Competitiveness and institutional change in Hungary

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COMPETITIVENESS AND INSTITUTIONAL CHANGE IN HUNGARY

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ABSTRACT

The competitiveness of a country, besides the quantity and quality of factors of production, is largely dependent on institutional factors. It is not surprising therefore that the alteration of formal institutions (e.g. laws, measures, policies etc.) is a hot topic nowadays. But it is important to note that the efficiency of formal institutions is based on informal ones. Traditions of a country, culture, the values of the people are all factors that fundamentally affect the functioning of explicitly recorded, and so easily changeable formal rules. Measures taken to enhance the competiveness of a country often fail to have any noticeable effect, because they don't harmonise with the value system or traditions of the people. The paper provides a short overview on the connection of values and economic performance, then considers the possible efficiency of a few economic policy instruments recently suggested by experts.

INTRODUCTION

Until the 1990ies mainstream economics almost completely neglected the institutional factors in the macroeconomic models. The change was brought by the changes in the Eastern Bloc, when the centrally planned economies of the former communist countries were transformed into market economies. At that time most leading economists and policy makers were surprised that the transformation process didn't go smoothly at all. Most countries experienced recurring macroeconomic stability problems, the system that seemed to work well in the US or in Western Europe, showed various signs of malfunction in Central and Eastern Europe. Opportunities presented by the new system were neglected by economic agents, while backdoors left in the system that were never really discovered in the West, were immediately exploited and abused in the East.

The Central and Eastern European developments lead to the blossoming of the institutional approach in economics. Hundreds of articles were published on the connexion of cultural elements, institutional factors and economic performance. It has become clear that the macroeconomic failures experienced in transition economies are partly due to inconsistencies between the formal institutions applied and the cultural endowments of the country. Thus the transition period not only includes the change from planned to market systems, but also the long iteration process during which the decision makers try to find the best suited instruments for the country.

One way of finding the best institutions is through trial and error. Governments can test several regulatory instruments, check out which ones work and which ones don't. However a better solution is to try to learn from the observations of others. If the critical cultural elements of a country are indentified, one can look into and learn from the experience of countries with similar value frameworks, and so the time needed to find efficient institutions can be shortened considerably.

THE INSTITUTIONAL FRAMEWORK

We accept the definition of Douglass North who defines institutions as 'humanly devised constraints that shape human interactions. They reduce uncertainty by establishing a stable (not necessarily efficient) structure to human exchange, whether political, social, or economic' [8, p.3.] Institution can be both formal, and informal ones:

- Formal institutions: laws, regulations, policy instruments etc.
- Informal institutions: beliefs, traditions, culture, values etc.

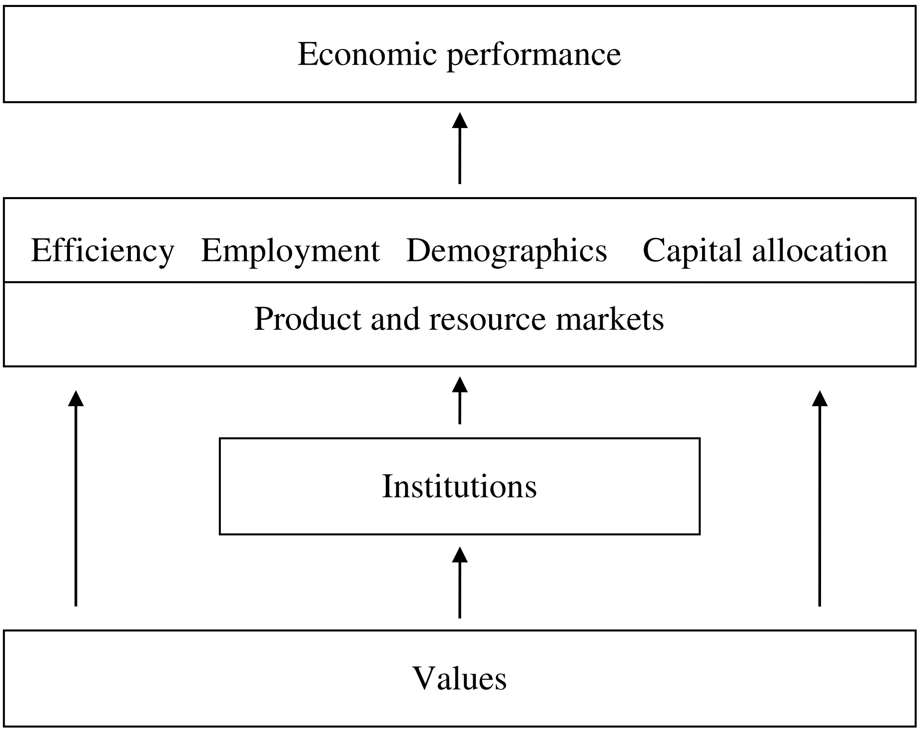

Figure 1.
The effect of values on economic performance [9]

