Coping with Challenges of Smallness: Hungary's "Orthodox" and "Unorthodox" Economic Models Compared

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Abstract

This thesis demonstrates how small states can maneuver to compete in global economic environment, and extend their markets by raising their exports. This requires specialization, and a high degree of competition, but on the other hand, the latter also generates masses of 'losers' who cannot cope with high standards, therefore small states pursue political stability via applying compensatory mechanisms to counterbalance the costs of openness. Hungary is also a small, and open economy, with tiny domestic consumer markets, while the transition also challenged the decision-makers to legitimize the new democratic regimes. The starting-point of the analysis is to uncover, how Hungary's "orthodox" model maneuvered to satisfy radical market forces, while parallel pacify opposing voices by introducing relatively generous welfare state. However, it was not affordable, costing large fiscal overspending, and a constant increase of government debt, making Hungary one of the most vulnerable countries in East-Central Europe. After the global financial crisis in 2008, the governability of the model was undermined by welfare state retrenchments, with the ascendance of low trust in the government. These factors mainly contributed to the landslide victory of the conservative alliance in 2010, allowing the new government to introduce paradigmatic reforms without considerable opposition. This thesis uncovers, how the "orthodox" model was replaced with "unorthodoxy", and what possible vulnerabilities may challenge the new model.

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Chapter 1: Introduction

Traditional international relations theory argues that a combination of size, ownership of natural resources, high-level of economic development, and military power may determine, whether a state is “resistant” or “vulnerable” to external shocks. (Vital, 2006, 1967, p. 77-78) However, as Peter J. Katzenstein argues, due to the high degree of international competition by the middle-1980s, even the United States had to reconsider its role to become a “rule-taker rather than a rule-maker”, in order to adapt to the changes in global markets. (Katzenstein, 1985, p. 22) But the most important factor, which can determine, whether a state is actually small, is its vulnerability to external shocks[1], and as Paul Streeten argues “we know a small state when we see one”. (Streeten, 1993, p. 197) As small states are exposed to exogenous factors beyond the control of the sovereign government, the perfect ingredients for success are “economic flexibility and political stability”. (Katzenstein, 2003, p. 15)

Hungary is also small state with tiny consumer markets, it lacks natural resources, therefore it is also vulnerable to external shocks. Although Hungary is a special case in the sense, that it experienced the effects of the 2008 economic crisis more dramatically than any other nation in the East-Central European (ECC) region.[2] This is one the main factors, which contributed to the overwhelming victory of the conservative alliance in 2010, as they promised to deliver paradigmatic reforms, and to correct the failures of the previous government. The new government introduced several economic measures under the sails of “unorthodoxy”, [3] but

[1] Bishop, 2012, p. 947
[2] Csillag 2009, p. 669
[3] Szikra, 2014, p. 488

their implementation generated several tensions both on a domestic and on a European level. [45]
The so called “unorthodox” approach means that the government proclaimed a paradigm shift to replace orthodox – or neoliberal – policies, and turned its face inwards to strengthen the role of the state, placed the independent institutions under political control and restructured the frame of the welfare state. [6] While “unorthodoxy” was an attempt to develop a unique economic model, it was mainly inspired by the global economic crisis, which illuminated the risks of openness and excessive demand on foreign capital.

But the origins of “orthodoxy” and its distorted implementation also induced tensions in domestic politics, empowering the conservative alliance in the long-run. The decision-makers in Hungary usually adopted policy best-practices from other regions, and - as Rodrick also argues – conditional loans from international creditors also required adopting neoliberal policies.[7] But as Rodrick claims, while neoliberal policies were usually considered as universal remedies, different problems need different implementations to achieve the stated goals. (Rodrick, 2006, p. 976) Simmons, Dobbin and Garrett also argue that even if a policy is successful in one region, it cannot be adopted without examining other factors, which might influence the potential outcomes. (Dobbin et.al., 2007, p. 461)

As Kornai argues, the “premature welfare state” (Kornai, 1997, p. 1184) in post-socialist countries imposed high expectations on transitional governments to provide universal entitlements, while they were unable to finance them from their budget without generating high

[4] Hungarian Telecommunications Office (*MTI – Magyar Távközlési Iroda*), Archives, (19th November, 2014), Foreign media on Hungary: German, French, Belgian, Austrian and Swiss newspapers, “*Külföldi sajtó Magyarországról: Német, francia, belga, osztrák, és svájci lapok*”, Retrived from http://archiv1988tol.mti.hu (Accessed online on 7th February, 2016)

[5] Taylor, P., (7th June, 2015), Despite „Hello Dictator”, EU struggles to curb Hungary’s Orban, Reuters, Retrived from http://www.reuters.com/article/us-hungary-eu-analysis-idUSKBN0ON09P20150607 (accessed on February 1st, 2016)

[6] Szikra, 2014, p. 486-488

[7] Rodrick, 2006, p. 974

fiscal deficits and accumulating more public debt.[8] Hungary is not an exception as it adopted ill-combined welfare and fiscal policies after the transition, and due to its smallness, and foreign indebtedness, it was extremely vulnerable to external shocks – for instance "…natural disasters, currency devaluation, high transaction costs, and external crises". (Bishop, 2012, p. 948) On the other hand, compensating the society for the costs of openness was necessary to legitimize the new democratic regimes.

As the introductory remarks suggest, this paper unfolds the conflicts which emerged from the embedded neo-liberal – or "orthodox" model, and presents how its specific vulnerabilities grounded its replacement by "unorthodoxy". The first part of the paper explains the most relevant theories about small states and their vulnerabilities, and more specifically about the ECC experience. The second part examines the embedded neoliberal model as a starting-point for the comparison, and the third part extensively analyzes the "unorthodox" model itself.

1.1 Previous Studies on the Topic

There is a large literature on small states, and developing transition economies in the post-socialist region, which can serve with extensive explanations on how small states can maneuver to legitimize economic openness. As a starting-point for the analysis is the challenges of smallness, and the forms of domestic compensation, one should study Peter J. Katzenstein's comprehensive work in the field. As he argues in his book "Small States in World Markets: Industrial Policies in Europe", some small states could maneuver more successfully in world markets, than large states with more resources. (Katzenstein, 1985)

[8] Kornai, 1997, p. 1183-1186

Katzenstein argues that small states, which have tiny domestic consumer markets – such as Denmark, Switzerland, Norway and Sweden -, could outpace the United States in GDP per capita (Katzenstein, 1985, p. 18), because they could adjust their industrial policies to produce competitive export goods and services to world markets. While economic liberalization generated an immense wealth for some segments of the society, small states had to remain politically stable to embed economic openness. In this regards, Katzenstein observed that small states justify openness via wage control[9], proportional representation[10], and democratic corporatism[11] to establish political stability.

The post-socialist experience also confirms that globalization, and enhanced competition leads to several tensions, as the newly established democratic regimes also had to legitimize openness, usually at the cost of large fiscal overspending. According to a book written by Dorothee Bohle, and Béla Greskovits "Capitalist Diversity in Europe's Periphery", while the Visegrad states and Slovenia established a "welfarist social contract" (Bohle, Greskovits, 2012, p. 152) to legitimize neoliberal market reforms, the Baltic states managed it through a "nationalist contract" (p. 113-114) allowing them to exercise more fiscal prudence. For instance, in the case of Estonia due the presence of a large Russian minority, governments could maneuver through *de jure* exclusion of minorities at the cost of undermining the quality of democracy. (p. 22)

In the case of Hungary, due to the aforementioned "premature welfare state" (Kornai, 1997, p. 1183), it was politically difficult to reduce social spending and to restructure the pensioner-biased welfare state,[12] therefore the most vulnerable groups of the society – namely the poor and Roma people – who had low bargaining potential were neglected by compensatory

[9] Katzesntein, 1985, p. 49
[10] p. 100
[11] p. 30
[12] Bohle, Greskovits, 2012, p. 15

mechanisms.[13] Parallel to this, Hungary was one of the most successful examples in the Visegrad area in reintroducing manufacturing industries, as it could attract foreign direct investment (FDI) with high-skilled and cheap labor. On the other hand, the tax competition among the Visegrad states rather induced a race to the bottom as they had to offer low corporate taxes to attract foreign capital.[14] As it was difficult to tax Transnational Corporations (TNCs), the state had to undertake more debt, as it was politically difficult to adjust or restructure the welfare state.[15]

The other important element of smallness in the ECC region is the importance of geopolitical claims. As a Hungarian scholar, István Bibó argues (1946, 2011), after Hungary experienced robust territorial losses, some political forces envisioned geopolitical claims as the primary goal of nationalism to preserve cultural and linguistic integrity. Those who wanted to reclaim the lost *status quo* believed that only reconquering the detached territories might restore the glory of the nation. But such views cannot be democratic, as he argues democratic societies promote creative spirits, and reject the idea of conquer.[16]

While nationalists were exposed to a constant fight for national sovereignty, and complete autonomy from foreign powers, other parts of the society became apathetic, seeking reconciliation with the prevalent situation. This opposition also exacerbated the radicalism of nationalist forces with a parallel decline of democratic development and marginalization of the society.[17] So basically, geopolitical claims divided the society into two groups during the past century: (1) ones who wanted to reclaim the lost *status quo* and preserve national sovereignty,

[13] Szalai, 2005, p. 312
[14] Bohle, Gresovits, 2012, p. 172
[15] p. 155-156
[16] Bibó, I., 2011, (1947), The Misery of Small Eastern European states – *„A Keleteurópai kisállamok nyomorúsága"*, Argumentum Press, Retrieved from http://mek.oszk.hu/02000/02043/html/234.html (Accessed on 16th May, 2016)
[17] Ibid.

and (2) those who could accept territorial disintegration and were able to adapt to the new context.

In sum, challenges of smallness mean an opposition between economic liberalization and voices against economic openness. The case of Hungary shows that while it was very successful in attracting FDI, and reintroducing manufacturing industries, maintaining the compensatory mechanisms was costly, and it undermined macroeconomic stability. So this paper focuses on how Hungary copes with its smallness to embed economic openness, and to legitimize it via different forms of compensation.

1.2 The Puzzle

As Hungary introduced a relatively generous welfare state to compensate the costs of openness, the 2008 economic crisis illuminated the vulnerabilities of the model. The dominance of the "premature welfare state" (Kornai, 1997, p. 1183) derivatively implied the accumulation of a robust state debt, and the economic crisis also aggregated the problems of fiscal overspending.[18] Following this paper examines how the "unorthodox" model has restructured economic openness and the compensation of the worse off, and what forms of vulnerabilities have emerged from the new model. The puzzle of this paper is that small transition economies have to be open to foreign direct investment to extend their capital markets, while they also have to compensate the losers of global competition. As the "unorthodox" model transformed domestic compensation, the government could also maneuver to adjust its macroeconomic policies. Ultimately, this paper uncovers, what possible forms of new vulnerabilities have emerged.

[18] Veress, 2012, p. 361

The "unorthodox" model compared to the "orthodox" one is selectively open to FDI focusing on the manufacturing industries, aims to enhance trade towards the Eastern region,[19] while it also redistributes monopolistic rights via concessions in the retail sector to its protégé followers[20]. In its political rhetoric the government promotes the "unity, autonomy and identity" of the Hungarian nation, (Johnson et.al., 2015, p. 536) while the economy remains dependent on foreign investors in trade and production.[21] The welfare state was restructured to benefit high-earners, and the state offered a low-paying "public works program" for the "non-productive" parts of the society, while parallel cutting unemployment benefits. (Szikra, 2014, p. 492)

	"Orthodox" model	**"Unorthodox" model**
Economic openness	Openness to FDI EU accession	Selective openness to FDI "Eastern opening" EU funds
Domestic compensation	"Welfarist Social Contract"	Identity politics Creating a national bourgeoisie Workfarism
Vulnerabilities	Financial openness Institutional misfit	*Erosion of international competitiveness* *Increasing poverty and mass emigration*

1. Table, comparing the "orthodox" and the "unorthodox" models

The emerging vulnerabilities may not have a negative impact in the short-run, but absorbing the second pillar of the pension-system to bail out firms, purchase corporate shares

19 Pogátsa, 2014
20 Szelényi et. al., 2015, p. 33
21 Johnson et.al., 2015, p. 536

and government bonds may show that the government treated private savings as extraordinary revenues and only party applied them to recapitalize the PAYG system.[22] Radical state intervention, and selective rule-of-law induced market failures, and a radical relapse of international competitiveness.[23] Increasing poverty, and parallel emigration means that less contributors will finance the indebted state budget and social security funds, therefore it holds a high-risk of bankruptcy or undertaking more debt in the long-term.

1.3 Research Question

This paper compares how the "orthodox" model maneuvered between economic openness and domestic compensation, and how the "unorthodox" model delivered paradigmatic reforms, replacing the former with a completely new economic model. Firstly, this requires providing a definition about smallness, and vulnerabilities and to elaborate why Hungary is a small state.

Secondly, one should examine how the "orthodox" model and its relatively generous welfare state was readjusted due to the economic crisis. More specifically, as the adoption of the Bajnai-package in 2009 demonstrates, parametric reforms were indispensable, hence to save the budget from bankruptcy. More particularly, the Bajnai-package technically abolished the 13th-month pension, froze the pensions on the current level, accelerated the extension of retirement age, and reduced maternity, and sickness benefits.[24] Basically the measures of the

[22] 'The nationalized pension funds are vanishing', - '*Eltűnőben az államosított nyugdíjpénz'*, (3rd October, 2013), World Economy (*Világgazdaság)*, Hungarian Economic Journal, Retrieved from http://www.vg.hu/penzugy/eltunoben-az-allamositott-nyugdijpenz-412988 (Accessed on 10th May, 2016)

[23] Chikán, 2015

[24] Summarizing the Bajnai-package step-by-step, *„A teljes Bajnai-csomag pontról-pontra"* (21st April, 2009), Portfolio (Online Economic Journal), Retrieved from http://www.portfolio.hu/gazdasag/a_teljes_bajnai-csomag_pontrol_pontra.113811.html (accessed on 10th February, 2016)

Bajnai-package parallel imposed a demand for a new social contract, and majorly contributed to overwhelming victory of the FIDESZ-KDNP coalition.

Thirdly, this paper unfolds how the introduction of "unorthodoxy" was legitimized, allowing the FIDESZ-KDNP government to deliver debated paradigmatic reforms without considerable political opposition. On the one hand, the welfare state retrenchment of the Bajnai-government allowed more space to maneuver, but the expectations towards the new government demanded other forms of compensations. Therefore, the research question of the paper is the following: How does the "unorthodox" model cope with vulnerabilities?

Based on the research question, and the main argument of the paper, the last chapter aims to provide an answer on what forms of new vulnerabilities emerged from the "unorthodox" model, and how does it maneuver to legitimize economic openness.

1.4 Methodology

The paper applies a descriptive method based on a comparative chronological perspective to identify the main differences between the "orthodox" and the "unorthodox" model. This requires a clear-cut definition of the two models, and a summary of the most remarkable characteristics of economic openness, the forms of domestic compensation, and vulnerabilities in each period. Therefore, the paper applies a trend analysis to compare the pre- and post-2010 era, after the FIDESZ-KDNP government was elected. In some cases, this involves cross-country comparisons to show the relevant measures on a European level and among the Visegrad states. But one should also treat exogenous factors – for instance the 2008 economic crisis -, and government policies separately, indicating their individual effects.

The measured period for the analysis is between 1990, when Hungary opened up its economy after the fall of the communist regime, and 2014, when the FIDESZ-KDNP government was reelected for a second consecutive term. As in some cases the data has limited accessibility, the figures aim to demonstrate the main differences between the two models, highlighting the major changes, and most significant findings. Hence to demonstrate the most relevant indicators, the paper applies data obtained from the Central Statistical Agency (KSH), the Hungarian National Bank (MNB), and the European Statistical Database (EUROSTAT).

Chapter 2: Theoretical Concepts: The Small State Theory

2.1 Challenges of Smallness

One of the most relevant books in this topic, written by Peter J. Katzenstein: "Small States in World Markets" clearly defines that the former dominant economic concepts and theories in international relations fundamentally changed in the past 50 years, and even large states had to reconsider their economic policies, to adopt to the post-WWII environment. Katzenstein identifies that some countries could raise their GDP per capita and actually started to compete with large economies in the sense of individual well-being.[25] The old fashion approach highlighted the importance of "natural resources, economic development, geographic location, and military might" (Vital, 1967, 2006, p. 77-78), while in the 1970s and 1980s the US had to realize that the ownership of these virtues are not key factors to success in itself.

