FINAL

SAPRI Hungarian National Committee

The Hungarian SAPRI studies

Final Report

Socio-Economic Impact of Structural Adjustment in Hungary

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This report is prepared according to decisions and recommendations of the Second National Forum of SAPRI held in Esztergom (Hungary) 26-27. June 2000.

It expresses common views of civil organisations, the World Bank and the Government of the Hungarian Republic. If NGOs opinions on certain questions differ, their views are indicated in the text.

Edited by
János Hoós, Károly Lóránt, Thomas Morva

Studies prepared by work-groups and experts of the
Hungarian National Steering Committee:

Work-group 1: The Reform of Public Sector Involvement is Social Provisions
NGOs) Zsuzsa Ferge – Head of the work-group, co-authors:
Tamás Morva, István Sziklai, Noémi Wells
World Bank) István György Tóth

Work-group 2: Economic Liberalisation and Deregulation in Hungary
NGOs) László Fodor – Head of the work-group, co-authors:
Károly Boór, Csaba Gombár, Éva Voszka
World Bank) Gábor Obláth: Liberalisation of imports in Hungary

Work-group 3: Privatisation and its Impact on the Society
NGOs) Károly Lóránt – Head of the work-group, co-authors:
Sándor Bessenyei, Erzsébet Hanti, Zoltán Kárpáti
World Bank) Márton Vági

Work-group 4: The Reform of Public Utility Sector and its Impact on the Economy, Environment, Consumers and Local Governments
NGOs)János Hoós – Head of the work-group, co-authors:
Rezsõ Gál, József Kozma, Károly Mayer
World Bank) László Szakadát

English translation: Tamás Morva

EXECUTIVE SUMMARY[1]

SAPRI OBJECTIVES

(1) After being exposed to the persistent criticism of non-governmental organisations (NGOs), James Wolfensohn, the World Bank's President, and the head of the Washington-based NGO called Development Group for Alternative Policies – on behalf of a broad international network of civil organisations, – agreed to launch an initiative in which civil organisations together with the World Bank and national governments would assess and analyse the economic and social impacts of the Structural Adjustment Loans (SALs) contracted by these countries and the World Bank. Participation of a country in the Structural Adjustment Participatory Review Initiative (SAPRI) was conditioned upon the agreement of concerned governments.

(2) Ten countries participation was envisaged, but, finally, seven countries, including Hungary, decided to take part. The governments of a few other countries opposed SAPRI and did not take part. In these countries examination has been started by the local NGOs alone, within the framework of a program called CASA.

(3) The preparation of SAPRI started in Hungary during the autumn of 1996, with the involvement of an increasingly widening range of NGOs. In April 1997 Hungary's government agreed with the country's joining to SAPRI. The official start was made in the First National Forum held in Esztergom June 1998. The Forum determined four main directions for examination:

- the reform of public sector involvement in social provisions;
- economic liberalisation and deregulation and its economic and social impact;
- privatisation and its economic and social impact; and
- reform of the public utility sector and its impact on the economy, environment, consumers, and fiscal position of the central and local governments.

Four research groups were established to which the NGOs and the World Bank delegated their experts and consultants. On behalf of NGOs almost 1500 experts participated in field studies in Budapest and across the country, and prepared around 150 reports. Work-groups of NGOs and World Bank experts summarised the conclusions of findings in studies of the four main research directions.

Present document summarises main results of the research. The Second National Forum held in Esztergom 26-27 June 2000 discussed the preliminary version of the study, which was revised according to decisions and recommendations of the Forum and finally approved by the Hungarian National Steering Committee.

[1] This summary reflects the common ground of understanding of the NGOs, Government of Hungary, and the World Bank. As agreed at the end of the Closing National Forum, this summary provided the basis for the final long report.

CRISIS AND TRANSFORMATION

(4) Until the 1970s, the Soviet type economies were able to showcase a few success stories. These included the industrialization of the backward economies of the region and material progress toward the elimination of poverty and illiteracy. The military and space industries of the Soviet Union managed to keep abreast of their US rivals. This, however, was achieved at a the price of severe cutbacks in living standards. Even basic consumer goods were frequently unavailable. By the 70s, however, the Soviet-style economies depleted their resources that had fed their extensive growth, and found their clumsy economic and political mechanisms unable to provide the efficiencies required for economic and technological adjustment and growth. As a result, these economies slowed down and started to show signs of structural imbalance.

(5) Up to the mid-70s, Hungary's economy showed good growth, as a result of the benefits provided by CMEA (such as cheap raw material imports and the highly profitable export of manufactures into the Soviet Union), and the market reforms introduced by the end of the 60s. Then came the oil price shock of the 70s, pushing Hungary deep into debt. To avoid insolvency, the Government slapped on severe economic restrictions, which cut the economy's growth from 6 percent to just 2 percent. Although these restrictions did heal the country's ailing balance of payments, the favorable terms of trade were gone and the prevailing economic structure failed to show any youthful dynamism. The economy staggered from one imbalance to the next.

(6) In 1982, Hungary was teetering on the brink of insolvency again. At this juncture the country's political leadership decided to join the IMF and the World Bank, against the opposition of the Soviet Union. The stand-by loans of the IMF did indeed help, and Hungary entered a new period of consolidation for the next four years. This consolidation, however, was based on restriction again, and Hungary's industry was not restructured. As a result, the economy locked into a stop-go cycle, and submerged under increasing waves of indebtedness.

(7) Influential groups of economists started to demand vigorous reforms to heal the country's economy, and the partially rejuvenated political leadership of the time did embrace the main points of the therapy they suggested. After 1987, however, the financial reforms (such as the establishment of commercial banks, and the introduction of value added tax and personal income tax) were accompanied by restrictions again, and social and political discontent deepened. To resolve the crisis, a group of economists started to demand the radical and democratic reform of the country's structures. At the same time, the Soviet Union sank into an economic and political crisis, socialist ideals were recognized as empty, ideologically committed party leaders were growing old, Hungary's economy failed to emerge from the doldrums – and the new generation of technocrats was ever more forcefully clamoring for change. In short, Hungary was ripe for turning over a new leaf.

THE ROLE OF THE WORLD BANK IN HUNGARY'S REFORMS

(8) Hungary joined the World Bank and the IMF in 1982. Hungary signed its first World Bank agreement in 1983. Since then, about 40 loan and program funding agreements have been signed, with program funding totaling almost $4 billion, of which $1 billion were extended as Structural Adjustment Loans (SALs). In the 80s, WORLD BANK loans were mostly provided for modernizing Hungary's production potential. Agricultural, energy, and transportation programs were targeted for financing.

(9) After the fall of communism, the Bretton Woods institutions turned toward structural and institutional reforms. They aimed to help Hungary along the road toward full-scale liberalization, privatization and deregulation. In the years immediately following the transition, large loan packages were provided to help restructure the country's financial sector, boost agricultural exports, develop telecommunications, human resources and markets, and nudge along corporate restructuring in key industries. In the second half of the 90s, the World Bank strongly influenced the reform of Hungary's welfare system.

(10) Recommendations of the World Bank (and IMF), the Bank loan conditionalities, and its reports about Hungary created an intellectual framework in the transition. Within this framework in many cases (e.g. in foreign trade, or liberalization of prices and privatization) Hungary's governments had broad room for maneuvering (e.g. Check privatization took place according to completely different principles than in Hungary). NGOs view that domestic economists that favored the international neo-liberal view influenced the governments and the parliament. This played a major role in the fact that reforms necessary for the transition to a market economy and rules of free market were introduced impatiently, within a few years, although neither Hungary's economy nor the Hungarian society was prepared for that. Contrary to this view, Hungarian and international experts and World Bank reports view that the Hungary's transition caused much less shock and took place more gradually than the transition in the surrounding countries where revolution, shock therapy, hyperinflation took place and that they later experienced a bigger drop of GDP and still stagnating economy.

DEREGULATION AND LIBERALIZATION

(11) Hungary jumped the gun of transition with its deregulation and liberalization efforts. Its political leaders were not as averse toward these two aspects of market reforms as toward privatization and started to implement them toward the end of the 70s. Thus, political decision were made about the deregulation of state companies in a period when their privatization was not yet on the agenda.

(12) Price reforms started in 1968, the year of the "new economic mechanism," by narrowing the range of centrally regulated prices, and continued in 1980 by linking them to world market prices. The next major step was the introduction of value added tax and personal income tax in January 1988. After this point, state price regulation and price subsidies were gradually eliminated. By the end of 1990, about 90 percent of all consumer prices were transferred to the "unregulated" category. In 1991, the National Price Office was abolished, and a Business Competition Office was set up to guard against unfair business practices.

(13) In the July 1988 meeting of Hungarian Socialist Workers Party (MSZMP), the Central Committee (KB) made a resolution to implement a rapid liberalization of imports and to consider foreign trade as a "basic right" of entrepreneurs, hence any company could carry on foreign trade. The liberalization program was planned to be completed in 4 years (25-30% every year) but it was shortened to 3 years before its start. By 1992 – the end of liberalization program - the share of products with liberalized price reached 90% compared to 35% in 1989 of non-ruble based import. Negative effects of the import liberalization was increased by the collapse of the Comecon trade system and the change of the previous clearing from ruble to dollar base – upon Hungary's initiative.

(14) In 1991 four key acts were passed by Hungary's Parliament to establish a strict regulatory framework for the operation of the market economy and to set the course for the further development of Hungary's economy. The acts on financial institutions and accounting set much stricter standards for business operations. Financial institutions, for example, were required to meet strict capital adequacy ratios along international standards. The Bankruptcy Act set forth that businesses unable to repay their debt within 90 days after maturity must file for bankruptcy within 8 days. The Central Bank Act restructured the financing of Hungary's national budget by capping the compulsory financing of the budget by the national bank at 3 percent of government revenues.

PRIVATIZATION OF THE ENTERPRISE SECTOR

(15) All political parties extant at the time of transition supported privatization. Their reasons for doing so, however, varied from the greater efficiency of private enterprise to the desire of creating a broad base of property owning middle class. Privatization was implemented in a number of waves. The Company Law of 1988 allowed for the creation of private businesses and triggered off the so-called spontaneous privatization, the first wave. This wave favored management of state owned companies and turned them into owners. Spontaneous privatization involved about 10 percent of privatized government property. With the formation of the State Property Agency (ÁVÜ) in 1991, privatization became more orderly. This orderly process started with the so-called preliminary privatization initiative, during which about 10 thousand retail outlets were auctioned off, mostly to their former managers. Most companies were privatized by organizations designated by ÁVÜ and sold to the highest bidder.

(16) Altogether, some one quarter of the state's property was privatized in the first wave, mostly to Hungarian owners. In 1995 the rules of the game changed significantly, insofar as obtaining hard currency became the major goal of the government's new privatization policy. As a result, most of the assets privatized between 1995 and 1998 were sold to foreign owners. This is the period when most banks and gas and power utilities were put on the block.

(17) Out of the 1858 companies initially owned by ÁVÜ and ÁPV Rt., and the additional 418 newly created or otherwise acquired, 1185 were privatized and 701 were terminated. According to NGO calculations from the original state property offered for privatization, which amounted to HUF 2213 billion in 1990 prices, 1073 billion was really privatized, 381 billion went to other institutions taking care for state property and 759 billion is still in state ownership. According to the NGOs, privatized and liquidated companies had a value of HUF 1073 billion (at 1990 prices) and generated HUF 553 billion in government proceeds, and NGOs consider half of the value to have been lost or not compensated for. These figures and conclusions are not consistent with ÁVÜ and ÁPV Rt. data.

(18) As a result of the unique 'Hungarian model' of privatization, the dominant enterprises in the competitive sector are no longer owned by domestic owners. Foreign property is dominant in the competitive, the financial, and in the infrastructure sectors, as a result of privatization, follow up, and green-field investments (USD 20 billion). The policy stimulating foreign investments was first of all motivated by the foreign inflow hunger of the country, and most of the FDI companies receive special tax and duty exemptions. As a result, a type of dual economic structure has evolved that bears risks in the long-run. Efforts so far to support domestic SMEs have not yet been successful, thus the reduction of duality should receive a high priority.

PUBLIC UTILITIES

(19) Besides the privatization of the competitive sector, and mainly following it, the reform of the public utility sector has been another important field of market transition. Considering the operating forms and problems of this sector, it was very similar to the competitive sector. Still it should be viewed differently, as a result of some fundamental conditions. These are so called natural monopolies, and that is why the safety of provision, the accessibility, and cost of services are much more important than in the competitive sector. Despite these reservations, the Hungarian government privatized most of the infrastructures with a dashing attack. As a result, Hungary's is the second in Europe just after Great Britain, respecting the proportion of private property in the utility sector. It is unique however, that the fundamental public utilities of Hungary have become the property of state utility companies of foreign countries.

WELFARE SYSTEMS

(20) Concepts for reforming Hungary's public finances emerged in the second half of the 80s. However, the early period of transition was first of all focused on the transformation of the competitive sector. Public finance reform gained interest only when the financing of welfare systems faced problems as a result of reduced capability of the country. In the middle of the nineties, the term of the so called 'premature welfare state' has become a mainstream paradigm. This characterization helped supporting initiatives that aimed at improving efficiency and targetedness of provisions and the extension of private financing. Besides partial efficiency results, the scope and value of welfare benefits and the level of social provision has dropped in the decade. The axiom of economic philosophy was to reduce state redistribution. Knowing this, it was rather peculiar to refer to any field of the social sphere as advantaged, strategic, or national priority, since the ruling economic policy was against it. The most illustrative paradox of the governments' policies was that while education, public health and the support of families were referred as priority areas, these fields became victim of repeated cut of public expenditures.

(21) The reform of the pension scheme represents a turn in the transformation of Hungary's welfare systems. The reform's necessity has been obvious even in the early 1980s, when the financing of the allowances was becoming harder and the reduction of their real value was part of fiscal stability measures. The system became unclear and dependent on the ruling government. The number of pensioners increased radically in the period of transition and the financing crisis of the pension system deepened. Demographic changes forecasted a structural crises on the long run. The reform could no longer be postponed, but its direction has changed several times during the decade. The World Bank had a significant role in preparing the 'three–pillar' pension scheme that was adopted by Parliament in 1997.

(22) Education also underwent major changes in the 90s. These changes centered around the buzzwords of modernization, closing the gap with Europe, aligning with the requirements of the market economy, freedom of choice, higher quality of service, and balancing the budget. Through the decentralization of government, responsibility for education devolved upon the local municipalities. Education split into a number of sectors with the appearance of religious, foundation supported and private institutions at all levels. In spite of the swollen ranks of high school and college students in general, those handicapped by lack of professional skills, unemployment, poverty in the family or in the neighborhood/region, or Roma ethnicity find their opportunities for general and professional education increasingly poor. The playing field is

getting increasingly unlevel, with small villages in poor regions being at the bottom. The gap separating elite schools from their counterparts in poor regions and neighborhoods is getting wider.

(23) The reform of health care has been going on for years, even though its basic principles are still undefined. The shortcomings of the reform, the contradictions of the health care system, and the difficulties of its daily operation all come rolling down on the patients at the very bottom. These people are the primary victims of the liberalized prescription drug market, the reduced subsidies for medical aids and supplies, the pressure to stuff doctors' pockets with "thank you" money, and the retrenchment efforts of hospitals balancing on the brink of bankruptcy. Vested interests and the complexity of the system, however, keep foiling attempts at finding out how and where patients get short changed.

THE ECONOMIC IMPACTS OF TRANSITION

(24) As a result of its ten-year transition period, Hungary has built up the institutional framework of a functioning market economy, has created the tools and resources of control, built an economy based on private ownership, and linked up with the economies of developed industrialized nations. By the end of the 90s, the economy has balanced, and Hungary is sporting a growth rate twice that of Western Europe. At the same time, the country's economic structure contains multiple distortions, and a number of factors are threatening to upset the balance of growth.

(25) As a result of losing the Comecon markets, the shock caused by liberalization without due protection of domestic companies, and peculiar land privatization significant parts of Hungary's production sector collapsed. The industrial and agricultural production decreased by 25-30% and 1.5 million jobs ceased – almost one third of jobs by the middle of this decade. After 1996 growth has been gradually increasing, GDP surpassed the prior peak (1989), and employment has started to increase when the transition was getting to end.

SOCIAL IMPACTS

(27) The economic transformation has polarized Hungary's society. While it brought forth a rich owner-manager segment, it also produced masses of losers. It also failed to engender a strong middle class. One and a half million jobs were lost, a stubbornly high level of unemployment was created, and the welfare services of the jobless have been gradually whittled away. Real wages are still below their 1989 level. While some knowledge workers and professionals have increased their earning potential, teachers and health service employees have fallen further behind. Textile workers and unskilled laborers have been hit especially hard. Foreign owned companies are paying their employees increasingly well, compared to their Hungarian counterparts. Regional differentials have also grown: while North West Hungary and Budapest, the primary targets of foreign investors, have surged ahead, the North West, South West and the East have fallen far behind. The real value of pensions has sunk even further than that of salaries and wages. Low income families with many children are especially handicapped by income regulation policies blind to the needs of dependent family members and the faster than average growth of the cost of living and schooling. These negative impacts exert a cumulative effect on the Roma.

SUMMARY AND RECOMMENDATIONS

(28) NGOs view that privatisation, liberalisation and austerity measures as the main tools of increasing GDP and living standards and decreasing poverty – known as "Washington consensus"- must be reconsidered. These measures themselves do not result in quick and automatic growth and decrease of poverty; in Hungary they seem to have increased social and regional disparities. Contrary to the latter assessment, international experts and institutions view that in comparison with the surrounding transitional economies and international development tendencies the present status of Hungary's economy and its development prospects indicate very positive results of Hungary's transition: increasing GDP and living standards and poverty reduction.

(29) After a decade of transition, it would be necessary to carry out a serious assessment of the process, results, and failures of Hungary's transition. The EU accession is going to be a serious, big, and complex transformation similar to the change of former regime. For the sake of a successful accession, Hungary has to learn from the success as well as failures and deficiencies of the 1990's. At the end of the transition during the preparation for the EU accession Hungary's economic policy must focus on some correction of the transition based on the lessons learned to stop segregation of the society. This is not only a social policy (social benefit) issue, all the segments of economic and social policy has to be rendered to this aim. Social features of the state must be strengthened, Hungarian Parliament should accept the European Social Chart, the support of international organisations and Western governments required for the program of social stabilisation and cohesion.

(30) NGOs are concerned by the ownership structure created in the course of transition. The initial targets have not been met. The aim was that privatisation should assist the creation of a domestic entrepreneurial sector that is internationally competitive. Presence of foreign ownership in industry, trade and basic infrastructure is considered too high by NGOs compared to international examples or compared to the 30% ceiling identified by the parties at the beginning of the transition. This limits the scope of manoeuvring of the Hungarian governments. The proportion of so-called democratic ownership forms (e.g. ESOP or co-operative) well known in market economies are extremely low in Hungary. Hence the NGOs suggest, the government should change this ownership structure by supporting domestic entrepreneurial sector and partnership property, the sooner the better.

(31) Considering the tools of economic policy besides developing effective financial systems, promoting fair competition, and building up necessary regulatory measures there is a need to create due social protection and well being systems and mechanisms, to give emphasis to the development of human resources, R+D, technological development and transfer.

(32) Neither the Hungarian practice nor the international comparison supports the theory that smaller state budget automatically results in the increase of economic efficiency. Therefore the public finance reform should no longer be focused on cut-back the GDP proportion of public expenses and decreasing social expenditure.

(33) The civil society, the various NGOs, most of which voice general social expectations rather than specific interest, must be involved much more intensively in the formulation of economic policy.

(34) The Hungary SAPRI inquiry, the two-year policy dialogue, and the reports prepared give a

good basis for sharing the lessons from and the assessment of Hungary's structural adjustment with the representatives of the other East European countries.

1. THE TRANSITION IN EASTERN EUROPE AND IN HUNGARY

The Soviet type planned economies were transformed into market economies in the 1990s. The previous decade was characterised by the economic crises of the countries belonging to the Council for Mutual Economic Assistance (CMEA). The inevitability of market reforms was increasingly obvious. Hungary on this road made much faster steps than other countries of the region, and received important encouragement from the IMF and the World Bank. Between 1988 and 1995, a fundamental institutional transformation took place. During this period the main political forces of the nation remained committed to the introduction of the market institutions, despite the fact that this transition demanded a great economic and social sacrifice in the first period. The results of the transition showed in gaining membership in certain international organizations, and also in the dynamic economic growth that became a constant feature of the Hungarian economy after 1996.

1.1. Crisis and disintegration in the 1980s

The collapse of the East European state socialist systems took much of the societies of the region by surprise, and the global public opinion was unprepared to these changes too. The events of 1989 were evaluated as unexpected despite the fact that in some countries it was preceded by an acute political crisis, and the economies of the region had stagnated in the previous decade in almost the entire region.

Until the 1970s, the Soviet type economies showed some success. The industrialization of the backward economies of the region was carried out, and the material basis was created for the abolition of poverty and illiteracy. The Soviet military and space industries developed paralel with the American rivals. The price of this, however, was the severe restriction on the living standards. The population often suffered the shortage of basic consumption goods.

In Hungary, important economic and social measures were implemented to improve the living conditions of the people. As compared to other state socialist countries, with the exception of the relatively independent Yugoslavia, private life was fairly liberalized, there was a room for individual enterprise, and even a golden age came about in the sphere of culture. These improving living conditions were partly due to the progressive introduction of market mechanisms, and to a greater role of competition among the state owned enterprises. Foreign trade increased towards the West, and particularly West-Germany.

In most countries of the region political considerations blocked the road of market reforms. In the 1970s, the Soviet bloc intended to find the road of economic modernization through a deepening of international cooperation within CMEA. This initiative did not bring about the expected results. The oil price shocks of the 1970s made it apparent that the CMEA countries fell behind in economic development. From the second half of the 1970s, this fact was demonstrated in the increasing indebtedness of the region--with the exception of a few nations.

In the early 1980s the economic policy cohesion of the Soviet bloc faded. The latent disintegration of CMEA produced some critical situations, though it also created new opportunities inasmuch as countries belonging to the Soviet zone of influence were allowed to make their own choices in economic policy. The indebted state socialist countries tried to find the way out of the crisis on various ways. East Germany started to take advantage of her special relationship with West Germany. The leadership of Romania decided to repay all the debts which aggravated the shortages and increased the human suffering. Poland, Hungary and Yugoslavia turned increasingly toward market reforms, and in the same time toward more intensive economic relations with the West. In Hungary, a political decision was made at the end of 1981 to join the IMF and the WB.

After building up the foreign debts between 1976 and 1978, the Hungarian leadership significantly lowered the rate of growth in 1979 (the earlier 5-6 per cent annual GDP growth was lowered to 2 per cent). In spite of this, a major liquidity crisis emerged in 1982. The consolidation, however, was based on restriction again, and the necessary changes in the structure of industry were not carried out. The products developed in the CMEA framework did not prove sufficiently competitive in the global markets. The market incentives were not yet strong enough to encourage the necessary changes, while the political will was not any longer strong enough to do the same from the center. Under the regulation of the time, the state owned enterprises managed to gain the incomes necessary for survival, but that was not enough for the modernization of their organization and product structures (Lóránt 1989).

Frame 1. Milestones of the crisis and the transition

1979	Start of the economic restriction
1982	Joining the IMF and the World Bank
1984/5	Decentralizing in company management
1987/8	Financial reforms (banking and tax systems)
	start of deregulation and liberalization
1989	National Round Table negotiations. Start of privatization
1990	First multiparty parliamentary and municipal elections
1991	Abolition of CMEA and WTO
	Association agreement with the European Communities
1992	Bankruptcy act, start of debtor consolidation
1994	Application for EU membership
1995	Macroeconomic stabilization
1996	Membership in the OECD
1998	Start of EU accession talks
1999	Membership in NATO, participation in the war against Yugoslavia

See extended chronology in Appendix 3.

The stop-go cycles of the economy resulted in ever increasing waves of indebtedness in the periods of recovery. Following the liquidity crisis of 1982, GDP growth started again after 1985, but this resulted in the doubling of the gross foreign debts within three years. The leadership of the country became disoriented, and certain groups of economists and other intellectuals started to demand radical reforms and the introduction of pluralist democracy. The economic weakening of the Soviet Union with the deepening political crisis, the retiring of the ideologically commited leaders, and the emergence of a new, pragmatic technocracy, in addition to the lasting economic crisis, created the political conditions and the social demand for a fundamental transformation. The dominant circles of economic analysts believed that the key to the solution of the crisis is the fulfillment of market reforms, and the essential parts of this analysis were adopted by the political leadership as well (Antal et al. 1987, Kornai 1989). The financial reforms of 1987-8 (the introduction of value added tax and personal income tax, and the establishment of commercial banks) were accompanied by another restriction, during which the social and political discontent deepened.

The year 1989 was the time when multiparty pluralism emerged in Hungary. A dozen new political parties emerged, which demanded not simply a correction of state socialism but also the introduction of a competitive multiparty system and the market economy. In September 1989, a consensus was reached around the National Round Table--the ruling HSWP, the opposition parties and the NGOs--on this program. During the Fall of 1989, a transition began in other countries of the region as well, and the irreversibility of these changes was expressed by the Soviet-American summit at Malta. (See the milestones of the crisis and transition in the Frame 1. .)

