voucher privatization in Russia did quickly transfer ownership from away from the state, it did not necessarily result in efficient owners.[62]

Part of the explanation for why Hungary pursued its privatization strategy involves controversies over the privatization program introduced by the socialist government. That program, which led to "spontaneous" privatizations benefiting managers and foreign investors, was considered a failure that led to ill-gotten gains. Once again, the experimentation with market reforms under socialism resulted in lessons learned and a strategy shift. Another reason why the Hungarian government sought privatization through sale was because, with its deepening fiscal imbalances emerging as a critical macroeconomic problem threatening stabilization efforts, it placed a premium on achieving the highest price possible for its enterprises.[63] Still, the desire to seek the highest possible price for state

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[60] OECD, *Hungary 1993*, 73-74.
[61] Ahrend and Tompson, "Fifteen Years of Economic Reform in Russia," 31-32.
[62] For a lengthy account and explanation linked to the absence of a proper legal or institutional framework for corporate governance, see Bernard Black, Reinier Kraakman and Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong?" *Stanford Law Review* 52 (2000), 1731-1808.
[63] Crane, "Privatization Policies," 211.

holdings – in part because of Hungary's high levels of foreign indebtedness and comparatively low foreign exchange reserve levels – resulted in a slowdown of privatization efforts in Hungary as these bidders failed to materialize.[64] Reformers in Russia thought that such a slowdown might have proved fatal for the Russian privatization program and at a minimum represented a tradeoff for policy makers.[65] The underlying logic of mass privatization was that efficient owners would emerge based on the Coase theorem, but that cannot hold in situations of imperfect or non-existent property rights.[66]

3.3 – Stabilization Redux

The reforms described in the previous section had altered the basic role of the state in the economies of both Hungary and Russia and set both on a path towards the market economy. The period from 1995 to 1998 would prove critical in both countries to the progress of this reform agenda. In the case of Hungary, a package of stabilization measures adopted in 1995 would mark a dramatic breakthrough in reversing deepening fiscal and current account imbalances that threatened to trigger an economic crisis and also created momentum for further privatization and institutional reform. The adoption of these measures marked a break with the pattern of economic policymaking in post-communist Hungary characterized by strong continuities from the socialist period and an emphasis on maintaining political calm.[67] In the case of Russia, a new effort at stabilization was undertaken in 1995, with an exchange-rate based strategy that brought inflation down rapidly but was not accompanied by any significant fiscal adjustment and ultimately proved unsustainable, contributing to a financial collapse in the fall of 1998.[68] At the same time as these stabilization efforts were underway, Russia's most valuable state-owned enterprises were

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[64] OECD, *Hungary 1993*, 73.
[65] Aslund, *How Russia Became A Market Economy*, 240.
[66] Black, Kraakman and Tarassova, "Russian Privatization and Corporate Governance," 1752.
[67] Kornai, "Paying the Bill for Goulash Communism," 130-135.
[68] Ahrend and Tompson, "Fifteen Years of Economic Reform in Russia," 12.

sold in controversial “loans for shares” auctions. The legacy of this period would prove to be mixed for subsequent Russian reform efforts – institutions of the market economy had further developed, but economic policy had led to crisis.

The reform push in 1995 in Hungary came the year after an election in which the center-right coalition that had governed from 1990 experienced suffered defeat at the hands of the reformed Socialist Party, which emerged with a landslide victory but was confronted with formidable economic policy challenges whose origins were discussed in the previous section. In 1994, Hungary posted a general government deficit of 8 percent of GDP and a current-account deficit of almost 10 percent of GDP.[69] While alarming to professional economists, these figures had not translated into a sense of panic on the part of the public or politicians. Like the initial months after the 1990 election, policy making in the economic arena was characterized by drift or even paralysis in after the Socialist Party established a governing coalition, with similar internal rivalries posing as obstacles to action on structural reform.[70] Attempts to negotiate an agreement with trade unions and business interests on a package of austerity measures being pushed by Minister of Finance László Békesi failed, and Békesi ultimately resigned in January 1995. His successor Lajos Bokros pursued a fundamentally different strategy, though in a broad sense the package he would unveil was similar to that proposed by Békesi. The inability to reach agreement on an alternative to tough stabilization measures in negotiations with social partners and the resignation of a potential rival to Prime Minister Gyula Horn strengthened the position of Bokros and provided an opening for his strong commitment to deep macroeconomic adjustments.[71]

The main components of the stabilization package – often dubbed the “Bokros Package” for its close association with the Minister of Finance – were an immediate and

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[69] European Bank for Reconstruction and Development, “Economic Indicators;” Available from http://www.ebrd.com/country/sector/econo/stats/sei.xls; accessed 13 April 2007.
[70] Greskovits, “Brothers-in-Arms or Rivals in Politics,” 130-131.
[71] Haggard, Kaufman and Shugart, “The Politics of Hungarian Fiscal Policy,” 97.