Large states have the margin to rely on domestic consumption, and they were usually reluctant to concentrate on export sectors. But by the end of the 70s, and during the early 80s, economic experts recognized that some smaller countries, such as Denmark, Switzerland, Norway, and Sweden surpassed the US in GDP per capita growth. However, the US remained the largest economy in size, but it seemed that some smaller countries could enhance living standards and sustain a broader welfare state. Concerning the new economic environment, the US markets had to develop a new approach that could be resilient, and adjusted to the appearing challenges. By the middle of the 80s openness became the key element of economic development, and by its adaptive approach, the US economy raised its export up to one-fifth of

[25] Katzenstein, 1985, p. 19

the national production, while this number was more than forty percent in the agricultural sector.[26]

However, opening up the economy was a step-by-step process, which took decades, to shift the behavior of economic actors. The trends may also show that the US economy became more open to world markets starting from the 1960s: between 1960 and 1979 steel imports increased from 4 to 14 percent, consumer electronics imports increased 6 to 51 percent, while apparel imports also increased from 2 to 10 percent. The economic development strategy of the US can be considered successful, and openness could raise the competitiveness of domestic goods and services, and by the middle 80s two-thirds of products were present on global markets.[27]

Katzenstein concludes that while geographic endowments influence the political strategies of large states, they are not the key factors to determine economic performance. The attachment to natural resources took the back seat, and competiveness on global markets became the focus of economic strategies. Some export-oriented states –such as Japan -, could produce high-quality products in the electronics sector, and their exports to the US also significantly increased. As these new products appeared on the market, consumers started to replace the domestic products with high quality imported ones, as they were more innovative, and affordable. It is important to note that the achievements of the Japanese export were not a coincidence, but a deliberate economic strategy of a "smart state". (Katzenstein, 1985, p. 19)

As large states are less vulnerable, and they can host a wide-scale of industries to support domestic demands, the puzzle of small states differs in several respects. As large states are more determining actors, it also infers that small states are vulnerable to large states. Defining vulnerability, according to Briguglio (Bishop, 2003, p. 944) it suggests the following features:

[26] Katzenstein (1985): pp17-19
[27] Katzenstein (1985): pp205

"(1) natural disasters; (2) currency crises; (3) dramatic environmental degradation; (4) high transaction costs; (5) price fluctuations in commodity markets, especially oil; (6) weak administration; (7) high levels of out-migration; (8) and volatile growth of GDP, amongst numerous others." Being small also derives that they have limited natural resources, small domestic market, and a robust dependence on export-oriented industries." (Bishop, 2003, p. 944)

So developed states, which have limited domestic market capacities, usually rely on export of competitive goods and services, and their economic growth is massively dependent on these industries. "Smart-states" (Katzenstein, 1985, p. 19) are open to criticism, and they have the ability to identify key sectors which can compete on world markets. On the other hand, this also requires an awareness of their weaknesses, and an assertive approach towards domestic actors. Japan performed poorly in producing textiles, and commercial aircrafts, so it had to realize that capital invested in these sectors are excrescent, while it could rather concentrate on industries that could compete with powerful global economic actors.[28] One can argue that identifying key sectors is one of the most important factor to enhance long-term prosperity and should concentrate on the export of competitive products. On the other hand, this requires embedded assertive – or critical - approach in the society, and an unbiased evaluation of economic performance.

If the assertive approach, and open-mindedness to competition are embedded within the society of small states, according to Ingebritsen (in Bishop, 2012, p. 944), they may have a more advantageous position to maximize their benefits from global markets.

[28] Katzenstein, 1985, p. 19

"… recognition of the fact that small states have 'greater freedom for maneuver than classic international relations theorizing suggests'; smaller players as 'norm entrepreneurs' can play innovative roles that larger countries perhaps cannot; influential small states can provide examples to others because of their exclusion from the 'formal corridors of power'; small states do not set the rules of the international game, so they can fly under the radar to influence system operation in ways that are, at present, poorly understood; and, finally, 'might does not make right', the implication being that small states have a crucial moral role to play in illuminating power abuses by bigger players." (Ingebritsen, 2006, p. 289–290)

According to Ingebritsen's argument small states have to accept the rules of international competition, while they also have the ability to "fly under the radar" and respond effectively to global changes. They can also benefit from their smallness as they are not "rule-makers", but "rule-takers" (Katzenstein, 1985, p. 22) and avoiding the spotlight also relieves them from the responsibility encumbering great powers. So the advantage of smallness is economic flexibility, which enhance their potential to maneuver more gracefully, unlike large states with strong attachment to their incremental *status quo*. So assertively has two dimensions in this sense: (1) one suggests the unbiased evaluation of domestic sectors to identify key industries, where more development has squared benefits, and secondly (2) small states as norm entrepreneurs can highlight power abuses of large states, which may serve as a virtue.

As the short theoretical summary on the behavior of open economies has demonstrated, openness established a new global economic environment, whereby the behavior of certain actors by size may differ. The role of export-oriented sectors significantly increased, but it is also worth mentioning, how small states maneuver to keep these industries growing, while also compensate other segments, which are vulnerable to enhanced competition. One of the major differences in size is that large states are rule-setters, and shapers of the global economy, small states are rather “price-takers”, and “rule takers”,[29] while they might also become influential actors as “norm entrepreneurs”. So small states are constrained to become adaptive, and resilient both politically and economically.

2.2 Domestic Compensation

As small states may become vulnerable to many possible external shocks, which may necessitate the establishment of protective mechanisms that can reduce the negative impacts on the national economy. Resilience in this sense should refer to the ability that the appearance of a particular crises should facilitate rapid adoption of a new environment, while large states are not capable of implementing rapid reforms as they are less flexible according to their size. Anthony Payne highlights the notion that vulnerability should always come with resilience, and together they may create a perfect fusion of managing crisis situations. (Payne, 2009, p. 280)

Katzenstein argues that Keynesianism ended especially in the case of small states in the 1970s, and a new kind of welfare approach has been developed based on the grounds of democratic corporatism, while the market had a strong role in shaping the economy. [30] On the other hand, such governments were seeking cooperation with the different groups, in order to satisfy various demands through a wide-scale and generous welfare state. Vulnerability and resilience has costs and openness usually generates a mass group of losers, who usually lack the skills to compete on world markets. Their deprived situation usually undermines international liberalization, so the government has to implement compensatory measures, and industrial adjustment.

[29] Bishop, 2012, p. 948
[30] Katzenstein, 1985, p. 196-198

Hence to support the abovementioned argument, David Cameron argues that the higher proportion of export in the balance of payments usually positively correlates with social expenditures. (Cameron, 1978, p. 1243-61) So small states are quite generous in a sense that they usually promote welfarism, while they imply egalitarian redistributive measures, in order to minimize inequalities.[31] Katzenstein also addresses a very important observation that governments in small states established a tight partnership with societal groups through democratic corporatism which "serves as a glue" (Katzenstein, 2003, p. 11), so basically strong ties with the domestic actors is a key element in creating stability. On the other hand, it may also reduce the harmful impacts of openness, helps minimizing the size of the worse off, and the government has a more straightened track to pursue economic development.

Small states cannot allow inequalities, and they need to pursue a high-level of confidence in the actual government, in order to sustain economic flexibility in the long-run. Egalitarian policies also serve as a political strategy,[32] because governments need to enjoy a high-level of confidence, in order to sustain their economic policies, and to silence opposition voices blaming openness for the misery of 'non-productive" groups and "under-performing" industries. Katzenstein also argues that "economic flexibility and political stability are close cousins" (Katzensetin, 2003, p. 15), so the argument suggests that resilience cannot be implied without massive public support of economic policies.

However, according to Olson, taxation is not the most important tool to enhance economic growth (Olson, 1996, p. 29, 32, 40, 47–53, 88–90) –, but one may claim that income inequalities may be affordable for large states, where there is a large consumer market with a high-level of purchasing power parity, and lack of demand to rely on export to have long-term economic growth perspectives. In the case of small states, exporting competitive goods is the

[31] Katzenstein, 2003, p. 4-10
[32] p. 18-19

most important factor that can influence the economic performance, and it is the key element to ensure long-term economic growth. So as small states cannot influence the global economy, but have to suffer from exogenous factors, it is crucial for them to sustain a high-level of confidence in political institutions. If the redistributive measures may create sharp inequalities within the society, losers may blame openness for their own misery, while simply relying on domestic consumption is not an option for them because of the small size of their markets.[33]

Katzenstein also observes that small states are advised to enhance institutional trust that can be achieved by strong democratic and preferably proportional representation. Large states – such as the US or Great Britain – with majoritarian electoral systems based on a "winner-takes-all" principles may generate a lot of losers, and low trust in political institutions. But proportional representation can moderate opposing voices, establishing a close partnership with the society, and therefore minimize the number of losers, substantiating political stability.[34]

2.3 Hungary as a Small, Non-oil, Transition Economy

The measurement of smallness by the classical international relations theory is based on geographic size, population, the ownership of natural resources and military might.[35] As the primary assumption of this paper is that Hungary is a small, non-oil, transition state, ones should confirm these hypotheses step-by-step, before going on with the detailed analyzis of the "orthodox" and "unorthodox" models. The most consistent method to determine Hungary's eligibility, whether it fits in the small state puzzle may be managed by comparing its endowments to some of Katzenstein's sample countries.

[33] Katzenstein, 2003, p. 15
[34] p.18-20
[35] Vital, 2006, (1967), p. 77-78

The geographic size of Hungary is ninety-three thousand square kilometers, which is slightly more than the land of Austria, more than four times less than Sweden's, and almost three times more than the Netherlands's. Although its population is 60% of the latter's, it is almost equal to the Swedish, and the Austrian.[36] So one may claim that Hungary fits into Katzestein's sample in this regards, even if it owns more territory than some other small states. Incrementally one may confirm that Hungary has a small population, and therefore small domestic consumer markets, so according to the small state puzzle, simply relying on domestic consumption is not an option.

Concerning the ownership of natural resources, while some small states export these virtues – such as Norway or Denmark –, Hungary has a massive import dependency on gas, petroleum products, and solid fuels, similarly to the other small states in Katzesntein's sample.[37] As the measurement of an oil country is the surplus in its trade account generated by exporting energy sources, one can confirm the third hypothesis that Hungary is a non-oil country. So while oil-countries can generate wealth by relying on the export of natural resources – except the case, when global markets depreciate energy prices -,[38] this path is clearly not an option for Hungary.

When it comes to military might, one may deduce that Hungary is not a great power, and due to its NATO membership and advantageous geographic location, it makes it unnecessary to maintain a large army. This hypothesis may be confirmed by examining its expenditure on sustaining its military infrastructure, which was no more than 0,8% of its annual GDP in 2015. As a matter of comparison, even less significant states with large budgets spend

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[36] Own calculations, source: The CIA World Factbook (accessed on 20th May, 2016)

[37] Energy Dependence, Retrieved from Eurostat, http://ec.europa.eu/eurostat/tgm/refreshTableAction.do?tab=table&plugin=1&pcode=tsdcc310&language=en (Accessed on 28th May, 2016)

[38] Parker, Andrew, 22nd March, 2016, “Oil price crash has far-reaching consequences for business and politics”, Financial Times, source: https://next.ft.com/content/b79a0924-ea8b-11e5-888e-2eadd5fbc4a4 (accessed on 25th May, 2016)

more on their army – while Denmark is 71st and Norway is 72nd on the list showing government expenditure on military as a percentage of GDP, Hungary occupies the 113th position lagging behind even Katzenstein's small states. So Hungary with a nearly equal GDP spends almost half as much as Denmark on maintaining its army.[39]

Concerning to this, István Bibó (2011, 1946) also declares Hungary as a small state, while he also highlighted that coping with smallness was a difficult task for Eastern European societies. In his book as – "The Misery of Small Eastern European States" – he argues that some states in the region couldn't process their territorial losses during the past century and they constantly pursue the restoration of their lost *status quo*. They usually had territories, which they were afraid to lose, or territories, which they wanted to reclaim, and politics identified the ownership of territories as a key factor to prosperity. Whether their demand to redraw the borders in the region is just or unjust, it undermines the progress of democratic development, as it might be even challenging for developed democratic countries to pacify pessimistic voices concerned about smallness and vulnerabilities. Therefore, the traumas of territorial losses, and the importance of territorial claims blocked the way for a balanced democratic development, clearing the path for quasi-democratic regimes reflecting pessimistic echoes. [40]

Incrementally the politicians of small Eastern European states started to compete for the hegemony to become the primary advocates of Christianity, democracy, and European culture. This basically means that domestic politics was always determined by pursuing some universal good, which other countries "failed to achieve". So basically one can identify an arrogant behavior, and a pursuit of "universal justice" in nationalist rhetoric among small EE states. But this "universal justice" is usually distorted by politicians, and they use it as a tool to justify their demands from others, and to exonerate their responsibility for their actions. Usually the

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[39] CIA World Factbook, own calculations, (accessed on 20th May, 2016)
[40] Bibó, 2011, 1946

winners, who claimed territories from others became peace advocates, while the losers argued that first "we want our territories back, then there can be peace".[41] This constant struggle is also exacerbated by the opposition between those who wanted to reclaim the lost *status quo* and apathetic voices, who could find reconciliation with the prevalent situation.[42]

So what is important in the aforementioned statements is that very few EE countries could adapt to the new geopolitical environment, and especially Hungary – which had lost two-third of its territory – demanded justice from other nations, and some voices couldn't forgive the world for this robust loss of territorial, and political weight. One might conclude that the Hungarian political culture still carries these traumas, and there was limited success in adopting the Katzensteinen assertive, or Ingebritsenian "norm entrepreneurial" position, while the debate remained open, whether the territorial losses were just or unjust. Another implication is that debates still circle around the argument that "size does matter" and some politicians perceive geopolitical weight as the only remedy for economic stagnation.

The transitional period also challenged governments to legitimize economic openness and substantiate political stability via compensating the losers of the global competition. While the compensation was relatively generous benefitting a major part of the society, it was not affordable due to the country's backward economic performance.[43] The next chapter summarizes how Hungary's "orthodox" model coped with the challenges of smallness, and how the 2008 economic crisis highlighted the vulnerabilities of the model.

[41] Bibó, 2011, 1946
[42] Ibid.
[43] Kornai, 1997, p. 1183-1184

Chapter 3: The ”Orthodox” Model of Hungary: Economic Openness, Domestic Compensation, and Evolving Vulnerabilities

3.1 Defining “Orthodoxy”

This chapter focuses on the “orthodox” model in Hungary, and explains how the economic policies were shaped after the transformation from socialism to capitalism. The first section helps to define the “orthodox” model, and explains the specific implementation of neoliberal policies. Section two describes Hungary’s foreign-led modernization strategy by attracting FDI, with the parallel introduction of complete private ownership, and dismantling the role of the state. Then the paper explicates the compensatory mechanisms applied by the model to legitimize openness, and in the last section it explains how the evolving vulnerabilities destroyed political stability.

Jeffrey Sachs argues that post-socialist states in Eastern Europe needed to immediately introduce a market based economic system after the transition, in order to stimulate economic growth, and development. In his article published in *The Economist*, he argues that for EE states there was no possible “Third way” solution, should not to consider public ownership, and labor self-management as a path, in order to become a “Western-style market economy”. (Sachs, 1990) He also claims that Western European countries needed to cooperate with the newcomers, providing them debt relief, and fiscal support for their development, in order to establish the necessary ties and conditions for an integrated European market.[44]

Sachs also argues that the transition period, and the future prospects of these countries was needed to be separated, and firstly they meant to “introduce complete private ownership,

[44] Sachs, 1990

liberalize financial markets, and enhance labor market flexibility." (Sachs [1990]) So according to Sachs, before determining the future prospects of EE countries they should catch up with the West, and then they can decide, whether they want to establish a "Swedish-style social democracy" or a "Thatcherite liberalism" (Ibid.). Sachs was a major advocate of "orthodoxy" and shock-therapy in reforms, while as some scholars argue, the Hungarian neoliberal reforms considerably had a gradualist path. (Hare and Révész, 1992, Székely and Newbery, 1993 in Hoen, 1996)[45]. While other scholars – such as Stephan Johannes,[46] - argues that one can consider the Hungarian reforms gradual only in a limited extent, as for instance trade and price liberalization was introduced within a very short-period of time after the system transformation.[47]

But as "orthodoxy" became the hegemonic economic paradigm of its age, imposed on the newcomers from the post-socialist region, one should explain its origins to comprehend its relevance. Danni Rodrick argues that the 1990s brought a new era to globalization, and some of the main actors of global economy – such as the IMF, the World Bank, and the U.S. Government – declared the most recognized policy recommendations in the Washington Consensus (WC), to reduce poverty, and stimulate economic growth in poor, and peripheral countries. It was a fundamental paper of its age, and a pillar of orthodox economics recommending to "stabilize, privatize, and liberalize". (Rodrick [2006]: pp973.)

Basically, the WC was a basket of policy recommendations, suggesting developing countries to follow Orthodoxy in economics:

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[45] Hoen, 1996, p. 2

[46] Chawluk, A. "Economic transition in Hungary and East Germany: Gradualism and shock therapy in catch-up development." Economic Journal 110, no. 467 (n.d.): F811-F813. Social Sciences Citation Index, EBSCOhost (accessed April 13, 2016)

[47] Ibid.