1.2. The directions and phases of the transformation

The main feature of the transformation that began after the Fall of 1989 is that a dual transition took place following the collapse of state socialism (Bartlett 1997). This circumstance increased the complexity of the transformation process, and made the predictability of events extremely hard. Since the CMEA-economies had been politically managed systems, the political crisis and the desintegration of the communist parties resulted in an economic desintegration too, both within the countries and on an international scale. It needs mentioning, however, that in Hungary the early start of the marketization made this process less shocking than elsewhere, and also that the state apparatus, that was working under changing political authority, managed to keep the changes under control. Thus, for example, the Polish or Russian type hyper-inflation was avoided.

The decade of the transition can be described for all the countries in the region with three phases: euphoria, chaos and recovery. The length and intensity of these phases were different in various countries, but the general trend was the same everywhere. The reason for the euphoria was that most of the people in these countries saw the emergence of new freedoms and opportunities when the communist system fell. In the economy, this translated into the rise of living standards, and the hope to catch-up with the Western quality of life.

For those actors of the transition who became euphoric in 1989, it was extremely difficult the understand the complexity of the changes and also to recognize the hidden risks and contradictions. Thus their voluntarism, ignorance and unbased decisions became major sources of the chaos. In the economy, this chaos manifested itself in a sudden drop in output, which in case of Hungary amounted to about 20 per cent of the GDP. In some other countries it was twice as large. In this "transitional recession" (Kornai 1993), the various factors of crisis--the disintegration of regional trade relations, the institutional void arising from the institutional transition, the negative effects of the accelerated liberalization, and the recession accompanying the economic restructuring--made an impact in a combined form.

The new leaders of the transition countries had to make a decision an a few crucial questions very quickly. For instance they had to decide what model of the market economy they wanted to introduce, how they wanted to deal with the legacies of state socialism, how fast changes they wanted, and also about the techniques of achieving various economic policy goals. The government of Hungary elected in 1990 saw the German (Rhein) type social market economy as the goal of the transition. Following some short disputes and negotiations, they decided to undertake continuity with the foreign debts left behind state socialism, and abandoned an explicite shock therapy. The program of gradual but consequent reforms was summarized in the so-called Kupa-program, named after finance minister Mihály Kupa (1990-3). The laws that were supposed to be inevitable for the creation and operation of the market economy were enacted during this program.

The acts on financial institutions and accounting were aimed at clarifying the management of companies. This was highly important because in 1987 the newly established commercial banks inherited a credit of uncertain value. They did not have sufficient expertise to handle risk. The rules of judging outstanding assets and managing reserves were rather loose. The act on financial institutions required capital adequacy ratios along international standards. The regulation created in 1991 made it easier to judge the financial situation of debtors and thus the criteria of credit rating became tighter.

With the bankruptcy act, bankruptcy and abolition became a real opportunity for enterprises. One of the main functions of this act was to put an end to involuntary inter-enterprise lending (or "queuing") that had become a practice during the previous years. The bankruptcy act was fairly hard. Its 9th paragraph ordered that enterprises that cannot pay any of their debts 90 days after maturity must report bankruptcy within 8 days.

The central bank act was aimed at the restructuring of financing the national budget by limiting the compulsory financing of the budget by the national bank (MNB) at 3 per cent of the planned incomes of the budget. The borrowing needs beyond this limit had to be covered by issueing government bonds at a market interest. Apart from replacing the cheap central bank loans with expensive bond financing, the earlier level of interest at the central bank (6-7 per cent) increased to the base rate (22 per cent in 1992).

According to their rhetoric, all Hungarian governments, for well-known political reasons, considered themselves gradualists. Nevertheless, all of them implemented radical reform policies while they were in office. The reason for this was not simply a belief in the advantages of rapid, or even shock type transformation, but first of all that the leading politicians saw the transformation of the region as an international competition--for aquiring foreign capital and gaining membership in certain organizations. They found themselves in a race against time, and often gave way to changes that had not been sufficiently prepared, neither professionally, nor politically.

All the reforms could not have been implemented even in the greatest hurry. The areas of economic policy were reformed in a shifting manner. The largest chapters of liberalization and deregulation were implemented simultaneously with the political crisis and transformation, and the political transition itself opened the way to mass privatization. It started in 1989, but it could accelerate only after the elections of 1990. The most significant stabilization operation was implemented in 1995, following the emergence of the unsustainable trade and budget deficits in the previous two years. After 1995, privatization was extended to the physical and human infrastructure too.

Another dimension of the reform process was that the challenges, initiatives and policies emerged from both domestic and external sources. The transition countries declared their intention to join certain organizations (GATT, IMF, OECD, EU, NATO etc.), and these organizations obviously set certain criteria. They made a strong impact on domestic politics, together with some Western governments. In the first half of the 1990s, the Bretton Woods institutions were the most significant out of the international organizations to influence economic policy in Hungary, and in the second half of the 1990s--from the preparations for the accession talks--the role of the European Union strengthened.

1.3. The IMF, the World Bank and the Hungarian economic policy

Hungary joined the IMF and the World Bank in 1982. The IMF played a major role in overcoming the liquidity problems in that year and later, and also contributed to the maintanence of the impetus of reform policy. From the co-operation with the World Bank Group, the Hungarian economic policy expected access to 1./ significant development resources, 2./ foreign markets and orders, and 3./ guidance to the modernization of production and management.

Between 1982 and 1990, the Wold Bank supported the reforms of state socialism in Hungary by twenty program loans. These loans were taken by the National Bank, the Hungarian State, and in two cases the National Oil and Gas Trust (OKGT). These loans--amounting to USD 25 to 200 million--helped strengthening the role of market incentives and improve export capacities in all different branches of the economy (energy, chemical industry, agriculture etc.). These programs helped strengthening the role of market incentives within these industries, and also to improve export competitiveness. As a result of membership in the WB, Hungarian companies won tenders of the WB and IDA to the extent of USD 160 million.

Well before the collapse of state socialism the IFC became active in Eastern Europe too. Hungary joined the IFC in 1985, and the first steps of co-operation concerned the area of banking. The first IFC-project was the establishment of UNICBANK. In the following years, the IFC helped the foundation of some joint ventures in industry as well. In 1985, Hungary joined IDA too, but she was not entitled to receive funding from it.

Following the changes of 1989, the Bretton Woods institutions turned toward structural and institutional reforms with great ambitions. The Hungarian government took two comprehensive structural adjustment loans from the World Bank in 1990 and 1991. The aims of the loans were fulfilling liberalization and accelerating deregulation and privatization. In the early phase of the transition, further large-scale loan packages supported the transformation of the financial sector, the export of agriculture, the modernization of communication, human resources and product markets, and the restructuring of companies.

In the new situation, the IMF also supported the transition with extended authority and facilities. It made stand-by, compensational and extended agreements with Hungary, and expected the acceleration of structural adjustment, the rapid liberalization of imports and the abolition of subsidies. The 1991 extended agreement was new in its size (SDR 1.1 billion) and its maturity (3 years). Apart from this, the IMF provided assistance in a separate agreement to cover the extra costs resulting from the Gulf crisis, and also to offset the price changes resulting from the abolition of CMEA.

Due to the disintegration of the trade relations of the Soviet bloc and the unintended consequences of transition policies, the economy did not develop as the IMF would have demanded and as the Hungarian government promised to its voters and creditors. Therefore a good deal of difficulties and conflicts emerged in financial relations. Because of the budget deficit of 1991, the government asked for exemption from the performance criteria attached to the IMF loan. Due to the excessive deficit, however, the IMF temporarily suspended the due instalment. Nevertheless, another stand-by agreement was made in the Summer of 1993, but since the government did not follow the guidelines agreed upon, the IMF did not allow Hungary to draw the quarterly instalments.

When the return of economic growth created an unprecedented imbalance in 1993-4, the IMF urged tough measures. However, these demands were not accompanied by loans, when the government made a decision to act and committed itself to austerity. The IMF was prepared to sign another stand-by when the measures of the so-called Bokros-package were already bringing results in the Spring of 1996. The instalments of this credit were not drawn by Hungary, though the agreement itself helped in bringing down the interest spread on market loans and also to bring about membership in the OECD in March 1996.

Comparing the roles of the two institutions, we can conclude that by the second half of the 1990s it was again the WB that apperaed more active in shaping the economic and social policies in Hungary. This meant first of all the participation in the attempted reform of the Hungarian public sector. The pension act of 1997 was created under WB guidance, and despite its compromising nature it gained international attention and importance. The assistance of the WB was significant in other areas too; for instance the Hungarian education minister signed a USD 150 million loan agreement in Washington to support the reform of the higher education in Hungary.

Frame 2. The most important program loans of the World Bank in Hungary

ISAL (1988) USD 200 m
SAL (1990) USD 200 m
SAL2 (1991) USD 175 m
ERL (1992) USD 200 m
EFSAL (1997) USD 225 m
PSAL (1998) USD 150 m

Frame 3

The stabilisation package

In response to the deterioration of the current account in 1993-1994 the Hungarian social-liberal government of the time introduced a strict stabilisation program. Lajos Bokros the finance minister presented the package on the government meeting of 12th March 1995; two socialist ministers resigned, but the government adopted the program.

The government decision subordinated all policies (fiscal, monetary, trade and social policy equally) to the aim of re-establishing the short-term equilibrium. The currency (forint) was devaluated by 9 percent and a system of crawling devaluation was introduced with declining the national currency in each of the first three month by 1,9 percent and afterwards by 1,3 percent monthly. As a temporary measure (valid until 1997) an 8 percent surplus import duty was imposed on all products except energy. Salaries were frozen in state enterprises and budget institutions, the payment of a large proportion of sick pay were transposed on employers, 0 rate of PIT and VAT and after children tax allowances were abolished. Tuition fees were introduced in higher education and the system of social provisions were transformed, the general right on family allowances, child care benefit and child support, pregnancy assistance were made dependent on the social situation of families. The Ministry of Finance projected that these measures will decrease the budget deficit by 170 billion forints. In the summer of 1994, soon after the formation of the government of Gyula Horn, the government started the stabilisation of the economy, devaluated the forint by 8 percent, renounced hosting the World Exhibition, prepared new budget estimates, but these measures proved insufficient to turn the negative tendencies. The character and stringency of the package elaborated in the spring of 1995 were influenced also by external factors as the psychological impact of the Mexican crisis. The announcement of the package set off passionate protests among university students and other interested strata of the population. The most significant attack was launched by the Constitutional Court cancelling one part of the social instructions and mainly postponing the introduction of others.

Due to the consequent commitment for stabilisation and to the surge of privatization the estimation of the country and the government changed and significantly improved in the international business and political circles during 1995. National balances soon started to improve mainly as a result of the 10 percent fall of real wages and of the exceptionally high increase of privatization incomes. One year after the introduction of the package the government succeeded to make a new stand-by arrangement with IMF and in the spring of 1996 the country achieved OECD membership.

According to civil organization social measures of the stabilisation package brought unreasonable small economies and proved needless in the short run, but exerted negative impact on security feelings of the citizens, and on demographic and long-term social changes.

2. POLICIES OF STRUCTURAL ADJUSTMENT

Under the auspices of SAPRI, four main aspects of the Hungarian economic transition have been investigated. They are the following: 1./ deregulation and liberalization, 2./ privatization, 3./ public utility reform, and 4./ the transformation of welfare systems during the transition period.

2.1. Deregulation and liberalization

From the 1970s, governments in the advanced market economies applied deregulation and liberalization policies, in order to roll back excessive state intervention. Those who initiated these reforms claimed that the existing level of state intervention has a negative impact on entrepreneurship and productivity, and eventually decreases the welfare level of society. Deregulation wanted to diminish the role of the state by reducing the number of regulation and duties of companies, while liberalization attempted the same by the abolition of certain restraints. Since in the CMEA countries the state played an even greater role in the economy than in the OECD states, deregulation and liberalization had an even greater importance during the market reforms and transition.

In Hungary, market reforms started with deregulation and liberalisation, with first steps in this direction taken before the political change. Since the end of the 1970s, when political leadership gradually opened towards market-type reforms, deregulation and liberalisation were more acceptable than privatization. Thus, political decisions were taken to reduce state regulations and subventions during a period when the privatization of state- owned entities was not yet at issue. The end of the 1980s brought a breakthrough in deregulation and liberalisation, the results of which would emerge in the first part of the 1990s.

2.1.1. Deregulation in the enterprise sector

Deregulation aimed at free-enterprise competition and the reduction of constraints binding enterprises. This purpose was served by organizational reforms as well as legislative changes. By the second half of the 1980s, ministries lost their rights to withdraw incomes from the state companies or to support them directly. Income relations became more rule based, primarily through the introduction of the new tax system (value added tax, personal income tax and company gains tax). The review of legislation and cancellation of unnecessary regulations were accomplished in Hungary in three stages: in two short campaigns and in a third lasting wave (Fodor 1999).

The intention of the first stage of deregulation (in 1979-1980) was to widen the scope of motion for state-owned enterprises, as Hungarian economic policy aimed at reducing overcentralisation and at the extension of flexible forms of enterprise undertaking and functioning. Legislation related to state-owned enterprises was reviewed from that point of view, i.e., how far the rules impeded flexible enterprise management. Also, several outdated rules were repealed. This early stage of deregulation had limited social effect but formed an element of a complex change of policy orientation towards enlarged freedom of private and small enterprises.

The main aim of the second stage (1988-1990) was the increase of transparency. Not only was the legislation related to state-owned enterprises reviewed, but all effective laws and regulations. This campaign was the first to be named deregulation and was an element of the structural adjustment program of the World Bank in Hungary. The second stage exceeded in its economic and social effects that of the first stage ten years earlier. Several laws and institutions were eliminated that were extraneous to a bourgeois society and market economy.

The third stage during the 1990s was characterised by the continued activity of governments in which deregulation was no longer a campaign but an organised review activity. In this phase, deregulation was understood as a concomitant task of the transition to market economy and was managed by a government commissioner. The main direction of activity was the rationalization of state administration and, as this was a longer phase than previous campaigns, there was greater possibility to prevent the rise of disadvantageous social effects.

The first two phases of deregulation had given a noticeable impulse to the expansion of the enterprise sector. Small enterprises were a rather large sector of the Hungarian economy in the 1970s that became even more important at the beginning of the 1980s. Nevertheless, the 1989 political change brought a leap in new enterprises; in a few years the total number of enterprises passed one million. Now private undertakings were established in large numbers, constituting three quarters of registered enterprises in 1991. The number of enterprises, however, might cause a misunderstanding. Many new undertakings originated from the disintegration and liquidation of state enterprises or came into being on the request of employers to employees, for employers could in this way decrease their costs, including taxes, sick pay, payment of annual vacations, etc.

The systemic change did not improve the situation of long-time existing family or small enterprises. To the contrary, they suffered increases in running expenses (e.g., caused by energy price increases) and losses as a result of import liberalization and the diminishing purchasing power of the population. Although for ten years all government programs emphatically promised support to medium-sized and small enterprises, the realization of this aim has always been delayed; for instance, there is still no adequate solution for providing credit to small enterprises.

The reduction of restrictive regulations could not guarantee in itself the success of entrepreneurs, since the development of the new undertakings faced other kinds of obstacles, such as: absolute (demand-side) and relative (deriving from competition) market limitations; and different financial difficulties (e.g., high interest rates, slow crediting procedures, low quality of financial services, cautious behavior of banks). As time has passed, the situation has worsened. In 1993, small enterprises received 11 percent of all bank credits, while in 1996 their share was less than five percent.

2.1.2. The liberalization of prices and wages

The price and wage liberalisation was meant to assure the full independence and decision making freedom of enterprises so that the assessment of the market and competition rather than administrative regulations govern prices and wages, the profitability and future prospects of enterprises.

Price reforms started in 1968, the year of the introduction of the "new economic system," with gradual liberalization of the fixed price system of the directive planned economy. However, the scope of free prices remained narrow until the end of the 1980s. Price liberalisation continued in 1980 by building domestic prices on the basis of world market prices. A decisive step in approaching Western-type tax and price systems was the introduction of the value-added and personal income taxes in January 1988. Henceforth, state price regulation and the previous system of price subsidies were eliminated at a rapid pace.

Price liberalisation and the reduction of consumer price subsidies were explicit parts of the state obligations in SAL agreements. By the end of 1990, about 90 percent of all consumer prices were placed in the free price category. The ratio of consumer price subsidies to GDP decreased from seven percent in 1987 to below one percent over four years. As a result of price liberalization, the closing of the National Price Office was declared in 1991 and a Competition Controlling Office was established to defend against unfair business practices.

Wage liberalisation was delayed compared to other elements of liberalisation policy, because monetarist policy held that wage outflow was the main threat to financial stability. Therefore governments instead of a full wage liberalization gave priority to budget contraints and keeping down the increase in real income. The government elected in 1990 maintained the progressive taxation of average wages in the early 90's.

The 1 January 1993 central wage process was abolished and substituted by the recommendations of a newly established Interest Arbitration Council. This tripartite forum (employers, employees and government) made recommendations to enterprises on the lower and upper limits of wage increases. The recommended margins were not obligatory, but enterprises respected them in practice. The subsistence wage remained the single obligatory wage indicator, the level of which was determined annually by the Interest Arbitration Council by consensus until 1998; i.e., the agreement of the three partners was needed for its validity. The annually determined subsistence wage served as a basis for determining the level of different social provisions, as well. Between 1990 and 1998, the subsistence wage increased 3.3 fold, much less than gross or net salaries; after 1994 it was less than the statistically stated subsistence level (Fodor 1999: 46).

During the years of transformation and, also after the elimination of centralised wage determination, restrictive finance policy continued the decline of real income. The index of consumer prices increased in the period between 1990 and 1998 by 518 percent, the average of gross salaries by 494 percent and that of net salaries only by 439 percent. Therefore, the real value of gross salaries fell by five percent, while net salaries were valued at 15 percent less. As a consequence of the increase in charges on wages and salaries, the gap between gross and net salaries opened from three quarters in 1990 to one third in 1998.

During the transition to a market economy, not only did the diminution of the real value of salaries and pensions cause increasing tension in the society, but even more unjustified, there was also, by international comparison, a very high differentiation of incomes. Government policies increased income differences, e.g., the range of tax rates in PIT gave preference to the higher-income strata, and average gross salary continuously approached the highest tax rate.

2.1.3. The liberalizaion of foreign trade

Transformation into a market economy included the elimination of export and import restriction, thus introducing the operating mechanism of market economies. The liberalisation of foreign trade promoted competition in the internal market.

Hungary has an open economic structure; the country strongly depends on foreign trade. In the CMEA bilateral state agreements that regulated foreign trade, the share of barter trade was high. The transferable ruble, an account money, functioned as a means of payment. In the gradually increasing Western economic relations, these methods could not be applied. But, also in these relations, there functioned for a long time the central authorisation of exports and imports, which was executed by the Foreign Trade Ministry.

The Central Committee of the Hungarian Socialist Workers' Party decided to begin the rapid liberalisation of imports in July 1988. The decision launched a four-year program from January 1989 until the end of 1992, which scheduled the realisation of trade liberalization according to commodity groups. In 1992, the final year of the liberalization process, the proportion of liberalised imports reached 90 percent compared to 35 percent in 1989. The Central Committee of HSWP also decided to free foreign-trade activity; henceforth, any competent enterprise could carry on foreign business.

The positive effect of import liberalisation was the extension of domestic supply and the improvement of national export conditions to a certain extent, as it enabled domestic enterprises to buy materials and semi-finished products under similar conditions as their foreign competitors. In the same time, however, rapid liberalization within the circumstances of the economic transition had a negative impact on the current account and the competitiveness of certain companies.

Simultaneous to import liberalisation in regard to Central and Eastern European countries, the previous clearing turnover was changed to dollar accounting, and in 1991 the CMEA dissolved itself. The transition to dollar accounting in Eastern European trade – although it was a Hungarian initiative designed to make usable the excess balance accumulated in Soviet economic relations – caused a 10-percent deterioration in the terms of trade of the total turnover. The loss was half as much as that in the 1970s, which was caused by the oil price shock that pushed the country down toward indebtedness.

For a while following import liberalisation the foreign-trade balance remained stable, since the fall of production diminished the country's import demand, but later the balance worsened dramatically. In 1993 and 1994, the current-account deficit grew to almost 10 percent of GDP, mainly because Hungarian enterprises had to compete without any transition with stronger, more competitive Western producers. Import liberalisation without any transitional defence of the domestic economy (beside the real, effective revaluation of the forint), together with the implementation of the strict Act on Bankruptcy, restrained both exports and import-substituting domestic production, while import demand increased (Obláth 1999: 53).

Empirical examinations (Oblath 1999) prove that imports jumped after the reduction of limitations and crowded out domestic production significantly. It is true that, when the import liberalisation program was elaborated, regional disintegration and its impact on the domestic economy could not be taken into consideration yet, but even at that time opinions existed that the speed of import liberalisation was precipitous. Modifications could have been made in the course of events. The exchange-rate policy's role in the emergence of the deficit requires special attention since import liberalisation was accompanied by the real, effective revaluation of the currency without defending the economy through custom duties or other methods. These problems were also mentioned in the World Bank study evaluating the program's execution. Bank experts interpreted the realisation of import liberalisation under the above-mentioned circumstances as a voluntary undertaking that well exceeded the practice of countries implementing shock therapy. It would be good if the attention of decision-makers would be focused upon import regulations applied in other countries, replacing quantitative prescriptions with duties and preventing the real, effective revaluation of the currency, which would help in avoiding significant losses in Hungary, as well.

2.2. Privatization of the enterprise sector

The evaluation of privatization and its impact is made difficult by the fact that the use of the concept is consequent neither in the professional, nor in the general discourse. There are many who believe that privatization means the increase in the share of the privately owned companies as compared to the total of the national economy. In a nerrower, and more precise sense privatization means the transfer of publicly owned property to private ownership. In the analysis below, we apply the latter concept, while taking into account that teh development of the private enterprise sector in Hungary was to a great extent due to green field investment and the expansion of existing companies. Most of the foreign capital arrived in the country in these latter forms, and not through the purchase of state owned enterprises.

All political parties existing at the time of transition supported privatization, motivated partially by a search for higher efficiency from private as opposed to state owners and partially by intentions to create a broad domestic middle class, a bourgeoisie. Privatization was implemented in several stages. (A detailed chronicle of privatization can be found at Mihályi 1998.)

Influenced by the deepening economic crisis, the reduction of state ownership started before the political change happened. Three important laws made it possible to begin privatization: 1) the Act on Economic Associations (tv.VI.1988); 2) the Act on Foreign Investments in Hungary (tv.XXIV.1988); and 3) the Act on Transformation of Enterprises (tv.XIII.1989). These laws opened the way for the so-called spontaneous privatization that did not serve general national interests, but rather the interests of some managers.

The World Bank decidedly supported privatization in the first part of the 1990s. A SAL agreement signed with the Bank in July 1988 already mentioned the enterprise ownership problem. Schedule 4 of the agreement formulated the expectation: "Enactment of a law of associations and related legislation which would permit: (a) State enterprises to convert themselves into joint stock companies; (b) individuals to hold negotiable share in joint stock companies; and (c) individuals to form limited liability and joint stock companies." In the government cycle of 1990-1994, all three SAL agreements (July 1990, July 1991, April 1992) dealt with privatization. However, the World Bank did not intervene in the forms of realization; those decisions were determined by the Hungarian governments. (Vági 2000: 48)

2.2.1. Spontaneous **versus** *controlled privatization*

The first phase of privatization in Hungary was characterized by spontaneous transactions, i.e. those without substantial state influence. These transactions were facilitated by the legislation of 1988-9. In the subsequent years, all governments attempted to impose their own economic and societal policies on the process of privatization, which continued in a controlled manner.

During the spontaneous privatization phase, state enterprises remained, but their property and financial assets were transferred to economic associations, while, in exchange, the enterprises received shares from the limited or stock company. These transactions were called enterprise emptying. The workable parts of the enterprises went into the associations, while unviable and charged elements remained in the enterprises condemned to liquidation.

The essence of the spontaneous privatization was that managers of state-owned enterprises became owners of part of the wealth. Altogether in that process, out of at most 100 state-owned enterprises, 300-400 associations have arisen with some 150-170 billion forints in wealth, which amounts to around one tenth of the privatised state property.

The government of József Antal that took office after the first free elections in the spring of 1990 considered the strengthening of a domestic middle class important and arranged to put privatization partially into the service of this aim. According to the document "Ownership and Privatization", adopted in August 1990, the aim of privatization was to bring into being the forms and proportions of ownership, enterprise and organisation characteristic of developed market economies over the subsequent 3-5 years. The requirements were established to widen the domestic circle for whom obtaining ownership was open -- the principle of fair privatization. The government moved forward on controlled and organised privatization; to manage the process, it established the State Property Agency (with the Hungarian initials ÁVÜ) at the end of 1990.

The establishment of the State Property Agency made the process better organised. The first step of the organised privatization was a *pre-privatization program*, during which about ten thousand retail shops and restaurants were auctioned off and bought mainly by the former managers. ÁVÜ privatised companies mainly by designating specialised organisations that sold the units to the highest bidder.