significant currency devaluation, a nearly 8 percent import surcharge and the imposition of restrictions on government spending, certain welfare benefits and public sector wage increases.[72] The package combined policies intended to minimize an absolute fall in production from adjustment and reorient production towards exports. Its more controversial components were the reductions in welfare entitlements in areas such as education, maternity leave and family allowances – many of which were overturned or postponed by the Constitutional Court. A main achievement of the package was to avoid the financial collapse which could have easily occurred in Hungary, especially given the currency crisis in Mexico the year earlier that had been provoked by similar imbalances and the declining investor confidence in Hungary in the run-up to the announcement of the stabilization package.[73] The measures did effectively stabilize the economy, with export growth continuing and the imports declining and the import surcharge giving a boost to the fiscal balance. Another outcome was increasing investor confidence, which translated into higher credit ratings and thus removal of further barriers to borrowing for the Hungarian government.

Meanwhile, stabilization efforts in Russia were also still underway, focused on containing inflation through an exchange-rate based strategy. An exchange rate crisis in October 1994 had provoked yet another change in economic leadership in the Yeltsin administration, which decided anew to attempt to contain inflation.[74] That an exchange rate crisis triggered a political response was an indication that development of the market economy had progressed, and its institutional structure had developed sufficiently to allow for monetary policy to emerge – indeed, in the initial years of transition the Central Bank had been a force against stabilization as had the existence of the ruble zone. But this new approach brought about a rapid real appreciation of the exchange rate, which roughly doubled

[72] Kornai, "Adjustment Without Recession: A Case Study of the Hungarian Stabilization," in Kornai ed. *Struggle and Hope*, 180-215.
[73] Ibid. 185-186.
[74] Aslund, *How Russia Became a Market Economy*, 206-207.

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in value during 1995, and harmed the competitiveness of Russia's industrial enterprises.[75] Given the continued strength of the enterprise managers as a political lobby and the lack of a legal framework for bankruptcy or other restructuring, these enterprises were increasingly kept alive via subsidies in the form of arrears to the state-controlled gas and electricity monopolies or through unpaid wages and taxes.[76] This exerted more of a drain on the Russian government's fiscal balance – the general government deficit was almost 7 percent of GDP in 1995 and climbed to almost 10 percent in 1996.[77] Although an indirect form of subsidy compared to the direct credits that had proliferated during 1992-93, these arrears were indicative of the persistence of soft budget constraints and the extent to which structural reform of these enterprises had not occurred.

A second phase of privatization launched in 1995 did not improve the fiscal situation in Russia although it was initially designed to be a cash sale, which could bring revenue to the state. This privatization wave involved fifteen of the largest, mostly resource-based enterprises that were thought to be the most valuable and thus withheld from the voucher privatization. Under murky auctions that were supervised by Russian banks and not opened to foreign investors, these large enterprises were sold for a small fraction of their estimated value – often to the same banks or connected financial groups who had accepted shares in the companies as collateral for loans extended to the Russian government.[78] Cash privatization should have earmarked about US $2 billion to the budget but instead delivered just 10 percent of that amount.[79] These auctions proved enormously controversial within Russia, and the insiders who gained control of these enterprises, known as "oligarchs," would emerge as a

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[75] Ahrend and Tompson, "Fifteen Years of Economic Reform in Russia," 12.
[76] Ibid.
[77] EBRD, "Economic Indicators."
[78] OECD, *Russian Federation 1997*, (OECD Economic Surveys. Paris: OECD, 1997), 138-142.
[79] Silvana Malle, "Russia after a Decade of Transition: Economic Failures and Current Policy Options," in Brzeski and Jan Winiecki eds. *A Liberating Economic Journey*, 70.

dominant force in Russian business and politics after Yeltsin's reelection in 1996 against a resurgent Communist Party, which they largely financed. In this respect the contrast with Hungary could not be greater –- especially as it was at the same time undergoing a wave of renewed privatization in the aftermath of the 1995 stabilization package. The bulk of the energy sector, the telecommunications monopoly and the bulk of the remaining state-owned banks were sold to Western investors. The windfall income was used to pay down a portion of Hungary's state debt, thus boosting stabilization efforts. It also implied a radical opening up of the economy to foreign penetration, which would prove to be a fundamental point of divergence between the Russian and Hungarian cases.[80] The mix of policies discussed in the section above on private sector development served to encourage foreign involvement in the Hungarian economy and discourage it in Russia. Special reference has been made in the transition economics literature to the benefits of foreign ownership of the financial sector given the particular weaknesses and legacies of the socialist banking system.[81] The early consolidation of the banking sector in Hungary facilitated its privatization to foreign strategic owners – a process that would be followed in some of the other frontrunner groups – while in Russia the sector remained dominated by state-owned banks.[82]

Overall indicators of structural change and economic development indicate the reform trajectories sketched out above delivered, as expected, strikingly different results for Hungary and Russia over the initial phase of transition. Although neither country had reverted to their pre-crisis levels of GDP by 1998, Hungary was at that point in its fifth year of growth

