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

Background Paper 3: Varieties of Capitalism and CEECs

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Background Paper 3: Varieties of Capitalism and CEECs

Miklós Szanyi (KRTK MTA)

Abstract

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

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

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

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

Contribution to the Project

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

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

Jel codes: P10, P51

Introduction

Central- and Eastern European countries underwent two major systemic changes in the 20th century. Both of them were directed by some kind of uniform ideological background. In case of Central Europe socialist transition was engineered to fit Soviet models and political expectations. This doctrinaire policy lasted long in some countries (Czechoslovakia, Bulgaria or the GDR), meanwhile Yugoslavia, Hungary and Poland experimented with variations in order to overcome some of the most severe bottlenecks of the socialist economic system (e.g. lack of price orientation, low level of working morale and incentives). Nevertheless, strong state paternalism, soft budget constraints, isolation from world markets and -competition remained in place. Still, the communist experience of Central-European countries was not quite uniform.

The second systemic change was back to market economy. At the very beginning of the process Washington Consensus was still in place and international organizations and advisers suggested the neoliberal transition treatment expressed in the acronym SLIP (stabilization, liberalization, institution building and privatization). Although advisers' mind changed rather slowly, the various transition economies applied SLIP with large variations in sequencing and timing. Some elements were postponed or never implemented. In case of institution building a large variety of models was used. Hence, transition economies developed in largely different ways during the past 25 years. Uniformity remained in place only on the side of international organizations and financial institutions. These kept on evaluating transition and economic performance using sometimes rather arbitrary, uniform schemes of measurement.

Thus, after almost 25 years transition process has created quite differing new market economic systems in Central and Eastern Europe. At the same time, new branches of economic thought got established that compared transition process and the variety of capitalist systems in order to find best practices. The varieties of capitalism (VoC) literature aimed not only advising transition economies, but also reforming mature market economies' ailing systems (e.g. social security and innovation systems). This new branch became part of a larger stream of economic thought the comparative economics.

The use of VoC literature on transition economies has been rather ambivalent. While it tried to figure out good solutions of institutional structure and policies using the experiences of established market economies it did not succeed finding general best practices or suggested solutions were rarely implemented. On the other hand, diverse transition trajectories fuelled important discussions on the same topic. Varieties of transition were described and analyzed with the same aim: finding best practices for the different tasks of transition process. Nevertheless, scholars of the VoC literature keep on comparing Central and East European countries' capitalist models with established market economies (see: Farkas, 2011a). In this paper we review transition process in Central and Eastern Europe using results of comparative economics (especially VoC), and highlight the main features of market economic systems of the region, but especially those of Hungary.

Determinations

One of the most important questions of comparative analysis of Central and East European market economies is if there is a common model of transition and capitalism? Put the question in another way are cross-country differences in the region bigger than differences compared to other established market economies? Nobody would of course claim that transition trajectories and current market economic models of the region are identical. But the argument of the German school stating that each case is different is not applicable either. There is no clear answer to this question, researchers' opinion is divided. In fact, only few comprehensive analyses were carried out with the aim of fitting transition economies into the more or less codified modeling structure of VoC literature using 4 or 5 types of capitalist models[1] (see: Hall and Soskice, 2001, Amable, 2003). Most researchers compare only countries of the region and figure out similarities and differences verbally with the 5 codified models, or try to establish new typologies within the region (Bohle and Greskovits, 2007; Csaba, 2007;). Only little comprehensive research was carried out using the same analytical tools for both established market economies and transition countries (see: Farkas, 2011a).

What seems clear is that most CIS countries and transition economies of Central Europe follow much different development paths. Large and rich in natural resources CIS countries run rather undiversified resource-based economies that are strongly controlled by the state and have weak democratic institutions but rather an autocratic political system. Central European transition economies on the other hand have more developed and diversified economies that are integrated in world economy through transnational corporations' presence, and stronger democratic institutions which however, do not work most effectively. This difference among the two groups is also reflected by the countries' external orientation, their relationship with the European Union[2].

While it is important to review and realize main systemic differences within the group of transition economies, it is also necessary to understand the underlying reasons. This is of course, an even harder task, since we can observe in the background a number of societal, historic, cultural and even geographic determinants. The more exact mapping of these elements remains for future research. However, a few facts can be pinned also in this paper.

The Gerschenkronian argument on prevailing historic features in societies is applicable here. The area under discussion had been ruled by 3 empires in the late XVIII, XIX and early XX. centuries. The 150 years of history did not pass by without having strong influence on various parts of these

[1] While differences of capitalist development were registered and analyzed at least 150 years ago by Friedrich List and Karl Marx or more recently by Max Weber, the VoC literature originates from the much referred studies of Peter Hall, David Soskice and Bruno Amable. They established a typology based on quantitative and qualitative information for established, traditional market economies differentiating among Anglo-Saxon, Nordic, Continental, Mediterranean and Asian models. Structure and functioning of capital- and labour markets, social security system, extent and efficiency of state institutions were the most important areas where main differences among the models were described.

[2] This is by and large a valid statement, although Csaba (2007) has of course right when he says that relationship to the EU per se does not determine a country's market economic system (see for example Greece). On the other hand,, new EU members had to change their institutions according to the acquis, hence the process of accession had a strong influence on the transition process.

empires. The more so because the nations in the region witnessed the decades of the establishment of the modern societies in the second half of the XIX century in the larger frames of the Russian, Turkish and Austro-Hungarian empires. These on the other hand differed fundamentally due to the traditional societal and cultural background of the ruling nations, and much of the main features were delivered to all parts of the empires. One clear evidence of this is the similarity of architectural styles throughout the various parts of the empires. For example, in the most eastern part of the Austro-Hungarian empire say in Lemberg (today Lviv in the Ukraine) public buildings like railway stations, theatres, public schools and caserns were very similar to those in the Austrian, Hungarian or Czech parts. But also relationship to the state, the role of local authorities, development of civil society was very similar.

This joint historic development path is reflected even today, when the three empires had been dissolved for many decades. It is still reflected in the picture and atmosphere of cities and villages, but also in the cultural heritage of the citizens. "The state cannot set taxes low enough so that I could not pay even less!" say citizens of the Southern part of today's Serbia. This part of the country belonged to the Turkish empire which did not do much for the development of public utilities, hence tax-paying was not linked to state services, therefore it was regarded as a kind of robbery. In Voivodina, the Northern part of today's Serbia tax evasion had not been so strong and people were more disciplined because of the obvious positive impacts of state services in infrastructure, health and education in times of the Austro-Hungarian Empire. But civil society was also much stronger here. The cradle of the Serbian literature and modern language was in Újvidék (today's Novi Sad) and not in Beograd. The clash of different cultural heritage of people causes frequent conflicts which are most clearly expressed by the desire of Voivodina for more autonomy, especially with regard to fiscal policies. But similar conflicts can be detected in the Ukraine, less strongly in Romania and Poland: countries the territories of which were created in the XXth century from parts of the three ancient empires.