Another mass privatization initiative of ÁVÜ was the *self-privatization program*. The ÁVÜ commissioned a consulting firm to transform and privatise around 700 enterprises. Ownership rights were delegated to the consulting firm, and the firm was remunerated from the receipts from enterprise sales. The program accelerated the mass privatization of small and medium-sized enterprises, and ÁVÜ was able to concentrate on the privatization of other medium-sized and large firms. The program was realised in two phases. The first started in September 1991 and dealt with enterprises of which the value of its assets was less than 300 million forints (some USD 4 bn at exchange rate parity), annual receipts from sales less than 100 million forints, and the number of employees no more than 300. This action included 457 state enterprises.

Based on the favourable experience of the first phase, a second round was set on 1 August 1992 and involved 292 enterprises, each with assets valued at less than one billion forints and no more than 1000 employees. In the full program, 478 enterprises were transformed into associations (in most cases into limited liability companies) and out of them 412 were sold totally or partially. This privatization was successful, with projected aims and principles having been fulfilled.

In Hungary, the governments did not distribute shares or coupons based on citizenship, but made it possible to issue employees shares in order to interest them in the ownership-reform and economic-efficiency processes. Close to 300 privatised enterprises participated in the Employees Participation Program (known by the Hungarian initials MRP) and 45-50 thousand people received shares in this program through the end of 1996.

Until 1994, around one quarter of the state property was privatized. During this period, mostly domestic owners bought the privatised assets.

A major development in property policy was the establishment of the State Holding Company in 1993. In the view of the Antall-government, this was necessary to create an effective and rational owner above those state companies that were expected to remain in public ownership in the long run. So-called strategic industries fell into this category, like energy and public utilities.

The Horn-government that entered office in the summer of 1994 had distinct ideas about privatization. It was decided to unify the management of the state-owned sector and to create the legal conditions for the privatization of the large utility firms and commercial banks. These concepts were enacted in the Act on Privatization (tv. XXXIX. 1995). The Act declared the aim and requirements of privatization and established the united privatization and property management organization, the ÁPV Rt. ÁPV Rt. is a holding company, the task of which is to manage the remaining state property and to sell as quickly and as efficiently as possible all other parts of the state property. The ownership functions of the joint stock company (in Hungarian: Rt.) were fulfilled by the privatization minister without portfolio. In the Act the aim was set to accelerate privatization and finish mass privatization during the 1994-1998 cycle of the Parliament.

The principles of privatization changed once again, with emphasis being placed on cash sales (see Figure 1.) and the income from privatization having to be used for diminishing the budget deficit and state debts. The scope of action was extended to include foreign (professional and institutional) investors, since these investors brought foreign exchange into the privatization process and this income could be used to decrease foreign indebtedness. The foreign professional investors have real ownership experience; therefore, it was felt, they were best qualified to organise efficient management, reorganise the firm, renovate the technology and find new markets. The new conception of privatization allowed majority ownership by foreigners even in strategic branches, as, for example, in the energy industry and services, or in the case of large commercial banks (see the role of foreign investors in Frame 5.). The Horn-government gave priority to investors with resources enough for taking risk and financing restructuring, and other forms of privatization were thus discouraged. This policy allowed the government to gain privatization revenue for a large-scale debt reduction.

Frame 4.
Account on privatised enterprises
(Status as of 30 July 1999.)

On 31 December 1990 the State Property Agency (ÁVÜ) established the ownership rights of 1858 state and local community enterprises, the wealth of which was estimated at 1630.6 billion forints. After transfers to and take-overs from other ownership administrations, 531 remained state-owned enterprises and 1327 were transformed into associations.

The status of the 531 state enterprises breaks down as follows:

under liquidation	337
under final settlement	92
transferred to other administration	85
ceased	14
still working	3

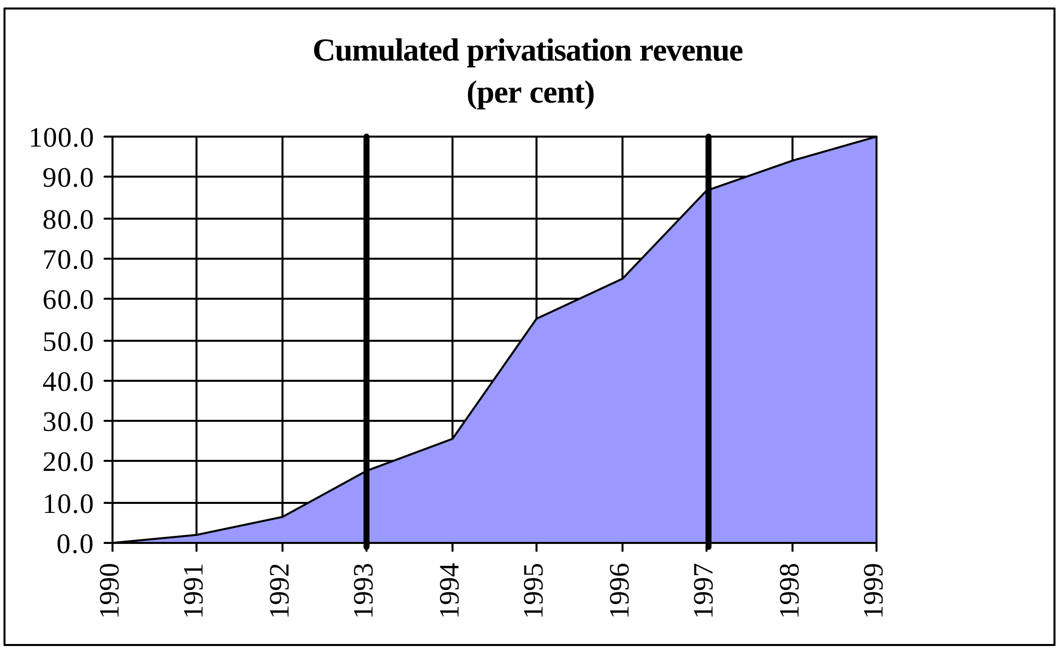
After new establishments and take-overs from other ownership administrations, ÁVÜ and ÁPV Rt. increased the number of 1327 associations by 418. The status of these 1745 associations is as follows:

completely privatised	1185
under liquidation	178
transferred to other administration	86
under final settlement	45
ceased	35
permanently remains state property	97
remains under ownership administration	2
will be privatised	117

Source: www.apvrt.hu/menu1/v22130.html (2000. 05.19.)

Figure 1.

Cumulated privatization incomes
(Percentages)



The Government's new concept of privatization allowed majority ownership by foreigners also in so-called strategic sectors, such as the energy industry and services, and large commercial banks.

3.2.3. Privatization of commercial banks

Some institutions in the financial sector were privatized in the opening phase of Hungarian privatization, though most of this sector changed ownership under the Horn-government. Between the two phases, i.e. during the so-called transitional crisis, the state provided hundreds of billions of forints for the consolidation of its banks. Without the bail-out, these banks would not have been viable or privatizable.

In the region of Central and Eastern Europe, three methods of bank privatization were implemented: open sale to small investors on the Stock Exchange (initial public offering, IPO); sale of majority ownership to strategic (professional) investors; and offering of any form of coupon to place ownership into the hands of citizens (see Várhegyi 1999). Variants of the three methods were applied in Poland, Hungary and the Czech Republic, respectively. It should be mentioned that originally the Polish government intended to implement a combination of the first two methods.

In Hungary, from 1991-1992, a large percentage of experts suggested rapid bank privatization through the sale in the first instance to foreign strategic investors. The Act on Financial Institutions of November 1991 limited the maximum ownership percentage held by non-professional investors – including the state! – in commercial banks to 25 percent, but allowed a five-year grace period for diminishing the participation of the state. Foreign ownership was handled in a liberal way; the Act prescribed only the requirement of registration in cases above 10-percent ownership.

In the case of banks and insurance companies at the time of privatization, the competent branch ministry, in most cases the Ministry of Finance (and not the organisation of privatization) exerted the ownership rights of the state. A similar situation did not exist either in the industrial sector nor in agriculture or services. In this way, the Ministry administered the privatization of the Hungarian Insurance Company (1990), the General Banking and Trust Co. LTD. (1990), the State Insurance Company (1991), the Budapest Bank (1995), the Hungarian Credit Bank (1996) and the Danube Bank (1995). These transactions were organised without any publicity or competition, and the public does not know the conditions even today.

Bank privatization was completed in 1998. In comparison to characteristics of bank ownership in the developed countries and countries of Central and Eastern Europe, the bank privatization in Hungary was unparalleled. Not only because in less than ten years the percentage of state ownership decreased to 20 percent, but also because, at the same time, foreign professional investors assumed a dominant role.

The sale of bank and insurance company shares did not bring in significant budgetary income, and foreign investors achieved the majority position through capital increases. The primary interest and rational behaviour of privatised banks was to concentrate on risk-free, state deficit financing, which brought tens and hundreds of billions in profit. Granting credits to enterprises sunk to second place, since the HUF five-to-ten billion profit gains or losses had no real importance to the banks.

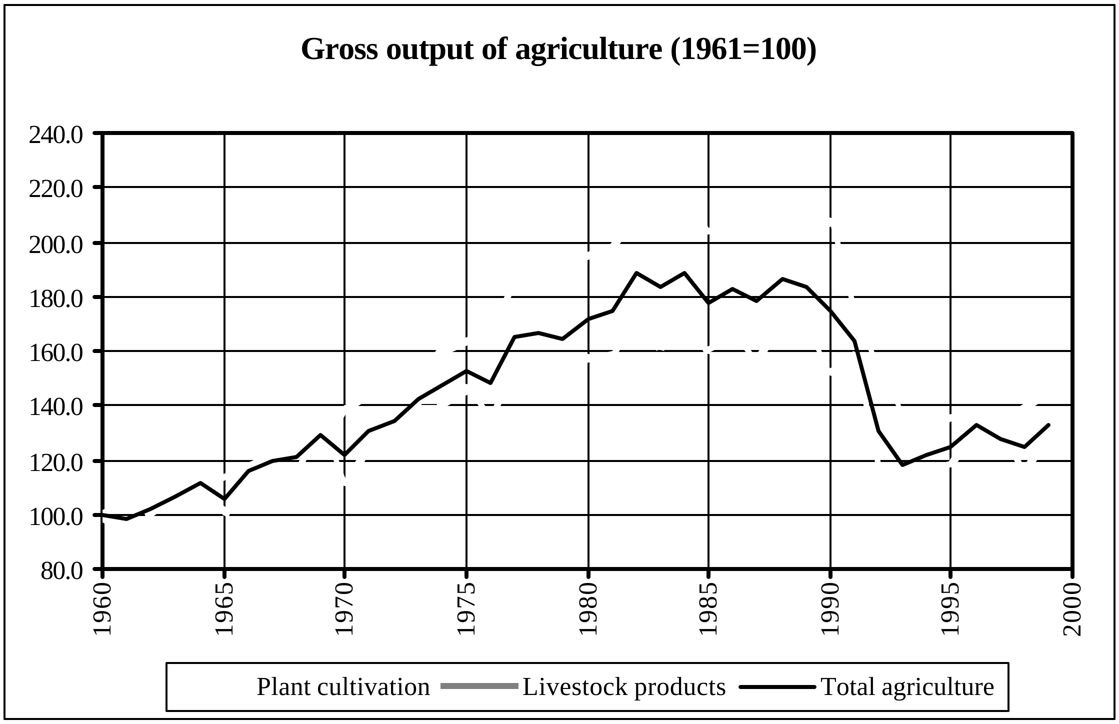
Privatisation, on the one hand, enhanced the economic capacity of traditionally better-off regions (the capital and its area and Transdanubia), while, on the other, contributed to a large extent to the economic decline of regions dominated by socialist economic monoculture (especially in northeast Hungary). In the latter areas, unemployment far exceeds the national average.

3.2.3. Privatization and structural change

Privatization in the Hungarian industry directly and indirectly became an engine of economic modernization, in as much as it set a great wave of green field and expanding investments in motion. Notwithstanding the positive impact of privatization, however, privatization enhanced the economic capacity of traditionally better-off regions primarily (the capital and its area and Transdanubia), while, on the other, contributed to a large extent to the economic decline of regions dominated by socialist economic monoculture (especially in northeast Hungary). In the latter areas, unemployment far exceeds the national average (Rechnitzer 1998).

The privatization of Hungarian agriculture was a most political exercise in the first half of the 1990s. The abolition of the collective farm system was carried out through the compensation of the former owners of the land. However, the new entrepreneurs created by compensation did not have enough capital to start, carry on and develop farms, and they were driven to draw on external resources, which later worsened their situation. It is characteristic that tractive power in the agricultural sector declined by 30 percent and the use of fertilisers by one fifth. The initial decline in employment continued during the decade both in agriculture and forestry; in food processing, the nearly total privatisation over five years was accompanied by a 30-percent decrease in the number of employed in that sub-sector. Although the drop in agricultural output stopped in 1993, in the following period growth was slow and unstable, and on average around a two-percent increase could be observed (see figure 2.).

Figure 2.



Economic policy makers of the present and the future must take into account, with respect to the coming EU accession inparticular, that **the separation of landed property and leasehold remains a major sourse of tension in Hungarian agriculture. The landed property is split up into small pieces,** while the holding of land is more concentrated. 97.6 percent of landowners have less than 10 hectares of land, and their property makes up 41.2 percent of the total arable land. A large majority of smallholders leases its land to still existing co-operatives or to private entrepreneurs. No coherent agricultural strategy has been elaborated for the structure of Hungarian agricultural that is viable and efficient in the long run. A clear and well-considered agrarian strategy in the coming years will be needed both for domestic development and EU accession. The strategy could serve as a base for also taking correct decisions, from a long-term point of view, even if they should be made rapidly and under difficult circumstances.

Table 1.
Account on privatised wealth
(Billion forints)

Year	Original value of assets	Value difference at privatization	GDP deflator	Value difference in 1990 prices	Original value in 1990 prices	Privatization income at current prices	Privatization income in 1990 prices
1990	1631	5	100	5	2213	1	1
1991		80	136	59		31	23
1992		723	165	438		77	47
1993		152	200	76		170	85
1994		10	239	4		157	66
1995		0	303	0		481	159
1996		0	367	0		176	48
1997		0	435	0		340	78
1998		0	490	0		112	23
1999		0	532	0		130	24
1. Total	1631	970		582	2213	1675	553
2. Given to other property handle agency					-407		
3. Overtaken from other property handle agency					26		
4. Net (2+3)					-381		
5. Remaining in the possession of Stat property Agency					-759		
6. Privatized (1+4+5)					1073		
7. Income from privatization in 1990. price					553		
8. Privatization loss (6-7)					520		
9. Privatization loss in percentage of privatized wealth (7/5)					48		

Source: ÁPV Rt. Internet data – Statistical Yearbook, KSH 1999.

2.2.4 Economic and social impacts of privatization

The Hungarian privatization can be distinguished from similar reforms in other countries by a few major characteristics. In Hungary, privatization for cash played a leading role, instead of distribution by using coupons (on the basis of citizenship). In the first ten years of the transition, much more foreign capital arrived to Hungary than to other countries of the region, though it was only partly related to privatization, and mainly promoted green field investment. Employee shares and concessional credit facilities played only a limited role.

Having seen the different forms of privatization in practice, it is obvious that they were unable to satisfy all types of expectations in the same time. Spontaneous privatization was fast and less bureaucratic than other forms, but it was not satisfactory for financial and moral reasons. The demand for a controlled privatization emerged inevitably. Concessional privatization forms answered societal and party political demands, while privatization for cash contributed to the selection of strategic investors, expanding investments, and financial stabilization.

Structural adjustment through privatization inevitably led to tensions around employment on both company and macroeconomic levels. For employees, the number of employees is an important determinant of efficiency, costs and labour organisation; for employees, privatization was a cause of great conflict, mainly for those who lost jobs of many decades and, lacking convertible knowledge and adequate employment possibilities, remained permanently unemployed. The uncertainty of survival that accompanied the reduction of the work force weighed heavily on all employees. At the same time, the interests enforcement possibilities of employees also worsened against the new management.

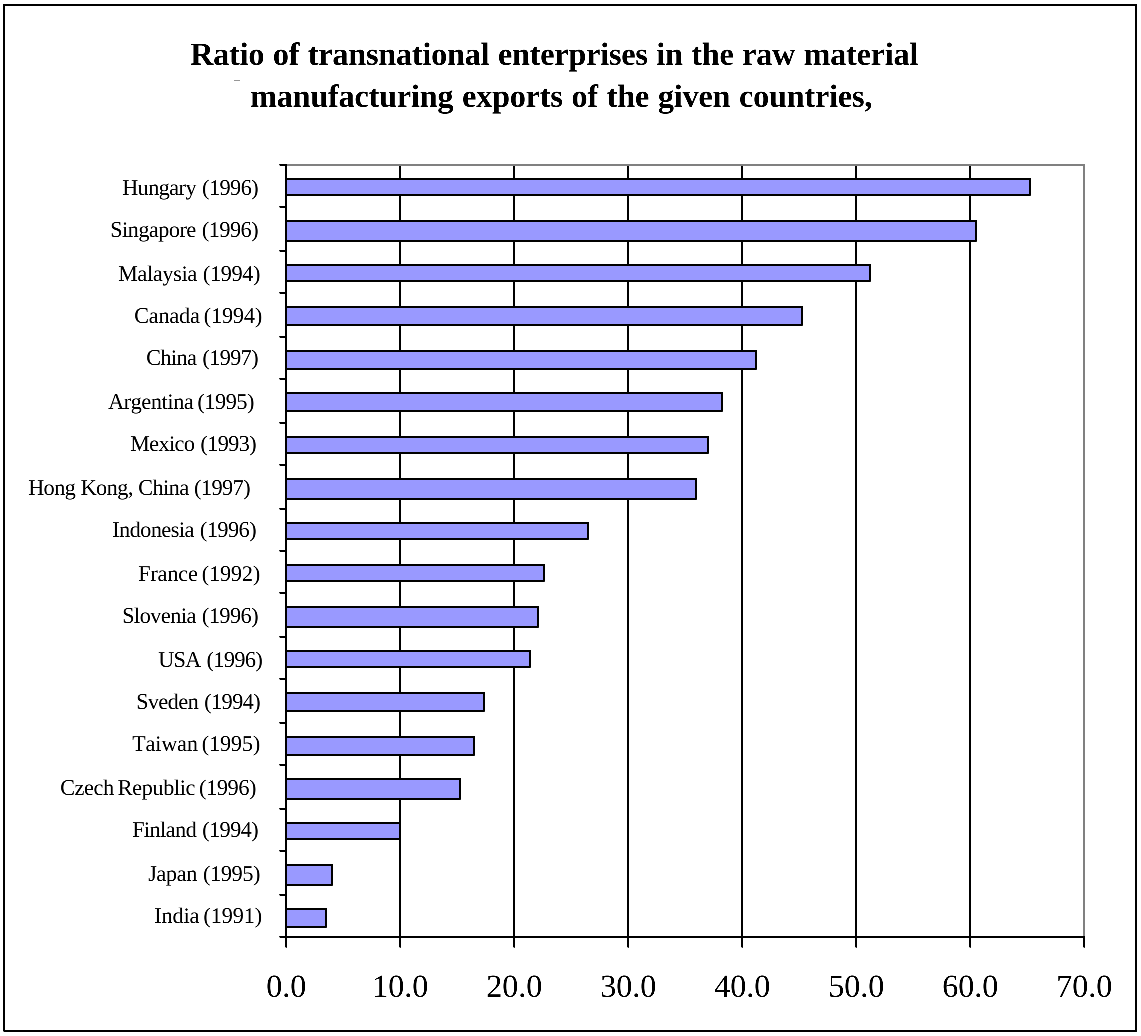
In cases in which transformation was successful, previous social provisions generally remained. However, when transformation financial difficulties arose, social provisions were eliminated slowly or more rapidly. Two types of typical processes can be identified in the case studies: either the immediate termination of social provisions and institutions (e.g., libraries, sports establishments, cultural houses, canteens, crèches, kindergartens); or, as a business situation worsened, the slower liquidation of provisions (refunding of meal and travel costs, working clothes, holiday contributions and own holiday houses, different allowances, etc.) (Hanti 1999).

Privatisation together with green field investments resulted in a ratio of foreign ownership in Hungary that is outstandingly high in international comparison. According to an analysis published by UNCTAD (UNCTAD 1999), the share of transnational companies in the exports of raw materials and processed products is the highest in Hungary at 65%, while the same ratio in countries better integrated into the European Union and comparable to Hungary in size (Sweden, Finland) is only around 10-20% (Figure 3).

The proportion of foreign capital exceeds 50% in almost each industrial sector (Table 2). In the view of the civil organisations this is excessive, fragments the domestic production chains (e.g. agriculture – food processing – wholesale and retail trade), and results in considerable uncertainties in the external equilibrium of the country.

Civil organisations consider that privatization has not resulted in creating an internationally competitive domestic entrepreneur stratum. They consider the participation ratio of foreign ownership to be too high, and the ratio of employee or cooperative ownership (which they consider „democratic" too low.

Figure 3.



Source: World Investment Report 1999, UNCTAD

Frame 5.
The role of foreign investors

The total of privatization receipts amounted to 1601.3 billion forints (in current prices) between 1990 and 1999. 59.7 percent of this amount, the equivalent of 955.4 billion forints, came in foreign exchange, which means that around two-thirds of the privatised wealth went into foreign hands. Foreign participation further increased later, since in several cases the foreign owner increased capital, bought shares or in other ways bought the assets of Hungarian owners.

The share of foreign capital in privatization according to countries of origin and based upon foreign-exchange receipts was as follows:

	Percentages
• International open sale of shares	30.3
• Germany	25.5
• USA	13.3
• France	9.0
• Austria	5.2
• Holland	4.4
• Italy	3.0
• Belgium	2.9
• Great Britain	1.7
• Switzerland	1.6
• CIS	0.9
• Finland	0.6
• Others	1.6

Source: www.apvrt.hu/menu1/v22140.html (2000.05.29)

Frame No. 6: Non-governmental Organisations about Public Utilities

The privatisation of public utilities brought about positive effects manifested in the improved service standards as well as a number of negative consequences, most specifically the dynamic price increases considerably in excess of the average rate of inflation. The increase of prices to the market level was justified, but its speed was unexpected to most consumers. The income levels could not keep pace with the explosive price increase of the public utility sector, which contributed to a considerable extent to the process of impoverishment after the systemic change.

In the view of NGO's:

– The state should not withdraw from the public utility sector; a controlling majority or ownership holdings representing at least 25% + 1 votes should be retained or acquired with market techniques in every company without exception.

– New types of relationships should be established with municipalities so that local interests can be harmonised with strategic considerations and public utilities in mixed ownership can be operated efficiently.

– Price regulation covering all public utility services, the design of pricing principles and their co-ordinated enforcement, the approval and announcement of prices should be transferred to an independent price regulator. Such activities should be terminated in line ministries and transferred to the aforesaid agency.

– Preparations should be made for exercising ownership rights in the companies to be retained permanently in state ownership and falling under sectoral control. (In the outlined regulatory environment the state can act as just as good an owner as any private investor).

2.3. Reform of public utilities

The management system and basic problems of public utilities were similar to those of enterprises in the competitive sector. Nevertheless, for a few basic reasons, utilities had to be treated differently. Public utilities are largely natural monopolies and, therefore, the security of provisions, general access to services and affordable price levels are issues that have heavier weight than in the case of other products or services. Despite these reservations, the Hungarian government privatised a large segment of the infrastructure sector (telecommunications, energy production and services) in a single campaign in the mid-1990s. As a result, Hungary now ranks second in Europe after England in the proportion of private ownership in the utility sector.

During the period of privatization, service prices increased continually. Extremely striking is the fact that the price of household consumption of electric energy in 1998 was ten times higher than in 1989, which caused profound payment difficulties for families living on or below the subsistence minimum. No compensation system was elaborated, and the problem remains unresolved to this day.

2.3.1. The reform of the energy sector

The transition to a market economy and the profound change in the national economic structure required the elaboration of a new energy policy and the adjustment of the company structure to the international standards. As early as 1990, the government's intention was to join the Western European electric-energy system (UCPTE) as soon as possible. Following a broad professional discussion, the Parliament adopted a resolution based on the principles of the new energy policy in 1993. The principles that were affirmed and then slightly modified in 1995 emphasised market conformity and gradual liberalisation, **but did not content the aim of privatization**. Shortly after, however, structural adjustment was carried out through privatization. For the execution of the new energy policy, a state regulation office was organised (Hungarian Energy Office, or MEH).

Table 2. The ratio of foreign capital in the subscribed capital 1999

Branches	Subscribed capital	Foreign share in subscribed capital	Ratio of foreign share, %
Agriculture, forestry, fishing	310.0	29.9	9.7
Mining and quarrying	31.2	10.1	32.5
Food beverage, tobacco	378.3	229.1	60.6
Textile, wearing apparel	82.5	42.7	51.7
Wood, paper, publishing	119.3	51.7	43.4
Chemistry	327.6	189.6	57.9
Non-metallic mineral products	96.2	66.5	69.1
Basic metals	135.1	76.0	56.3
Machinery	417.7	296.7	71.0
Furniture and other manufact.	25.5	10.5	41.1
Electricity, gas and water supply	1038.3	289.3	27.9
Construction	132.6	39.1	29.5
Wholesale trade	443.5	207.7	46.8
Retail trade	250.8	101.0	40.3
Hotels and restaurants	175.2	50.4	28.8
Transport	458.9	16.5	3.6
Telecommunication	273.6	195.9	71.6
Financial intermediation	503.4	274.8	54.6
Real estate activities	590.7	149.1	25.2
Other services	816.5	230.9	28.3
Total	6606.8	2557.6	38.7

Source: ECOSTAT Institute for Economic Analysis and Informatics of Hungarian Central Statistical Office

In the state socialist system, the three segments of the electric-energy sector—production, distribution and sales—operated within the same company, the Hungarian Electric Works (Magyar Villamos Mûvek, MVM). During the transition, a three-level system was developed. In one group are eight electric power stations that were previously integrated with the supplier mines in common companies. MVM remained independent and is responsible for the functioning of the national electric network and for the electricity transport between the power stations and service companies (wholesale trade). The third group consists of six service companies that supply the population, enterprises and institutions with electricity. Similar to electric-energy supply, the gas-supply system was also developed in six regions, with six companies established for this function.