Figure 1. shows the connection among institutional factors and the traditional factors of production. Market performance is largely dependent on the regulations that are applied by the government (e.g. protection of jobs, high unemployment benefits can lead to problems on the labour market; central allocation of financial resources may hit the yield of investments; the protection of internal markets can lead to monopolistic structures etc.). Not only that, a certain method of market regulation may be effective in one country, but can be a complete disaster in another one, simply because of dissimilar values. In other words, market performance is not

only determined by formal institutions, but also by informal ones, like values and traditions. Finally, values have a double effect on the economic system: a direct one, because they influence the way economic agents behave on the market; and an indirect one, because the values of the population push politicians, decision makers towards certain sets of formal institutions (which will, again, affect the performance of the markets).

Formal and informal institutions can also be integrated into the standard macroeconomic models [2]. Generally:

$$(1) \qquad Y=F(K,D,E)$$

where Y stands for the output of the economy; K represents the capacity of the economy (the amount of factors of production available); D notes the decision structure of the economy (decisions made by individual agents, and decisions made by the government – many of which can be called formal institutions); while E is the set of exogenous variables. Formal institutions can be included into the model this way, but we can also integrate informal ones in an indirect way:

$$(2) \qquad D=F(K,M,E)$$

So decisions are determined by the current internal situation, by certain exogenous factors (like the state of the world market, geographical factors etc.), and also by the values of the decision makers (M), and the people in general. Savings rates, the rate of entrepreneurship, the rate of employment are all outcomes that vary a great deal from country to country, and these variables are all largely determined by the value sets of the people.

Relevant values for the economy

Over the past centuries several values were mentioned as ones that are critical for economic success. Max Weber, whose 1905 essay [13] is one of the pioneering works on the field of institutional studies, claimed that hard work and thrift, values carried by the protestant churches, played a fundamental role in the unfolding of the industrial revolution and the capitalist system in the West. Similar claims were made by several American authors when comparing the economic performance of North America and Latin America [5].

Looking for new answers and new perspectives, seeking change and creativity were also mentioned in the economic literature as key factors of success. Creativity of the entrepreneur is in the focus point of Schumpeter's work on innovation [12], and some of the so called endogenous macroeconomic growth models included innovation and creativity into their area of analysis [1].

Myrdal also concludes in his 1968 work [7], that cultural factors are the main obstacles to modernisation. The values of the community can enhance, or very often get in the way of entrepreneurial activity: 'the conflict between articulated specific traditional valuations and the modernisation ideals can be expressed in terms of the cost to the latter through lost opportunities' [7, p. 7].

Another strong argument on the connection between economic performance and values is based on the social capital theory [11]. Intensive and meaningful social relations are crucial if a community wants to run an efficient democratic system. But these social relations are important for the economy as well. If the members of a community are interconnected through a wide network of social ties, the cost of doing business is decreased, and new opportunities can be exploited much easier. In other words the horizontal transaction costs are limited to a low level.

Fukuyama [4] makes a similar argument, but instead of sticking to the social capital concept, he introduces trust as a key element of economic success. He distinguishes two main groups of the developed countries: family-centred societies, where trust stops at the borders of the family; and institutions centred societies, where trust is extended beyond the limits of the family. The economy of the countries falling into the former group is based on relatively small, family-owned enterprises, and the role of the government is very important. While countries in the second group have large public companies and a strong civil society, which makes the role of the government relatively unimportant. Although both types have their pros and cons, institutionalised trust is usually considered to be better, because – just as social capital – it also helps to decrease transaction costs.

Bruni and Porta in their 2005 study [3] analyse another interesting element of traditions and values. Economic output can be boosted enormously if the people rank free time lowly, in other words people tend to devote much of their time to their jobs. The superior statistics of the US economy as compared to Europe cannot be attributed to the higher efficiency of the American employees, but rather to the fact that Europeans value free time much higher than Americans, so they work much less. In other words the efficiency per working hour is very similar in the two regions, however Europe has much less working hours because of the different mind set of the European population.

MEASURING VALUES

As the examples mentioned above prove it, the literature lists a number of values that can affect the performance of the economy. The measurement of these values however is very difficult. Even more difficult it is to find comparable data, as the number of international projects spanning over many countries is very limited. The two most well known are both Dutch initiatives.