“The principles of… ‘macroeconomic stability, domestic liberalization, and openness’ have been interpreted narrowly to mean ‘minimize fiscal deficits, minimize inflation, minimize tariffs, maximize privatization, maximize liberalization of finance’, with the assumption that the more of these changes the better, at all times, and in all places – overlooking the fact that these expedients are just some of the ways in which these principles can be implemented” (Rodrick, 2006, p. 976)

The abovementioned quote from Rodrick suggests that the claims of the WC are simply policy goals, but it doesn’t declare the way to achieve them. So basically the WC ratifies no universal remedy fitting to all countries, as their previous institutional path is non-identical. This was basically the strength, and the weakness of this document, as while it didn’t provide a strict policy agenda, it imposed high expectations on the decision-makers. Although one should clarify why “orthodoxy”, and liberalization was dominant in the EE region, and why was it important to pursue such policies.

According to Simmons, Dobbin and Garrett (Dobbin, et.al., 2007), there have been always waves of global economic reforms during the 20th century, but in the 1990s, neoliberalism was the hegemonic economic paradigm, stimulating privatization and economic liberalization.[48] The authors argue that several case studies show the tendency that if a country adopts a policy, which is likely to increase economic efficiency, and tends to be prosperous in the particular context, other countries may also adopt them, even if it is not necessary, and the institutional path is non-identical.[49] In respect of constructivist theory, as the United States, and its liberalized economy was considered as a peerless success story, it was not an unexpected

48 Simmons et. al., 2007, p. 450
49 p. 454

outcome that other countries also adopted neoliberal economic measures as best practices – which basically happened in the 1990s in many EE states as well.

Another important form of adoption is the *coercion* theory suggesting that institutional creditors provide conditional loans or benefits demanding the addressees to adopt neoliberal or "orthodox" policies – such as trade liberalization, and fiscal conservatism.[50] Conditionality was usually exercised by the U.S., the EU, the International Monetary Fund (IMF), and the World Bank showing that Western powers, and international institutional actors had a strong influence in shaping policy reforms. [51] For instance the role of the EU was very influential in the ECE region, as the accession criteria imposed the expectation on candidate countries to adopt neoliberal policies, in order to meet common market standards, and to incentivize the inflow of foreign direct investment.[52]

Between 1995 and 2010, Hungary also received loans from the IMF in nine cases,[53] which might show the vulnerability of the Hungarian economy to external creditors, demanding neoliberal reforms. While Hungary followed a quasi-gradualist path to introduce neoliberal reforms, it is also noteworthy that introducing neoliberal reforms by non-market actors is quite paradoxical per se. As Stephan Haggard and Robert R. Kaufman argues, "orthodox" or neoliberal policies demanded less state intervention to provide more freedom to markets through privatization, and economic liberalization, while this could be only managed by strengthening the role of the state. (Haggard and Kaufman, 1992, p. 25) This is usually referred to as the "orthodox paradox", which means that the state is the only agent, which can conduct reform procedures, to replace statist policies. (Kahler, 1990, p. 55)

[50] Dobbin et. al., 2007, p. 449
[51] p. 454
[52] Medve-Bálint, 2014, p. 39
[53] Hungarian Central Bank, Retrieved from https://www.mnb.hu/a-jegybank/nemzetkozi-kapcsolatok/a-nemzetkozi-valutaalap-imf (Accessed on 10th April, 2016)

After the transition during the 1990s, the introduction of private ownership incrementally induced the privatization of former state owned enterprises (SOEs), but as Gil Eyal, Iván Szelényi, and Eleanor Townsley argue, the new economic realm was basically a "capitalisms without capitalists". (Eyal et.al., 2001, p. 1123) As the former socialist elites conducted the privatization procedures, they could abuse their previously earned privileges to expropriate state property technically with the absence of market principles.[54]

As the insufficient implementation of privatizing former SOEs procreated a new national bourgeoisie, who were basically the winners of the transition, governments had to compensate the less fortunate parts of the society to legitimize the new democratic regime. Although the Visegrad states – including Hungary -, propagated their neoliberal reforms, Katzenstein argues that one should rather label the ECE economies as "European-style welfare capitalisms". (Katzenstein, 2003, p. 22) So one can conclude that embedded neoliberal approach in the Visegrad region was rather a mixture of ill-combined insufficient market reforms with large fiscal overspending on the welfare state.[55]

In this respect, Hungary can be considered as a salient case due to several factors challenging the governability of the embedded neoliberal model, which makes it relevant to the analysis. Bohle, and Greskovits calls it "ill-conceived embeddedness", as the model had both policy-related, and politics-related symptoms, including lack of macroeconomic stability, with the parallel emergence of radical forces. (Bohle, Greskovits, 2012, p. 23-24)

3.2 Foreign Direct Investment After the EU Accession: Hungary's Export-based Foreign-Owned Manufacturing Industries

[54] Bohle, Greskovits (2012): pp9.
[55] Ibid: pp19.

The small state theory suggests that countries with small capital markets, and tiny domestic consumer markets may generate growth by attracting foreign direct investment, and produce competitive export goods and services. As Hungary was vulnerable in many extents – currency devaluation, robust public debt, mass unemployment, and lack of political stability – it was essential to envision a prosperous growth perspective, in order to legitimize the newly established democratic regimes. In this context the EU accession was the most promising alternative to provide future prospects for the society, and it was also a tool to legitimize and embed the necessary market reforms.

The EU accession was also a tool to increase the “output legitimacy” (Scharpf, 1990) of the new democratic regimes in the ECE region, contrasting the loss of crucial control over public policy decisions. “Returning to Europe” carried positive messages, reflecting to the desires of societies and their leader after the fall of the “iron-curtain”, promising an efficient economy, a generous welfare state, political freedom, and national sovereignty”. (Bohle, Greskovits, 2012, p. 58.) On the other hand, the top-down policy agenda of the EU also incited governments to pursue economic liberalization, which was beneficial to attract foreign investors.[56]

As the previous chapter explains, the IMF, and the World Bank usually applied conditionality to provide loans, and based on the Washington Consensus’ declarations they demanded neoliberal reforms in exchange. But the EU also played a major role in shaping policy-decision during the accession negotiations. As Bohle, and Greskovits argue, the EU was relying on the “coalition approach”, and provided a road map to like-minded movements to follow -while as a consequence parallel limited party competition. (Bohle, 2010, p. 6) The EU agenda for the accession process demanded pro-market measures, democratic development and

[56] Bohle, 2010, p. 6

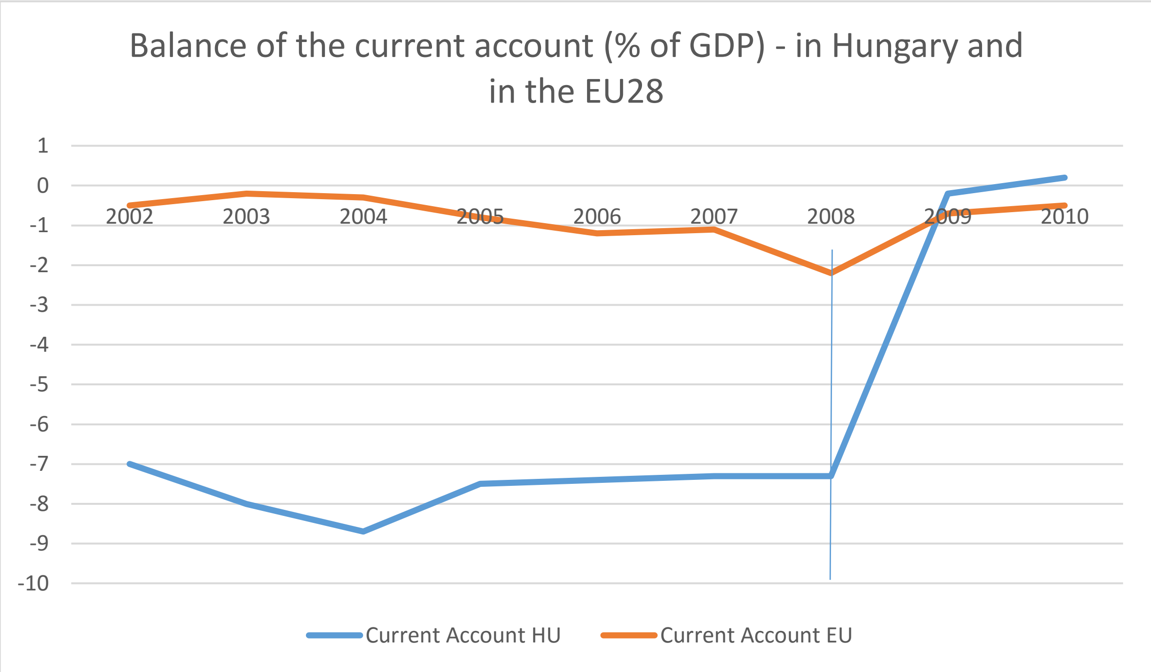
institution-building, and it also promoted depoliticized institutions conducted by experts to set checks and balances against political forces.[57]

By the EU accession, central banks in the ECE region pursued the introduction of the euro, which could prevent speculative attacks against their domestic currencies, reduce transaction costs, and stimulate foreign trade and investment. But to meet the accession criteria, governments also had to tighten their budget, and harmonize it with monetary policies. While the former was undermined by welfare overspending, the latter was exposed to partisan interests, transforming the Central Bank into the battlefield of the two major parties. As parties were competing to pursue the desires of the society – namely social welfare and the EU accession – their political strategy was to illuminate the incompetence of their opponents in achieving these goals.[58]

After the reelection of the Socialist Party in 2002, the conservative alliance sabotaged the central bank to lower interest rates, and promote monetary relaxation by backing the former president of the CB appointed by the first Orban-government. As an outcome, the president of the central bank made monetary relaxation conditional to fiscal prudence, and while high interest rates were maintained, it parallelly exposed the currency to speculations, devaluation and loss in export competitiveness as well. But this was neglected by the FIDESZ party which was in opposition at the time, as they simply wanted to see the socialists struggling to adjust fiscal policies, at the cost of losing their popularity.[59]The accession criteria also required liberalizing the financial markets, and by rapidly liquidating strict regulations, it incrementally generated a large credit boom, which was halted by the 2008 financial crisis.[60] As the private sector had a negative net savings position (see in figure 1), foreign owned banks, usually

[57] Bohle, Greskovits, 2012, p. 83-85
[58] p. 173-174
[59] p. 178-179
[60] p. 91-92

borrowed from their mother banks to finance the expansion of their credit substance, hoping high returns.[61] Financial openness also allowed households to access cheap loans in foreign currencies, while the aforementioned risk of currency devaluation was neglected both by government policies regulating the financial markets, and by private actors as well.[62] However, as the Central Bank maintained high interests rates, it basically incentivized to undertake loans in foreign currencies, and it also made financing the state debt relatively expensive.[63]



1. Figure, Balance of the current account in Hungary, compared with the EU average, source: Eurostat

Basically this was a financialized boom in the economy, which also made both the Hungarian private and public sector extremely vulnerable to external shocks. With the ascendance of negative net savings position in the private sector, the government was constrained to undertake a large amount of foreign debt, which basically made the "orthodox"

[61] Bohle, Greskovits, 2012, p. 91-92
[62] Csillag, 2009, p. 669
[63] Bohle, 2014, p. 929

model extremely vulnerable to external shocks, and challenged the sustainability of the "welfarist social contract".

So in respect of the abovementioned remarks, FDI has two important implications. One is that it increases the capital stocks, while it doesn't generate more debt. The second is that foreign ownership, and management control implies the right to decide about reinvesting the earned profit, which increases the vulnerability to capital outflow. As the economy depends on foreign actors, who may reinvest their earning elsewhere, governments are also exposed to attract then keep foreign investors within the borders. In this respect FDI can be a two-edged sword, and excessive reliance on it may increase vulnerability.

There was a high-degree of competition among the Visegrad states to attract FDI, and this basically derived a race-to-the-bottom in offering low corporate taxes, and introducing various forms of incentives.[64] In the case of Hungary, this was basically implemented via radical cuts of corporate taxes, making Hungary the victor of tax competition among its neighbors by the middle of the 1990s. However, in the early 2000s, Slovakia has introduced a flat income tax for income, corporate, and value-added taxes, taking the leading role in the whole EU, and among the newcomers as well. Although, incentives also became important – such as infrastructural development, free education for employees, and public services – Hungary could attract the South Korean Hankook Tire's to invest in Hungary rather than moving to Slovakia.[65] So low corporate taxes, and incentives equally contributed to attract FDI, basically they imposed high costs on governments at the same time, not to mention that paradoxically international corporations became the primary advocates of low corporate taxes at the EU.[66]

[64] Bohle, Greskovits, 2012, p. 161-162
[65] p. 168-170
[66] p. 169

As Adam argues, FDI can be both a 'blessing' or a 'curse' for transition countries in Central and Eastern Europe. On the one hand, they can satisfy the massive demand for development, and capital import, while the greenfield investments of foreigners are also beneficial to bring management know-how, technology, and an increased demand for labor – which was essential to consolidate the high-level of unemployment in the 1990s. But parallel to this the increasing presence of foreign owned companies may also infer the decline of domestic companies with less know-how, and financial resources.[67] In a small and open economy – especially within the integrated EU markets – the bankruptcy of a domestic firm may imply the immediate takeover of its markets by foreign actors, or simply increase import demand.

Concerning the abovementioned claims, FDI has its pros and cons for small states, but several factors may also influence, why foreign investors may tend to consider the region attractive. Christoph Dorrenbacher claims that Hungary is strategically important for foreign investors, who consider the following factors, when establishing a subsidiary abroad: (1) The Headquarters should have easy access to the subsidiaries, in order to mediate investment decisions; (2) the management should be committed to the mother firm; (3) and lastly, but not less importantly, subsidiary units should have access to unique resources, enhancing their autonomous operations. (Dorrenbacher, 2007, p. 192-193) As Hungary is not rich in natural resources, it has an industrial legacy from the socialist era, and masses of high-skilled and cheap labor, made it desirable to reallocate manufacturing industries from Western countries to reduce production costs.[68]

So as Hungary has an immense demand for foreign capital, its strategic position also makes it very attractive for foreign investors. The Central Bank's report may also show, how

[67] Adam, 2007, p. 73–88
[68] Medve-Bálint, 2014, p. 43

the flow of FDI has changed between 1995 and 2005, and it also emphasizes the main events influencing the indicators. According to the Central Bank's report, the asset value of FDI has increased six time more compared to the 1995 level in 2005 - 1 year after joining the EU - reaching a stock value of more than 52 billion euros. In the meantime, the residents' FDI to abroad has also increased, and it was 30 times more compared to the 1995 level in 2005, at stock value of 6,8 billion euros.[69] The numbers show that the efforts to join the common market, and the decreasing role of the state in the economy had a significant impact on capital inflow, while Hungary could also benefit from openness as an investor, however only in a limited extent.

As capital markets in Hungary are small, it was likely to be expected that outwards FDI stocks would be negligible, compared to inwards stocks, which might be considered to have a positive effect on increasing the size of the capital market. On the other hand, 50% of the stock increase was composed by reinvested capital, which means that foreign investors had a trust in the Hungarian economy, but a large amount of capital was extracted from the domestic markets, supporting critical voices in politics, challenging openness. According to the CB's report, the proportion of extracted capital was varying until 2005, but in a comparative perspective the balance still had a surplus in favor of increase in FDI stocks, and the only precedent when FDI extraction exceeded FDI inflow was in 2003. (See Table 2 below)

Between 1991 and 1997 capital inflow was usually assigned to privatization, targeting gas provider, electricity and telecommunication firms. The second round of privatization targeted the Post Bank (*Postabank*) in 2003, and in 2005, Budapest Airport and Antenna Hungaria (broadcasting firm) were sold by the state. These firms were usually operating in the

[69] MNB, 2007, p. 16-20

service sector, and their primary profile did not necessarily include cross-border activity (export), and they rather became subsidiaries of multinational corporations.

Annual change in FDI stocks between 1995-2005 (in million euros)					
Year	FDI	Extracted capital	Balance	Reinvested capital	Net increase in FDI stocks
1995	3801,7	176,8	3624,9	909,2	4034,8
1996	1793,3	47,3	1745,9	397,3	2625
1997	2242,8	232,6	2010,2	1154,9	3681
1998	1620,6	248,9	1371,8	1009,2	2988,1
1999	1858,7	423,8	1434,9	1054,2	3106,3
2000	2371,1	861,5	1509,6	1135	2998,4
2001	2349,9	1253,5	1096,3	1478,7	4390,7
2002	1690,9	534,2	1156,7	1911,4	3185,1
2003	5978	6642,1	-664,1	1787,6	1887,5
2004	2354,1	1272,5	1081,6	2227,4	3633,3
2005	4442,3	476	3966,2	1917,9	6099,4

2. Table, Annual FDI flow between 1995-2005, from MNB report, 2007, p. 30

By 2005, the main and most relevant investors in Hungary were German owned companies in a net asset value of 13 billion EURO, the second biggest investor was the Netherlands, and the third and fourth were Austria, and Luxemburg. Germany traditionally has a strong interest in the Hungarian markets, and Austria is also a relevant investor because of the historic ties between the two countries, not to mention the extensive and comprehensive infrastructure connecting Hungary to these countries. When examining FDI by sectors, in 2005, 40% of the stock was invested in the manufacturing industry, especially in automobile, electric instruments, spare parts, and chemical production. The share of services in the foreign investment portfolio was even more relevant – more than 50% - mostly concentrating to finance, telecommunication, and retail businesses.[70] The former plays the most important role in the export sectors, and the following chart shows, how the export was composed by sectors, and in respect of ownership.