In the spring of 1993, the property of the electric-energy sector, which was worth nearly 600 billion forints, was in the hands of three owners. ÁVÜ disposed of about 48 percent of the property; it preferred rapid privatization, being pressed by budget payment obligations. In two years, ÁVÜ was able to sell the six electric-service companies and six power stations. Service companies were bought in large part by German firms (RWE, Bayernwerk) and otherwise by French (EdF) professional investors. Power stations were purchased by German (RWE), Belgian (TRACTBEL), American (AES) and Finnish-Japanese (IVOTHOMEN) professionals and by American and Hungarian financial investors. MVM Rt., Atomic Power Station Rt. Paks, Power Station Rt. Vértes, and OVIT Rt. remained in state ownership.

Frame 7.
Critical remarks on and deficiencies of privatization
most frequently mentioned in citizens' opinions

- State policy could not impede foreign market purchases;
- Financial investors often withdrew profits quickly and, for short-term advantage, also liquidated efficient production;
- The preference given to foreign investors (1994-1998) worsened chances of the domestic middle class;
- The new owners didn't give or implement employment guarantees, and, for that reason, firms were sold again or liquidated in two-three years;
- Local trade unions were not involved either in the preparation or in the execution of transformation;
- **Possibilities** of functionaries of trade unions were often curtailed; in some cases they were subjects of staff reduction, too;
- In staff reductions, dismissals, payments of indemnification, **wages and salaries on the period of notice**, the rights of employees were often infringed upon, and disbursements were often deficient;
- Employees' participation was neglected or excluded from the competition.

In the privatization process, foreign professional investors could purchase a package of shares up to 50-percent ownership, but, in accordance with privitisation contracts, they received the majority of voting shares in the principal organs of the companies (board of directors and supervision). Therefore, the control over the companies was put directly into the hands of foreign investors, and they subsequently strengthened their position through ownership of more than 50 percent of the shares. Minority shares are divided among ÁPV Rt., local communities, employees and small investors. In the contracts, the state has given guaranteed profitability to private firms (ROE, 8 per cent) and also built into the price level the costs of loss-making mines **on the account of the population**. (The latter was primarily due to the power of trade unions that lobbied effectively in defence of jobs in the mining industry.) Privatization contracts were qualified secret documents as far as the public was concerned. Service prices soared and further conflicts arose.

Structural adjustment of the Hungarian gas and oil industry was on the agenda starting in 1990. The first step was the division of the National Oil and Gas Industry Trust (OKGT) into various parts. Privatization was carried out in 1995 when six gas-service companies were operating gas pipelines supplying nearly the whole territory of the country. Five companies were in state ownership, while the sixth, unique owner was the municipality of the capital.

The French GdF acquired from ÁPV Rt. the majority of the ownership of two gas-supplier companies, the German Bayernwerk/EVN and Ruhrgas/VEW bought two others, and the Italian Italgas-SNAM acquired the fifth company. Thus, the ownership and management of the Hungarian consumer gas services were taken over by European multinationals. Since the privatization period, the above-mentioned foreign companies and other foreign and domestic investors (e.g., Gasprom, MOL Rt.) bought the largest portion of the shares of municipalities and employees, as well.

2.3.2. Transport and communications

In the 1950s and 1960s, during the forced industrialisation of Hungary, infrastructure, transport and communications lagged behind significantly. The catching up began in the 1970s, but in the 1980s it stopped due to the general economic recession in the country. Therefore, governments faced a considerable challenge in this respect after the systemic change.

Transport could not be privatised through methods similar to those utilized in the competitive sphere. Efforts had to be made to carry on the needed developments in the sectors remaining in state hands. The Parliament decided to keep railways (MÁV Rt.) in 100-percent state ownership. According to the decisions taken regarding the shipping company (MAHART) and the main local and inter-city traffic companies (29 VOLÁN companies), state participation cannot be less than 50-percent-plus-one voting rights. A 25-percent minimum, i.e., minority participation, was established for the national air-traffic company (MALÉV), but at the end of the 1990s the state ratio was still above 60 percent, **as an attempt at merger** was unsuccessful.

Over the past one-and-a-half decades, financial resources have been insufficient for the comprehensive modernisation of the state-owned mass-railway and road-traffic systems, despite the fact that these sectors, and particularly the railways, received substantial annual subsidies from the government. The situation is particularly grave as regards railway traffic. High price increases were typical for both railway and private vehicle traffic, while the level of services often declined.

Communication is one of the real success stories of the Hungarian transition. These systems were reorganized and partially privatised at the beginning of the 1990s. Before 1990, the Hungarian Post, as a single mammoth enterprise, provided all post and telecommunications services. After the systemic change, telecommunications was made independent, with MATÁV Rt. established through separation from the Post. Although MATÁV is still in a monopoly position, the company initiated and executed the comprehensive modernisation of the country's telecommunications system during the 1990s. Transition to digital systems started in 1991, and in a few years all centres were changed to digital guidance. The national network was built, assisted by loans from the World Bank, the European Investment Bank and, later, the EBRD.

MATÁV was the first Central European company the shares of which were introduced in the normal trading on the New York Stock Exchange. Before the shares' introduction, the government decided to keep only a golden share. The company was sold to strong, strategic investors in the middle of the decade. A consortium of Deutsche Telecom and Ameritech paid for the sale package of shares US$875 million (117 billion forints) and invested in the company another US$400 million in the form of a capital increase (Szakadat 1999: 33).

2.3.3. Water supply and disposal of sewage

In Hungary, half of the population was supplied with piped drinking-water in 1990, and this proportion reached some 98 per cent ten years later. Only 2-3 percent of the population is not supplied with network water, which is the result of a comprehensive government development program. The quality of water supplied by public utilities is adequate by sanitary norms, though the fulfillment of EU criteria causes problems in nearly 500 settlements. The situation of canalisation and disposal of sewage is much worse.

Water-supply ownership relations were transformed in the 1990s. Before the transformation, 28 public-service enterprises provided county or town water supply and five regional public associations also existed. With respect to the special role of the five regional associations, they still remained state property, but partial privatization is on the agenda. During the transition, local governments became owners of the water companies, which seemed politically reasonable, but raised economic problems in the later period. The ambition of local governments for autonomy resulted in a too fragmented structure, where more than 350 companies are in operation (Hoós 1999: 18), and this can guarantee neither quality, nor development facilities.

Public water-supply and sewage-disposal enterprises were transformed in two phases. In the first, the Act on Property Transferring (1991) gave the largest part -- around 80 percent of the wealth of public utilities -- to settlement municipalities, while the wealth of regional associations remained public property. In the second phase of the transformation, **getting 2-3 years experiences in independent operation**, parts of the associations were privatised. Only large size municipality and town water-supply and sewage-disposal associations went over to private ownership, mostly to foreign owners.

The major part of public-utilities privatization was prepared and executed during 1994-1995. At the end of 1995, around 42 percent of the property of this sector was in foreign ownership.

2.4. The reform of public welfare provision

The first blueprints of the reform of Hungary's public finances were outlined in the second half of the 1980s. However, the early phase of transition concentrated its efforts on restructuring the enterprise sector, and the reform of social systems was brought onto the agenda only later, when financing the country's social institutions ran into major difficulties. In the strained situation of the mid-90s, the World Bank proposed a detailed concept of the reform of the large social systems.

During the years of transition, the reform of public finances was never outlined as a complex program; even individual parts of public finances (municipalities, social insurance, aid, etc.) were not presented in the form of concretised reform programs to the public. In most cases, instead of reform we can speak only about adjustments within some segments of the social systems. One of the most characteristic paradoxes of government policies was that, although all governments stressed the extreme importance of education, health and the support of families, no substantial reform programs emerged for these sectors. Instead, these areas typically and continually suffered from the decrease of state expenditures.

In the mid90s, the notion of a "premature welfare state", coined by János Kornai, spread broadly among policy makers and the public. An axiom of the economic philosophy of transition was that the redistributive role of the state should be reduced. No scientific formula could have been given to the extent of the diminution, but economic-policy thinking usually said that the original 60+ percent redistribution (i.e., state expenditure as a percentage of GDP) should be decreased to close to 40 percent. Consequently, to mention any social area as a strategic aim or national priority was meaningless, since it ran up against an opposing dominant economic notion. In the seven years that followed 1989, state expenditures on education, health, culture and social provisions diminished by 25 percent in real terms (see Table 4.)

Table 4.
Social expenditures 1991–1999
(Percentage of GDP)

	1991	**1995**	**1998**	1999 modified estimates
Education	5,6	5,2	4,8	4,4
Health	5,5	4,4	4,6	4,3
Social insurance, social and welfare services	20,7	17,4	15,2	14,9
Housing, settlements and regions	4,0	1,9	1,4	1,1
Leisure, culture	1,7	1,7	1,2	1,2
Environmental protection	0,7	0,8	1,0	1,0
Social expenditures total	**38,2**	**31,2**	**28,1**	**27,0**

Source: Ministry of Finance, AHIR database, consolidated data

2.4.1. Public health reform

Similarly to many other areas, the post-1990 reform of Hungarian health care was inconsequent and controversial. The freedom of choice was established in basic provision, in as much as the previous district doctor system was replaced by electable family doctors. Another fundamental reform measure transferred the state-owned health-care institutions to the ownership of local and regional governments. However, the operations of these institutions were financed from 1993 by the newly established health care self-governments from contributions collected after wages. The total value of these contributions suffered a continuous decline because of the decline of employment and real wages, thus the costs of health care were increasingly burdened on the patients themselves. In the meantime, the financial facilities of local and regional governments narrowed too, which presented a threat to the maintenance and modernization of buildings. Thus the system has been working amidst a chronic financial crisis, while its structural inadequacies became more and more apparent too (i.e. excess capacities in hotel service).

Despite the deepening financial crisis and the apparent structural problems, the stakeholders of health care (subsequent governments, chamber of doctors, trade unions, local governments, insurance companies etc.) have not come to an agreement on the adequate model of health provision. In order to overcome the financial instability of the health care self-government, the ministry of finance initiated re-nationalization as early as 1995, but this was only carried out by the Orbán-government in 1998. The financial government, the insurance companies and the medical profession is seeking the way out towards privatization, but there is no political consensus about the actual method and acceptable extent of this (hospitals, insurance, family doctor network etc.).

While the debate continues among experts and politicians about the coming health care reform, the sector suffers from lack of adequate funding. The real value of budget expenditures on health has decreased by at least 15-20 percent since 1991, and the ratio of health expenditures to GDP declined from 5.5 percent in 1991 to 4.3 percent in 1998. Budget estimates project a further decline to 4.2 percent in 2002. The reduction of state expenditures and resources affected changes in the opposite direction from those reflected in strategic and professional views.

In spite of resource reduction and contradictions, health care still functioned and provided universal access to nearly all. It also more or less kept its integrative role, which is so important for sustaining the physical and social opportunities of life. The sense of vocation in the medical and nursing profession can be praised and credited for the continuation of medical treatment of sick persons under deteriorating and uncertain circumstances. The doctors and nurses bridged – as far as they were able – through their own sense of responsibility, honesty and intensity of work the organisational perturbations of the public-health system. But this sustaining force is also increasingly weakening.

The public-health strategy of the World Bank was built around three elements: cost efficiency; access; and quality. However, as regards the practical proposals, the first element proved much weightier than the other two. The requirement of universal access to health care was mentioned as a priority, but it is regarded feasible only if the realisation of this aim does not exceed the limits of economic performance and does not collide with the interests of sustainability and the labour market. These conditions could be met if the state would provide only a "basic package", which means that health services would also fall victim to the reduction of the redistributive role of the state.

The notion of an integrative, non-market reform of public health received some support recently. OECD recommendations, as well as several Hungarian experts and some politicians and a group of World Bank experts all argued for maintaining a high level of public financing of health care. The Bank proposed several times that very high health charges not be imposed on employers and employees and that taxes be utilized in the financing of public health. (That proposal has not gained a hearing yet.) Public financing does not exclude changes in ownership nor reorganisation. It assumes, however, stronger public control than is the case today, first and foremost on behalf of social institutions, and that voluntary insurance will play a complementary rather than substituting role when introduced into the system.

The contradictions among reforms coming from the unfounded, inadequate market models and the increasing difficulties related to the daily operation of the system are all coming down on the patients at the very bottom. Sick people are the primary victims of the liberalised pharmaceutical market, the reduced subsidies on therapeutic equipment, the growing costs and gratuities, and forced economies of indebted hospitals. Similarly, these patients have suffered from the reform of the sickness benefit system in and after 1995. The danger of discrimination by the employers grew, and due to the fear of being sacked, the number of employees who try to work even when they are sick increased.

In the perception of World Bank experts, health is not a social value, but the subject of individual responsibility. This approach met with the support of influential Hungarian economists and politicians and served the strong and growing interests of the insurance companies, too. However, this one-sided perception of public health is neither accepted in Western European societies (see as an example how far British society insists on the National Health Service). Even less relevant is the application of such an approach in the situation of transition economies, in which the general state of health deteriorated, income levels strongly differentiated and state control over social processes weakened. With the uncontrolled functioning of markets, the mass of market failures requires much more assistance from existing collective structures and their internal reforms than do an individualized system built on market forces and individual responsibility. In Central and Eastern European countries, required state intervention cannot be reduced to basic package, the limits of which are determined by cost efficiency without serious social consequences.

2.4.2. Education

The educational system was deeply transformed in the 1990s, despite the fact that none of the education ministers have presented a complete and comprehensive plan for the reform of education. Modernization, getting in line with Europe, adjusting to the requirements of a market economy, freedom of choice, improving the level of education, and cost economies were the clues to the direction of change.

The role of the state decreased in favor of local government. The decentralization to municipalities evolved the responsibility for education to the local level. Current financing is based on a normative head quota, while development financing is up to the resources of the owner local government and the state funds available through competition. At the end of the decade, the majority of schools became embedded in local communities, with the many advantages and disadvantages of that situation. Schools began to play an integrative role in the villages, but it was also more and more difficult to maintain schools, including kindergartens where the municipalities were poor.

In addition to state institutions, ecclesiastic, foundation and private schools began to appear. The multisectoral school system increased the freedom of choice for parents, but the return of some schools to the churches caused tensions at the beginning. Foundation and private schools often segmented the system and increased inequalities of opportunity, though the share of **private** schools increased slowly.

Although the Bank has supported the education development, viewed that the system inefficient, wasting the resources and almost fully financed from public money (e.g. pare 8-9 in report No P7124-HU). This viewpoint ignored the Hungarian wage and income system, and resulted in saving proposals which made the education sector one of the greatest looser of the system transition. In the beginning years the real value of the education expenditures decreased, then during the fiscal squeeze the government requested big savings. Overall the real value of the education expenditure dropped by one third from 1990 to 1998. The support for higher education has decreased from 1.3 to 1.0 percent of GDP between 1994 and 1997, while the average in the OECD countries is 1.6 percent of GDP.

Education faced serious problems due to demographic changes in the 1990s: the second demographic wave impacted the higher grades of primary schools at the beginning of the decade, then moved to the secondary schools and, at the end of the ‘90s, reached higher education. In kindergartens and primary education, the number of children decreased more rapidly than the number of teachers, which improved the child-per-teacher ratio. In secondary schools, the number of pupils greatly increased, but the number of teachers grew at a somewhat higher rate. Thus, by international comparison, temporarily too few pupils were left for teachers in the primary and secondary schools. The "low efficiency" of education became a target of international (World Bank, OECD) criticism. The dismissal of teachers created pedagogue unemployment.

Following the advice of the World Bank and the European Union, the number of students more than doubled in the high schools and universities. The burden on teachers and the number of students per employed teachers grew significantly. But, after the dismissals, the number of teachers has been increased again. The growing number of high school and university students is an important contribution to the future and a particularly positive feature of the reform in the context of the country's accession to the European Union. However, the last loan of the Bank supported higher-education reform only, and higher education will not be successful in the long run if the level of education worsens in the primary and secondary schools.

The pedagogues suffer the main losses these constraints -- the schools that have no possibilities to find complementary resources, as well as the infrastructure of education that is, generally, deteriorating or being only slowly modernised. Nowadays, the teachers' particularly bad salaries also place obstacles in the way of improving education.

The central personage of education is the teacher; in Western countries, teachers' salaries express somehow their important role. According to OECD data, in all Western countries, including in poor countries like Greece or Turkey, teachers' salaries are 1.1 to 1.7 times higher than per capita GDP. In Hungary, salaries of primary school teachers were 68 percent of per capita GDP in 1993, and that of secondary school teachers 72 percent. The situation worsened as GDP increased while the real value of teachers' salaries declined. Only employees in the health and social service industries are in a worse position among intellectuals and sectors of the economy (see Table 5.) (Ferge 1999: 104-106).

Table 5.
Net salaries of employed intellectuals in 1998

	National economy total	Within the national economy:		Mostly within the budget:		
		Competitive sphere	Budget	Administration defence etc.	Educa-tion	Health and social services
Average net monthly salary HUF	58,072	66,587	49,435	61,934	44,542	40,776
National economy average=100	100	115	85	107	76	70

Source: Monthly Statistical Bulletin, KSH, 1999. 1. 10.

The cost of education increased to a large extent in the 1990s, which fact diminishes the opportunities of children living in families of bad financial circumstances. Normative funding cannot offset this problem. In spite of the increasing number of pupils in secondary and higher education, the chances of continuation of studies and the learning of a profession are bad and worsening for children coming from unskilled, unemployed, poor or romany families and for those who live in crisis districts. The gap between elite schools and those of poor settlements and districts increases. District forming appears to be a rational answer, though this has been opposed on the basis of political aversion.

The World Bank played an initiating role in the Hungarian educational reform and continuously urged its implementation. In fact two loans served educational aims. The first financed the Human Resources Project, which was signed in 1991 and produced very positive results. The loan contributed to the building of labor-market organizations, to the development of adult education and retraining, and to qualitative changes in middle and higher education. The second loan – the Higher Education Reform Loan – was signed in 1998 and was aimed at assisting the development of the technical, organiza tional and substantial conditions of a modern higher-education system, with some positive and several questionable elements. The educational recommendations made valuable contributions to the improvement of technical, organizational and substantial conditions, but their implementation caused several problems, too, since they over-emphasized the copying of the experiences of developed countries.

2.4.3. Family allowances

In the area of family allowances, a number of important, and often contradictory reform measures have been taken. Altogether, the guiding principle at this field was reasonable cost economies, as the budgetary proportion of these allowances (family allowances, child-care benefits, cheap child-care institutions, etc.) was high in comparison to Western standards. However, that comparison gives a false impression, in as much as the allowances functioned in the past as "indirect wages". In spite of the relative low wages of the time, the families could live on them, because **price and other subventions** diminished the cost of bringing up the children. In the 1990s, all these wage supplements were abolished without compensatory increases in the wage level.

The *Antall-government* in 1992 transformed the earlier maternity aid into a maternity allowance provided during the whole gestation period in order to inspire childbirth. In 1993 a new provision was introduced, the child education support (with the Hungarian initials GYET) for mothers educating three or more children. From the beginning, this support was due to families below a certain income level, and until 1996 a condition was also that the mother had previous employment. There is no evidence that IMF or World Bank criticised the new provisions directly, though these extra budget expenditures could play a role in the negative evaluation of the government's financial policy. At the same time, between 1990 and 1994 the real value of the family allowance decreased by 30-35 percent, the reduction of crèches began (the normative support ceased), and the costs of children's meals were raised in child-care institutions and schools.

The *Horn-government* introduced a stabilization package in March 1995, whichproposed as an element of the reform of public finances -- not as a temporary measure but as a final change -- "to reduce the scope of free-of-charge provisions, the partial privatization of non-basic elements of the provisions". The package and the follow-up measures were based upon the principles and strict requirements of the IMF and the World Bank. The Act on Stabilization decreased family allowances (family allowances, childcare benefits, child- education support, maternity allowance) and tightened the entitlement conditions. The Constitutional Court objected mainly to the speed of introduction, so most elements of the package remained and only the validation was delayed. In the end, only few families (6-7 percent) were driven out of the family-allowances program as a consequence of the introduction of the income certification since the income ceiling was set at a relatively high level. Significant cost savings were achieved by decreasing the real value of provisions. The economic measures of the stabilisation package might have been successful, but the impact of the social-policy elements was damaging to Hungarian society , while they brought about only limited savings in public finances.

The adoption of the Act on Child Protection was a landmark in 1997. The law represents a new approach in caring for "children in danger": it tries to prevent children leaving their families and to accelerate their re-joining the family by using new instruments, creating new institutions and applying new methods. Broad and important functions are given to a modern social-service system. The law regulates child assistance for the first time at almost a European level. Unlike the earlier education aid program the new child-protection allowance is not discretionary, but established on a legal basis. However, in its technique and methods of regulation many anachronisms remained. The fixed allowances, that neglect the differences among the circumstances of families, are unjust and have a significant negative effect. The assistance to families is based upon two (or more) laws and is not concentrated on the family per se, but rather supports separately the child, the unemployed, and the elderly. This deficiency contributes to the lack of guarantee that the aid will be truly sufficient for solving the most serious problems, for example, keeping the roof over the heads of families with children.

The *Orbán-government* in 1998 made family allowances, childcare benefits, and child-education support universal, which simplified and made less expensive the administration and ceased the negative effects of the previous regulation. Family allowances became more transparent, and the partial centralization of claiming the allowances (in part by freeing local governments and smaller enterprises from administration) might mean a step forward towards better organising the rather chaotic welfare system. However, claiming allowances became more complicated, the administrative tasks of schools increased, and more institutions subsequently had to deal with family support.

It is noteworthy that beside the "responsibility for the well-being of children" the new legislation indicated two other aims: support for social equality of opportunity and the demographic policy aim of increasing the birth rate. Unfortunately, these aims have been accomplished in practice only partially, contradictorily or not at all.

Disintegration is a serious problem of the operating system of family provisions. Only children are provided rights to three-four different allowances. Besides, the rules often change while the real value of allowances further declines. The majority living in relatively better circumstances is able to utilise the conditional allowances, weakening the correctness of the system. The policy of the third government is aimed at supporting middle-class families, and its conservative-oriented family policy applies rigor against the poor and those living under the worst circumstances.

Concerning families with children, the balance after ten years after the systemic change is disturbing. The decrease of the principal family allowances (see Table 6.) demonstrates this conclusion, since tax exemptions only partially compensate for the losses.

The many kinds of changes -- labor-market, legal, budgetary – taken together have deteriorated the circumstances of families with children. There exists strongly differing data about the poverty of children and families with children. From of civil-society information a dramatic picture emerges about children who are badly nourished, have colds and do not receive medication. According to the data of the Central Statistical Office (with the Hungarian initials KSH) derived from a broad sample in 1987, families with one child could live slightly above the national average standard of living, while families with three or more children could achieve only 65 percent of the national average. In 1995, the numbers were 97 percent and 58 percent, respectively.

Table 6.
Changes in the principal family allowances, 1990-1998

	1990	**1998**	**1990**	**1998**
	Family allowance		Child-care benefits and child-education support together	
The number of beneficiaries, thousands	2498	2041	240	244
Per head average, forints in current prices	2144	4908	4660	14305
Real value, 1990=100*	100	4	100	5
Percentage of GDP	2.5	1.2	0.53	0.38

Source: Statistical Yearbook 1998, KSH — Review of social circumstances 1999, KSH, 2000
*/ Note: The consumer price index 1998/1990 is 517,7

Concerning children and families, the recommendations of the World Bank emphasized two contradictory aims. The first advocated the decrease of family allowances deemed too high in relation to the Western European average. The other, somewhat later emphasized aim was the prevention and reduction of child poverty by means of well-targeted subventions. The proposal implied not necessarily individual targeting, with the certification of income and wealth levels justifying aid, but also the acceptance by the World Bank of the practice of group targeting.

In the view of non-governmental organisations the two objectives are mutually exclusive, not only because child benefits in the previous system were income supplements but also as other factors aggravating the position of children or families with children have appeared such as the reduction of price subsidies affecting children and, in particular, unemployment. The situation of the unemployed is somewhat improved by the fact that since 1990 child benefits have not been linked to employment, that is, unemployed families are also eligible, even if the amounts are low and declining in real terms. However, the position of families and their willingness to have children have been adversely affected by the frequent changes in and unpredictability of child care benefits. The contradictory nature of the two objectives is further highlighted by the fact that the World Bank identified, among the conditions of credit disbursement, only austerity measures and cuts in social expenditure. Proposals for improving the situation were only recommendations, the implementation of which depended on the decision of the governments under financial pressures.