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[80] Csaba, *The New Political Economy of Emerging Europe*, 64-68.
[81] Michael Keren and Gur Ofer, "Globalization and the Role of Foreign Banks," in Grzegorz W. Kolodko ed. *Emerging Market Economies: Globalization and Development* (Aldershot: Ashgate Publishing, 2003), 237-266.
[82] Robinson, "Banking Crisis and Recovery," in David Owen and David O. Robinson eds. *Russia Rebounds,* 73.

following four years of output decline.[83] Russia, by contrast, had seen negative real GDP growth in every year except for 1997 – when growth registered merely 1.4 percent.[84]

Although controversial, riddled with mistakes and failures and ultimately economically painful for many in the Russian populace, this first sequence of reforms did lay the groundwork for a market economy. Moderate levels of inflation and growth did appear in 1997. Owing to the conflict between monetary and fiscal policy, however, and exacerbated by massive capital flight and falling commodity prices, this stabilization did not prove sustainable and ultimately exploded into a full-blown debt crisis that forced the government to abandon its monetary policy and accept a restructuring of debt that was tantamount to default.

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[83] EBRD, "Economic Indicators."

Chapter 4: Unforeseen Trends: Economic Reform since 1999

Russia emerged from the crisis into a recovery phase rather quickly – sooner than many observers expected. The economic recovery has so far been sustained and delivered impressive rates of economic growth, also defying predictions. This post-crisis period witnessed a period of renewed attempts at structural reform, but they have since slowed and in some areas have even been reversed. In Hungary, the window of opportunity opened in the years following the 1995 stabilization package for further institutional and structural reforms proved to be limited, with economic policymaking in the years since characterized by a move towards economic populism and away from the structural reform agenda – although a package of austerity measures to deal with the macroeconomic consequences of previous spending was adopted in 2006. The trend for the last decade is thus uneven, yet indicates some common features – an economic crisis or the threat of a crisis can temporarily disrupt institutional impediments to reform and stabilization, which has a favorable impact on the ability to undertake structural reforms. Yet the window for these endeavors is limited, and both Hungary and Russia have seen the recurrence of the same key institutional weaknesses that have inhibited macroeconomic policymaking in Hungary and structural change in Russia, meaning that for now both countries appear locked in a pattern of postponing reform.

4.1 – Recovery in Russia

A massive fiscal adjustment was executed in the immediate aftermath of the financial collapse in Russia in 1998 – aided both by the economic conditions brought on by the crisis and a shift in the political climate. The government executed the adjustment by refraining from boosting expenditures to reflect rapid inflation. In fact there was little choice but to follow this course because significant additional borrowing was impossible after the default and to finance spending by increasing the money supply would have triggered

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hyperinflation.[85] The result was a sharp decrease in real wages. Imports decreased dramatically as prices of imported goods rose in terms of rubles after the devaluation, and exports became much more competitive as wages and energy prices fell. As a result, the current account balance showed a large surplus in 1999 – almost 13 percent of GDP – after being essentially balanced in 1996 and 1997.[86]

The economic recovery was accompanied by, and indeed sustained by, a fiscal stance that stands in stark contrast to the pre-crisis period. Although initially automatic, the adjustment set out in the 1999 budget proved to be a watershed in Russian fiscal policy. Government expenditure as a share of GDP had been hovering around 45 percent since 1993, but dropped nearly 10 percentage points in the two years after the crisis. Expenditures have been hovering at around 35 percent of GDP ever since. Revenues relative to GDP remained at roughly the same level, so the fiscal balance showed rapid improvement. The pattern of deep budget deficits that had characterized the transition years gave way to budget surpluses.

The drafting and adoption of the 1999 budget coincided with a brief redistribution of power within the executive branch. It was adopted under the leadership of Prime Minister Yevgeny Primakov, who Yeltsin had tapped for the position in the aftermath of the financial crisis. Primakov's brief tenure was marked by the strengthening of his role over economic affairs and the shifting of political weight toward the cabinet and away from the presidency – reflecting his broad support and Yeltsin's political weakness following the crisis.[87] The debate over the budget thus marked a break from the pattern of hostile relations between the executive and parliament that characterized most of Yeltsin's tenure. Indeed, Primakov was able to gain support for the budget from the Communist Party – a remarkable achievement considering its austerity.

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[85] Ahrend and Tompson, "Fifteen Years of Russian Economic Reform," 15.
[86] EBRD, "Economic Trends."
[87] Lilia Shevtsova, *Putin's Russia* (Washington: Carnegie Endowment for International Peace, 2003), 18-20.