[70] MNB, 2007, p. 16-20

Export by industries (in 2008)		
Produced goods	Aggregate value in million forints	Export market share (in %)
Agricultural prodcuts, beverages, and tobacco	1235	6,7
Raw materials	434	2,4
Energy	692	3,8
Chemicals	4895	26,5
Machinery and automobile	11185	60,7
Total	18440	100

3. Table, Exports by industries, data retrieved from KSH, 2014, p. 12

The above chart demonstrates that the most relevant export sectors were processing, and manufacturing, together aggregating 87.2% of total export, and these sectors were also the primary target of green field investments established from FDI. According to a MNB report, 82,5% of the exported products were produced by foreign owned companies by 2006.[71] When comparing the two numbers, one may conclude that there is a recognizable overlap between the share of foreign companies in export, and their primary investment activities. So one may argue that FDI played the most important role in the export sector, which is crucial to generate growth, and Hungarian companies were superseded from these markets by the end of the 2000s. However, the share of foreign owned companies in export was 69,5% in 1995, by joining the EU, there was a recognizable decline of domestic firms' market share in export industries.

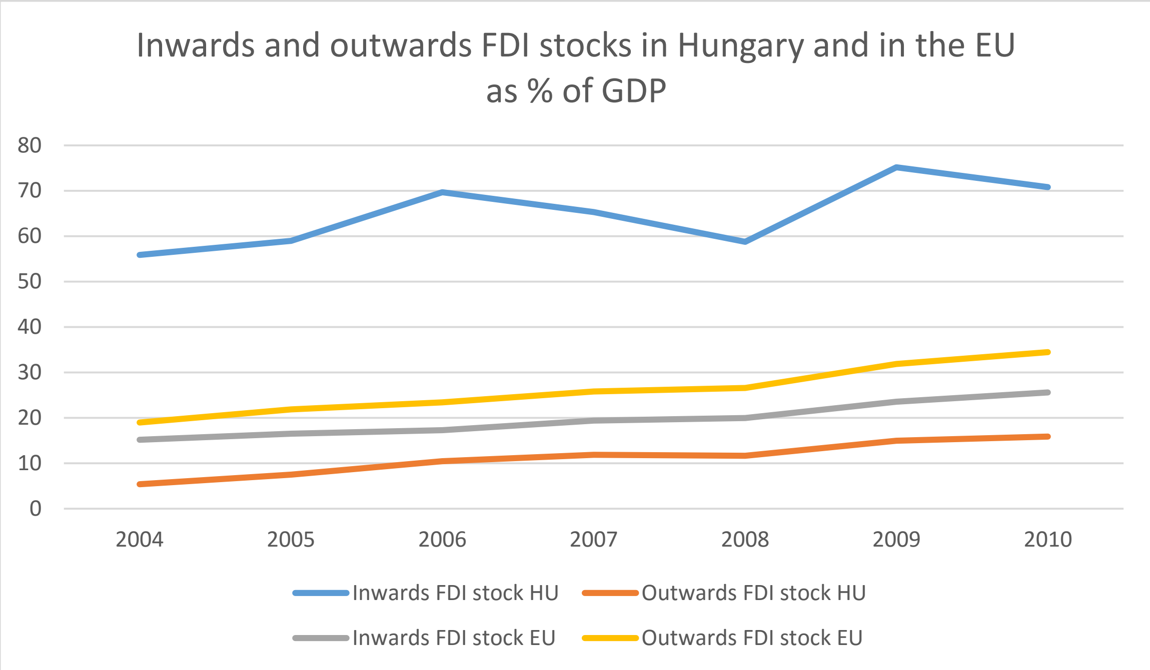
Hungary is also an investor to abroad, and it is also counts to the capital account in the BoP, but compared to the FDI of non-residents it was 8 times less in 2005 (own calculation). Hungarian investors appeared on the foreign capital markets after the second half of the 1990s, and the biggest capital exporters were MOL (oil company), Magyar Telekom (telecommunication) and OTP Bank. Resident foreign investors didn't likely to reinvest their capital, and its proportion compared to FDI was always less than 50% (it reached 50% only in

[71] Munkácsi, 2009, p. 28

2004 during the measured period).[72] Basically the generated profit of these firms were usually brought back to Hungary or reallocated to other countries, establishing new subsidiaries. The residents were mostly investing in Slovakia, Croatia, Macedonia, and some of them were also present on the Dutch, and the South Korean markets. Residents invested in services – such as financial consultancy, and retail -, while in the manufacturing industry processing crude oil, and maintenance were the most outstanding sectors.[73]

As figure 2 shows that while there was some fluctuation in FDI inflow in the measured period, foreign owned companies probably shared a major role in shaping the Hungarian economy. The chart also shows that the Hungarian economy is more dependent on FDI and quiet salient compared to the EU average – the share of FDI in the GDP was always two times more -, while its outwards FDI stock is below. The proportion of inwards FDI is significantly higher than outwards FDI's, so the chart also confirms that Hungary is not a capital exporter, but rather a host of foreign investment. In 2003 and 2005 the second wave of privatization increased FDI inflow, and since joining the EU in 2004, FDI remained a determinant factor in the Hungarian economy. The gap between inwards and outwards FDI stocks is static, but the proportion of outwards FDI in % of the GDP also shows a constant growth as resident investors allocated more FDI in the neighborhood. However, one should also note that one of the biggest foreign resident investors (Magyar Telekom) is a subsidiary unit of the German owned Deutsche Telekom brand, while MOL also has a significant foreign ownership. In 2009, the increase in stocks was due to purchasing 21.2% of MOL shares previously owned by the OMV by the Russian Surgutneftegas.[74]

[72] MNB, 2007, p. 20-21
[73] Ibid.
[74] Surgutneftegas (9th April, 2009), Surgutneftegas successfully acquires 21,2% shareholding in MOL, Retrieved from http://www.surgutneftegas.ru/en/press/news/item/267/ (accessed on 18th April, 2016)



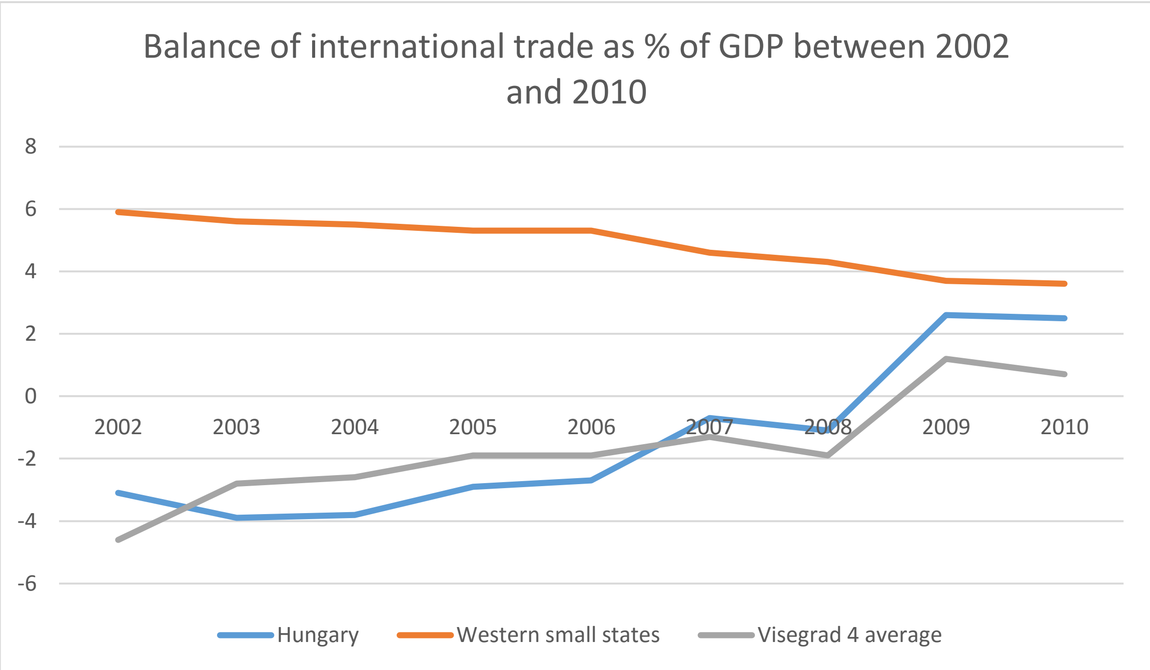
2. Figure, Comparing inwards and outwards FDI stocks in the EU and Hungary, source: Eurostat

In conclusion, Hungary became extremely dependent on FDI, and derivatively this also enhanced vulnerability to exogenous factors. Parallel events on foreign markets, beyond the supervision of the sovereign government may influence domestic production, and result mass layoffs, demanding welfare state retrenchment by the government to balance the fiscal budget. These factors may raise radical voices, and critiques of openness can blame the global economic realm for the misery of the worse off. As Hungary opened up its markets, and became an EU member, foreign-owned companies became dominant actors of the economy, generating more than 50% of the aggregate revenues, while employed almost 25% of the active labor in the non-fiscal sector (2010 data).[75] This also means that labor employed by foreign owned companies had significantly higher value-added, which has increased inequalities between domestic, and foreign-owned companies. They also operate with higher efficiency, as they have more fiscal funds, and management know-how, and Hungarian companies lacking market experience had

[75] KSH, 2013

difficult times to compete with them (as the data shows above, more than 80% of the export is produced by companies with major foreign ownership).

Another important implication is that Katzenstein's small state miracles such as Austria, Belgium, the Netherlands, Sweden, Norway, or Finland, and they export-based economies could develop competitive industries leading to surplus in their trade balance. The Visegrad experience shows that the effort to develop competitive export industries has paid off,[76] and by the end of the 2000s they were catching up with Western European small states, while noting that their surplus has parallel dropped as well. (see in figure 3)



3. Figure, Balance of international trade, comparing Western European small states, the Visegrad 4, and Hungary, between 2002-2010, source: Eurostat

The presence of foreign-owned companies also generated inequalities in wages, as according to the Statistical Agency's report (Index, 2010), the average income of foreign-owned company employees earned 160% of the national average.[77] So inequalities were high between

[76] Balance of international trade in % of GDP, data retrieved from eurostat (accessed on 26th April, 2016)

[77] 'JM' (3rd February, 2014) 'We have many to be greatful for multinational companies' – 'Skat köszönhetünk a multiknak', Index, Retrieved from http://index.hu/gazdasag/2014/02/03/multik/ (Accessed on 25th May, 2016)

corporate employees working at foreign-owned firms and those who fell short in the competition. Hence to compensate the worse off for the costs of openness, governments had to embed neoliberalism into the society by several forms of compensations. In order to manage the "social deficit" due to the decline of general welfare, the governments of the new democratic regime had to justify economic openness via compensating the losers of global competition. Its successes and failures are the topic of the following chapters.

3.3 Compensating the Losers of Openness: "Welfarist Social Contract"

The challenges of openness impacted upon the society rapidly after the regime change in the 1990s, and radical marketization demanded compensatory mechanisms to be implemented by the subsequent governments. When designing the welfare state, decision-makers had strict paths to follow, as most of the Visegrad countries had a socialist welfare legacy[78], while openness and the neoliberal paradigm also coerced them to decrease the role of the state. The new economic realm divided the society into two groups - as Julia Szalai argues -, ones who could quickly adapt to the new environment, and compete on the labor market, while the incapable others became poor. (Szalai, 2005, p. 314)

As Iain Ferguson argues, neoliberalism mainly focuses on market efficiency, by privatizing SOEs, and outsourcing as many capacities as possible. However, the increasing role of the competition and managerialism lacked solidarity towards low-skilled groups of the society, who were unable to cope with high standards. In a competing environment these vulnerable groups may be forced out from the labor market, demanding compensatory measures from the government.[79] Neglecting these vulnerable groups, and the parallel increase of

[78] Bohle, Greskovits, 2012, p. 152.
[79] Ferguson, 2009, p. 81-92

unemployment may give rise to anti-globalist, racist, and xenophobic ideas, meaning social welfare policies, and social work are necessary mechanisms for social justice and to repel radical voices.[80]

Therefore, the welfare state after the transition mainly targeted the “nonproductive” groups of the society, - specifically aging people – in order to compensate their respected work during their active years. (Bohle, Greskovits, 2012, p.36) This bias led to the introduction of a relatively generous pension-system generating masses who could retire earlier or obtain a disability pensioner status. The number of pensioners between 1989-1996 increased by 20% - while there were also 1.5 time more disability pensioners - at the same time.[81] Incrementally the welfare state supported the coexistence of the “…state-regulated segment of the economy in combination with an intensive participation in the family-run micro-level endeavors…” (Szalai, 2005, p. 314) The former absorbed the competitive labor, while the latter provided livelihood for almost three-quarters of the households, technically creating a secondary market for labor beyond the control of the state. In this context, welfare payments served as an additional payment for low-paid labor and as an informal salary for unpaid jobs.[82]

Szalai claims that the decline of SOEs and the previously maintained framework of compulsory full-employment made it necessary to create informal channels of employment: “(1) disability pension allowed early retirement, hence to stimulate home-based agriculture; (2) three-years long maternity-leave was a state financed period for home-based service-work, and (3) sick-leave was utilized for house-building and gardening.” (Szalai, 2005, p. 315) Bohle and Greskovits note that most of those who retired early were rewarded regarding to historic privileges of special occupations such as miners, firefighters, policeman, railroad, and steel

[80] Ferguson, 2009, p. 82
[81] Bohle, Greskovits, 2012, p. 155
[82] Szalai, 2005, p. 314-316

workers granted early retirement. (Bohle, Greskovits, 2012, p. 155-156) One may conclude that the welfare state was designed to keep people employed via informal channels and to provide them an additional income, hence to minimize the gap between the active labor in the formal economy, and the losers of transition struggling in the secondary economy with lower incomes.

According to Szalai, the welfare state was designed to prepare the society for market transition, and to reduce the harms of radical market forces, allowing people to adopt essential market-related skills. She argues that as a result it rather prevented successful integration, and the establishment of market culture, and the system allowed to abuse these benefits to promote secondary activities, basically jointing the two economies. (Szalai, 2005, p. 314-315) The real implication of the welfare system in the absence of labor market flexibility, and sufficient unemployment benefits, rather incentivized reliance on state resources, and grounded the culture for tax avoidance, debiting the already leaky state budget. And as three-quarters of the households were involved in the secondary economy, not to mention the "abnormal pensioner-boom" (Vanhuysse, 2006) it was politically difficult to introduce welfare state retrenchments.[83]

As the welfare state could provide a material security via early-retirement and disabled pensions it could save many elderly people from impoverishment.[84] The government had limited options to cut social spending due to the risk of anti-incumbent voting, thus usually poor people were neglected by social policies. On the one hand this was feasible due to the widely-shared perception of poor people that they themselves can be blamed for their underclass status. Secondly, indeed they relied on state resources (public pension, unemployment benefits, social aid, local-government subsidies, etc.) and had low or no secondary income at al. So the general perception of the poor fostered the social consensus that as their daily livelihood is based on the contributions of the working-classes, it is just to take it back when it's needed. Albeit the

[83] Bohle, Greskovits, 2012, p. 155

[84] p. 157

today's poor could be hardly blamed for their *status quo*, as most of their families had been exposed to poverty since the early decades of socialism.[85]

Hungary also has the second largest Roma minority in its population among the Visegrad countries, however, no government could develop a satisfactory integration program to protect them from long-term exposure to poverty. Until the end of the 1980s SOEs could employ them in temporary, low-skilled positions, but ever since they are threatened by long-term unemployment or non-employment. Their demands on social assistance was lost among dominant rivalry voices in the society, as governments were locked in a pattern of high expenditure on pensions, and wages. The increasing role of the state also absorbed a lot of resources, as between 1992 and 2002, the number of government employees increased by 25%, while the employment in the private sector dropped by 3% in the meantime.[86]

If one compares Hungary's social expenditure to the Visegrad states, it spends the most on social protection compared to its GDP - in 2006 it was 22,3% -, while the percentage of people at risk of poverty or social exclusion in the society is more than in the Czech Republic, and in Slovakia, and only Poland could aggregate higher numbers. According to the Eurostat's measurement, almost one-third (around 30% constantly) of the population is exposed to absolute poverty, practically lack decent housing, cannot afford to consume meat regularly, and unable to pay utility bills.[87]