(repetition)

2.4.4. Pension reform

Hungary's pension reform marked a turning point in the transformation of the welfare system. Experts recognized the inevitability of reform early in the 1980s when the financing of pensions became more and more difficult, and the diminution of the real value of pensions became an element of stabilisation policies. Transparency of the system worsened, and the system was fully exposed to the policies of changing governments. Different options or modifications were not professionally elaborated; actuarial estimates were not prepared on the long-term relationship between contributions and pensions since the 1940s. During the transition, the number of pensioners rocketed, financing difficulties increased, and demographic changes projected a structural crisis in the long run. Reform could not be postponed any longer, but its tendency changed several times during the decade.

Principles of the pension reform as drafted in 1991 implied (a) a pension system of three basic elements, (b) a gradually rising pension age-centre, and (c) a clear and transparent relationship between contributors' contributions and their pensions. Implementation started sluggishly. Between 1990 and 1994, the laws on social insurance **self-governments** and voluntary pension funds and, in 1996, the law on rising retirement age were passed. The rise of retirement age was also supported by studies of the World Bank.

The need for pension reform appeared in loan agreements and other studies of the Bank at an early stage (Tóth 1999: 25-26). In the first period, goals were established to reduce the ratio of pensions in social expenditures, to diminish the number of pensioners and to correct some deficiencies in the existing system. After 1992, the reduction of expenditures continued to be found in loan agreements, though in other Bank documents there also appeared the idea of privatization. In 1994, the World Bank published and widely publicised the **great** monograph entitled "Averting the Old Age Crisis," which set forth in detail the multi-pillar proposal, which generated wide public debate over the issue. An unprecedented professional and public dialogue emerged on the introduction of the three-pillar pension system. There was no example before for such a vivid discussion of policy issues between government experts, stakeholders and individuals in Hungary. Finally, the government and the parliament passed the bill on the three-pillar pension system in 1997 Fall, and it became effective from January 1, 1998.

The three pillars of the system are the following. The first is a pay-as-you-go type, compulsory public pension, financed from contributions paid by employees. The second is a compulsory private pension, which is collected on individual capital accounts. The third pillar is the voluntary insurance that can be contracted with private insurance companies. According to the law, every person entering newly the labor market must join the three-pillar system, while those already employed had the right to choose within a certain period.

Following the adoption of the law, the government and interested financial institutions initiated a large-scale campaign to make known the advantages of the system and to gain clients. This was so successful that many more people joined the private pension funds than foreseen.

Calculations suggested that those below the age of 40 or 45 could gain substantially by joining the new system. Indeed, some 90 per cent of those who transferred belonged to the generations below 40. The number of members in the new system reached 2 million, which was double of the original expectation. This success was devoted to the lack of confidence in the old system and the success of the new, though other experts believe that the massive marketing campaign was the main cause of the tide.

As a consequence, the budget deficit increased more than expected. In 1998, the new government taking office took actions to diminish the deficit.

The NGOs view that the new pension system is primarily beneficial for the higher income social groups. The first pillar, the citizens minimum is too low, it is rather a grant than a basic pension benefit. The second pillar is a biased nature, because on the one hand compulsory, on the other hand is managed by the private pension fund. Under these new conditions, the future pensioners ought to pay a higher share of their income for pension premium and still they have a chance for a lower pension benefit than before - except the higher income social strata.

Voluntary pension benefit is practically available only for the social groups with high and stable income.

Frame 9
NGO view on the pension reform

The World Bank study on pension reform encouraged those experts, interest groups and political forces that stood for privatization or were directly interested in it (e.g., the private insurance institutions). The fight between the Ministry of Finance, which turned into a devoted advocate of liberalization, and the other government offices and civil actors went on for three years. Finally, the position of the Ministry of Finance, enjoying the support of the financial sphere, won. The socialist-liberal coalition government accepted the reform recommendations of the World Bank, and the Parliament passed legislation creating the three-pillar pension system in 1997.

In examining the social impact of the new pension system, it is doubtless that it favors the higher-income strata of the population. The adoption of the law can be explained by the fact that these strata of the population (often called the winner of the systemic change) could better assert its interests within the political elite than could the average citizen. Following the adoption of the law, the government and interested financial institutions initiated a large-scale campaign to make known the advantages of the system and to gain clients.

On the matter of private pension funds, many rather irresponsible and tempting promises were made about the future benefits. In reality, private pensions depend partly on the performance of institutions (which itself depends on the calculated costs that are seldom mentioned) and partly on the development of the economy over the next 20-50 years. Of course, the state of the economy also influences public pensions, but in a less irreversible way. Private pensions bear accumulated risks. Therefore, we know less about the future of these private pensions than about public pensions. It can be stated with near certainty that the chances for the degradation of the relative (and perhaps also of the absolute) level of pensions are greater than for their improvement. Such intuitions might influence the present malaise of the pensioners.

The situation of the pensioners during the transition was influenced by the fact that the number of pensioners soared under the threat of unemployment. At the same time, in the economic-crisis situation, total expenditures on pensions slightly declined and individual pensions significantly decreased. The real value of average pensions decreased more than that of wages and salaries. To make matters worse, those pensioners who previously were employed were forced out of the labour market, and many of them became participants of the shadow economy. During the economic transition, the income gap between pensioners and family members living in households where the head is active and those with an inactive head of household substantially increased. However, the proportion of the poor and very poor is smaller among pensioners than in other groups of the population, since the pension minimum – be it as low as it is – is still more than other social provisions.

Frame 10
NGO view on the situation of pensioners

Beside the income level, the price system also influences the situation of pensioners. Price **proportions** changed for the elderly and families with children in an unfavorable direction. Prices endanger the satisfaction of certain needs of the elderly and pensioners (e.g., buying medicines and household energy) to a larger extent than do decreases in incomes. Thus most pensioners believe that there is no hope for the improvement of their material conditions.

3. CONCLUSIONS AND RECOMMENDATIONS

3.1. The evaluation of the economic transition

It is a widespread opinion that it is too early for an evaluation of the systemic change, as the results don't manifest themselves at once. However, a continual evaluation is important to people living in this country, since that is the basis for correcting social and economic processes if it is needed and possible. Parliamentary elections every four years exert the main control on political actors, even if not all questions are discussed with adequate weight. There are no institutionalised mechanisms through which to control or exert pressure on international actors (multilateral and private institutions). Periodically or after the closure of programs, it is reasonable to find adequate forms for dialogue, that make possible a post-evaluation. That is why we deem it very important to assess the role of the World Bank in the Hungarian reforms. This task cannot be carried out without a brief evaluation of the reforms themselves and of the transition.

Frame 11.
NGO view on the question of responsibility

On balance, the Eastern European transition is much more negative than forecasted by the initiators in 1989. This could not happen for reasons outside the influence of acting economic policymakers; there is a common responsibility of Eastern and Western participants for the failures. The basic responsibility rests on the new political elite of the 1990s, but the leaders of various political and economic great powers are also not exempt from responsibility. Not a few Western experts, e.g., Timothy Garton Ash and George Soros, have declared that Western governments have remained indifferent to the many problems of transition countries and must help much more. Not a few leading economists, such as Joseph Stiglitz and Jan Kregel, have criticised for several years those exported economic ideas, that have guided the transformation of previous socialist countries. However, one should not forget about the responsibility of local decision makers during the transition. In the 1990s, many enterprises and local economic and political leaders cared only about protecting their advantages. A dangerous differentiation developed in the society; a deep gap now separates the liberal and humanitarian rhetoric of the transformation from the actual economic and social processes.

Similarly to other East European countries, Hungary suffered an income loss during the transition that was much greater than expected at the beginning. There were several, coinsiding causes for that, like the disintegration of CMEA, the deterioration in the terms of trade in CMEA relations, the impact of the accelerated trade liberalization, the severe bankruptcy law, the temporary lack of ownership interest that resulted from the wholesale privatization period. The coincidence of these factors resulted in a 20 per cent loss in the GDP in the early 1990s, with further repercussions on society.

Despite the substantial loss in incomes, various international evaluations suggest that in Hungary, the introduction of the market economy was much more successful than in most countries of Eastern Europe and better than in all of previous member states of the Soviet Union. A reason for this can be found in processes before 1989, because the introduction of market-economy elements already started in the sixties. The managers of state-owned enterprises were exposed to market effects to a large extent in the 1980s and there was an important small-enterprise sector, too.

Frame 12.
Differing opinions on the success of the transition

In the view of multilateral organizations, and much of the neighbouring and distant states, the Hungarian transition has been one of the most successful ones. This opinion is supported by the acceleration of economic growth and the declining unemployment in the late 1990s. The Hungarian economic transition has been an outstanding success in certain areas, such as the explosion in telecommunications and the development of the Hungarian personal car production. The country is no longer regarded as seriously indebted, and it has entered into negotiations on accession to the European Union, to which the country's economic policy is also approximating more and more.

In the view of NGOs, however, with successes have come the failures: losses in the real economy as a consequence of the precipitous import liberalisation; the weakness of the domestic small and medium-size enterprise sector and the overrepresentation of foreign capital in the economy; the ruining of Hungarian agriculture; the expansion of the hidden and black economy; and, above all, the poverty of one third of the society -- the social deficit. The performance of the Hungarian economy can give rise to satisfaction only in comparison to the tragic situation in the neighbouring Southern and Eastern countries. The Hungarian GDP achieved its 1989 level after ten years. Such often-mentioned opinions as, for example, "the Hungarian economy and society paid a hard price for the parliamentary democracy and free competition" (Bõhm: 7.) are not exaggerated. Without doubt, from the dual systemic change the political was more successful than the economic. It should be added, however, that the undeniable deficiencies of the new political system (the so-called democratic deficit and others) were also among the main reasons for the criticised economic distortions and social crises.

Due to the nature of privatization, liberalisation and large capital inflows, a dual economic structure developed, one sector of which is fully foreign owned, export oriented, dynamically developing and with few linkages to the domestic economy, and another, in majority domestically owned and slow growing (i.e., the customs-free zone and the customs zone sectors). Between these two sectors, the substantial economic linkages are weak. Customs free companies, which employ just 2 per cent out of the 2.1 million employees of the competitive sectors, provide some two fifth of the total exports (43 per cent in 1999). Their contribution to the trade balance is positive (they reached a USD 2.1 billion surplus in 1999). This large surplus hides the immense and increasing trade deficit of the customs zone. In 1999, the trade defici of the customs zone reached 5.2 billion, without counting the impact of the indirect exports. Thus, we can speak about a substantial internal imbalance in the economy, which can produce conflicts in case the capital inflow weakens significantly (see Figure 2. in Annex I.).

International comparisons of statistical data also point to the extremely large role of foreign capital in the Hungarian economy. The World Investment Report published by UNCTAD in 1999 compares participation ratios of transnational companies in the exports of 18 countries. The series are lead by Hungary with 65 percent, followed by Singapore, a commercial city-state, with 61 percent. In the case of Finland, a comparable and EU-integrated country, this ratio is only 10 percent, and for the Czech Republic, which is also a transition economy and in many respects in a similar situation to Hungary, the ratio shows 15 percent (see Figure 3.).

Performance indicators of productive infrastructure were essentially influenced by the main tendencies of the national economy, i.e., the general decline of economic performance and the market-economy transformation. The performance of the productive infrastructure sectors decreased drastically until the end of 1996 -- to the greatest extent in the commodity transport -- and since that time there has been a modest upturn. However, within the sector, telecommunications developed constantly and dynamically, in some years its growth rate being above 10 percent (see figure 4.). The structure of telecommunications follows the demand of consumers, and, beside traditional services, new up-to-date business technologies also developed (EDI, Internet, ISDN). Continuous progress resulted in an improvement of the density of main public telephone lines from nine in 1989 to 26 at the end of 1996. Digitalisation of the Hungarian network surpassed 60 percent in 1996, and the density of mobile telephones is more than 60 percent of EU average.

Frame 13.
NGO view on the demographic impact of adjustment policies

Hungary's economic, social and demographic crisis didn't start after 1989, though the country passed in the 1990s into an even more critical phase. It would be wrong to regard the negative consequences as the necessary price of transformation. The applied economic policies caused similar consequences not only in the transition economies, but also all over the world. The negative impacts were more serious and concentrated in time, because the policies corresponded to the historical and economic nature of these countries even less than elsewhere. An even more serious failure was the attempt to cure the initial difficulties and mistakes by the same means that caused them.

The economic transition polarized the Hungarian society. As a result of liberalisation, deregulation and the collapse of previous commercial relations, the performance of the economy declined. Between 1989 and 1995, the number of employed fell from 5.5 million to 4.0 million, i.e., by 1.5 million, and stabilised at around 37 percent of the total population and 52 percent of those people of working age, which is a low level by international comparison.

While in the previous 40 years unemployment was unknown, during the systemic change, unemployment increased at the national level in 3-4 years to 13 percent before declining slowly, but in some regions it is permanently around 17 percent. It is especially difficult for the young to find initial employment and for a 40- or 50-year old, if a job is lost, to find new employment.

Income advantages emerged among the white collar employees, the highly educated professionals, and particularly for those in the financial sector. The gap widened between those working for foreign and domestically owned companies. Those working in industries with low productivity (textile, health care etc.) fell below the national averages. Geographical differences increased--the Southern, Eastern and North-Eastern regions fell behind the target zones of foreign investment (North-West and Budapest). The transformation hit the families with low income large families unfairly, since the income regulation did not take into account the number of dependents, and the rapid increase in the everyday costs of families. The two groups that can be considered as main losers of the transition are the unemployed and the Roma.

The systemic change hit romanies more strongly than it did the permanently unemployed or other groups of losers, because the majority of romanies were affected by negative consequences of several changes simultaneously. Most of them have only low education and no specialised training, and in the past many worked in heavy industry or construction. Besides, they usually have large families with several children, and a large group lives in the North-Eastern part of Hungary, which was particularly badly hit by the economic crisis. Many romany families remained without a wage-earning family member. A household survey in Borsod-Abaúj-Zemplén county (in northeastern Hungary) ascertained that there was no labour income in 37 percent of romany families of villages in 1991, a percentage that increased to 57 percent in 1993. (Lukács 1999: 3.) The backwardness of the romany majority in education worsened, as well, which is probably the most difficult disadvantage to overcome. One part of the romany population had been left out of the progress made in education in the past. However, the new circumstances devalued the professional training previously achieved, and thus further retrogression adds up to a bad starting situation for the romany population.

3.2. The role of World Bank in the transformation

In the 1980s the society knew very little about the real activities of the IMF and World Bank in Hungary, while in the 1990s people might have attached greater importance to the activity of the two institutions than it was in reality. The distribution of labour between the IMF and the World Bank -- and which component of the government's economic policy came from one or the other institution -- was unclear not only for outsiders but also for many Hungarian politicians and experts.

The assesments by civil organisations participating in SAPRI found that World Bank (and IMF) policies determined only in a part the economic and social policy of the government. In many cases (e.g., the liberalisation of foreign trade and prices, privatization) the recommendations of the Bank and IMF have given a certain broader framework in which the government had large freedom of motion. Hungarian economic policy carried out the market-economy reforms much more radically and impatiently than expected by the international financial institutions, or more so than did the neighbouring countries. An example is the liberalisation of foreign trade, which happened without the usual defence of domestic enterprises.

A more intensive examination of the social dimensions of economic and public-finance reforms and greater determination to prevent the negative social impacts could have helped avoid the unfavourable public opinion. With greater transparency, the analyses and recommendations of the World Bank, which endeavoured to direct transition economies towards more rational economising, stability and development, could have received more attention.

Between the World Bank and civil organisations there exists opposition over the adopted economic philosophy. An essential element of the difference of views lies in the social-policy concept. What is the role of social policy? Only to aid those who suffered serious losses in the market or also to improve general living circumstances and prevent the emergence of bad and impossible situations, thus keeping the society integrated. In the recommendations of the World Bank, the notion of social policy was confined to a narrow concept, which is limited to giving assistance to the poor and to those who have lost out. On the assisting of the poor the Bank proposed efficient and effective means.

Frame 14
NGO opinion on the involvement of the World Bank

World Bank policies were not elaborated for a general systemic transformation (i.e., from a centrally planned economy to market economy), but for a medium-term structural adjustment of less developed economies that were already integrated into world markets. In the activity of IMF and World Bank there was not adequately reflected the fact that a key issue was the dismantling of a complex socio-economic system and the building of another. That is a different problem than the stabilisation and structural adjustment of a market economy in order to achieve sustainable improvement in efficiency and equilibrium. To characterise as structural adjustment what happened in Hungary in the decade after 1989 is a faint description of the actual, fundamental change. "Privatization, deregulation, adaptation to transnational economic processes and the appearance of foreign capital in a decisive role overturned the accustomed economic life in Hungary from the bottom to the roof" (Gombár: 1.).

It is understandable, that, as all careful financial institutes, the World Bank **cleared in advance the aim of the demanded credit**, which means, that it raised conditions and also controlled their execution continuously. However, since, in a complex systemic change of a country, the expertise and competence of World Bank, like that of any foreign actor, can be strongly queried, expectations concerning the transformation should have been expressed in a more restrained way. Under the confused circumstances of transition, the World Bank didn't consider enough the democratic deficit; therefore, the **institute** could be utilised in Hungary by the financial and political winners, who could place themselves on the favourable side of social polarisation.

Generally the World Bank didn't intervene in the decisions of economic policy and the social life in Hungary. However, the conditions of the loans, the conclusions of its analyses on Hungary and the intellectual and financial influence through which the Bank assisted the Hungarian neoliberal economists played an important role in regard to the problems of transformation. Notably, that the government in power rigorously applied the neoliberal economic and social policy and imposed on the country the free-market rules when the Hungarian economy and society were not prepared to such change.

The international financial institutions influence the economic policy of countries not primarily by their real, direct recommendations, but by developing an international atmosphere in which their views become the generally accepted basis of economic thinking. In the period under examination, that general basis was the so-called Washington consensus, the spirit of which inspired first the economic policy of the developed countries, but was willy-nilly implemented by other countries of the world, too (see Frame 8.). "The success of the Washington consensus as an intellectual doctrine rests on its simplicity: its policy recommendations could be administered by economists using little more than simple accounting frameworks. A few economic indicators – inflation, money supply growth, interest rates, budget and trade deficits – could serve as the basis for a set of policy recommendations" (J. Stiglitz: 1998).

Frame 15.
The Washington consensus

The Washington consensus is an agreement of the economic leaders of the U.S.A., IMF and World Bank on the implementation of concerted economic policies and on the recommendation of these policies to other countries. The consensus originated at the beginning of the 1980sunder the influence of the failures of state intervention policies in Latin America and in the socialist countries, and as the costs and losses of high inflation rates.

The consensus applies the neoliberal economic theory in practice. The substance of the concept says: if the governments cease the direct economic interventions of the state, private markets will distribute economic resources efficiently and dynamic economic growth will start, from which each member of the society will gain.

In the spirit of the consensus, the World Bank recommended to developing countries the implemention of the following economic strategy:

"The right strategy for developing countries, whether external conditions are supportive or not, is to

- Invest in people, including education, health and population control;
- Help domestic markets to work well by fostering competition and investing in infrastructure;
- Liberalise trade and foreign investment;
- Avoid excessive fiscal deficits and high inflation. (World Development Report, World Bank, 1991, p.148.)

In the 1990s, all over the world, the Washington consensus was more and more criticised for the many obvious and serious failures. A group of economists recommended the formulation of a new "post-Washington consensus". They state that "the policies advanced by the Washington consensus are not complete, and they are sometimes misguided. Making markets work requires more than just low inflation; it requires sound financial regulation, competition policy, and policies to facilitate the transfer of technology and to encourage transparency, to cite some fundamental issues neglected by the Washington consensus." Furthermore, the objectives of development have broadened "to include other goals, such as sustainable development, egalitarian development, and democratic development. An important part of development today is seeking complementary strategies that advance these goals simultaneously". (Source: Joseph Stiglitz, WIDER Annual Lecture, 1998.)

Regarding the formulation of the post-Washington consensus, a leading economist stated, "Whatever the new consensus is, it cannot be based on Washington. If policies are to be sustainable, developing countries must claim ownership of them" (ibid.). Also, the objectives of development have to be broadened to include other goals, such as environmentally sustainable, egalitarian and democratic development. "Promoting human capital is one example of a policy that can help promote economic development, equality, participation, and democracy" (ibid.). The new consensus – facing, among other experiences, the failures of the Eastern European transformation – revalues the role of the state and the importance of democratisation of decision making, and places greater emphasis on surmounting poverty. Since the emergence of the post-Washington consensus, two loan agreements have been signed between Hungary and the World Bank; one assists education, mainly the development of higher educational institutions, while the other supports pension reform. According to Hungarian civil society organizations, neither of the two reflects the spirit of this new consensus.

The results of the World Bank programs cannot be exactly quantified, but their order of magnitude can be estimated at above several tens of billions of forints annually; Bank loans increased the country's disposable resources, the national income, by that sum. However, these results were not felt in the living circumstances of the population. In the last 15 years, national output and the living standard of the population fell under the effects of various factors, among them those with no connection to World Bank programs (e.g., the collapse of the CMEA market). Therefore it cannot be stated to what extent these programs contributed to the decline or decreased the fall.

> **Frame 16.**
> **NGO opinion on the results of World Bank programs**
>
> It would be reasonable and expedient to make clear to the population the improvement in economic efficiency. For this purpose, different methods could have been applied, such as showing in an explicit form in the budget, the surplus income in those cases in which the surplus could be calculated (energy rationalisation and others).
>
> The acceleration of reforms inspired by the programs increased economic and social tensions in many respects and in the short run; it would be expedient to put forward measures that slow the decline and return some results of the resumed growth in a sensible way to the population.
>
> The programs and reforms should have been prepared and executed in a more transparent way, thoroughly informing and involving the population. The loans were surrounded by too much secrecy. The broader public, social organisations and trade unions were not involved even when the content of the program coincided with publicised aims and were favourable for all parts of the population. The lack of real information contributed to the development of aversion on the matter, brought about sharper criticism and often caused unfounded views and criticism. More transparency and social participation would not only improve public opinion, but also could increase the efficiency of execution and contribute to a socially just distribution of resulting surplus resources.

The World Bank was the first multilateral organisation that initiated social dialogue, which is highly appreciated by civil society. The dialogue must be maintained in the future; it would be useful if the Bank would make the broader public acquainted with its aims and activities. Although on certain basic problems full agreement of views between the World Bank and civil organisations cannot be expected, the developed dialogue is a good example for other international organisations, as well.

2.3. Recommendations

The practice – understood around the world as "the Washington consensus," – of using privatization, liberalisation and budgetary restrictions as the principal means for increasing GDP and the living standard of the population, as well as for diminishing poverty, needs to be reviewed. These measures don't result in themselves in rapid growth and the diminution of poverty; moreover, in the case of Hungary they were accompanied by increasing social and regional disparities. Pursuant to international views, however, the situation and development prospects of the Hungarian economy, in comparison to neighbouring transition economies and international tendencies, indicate positive results of the Hungarian systemic change. The increase of GDP involves the chance of a future decline in poverty, but it needs the active role of governments

The accession to the European Union will be a major and complex change of similar significance to the systemic change; to assure its successful implementation, we must learn from the mistakes and failures of the 1990s. After the years of systemic change, drawing conclusions from them and preparing for accession to EU, Hungarian economic policy should endeavour to effect a correction of the biases and mistakes made during the transformation and, above all, to curb a final split of Hungarian society into two parts. The question is not simply to apply more social aid policy; all elements of economic and social policy should be subordinated to this aim. The parliament should apply the principles of the European Social Charter, and take on the social institutions of the European Union, and the government should obtain the support of international organisations and Western governments for a program of social stabilisation and cohesion.

The accession to the European Union is now in the forefront of Hungarian economic policy. The accession opens new possibilities but faces the Hungarian economy and society with new challenges. It would be desirable that, beside favourable possibilities, the real accounting of expected difficulties and risks were overlooked in order to avoid such disappointments that had been suffered in the last decade. Issues of discussion should be clarified before entry, and national interests have to be defended in the negotiations.

EU membership brings additional resources for the Hungarian economy but, similarly to the IMF, it requires financial discipline too. The obligatory convergence criteria of Maastricht express analogous features to the Washington consensus (see Frame 9.). Maastricht criteria raise – being quantified, in a more rigid form – identical requirements on restrictive budget and monetary policy as the recommendations of the IMF and World Bank. The strengthening of the competitive force of the economy, the preparation of certain branches like agriculture for the hard relationships after the accession, and the diminishing of the existing large gap in earnings require another type of economic policy, first of all in the preparatory phase. The catching up would certainly need more time than will be available before the accession. Therefore, after the entry, there will also be a need for different policies from those of the developed countries and for energetic support from the Union.