The budget also had important positive implications for structural reform and future fiscal relations. Among its most consequential features was a provision requiring that federal tax collections be paid in cash and steps to encourage tax compliance. The prevalence of noncash payments in Russia prior to the crisis was staggering – in 1998 the share of industrial sales conducted through barter had reached 50 percent – and an indication of the predominance of soft budget constraints and indirect subsidies documented in the previous chapter.[88] The budget's cash payment requirement and accompanying pressure on utility companies to increase their cash payment revenues signaled a new commitment to hardening budget constraints. A wave of bankruptcies and corporate restructurings followed, accelerated by the government's determination to collect on tax arrears.[89] The macroeconomic environment was favorable for such a development, as the devaluation of the ruble gave domestic industry a boost and reduced their need for subsidies while the federal government had little choice but to boost collections as external sources of financing were not forthcoming.[90]

The increased export competitiveness of Russian industry after the devaluation and the opportunities for import substitution that also opened up contributed to a rapid economic recovery. The recovery was initially strongest in domestically oriented non-resource sectors, the industries that had been doing worst prior to the crisis.[91] The recovery was also notable because its speed and scale both appeared to be influenced positively by the market institutions established in the first years of transition – indicating that growth was not simply the result of devaluation. A recent study performed cross-regional regressions and determined

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88 David O. Robinson, "Macroeconomic Policymaking" in Owen and Robinson eds. *Russia Rebounds,* 36-37.
89 Ibid.
90 Brian Pinto, Vladimir Drebentsov and Alexander Morozov, "Give Growth and Macroeconomic Stability in Russia a Chance: Harden Budgets by Eliminating Nonpayments," World Bank Policy Research Working Paper 2324, 2000, 25.
91 Ahrend and Tompson, "Fifteen Years of Economic Reform in Russia," 16.

that regions in Russia with higher reform performance during the 1990s had higher growth rates during the period immediately following the crisis.[92] A comparison can also be drawn between the recovery after 1998 and the situation in 1994, when devaluation of the ruble coupled with relatively low domestic energy prices but high export prices did not lead to growth.[93] It thus appears that private enterprises operating in a more liberalized business environment were able to respond to the opportunity presented by ruble devaluation.

The crisis impacted Russian society on a deep and painful level, with negative consequences for income distribution and living standards. Poverty rates rose dramatically in the immediate aftermath of the crisis – estimates are that poverty increased to about 33 percent of households in 1998 from 22 percent in 1996.[94] Yet measures to centralize the budget through the establishment of a new federal treasury and a general decrease in wage and pension arrears on the part of the federal government blunted the welfare impact of the fiscal adjustment itself, with evidence suggesting that expenditure management is more efficient and that reduction in government expenditure has not been accompanied by any substantial deterioration in the provision of public services.[95]

4.2 – Hungary After 1998: A Shift Away From Sustainability

The fiscal adjustment undertaken in Hungary in 1995 and discussed in the previous chapter averted the sort of financial crisis that Russia ultimately experienced in 1998. Although the adoption of the stabilization package had opened up the way for some structural reforms – most notably the acceleration of privatization and initial steps toward pension system overhaul – and ultimately was followed by a period of substantial economic growth, it

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[92] Ksenia Yudaeva et al, "Down and up the stairs: paradoxes of Russian economic growth," in Gur Ofer and Richard Pomfret eds. *The Economic Prospects of the CIS: Sources of Long Term Growth*, (Cheltenham, UK: Elgar, 2004), 51-52.
[93] Ahrend and Tompson, "Fifteen Years of Economic Reform in Russia," 16.
[94] Michael Lokshin and Martin Ravallion, "Welfare Impacts of the 1998 Financial Crisis and the Response of the Public Safety Net," *Economics of Transition* 8, 2 (2000), 269-295.
[95] Rudiger Ahrend, "Account for Russia's Post-Crisis Growth" OECD Economics Department Working Paper No. 404, 30 Sept. 2004, 16-17.

did not translate into a mandate for the continuation of the policy course. Efforts to undertake healthcare reform were quietly postponed as the 1998 election approached.[96] More ominously for the reelection prospects of the Horn government, there was little recognition beyond the realm of professional economists for what was achieved by the stabilization package – as János Kornai noted in 1996, “for the man in the street, there is no sense of accomplishment in having averted a catastrophe outside his experience.”[97] Reductions in entitlements and expenditure cuts had proved deeply unpopular and despite some loosening of the fiscal stance in the year leading up to the 1998 election, the governing Socialist Party was defeated and replaced by a centre-right government with Viktor Orbán, the leader of the Alliance of Young Democrats / Hungarian Civic Party (Fidesz-MPP), as Prime Minister. Fidesz-MPP had been highly critical of the 1995 stabilization package, which they called unnecessary and unfair.[98]

The new government thus assumed power amidst clear evidence that voter support for further reforms was low and an increasingly favorable macroeconomic situation caused by the 1995 stabilization package that reduced short-term budgetary pressures. The relatively weak position of the Ministry of Finance, which was effectively blocked from its role as an independent agenda-setter within the government, and the atmosphere of permanent campaigning after the highly contested 1998 campaign further hinted that only a modest reform agenda would emerge.[99] Budgets drafted in the new governments first two years did reduce the deficit, but coincided with measures boosting entitlements and tax cuts that were paid for by postponing public sector investment and wage freezes, temporary offsets which have not proven to be sustainable. The 1997 pension reform was also scaled back. While there was limited further progress on the reform agenda in the first two years of the Orbán

[96] Joan M. Nelson, “The Politics of Pension and Health-Care Reforms in Hungary and Poland,” in Kornai, Haggard and Kaufman eds. *Reforming the State*, 253-257.
[97] Kornai, “Adjustment Without Recession,” 15.
[98] Bönker, *The Political Economy of Fiscal Reform*, 129-130.
[99] Ibid.