The strong historic, societal, cultural and geographic determinations can be observed in other geographic regions as well. Far away countries' capitalist models differ substantially due to these reasons. Japan or the USA run completely different institutions then European countries. Nevertheless, within Europe VoC literature has figured out substantial, systemic differences as well. They also have long term historic roots. We already touched briefly the question of "uniform" transformation efforts in transition economies, whether or not they contributed to a model convergence. The same question can be raised concerning established market economies, namely if the process of globalization and regional integration would lead to convergence of their models? Impressions are mixed. While the common trade, agricultural and monetary policies eliminated much of the potential room for systemic differences, on important areas they survived. Sapir (2006) argued that systemic divergence remained in place most visibly on European welfare systems. Based on this element of capitalist models he successfully identified the 4 main European types, while searching for solutions of reforming the out-dated welfare institutions. Another important albeit less cited in VoC literature area is management and corporate cultures. Based on Hofstede's seminal empirical work on figuring out the main dimensions of differing corporate and management cultures another string of literature has been established within management science that stresses similar to VoC typology which is also based largely on historic and cultural determinants. These examples suggest that the process of globalization did not eliminate systemic differences among countries' capitalist models.

Thus, the main conclusion of studying VoC literature is that systemic differences have remained in place during the past few decades despite of the process of globalization and regional integration. With regard to transition economies we can expect the same. The most obvious dividing line is between CIS countries and the former allies of the Soviet empire (Lane, 2007; Csaba, 2007). But among CIS countries as well as among the new member states of the EU (EU-10) important differences are also visible. The main question is whether these are as significant as the differences among the main capitalist models, and thus, we can create new typology for EU-10 (and CIS)? If not, then whether EU-10 can be subordinated to the various types of capitalism known from the VoC literature, or they together form a new capitalist model?

Evidence from the VoC literature

A comprehensive overview of the literature summarizes much of the EU-10-related VoC research results (Farkas, 2011b). Many contributions tried to relate transition economies features to the existing 5 capitalism models. Results were rather mixed. Berrou and Carrincazeaux (2005) ran cluster analysis and found Czech Republic, Poland and Hungary Mediterranean model. Cernat (2006) found quite surprisingly that Bulgaria, Poland, Latvia, Lithuania, Romania and Slovakia were continental and Czech Republic, Hungary and Slovenia rather Asian.

An important segment of the literature strongly emphasizes the relationships between the economic system and political stability, and differentiates among liberal and non-liberal (patrimonial) models of capitalism in the transition economies. King (2007) compares two models: Czech Republic, Poland and Hungary (as liberal and dependent countries) with Russia, Ukraine, Romania and Serbia (patrimonial states). The former group differs from the West and is regarded dependent because of the high importance of foreign investments and markets and low level of coordination on the labor market. Bohle and Greskovits (2007) analyzed the relationships of economic change and new institutions and related social costs of the change with political risks and behavior. They argued that Baltic states ran neoliberal model, mainly because these countries concentrated policies on macroeconomic stability (a sign of vitality after braking the ties with Soviet empire and Russia). Although these policies had had extremely high social costs (in form of GDP decline and high unemployment, furthermore a rather unhealthy degradation of the economic structure), political stability was not challenged since majority of the losers of the systemic change were industrial workers from the Russian minority. Many of them did not have citizenship and were excluded from political arena. On the other hand, Visegrad countries of Central Europe (the embedded neoliberal type) had had more gradual reforms and made strong efforts to compensate losers of the transition process in order to accommodate the political consequences. An interesting conclusion was that this compensation was not based on strong tripartite institutional system but on the arbitrary decisions of ruling governments. Bohle and Greskovits (2007) also differentiated a third type the "neocorporatist" one of Slovenia, which they regarded most successful both economically and politically. Blanke and Hofmann (2008) also separate the Baltic states as liberal model and various Central-European countries as coordinated market economies.

Some of the authors regard EU-10 capitalist models eclectic. The main reason of this is the arbitrary mix of the development of various market economic institutions, stemming from various types of established capitalist economies. Cernat (2006) calls this "cocktail capitalism". The main problem of this is that components do not fit together if they come from economies working at differing logic. The clash of contradicting elements creates much room for opportunistic behavior for economic and political agents that may deteriorate economic performance substantially. The lack of institutional consistency creates situations when ad hoc decisions set the rules of game and thus state institutions and political parties gain much influence over the economy. This process is called based on the Russian experience "business capture" (Yakovlev, 2006).

A still further approach regards the level of formal state intervention as decisive factor in separating systemic models. This is not equivalent with the above mentioned arbitrary intervention of business capture, but reflects the aspects of either strong welfare institutions (extension of central redistribution) and/or aspects of development state (Csaba, 2007). When compared by the extent of central redistribution Czech Republic, Hungary and Poland has high levels similarly to the traditional continental and Nordic models. On the other hand, Slovenia and Slovakia, and the Baltic states have significantly lower levels of state redistribution which is similar to the Anglo-Saxon model of capitalism. Lane (2007) also uses the level of state intervention as lead characteristic in his typology, albeit his country groups do not overlap with other authors'.

Summing up, there is no clear research result concerning the analysis of EU-10 countries' fit into the existing 5 traditional capitalism models of the VoC literature. Rather, results are contradicting, and vary according to the chosen selection aspects and also the observation periods. The EU-10 related VoC literature is nevertheless very valuable reading, since it provides lots of basic information on aspects of transition and new institutions, which helps readers to a better understanding of the non-orthodox processes that characterize most of these economies. In line with the lack of convincing evidence for the fit with existing models some authors tend to regard EU-10 (sometimes even together with CIS countries) as a further new model of capitalism (EC 2008). Rodrigues (2009) also suggests the development of a new capitalism model for the transition economies and suggests some aspects. Farkas (2011a) carried out cluster analysis comparing EU-25 on five institutional areas using measurable hard data. Her results have also been rather mixed in the various areas, but suggested that EU-10 established a separated group in most aspects. The calculations showed some degree of homogeneity within this group. Still, these calculations also suffered of the usual handicaps of international systemic comparisons. The 5 investigated areas missed to capture many important aspects, the chosen variables may be replaced by others that would perhaps show different results (the selection of indicators may always be criticized). Nevertheless, Farkas' contribution is currently the most comprehensive and methodologically most stable approach to the topic with clear defendable results.

Farkas (2011a) summarizes her typology as follows. EU-10 can be placed as far as product markets flexibility is concerned in between the Continental and the Mediterranean model. Foreign investment is the base for high technology development level. The national innovation system fits the Mediterranean model, with relatively low level of R and D spending especially by the business sector and weak innovation. The financial system is similar to the Continental model with dominant role of the banking sector over capital markets, but the level of capitalization is much lower, financial markets are rather shallow.

Labor market does not have the dual character of the Mediterranean and Continental models with insiders dominating positions over outsiders, therefore it is more flexible, like in case of the Anglo-Saxon model. Industrial relations are ambivalent as well. The state moderates in industrial relations like in the Mediterranean model, but the process of collective bargaining (with rather limited applicability) is almost free from conflicts anyway. As concerns social protection three countries belong to the Continental model, others rather to the Anglo-Saxon model, but these also maintained traditions of the Continental model in financing. Farkas did not find clear evidence for any of the established models in the area of education, but the structure and applied methods come from the Continental traditions.