Geert Hofstede's cultural dimensions [6] are the results of one of the main cultural surveys. The survey provides comparable data for more than 50 countries. Among the cultural dimensions are cultural characteristics that have high macroeconomic relevance as well: uncertainty avoidance that deals with a society's tolerance for uncertainty and ambiguity is an important factor in the entrepreneurship level; power distance (the extent to which the less powerful members of organizations accept and expect that power is distributed unequally) on the other hand affects vertical transaction costs in modern, knowledge-based firms. The index values for the five cultural dimensions of Hofstede however are not refined enough: different countries score quite similar uncertainty avoidance index values for example, which makes statistical analyses almost impossible.

For this reason researchers often use the data provided by the World Values Survey instead. The WVS started as the European Values Survey in 1981. The project was joined by Ronald Inglehart, and it was extended to countries all over the world; the latest wave of surveys included more than 60 countries. Although the WVS primarily is a social survey, and so many of the measured values concern the social life within societies, the comprehensive database includes so many analysable data that economists can find a lot of valuable information, too.

Figure 2. shows the position of some selected countries along two dimensions. On the horizontal axes the two extreme points are survival values (left) and self expression values (right). The central component of this emerging dimension involves the polarization between materialist and postmaterialist values. Survival values include: priority to stability and materialistic needs, risk avoidance, hard work, apathy toward others, low tolerance of diversity etc., while self expression values are centred around tolerance, trust, with emphasis on subjective well-being, and priorities to environmental protection.

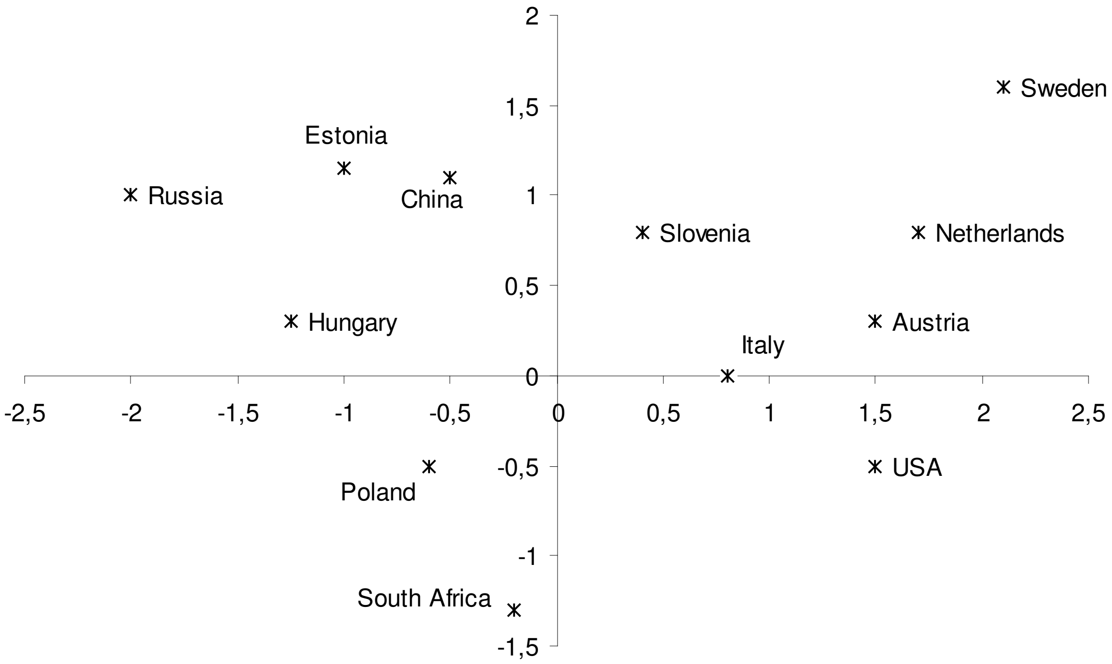

Figure 2.
Inglehart-Welzel cultural map of selected countries (Source: http://www.worldvaluessurvey.org)

The vertical axes shows the Traditional-Secular scale of values, which reflects the contrast between societies in which religion is very important (lower end) and those in which it is not (top part). An emphasis on traditional values means belief in absolute standards, a need for hierarchy, deference to authority, high level of a national pride, rejection of divorce, abortion and euthanasia. Secular values express opposite attitudes toward the aforementioned issues.

These two indices therefore concentrate the effect of several values. All these could be analysed individually as well, but the two dimensions give a good idea of the countries' relative position to each other. As it is shown by Figure 2., more developed countries tend to score highly on both dimensions, while the less developed ones are concentrated towards the bottom left part of the frame of reference.