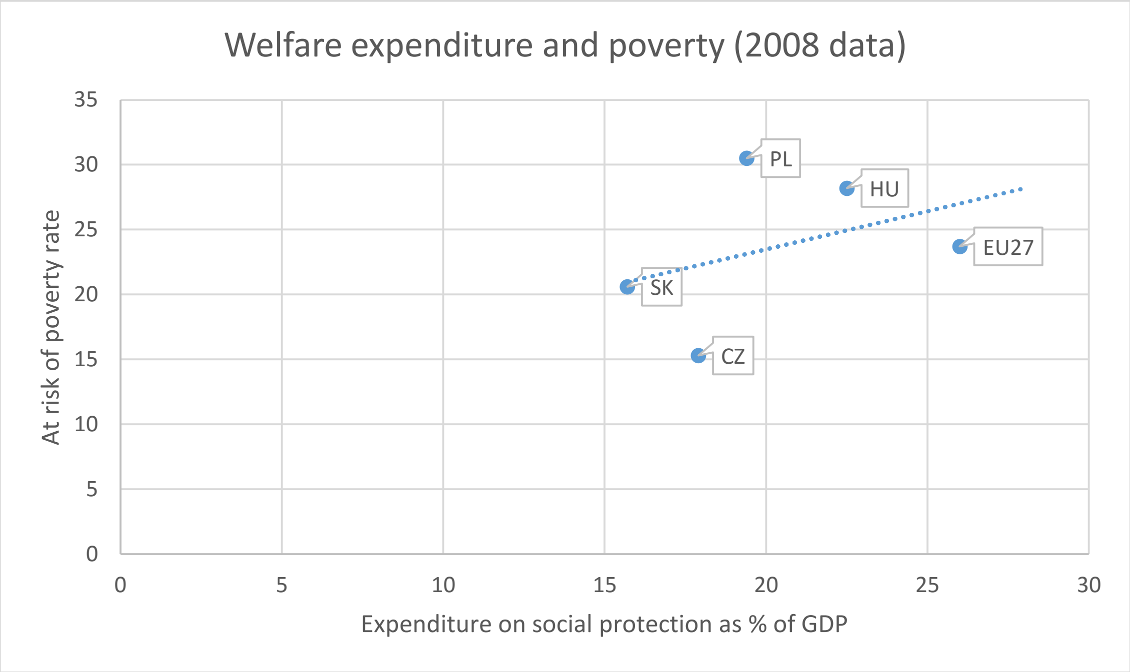
As one could learn from the previous chapters, 25% of the active labor in the private sector contributes the most to the GDP, basically those who are employed by multinational companies. Foreign-owned companies are also competing on world markets, they have the highest value added, while most of the Hungarian firms operate with lower efficiency, therefore

[85] Szalai, 2005, p. 319-320
[86] p. 317
[87] Data retrieved from Eurostat (accessed on 2nd May, 2016)

they were not able compete on global markets. In this picture, those who could not adopt market-skills, and acquire high-paying jobs at multinational firms, became the primary losers of the competition, and the government had to apply several compensatory mechanisms to reduce inequalities. Basically, “nonproductive” groups of the society were compensated by these measures, providing additional salaries in a form of early retirement, and disability pension, enhancing participation in household agriculture, and in the service sector. In the meantime, the poorest segments of the society were neglected and excluded from the welfare state mainly because of political reasons.

The Gini-coefficient shows that Hungary was an egalitarian state, as the coefficient was 0.27 in 2007, which shows a low-level of inequality similarly to Katzesntein’s small state miracles.[88] This meets Katzenstein’s criteria for embedding openness, but this doesn’t mean that the welfare state in Hungary would be efficient. Although Hungary also took a leading role in welfare expenditure among the Visegrad states, the results were behind in decreasing poverty. In 2008, Hungary spent 22,5% of its GDP on social protection, while the poverty rate was almost 30% of its population. Compared to other Visegrad states, Hungary had the least efficient welfare state. For example, the Czech Republic spent less, the poverty rate was half of Hungary’s. Figure 4 demonstrates that the Visegrad states were lagging behind the EU average in welfare sending, Slovakia, and the Czech Republic could keep the level of poverty low with less expenditure of social protection than the average.

[88] OECD website, Income Distribution Database (accessed on 3rd May, 2016)



4. Figure, Welfare expenditure as % of GDP and poverty rates, source: Eurostat

As Hungary's foreign-owned manufacturing companies tended to keep the highest value-added stages of production (namely research and development) at their corporate headquarters in Western Europe, their subsidiaries in Hungary were mainly focusing on the manufacturing itself. As Peter Evens argues "it is not what you produce that counts so much as what role you play in producing it… what is important in the final analysis is not the sector per se but the set of productive roles that go with it." (Evans, 1995, 251 n.16.) This explains the low GDP per capita in the ECE region, which incrementally kept the average nominal wages low compared to Western European states even in purchasing power-parity as well. The numbers show that the average wages in PPP were half in the Visegrad region compared to advanced small states, which shows that openness, and attracting FDI was not adequate per se to catch up with the "small state miracles" in Western Europe.[89]

So incomes compared to Western European states are lagging, and the compensatory mechanisms were hardly sufficient to boost domestic consumption and stimulate growth in the

[89] OECD, Average wages on Purchasing Power-Parity, retrieved from stats.oecd.org (accessed online on 25th May, 2016)

long-run. The low corporate taxes offered by the Visegrad states to attract capital (whereby Hungary had a leading role) also demanded to keep personal income taxes, social security contributions, and consumption taxes on a high-level, to sustain the welfare state, with the parallel indebtedness of the private sector. The latter was mainly due to the extensive liberalization of the credit markets to meet the accession criteria, and as Bohle argues, there was also a pent up demand in the housing sector due to the privatization of previously state-owned real estates. While this was also form of compensation so that private actors could obtain high-value assets, seventy percent of the loans allowing them to purchase real estates was in foreign currency, which made them extremely vulnerable to currency devaluation. This was mainly induced by the high interest rates maintained by the CB, and foreign banks could also easily access foreign capital markets through their parent banks. Parallel domestic corporations didn't receive loans, while their role would have been crucial to earn profit, and incrementally increase the private savings.[90]

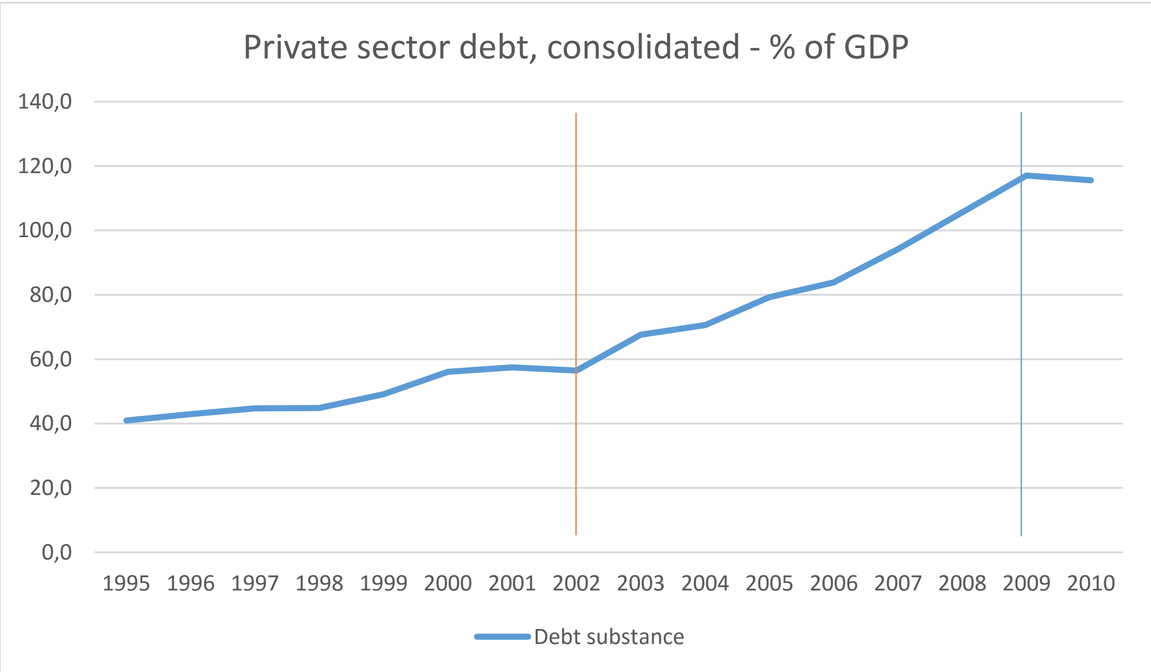
When the financial crisis hit in 2008, it radically affected both the private and the public sector, as the *Hungarian Forint* was devalued by the markets with the parallel appreciation of the *Swiss Frank*. The next section demonstrates, how the vulnerabilities of the "orthodox" model challenged the integrity of the welfare state, allowing the conservative alliance to obtain overwhelmingly high results in the 2010 elections.

[90] Bohle, 2014, p. 916-917

3.4 The Vulnerabilities of the "Orthodox" Model: Twin Deficit and Twin Debt

As there was already a large fiscal overspending, and austerity or structural reforms were politically difficult to be implemented, the state had to rely on foreign lending to fill the holes in the budget. According to István Csillag, while the revenues of the state were quite narrow – its proportion in the GDP was around the average in the EU –, government expenditure was the second largest compared to the GDP (2006 data), aggregating large deficits.[91]

In the meantime, one could learn from the previous chapters that Hungary opened its economy to capital inflow and dependency on FDI increased intensively after the 1990s. However, attracting foreign capital was indispensable to expand the capital market, foreign-owned companies were just one part of the picture, and one should also highlight the importance of parallel financial openness. The latter allowed domestic households to access cheap loans in foreign currencies,[92] while it also held a risk of external shocks influencing the exchange-rates.



5. Figure, Private sector debt as % of GDP, source: Eurostat

[91] Csillag, 2009, p. 650-652
[92] p. 669

One of the main reasons of the large "credit-boom" (as figure 5 shows the period between 2002 and 2008) was the pent-up demand in the housing sector, and the quite liberal conditions of receiving mortgage loans. As Bohle argues, in many OECD countries governments deliberately promoted private housing to decrease the expenses of the state, and to obtain extraordinary incomes by privatization.[93]

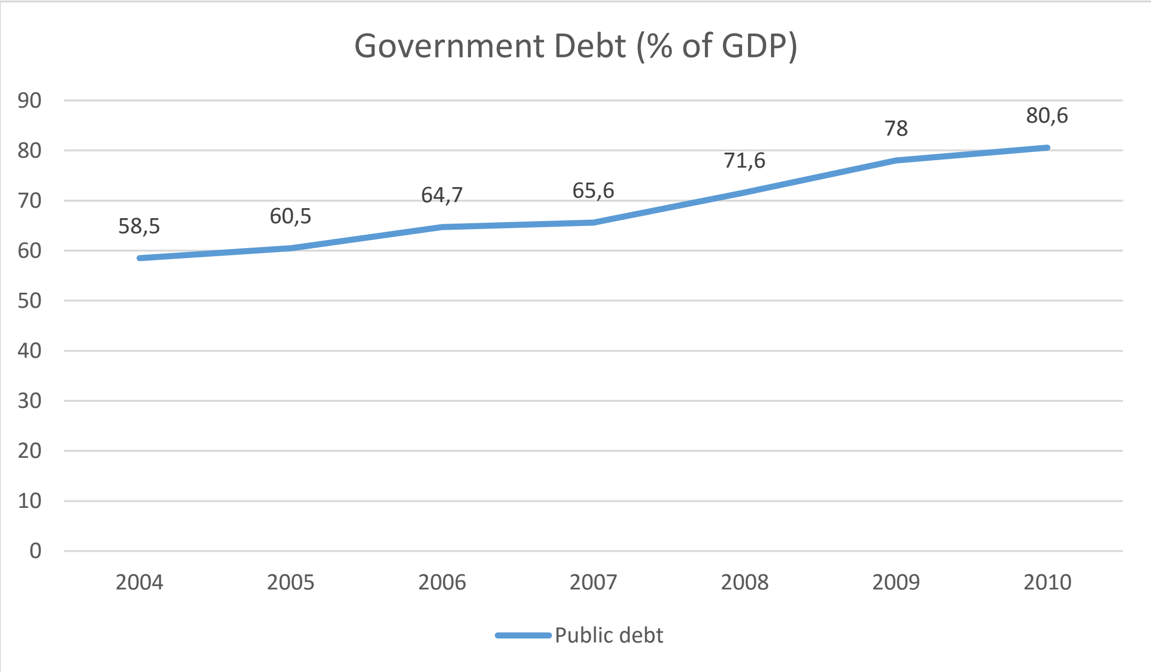
However, governments had to deregulate the financial markets to meet the EU standards resulting "increased volatility, balance-sheet mismatches, short-term and increasingly risky investments, speculative bubbles, and ultimately in the global financial crisis of 2007-2009" (Bohle [2014]: pp914.) Practically this means that non-creditworthy customers could also access cheap mortgage-loans, while many of them were not able to repay it even in a short-term. While this was a global phenomenon, Hungary also jumped on the bandwagon, delivering an extremely high-risk of indebtedness of the private sector. In the meantime, - according to Csillag -, nor the government nor the Central Bank applied restrictive measures to moderate the foreign indebtedness of the households by raising taxes, or defining domestic currency reserves or insurance, defending the stakeholders.[94]

The current account also shows – see Figure 1 on page 27 - that the households had negative net savings position, so the credit-boom basically had to be financed from foreign savings. This also means that the government couldn't finance its fiscal deficit primarily from domestic savings, and mainly had to rely on foreign investment as well. This was a "moral hazard" incentivizing a low propensity to save, as the government took this role in the form of early retirement, disabled pensionary, and by the 13th-month pension.[95] With a low propensity

93 Bohle, 2010, p. 914
94 Csillag, 2009, p. 669
95 Csillag, 2009, p. 669-670

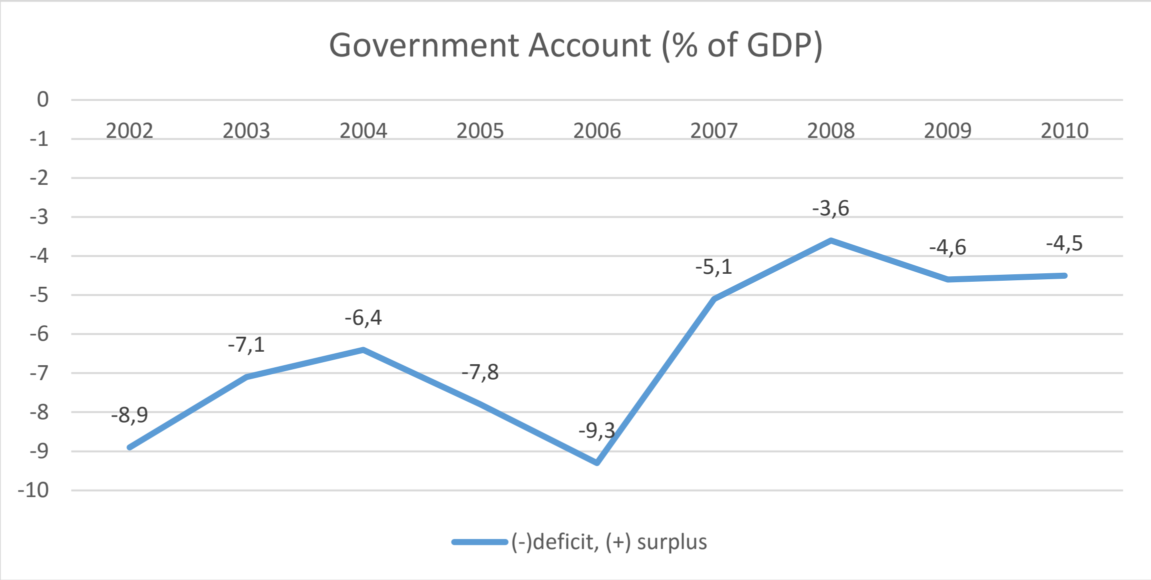
to save, and government sparring in lieu of the society, the relative security also boosted pent-up demand, and the undertaking of an immense amount of debt.

Figure 1 and 5 shows that from 2002 the private sector debt and parallel the current account deficit have increased intensively, and only from 2008 after the credit-crunch it started to generate a very small positive net savings position – mainly due to the repayment of the loans, and the slowing inflow of foreign lending. Figure 6 and 7 also shows that the government sector also had a robust increase in public debt, due to the large fiscal deficits, and the undertaking of foreign loans, hence to finance the generous welfare expenditure. According to the State Debt Management Office (*Államadósság Kezelő Központ*) data, by the end of 2007, the foreign debt of the country was approximately 25% of the total debt substance, which number has doubled by 2010 due to the financial crisis. While most of the foreign debt substance mainly had a short-term (0-2 years) maturity profile[96], it was inevitable to introduce austerity measures, hence to balance the budget.