As is seen, Farkas (2011a) found similarities in the various areas with basically all European capitalist models. It seems, that the EU-10 implemented market economic institutions in mixed ways and can perhaps be really called cocktail capitalism. We do not share the opinion that this sometimes rather contradictory system is a separate model. We believe that its internal tensions will move it to a more stable and less contradictory status. It is a still open question if this movement will head towards one or another established market economic model, or will remain a separate one. It seems possible that the shifts will depart the individual EU-10 countries from each other, and they will run more different capitalist systems. It is also possible that the shifts will head towards the Russian-type capitalist model, which has not been discussed by Farkas (2011a). Crony capitalism with increasing business capture by the state has been observed in some countries (e.g. in Hungary or Romania). Possibly, crony capitalism will be the capitalist model of Central and east European Countries?

The process of transition: main tasks and policy relevance

Transformation in Central and Eastern Europe (CEE) included all major areas of social life. Changes in the main areas like polity, society and economy interacted in many ways. Hence, the process can be best understood if treated in complexity. For example, economic stabilization through austerity measures strongly reduced incomes and living standards, causing important changes in political support of governments. On the other hand, the same measures established the basis for future prosperity in many countries, the benefits of which emerged with substantial time lag frequently under the reign of a new government. Therefore, political calculations especially in case of strong societal impacts always influenced economic policy decisions shaping the timing, extent and other features of important decisions.

Another important general determinant of transition was the widespread application of international consulting. International organizations, foreign governments often offered their advice services to CEE governments. Since transition from planned economy to market economy had never been experienced before, both governments and advisors did not have a solid empirical background to rely on. Hence, it was rather likely that they would study and try to apply knowledge earned in somewhat similar cases using receipts of the Washington Consensus' SLIP. Due mainly to diverging political situations actual policy steps differed largely among transition economies, albeit, the main logic of the policies remained the same and reinforced by the consulting (and lending) international institutions.

The SLIP logic is very straightforward and is based on neoliberal assumptions about the strength of free market competition. Market economic institutions must serve the logic of free market competition, which will on the long run create favorable conditions for economic growth and prosperity. Two important conditions must enjoy preference in this process: the state must withdraw from direct activities in the economy (not only as owner, but also as planner), and macroeconomic stability must be provided in order to eliminate disturbing market economic processes imbalances. In this regard strict fiscal policy and inflation centered monetary policy was suggested. Though the orthodox usage of SLIP was not typical for CEE transition, the main logic of balanced budget and priority of anti-inflation policy has remained in place up till today.

Pace and sequencing of institutional changes, macro stabilization policies, liberalization and privatization varied greatly among transition economies[3]. This was due to mainly two factors. One was the difference of macroeconomic stability status (level of foreign debt), the other was the main political concept of how economic transition should serve political and societal changes in the CEE. Substantial levels of government and foreign debt forced Poland to undertake very drastic stabilization measures. Cutting of state budget expenditure as well as a deep devaluation of the currency shrunk incomes drastically causing a deep cut in welfare. Poland decided not to pay back the accumulated debt and initiated negotiations with commercial and government creditors. In contrast, Hungary wished to repay and tried to generate the necessary foreign currency incomes from selling state-owned enterprises to foreign investors in the privatization process.

In case of Czechoslovakia[4] the prevailing concept of economic transition was directly linked to political considerations. Governments tried to overcome a deep economic decline (called as "transformational recession" by Kornai (1994) through continued government subsidization of ailing industries, what was in fact contrary to the neoliberal concept of SLIP. Also, privatization policy should have served political goals. Large part of sate property was evenly distributed in the voucher

[3] Roland (2000) provides an excellent overview of literature on the various aspects of SLIP in transition economies. Similar but less comprehensive summaries near the „10th anniversary" of transition were provided among others by Kornai (2000), Stiglitz (1999), Fischer (2000), EBRD (1999) and others.

[4] This country ceased to exist in 1992, and the new Czech and Slovak Republics were established instead.

privatization process among the Czech and Slovak nations. The aim of this was completely political: designers of this policy wanted to strengthen domestic capital ownership and create a new bourgeoisie that they hoped would support the government. This policy was only possible because the government was not indebted and hoped that the economy will recover soon using the state subsidies[5].

These examples could perhaps properly illustrate the strong impact of polity on economic transition. This interplay is conceptualized in Bohle and Greskovits (2007). They argue that the character of transition policies, the intensity of austerity measures of stabilization policies for example depended very much on internal policy considerations. In the Baltic states for example currency stability was a symbol of the newly established sovereignty and was of high priority, the high cost of macroeconomic stabilization did not cause political crisis because first, the local population strongly supported this, second, because most strongly hit losers of the policy were inhabitants of Russian nationality, who in many cases were not granted citizenship and were therefore excluded from political life. This was not possible in Poland or in Hungary, because the mentioned two factors did not work in these countries. On the contrary, both countries spent quite a lot on accommodating the social shocks and compensated society[6].

But why could transition economies not maintain the level of economic performance on previous levels? Why was there a transformational recession with output drops of 30-40 % (in some cases even more)? The analysis of SLIP must start with the explanation of economic decline and the necessity of stabilization policies. Kornai (1994) analyzed the main reasons of the recession. These were (1) the shift from sellers' to buyers' market, (2) the transformation of the real structure of the economy, (3) the disturbances in the coordination mechanisms, (4) the macroeconomic consequences of the hardening of financial discipline, and (5) the backwardness of the financial system. In our interpretation the process of transformational recession was caused due to the inherited from the planned economy real economic structure and functional logic that could not be maintained under the circumstances of market economy. This meant simply, that huge parts of industrial output were not competitive on world markets[7]. In an attempt to save production capacities from immediate collapse most governments continuously subsidized producers, who were still in state ownership and were the main employers. Subsidization was sooner or later given up partly because it was not compatible with the newly introduced market economic logic and institutions since it crudely distorted competition, partly, because subsidized companies mostly failed to adjust activities to the new market economic frames (Szanyi, 1996). Subsidization also seriously burdened the state budget.

[5] It is another chapter of the saga why this intention did not come true and the Czech and Slovak governments could not maintain the favourable budget positions.

[6] It is also a nice touch in the story that governments used compensations to achieve political goals: compensation was hardly coming from regular sources of social solidarity funds but were bound rather to ad hoc government measures, that were of course clearly articulated as „achievements" of the ruling parties and governments.

[7] The production of these goods was intended to serve protected markets cut off from world economic competition.

The recession could be temporarily postponed by other policies like devaluation of the currency or the more gradual liberalization of the economy. Such policies were in extensive use in the Czech Republic (Mertlik, 1995), but the extended time lag was hardly used by companies for adjustment. The main reason of this was the slow hardening of the budget constraints and the disturbance of coordination mechanisms in the economy. There was no effective market force to induce adjustment policies, state owned companies continued relying on various kinds of paternalistic government support (from maintained trade barriers through currency devaluations till direct cash subsidies). This was a very straightforward application of policies used in crisis situations by the governments in the pre-transition period. As a result, huge debt burdens were accumulated throughout the economy originating mainly from the real economy's inherited long-term investment debt[8]. This original debt was then refinanced by new loans and amended by new debt stemming from loss-making production. This process happened in all transition economies, but its measure was different depending on the length of the period of state paternalism's survival and the extent of subsidization.