Frame 17.
The Maastricht convergence criteria

The 1st of January 1999, eleven member states of the European Union called into life the "euro", a common currency. The introduction of the common currency is a major step in realising European integration, the free exchange of commodities, services, capitals and people, and requires a close harmonisation of economic policy of the countries entering into the monetary union. For the countries that intended entering into the monetary union the main precondition was to have a stable currency, not to carry out devaluation in the two years before the entrance and to avoid situations in which the need for devaluation would arise. The Maastricht convergence criteria determine the main quantitative conditions of that economic policy as follows:

- Consumer price inflation can exceed at most by 1.5 percent the average of the three members with smallest inflation rates; that meant that the ceiling was 3.1 percent at the beginning.
- The interest rate of long-term deposits can exceed at most by 2 percent the average of the three members with the lowest interest rates; a ceiling of 8.5 percent at the introduction.
- The state debt cannot be higher than 60 percent of GDP and should have a decreasing tendency.
- The budget deficit cannot be higher than 3 percent of GDP and should have a decreasing tendency too.

The criteria express the neoliberal requirements of economic policy generalised on developed Western European countries and oblige the governments of member states to implement rigorously restrictive financial policy. The threshold values were flexibly applied, as, at the beginning the majority of entering countries did not achieve one or another criterion (in a few cases the difference was significant and concerned more indicators), but decisions obligatorily prescribe the continuing approximation to the quantitative criteria and, when achieved, maintaining that level in the long run.

The assertion of the criteria is not a condition of accession of EU candidate countries, but movement in the direction of the criteria weighs seriously when accession is judged and even more so after the entrance. The consequence is that government of Hungary, insisting on accession, already must pay attention to the criteria in its present economic policy.

Hungarian civil-society organisations worry about the ownership structure developed during the transformation. They believe that the aim of promoting the evolution of an internationally competitive domestic entrepreneurial sector has not been achieved. They consider the presence of foreign ownership in manufacturing, commerce and fundamental infrastructure to be excessive, and employee and cooperative ownership (which they consider „democratic") too limited. The NGOs recommend that government should act upon altering the ownership structure in the next future by promoting domestic entrepreneurs and supporting common forms of property.

The correction of economic-policy instruments – beyond such elements as improving the efficiency of the financial system, promoting fair competition, developing means of regulation, and managing macro-economic stability in a rational way – should be accompanied by the establishment of social protection and welfare systems and mechanisms. Appropriate emphasis must be placed on the development of human resources, as well as on technological progress and technology transfer.

Neither domestic experiences nor international comparisons prove that a smaller state budget would automatically improve national efficiency. Therefore, further reform of public finances cannot be based on the reduction of public consumption as a percentage of GDP or on the cutting of social expenditure. Instead, efforts could be made to reduce internal debt and its costs. Special comprehensive programs are needed to solve the gravest problems of the economy and society, such as on improving the situation of the romany minority.

Civil society, the various social organisations, most of which voice general social expectations rather than separate interests, should be involved in the formulation of economic policy much more intensively than before. (See the economic policy proposals of civil organisations in Frame 18.)

Frame 18.
The economic policy proposals of civil organisations

- Besides equilibrium, fiscal and monetary policy should attach adequate importance to sustainable economic growth and demands for raising wages and incomes.
- The conditions of public utilities should be newly regulated in order to cease the uncertainty of provisions for the low-income strata of the population; possible further privatization should be prepared adequately.
- The regulation of prices and tariffs of public services is to be conferred to a merged, single and independent price authority; this function should be abolished in branch ministries and transferred to the mentioned authority.
- Considering the change of circumstances, the government should prepare a new comprehensive energy conception and regulate the development and functioning of energy sectors accordingly.
- **The practising of ownership rights concerning enterprises in steady state ownership and under branch direction is to be rearranged.**
- The relationship between the central budget and local self-governments should be readjusted to provide adequate resources in poor regions, small areas and settlements for equal social provisions and needed maintenance and development costs.
- The development of human infrastructure, and its urgent investments should be managed as a high-priority task.
- Reforms of the health and education systems have to be carried out with full attention to national traditions, saving the system's existing and lasting values, improving competitive capacity, and increasing equal opportunities for the young. Sufficient health care provision must be supplied for those who can only use the institutions financed from duties (taxes).
- The pension system should be stabilised and developed, establishing adequate guarantees for saving and increasing the real value of pensions and for a higher level of the newly created basic pensions (the first pillar).
- In the family allowances and particularly in children's provisions, should be taken into account the ceasing of previous subventions (the indirect wages); the emerging income deficit should be gradually eliminated.

There is a need for continuous improvement in the quality of the existing housing stock. Baed on the account of realistic demand, the state must support the building of new homes as well.

SAPRI research in Hungary, a two-year dialogue among different parties and prepared studies, provide a good base for the World Bank and civil organisations discussing together the lessons of the Hungarian economic transition with representatives of Eastern European transition economies and familiarising them with our analyses of structural adjustment policies.

The major issue of reform policy in the next decade will be how the Hungarian economy could be more competitive in the twenty-first century. The new modernisation program, which will also be the program for closing the gap with the European Union, should no longer be based upon the continuous devaluation of the labour force, natural endowments and the environment, but on developing the competitive capacity through knowledge.

ANNEX I.: THE CIVIL ORGANISATIONS' VIEW ON THE SOCIO-ECONOMIC IMPACT OF THE STRUCTURAL ADJUSTMENT

(THIS VIEW IS NOT SHARED BY THE WORLD BANK AND GOVERNMENT)

Results of the ten-year transition period in Hungary are the effectuation of the institutional and controlling system of market economy, the domination of private ownership, and the close economic linkages with developed industrialized countries. By the end of the nineties the financial situation of the country stabilized and dynamic economic growth, twice as high as the western European average, has been launched. Nevertheless, manifold distortions of the economic structure, internal and outside factors curb development and threaten balanced growth. The reform of the large well-being systems hasn't been finished yet and in the last ten years the structural adjustment was accompanied with severe social and environmental problems.

1. Economic impacts of structural adjustment

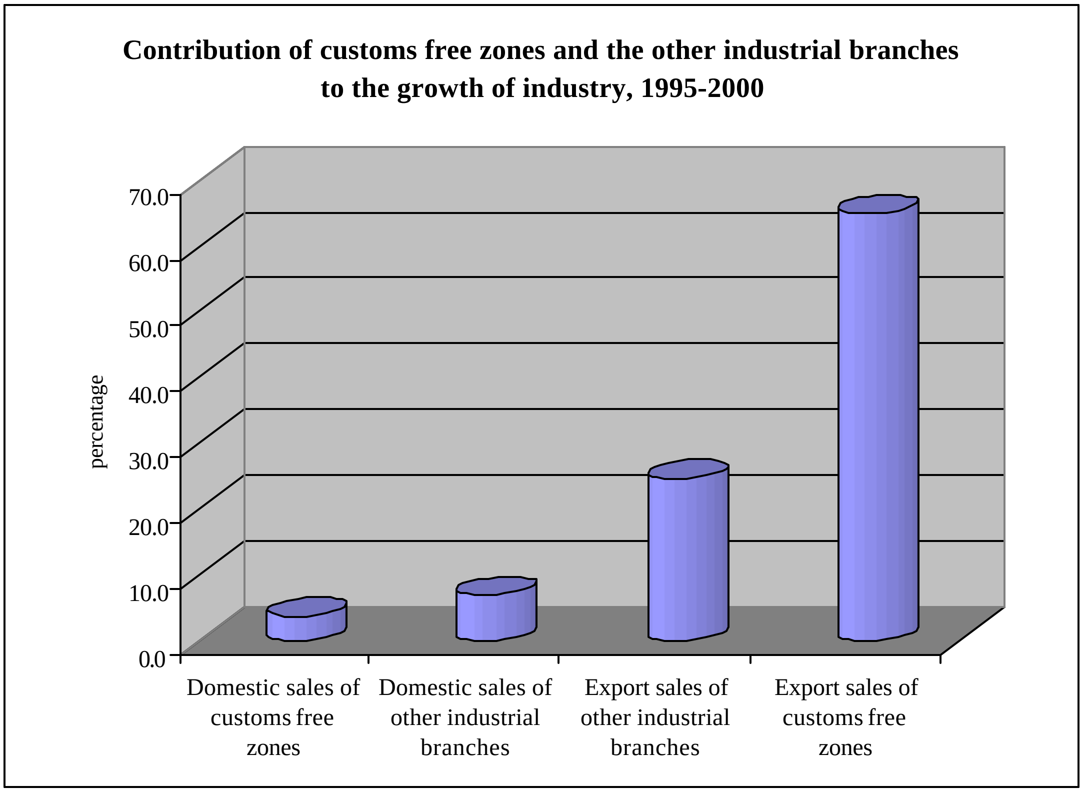
1.1 Emerging dual economy

Industrial output fell after the systemic change, hitting bottom in 1992, and it has since recovered, first due to the activity of multinationals in the country. In 1997, the industrial output surpassed its highest level before the systemic change (achieved in 1988) and ever since has developed dynamically. During the last decade, the macro- and microstructure of the industry was transformed completely; the change is manifested in the ownership structure, the enterprise organization systems, markets, and, not least, in the deep alterations of the branch and product structures.

Due to the particularities of the systemic change in Hungary, a dual economic structure developed, which contains a fully foreign owned and dynamically developing part (customs free zone sector), and another, barely growing part in mixed (domestic and foreign) ownership (customs zone sector), see Figure 1. Economic linkages between these two sectors are weak and grow slowly. Customs free zone companies that employ only 2 percent of the 2,1 million employed in economic sectors produce two-fifth (43 percent in 1999) of the total of exports. Their contributions to the balance of foreign trade are strongly positive, the surplus made dollar 2,1 billion in 1999. The surplus of those enterprises conceal the large and increasing deficit of the customs zone sectors, which attained dollar 5,2 billion not including effects of indirect exports. That points to a strong internal imbalance in the economy, which could come to the fore if the actual capital inflow would decline (Figure 2.).

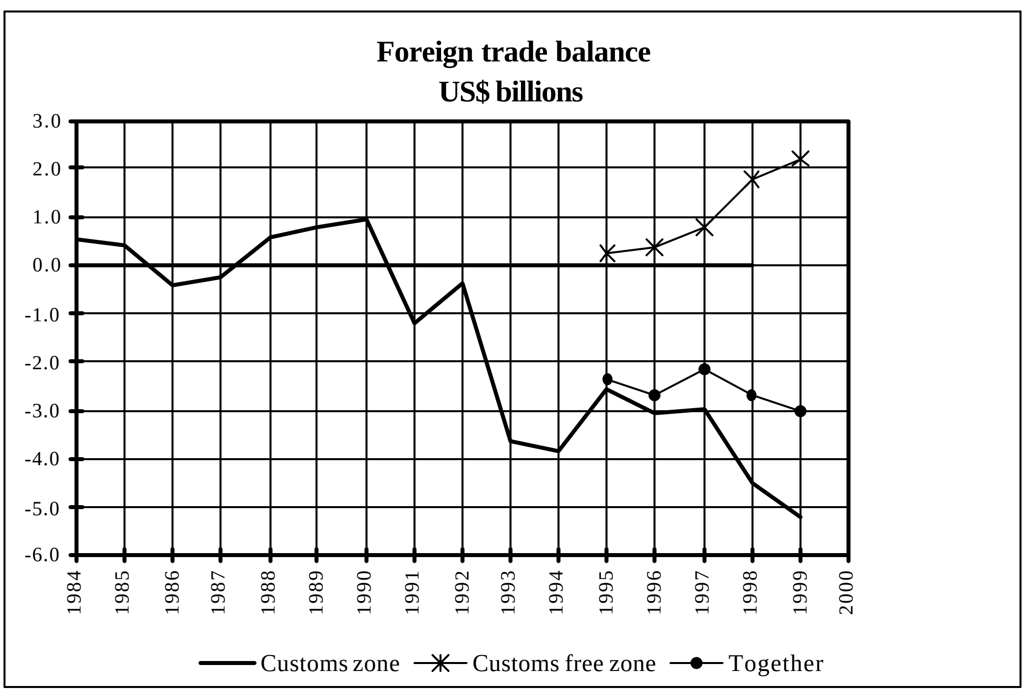
The dual structure of the economy can be well illustrated by the input-output table for 1998. The customs free zones the export of which amounts 1/3 of the total, purchase the materials and parts used for production mainly from abroad. The materials and services coming from Hungarian firms amounts only 12 per cent of the net sales while this ratio in the case of customs zone sector reaches the 59 per cent (Table 1.).

Figure 1.



Source: Ipar és építõipar (Industry and construction) monthly publications of Central Statistical Office of Hungary

Figure 2.



Source: Ministry of Economic Affairs, Quick overlook of foreign trade

International comparisons of statistical data point to the extremely high role of foreign capital in the Hungarian economy. The *World Investment Report* published by UNCTAD in 1999 compares participation ratios of transnational companies in exports of 18 countries. The series are lead by Hungary with 65 percent followed by Singapore a commercial town-state with 61 percent. In the case of Finland, a comparable and EU integrated country, this ratio is only 10 percent, and for the Czech Republic that is also a transition economy and in many respect in a similar situation to Hungary, the ratio shows 15 percent (Figure 3.).

Figure 3.

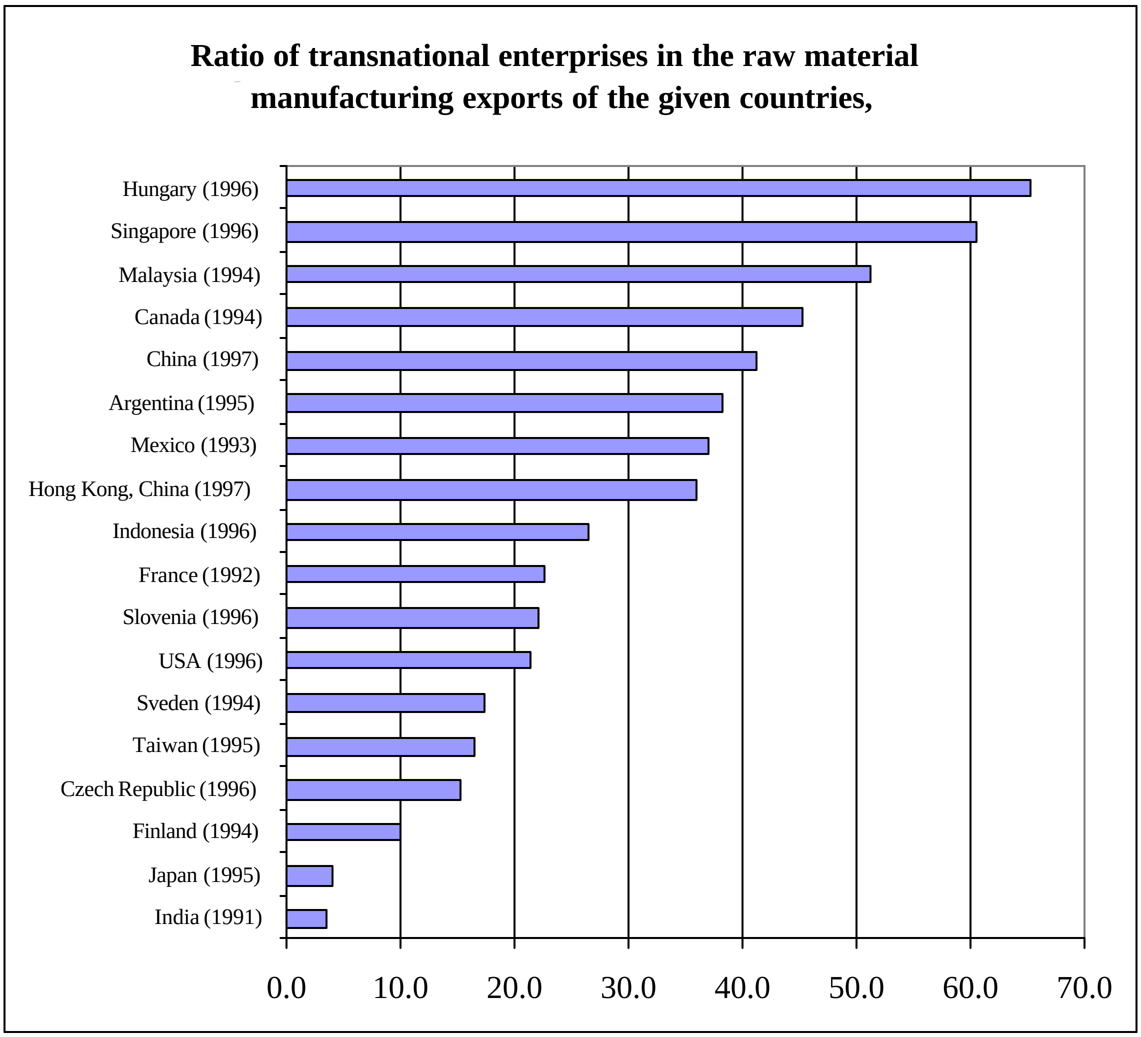


Table 1.

Input-output table of Hungary 1998
(at current prices billion HUF)

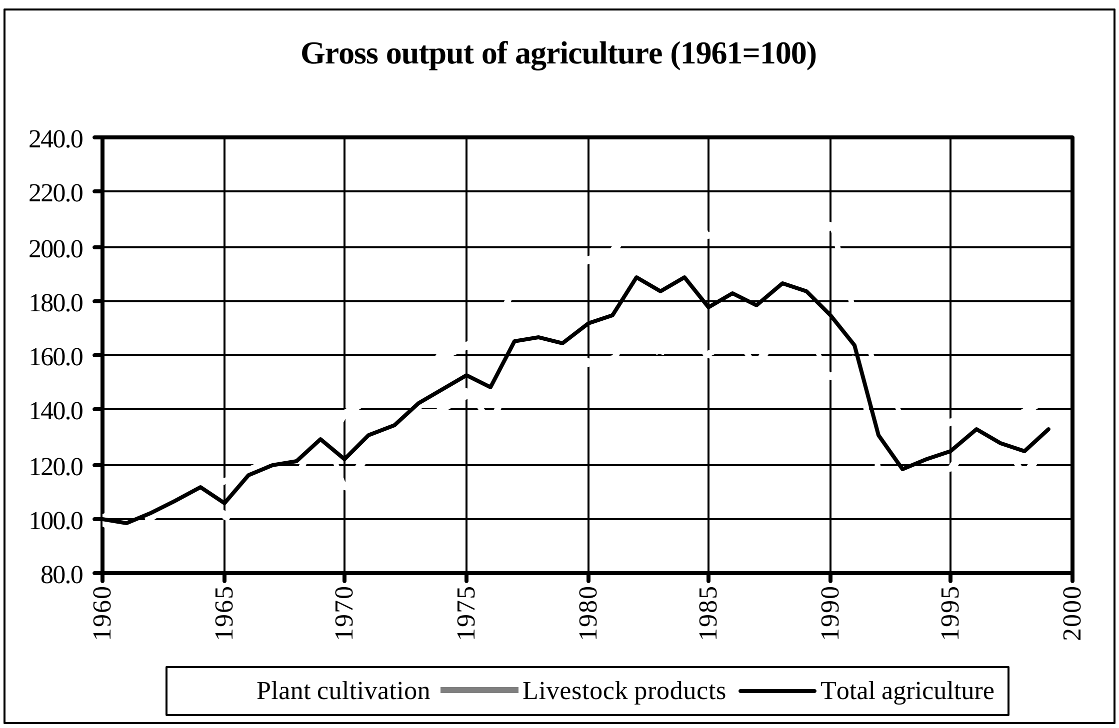
Industries	Agri-culture, forestry, fishing	Industry exc. customs free zones	**Customs free zones**	Const-ruction	Produc-tion related services	Public services	Total interme-diate output	Total domestic final use	Exports	Total use	Ratio of total domestic use in total use %
Agriculture, forestry, fishing	211	420	**1**	4	60	18	716	332	180	1 228	85
Industry exc. customs free zones	205	1 236	**81**	244	478	228	2 472	1 738	2 216	6 426	66
Customs free zones	**2**	**16**	**14**	**4**	**29**	**6**	**70**	**148**	**1 709**	**1 927**	**11**
Construction	2	46	**5**	10	67	32	160	844	42	1 047	96
Production related services	163	753	**75**	171	1 430	362	3 199	2 937	538	6 674	92
Public services	24	95	**16**	12	205	135	486	2 192	18	2 696	99
Total	608	2 565	**192**	445	2 268	780	7 103	8 192	4 704	19 999	
Imports	102	1 679	**1 341**	152	510	127	3 911	1 501	0	5 412	
Net taxes on products	41	82	**22**	25	149	67	386	1 090	-17	1 459	
Intermediate consumption at basic prices	751	4 326	**1 555**	622	2 927	975	11 401	10 269	5 200	26 870	
Gross output	1 228	6 426	**1 927**	1 047	6 674	2 696	19 999				
Ratio of intermediate consumption to gross output, %	81	59	**12**	72	77	80					

Source: Central Statistical Office of Hungary

1.2 Agriculture

In the first three years of the nineties an agrarian crisis similar to the one of the thirties shocked the Hungarian agriculture as a consequence of the declining internal food market, the mass unemployment, and the diminishment of the purchasing power of producers. Typical to the size of the crisis are the 35 percent decrease of the agricultural output on constant prices between 1989 and 1993 and the slow growth since 1993. The agricultural output in 1998 was one quarter less, than in 1989 (Figure 4.). The employment data also indicate the deepness of the crisis. In 1988 738 thousand people found their main occupation in the agricultural branch, while 11 years after, in 1999, only 277 thousand were employed. The tractive power in the agriculture fell back by 30 percent and the use of fertilizers to one fifth. Compared to domestic food demand and foreign market selling possibilities, a large overproduction capacity exists, which – together with increased import supplies – depressed prices far below production costs. Further negative factors are the domination of multinationals in the food processing industry and the aggressively advancing foreign dominated commercial chains which using their immense market superiority bring domestic producers in a fully defenceless situation.

Figure 4.



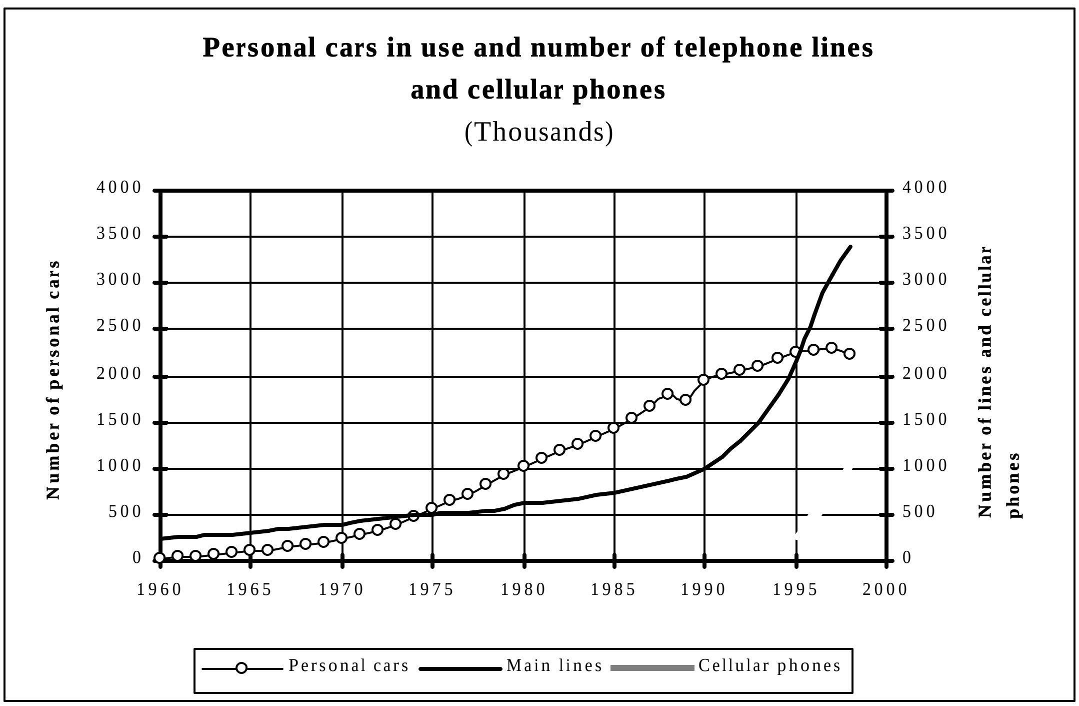
Source: Yearbooks of the Central Statistical Office of Hungary

Mostly, the new entrepreneurs' had not enough own capital to start, carry on and develop the farm, and were driven to draw external resources, which later worsened their situation. At present and in the future a resource of grave problems is the separation of landed property and leasehold. The landed property is split up into small pieces, while the holding of land is more concentrated. 97,6 percent of landowners have less than 10-hectare land and their property makes 41,2 percent of the total of arable land. A large part of smallholders leases its land to still existing co-operatives or to private entrepreneurs

1.3 Services

Performance indicators of the productive infrastructure were essentially influenced by the main tendencies of the national economy, i.e. the general decline of the economic performance and the market economy transformation. The performance of the productive infrastructure branches decreased drastically until the end of 1996, to the greatest extent in the commodity transport, and since that time there is a modest upturn. However, within the branch, telecommunication developed constantly and dynamically, in some years its growth rate was above 10 percent (see Figure 5.). The structure of telecommunication follows the demand of consumers, beside traditional services also new up-to-date business technologies developed (EDI, Internet, ISDN). Continuous progress resulted in an improvement of the density of public telephone main lines from 9 in 1989 to 26 at the end of 1996. Digitalization of the Hungarian network surpassed 60 percent in 1996, and the density of mobile telephones is more than 60 percent of EU average.

Figure 5.