INSTITUTIONAL CHANGE IN HUNGARY

Having seen that values affect institutions and economic performance (Figure 1.), and Hungary's values significantly differ from those of the more developed countries (countries that usually are mentioned to serve as a model for Hungary, situated to the top right side of Figure 2.), it can be stated that institutions applied in developed countries are likely to fail in Hungary's very different value system. Based on the World Values Survey's results, the paper ponders the possible efficiency of the policy instruments most often suggested to boost the country's competitiveness.

Reduced role of the state

Most experts agree that many of the competitiveness problems are due to that fact that the central budget overextended itself in Hungary. The redistribution rate is as high as 50%, while the burdens on labour are higher than 50%. The high redistribution rate discourages employment and gives way to black payment, and hits hardest the small and medium sized companies, the sector that should play the key role in creating new jobs and boosting economic growth. Therefore it is generally regarded as necessary to reduce central budget expenses, which will make it possible to reduce taxes as well. The most common recommendations regarding the role of state are:

- Reducing the central transfers to GDP ratio;
- Reducing the state's role in the allocation of investment and development resources;
- Reducing the redistribution rate, and especially reducing taxes on labour.

Although the recommendations listed above usually enhance the competitiveness of an economy, one must set them against the value framework showed by the World Values Survey to be able to tell their true efficiency. Figure 2 shows that survival values are dominant in Hungary. The country is characterised by a low level of trust, people's deference to authority is very high, the hierarchical structure of the society still survives, one of the most highly ranked values is stability, decision makers generally try to avoid risky situations as much as possible etc. These values are not in the greatest accordance with the principle of free enterprise and the logic of the free market. In other words: the opportunities offered by the market system are often neglected in Hungary because decision makers are driven by incentives that are fairly alien to the logic of the market.

What we can see is that in countries where the level of trust is quite low, people's deference to authority and vertical structures are high, just as risk avoidance, generally the state and the government is a very important economic actor. Even in very developed countries (e.g. Italy or France [4]), the level of central redistribution

is very high, just as the role of government transfers and centrally allocated investment resources [10]. Yet, in these countries survival values are by far not as important, as they are in Hungary.
It seems that in countries dominated by survival values the market system can only be operated efficiently if it is often corrected or overruled by the government. An extremely high level of central redistribution doesn't necessarily guarantee economics success (because there is no guarantee that the government works efficiently), but it seems to be an important prerequisite.

Labour market regulations

While the previous set of institutional changes may not work well in a survival values dominated environment, labour market deregulation may do. The regulation of the labour market is strict in those European countries where social cohesion and solidarity is very strong. But again, where survival values are important, people tend to care only about themselves, so in these countries social solidarity is practically nonexistent. A deregulation of the labour market will not lead to persistent, country-wide protests, as it would do in many Western European economies. But a deregulated labour market enhances the mobility of the work force, and so it can lead to stronger employment figures and a better allocation of resources.

Public transparency

If an extensive central budget is to last, competitiveness is to a great extent dependent on the efficiency of the public administration, or in a wider perspective on the efficiency of the public sector (which includes health care and education as well). Transparency of the public sector therefore is a key element of economic success. If we accept that resource allocation through the market is inefficient at times, and it is the role of the state to stand in and correct market deficiencies, we also have to add that it can only be done if the state works efficiently. Where survival values are dominant however, there is a high risk of corruption on all levels of the society. That is because of the lack of trust, and because of high emphasis on materialistic needs.
That is why breaking down corruption becomes a principal challenge. A major slimming diet for the state could be an alternative solution, but we have seen that it is not necessarily a good option. The transparency of the public sector not only helps decreasing corruption, but it also makes public functions more efficient.

CONCLUSION

Economic performance is a function of factors of production, exogenous factors, and also institutional factors. Good formal institutions can make an economy successful, even if it is not well-endowed with factors of production. Bad formal institutions on the other hand can be the major obstacle to economic development. Whether a formal institution is good or bad, it is determined by informal institutions, such as culture, tradition and values. In short: economic performance depends on the coherence between informal institutions and formal ones chosen by the decision makers, or developed over time through legislation.

The paper presents a few instruments that were suggested by experts to counter the competitiveness problems of the Hungarian economy. It suggests that the reduction of government spending and central taxes is not a good solution, because it usually doesn't work in countries where survival values are strong. Taking measures in order to enhance the transparency of the public sector on the other hand is crucial, because if the size of the state cannot be reduced substantially, the efficiency of the public administration is one of the most important factors of economic success. Labour market deregulation is another element of successful institutional changes suggested. Although labour market deregulation can boost employment, most European countries cannot take that opportunity because of spirited protest from the population. In Hungary however, as social solidarity is very low, there are no such obstacles.

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