Instead of long period of subsidization some countries applied "shock therapy". Market economic shocks were not accommodated, liberalization was quick and the state did not intervene in accommodating the results of the shocks either. The social costs of transition were of course compensated through the welfare system. This was more comprehensive in countries where also the political arena was characterized by competition (democracies). "Shock therapy" basically meant a quick and immediate departure from the old type of paternalistic state. This policy could be also supported by the newly established market economic institutions. With regard to the hardening of the budget constraints we can emphasize two of them: the two tire private banking system and market exit procedures. Both of these affect real economic activity through external control on activities. Loss making is not tolerated if creditors also have hard budget constraints and regularly monitor debtors. Loss making cannot be continued if effective exit procedures impose the direct consequences in form of market exit (liquidation). In an empirical survey Gray et al (1996) proved that the exceptionally harsh Hungarian bankruptcy law of 1992 resulted in an immediate and deep decline in debt arrears in the economy, as well in an effective reallocation of resources towards financially sound activities[9].

"Shock therapy" was also useful for establishing the credibility of economic policy. As it was described in an earlier paper (Szanyi, 2002), the old imprint of paternalistic state also had to be changed. Firms did not take serious threats of insolvency until they could effectively rely on state accommodation. Without taking the full responsibility for the risks of activity companies did not enter into difficult and time-consuming long-term adjustment (Szanyi, 1996). Loss-making was continued. A series of policy steps and new institutions and the consequent application of these

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[8] This debt could not be repaid because production on the established capacities lost markets and did not generate revenues.

[9] Contrary to most bankruptcy regulations the 1992 Hungarian bankruptcy law called debtors (instead of creditors!) to file for bankruptcy if they had overdue obligations. The „automatic trigger" launched an avalanche of bankruptcies resulting in a dramatic drop of debt arrears. Of course, negative effects in form of output drop and increasing unemployment were also registered. From the point of view of hardening the budget constraints the law was rather successful.

helped Hungarian governments to overcome this problem. The main task of the measures was to clean the economy from accumulated not performing debt and stop further debt accumulation by stopping loss-making activities. Besides of the already mentioned harsh bankruptcy law, which was fully implemented, banking activity was also newly regulated introducing new (in other countries rather standard) prudential regulation. Banks were obliged by law to evaluate their asset portfolio and separate not performing loans. They were also required to set aside adequate amounts as risk reserve, and to set up workout departments to handle insolvent clients. These activities were controlled by the bank supervision. Thus, banks discontinued refinancing non-performing loans.

Loss-making activities were discontinued since neither banks nor government extended new loans to refinance old debt or clearly loss-making activities. The already accumulated debt was written off in the books of the commercial banks and the government as well. As a result, major still state owned banks became financially weak and were recapitalized by the state. Hence, the cost of transformational crisis in form of debt write-off was paid in the end largely by the state. But there was also a third pillar of braking the old imprint, privatization. Government paternalism was discontinued also because the Hungarian government set up privatization policy goals that aimed the sale of state enterprises (SOEs) in virtually all economic branches, including services and banking. SOE managers could not turn for support to the state as owner any more.

The three pillars of microeconomic adjustment (bankruptcy, prudential regulation of banks and privatization) could eliminate the old imprint of the paternalistic state. SOE managers had to start corporate adjustment process if they wished to keep a chance to remain in place (Szanyi, 1996). In many cases they also took a role in the design of the privatization of "their" companies. This way the credibility of the government and its policies was established. This credibility was also fully utilized in the stabilization efforts. The 1995 austerity measures which successfully limited budget deficit accumulation could be introduced because government policies seemed to be serious, that is no later accommodation was expected. On the other hand, their effect was also trusted. In fact, the government could substantially reduce foreign debt as well, using privatization revenues.

Privatization patterns

The fourth element of SLIP, privatization was carried out in very different ways in CEEs[10]. Design and actual policy steps were very much determined by general political considerations. As Freedman and Rapaczynski (1994) stated, privatization was primarily a redistribution tool of economic power which strongly affected the political power relations. They explicitly formulated the claim that privatization should serve the breakup of economic might of the communist nomenclature in order to make irreversible and complete political turmoil. The idea effectively influenced privatization policies in many CEEs. But the question of how and whom to transfer state property was answered differently by various privatization policies.

[10] The huge literature on privatization expands from the seminal conceptual work of Frydman and Rapaczynski (1994) through later assessments of the practice (e.g. Sutela, 1998) to applications with conclusions to latecomer transition countries (Rakova, 2006).

But not only political considerations influenced privatization. There was also a strong desire to use privatization for putting an effective ownership pattern in place in (former) SOEs that could actively contribute to the adjustment and modernization of the companies (Szanyi, 1996). The low level of efficiency, lagging behind technology and management practices, as well as the introduction of new markets required substantial investments into technology, marketing and managerial know-how. The accumulation of these properties started at rather clumsy speed in SOEs, since they lagged the necessary capital for investment (they were chronically undercapitalized, and many of them was seriously indebted). But they also lagged the necessary knowledge and experience. Moreover, they did not have much time to deal with the adjustment tasks. Transition process delivered important changes in the organization, book-keeping and taxation, managers also had to deal with ongoing privatization issues. The business considerations and tasks of privatization were therefore frequently pushed into the background.

A further important aspect of privatization policy was the outside pressure on governments. As part of SLIP international financial institutions and other parties effectively urged quick and effective privatization. The EBRD Transition Reports for example evaluated transition economies' "transition performance" using also the degree of privatization (mainly the share of private sector in GDP) as an important progress measure. Sometimes "package deals" were offered to governments. Financial support for institution building was treated in one package with the request of extending privatization on certain economic branches or companies. Governments could not always skip from the pressure. In case of Hungary the aim of reducing accumulated foreign debt also contributed to the choice of privatization methods. The government wanted to receive quick cash revenue from privatization.

There were four major types of privatization methods, the sales method, voucher privatization, ESOP and insider privatization. Other policies like restitution (in kind or in other forms) or bankruptcy of SOEs also affected elements of state property. Dominant policies were the first two, sales and vouchers although virtually all transition economies applied a mixture of all four methods with different weights. The resulting ownership structure of the economy, identity of the actual owners, new owners' ability to adjust and modernize companies did not show a clear preference for any of the privatization models.

The sales method was chosen as primary tool mainly because of the government's desire to reduce foreign debt using revenues from the privatization process. First manufacturing and trade, later services and banks were sold mainly to foreign investors, who were in superior bidding position as compared with domestic investors. Big business' most lucrative segments were sold to multinational companies the rest was bankrupted and sold out to domestic owners almost as scrap[11]. Privatization became the most important channel of foreign direct investments (FDI) in Hungary already in the mid 1990's. The sales contracts were usually amended with clauses containing requirements for future employment, new investments, etc. On the other hand, foreign investors usually bought only

[11] Bankruptcies were often suspicious of fraud. Incumbent management could often buy out valuable assets at low price. In many cases the thus „privatized" assets were run later quite efficiently Szanyi (2001).

segments of larger SOEs that they could insert into their international production and distribution networks. Also, in most cases environmental cleanup, in the case of banks the cleaning of the asset portfolio was necessary before SOEs could be sold. This reduced state revenues quite substantially. The newly acquired facilities were then quickly rebuilt, equipped and inserted into the international networks Szanyi (1999). Privatized to foreign investors firms became (remained) flagship companies of Hungarian manufacturing with very high levels of productivity and cutting edge technologies.