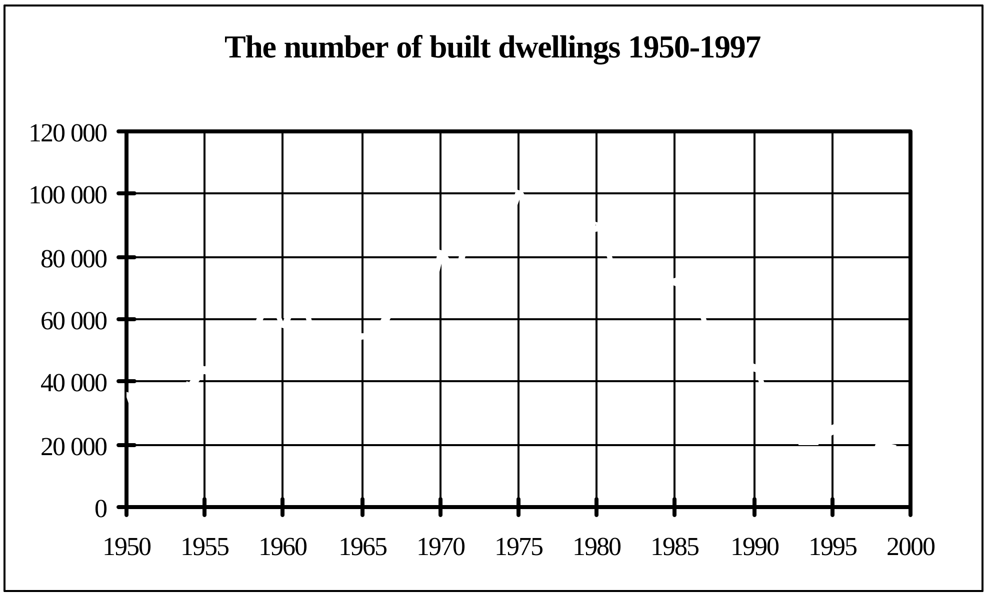


Source: Statistical Yearbooks of Hungary, Central Statistical Office

1.4 Home building

In the seventies 90-100 thousands of dwellings were built in Hungary, in the second half of the nineties only 20-25 thousands. In 1998 and 1999 less new dwellings were built than in 1938 (figure 6.). The state left the terrain quite completely and only in 2000 happened some progress with introducing a system of subvention of credits given to the construction and purchase of new dwellings. The number of flats to rent is disproportionately low that makes difficult the adjustment to the changing demand. To the rigidity of the dwelling market contributed the privatization of municipality flats; actually 90 percent of flats is in private ownership. Maintenance and reconstruction of dwellings cause a severe problem for the population who is unable to cover the expenditure from its income. There are only very limited number of newly-build dwellings and the rents are extremely high.

Figure 6.



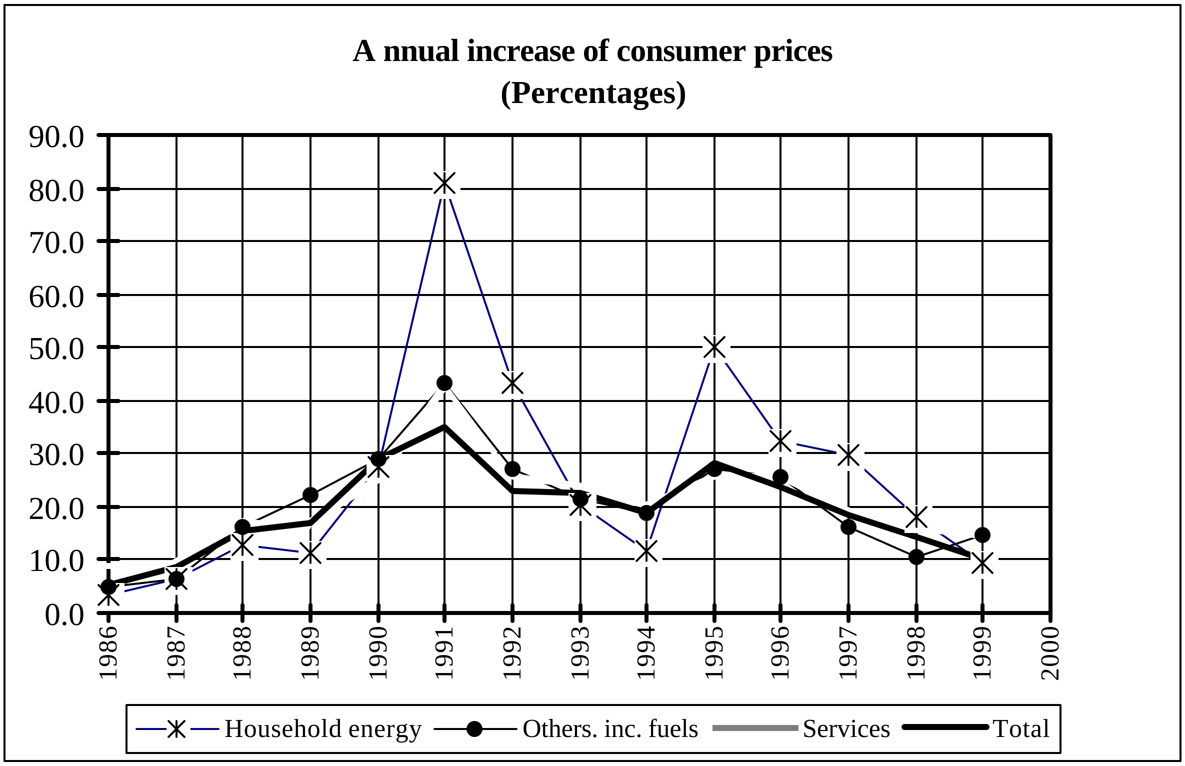
Source: Statistical Yearbooks of Hungary, Central Statistical Office

1.5 Equilibrium and foreign debt

In the last years before the system change the foreign trade was balanced, in the period of 1988-1990 an average annual dollar 7-800 million surplus was achieved. However, the structural adjustment processes caused a steep fall in the balance from 1991 and the deficit bottomed on dollar 4 billion, more than one third of the total value of exports in 1994. Parallel to the foreign trade the current account balance also declined, since the surplus of services and others was compensated by the deficit of interest payments.

The stabilization package of 1995 mainly aimed at decreasing the twin-deficits of the budget and foreign trade, but among means of action emphasize was given to economies coming from cost-cut in education health and social provision too. However evidences show that the main factors in realizing stabilization instead of cutting in social expenditures, were the dynamic growth of exports of foreign owned companies and the upswing in foreign direct investments. The monetary policy, the system of crawling-peg exchange rate mechanism introduced in 1995, contributed to large extent to the stabilization. After an initial jump the rate of inflation slackened and the confidence toward the forint strengthened. These factors prove that the extent and means of budget tightening were not inevitable and required too high price from the population. The change of consumer prices and its main components are presented in figure 7.

Figure 7.



Source: Statistical Yearbook, Central Statistical Office of Hungary

Since the beginning of the system change, which means the period between 1990 and 1999, dollar 16,2 billion deficit cumulated in the current account, a sum almost equal to the cumulated deficit of the foreign trade balance (dollar 18 billion). The surplus of services (dollar billion +13,8) nearly compensated the deficit of income expenditure (-14,7 billion). During the period direct foreign investments (dollar 18,3 billion) fulfilled a basic role in financing the current account. Around half of previous loans were returned and foreign exchange reserves were increased by dollar 12,7 billion. In the same period the debt in foreign exchange securities, i.e. the portfolio debt increased significantly. The portfolio investments in a part financed the return of previous debts and in a part, served the growth of foreign exchange reserves.

The chosen way of financing the current account runs large and increasing risks, as main items of balancing are the foreign direct investments, international bond issues and net credits. After the increased foreign capital more and more interests, dividends, profits or other incomes may flow out from the country and with time the risk is growing that the increase of capital stock may stop or turn back. Though the bond and credit financing fully depends on the conjuncture of international capital markets and the external rating of the Hungarian economy. These considerations support the conclusion that the strengthening of the domestic economy is an urgent task.

2 The social impacts of transformation

In consequence of liberalization, deregulation and the collapse of previous commercial relations the performance of the economy diminished. Between 1989 and 1995 the number of employed fell from 5,5 million to 4,0 million, i.e. by 1,5 million and stabilized on around 37 percent of the total population and 52 percent related to people of active age, which is a low level also in international comparison. In the statistically observed history of Hungary, including years of crises, world wars and revolutions, there was no example on ceasing of one third of the workplaces. While in the last forty years unemployment was unknown, during the system change, in three-four years, unemployment increased on national level to 13 percent and since then lessens slowly, but in some regions it is permanently around 17 percent. Especially difficult is for the young to find the first employment and above an age limit (40-50 years), if the workplace is lost, to find a new job. In a short period the real income of the population fell by 13 percent on national average that conceals large differences among strata and regions. (The change of a group of typical social indicators are shown in figures 8. and 9.)

2.1 Social inequalities

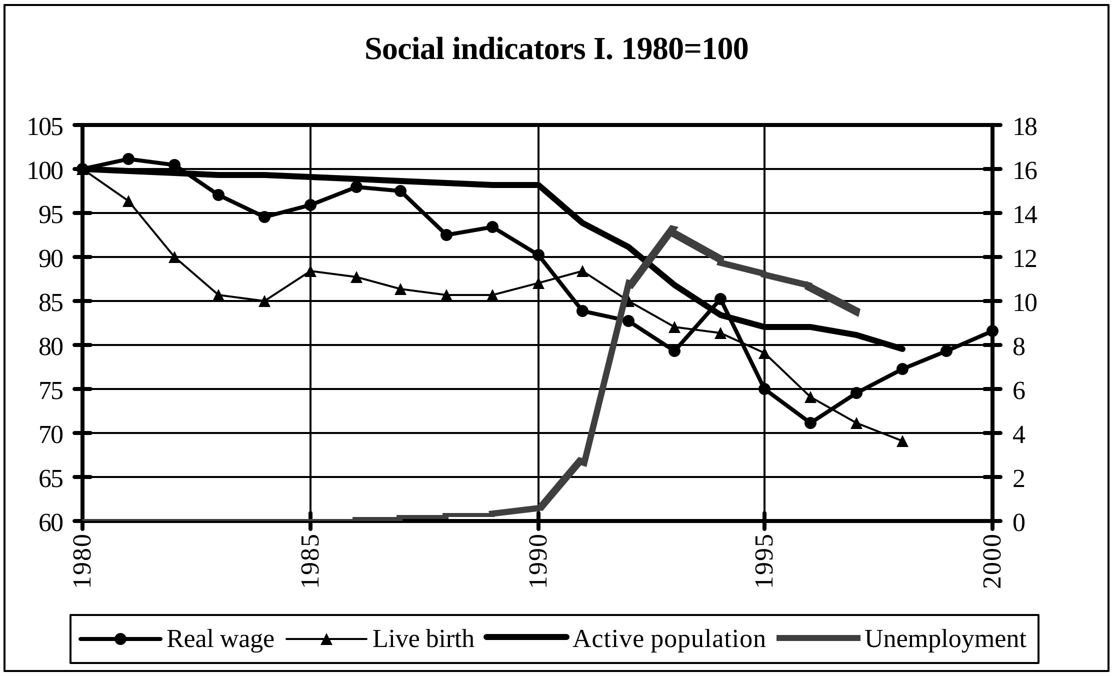
The economic transformation polarized the society. Transition made possible to rise in all respects for those, who could attain a significant amount of competitive property in the private sector or could engage in the new structures of the private sector as direct supplier. Still a broader bourgeoisie did not develop; also a part of middle strata that had in the past firm living circumstances sank down. A broad part of the population can be regarded as looser of the change, from which around one third of the society fell behind lastingly and hopelessly. The proportion of the population living from less than the subsistence minimum was in 1991 around 15 percent, in 1992 22 percent, in 1993 25 percent, in 1994 32 percent, in 1995 30-35 percent and in 1996 35-40 percent (Andorka 1997 p. 139.).

A complete readjustment of income levels followed the political change. The difference between the lowest and highest decimal class of per head income increased from 4-4,5 times before 1990 to 8-9 times in 1999. As in those years the average real income first declined and afterwards has been slowly nearing to the 1989 level, it is obvious that the steep growth of income in the highest 10-20 percent category was accompanied by the smaller or larger, sometimes even tragic impoverishment of the low income strata.

Due to the significant decline of income the alimentation of the population worsened, and the per head food consumption diminished even on average. The nutritional value of per head consumption calculated in kilojoule decreased by about 13 percent, the daily protein consumption by about 16 percent, the annual meat consumption fell from 81 to 68 kilogram, the milk consumption from 190 to 137 litre, the consumption of fruits from 70-75 to 60-65 kg (see Figure 10.). The difference increased between the per head consumption of the lower and higher income strata, particularly in the consumption of more valuable products as milk and milk produces, meat and vegetables and fruits. The backwardness of low income strata deserves special attention, because half of the total number of children live in the 30 percent lowest income families and children need increased milk and milk produce consumption for healthy growth.

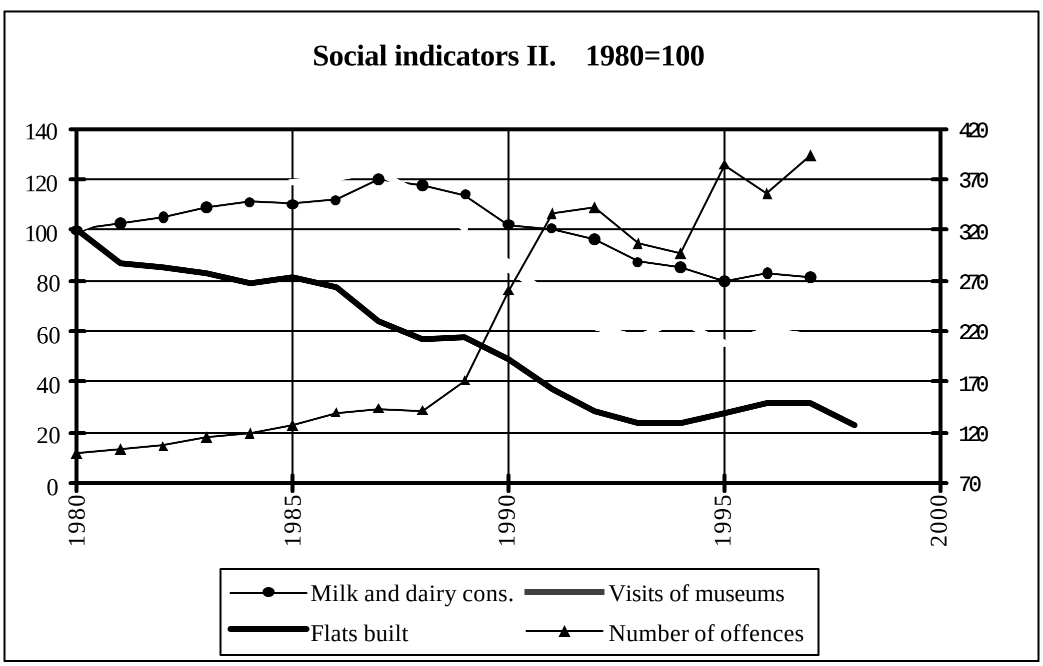
The big differences in earnings improved the living circumstances of some groups of the population while worsened that of others. The advantage of a large part of intellectuals and higher diploma employees enlarged, while the situation of teachers and health employees further worsened. The ratio between incomes of employees in foreign owned and domestic enterprises increased in favour of the first group. The wage of textile workers and unskilled heavy physical labourers is extremely low. Regional differences also expanded: regions of the

Figure 8.



Source: Statistical Yearbook, Central Statistical Office of Hungary

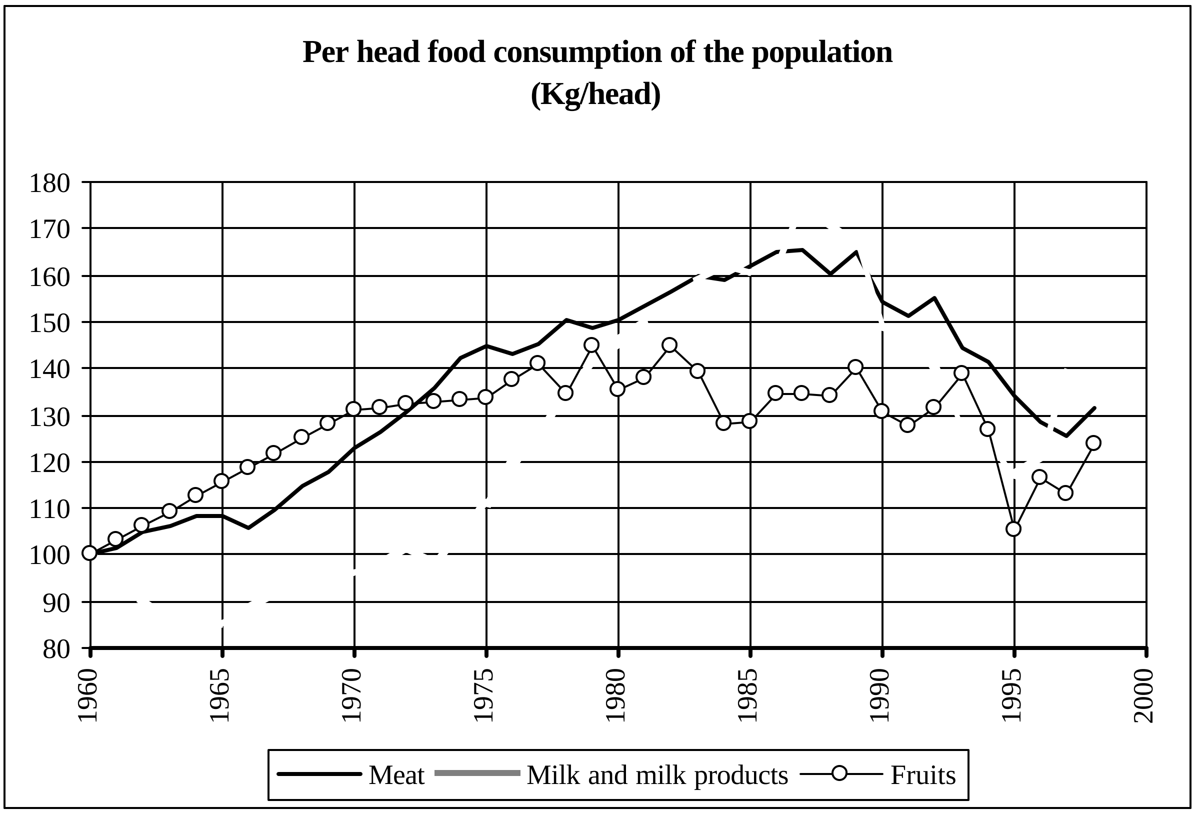
Figure 9.



Source: Statistical Yearbook, Central Statistical Office of Hungary

Great Plain, the North, and the southern part of Transdanubia remain more and more behind the main target zones of foreign investments i.e. the western part of the country and Budapest and its outskirts. The situation of low income families with more children is unfairly bad, for income regulations doesn't take into account the number of dependent family members, and for the much above average increase of living and schooling costs.

Figure 10.



Source: Statistical Yearbook, Central Statistical Office of Hungary

According to different sources the most impoverished groups of the population are the following:

- The unemployed, first and foremost the long-term unemployed;
- Low income groups, people with no vocational training or with non-marketable education;
- Lonely parents, mainly women;
- Young entrant unemployed;
- Gypsies, whose unemployment rate is several times higher than the average of the plural society;
- Large families, particularly with several children;
- The old aged, particularly the single households and among them the single women;
- Low income village households that have difficulties in reaching jobs and public services, especially due to bad transport relations;

- Physical and mental handicapped;
- The homeless, whose number is estimated at forty thousands.

The Social Research Institute (TÁRKI Rt.) regularly observes the income relationships of different social strata from which it is possible to estimate, which are the impoverishing strata of the population and what is the extent of impoverishment. The observations do not extend on all above mentioned strata, but the data provide a grim picture on impoverishment in the period 1992 -1997 (see Table 2.).

Table 2.

The ratio of relative poor in a few typical groups
(Percentages)

Groups	**1992**	**1997**
0-2 year old children	15	35
3-6 year old children	14	28
Living in villages	13	20
Gypsies	46	58
Unemployed	17	37
Living in the north-east region	14	26
Total	10	14

Note: Living below the half of the average income level is regarded as relative poor.

The influence of World Bank on Hungary's social aid system is contradictory. Although in all agreements dealing with the reform of social system it was emphasized that structural adjustment will go inevitably with an increase of poverty, the establishment and functioning of an adequate social security network has not yet been realized. In the light of events, the opinion presented by World Bank experts, that the change of the system, the building of a free market economy will in itself ease and solve the problem of poverty, proved undoubtedly erroneous. Aid programs provide neither efficient nor permanent assistance to the poor and even less are able to prevent poverty. At the same time the programs' impact on the differentiation of the society is rather important.

2.2 Unemployment

The root cause of social differentiation is to be found in the production and the labor market that radically changed during the economic transformation. The ten million population is living from the work of 3,6-3,7 million employed. Anyway, social security contributions and personal income taxes are paid only by or for them. The situation would be completely unsustainable if many people would not live from the gray or black economy. However, that solution is unacceptable from economic, social and ethical points of view, for the workers in the black economy have no rights and no social defense of any form. Beside several other problems, the black economy weakens legality and strengthens social exclusion.

Neither the state nor the society were prepared on the appearance of open unemployment. Following a few inadequate trials, the up-to-date and just Act on Employment was born in 1991, which introduced the unemployment insurance, the provision for entrants and the possibility of early retirement for elderly. These structures were built on a conception – inspired also by the World Bank – that the bulk of unemployment will be of a transitory character.

In the first years the unemployment provision system registered and provided those who lost work and didn't escape into retirement quite well. The number of registered reached its peak with 663 thousand persons in 1992. The number of registered unemployed gradually decreased, nowadays it is below 400 thousands, somewhat lower than EU average. At the same time the number of active age pensioners increased from 260 thousands in 1990 to near 600 thousands in 1999, and more than 500 thousand persons are outside the labor market without permanent income resources. Some signs of improvement of the employment situation can be seen first from 1998 or rather from 1999, but we cannot speak about a more significant change yet.

Adequate instruments of easing and managing permanent, long-term unemployment did not develop. Investments for creation of working places and employment policy are seldom mentioned, false slogans. Despite some efforts, policy paid no attention to possibilities for employment creation implied in whitening the black labor instead of criminating it. It is true; such policy would claim budget resources in form of tax and social charge allowances given for both employers and employees. These extra expenditures would recover in a few years, but the short-term budget thinking could hardly accept such a "sacrifice".

At the beginning the World Bank played an active and positive role in developing a system for preventing and managing unemployment. The Bank assisted by advice and loans the introduction of up-to-date instruments and methods, the establishment of state labor market services, the development of services providing vocational guidance, and building a network of regional labor developing and retraining centers. However, in the continuation it did not deal with the problem. The World Bank later regarded unemployment as a side produce of the economic development, which will disappear automatically with better growth; therefore deeper causes and social consequences of unemployment were not examined.

2.3 Living circumstances of gypsies

The system change hit gypsies stronger than the permanently unemployed or other groups of looser, for the majority is affected by bad consequences of several changes simultaneously. Most of them have only low education and no specialized training, in the past many worked in the heavy industry or the construction. Besides, usually they have large families with several children, and a numerous group lives in the north-eastern part of Hungary, which is mostly touched by the economic crisis. Table 2. refers also to the bad and worsening situation of gypsies.

Many gypsy families remained without earning family member. A household panel examination in Borsod-Abaúj-Zemplén county (in north-eastern Hungary) ascertained, there was no income of labor origin in 37 percent of gypsy families of villages in 1991, and in 1993 that ratio was 57 percent (Lukács 1999: 3.). The unemployment rate of working-age women in the whole population was somewhat less that 9 per cent while the same data for gypsy-women reached the 40 per cent. (Asbóthné et.al.: 12)

The backwardness of gypsies' majority in education worsened too, which is probably the most difficult disadvantage to overcome. One part of the gypsy population remained out of the progress in education during the past. The new circumstances devalued even the half or full professional training achieved previously, thus present falling back adds up to a bad starting situation.

The number of gypsy pupils in primary schools is estimated at 75 thousands; in auxiliary schools the rate of gypsy pupils is 30-50 percent. In 1995, a survey of data found that in 840 informant schools 132 segregated gypsy class functioned. Programs in these classes served mostly catching up, and rarely some development of skills and people's knowledge, but all that on very low level. The 1998 country report of the European Union objected to have 150 segregated gypsy schools yet.

In dealing with the problems of the Hungarian gypsy population the social, the minority and the stratum policy elements are confused in a particular and deplorable way. Gypsies are often handled as a minority and not as part of the Hungarian population. Furthermore, there is a tendency to present the problem of poverty as a problem of gypsies, and this way to increase in the society and in a part of the political elite existing racist prejudices. The European Union marked the improving of the living circumstances of the gypsy population on good grounds as one of the most important tasks in 1999.

2.4 Large families

Parallel to the increase of the number of children increases the chance of poverty, the overcrowding in the flat and the malnutrition and as a consequence the child will be more often sick, and his/her chances at school will again worsen. All of these factors contribute to the growing inequalities in the chances of the families and children. In consequence of the decrease of budget expenditures one third of the children at school doesn't obtain even the minimum of subsistence conditions, which means not only the meagre or omitted meals, but also poor clothing and the parents problem how to pay the minimum 8-10 thousands on textbooks and others.