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government, there was also a general macroeconomic framework in place that promoted further development and economic growth. These conditions would not continue, however, as Hungary felt the impact of the global economic slowdown in 2000 and the government responded by loosening previously tight fiscal policies.

The loosening of restraint was typified housing and wage measures whose scale and timing appear to have been driven by the election cycle.[100] A generous mortgage subsidy scheme was introduced in 2001 and led to a credit boom that caused a dramatic decline in household savings and a worsening of the current account balance as foreign savings replaced domestic savings as a source of investment. In the area of wages, a doubling of the minimum wage and a decision to increase the salary of public sector employees by more than 30 percent before the election in 2002 led both to a loss of competitiveness as labor costs rose and higher levels of public expenditure. Both the incumbent centre-right parties in the governing coalition and the opposition Socialist Party made increasingly lavish election promises throughout the 2002 campaign to boost public benefits while reducing the tax burden.[101] When the Socialist Party won in the election and subsequently replaced the center-right government, it implemented many of its campaign promises – in part because it still faced electoral pressure in the form of local elections held several months later.[102] Thus, additional public sector wage increases, tax relief for minimum wage earners, and measures brining higher levels of child-care benefits all passed. Though the government committed to reducing fiscal deficits as part of its goal of Euro-zone entry, deficit targets were missed – reflecting institutional weaknesses in the budgeting process – and much of deficit reduction that was achieved through 2004 was the result of accounting techniques and one-time

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[100] Dóra Gyorffy, "Governance in a Low-Trust Environment: The Difficulties of Fiscal Adjustment in Hungary," *Europe-Asia Studies* 58,2 (2006), 246-247.
[101] Ibid. 252.
[102] Bönker, *The Political Economy of Fiscal Reform in Central-Eastern Europe*, 134.

revenues.[103] What evolved was a political environment as well as a macroeconomic environment ill suited to undertaking further structural reforms – despite or perhaps because of the apparent success of the economic transformation.

4.3 – Putin's Ambiguous Record

The dramatic fiscal adjustment that was achieved in Russia in the aftermath of the economic crisis proved to be sustainable – assisted by but not entirely dependent on increasingly high oil prices – and afforded a window of opportunity for the Russian government to undertake structural reforms. This development coincided with a profound shift in the political climate under President Vladimir Putin, who assumed office after Yeltsin's resignation on New Year's Eve 1999 and was subsequently elected to a four-year term in March 2000.

Perhaps the key political event leading up to the Putin era, one that transformed the political landscape in Russia, was the parliamentary election for the third Duma held on December 19, 1999. A pro-Kremlin political party known as Unity had been formed in a matter of weeks as part of a broader effort to ensure a smooth succession after Yeltsin's constitutionally mandated exit. Unity was organized and financed to a large extent by Boris Berezovsky – the leading oligarch associate of Yeltsin. Putin, who Yeltsin had chosen to become Prime Minister in August, publicly allied himself with Unity and the resources of the Kremlin administration and its oligarch allies were deployed to ensure that they would carry the vote.[104] Unity did, gaining a strong plurality in the Duma, meaning that it could build majority coalitions to pass legislation proposed by Putin – although it would have to work across factions to do so.[105] The election results also testified to the enormous political popularity of Putin, who had been until recently an unknown figure in Russia, easing the way

[103] Bönker, *The Political Economy of Fiscal Reform in Central-Eastern Europe,* 134.
[104] Shevtsova, *Putin's Russia,* 47-48.
[105] Remington, "Parliamentary Politics in Russia," 50.

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for his assumption of the presidency after Yeltsin's resignation and his subsequent election in March.

When he did assume the presidency, Putin could count on his relationship with parliament being much different from what it was under Yeltsin. For much of the Yeltsin era, relations between the legislative and executive branches were characterized by discord and mutual opposition – with impeachment attempts, not infrequent vetoing of legislation and many major decisions, particularly in matters of economic reform, issued by decree. The exception described above was the 1999 budget. This pattern changed immediately with the ascendance of Putin and a Unity-led Duma, with Putin using the legislative process rather than decree to enact his the bulk of his program of ambitious economic reforms – aided by a commanding base of support in the parliament, which Yeltsin had lacked for most of his tenure.