The other main type was the voucher privatization. This method was also used in all transition economies (including Hungary). The main aim used to be strengthening domestic owners, a kind of new bourgeoisie with the even distribution of property rights among citizens. Czechoslovakia was the most important pioneer of the method. In the Czech Republic it was consequently continued after the 1992 breakup of the former country, meanwhile in Slovakia other methods, mainly forms of insider privatization gained momentum[12]. The original idea was to distribute ownership coupons for almost free among citizens that could be exchanged via secondary capital markets to real stocks of privatized companies. Designers hoped not only that many people will express interest and gamble with shares, but also that this way capital markets got boosted.

Though the original idea was not "hijacked" by new political interest and the program was carried out in the Czech Republic largely in the line of the original plans, the results were at most mixed. Not many Czech citizens became wealthy new owners, since most of them not only transferred their coupons to the so called "privatization investment funds", but effectively sold them for cash even before the coupons were exchanged to corporate shares. Hence, the "real owners"[13] of the Czech SOEs' became the funds, not citizens or coalitions of them. Thus, the primary political goal was not achieved. Unfortunately, the economic (business) goal was not achieved either. On the contrary, opportunistic behaviour of incumbent managers was further fuelled, since no effective owners' control evolved. 5 out of 7 main investment funds were funded by state owned large commercial banks. The process was therefore described by the later Minister of Finance Pavel Mertlik a process "from public ownership to public ownership in five years" (Mertlik, 1995). Needless to say, the coincidence of two main external controller positions (owner and creditor) further fuelled opportunistic behaviour of managers.

The result was continuous rolling over of debt by banks, and the steady accumulation of losses in the quasi privatized companies, a substantial increase of state debt. Not performing assets were allocated to a separate state bank, the Consolidation Bank, which on the other hand was not directly linked to the state budget. Therefore, increasing state debt was hidden. This was a basic element of the "Czech miracle" during the 1990s, an exceptionally high degree of privatization, seemingly balanced state budget and good external competitiveness (this was based on a drastic one-time devaluation of the Czech currency). In the background no structural change, declining competitiveness and steady (albeit covert) increase of state debt occurred. The hidden tensions

[12] The same happened through other ways in Russia and in many other CIS countries.

[13] A term which was frequently used in Hungarian papers in 1988-90 that expressed the desire to find an owner for SOEs, who is responsible and enjoys ownership licences at full extent, who could then initiate adjustment and restructuring.

broke out in the late 1990s when a second transitional crisis swept through the Czech economy removing many of the ailing manufacturing firms. Bad debt had to be written of like in Hungary 5 years earlier in order to clean commercial banks' portfolios before their privatization. By this time the Czech governments did not repeat the voucher privatization scheme involving the remaining state property, but rather changed over to the sales method.

In many transition economies insider privatization became the predominant "method". Most infamous case is of course Russia. In this country the initial voucher privatization scheme was turned into insider deal. Russian privatization process was designed by neoliberal advisors and young Russian economists focusing on speed rather than on real effects. The original method was based on the employee stock ownership plan (ESOP), a known from developed welfare states method of increasing incentives of employees in strengthening collective action also through shared ownership[14]. Ownership rights were distributed among employees and managers of firms. Advisers could quickly solve their tasks through another formal solution of ownership change. Corporate shares were not very valuable, since the transformational recession hit Russia especially hard (with output drops of 50-60 %). Shares could be accumulated very cheap by individuals (mostly senior managers of firms). Those lucky managers, who were employed in more prosperous branches (oil and gas industry for example) could easily increase their ownership share. The process was even encouraged by preferential credits from the state owned banks. Corruption was very widespread in the process. When energy prices started to skyrocket and the Russian economy became stabilized, the cheaply acquired ownership shares' value increased tremendously, lifting the new owners into the possession of huge wealth (oligarchs). They then soon developed close ties with political parties forming a solid basis for crony capitalism[15].

In Slovakia corruption and favoritism in privatization was even more pronounced. New owners were not randomly selected, or involved in "cooperation" with politicians at various government levels at later phase. New owners were rather chosen deliberately from the supporters of the ruling party (mainly the Meciar-clan). Less explicitly, but also other countries' privatization policies gave way for favoritism in more or less direct forms. Hungary is not an exception either. Thus, privatization became a kind of battlefield among political parties who wanted to redistribute parts of state property among loyal to them (business)persons. Oppositional parties used to blame governments for non transparent privatization deals, while in power they used the same methods to strengthen their business backyard. While favoritism can be observed in more developed countries as well, the main difference is more transparency, the effective role of watchdog institutions (which are absent in transition economies), and the stronger political consequences of open scandals.

Stark (1996) drew the general conclusion after examining the various privatization models of CEE that property rights did not really change owners, there was rather a kind of exchange and reallocation of assets among the same players. He called the new ownership pattern therefore "recombinant property". While this statement seems to be all too general, foreign ownership for

[14] The Yugoslav self-governing enterprise form was also similar concept.

[15] The topic will be covered more in detail later.

example does not fit into this logic it is true that in most transition economies the main political goals of privatization could not be achieved. The economic power of incumbent management and (mainly second line) communist party members remained in place. Privatization could not destroy it in the way Frydman and Rapaczynski (1994) envisaged and claimed. This fact, as well as the evolving cronyism in CEE may be an important factor of the capitalist model of Central and Eastern Europe.

Evolving new structures: foreign direct investment

One of the main differences between CEE and CIS countries is the level of foreign investments. In CEE only Slovenia showed little interest towards foreign investors. Relatively low FDI levels (especially in manufacturing) in Romania and Bulgaria are catching up. On the other hand, CIS countries deliberately avoided substantial inflow of foreign capital. This unfriendly policy then triggered a substantial caution also on the side of the investors: they did not rush to invest. Nevertheless, there is also foreign interest in the more important CIS countries, in Russia and the Ukraine, for example, but they concentrate on services and the banking sector, and are practically excluded from activities regarded in any way as of strategic importance. Another interesting feature is that many Hungarian, Polish and Czech companies invested in CIS, their overall share in total FDI stock is much smaller, than in CIS relations. Hence, it is important to differentiate among transition economies alongside with their openness and exposure to FDI. In the following we primarily deal with CEE economies, where FDI plays important role.