6. Figure, Government debt as % of GDP, source: Eurostat

[96] State Debt Management Office (ÁKK) website (accessed on 4th May, 2016)



7. Figure, Government account as % of GDP, Source: Eurostat

As governments were locked in a pensioner-biased welfare state scheme, fiscal overspending and accumulating a robust amount of state debt, welfare state retrenchment was nearly impossible without political consequences, as anti-incumbent voting had a strong tradition, especially in the 1990s and early 2000s (with the exception of 2006, when the MSZP-SZDSZ coalition was reelected for a second consecutive term). Being kept in the vicious circle of macroeconomic instability and strong ties of welfarism, the Bajnai-package in 2009 sealed the inevitable defeat in the 2010 elections by the FIDESZ-KDNP coalition. As Bajnai terminated the 13th-month pension, increased VAT from 20 to 25%, and reduced the subsidies during maternity-leave,[97] it dramatically cumulated the effects of the internal political crisis due to the leaked speech of ex-prime minister Ferenc Gyurcsány in 2006, when he admitted that his government lied to the electorate.[98]

Following the footsteps of Katzenstein, the other important element of embedding openness, namely the proportional electoral system also lacked from the institutional setting,

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[97] Portfolio (April 21st, 2009), Summarizing the Bajnai-package step-by-step, - *„A teljes Bajnai-csomag pontról-pontra"*, Retrieved from http://www.portfolio.hu/gazdasag/a_teljes_bajnai-csomag_pontrol_pontra.113811.html (accessed on 10th February, 2016)

[98] Bohle, Greskovits (2012): pp179.

leading to extreme polarization of politics (see in table 4). According to Katzenstein, embedding consensual traditions is essential to sustain a long-term development path, and sharp shifts in politics may undermine progress. According to the Gallagher-index measuring disproportionality, during some elections, Hungary produced less proportional results than the classical majoritarian states (such as the United Kingdom and United States), and it was even more disproportionate than the model country for the Hungarian electoral system, Germany.[99]

Election (Year)	Actual votes on party list (%)*	Representation in the Parliament (%)*[100]	Gallagher-index
1990	42,92	59,33	13,75
1994	52,73	72,02	16,18
1998	45,43	55,18	10,88
2002	47,62	51,29	7,3
2006	49,71	54,4	5,13
2010	52,73	67,88	11,67

4. Table, Votes on the governing parties, and their actual representation in the Parliament, source: valasztaskutas.hu

In conclusion of the orthodox model, one can argue that it was extremely vulnerable to external shocks as Hungary both had a twin deficit and a twin debt (including current account deficit, fiscal deficit, and external private and public sector debt), and due to the 2008 financial

[99] Gallagher index, retrieved from https://github.com/christophergandrud/Disproportionality_Data/blob/master/Disproportionality.csv (accessed on 4th May, 2016)

[100] *the numbers are aggregates of the governing parties' results, including coalition partners. In 1990: MDF-FKGP-KDNP, 1994: MSZP-SZDSZ, 1998: FIDESZ-FKGP-MDF, 2002, 2006: MSZP-SZDSZ, 2010: FIDESZ-KDNP

crisis the socialist welfare contract couldn't be sustained anymore. On the other hand, the polarization of politics established a very fragile context, where it was very difficult to introduce necessary market reforms due to the risk of high-political costs, and postponing the reforms induced what Alessina calls "the war of attrition". (Alessina et.al, 2006, p. 9) So governing parties basically played a political game, hoping that the ticking time-bomb will explode in the other party's hand. In the case of Hungary, the explosion took place during the 2nd Gyurcsány-government, technically eliminating the socialist party from the competition.

Chapter 4: The "Unorthodox" Model: Marginal Openness, and the New Social Contract

4.1 *Defining "Unorthodoxy"*

One could learn from the previous chapters that Hungary's "orthodox" model relied on a foreign-lead modernization strategy conducted by export-oriented multinational companies, and embedded economic openness by sustaining a relatively generous welfare state. However, due to significant welfare state retrenchments aggregated with the effects of the internal political and global financial crisis, the FIDESZ-KDNP government tailored its policies to respond to the challenges of the previous model. As László Urbán, a Hungarian economist addressed during his interview at a commercial television, Viktor Orban – the premier of Hungary – pursued more than a simple policy-adjustment, but less than a new system transformation. According to Urbán the new government increased the role of the state, centralized the allocation of resources, adopted protective measures to defend domestic production, and it promotes its own *protégée*, at the cost of eroding competitiveness.[101]

On the one hand this was a response to the decline of domestic production, and the dominant role of foreign-owned companies, clientalism and the patronage of the national bourgeoisie is just one part of the picture. As Tamás Mellár argues (Mellár, 2016), it is strongly questionable, whether one can call the policies of the government "unorthodox", as it bears strong "orthodox" or neoliberal characteristics as well. Firstly, by introducing a flat income tax they accept the orthodox principle, that everyone should contribute equally as their income is based on the marginal product of labor. Secondly, the government terminated property taxes,

[101] Baló, Gy. (3rd February, 2016), *„Kritikus Konzervatív Kör" – „Critical Conservative Circle", in* „Magyarul Balóval" – In Hungarian with Baló", interview with László Urbán, Hungarian economist, RTL Club, Hungarian Broadcasting firm, Budapest, Hungary, link: http://rtl.hu/rtlklub/magyarulbaloval/kritikus-konzervativ-kor (accessed on 8th May, 2016)

claiming that it harmfully interferes in the optimal allocation of resources. Thirdly, the economic experts of the government also argue that the welfare state and income redistribution undermines the endeavor of market forces to achieve optimal allocation of resources.

The deregulation of the labor market also enhanced flexibility, which is also a classical neoliberal dogma, arguing that low-wages and increased competition may decrease unemployment, and the increasing production and consumption will also increase salaries in the long-run. The new government still follows the path of foreign-lead modernization expecting foreign-investors to bring capital and knowledge, and their presence and accelerated industrialization may raise the competitiveness of domestic actors' as well. Finally, the Hungarian national bank (MNB) also devaluated the currency, hence to decrease the consumption of import products, expecting the empowerment of domestic production.[102]

Meanwhile Attila Chikán argues that while Hungary's premier refers to the Russian, Turkish or Singaporean path, one can barely compare the "unorthodox" model to these economies. According to him, the government pursues only political goals, while the "unorthodox" model is economically unsuccessful. He claims that while the government promote domestic firms in its rhetoric, the parallel emergence of clientelism, obstructs the daily operation of small and middle size enterprises with additional taxes, bureaucratic red-tapes, and selective rule-of-law.

But the real cause for the erosion of competitiveness, and constant relapse on global rankings is the visible presence of massive corruption. So "unorthodoxy" and illiberal democracy "walk hand-in-hand" and "short-term political gains always overwrite long-term economic rationality". (Chikán, 2014) While one can admit that the government sticks to fiscal

[102] Mellár, T. (February 12, 2016), 'How unorthodox the government's economic policy is?"- *„Mennyire unortodox a kormány gazdaságpolitikája?"* Élet és Irodalom – „Life and literature" Vol. XL. No. 9, Retrieved from http://www.es.hu/kereses/szerzo/Mell%C3%A1r%20Tam%C3%A1s (accessed on 8th May, 2016)

prudence, basically it extracts capital from key-areas, which would increase competitiveness in a long-term.[103]

In addition to the previous definitions about the "unorthodox" model, as László Békesi also argues (in Magyar, 2014), the Orbán government lacks a coherent economic model, driven by *ad hoc* decisions, to support its own *protégée.* Contrasting the pre-2010 era, corruption is supported by deliberate policy decisions legitimized by the intention to create a new national bourgeoisie. He argues that the government developed a model of state capture to dismantle the system of check and balances, and parallel limited the competition to benefit its own clientele.[104]

Juliet Johnson and Andrew Barnes claim in their groundbreaking piece about Hungary's financial nationalism that Orban's party is arguably a "nationalist-populist platform of 'economic self-rule'", and holds many characteristics of economic nationalism. (Johnson and Barnes, 2015, p. 536) The authors argue that nationalist governments likely make a distinction between groups, institutions, and individuals who are loyal to the national community, and minority groups, individuals and technocrats who are associated with foreign interests, therefore their privileges can be divested.[105] So referring to Bibó's argument in the second chapter, Hungarian nationalism has a long-lasting heritage of seeking autonomy, and restoring the lost *status quo,* therefore it was not challenging for the conservative party to find the connection with nationalist sentiments.

But while the Hungarian government pursue to promote the 'unity, identity, and sovereignty of the nation' (Shulman, 2000, p. 368.) it could maneuver to harmonize its policies

[103] Csuhaj, I., Hargitai, M. (5th December, 2015), „Hungary is at constant relapse", - „Magyarországon Folyamatos lecsúszás van" - interview with Attila Chikán, Professor of Corvinus University Budapest, Népszabadság Online, Hungarian daily newspaper, Retrieved from http://nol.hu/gazdasag/okok-es-rokonok-1578683 (accessed on 8th May, 2016)
[104] Magyar, 2014, p. 241
[105] Johnson, Barnes, 2015, p. 539

with economic liberalization and integration. (Johnson, Barnes, 2015, p. 542) So the following sections discover, how the "unorthodox" model copes with the challenges of economic openness, while it seeks to establish a new social contract justified by nationalist arrangements.

4.2 *Marginal Openness: "Assembling Capitalism" and the Promises of "Eastern Opening"*

The government in 2010 delivered a comprehensive model change, providing "unorthodox" solutions to economic issues, but there were many speculations about its real meaning. Therefore, one should focus on the actual goals addressed by government policies and analyze them step-by-step to identify how these measures were tailored to bring the promised changes. The first, and most visible goal of the government was to pursue complete autonomy from the policy-constraints imposed by the IMF, and the European Commission,[106] and the premier also claimed that he intends to compete with China, Brazil, and the US in the manufacturing industries. He stated in the national assembly, that "…it is more important to have high-skilled blue-collar workers who create real value rather than educating unemployed masses of intellectuals…". (Orbán, 2012) This argument clearly highlights that the new economic model intends to compete with highly industrialized countries with a robust manufacturing sector. As Benedek Jávor addressed in his interpellation, the government is focusing on creating low value-added jobs, rather than educating high-skilled workforce.[107]

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[106] Johnson, Barnes, 2015, p. 536.

[107] Hungarian Telecommunications Office (25th June, 2012), Orbán talks about masses of unemployed graduates wondering in ruin-bars, „*Orbán a romkocsmákban merengő diplomás fiatalokról*", World Economy *(Világgazdaság),* Retrieved from: http://www.vg.hu/gazdasag/gazdasagpolitika/orban-a-romkocsmak-felhomalyaban-merengo-allastalan-diplomasokrol-378340 (Accessed on 9th May, 2016)

According to this argument, one can barely recognize any difference between the post-1990 era, and the "unorthodox" model in this regards, the only discrepancy is that the high-share of manufacturing industries in the domestic production is not a spontaneous consequence of openness, but the government deliberately promote them, neglecting other sectors. Secondly, the prime minister also claimed in his famous speech at Tusnádfürdő that there is a recognizable decline of Western, liberal countries, and only those can be successful, who have followed their own path. He emphasizes Turkey, Russia, China, Singapore and India as good examples, as they didn't follow neoliberal policies, and they also rejected to adopt the liberal dogmas.[108] Basically the premier didn't argue to adopt the models of these countries, but he pointed out that he wants Hungary to follow his own path. This argument may seem confusing, but one should clarify the difference between Hungary's "unorthodoxy" and the aforementioned illiberal countries.

According to Zoltán Pogátsa – Hungarian economist – one cannot identify any similar characteristics, as these countries follow completely different policies. It is not similar to Russia, because their economic growth is based on the exports of fossil and natural resources, Singapore established a knowledge-based society with high value-added jobs, and Turkey relied on massive urbanization to decrease unemployment in rural areas. He argues that Hungary cannot be compared to none of these countries in an economic perspective as it nor want to follow these precedents nor have the ability to do so. He also concludes that Hungary rather follows the neoliberal path as it promotes market forces to create, dismantled social

[108] Orbán, V. (29th July, 2014), The full speech of Viktor Orbán, Retrieved from 'Hungarian Nation' (*Magyar Nemzet*), http://mno.hu/tusvanyos/orban-viktor-teljes-beszede-1239645?oldal=2 (Accessed on 8th May, 2016)

security nets, decreased wages by currency devaluation, and deregulated the labor market to enhance flexibility. [109]

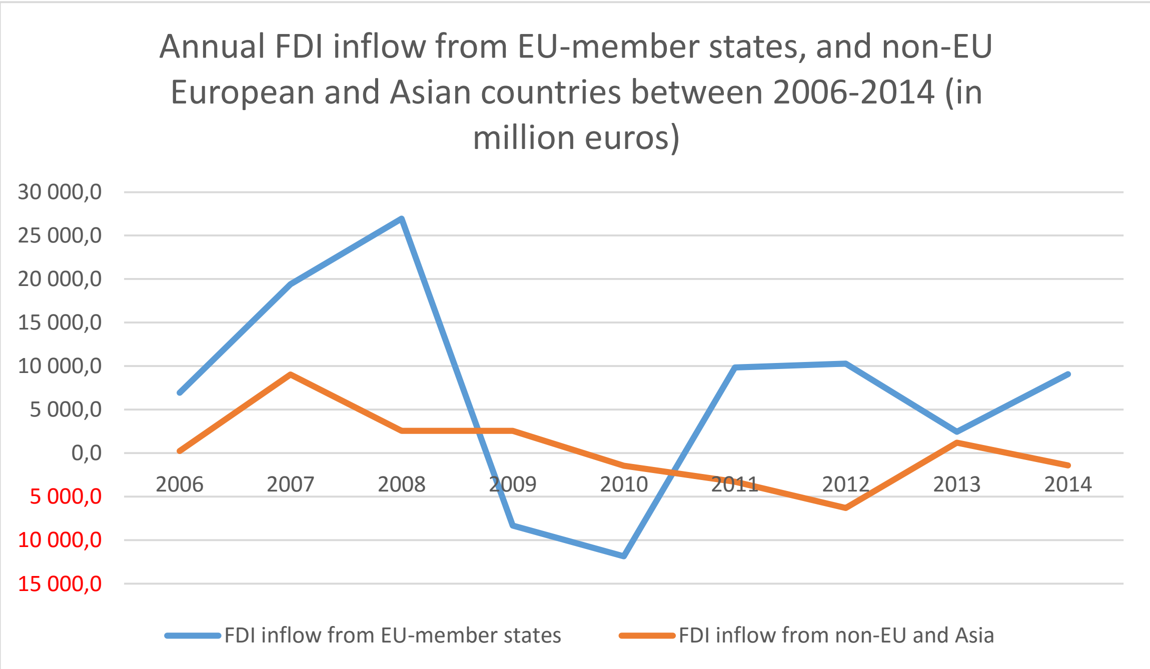
But first, one should address, how the government in cooperation with the central bank deliberately depreciated the Hungarian currency to support domestic production, and to keep the price-level of labor low. Firstly, the government accused András Simor, the president of the CB, calling him an "off-shore knight", as he assumedly owned a Cyprus-based company. The target of government attacks against Andras Simor were due to his monetary policies, which kept the interest rates on a high-level, enabled foreign currency loans, and parallel rejected the idea of 'monetary easing', which was practiced by many other nations in Europe, whereby the central bank is allowed to purchase government papers from the secondary market.[110] So controlling the CB was a crucial issue for the government, to enable cheap financing for the government debt, while it ideologically covered its intention, arguing that monetary sovereignty enhances the nation's independence from the IMF and the EU.[111]

So while the government pursued financial independence from powerful Western global actors, it needed alternative sources to finance the indebted state budget. This process was undermined by the depreciation of the Hungarian *Forint*, with the parallel downgrading of government papers to 'junk bond status'. After the failed attempts to pursue an arrangement with the IMF,[112] the government was desperate to find alternative creditors, who would buy government bonds. This is one of the reasons why the government launched the "Eastern opening" program, aiming to extend the possibilities of the economy beyond the borders of the EU. The "Eastern opening" was dreamed by the government to enhance diplomatic partnerships

[109] Pogátsa, Z. (3rd November, 2014), Declining West, Prosperous East, "*Hanyatló Nyugat, Virágzó* Kelet), World Economy Weakly (*Heti Világgazdaság)* Retreived from http://hvg.hu/gazdasag/20141103_Pogatsa_Zoltan_Hanyatlo_Nyugat_Viragzo_Ke (Accessed on 5th May, 2016)
[110] Johnson, Barnes, 2015, p. 547-48
[111] p. 536-538
[112] p. 550

with countries, which were historically connected to Hungarian tribes before they moved to East Central Europe. However, these bilateral arrangements usually had high costs, and with minimal benefits from the program, the government lost its diplomatic credibility towards the West.[113]

One of the most outstanding precedent for the abovementioned argument is the case of the Azeri "axe-murderer", who killed his fellow Armenian exchange student during an English education program in Budapest. The government released the imprisoned military officer to tighten diplomatic partnerships between Hungary and Azerbaijan, while some leftist-liberal journalists argued that Orbán was simply pursuing to sell debt securities to the Azeri government. This action shocked the international community, and the Armenian government also terminated its diplomatic partnership with Hungary. While the government insisted that they just passed the convict so that he can spend the rest of his punishment in an Azeri prison, he has been provided amnesty, and his return to the homeland was widely celebrated.[114]