Putin's attitude with respect to economic policy was not well established prior to the campaign or his assumption of the presidency.[106] He campaigned on a broader platform of stability – in effect promising a continuation of the market orientation of the Yeltsin years, yet with security and order placed at the forefront of concern. Only a few months into his office, he broke dramatically with two of the business oligarchs who had helped fuel his rise – Berezovsky and Vladimir Gusinsky – and ultimately stripped them of their media outlets and forced them to flee the country.[107] Given high levels of popular distrust of the oligarchs in Russian society, further crackdowns and reversals of privatization could have occurred during this period of consolidation. Yet Putin simultaneously assured other oligarchs in private, and followed up in public statements, that there would be no attempt at

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[106] Peter Rutland, "Putin's Economic Record," in White, Gitelman and Sakwa eds. *Developments in Russian Politics*, 190.
[107] Shevtsova, *Putin's Russia*, 104-114.

nationalization or state interference if they withdrew from the political sphere.[108] An uneasy balancing of power between business elites and the states thus materialized in the first three years of the Putin administration.[109]

It is against this political background that the Putin administration made its first foray into economic policymaking. Among the first, and ultimately most important, structural reforms Putin undertook was the introduction of a new tax code which featured a 13 percent "flat" personal income tax, a unified social tax, the elimination of various turnover taxes and a reduction in the corporate tax rate, among its numerous provisions.[110] This new tax code built upon the tax overhaul that took effect in 1999, in the aftermath of the financial collapse, which established an institutional framework for the administration of taxes, incorporated steps to boost compliance and limit the scale of noncash payments which had effectively been acting as implicit subsidies. Further increasing compliance and broadening the tax base was the major goal of the tax reform implemented under Putin. The overall reduction of tax burdens was aimed at reducing incentives and opportunities to evade taxes and engage in inefficient sheltering activities. The abolition of turnover taxes, which had been levied without respect to profitability, had the effect of lowering the tax burden on industry by an estimated 8.5 percent of value added.[111] Implementation of this new system was greatly aided by the favorable fiscal situation that had been evolving since the crisis – in particular the reduction of government expenditure that gave the Putin government room to maneuver in lowering the tax burden for enterprises and individuals.

Another aspect of the overhaul of the tax system that would prove crucial to Russian development was the adoption of a new tax on resource extraction, which can be understood

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[108] Rutland, "Putin's Economic Record," 190.
[109] Andrei Yakovlev, "The Evolution of Business-State Interaction in Russia: From State Capture to Business Capture?" *Europe-Asia Studies* 58,7 (2006), 1043-1044.
[110] Dale Chua, "Tax Reform in Russia" in Owen and Robinson eds. *Reforming Russia,* 87-90.
[111] Ahrend, "Accounting for Russia's Post-Crisis Growth," 16.

as a product of the post-crisis change in relations between business and the state.[112] The new tax structure was a product of complex negotiations between the government and the privatized Russian oil companies, for both of whom the 1998 crisis underscored the need for stable, predictable rules in the realm of tax collection and property rights. Throughout the 1990s, the Russian government had been dependent on the oil sector for much of its tax revenues through a fixed excise tax, which meant that producers owed taxes on the basis of production rather than world oil prices. When oil prices sank in 1998, the tax burden facing oil companies was unchanged and they ran up substantial arrears – increasing the threat of nationalization as the Russian authorities made tax compliance a priority in the aftermath of the crisis. The new tax code and the declaration by Putin in 2000 that he would not reverse privatization can thus be understood as part of a negotiation process set off by the institutional and macroeconomic shift triggered by the shock of the 1998 financial crisis.

The perception of greater security of property rights under Putin and some steps in the consolidation of state authority achieved during his initial year of office had a positive impact on investment levels, which were also boosted by the fiscal stance of the Russian government after the 1998 crisis. Growth in gross fixed capital formation had been negative for each year leading up to the crisis but turned sharply positive starting in 1999. Boosting the atmosphere for private investment had been a major goal of Putin's economic program. Yet rising oil prices were perhaps an equally important factor driving investment forward. Oil sector investment had contributed around 25 percent of industrial investment prior to the crisis but jumped to 35 percent from 2000 onwards.[113] Increased investment by private oil companies translated into sharp production and export increases over the period of 2001-2003, while investment by state-owned companies in the oil sector did not result in significant production

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[112] This reading follows Pauline Jones Luong and Erika Weinthal, "Contra Coercion: Russian Tax Reform, Exogenous Shocks, and Negotiated Institutional Change," *American Political Science Review* 98,1 (2004), 139-152.
[113] Ahrend, "Accounting for Russia's Post-Crisis Growth," 20.

or export gains by them.[114] Thus, private oil companies emerged as major contributors to the high GDP growth over the first three years of the Putin administration – by one estimate contributing up to a quarter of growth.[115] These trends illustrate the Russian economy's dependence on energy prices for its levels of growth.

Tax reform was accompanied by a host of other structural reform measures in Putin's first three years of office, including land reform, judicial reform and new labor and corporate governance codes. These measures contributed to substantial improvements in the quality of legislation compared against international norms, but most observers suggest that their implementation has been uneven and has yet to fundamentally transform the operating environment for businesses.[116] The persistence of corruption and inefficient state administration posed the most formidable barriers to their implementation.