Many believe that the essence of SLIP was the creation of favorable (uniform) conditions for the expansion of multinational business. While it is not quite sure if this was the single most important driver of "setting up the rules of the game", it is quite obvious, that SLIP contained measures that enhanced FDI. This is especially true for transition economies, since in these countries conditions of "level play" meant immediate confrontation of handicapped in many ways local business with large international competitors. Competition even in the simplest form of imports soon drove many local companies out of the markets. But multinational firms captured not only CEE markets but much of the local business inputs in form of local investments (location advantages[16]). There has been an ongoing debate whether integration into the world economy was possible via endogenous business too. Critics of dependence on foreign firms argue especially with current Polish business development, where an impressive number of local firms became international players. There are also examples in the Czech Republic and Hungary, albeit not too many. It is not our task to go into details in this paper, nevertheless it seems important to emphasize that Poland is four times bigger country than either Hungary or the Czech Republic, with much larger domestic market potentials and also thicker capital markets, which makes the emergence of local big business more likely in that country.

There were two main channels of FDI inflows in transition economies: privatization and greenfield investments. It is important to emphasize that in virtually all CEEs both channels had been used, and

[16] We use here terms of John Dunning's well known „Eclectic Theory" of FDI.

many large scale investments in manufacturing, services and the financial sector were carried out this way. The pioneering role was played by Hungary during the mid- and late 1990s (see in the previous section on privatization). But other CEEs soon caught-up by selling important SOEs at the turn of the millennium. The other form of FDI, Greenfield investments have been carried out in large numbers during the past 15 years in all CEEs including also Romania, Bulgaria. Foreign firms play important, in case of Hungary, Slovakia and Czech Republic determining role. Their share in the production of GDP, employment, investments and exports is large and growing over time. During the crisis of 2007-9 they usually played a stabilizing role despite the fact that their production also shrunk (they did not close down).

Table 1 – FDI inflow in CEE (EUR million) and per capita inflow and stock 2011 (EUR)

	FDI Inflow	Per capita inflow	Per capita stock
Bulgaria	1341	182	5018
Czech Republic	3880	369	9175
Hungary	2999	301	6558
Poland	9500	248	3712
Romania	1920	101	2858
Slovakia	1542	283	7339
Slovenia	791	386	5710

Source: Hunya (2012).

Table 2 – Inward FDI stock in CEE by economic activities in 2010 (share in %, NACE Rev 1 class.)

	Bulgaria	Czech R.	Hungary	Poland	Romania	Slovakia	Slovenia
A+B Agriculture	0.5	0.2	0.4	0.5	1.0	0.2	0.1
C Mining	0.7	2.8	0.3	0.2	4.0	1.1	0.1
D Manufacturing	17.3	32.0	24.8	31.8	31.5	34.5	26.9
E Electr. gas and water supply	5.3	8.0	5.5	4.1	5.5	13.3	3.0
F Construction	7.6	1.4	0.8	2.5	3.7	1.2	0.8
G Trade, repair	13.5	9.9	12.7	15.9	12.2	11.0	13.1
H Hotels, restaurants	1.7	0.5	0.4	0.4	0.4	0.2	0.2
I Transport, Communication	10.8	5.2	7.4	5.8	6.8	4.4	3.4
J Financial intermed.	17.8	20.4	9.5	18.6	20.5	20.9	40.4
K Real estate	23.4	16.2	30.8	17.6	13.7	12.3	11.5
L Public admin.	0.0	0.0	-	-	-	-	-
M Education	0.0	0.0	-	-	-	-	0.0

N Health	0.0	0.2	-	-	-	0.2	0.0
O Other commun. act	0.6	1.1	-	-	-	0.6	0.4

Source: Hunya (2012).

Table 3 – Outward FDI stock of CEE in 2011 (EUR million)

Bulgaria	Czech R.	Hungary	Poland	Romania	Slovakia	Slovenia
1312	11956	18439	28000	1149	3000	5519

Source: Hunya (2012).

Foreign investments created completely new economic structure where their influence was larger. For example, Hungarian electronics and automotive sectors have developed parallel with foreign investments. Foreign firms dominate both branches. Multinational brand-owners investments were followed by the investments of their traditional suppliers in the new location. This was due to their close technological cooperation which required spatial concentration. But also most local companies of the two branches are linked to multinationals at various levels of cooperation. Local supplier network development of the multinationals sometimes includes teaching and technological up-grading of local firms. The structure of CEE industries was completely altered and inserted into the global labor division, the multinational companies' network. This change can be also measured by macroeconomic measures like foreign trade data. Not only the commodity pattern and relational structure changed over the past 25 years, but intra firm trade's share also increased to high levels, which clearly shows the important role of multinational networks' activity.

In an earlier paper we summarized the potential benefits for host economies stemming from FDI (Szanyi, 1999). Both direct and indirect forms of positive effects may occur, but they are rather difficult to measure. Direct effects on employment, the application of new technologies, access to export markets, introduction of up-to-date management methods are clearly demonstrated. These but especially new knowledge is transferred also to other market players, a major form of indirect spillover effects. Strong competition can force local competitors to improve their performance, but there is also a chance that they cannot stand competition and will be crowded out of market (which is a negative spillover effect). In a measurement attempt we found evidence on prevailing positive indirect spillovers by the second and third tire suppliers of the multinational firms (Iwasaki et. al, 2011). Other scholars did not find convincing evidence[17].

Potential positive externalities may arrive at supplier companies, whose contribution is essential in the value chain of the multinational production. Several reasons cause the unexpectedly sluggish local supplier network development. Most importantly local companies' preparedness is low, in many cases there are no potential local suppliers at all, or they cannot work at the required accuracy, technological level and reliability. But existing potentials are not fully utilized either. Whenever local

[17] For an overview of literature on this topic see Szanyi (1999).

affiliates of multinational firms are in a subordinated status and have no decision license in important questions local supplies always fail to develop (Antalóczy et.al., 2011).

CEE countries applied strong incentives to FDI. Most important tools were the fiscal incentives. CEE countries entered a kind of incentive competition which was strongly criticized by Western European governments, who feared of loosing especially manufacturing capacities relocated from there to CEE. But much of the investments, especially in the early period aimed capturing local markets, hence they were not bound to the closure or downsizing of activities in the home countries. The number of relocations increased later, but Hunya and Sass (2005) argued that relocations were mutually beneficial for both home and host country, even if positive and negative impacts simultaneously occurred.

The appearance of FDI in CEE transition economies is historically not unparalleled. Foreign companies played important role in the industrialization process of the region in the late XIX and early XX centuries. In fact, catching-up with developed countries was always supported by two main development engines: development state and foreign investments. Both of them played the role of modernization anchors for local business. The state could support favorable business conditions and improve the supply of basic production inputs, but also supported local business with public procurement. Foreign companies served local development with technology transfer and investments. Both roles reemerged in the region after the transition, but especially around the turn of the millennium (Szanyi, 2003). The ways how foreign companies can be made interested in the general development tasks of host countries vary and also need further consideration.

Current status of CEE

The main aim of this study was to work out a positive definition for CEE capitalist development model. This requires underpinning in two dimensions. First, similarities of the countries must be described and second, peculiarities of the model must be defined that differentiates it from other capitalist models. In the previous section we gained a very brief insight in some of the main areas of transition in CEE, and realized that policies, the interplay of polity and business, economic performance varied substantially. In this section a snapshot of some economic performance measure will be provided. We would like to show that despite of the many differences in actual transition process the longer term development path of CEE economies became rather similar. Hence, CEE show the necessary similarities of being treated as a new capitalist model. In the last section we will argue, that a positive definition of the model is plausible concentrating on the dual structure of CEE economies: the domestic one which is characterized by features of crony capitalism, and the foreign which serves as an island of efficiency and knowledge. The main question of the model is whether and how duality can be limited.