8. Figure, FDI inflow, from the EU and non-EU Europe and Asia, source: MNB, own calculations

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[113] Farkas et. al, 2016, p. 5

[114] 'A.L.B., (4th September, 2012) 'Blunder in Budapest', Economist, Retrieved from http://www.economist.com/blogs/easternapproaches/2012/09/hungary-armenia-and-axe-murderer (Accessed on 5th May, 2016)

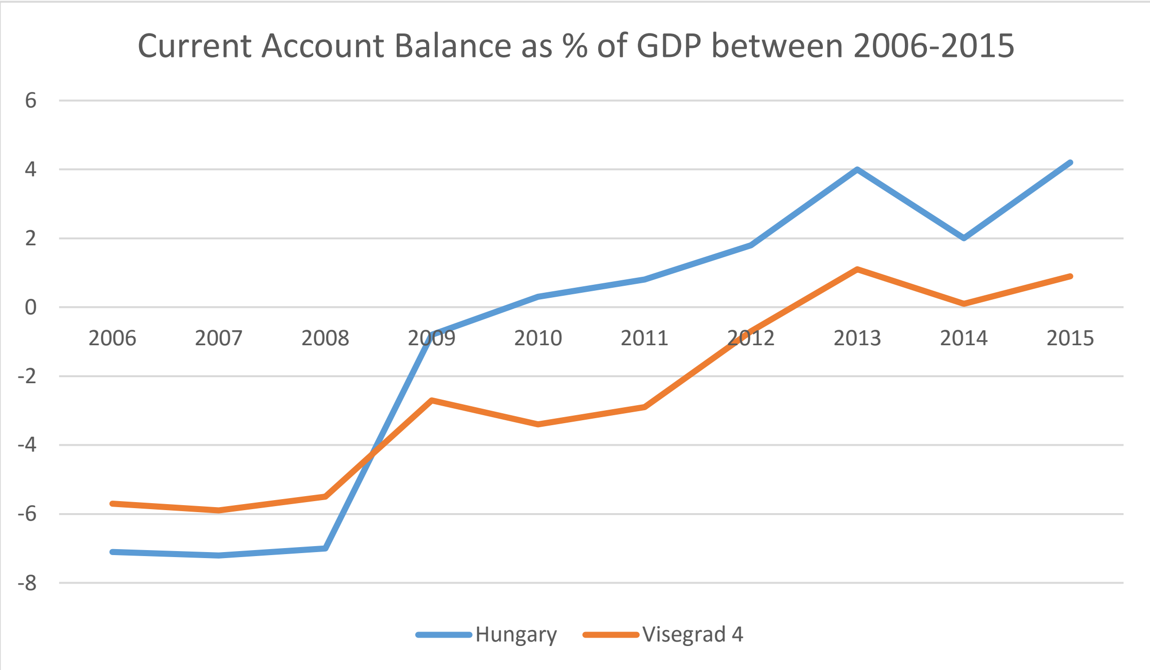
So as the “Eastern opening” seemed controversial, and the government was seeking for alternate sources of investment, Figure 8 shows that during the sub-prime crisis, the flow of FDI had significantly dropped, and around 20 000 million euros were extracted from the Hungarian economy between 2008 and 2010. After the new government was elected, the extracted amount of FDI was slowly trickled back, and additional funds also flown into the country, but compared to the pre-crisis era the intensity of flow became much slower. So basically it is hard to separate the effects of government policies and the effects of the crisis, but obviously one cannot claim that the governments industrialization policy was and unprecedented success as the decision-makers argue – at least in the extent of attracting new investors.

One would also expect that as the government claimed to focus on the “Eastern opening” the amount of FDI from the region would increase or at least stagnate, but the figure shows that capital invested from the region was rather extracted from the economy since 2010, showing that non-EU European and Asian countries are not interested in investing in Hungary and parallel they are healing their wounds marked by the crisis. The increase of FDI inflow in 2013 was mainly due to the investment of South Korea and Ukrainian investors also salvaged a large investment position, before their country was engaged in war with Russia.[115]

So while the Hungarian economy could not attract foreign investors, who could finance more manufacturing investments, the government introduced a loan program to stimulate economic growth (*Növekedési Hitel Program*) conducted by the central bank. Therefore, the CB liquidized commercial banks via “quantitative easing” techniques and monetary relaxation, but as Békesi argues, this could barely achieve remarkable results. According to his findings, the main indicators show that the exports surplus is still mainly contributed by multinational

[115] MNB data, Retrieved from mnb.hu (Accessed on 15th May, 2016)

companies, which still share more than 80% of the production (similarly as before 2010, see in chapter 3). According to him, increased liquidity, and a large amount of money circulating on the markets, may also expose the *Forint* to further devaluation, as the commercial banks' propensity to lend remained low after the sub-prime crisis.[116]



9. Figure, Current account balance as % of GDP, source: Eurostat

Parallel the prime minister of Hungary addressed to the press in 2014 that he would like to achieve that at least fifty percent of banking sector should be controlled by Hungarians. He argued that foreign-owned banks allowed to undertake a large amount of foreign debt in the private sector, and after the crisis, they still repatriate a large amount of profit to their homeland. Therefore, the government introduced a transaction tax imposed mostly on foreign-owned banks, allowing it to reduce the budgetary deficit.[117] This was also an attempt to decrease the role of foreign investors, which was partly allowed by the positive net savings position of the private sector, as the current account started to generate a small surplus after the credit crunch.

[116] Békesi, 2014, p. 246-47
[117] Johnson, Barnes, 2015, p. 545-46.

As Figure 9 demonstrates, the Hungarian households and enterprises could aggregate a somewhat larger net saving position than the Visegrad four in general after 2009, but the enhanced propensity to save is rather a general tendency than a country specific issue. This can be beneficial for the economy, as it allows the banking sector to finance investments from domestic savings, while the government could also reduce the external debt of the public sector. In this regards, the position of external debt was less than 30% by the first quarter of 2016, which means that the government is less vulnerable in this extent, than as it was in 2010, when the proportion of external debt doubled within 2 years up to 60%.[118] On the other hand, it was mostly not the savings of the people, which allowed the government to restructure the public debt substance, as the state also obtained extraordinary revenues, when it nationalized the private pension funds in a net value of $14 billion dollars, imposed several taxes on foreign companies in the non-manufacturing sector, and parallel budget cuts were also implemented targeting public institutions to reduce the state expenditure.[119]

As the section above illustrated how Hungary's "unorthodoxy" is seeking autonomy from external pressures with a parallel attempt to look for alternative partners in the East, one should examine whether its "Eastern opening" could extend its export markets. As enhancing the production capacity of the manufacturing industries was one of the main goals of the government, export notably is also based on aggregate demand in foreign markets. It is a common sense that many of the aforementioned countries in Eastern-Europe and Central Asia have weak domestic consumer markets, low nominal wages and insufficient purchasing-power parity. However, table 5 shows that export to Asia somewhat increased after 2010, albeit it is

[118] Government Debt Management Agency of Hungary, Retrieved from http://akk.hu/en (accessed online on 30th May, 2016)

[119] Johnson, Barnes, 2015, p. 550-551

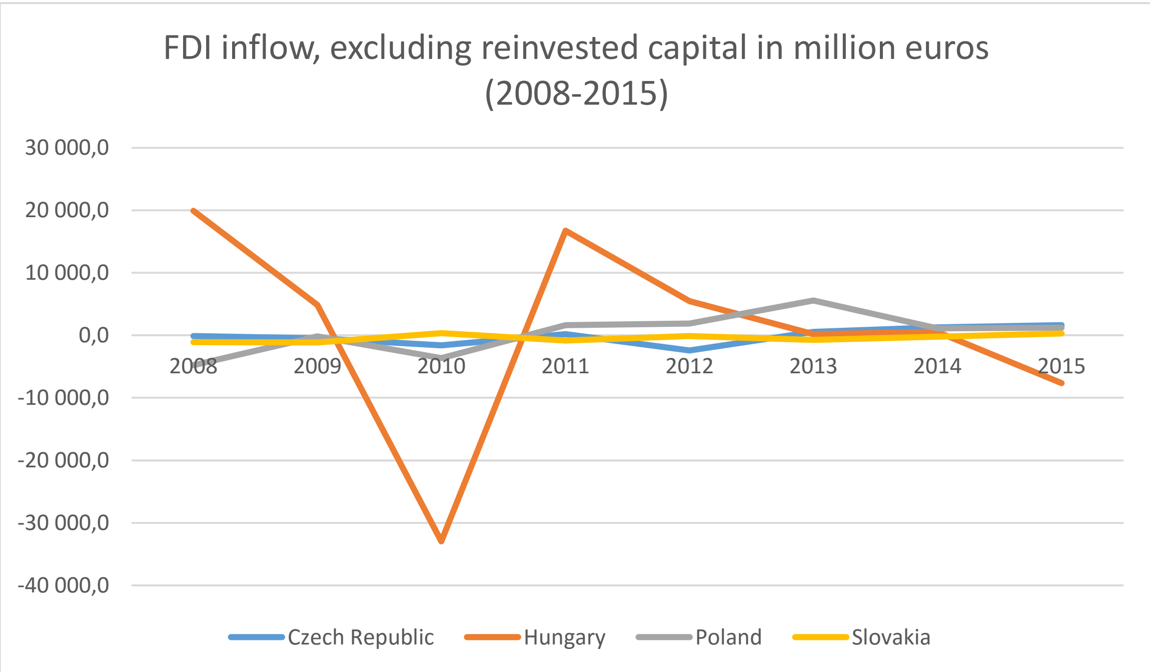
still negligible compared to the trade on common European markets (which is ten times more than the former).

Foreign trade by region between 2006 and 2015 (in million euros)							
Year	*EU-member states*			*Asia*			*Total*
	Export	*Import*	*Balance*	*Export*	*Import*	*Balance*	*Balance (global)*
2006	46632	43175	3457	3117	9667	-6550	-2379
2007	54588	48226	6362	3346	11815	-8469	-120
2008	57504	50344	7161	3756	11778	-8022	-319
2009	46552	38089	8563	3272	9846	-6574	3738
2010	55305	44731	10574	4613	12154	-7541	5515
2011	60879	50593	10286	6021	10589	-4568	7061
2012	60737	51615	9122	5118	9558	-4440	6655
2013	62639	53542	9097	4903	8930	-4027	6555
2014	66136	58901	7236	4461	8890	-4429	6274
2015	71639	63057	8582	5172	10586	-5414	8118

5. Table, Foreign trade between Hungary, and the EU compared to Asia

But what is notable about the changes compared to the pre-2010 era is that Hungary has a stable surplus in its trade account. On the other hand, one may observe that in 2009, imports dropped more dramatically than exports, which shifted the deficit in the first place, while parallel there was a constant increase in the exports as well. By 2011 the imports demand reached the 2008 level, and since then, exports always exceeded imports. However, Asian markets didn't contribute significantly to reduce trade deficit, and the insignificant increase in exports to Asia could have been achieved without strategic partnerships as well. But assumedly the main reason for generating a surplus in the trade account since 2011 is the enhanced production capacity of the foreign-owned exports industry.

In 2009 Gordon Bajnai ex-prime minister made a strategic agreement with Mercedes-Benz to establish a car assembling factory in Kecskemét, which basically started to operate from 2012. Parallel the FIDESZ-government also made strategic arrangements providing tax-reduction, educational programs, and research and development subsidies (from EU funds), encouraging capacity enlargement, involving Hankook Tires, Mercedes-Benz, Richter-Gedeon (Pharmacy firm), Coca-Cola, including numerous other firms as well.[120] But notably most of these firms established their subsidiary units before Orbán was appointed as prime minister, so one should also examine how his government performed in attracting new investors.



10. Figure, Balance of payments, direct investment and equity other than reinvested earnings, source: Eurostat

[120] Hungarian Government (n.b), 'Strategic partnerships', retrived from http://2010-2014.kormany.hu/hu/miniszterelnokseg/strategiai-partnersegi-megallapodasok (accessed online on 27th May, 2016)

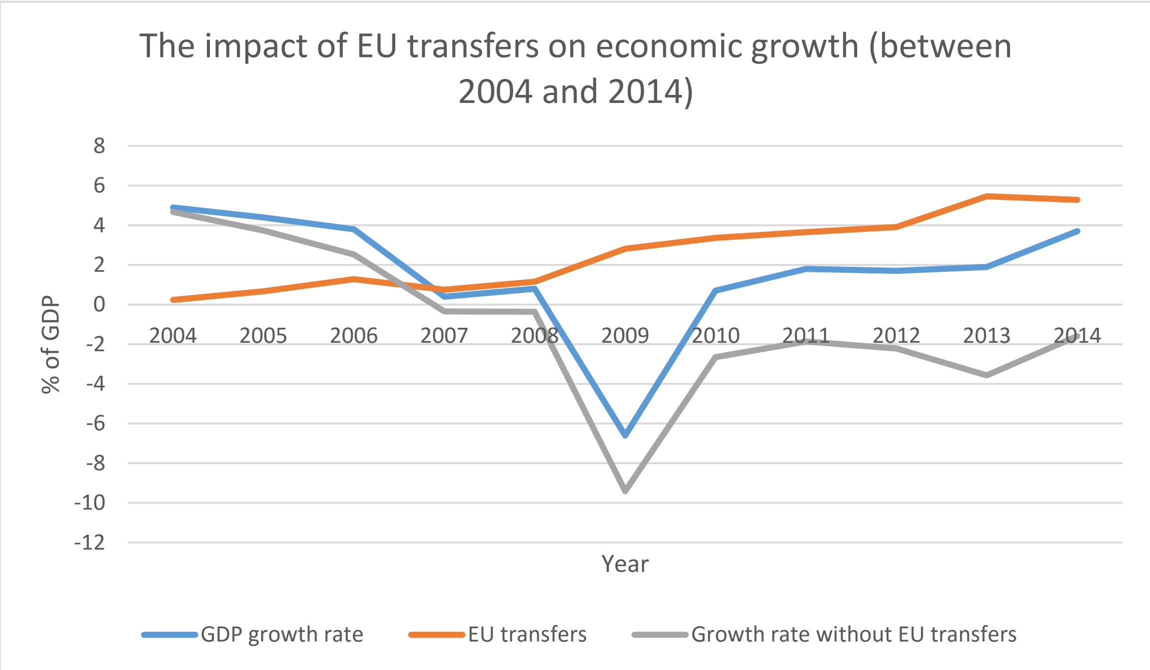
According to figure 10, the other Visegrad states could not attract new FDI projects, their net stocks value has stood on the same level with minor flows. Hungary appears to be volatile in this respect, as while in 2010 it experienced a huge loss in its FDI stocks in an amount of 32 billion euros, Bajnai's Mercedes-Benz project significantly increased the inwards flow. Concerning these findings, the Orbán government similarly to other Visegrad states could not attract new FDI projects since the 2008 financial crisis, while the previous Hungarian government was the only exception to succeed in this regards. So as the numbers show, the increase in exports is arguably a result of the production capacity improvement of the previously established subsidiaries. Hence the strategic partnerships of the government with foreign-owned manufacturing firms became quite fruitful, and as a result of constant dialogue they trusted the government, and reinvested some of their profit, creating 13.000 new jobs.[121]

So based on the previous observations, one might conclude that the Hungarian government seeks close partnerships with foreign investors, and apply several forms of incentives so that foreign-investors circulate their profit within the national economy. But as figure 14 shows, another important dimension of economic openness is the role of the EU funds, which is usually the primary financial resource of infrastructural developments. As the graph shows, since 2010 the government has accelerated the withdrawal of EU funds, and basically the economy would not produce positive growth rates without their contribution.

As Gergő Medve-Bálint addressed in his dissertation, accessing these funds became a crucial goal for domestic politicians, and redistributing them was based on power relations and political interests. (Medve-Bálint, 2013, p. 150.) Thus both leftist and rightist politicians pursued the centralization of redistributing these funds, benefitting the already developed

[121] MTI (2016) 'The Government Slaps its hands With a new Firm' – *'Újabb cég tenyerébe csap a kormány'*, HVG, Retrieved from http://hvg.hu/kkv/20150723_Ujabb_ceg_tenyerebe_csap_a_kormany (Accessed online on 30th May, 2016)

regions, while backward regions enjoyed a lower priority by government policies. Hence the focus of accessing and controlling these funds could serve *protégée* interests, embedded in the institutional framework. [122] But while the misuse of the EU funds enhanced cross-regional inequalities, Békesi argues, that they also became a tool for incumbent parties to obtain more votes, undermining quality investments targeting long-term infrastructural development. So when the government pushes “prestige projects”, like renovating main squares, or building new stadiums may temporarily revive the construction industry, but do not promise high-returns in



11. Figure, The impact of EU transfers on economic growth, source: KSH, MNB, own calculations

the future. (Békesi, 2014, p. 253)

So one may conclude that while the EU funds have a major role in supporting the Hungarian economy, cutting these funds may influence the economic performance in the short-run, while their misapplication cannot enhance the potential of high incremental returns in a long-term. As figure 11 demonstrates, there would be negative growth without the EU transfers, while there is a lack of tendency, which could confirm that the development projects of the

[122] Medve-Bálint, 2013, p. 150-52.

government would decrease the dependency on EU subsidies. And while the government intensively promotes the manufacturing industries, it underestimates the role of services sectors, which compose 70% of the total production, and employ 80% of the active labor. (Békesi, 2014, p. 245) But one cannot accuse the government that the economy is not open to world markets, and as Johnson and Barnes point it out, the government is rather focusing on financial nationalism, than pursuing greater independence in trade and production. (2015, p. 536)

4.3 Domestic Compensation: Identity Politics, the Emergence of the New National Bourgeoisie and 'Workfarism'

One could learn from the previous chapter that Hungary's "socialist welfare contract" has been a victim of robust budget cuts by the Bajnai-government, therefore the new government was expected to bring a new perspective and somehow compensate those who were fallen a pray of openness. This was a critical moment for the new government as there was a temporary loophole in the system providing a perfect opportunity to replace the pensioner-biased welfare state with new forms of compensation.