A notable exception to the trend in favor of structural reform under Putin's first administration was in the area of privatization. Further privatization had essentially ground to a halt in the aftermath of the financial crisis, and the trend saw only limited changes even amidst the economic recovery. Privatization plans were announced but not implemented – with about half of all plans postponed each year due to lack of bidders.[117] With a few exceptions, valuable enterprises still under state control or where the government maintained a large stake were not put up for sale. Transparency and competition in privatization deals continued to be limited. The European Bank for Reconstruction and Development's indicators of structural change estimate that the private sector remained at a constant 70

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[114] Ahrend, "Accounting for Russia's Post-Crisis Growth," 20.
[115] Ibid.
[116] Ahrend, "Fifteen Years of Economic Reform in Russia," 21-22.
[117] OECD, *Economic Survey of the Russian Federation 2006* (Paris: OECD, 2006), 68.

percent share of GDP after 1997, with a subsequent reduction to 65 percent in 2005 and 2006.[118]

Those figures indicate that, to the surprise of some observers, a slowdown in the pace of structural reform in Russia has been observed since the beginning of Putin's second term in 2004.[119] This slowdown was preceded by a Kremlin campaign against Russia's top businessman, Mikhail Khodorkovsky, who was the head of its largest oil company, Yukos. The arrest of Khodorkovsky was greeted with consternation in the West but boosted Putin's domestic popularity in the run-up to the 2003 Duma elections, in which a new pro-presidential party won two-thirds of the seats in the new Duma.[120] Putin himself would go on to win a decisive reelection months later. Although the second term has seen the continued implementation of many of the structural reforms adopted in the first, economic policy has also been characterized by an increasing role asserted by the state in directing economic development initiatives and in taking or consolidating ownership of "strategic" sectors such as oil, gas, aviation and finance. This trend was brought to international attention when the assets of Yukos were seized in a selective enforcement and eventually wound up under state control.

Perhaps counter intuitively, these developments point to the persistence of a weak state under the Putin years. Taking direct control of enterprises such as Yukos is a result of the difficulties the Putin administration encountered in managing its relationships with certain oligarchic interests, and in turn the belief on the part of these oligarchs that the government could be easily challenged.[121] This increase in state ownership thus can be linked to the high levels of industrial concentration which have evolved, in part because of the mass

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118 EBRD, "Transition Indicators," Available from http://www.ebrd.com/country/sector/econo/stats/tic.xls; accessed 13 April 2007.
119 OECD, *Russian Federation 2006*, 31.
120 Remington, "Parliamentary Politics in Russia," 51.
121 Yakovlev, ""The Evolution of Business-State Interaction in Russia," 1044.

privatization program of the 1990s as well as the consolidation of enterprises that occurred in the aftermath of the 1998 crash. A World Bank analysis in 2004 found that Russia's 23 largest private corporations accounted for about 30 percent of industrial sales and 11 percent of total employment.[122] The threat or materialization of increased state control over the energy sector has already had a negative impact on investment levels, which has meant that in recent years growth in the volume of oil exports has slowed – making the economy that much more dependent on oil prices.

The role of high oil prices should also be recognized as a factor behind the downturn in structural reform and the tendency toward increased national control of assets, although the Russian government has taken important steps to limit the impact of oil windfall on macroeconomic stability. The continued maintenance of a prudent fiscal stance – which has entailed large annual fiscal surpluses – has reduced the economy's vulnerability to price swings. The establishment of a formal stabilization fund in 2004 has also been an important development, although the fiscal stance showed some signs of weakening in 2005 and 2006 – with the non-oil fiscal balance deteriorating as a consequence of further tax reductions and increased social benefit payments.[123] Macroeconomic management in the context of high energy prices will continue to be a challenge for the Russian government – especially as trends point to the increasing resource dependence of the economy, which a substantial literature has linked to lower long-term levels of economic growth.[124]

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4.4 – Consequences of Fiscal Expansion in Hungary

While macroeconomic management has proven to be an area of remarkable progress in Russia, it remains a key challenge to sustaining economic growth in Hungary. The tend

[122] World Bank, *From Transition to Development* (April 2004).
[123] OECD, *Russian Federation 2006*, 30.
[124] For a review of resource curse literature and an empirical study demonstrating a negative correlation between natural resource abundance and economic growth in the transition economies, see Tobias Kronenberg, "The curse of natural resources in the transition economies," *Economics of Transition* 12, 3 (2004), 399-426.

towards populism discussed above brought about worsened fiscal imbalances and caused the government to abandon plans for euro entry in 2008 or 2010 – since the convergence criteria requires meeting certain fiscal criteria. Yet a shifting of course has materialized in the aftermath of the 2006 elections, in which the Socialist Party won reelection and soon announced a consolidation program to address the fiscal problems facing Hungary.[125] The goal of the program is to reduce the budget deficit to 3 percent of GDP (in line with convergence criteria) by 2010, from a current level of 9.2 percent in 2006.[126] As the OECD has noted in its recently released economic survey, in addition to temporarily curtailing growth, accomplishing this task would imply breaking a well-established pattern of election cycle increases in deficits.[127] The strategy involves a mix of temporary and permanent measures, including public sector wage freezes that in the past have proven hard to maintain and postponement of previously announced tax cuts. The package also is indicative of a renewal of limited structural reforms in public administration, health care, education, energy and transport subsidies. Public finance reform measures such as the establishment of a system of reserve funds to assure compliance with deficit targets.