As far as macroeconomic situation is considered, transitional recession was overcome in all CEE and GDP production reached the 1989 level in the second half of the 1990s. However, these economies underwent fundamental structural changes. The former heavy industry biased structure changed, the share of manufacturing industry declined, services increased share to the extent of developed market economies of Europe. There were no major differences in this regard, though the collapse of the former socialist industry gave more way for foreign investments in the Visegrad countries,[18] then in Romania or Bulgaria, where the share of industrial production remained at lower level. Economic restructuring was very much driven by foreign investments, which remained at low levels in manufacturing industry in the two later countries[19].

Foreign trade used to be an important driver of the CEE economies, since with the exception of Poland they all are small open economies. Their openness increased in the transition process. It is not only because large multinational companies' international cooperation networks automatically boost trade figures due to their deep specialization on components and parts. Also local companies started to actively participate in foreign trade. Many of them even started exporting capital (Antalóczy – Éltető, 2002; Kalotay and Sass, 2010; Hunya, 2012). Thus, CEE became integrated part of global world economy with strong ties to international production networks. High level of openness, important role of foreign companies, dependence from foreign markets on the side of exports and from energy imports coming from CIS (mainly Russia) create the external environment of these economies. The relatively larger domestic market of Poland gives this country a little bit more maneuvering room, but the Polish economy is also strongly linked with the global economy. This economic structure gave rise to impressive increase of productivity, which was in many years faster than increases in wage. Unit labor costs remained rather low compared to developed market economies (Szanyi, 2003). This helped boosting international competitiveness. In case of Hungary and the Czech Republic trade surplus was achieved during the past 5 years (Túry – Vida, 2012).

Table 4 – Miscellaneous macroeconomic data of CEE

	Bulgaria	Czech R.	Hungary	Poland	Romania	Slovakia	Slovenia
GDP per capita PPP US$[+] 2011 (rank 1-148)	13800 (92)	27400 (49)	19800 (62)	20600 (60)	12600 (97)	23600 (57)	29000 (46)
Government revenue as % of GDP* 2011 (2007)	33.1 (40.9)	40.3 (40.3)	52.9 (45.6)	38.5 (40.3)	32.5 (35.3)	44.5 (42.4)	33.4 (32.4)
FDI stock as % of GDP 2011[++]	89	58	60	38	38	53	31
Export as % of GDP 2011[++]	63	75	92	42	22	89	72
Imports as % of GDP 2011[++]	65	71	85	43	29	86	71
Industry v. a. % of GDP 2011[++]	31	-	31	32	25	35	32
Services, v.a. % of GDP 2011[++]	63	-	65	65	68	61	66

Source: *Eurostat, ++ World Bank, + CIA World Factbook.

[18] These are Poland, Czech Republic, Slovakia and Hungary.

[19] The two countries opened up for FDI rather late when major multinational companies already established their regional affiliates in the Visegrad countries. Nevertheless, market driven services companies invested also in Romania and Bulgaria extensively.

Another important macroeconomic feature of CEE countries is the relatively smaller role of the state in the redistribution of GDP. The difference does not seem to be very large when compared to EU average, but significantly lower than most continental countries, and much lower than in the Scandinavian economies[20]. The current crisis showed that most models of the welfare state need some rethinking. Sapir (2006) showed that most EU countries welfare systems were inefficient and in some ways also dysfunctional (they did not limit inequalities). The problems became more acute in the 2007/9 crisis. CEE countries are in this regard in a better position. Though the decade-long rhetoric on catching-up with living standards and welfare has not changed (this target was just postponed for the polity) yet, CEEs are in an easier situation than more developed EU-members because less welfare spending must be cut.

Debates on the Hungarian welfare system revealed the fact that services had been oversized compared to the abilities of the state (Kornai, 1992). Of course, levels of welfare services have always been lower than in any of the EU-15, nevertheless, growth of the Hungarian economy and of budget revenues has not been quick enough to reduce the budget gap in social spending. On the contrary, accelerated aging, increasing unemployment and pauperization in certain regions would have required increasing spending which could not be financed by the central budget, especially not after 2000. Therefore an effective (not volunteer) cut in spending has already been started. In fact, the decline in the level of state services already threatens the quality of some basic supplies. Other transition economies faced similar problems, though we could see some examples of better management. In Slovakia for example the overall size of the budget was successfully cut by ten percentage points. Redundant services were eliminated. Another example is the Polish health care system, which was successfully reorganized.

Table 5 – Miscellaneous social data of CEE

	Bulgaria	**Czech**	**Hungary**	**Poland**	**Romania**	**Slovakia**	**Slovenia**
Human Development Index* 2011	0.771 (55)	0.865 (27)	0.816 (38)	0.813 (39)	0.781 (50)	0.834 (35)	0.884 (21)
Labor participation rate 2010$^+$	54	59	51	56	56	59	59
Unemployment 2010$^+$	10.2	7.3	11.2	9.6	7.3	14.4	7.2
People at risk of poverty or social exclusion 2010$^+$**	3145 (41.9)	1495 (14.3)	3051 (30.5)	10409 (27.2)	8890 (41.6)	1118 (20.7)	366 (17.8)
Ease of doing business (1-183) $^+$	59	64	51	62	72	48	37
Corruption reception index (1-10) 2010$^+$	3.3 (86)	4.4 (57)	4.6 (54)	5.5 (41)	3.6 (75)	4.0 (66)	5.9 (35)
Shadow economy as % of GDP 2011***	32.3	16.4	22.8	25.0	29.6	24.1	16.0
Income inequalities (Gini koeff.) 2008^{++}	-	0.268	0.291	0.372	-	0.268	-

Source: *UNDP (2011), **Eurostat, *** Schneider, F. (2011), + World Bank, ++ European Commission (2010).

[20] Most influential paper on the types of welfare systems is that of Sapir (2006).

It seems that the main problem of CEE countries in this regard is the labor-saving character of their post-communist economic growth path. Productivity and output increased tremendously, but not employment. In some countries activity rates are very low, and also unemployment is high. The society became more and more divided. Those who got employed (large share of employment is bound to public administration) could increase living standards, meanwhile people in pension and long-term unemployed could not maintain it. The share of people at risk of poverty has increased and got to a rather high level in most CEE countries. As a consequence many migrated to more developed countries of the EU in search of jobs. The once so good quality labor force of these countries (see good rankings of the human development index) became scarce, because it's simple reproduction is not provided. The vicious circle of low employment, less social spending, declining labor force reproduction, even less job opportunities evolved over time. It is more severe in Bulgaria and Romania, but is being felt also in Hungary and Poland. CEE's main social problem is therefore to find an economic development path that creates more jobs (or spreads work more evenly among employees) so that out-migration is reduced, more income is generated, and it is distributed more evenly.