When Hungary took the presidency in the rotating system of the European Council in 2011, Viktor Orban claimed that Hungary wants to meet the convergence criteria of the EU, and would cut government spending to decrease the budgetary deficit under 3%. Therefore, the government shrunk expenditure on pensions, unemployment benefits, and subsidies on drugs.[123] Albeit, the prime minister promised no austerity measures after his election, he terminated the early-retirement of policemen, firefighters, and miners, while the government

[123] Fairclough, G., Feher, M. (13th January, 2011), 'Orban vows tighter spending rules', Wall Street Journal, Retrieved from: http://www.wsj.com/articles/SB10001424052748703889204576078220281339468 (Accessed on 11th May, 2016)

also adopted stricter regulations to obtain disabled pensionary. From 2012 the pensions of those, who had already received early-retirement would be recalculated respectively to their active years, and disabled pensioners were also reconsidered retrospectively whether their previously earned retirement was due to their actual condition.[124] The latter became the focus of the new pension policy, as there were admittedly many cases of abusing disabled benefits as their mass distribution was partly due to embedded corruption in the system.

So one should explain what factors enabled the government to adopt austerity measures, and to keep its supermajority for a second consecutive term. In 2008, Hungary experienced the impacts of the crisis more dramatically than other EU states, and while it was extremely vulnerable, previous governments went to institutional creditors – such as the IMF and the World Bank – to receive conditional loans, undertaking more foreign debt.[125] As one could learn from the previous chapter, conditionality also demanded neoliberal policies, restricting the sovereignty of the national government, while the country had become a primary target of FDI, and foreign banks redistributing loans in foreign currency. Parallel the EU also had a direct influence on the domestic legislation, as the accession criteria also derived financial openness, facilitating the private sector's indebtedness.

One may argue, that these two effects mainly contributed to the landslide victory of the conservative coalition, and by recalling Bibó's argument about the nationalists roots in domestic politics from the second chapter, they could easily empower pro-nationalist voices blaming Hungary's dependency on foreign powers. As Johnson and Barnes argue, Orban's rhetoric made a distinction between 'outsiders' – such as foreign bankers, the IMF, the Socialist Party, and the National Bank -, while he elevated national interests, granting the electorate of

[124] Act CLXVII of 2011, §1-10, Rerieved from The Official Webite of the Hungarian Parliament http://www.parlament.hu/irom39/04663/04663.pdf (Accessed on 10th May, 2016)

[125] Johnson, Barnes, 2015, p. 536.

his party, and powerful domestic firms and organizations granting them an 'insiders' status. After the elections, the primary goal of the government was to reunite the nation, providing citizenship to ethnic Hungarians outside the borders, empowering nationalist sentiments. (Johnson, Barnes, 2015, p. 545) So the government made a new national arrangement, privileging 'insiders' interests, and blaming the dominant external influence imposed by foreign actors for restricting the nations sovereignty.

Therefore, the premier of Hungary argued that foreign currency loans are limiting the nation's sovereignty, and it is crucial to keep the Hungarian Forint, instead of promoting to enter the Eurozone. (Fairclough, Fehér, 2013) So it was an important issue for the government to keep the country's monetary sovereignty, allowing monetary relaxation and 'quantitative easing' to support governmental policies. During its second term the government kept its promise, and converted the foreign currency loans to domestic *Forint*, offering to private households more stability and less exposure to external shocks. The large credit risk rating agencies welcomed the measures of the government, and Moody's immediately promoted the Hungarian government's bonds with a 'stable' status. Orban also claimed that this is a big step to reduce the vulnerability of Hungarian households, but the government still intends to promote major national ownership in the banking sector. (Johnson, Barnes, 2015, p. 546) So one may realize that the government's rhetoric clearly highlights the intention that even when it pursue to satisfy foreign financial actors, it emphasizes that it enhances the sovereignty of the nation.

These are all reflecting to the notion of Hungarian nationalism and the opposition between nationalist sentimentalism fearing the loss of political sovereignty and sceptic voices pursuing closer ties with the 'West'. This opposition mainly contributed to the governments mission to pursue financial autonomy, and to declare its intention to back from joining the Eurozone, promote monetary sovereignty via undermining the Central Bank to serve government interests, and to nationalize banks, utility firms, and to provide privileges to the 'national' clientele. On the other hand, the government values Hungary's EU membership, but it vindicates its sovereignty, and rejects any constraints imposed by 'outsiders'. (Johnson, Barnes, 2015, p. 545, 547-48; Békesi, 2014, p. 548)

Besides the spiritual compensation by promising sovereignty from external pressures, the government strengthened its own supporters with material benefits, under the slogan of strengthening the national bourgeoisie. So the tax burdens of high-earners were reduced by terminating the progressive income tax, being replaced with a unitary 16% tax rate. Albeit this was a tax-reduction on the one hand, the missing revenues of the central budget were substituted with the parallel increase of value-added tax up to 27% - which is the highest among the EU countries.[126] Basically, the new government policies limited the coexistence of the primary and secondary economy, promoting active labor markets, which was beneficial for fiscal prudence, while less fortunate for those, who had low or no income at al. The government also increased its revenues by nationalizing the second-pillar of the pension system, delivering a short-term solution, hence to support the PAYG-system. While this was an instant solution for the structural problems of the pension system – eldering society with parallel decrease of active labor -, 90% of the funds were technically extinguished by 2013, as the government also spent it on purchasing government bonds, decreasing the budgetary deficit, and to buy corporate shares.[127]

Albeit the significant decline of the welfare state raised dissatisfied voices in the society, the opposition couldn't benefit from the situation as the remembrance of the leaked speech of

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[126] Kalan, Dariusz, Durlik, Michael, (20th October, 2015), Central Europe's limping tigers: Hungary's unorthodox policy vs. Romanian austerity, Foreign Affairs, Retrieved from https://www.foreignaffairs.com/articles/hungary/2015-10-20/central-europes-limping-tigers (Accessed on 10th May, 2016)

[127] World Economy (*Világgazdaság*), 3rd October, 2013, The nationalized pension funds are vanishing, „*Eltűnőben az államosított nyugdíjpénz*", Retrieved from http://www.vg.hu/penzugy/eltunoben-az-allamositott-nyugdijpenz-412988 (Accessed on 10th May, 2016)

Ference Gyurcsány was still very intense, and the alliance of opposition parties involving the former prime minister produced low share of votes against the reigning government.[128] On the other hand the government also strengthened its position by targeted benefits to its own voters, supplemented with general welfare measures benefiting the whole society.

As Dorottya Szikra argues, the radical decline of the welfare state was not followed by mass protests due to several reasons, including the limitations of checks and balances, and informal partisan control of independent institutions. Although the main structure of the institutional framework was not transformed by the government, but it was undermined to serve direct partisan interests and to silence opposing voices. As the precedent of Constitutional Court shows, its authority to review legislative bills was restricted, clearing the path for the government to adopt radical measures. As the support for the opposition is quite limited, and protest against leftist-liberal parties was stronger than against the government, the emerged deadlock situation also prevented mass protests against the welfare state retrenchment of the government. Parallel several groups of the society were pacified by compensatory measures primarily via the tobacco distribution concessions to minimize opposing voices or at least prevent internal dissatisfaction among the supporters. (Szikra, 2014, p. 486-488)

As Csillag and Szelenyi argues (2015, p. 27-29), the main pillar for justifying the new system was the unique democracy concept of the government, what Viktor Orban calls 'illiberal democracy'. This term does not refer to the creation of an authoritarian regime, but an attempt to replace liberal democracy – particularly the system of checks and balances, and minority rights – with a majoritarian understanding of democracy, whereby the only tools for limiting power are the parliamentary elections. The authors call the ideology of this system more specifically "post-communist traditionalism or neo-conservatism". It is neo-conservative in the

128 National Electoral Committee (n.d.) data retrieved from valasztas.hu (Accessed on 11th May, 2016)

sense that it neglects the classical welfarism of the left-wing, while it is post-communist, because unlike original neo-conservatives, it argues that the will of the majority is above all other interests.

One may argue, that the Orban-government may have three elements of justification allowing it to maintain its support among the majority: (1) based on a majoritarian democracy concept, it exclusively distributes the wealth to its political supporters and to the members of its own clientele, (2) the rent-seeking behavior of the decision-makers is justified by the concept of creating a new national bourgeoisie, and (3) it also provides a response to the expropriation of state property by the transition governments in the 1990s, which was widely considered unjust by many. So basically the government and Conservative voters are 'more equal' members of the nation, and as the left-wing, and its supporters are serving foreign interests, they are not entitled to the same benefits.

This means that there is a restricted competition in the private sector, whereby the privileged members of the society – or if one prefers the 'insiders' – are entitled to receive monopolized rights. Therefore, the government redistributed tobacco concessions, and casino rights, nationalized community banks (*Takarékbank*) and then privatized and sold them among its protégées. However, these enterprises were not exclusively – if not mostly – owned by Hungarians, which shows how the government promotes its own national bourgeoisie, neglecting the interests of other members of the nation. But the most important part of the picture is the role of the EU concessions, and their role in financing the public procurements of the government. (Békesi, 2014, p. 246-48) As 90% of the public sector development projects are financed by the EU,[129] it is basically the EU itself, which allows the government to maintain

[129] Békesi, 2014, p. 246

its support via prestige projects aiming to restore the nation's pride and wealth redistribution among the supporters of FIDESZ.

Parallel the prime minister also became an echo of popular demand, firstly by nationalizing utility firms and reducing electricity and gas fees to provide universal material benefits to all members of the society,[130] while targeting the "nonproductive" groups of the society. As Szikra argues the Orban-government envisioned a "workfare society", whereby all members of the society are obliged to somehow contribute to the community the way their abilities and skills allow them. Therefore, the period of unemployment insurance was cut from 9 months to 3 months, which is the shortest among EU countries, and the subsidy was also cut from 20% to 15% of the average wage. Hence to receive unemployment benefits, it is also mandatory to accept the offered jobs by the authorities, and if there are no jobs available in the private sector, one must participate in the public works program for at least 30 days. In the case one denies these offers or fails to attend at work, he or she is not entitled to receive social benefits anymore, which technically preserves the deprived status of those, who lost their jobs once and had low-incomes before. Local governments are also entitled to check whether unemployed people keep their gardens 'tidy' at home, and failing to meet the criteria also derives exclusion from social assistance. And lastly, if the children of unemployed people do not attend at school, the parents may be also excluded from receiving local government subsidies as well.[131] In this respect workfarism in the Orbán-era is similar to the socialist concept of compulsory employment, when unemployed people were criminalized, but today 'noncontributing' members of the society are simply excluded from social assistance. As the "orthodox" part of the paper explored, the majority of the society is not sensitive for the issue of poverty, allowing Orbán could to justify their exclusion from the social security net.

[130] Szikra, 2014, p. 493
[131] p. 492

Family policies have been also restructured in the Orban-era, and the Conservative ideology of the governing party also highlighted the importance of maintaining the Hungarian nation by higher child-birth rates. The long-lasting debate between the Socialists and the Conservatives was technically ended in 2010, as the government restored long-term parental leave (up to three years), and by separating family policy from social policy. The government claimed that mothers have the right to 'stay home with their children', which policy derivatively preserved low female employment rates in the society due to the high-risk of average 5-years maternity leave. While the Socialists argued that universal child poverty should be in the focus of family policies, therefore they introduced relatively generous cash benefits to increase family incomes, the new government introduced tax credits, benefitting those, who already had high earnings. The other concerning issues is that the definition of family was also rewritten by the government, claiming that "(t)he family shall be…. based on the marriage of a man and a woman" (Fundamental Law, Article L). This means not only the constitutional exclusion of same-sex marriage, but the discrimination of one-parent families as well.[132]

So the welfare state of the "unorthodox" model is mainly based on majoritarian principles, and the as the new Labor Code or the tobacco concessions show, it supports the assets owners who form the new national bourgeoisie. Furthermore, deregulated labor markets also promote flexibility, which is beneficial for the employers not for the employees themselves. On the other hand, the compensation of the less fortunate is rather ideological than material. This has three dimensions: (1) provide universal material benefits to all members of the society – via utility fee reduction[133], (2) promoting high-level of employment via public work – which is based on the principle that solidarity towards poor and unemployed people lacks from the society -, and (3) due to lack of adequate welfare state, the government also

132 Szikra, 2014, p. 493-94.
133 p. 493

empowers xenophobic, and racist echo from the society to justify the deprived status of the worse off. In sum, people in absolute poverty are still excluded from the welfare state, becoming more vulnerable to the state, which only offers public work with an extremely low wage under the minimum wage.

Chapter 5: Conclusions: The vulnerabilities of the "Unorthodox" Model

One could learn from the previous chapters that during the past two and a half decades, foreign-owned manufacturing firms became the primary contributors to Hungary's export balance. However, the high degree of competition could generate a relative well-being for a major part of the society, others couldn't cope with the new environment. Hence the "orthodox" model was legitimized by a relatively generous welfare state providing additional incomes to the 'nonproductive' groups of the society to promote their secondary activities outside the formal labor market. But sustaining the welfare state was not affordable, and the state budget generated large deficits, while the parallel financial openness also incrementally supported the foreign indebtedness of the private and the public sector as well.

As political stability was both undermined by a disproportionate electoral system, and welfare state retrenchments were imposed by the interim government in 2009. These factors mainly contributed to the landslide victory of the conservative alliance in 2010. The new government's measures mainly targeted financial openness and pursued financial autonomy from 'outsiders' interests. The "unorthodox" measures parallely supported the emergence of the new national bourgeoisie, and silenced opposing voices by satisfying popular demands via universal material benefits, 'workfarism', and most importantly identity politics.

Nationalist policies mostly targeted the banking and the retail sector, while foreign-owned manufacturing firms remained the primary exporters in the national economy. Parallely the daily operation of the service sector was exposed to bureaucratic red-tapes, additional taxes, and selective protectionism undermining their competitiveness. The "unorthodox" model deliberately suppresses the creative forces of the market, as the distribution of resources is driven by clientalism and patronage interest. Due to the 2008 financial crisis the private sector started to generate a small surplus in the current account, showing an increasing propensity to save, which was partly due to the slower inflow of capital.

While the “unorthodox” model pursues financial sovereignty, it could reduce both the private and the public sector’s foreign debt substance, but this doesn’t mean that the economy would be not vulnerable to currency devaluation. As the government consumed both the private reserves – when it nationalized the private pension funds – and there are limited options to obtain further extraordinary incomes, the government would need to cut public expenditure and to privatize the nationalized assets to save the budget from bankruptcy. This would dismantle the main pillars of the “unorthodox” model, challenging the conservative alliance to legitimize its power, and may induce a chaos in domestic politics.

But most remarkably, excessive dependency on exports markets, and EU subsidies, are the most determining factors which make the “unorthodox” model vulnerable to exogenous factors. If foreign consumer markets could not absorb the Hungarian export products, it would lead to mass layoffs, and parallelly result a serious drop in government revenues. While on the other hand cutting the EU funds would also directly affect the economy and decreased the public demand immediately, stopping the primary engine of economic growth, which is currently the construction industry.

On the other hand, the “unorthodox” model could maintain political stability, but at the cost of undermining the quality of democracy. Although the agony of the leftist-liberal opposition also contributed to the high support of the government, as separately none of them had a chance win the elections. But as 2014 elections shows, the votes on each party didn’t sum up when the opposition parties allied, as many voters couldn’t accept the presence of the former prime minister, Ferenc Gyurcsány among the common candidates.

As final concluding remarks, the economy couldn't become resilient to external shocks, and the "unorthodox" model just postponed the most crucial issues, addressing great challenges to future decision-makers to overcome. According to Katzenstein's puzzle, a new model should be fiscally sustainable, provide material compensations via egalitarian measures, and embed economic reforms by consensual mechanisms. But probably the major factors, which are undermining economic growth since the transition are state capture, clientalism, patronage, and embedded corruption in the society on many levels.

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