It is too early to evaluate this consolidation program, but a nearly continuous story of failed or only partially successfully fiscal consolidation has characterized Hungary's recent history, and there is reason to be skeptical that this package will mark a break in that pattern. An OECD analysis is optimistic that fiscal consolidation can be achieved in 2007 and 2008 on the basis of already implemented measures, but it notes that further consolidation requires the continued implementation of structural reform measures that may get increasingly difficult as the 2010 election approaches.[128] A repetition of the established pattern of initial

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[125] The 2006 election was the only time in Hungary since the transition to democracy that a political alliance has won a second consecutive term in office.
[126] OECD, *Economic Survey of Hungary 2007* (OECD: Paris, 2007), 24.
[127] Ibid. 21.
[128] OECD, *Hungary 2007*, 26.

tightening of fiscal policy in the first two years of a government followed by increased laxity thus appears likely. The consolidation program has been fiercely resisted by the centre-right opposition to the Socialist Party, who gained ground in local elections held in October 2006 – aided by a controversy arising from a leaked post-election speech by the Prime Minister in which he admitted economic policy shortcomings from the previous government's term in office.

4.5 – Implications of Slowdowns

The past decade will in all likelihood offer a mixed legacy for the unfinished reform project in Russia and Hungary. In a limited way, a kind of convergence around the pace of policy reform can be observed in which indicators of structural change have in both cases slowed from levels shown in the mid-1990s.[129] As more complex legislative undertakings take time to implement or impact the structure of the economy, this is to a certain extent inevitable. Favorable external developments that have reduced pressure for radical measures have also played a role.

In Hungary, the successful accession to the European Union may have nurtured a complacency about the prospects for long-term convergence, which analysis has suggested is anything but guaranteed by EU accession.[130] The difficulty of constructing long-term structural reform measures in tight fiscal situations has also limited the range of policy options available as fiscal and current account imbalances have deepened. That the primary policy challenges relate to questions of redistribution – technically even more complex and characterized by an absence of consensus --

In Russia complacency has emerged that is tied to the high levels of transitory resource-based growth, with the continued lagging behind in the majority of indicators of

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[129] European Bank for Reconstruction and Development. *Transition Report 2006*. (London: EBRD, 2007), 12-13.
[130] Csaba, *The New Political Economy of Emerging Europe*, 139-163.

structural change and the emergence of a more forceful state role in the economy putting it on a developmental path. The favorable macroeconomic indicators since 2000 appear on the whole to be based on transitory phenomenon – passive enterprise restructuring, a favorable exchange rate and high energy prices. A recent quantitative analysis found no evidence of a link between Russia's aggregate growth figures and Putin's reforms or general transition policies at the federal level.[131] The Putin government has even acknowledged these challenges and declared an ambitious agenda to promote diversification and foster an "innovation" economy. This strategy, however, is linked to an increased role for the state to selectively intervene in certain regions and sectors of the economy, which is an indication that the Putin administration is moving to implement a national economic model that is at odds with most conceptions of how to foster innovation and in fact symptomatic of a weak state.[132]

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[131] Peter Voigt, "Russia's Way From Planning to Market: A Success Story? A Review of Economic Trajectories, Transition Progress and Putin's Merits" *Post-Communist Economies* 18,2 (2006), 123-137.
[132] World Bank, "Russian Economic Report," December 2006. Available from www.worldbank.org.ru. Accessed on April 10, 2007.

Conclusion

This paper undertook a broad view of the economic transformation stories of two post-communist states that have differed in the social, economic and political context of their transformation experience, yet –it has been argued – exhibited some of the same fundamental dynamics with respect to policy reform, despite their wildly different outcomes.

This analysis has indicated that positive shifts with respect to the pace of structural reform have taken place in response to crises in both cases – the one triggered by the collapse of central planning, the threat of a balance of payments crisis for Hungary in 1994-95 and the materialization of a financial crisis in Russia in 1998 – and that in general there has been a tendency to backtrack or postpone additional reform under improving macroeconomic conditions such as those that predominated in Hungary between 1997 and 2005 or in Russia since 2002. Policies were shown to compliment one another – with liberalization and stabilization measures embedded in a strong legal framework in Hungary promoting the development and growth of the private sector. Meanwhile, in Russia the weakness of the government and market institutions generally mean that poorly designed or impartially implemented policies in one area further hampered progress at structural reform in other areas. These institutional qualities appear to be path dependent, based on the social and political context of transformation as well as the different experiences with reform under socialism.

The ability to draw these conclusions from the experiences of Hungary and Russia implies that a single framework can still be employed for both cases. Moreover, it suggests that the post-communist transformation experience itself will be of continuing relevance. How policymakers in these countries navigated the complex policy choices available to them during this precarious time of crisis and hope will have a lasting impact and shape the range of choices available to subsequent generations of leaders.

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