The relatively higher share of the shadow economy in most CEE countries is closely connected to the low employment situation. It also affects budget revenues quite substantially. In fact, there is a third part of CEE societies, who has regular income and is not threatened by poverty. But incomes in the shadow economy are by definition not taxed. Therefore many "entrepreneurs" and even more who work for them do not contribute at full extent of their incomes to the budget, but receive full size services. Similar effects are caused by regular tax evasion (underreporting of sales revenue). The most widespread form of tax evasion is not billing sales and thus "economizing" on value added tax. Citizens do not even know that they themselves are accomplices of tax evasion when not asking for the bill in a shop. A vicious circle has evolved in this respect too. The poorer citizens are (also because budget cuts limit their incomes and also their chances for future employment), the more they feel forced to take the opportunity of cheap solutions (tax evasion, purchase of low quality goods from uncontrolled imports, etc.) that further increases shadow economy and reduces budget revenues.

State paternalism and crony capitalism in CEE

In search for a positive definition of CEE capitalist model we highlighted some important similarities which seem to be important elements of a potential model (small open economies, high level of integration into global corporate networks through FDI, dual economic structure, relatively low level of government redistribution that needs further cuts, problems of job creation and the resulting out-migration and pauperization, and high level of the shadow economy). This description already touched the role of state as provider of welfare services. In this section we concentrate on the interaction of polity and business. We state that the origins of crony capitalism in CEE and CIS economies stems from state paternalism that was inherited from pre-transition period.

The term state paternalism was developed and applied for command economies by Kornai (1980). It described the relationships between state bureaucracy and company management. In the command economy companies did not take responsibility for decisions, in fact they had no freedom to decide on important questions but had to fulfill commands sent to them by institutions of state bureaucracy. Since however, state bureaucrats and company leaders worked under the political control of the communist party, their relationships was not characterized by strict discipline of commands (like in case of military organizations). They collaborated in preparing plans for production. Yet, the two levels of bureaucracy might get into conflict, since company leaders preferred getting easier jobs as plan targets (more than necessary resources to lowest possible levels of output). They also felt forced to bargain with state bureaucrats over plan targets because due to this process and also other reasons production resources, goods but also capital was always very scarce (shortage economy). As a consequence, the relationship between state and company leaders became rather informal. The classic roles of managers and owners did not apply. This informal relationship with the final risk-taking of the state (communist party) gave way to opportunistic behavior of company leaders. They could effectively use their insider information in the companies in the bargaining process of economic plan preparation. On the other side communist party-governed state took responsibility for the economy and society and always corrected and intervened when individual companies, branches or the economy as a whole got into trouble[21].

Company leaders inherited state paternalism from the command economy and relied on it also when transformational recession hit transition economies. Incumbent managers argued that much of their problems were inherited and not created by them, therefore they should not be made responsible for past decisions, neither should "their" companies bear the financial consequences. Surviving state paternalism intervened, state banks rolled old debts over, governments bailed out loss-making firms. The paternalistic attitude of CEE governments remained in place virtually up till the moment SOEs were privatized. The 1992 bankruptcy regulation in Hungary broke with this practice (see the section on privatization), but it was also accommodated slowly but surely by successor governments. Nevertheless, the old type of paternalism, which was based on state ownership was restricted to a few companies by the end of the 1990s in all CEE economies. New forms of polity-business interaction evolved.

As it was argued earlier political parties considered privatization as a means to complete political transformation, and to create and strengthen loyal to them business partners. Favoritism ploughed the privatization process. The creation of loyal clients was not only important because of self-interests of individual politicians, but also because the financing of political parties and activities has not been regulated properly. Support from the business and from state controlled companies contribute largely to the financing of political parties. Unfortunately, this type of financing is not effectively controlled unlike in more developed democracies. In return to their support companies

[21] Mihályi (2003) compared company leaders' attitudes in command economies and in companies with management share ownership in the frame of corporate governance. He found similarities because in both case leaders became also owners,"insider ownes" in one or another sense. In both systems „insider ownership" deteriorated company efficiency because it gave way to rent seeking behaviour of leaders (see the famous scandals of ENRON, World Com, Parmalat, and other frauds).

may expect various forms of further favoritism. This type of interplay between polity and business is called crony capitalism.

Cronyism is in place in all market economies, but it may be put under control by effective watchdog institutions of the society. CEE societies are not yet strong and organized enough to establish powerful control institutions. Hence, cronyism is especially strong in these countries. Russia, the Ukraine are perhaps the mostly discussed examples of crony capitalism. In these two countries even most basic institutions of democracy are rather weak. Political murders happen, politicians and influential business people got arrested. Nevertheless not only CIS, also other CEE countries produced dark scandals. For example Borut Pahor's government was removed from power in Slovenia due to a scandal, several politicians of the previously ruling coalition were arrested because of suspect of bribe by the current Hungarian government.[22] But other CEE countries are not exempt of rather rude examples of cronyism expanding into bribery and corruption as well.

There is a special form of crony capitalism, which is present in the CEE economies, and is different from other countries. The "classic" form is dominated by business. In cases of Latin-America or the Far-East it has been business who approached and directed polity in this dubious relationship. This is called "state capture". The state, that is governments are controlled and influenced in their decisions by strong business groups. In exchange for supporting political institutions (election campaigns) business groups lobby for preferential for them regulations, exceptional treatments. In the classic case big business supports all political parties, so that preferences prevail also in case of eventual changes in government.

However, in CIS and also in CEE countries the relationship is often reversed. "Business capture" (Yakovlev, 2006) means that governments and political parties (political interest groups) regard economy as hunting ground. Strong state, strong governments may use power to rob business, not only those who dared to oppose in any way government decisions, but also those who tried to keep distance from polity. Political power may be used as tool for favoritism, but also for repression. Yakovlev (2006) convincingly argues that the Putin government effectively turned the ties and crushed opposing business circles using the might of the then already stronger state (see the fate of the oligarch Khodorkovski). Capturing state can either drag something unlawful from the privatization or any other action of big business and use it for repression, or simply drop it from the list of favored companies. But business capture also means the strengthening and recreation of state ownership, the direct intervention of state in business (see the Gasprom-story in Russia). This way, the business capture form of crony capitalism seems to turn back in some ways to the original departure point, the paternalistic state.

Conclusions

The economic model of Central and Easter Europe does exist, however research could not yet properly describe its values. In this paper we tried to summarize the existing literature and gave an

[22] A state secretary position for accountability of the previous government was set up in Hungary.

overview of the transition process of CEE that fundamentally shaped the type of capitalism in the region. Further research is required to elaborate more the details. It seems likely, that CEE capitalist model differs substantially from other models. Nevertheless, an adequate positive definition is necessary. This paper tried to give a draft overview of these positive values. They partially stem from geographic, historical and social similarities (e.g. they are small open economies). Other features of the model were developed during the transition process (e.g. the role of FDI, problems of job creation). A third important element comes from the interplay of polity and business. It is not just the emergence of cronyism, but the establishment of business capture. Some of these factors have already been described and evaluated in the VoC literature. Nevertheless, the co-influence and parallel development of the main features has not been elaborated. This may be the main line of future research on the topic.

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Project Information

Welfare, Wealth and Work for Europe

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

Abstract

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

For details on WWWforEurope see: www.foreurope.eu

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