2.5 Worsening situation of women

During transformation the official social policy put forward the one earner family model, in which women remain in the background, but neither the average wages nor family allowances reflect the changed concept. The number and support of children institutions, the real value of family provisions, subventions on child wear and schooling diminished or ceased. Simultaneously, the tasks of women increased even in comparison to the past in the childcare, in the maintenance of old aged family members, in the households, and to let function the family as a micro-community. That work is not valued in any forms, the performance of women in the family doesn't create rights to health insurance, i.e. to public dispensary, and to adequate pension.

One part of quality indices of still employed women improved. The proportion of women employed in intellectual occupations grew above 50 percent since the educational disadvantage decreased. Also the advantage of men in average earnings lessened. At the same time employees discriminative behavior against women strengthened in the competitive sphere and appeared in new forms particularly towards pregnant women and mothers with children. For more than fifty year old women the increase of retiring age created new and more severe competitive situation in the second half of the decade. The successful return into the labor market got to be extremely difficult especially for women who lost the job and had to leave the jobless register too.

2.6 Demographic changes

The birth rate – apart from the effect of the post war peak – has a declining tendency since 1976 and the number of the population total declines since 1980. Therefore, the ageing of the population proceeds, the proportion of older generations within the population increases. Active age generations bring up fewer children than their own number, which is the demographic basis for the growing difficulties in pension provisions. To the decline of birth rate later the diminishment of the average age of men has been added as a consequence of the increasing death rate of active age men. The unfavorable demographic processes developed much before the system change, but against expectations they further strengthened after the change (see Table 3.). The demographic processes are shaped by the totality of social relationships, being influenced in the strongest way by the change of living standards and circumstances and by the confidence of the members of society in the future.

A main material precondition of founding a family is attaining a dwelling; however, nowadays that runs against major difficulties. One of hard conditions in World Bank loans was the decrease of dwelling subventions, which measure strongly influenced demographic processes. The young couples who live in sublease or with parents don't take children, because they have no flat. While the couples who could get a flat with much difficulty say: we have already one child (for they usually have one child at that time), but we have no place for another and no money to buy a larger flat. Therefore, the coming of a second child is already uncertain. The live birth rate per thousand women of the age generation of 15-49 years decreased from 49,4 to 37,3 between 1990 and 1999, which fact proves the above mentioned tendency.

Table 3.

Demographic changes 1949-1999

	1949	1970	1980	1990	1999
Population thousands (1st January)	9205	10322	10710	10375	10044*
Live birth rate per thousand persons	20.6	14.7	13.9	12.1	9.4
Death rate per thousand persons	11.4	11.6	13.6	14.1	14.2
Natural increase per thousand persons	9.2	3.1	0.3	-1.9	-4.8
Number of women per thousand men (1st January)	1081	1063	1064	1081	1096*

*/ 1st January 2000
Source: Statistical Yearbook 1999. KSH

3. Protection of the environment

In the protection of the environment the after 1989 governments had to fight a grave inheritance. The environment often suffered large damages in consequence of the activity of a part of state owned enterprises in the past, which fact caused difficulties in the privatization of those enterprises, since also the new owners would not accept to solve these problems. In certain cases the cure would cost more than the total value of the enterprise.

Serious dilemmas remained in the protection of the environment after the privatization too. Privatization contracts usually enclosed different conditions concerning employment and protection of the environment, but the conditions could have been rarely enforced. The legal way is slow and heavy and mass application could have induced foreign capital to reconsider its presence. The sanctioning of new owners is difficult also because if decision had to be made between employment and environmental points of view, concerned people prefer keeping the workplace even if in an unhealthy environment, than become unemployed.

Due to the shortage of resources the backwardness in the protection of the environment further increased in the last decade. Large damages were caused by floods and water pollution, though they originated from external, independent factors, their unusually grave consequences revealed internal grounds too. The conclusion was drawn that much more financial resources should be given to prevention and defending. A popular result of the system change was the acceleration of motorization, however, that also had a negative by effect. The air pollution and harm of noise increased for the out-of-date stock of cars and for the lack of parallel development of road conditions. The reduction of railways, supported also by World Bank, accelerates the switch over of traffic to the roads. At the same time World Bank supports also the development of mass transport, which is very important, but progress in this direction is far behind the demand. In recent years emphasis was put on sewage purification to which contributed also the World Bank. Problems of up-to-date waste management, recycling and prevention had to be dealt with in a more organized way, beside other reasons, also for the conditions of accession to the European Union.

Hungary won't be able to fully satisfy the norms of protection of the environment from its own resources in the coming decades, as such immense investments and reconstruction were needed. Some groups of environmentalists recommend the stronger taxation of environmental pollution and energy use (see Frame 1.), but this proposal doesn't meet with the opinion of broad circles of the economic profession. For the very large difficulties the protection of the environment will be one of the hardest chapter of the negotiations on EU accession.

Frame 1.
Recommendations of the Working Group on Air

- Taxation of the environmental pollution (e.g. taxation of the car use).
- Raising of energy prices at a level, which corresponds to total costs including external costs of environmental damages.
- The earliest possible introduction of charges on loading and for protecting the environment.
- Taxation in order to promote the defence of green areas and the land, or to make agriculture more protective to the environment (e.g. the increase of the land defence contribution).

ANNEX II. HUNGARY SAPRI

EVALUATION OF WORLD BANK ADJUSTMENT LENDING

(THIS VIEW IS NOT SHARED BY THE NGOs)

Introduction

During 1990-1998 adjustment lending represented a major proportion of the World Bank assistance to Hungary. Prior to that, since Hungary joined World Bank in 1982, assistance had focused on liberalization of the economy and modernizing and expanding its productive capacity (particularly in industry and agriculture) and infrastructure (transport, energy, and telecommunications). During the 1980s total lending amounted to about US$2.0 billion for some 20 projects and programs. During the 1990s support for macroeconomic and structural adjustment during the transition became a key element of the assistance program, with four loans totaling close to $1.0 billion, or about half of total lending (commitments) during the 1990s, including two Strucural Adjustment Loans (SAL), accompanied by Japan Exim co-financing and an IMF Extended Fund Facility (EFF) Program, in the early 1990s, and sector adjustment loans supporting financial sector and pension reform in the mid-1990s (EFSAL and PSAL). This was accompanied by support for strengthening public institutions (e.g. in tax administration and public finance, health and social assistance).

The last Country Assistance Strategy (December 1997) had as main objectives to help Hungary to sustain economic growth and support its efforts to join the European Union. The focus of the proposed assistance program was on helping Hungary finalize the public sector reforms initiated in the mid-90s, strengthen institutions and markets in key EU-related sectors, enhance social cohesion and protect the environment. Recent lending includes support for higher education and youth training, and, most recently in 1999, for municipal waste water, in collaboration with the EU. Currently six projects are under implementation. With the steady improvement in the current account of the balance of payments and in Hungary's access to private capital, Bank lending has been limited in recent years. The ongoing Bank assistance program focuses on advisory and analytical support in key selected areas, related to the EU accession process (e.g. sub-national development and energy) and to poverty reduction (with a poverty assessment and an assessment of Roma support programs recently completed).

Evaluation

The attached annex contains the evaluation of the four adjustment operations in Hungary from the World Bank perspective as provided in the completion reports that were distributed to the World Bank's Board of Executive Directors representing member countries[2]. Each of the reports also contains a Borrower's opinion which is replicated in the annex as well.

2 For the first SAL, the annex also contains the summary of the Performance Audit Report completed in 1993 by the World Bank's Operations Evaluation Department, which reports to the Board of Executive Directors independently.

PROJECT COMPLETION REPORT

HUNGARY

STRUCTURAL ADJUSTMENT LOAN

(LOAN 3228-HU)

EVALUATION SUMMARY

Background and Objectives of Loan

(i) At the beginning of 1990, Hungary was faced with its most severe foreign exchange liquidity crisis since 1982. This crisis was directly attributable to inadequate macroeconomic management in 1989, which was compounded by unfavorable external developments that added to Hungary’s difficulty in maintaining access to international, especially commercial capital markets. To overcome this crisis, in early 1990 the Government implemented strict stabilization policies aimed at restoring the external balance and improving Hungary’s creditworthiness. These measures were supported by a one-year Standby Arrangement with the IMF. After Hungary’s first free multi-party election in March 1990, a comprehensive program of structural reforms, to establish a market economy and increase the competitiveness of the economy, was adopted by the newly elected Government in mid-1990. The Structural Adjustment Loan (SAL 1) in the amount of $200 million supported this program. The Export-Import Bank of Japan co-financed the SAL with $200 million equivalent. The EC also approved a $1 billion loan in support of the Government’s program. The strong and visible support of the Bank, in the form of the SAL and the subsequent ECO operation, was important in bridging the external financing gap and in maintaining the impetus to reforms during a difficult period of political and economic transformation.

Implementation Experience

(ii) Implementation of policies agreed under the SAL 1 was good. Except for a slight shortfall in meeting the subsidy reduction target, all other conditions for the release of the second tranche were more than met (Attachment I). An ambitious program of privatization of SEs was initiated. Competitive pressures were intensified by significantly decontrolling prices and liberalizing foreign trade. Financial discipline was tightened by cutting subsidies by almost 4 percent of GDP and, for the first time, the Government took measures to ensure that a large number of insolvent enterprises were taken through the bankruptcy procedures. To cushion the impact of the structural changes, an unemployment insurance scheme was established, and other steps were taken to protect the real value of pension benefits for the poor, and to improve the delivery of health care services and contain health costs. Indeed, in some important areas (foreign trade. domestic price, and financial sector liberalization) the pace of structural reforms was faster than envisaged under SAL 1. Two areas (which were not conditions of tranche release) where progress was slower than expected were the efforts to establish an efficient framework for the governance of SEs, and financial sector reform. These issues are currently being addressed.

(iii) The loan was to finance general imports, except for a specific list of excluded products such as military or paramilitary items, luxury goods, nuclear reactors and parts, and uranium. The loan was disbursed in two equal tranches, the first upon effectiveness in July 1990, and the second in February upon satisfactory implementation of tranche release conditions. The entire Bank loan was disbursed by March 6, 1991.

Results

(iv) The stabilization-cum-adjustment program resulted in a significant improvement in Hungary’s current account balance, though this was offset by the continuing weakness in the capital account. Nevertheless, there are clear signs that Hungary’s external creditworthiness has improved, as witnessed by the growth of direct foreign investment and improved access to private commercial creditors in 1991. However, real output has been declining (partly due to the contraction in demand from CMEA countries and the impact of stabilization policies). Moreover, the continuing high rate of inflation (30 percent in 1991) remains a cause of concern.

(v) The program also accelerated structural change. Signs of such progress include:

- (i) the dynamic growth of small and medium enterprises. Industrial production increased by more than two and half times in companies with less than 50 employees while it fell by 8.5 percent in companies with more than 50 employees in 1990. The number of new private business increased from 3100 in 1989 to 12,000 in 1990;
- (ii) the strong growth in direct foreign investment, from a cumulative inflow of less than $200 million till 1989 to $357 million in 1990 (and estimated at more than $800 million in the first 8 months of 1991);
- (iii) the continuing strong growth of exports (10.5 percent volume growth in 1990. and expected 9.5 percent in 1991), reflecting in part the successful re-orientation of exports from the ex-CMEA countries to the advanced industrialized economies of the West. The share of the advanced industrial economies of the EEC in total exports rose from 25 percent in 1989 to 35 percent in 1990; and finally.
- (iv) the increasing unemployment consequent to the restructuring of unprofitable enterprises. The number of unemployed rose from about 23,000 at the beginning of 1990 to 80,000 by end of 1990 and to 200,000 (4 percent of labor force) by mid-1991.

Lessons

(vi) Some lessons that have emerged from experience with reform implementation in Hungary are summarized below:

- (a) Given the fundamental nature of the transformation being attempted in Hungary (and elsewhere in the region), structural reforms will necessarily be implemented over several years. It is thus important to keep a medium-term perspective in assessing the scope and achievements of the reforms. For the countries implementing reforms, this means that the design of reform, and the pace of implementation, should ensure that the momentum can be sustained over time and does not flounder due to unrealistically high expectations, or too severe a recession (see also (f) below). For multilateral institutions, including the Bank, the lesson is to be prepared to support these efforts over the medium-term. This is being done in Hungary: important institutional reforms in the late 1980a were supported through previous lending operations (such as the ISAL); the SAL I in 1990 supported the first round of a comprehensive reform package, which has since been deepened and extended to other areas and supported by 1991 SAL 2 and the proposed 1992 ERL.

(b) The success of structural reforms depends critically on good macroeconomic management. The commitment of the new Government to tight fiscal and monetary policies contributed to ‘hardening” the budget constraint and intensifying competition. The failure to maintain this commitment was an important reason for the limited success of earlier reform efforts (see PCR for ISAL). In view of its importance, explicit macroeconomic conditionality in the SAL was appropriate.

(c) In terms of the design of SAL 1, apart from the insistence on a satisfactory macroeconomic framework, the focus was on structural reforms that (a) intensify competition and strengthen financial discipline. and (b) provide a safety net for those most adversely affected by economic restructuring. Privatization, the liberalization of domestic prices and imports, the elimination of subsidies, and the emphasis on liquidation of insolvent enterprises were among the core elements of SAL 1. This emphasis was generally appropriate for Hungary, and may have broader validity.

(d) Also relating to the design of SAL 1, the reliance on quantitative measures to assess implementation of structural reforms was appropriate, except possibly in one case. This related to the initiation by the Government of liquidation procedures against a certain number of enterprises. In retrospect, it is not clear if much was achieved through such conditionality, other than focussing the attention of the Government on this important issue. There may be no alternative to relying on policies that intensify competition and letting markets force closure or restructuring of non-viable companies. (e) A key element of the SAL was the initiation of the process of privatization. Experience suggests that in the best of circumstances, this process will not be rapid and even in the medium-term a large part of the productive assets will remain under state ownership. Thus it is important to continue to emphasize other structural reforms that promote competition (domestic and foreign), tighten financial discipline, promote new private ventures, and improve the governance of SEs.

(f) Even with good implementation of policies, it is prudent not to count on significant supply response in the near term (3-4 years). Typically, market institutions take more time to function adequately, attitudes change slowly, and adequate profession and managerial skills that conform to a market economy can only develop gradually. Hungary was ahead of other countries in these respects, and yet productivity improvements in the large SE sector are only gradually beginning to emerge. This should be recognized in elaborating any reform program.

(g) The restoration of creditworthiness also takes time - it has taken almost two years of relatively good macroeconomic management to improve Hungary's access to the private capital markets. During this time, the role of multilateral financial institutions will be critical in bridging the external financing gap. Provided the country continues to implement appropriate macroeconomic policies, „burden-sharing" concerns should not become paramount and the Bank should be prepared to increase its exposure for a few years, unless its exposure is already dangerously high.

PROJECT COMPLETITION REPORT

HUNGARY

STRUCTURAL ADJUSTMENT LOAN
(LOAN 3228 HU)

PART II: LOAN REVIEW FROM THE BORROWER'S PERSPECTIVE

Objectives

29. The SAL 1 supported the Government's medium-term economic reform program which aimed at establishing a competitive market economy, restoring a reasonable and sustainable rate of growth, improving the country's external creditworthiness and reducing the rate of inflation. These objectives were intended to be realized through the implementation of a vide-ranging reform program, which incorporated among other measures. the intensification of competition by way of further import liberalization, decontrol of prices, and promotion of private sector; the strengthening of financial discipline including the reduction of subsidies; ownership reform; and the reform of social programs.

Benefits

30. As far as the macroeconomic performance is concerned, major adjustments started in 1990 which continued in 1991. For the first time in six years, despite the adverse impact of erogenous shocks, the current account of the balance of payments in convertible currencies turned into surplus, representing an improvement of $1.6 billion by the end of 1990.

31. Foreign trade was characterized by the pressure to change markets, deriving from the collapse of the CHEA market. In the foreign trade in convertible currencies, a surplus of almost $1 billion was realized and the trade settled in rubles was essentially balanced, with a 36 percent reduction in the volume of @orts and 10 percent reduction in imports.

32. As a consequence of the corrective actions taken by the Government in the middle of the year, demonstrating its commitment to maintaining tight domestic demand management policies, the budget was also balanced. The number of new ventures grew rapidly and there was a significant increase in direct foreign investment as well. This reflects the growing confidence of Hungarian and foreign investors in the economic prospects of the country. These favorable tendencies have continued in 1991.

33. The unsatisfactory developments of this period, like decreasing GDP and rising unemployment were mainly due to the shift in the market structure and the larger than expected contraction of CHFA trade. Inflation was accelerating in 1990 over the previous year exceeding the original target. This increase is partially due to external factors and to the necessary corrective measures, such as subsidy reduction and the devaluation.

34. Overall, the initial results of the adjustment program met the expectations and substantial progress was made in implementing structural reforms in all the areas of the policy matrix agreed under the SAL, having achieved in some cases far more than what was envisaged at loan approval.

35. One of the most important objective of the program was the reform of ownership to establish a functional ownership interest in state enterprises and to promote their privatization. A medium term framework for privatization was elaborated in broad terms by the Government. Specific measures to implement this program were elaborated in the Asset Policy Guidelines which were reviewed with the Bank. Two ‘active’ privatization programs were launched by the SPA and the so-called Pre-privatization Act concerning the privatization of 10,000 retail outlets was adopted in 1990.

36. Competition has increased as a result of the further liberalization of foreign trade and the el4-4n-tion of price controls. The import liberalization program announced for 1991 goes well beyond the target that was agreed under SAL 1. As a result of the liberalization of the price system, slightly less than 90 percent of consumer prices are free. The Price Office ceased to exist from 1991.

37. The Government has continued to break-up highly concentrated market structures. An Office for Competition has been established to implement the new Law Prohibiting Unfair Market Practices. The level of subsidies was reduced significantly in 1990, by almost 4 percent of GDP compared to 1989. The reduction in budget subsidies to enterprises, combined with tight monetary policy strengthened financial discipline, increasing pressures to restructure inefficient activities.

38. The Government also accelerated the restructuring and liquidation of insolvent enterprises through the tightening of the Bankruptcy Law and by encouraging commercial banks, the Social Security Fund and the tax authorities to take actions against enterprises in arrears.

39. There was some delay in the financial sector reforms. In this area major stops were taken in the course of the preparation of SAL 2. With the Bank’s assistance, a now Banking Law containing satisfactory prudential regulations and providing for adequate supervision authority was elaborated and will be effective from 1992, along with the now Accounting Law which will introduce Internationally acceptable accounting standards and procedures. The now Bankruptcy Law will also become effective from 1992.

40. It is recognized that the unavoidable costs of the adjustment process, namely the rising unemployment, the inflation and decreasing living standards for the large sections of the population endangers the success of the adjustment. As a first step in 1990 the Goverrment initiated various reforms to strengthen social assistance programs aiming at halting the spread of poverty by improving the quality of social services, targeting benefits to those who need them most.

<u>Relationship</u>

41. Under the conditions of political transformation the continued adjustment lending operations of the Bank were of special significance

in contributing to a large extent to the maintenance of the Government’s priorities in economic policy and reaffirming confidence of the international financial community.

42. The excellent cooperation characteristic of the joint work of the Bank and the Hungarian authorities facilitated the preparation and implementation of the SAL 1. The Bank staff played an important role in assisting the Hungarian counterparts to prepare a coherent program. The ongoing policy dialogue between the Bank and the Hungarian authorities under the adjustment operations were supplemented by a broad cooperation in the economic and sector work.

43. To broaden and deepen the program elaborated under SAL 1, a second structural adjustment loan was prepared and signed in the middle of 1991. The Bank’s efficient catalytic role is evidenced in the fact that both SALs were cofinanced by the Export-Import Bank of Japan.

PERFORMANCE AUDIT REPORT
HUNGARY
STRUCTURAL ADJUSTMENT LOAN
(Loan 3228-HU)

EVALUATION SUMMARY

Introduction

1. SAL I was a timely and important operation. It coincided with Hungary's peaceful democratic transition: elections were held in the spring of 1990 and SAL I was approved by the Board in June 1990. This was a turning point in Hungary's history, given the advent of a coalition government committed to the country's transformation into a market economy. This was also a time when Hungary was experiencing economic stagnation, rising inflation, a severe liquidity crisis in its balance of payments and was facing severe exogenous shocks from a drought and changes in the CMEA.

2. Thus, SAL I coincided with the first stages of a dual, systemic transformation. On the political side, the intended transition was from one-party communism to multi-party democracy. On the economic side, the transition was to be from a form of „market socialism" (still characterized, however, by central planning, administered controls and state-ownership of most resources) to an open and competitive market economy with predominantly private ownership of property.

3. SAL I comprised a loan in the amount of US$200 million, with co-financing of another US$200 million equivalent being provided by the Export-Import Bank of Japan. The loan became effective on July 3, 1990 and was fully disbursed by March 69 1991—well before the expected closing date of June 30, 1991. This eight-mouth period between effectiveness and the last disbursement coincided with the span of a one-year IMF Standby Arrangement (SBA) approved by the Fund's Board in March 1991. All the conditions of this SBA were met without waiver.

4. This Performance Audit Report (PAR) agrees with the assessment of the PCR that (i) the project was successful in meeting its objectives; and (ii) most importantly, the project objectives were themselves the „right" ones given the special circumstances of the times. Overall, the project outcome is rated highly satisfactory.

5. The PCR did not explicitly address the issues of SAL I's contribution to institutional development or its sustainability; it could however be inferred that its assessments were favorable. This PAR is more explicit in identifying why it rates this operations contribution to institutional development as „substantial" and its sustainability as „likely." Both Bank's and the Borrower's performance in relation to SAL I were found to be highly satisfactory.

Background

6. Following the end of World War II Hungary's economic system became that of a command economy characterized by state ownership of the means of production, collectivized agriculture,, central planning, an emphasis on the development of heavy industry and the orientation of external trade to the CMU countries.

7 Between 1968 and 1989 Hungary implemented a variety of limited reforms that led to some decentralization of decision-making a partial liberalization of foreign trade and domestic prices, limited and small-scale private sector activity, and the establishment of parts of the institutional and legal framework needed in a market economy.

8. The extent of progress should not be overstated. For when SAL I was approved in 1990t the state share of Hungary's GDP was still over 90 percent, the budget constraint on public enterprises was still „soft," most industry was protected by QRso, about half of foreign trade was still oriented to CMU markets, the external debt burden was high, and many forms of state intervention continued to create distortions and dampen incentives.

9. Thus, while Hungary was ahead of other socialist countries on the path towards a market economy, it remained at the time of SAL I largely state-owned and managed, highly distorted and inefficient, and highly indebted.

10. Hungary joined the World Bank in 1982. Between then and the time that SAL I was negotiated in 1990, the Bank extended to Hungary some 27 loans totaling almost US$2 billion. During that same period, in addition to the loan-related documents, some 37 Bank economic and sector studies were issued. Thus the Bank's investments in Hungary, „intellectual" as well as financial, were considerable prior to SAL I and served to build over the years generally good working relationships and a foundation of Bank knowledge of the economy.

11. Throughout the 1980s, the Bank's assistance strategy was aimed at making Hungary's so-called „market socialism" work betters with emphasis on achieving efficiency gains throug'n technological improvements, enterprise autonomy and other policy reforms. Over the years, the Bank supported an increasingly broad agenda of structural and macroeconomic policy reforms. Two hybrid operations and one SECAL operation were undertaken prior to SAL 1. The Bank did not however push the Government to undertake such fundamental reforms as large-scale privatization or breaking from the CMU trading system.

Project Preparations and Objectives

12. During the period of intensive project preparation in late 1989 and appraisal in February 1990, the Hungarian Government was still under the leadership of the Hungarian Socialist Party (the communist party). But because this Government had agreed to hold free, multi-party elections in the spring of 1990, it was in effect a lame-ducks interim government.

13. SAL I's preparation coincided not only with the beginning of the dual transformations but also with the emergence of a liquidity crisis in the balance of payments that was worsening by the minute in early 1990. The Government, which prided itself on its unbroken record of debt service, was on the brink of default. The proximate cause of the crisis was the commercial creditors' nervousness about the political and economic uncertainties characterizing the region at that time. This led them to seek to reduce their exposure to Hungary by withholding now and rollover loans.

14. The Government considered but rejected the option of seeking debt rescheduling. It was determined

instead to restore it's creditworthiness by dealing with the balance of payments crisis by (i) cutting substantially the current account deficit (i.e. the convertible currency or non-ruble deficit) through its stabilization-cum-adjustment program; and (ii) obtaining official capital and foreign investment to make up for the restricted availability of commercial capital.

15. Meanwhile, the interim Government (notwithstanding that it was still controlled by the Hungarian Socialist Party) undertook to launch an economic reform program that represented a radical paradigm shift. For this was the first time that a Hungarian reform program emphasized private property rights, promised large-scale privatization and downscaling of government, accepted the prospect of unemployment, and welcomed foreign ownership. The main four national objectives as of 1989-90, were democratization, stabilization, structural adjustment, and privatization.

16. The now economic strategy was pointed towards integrating Hungary as rapidly as possible into the EC and other Western institutions. The export sector was seen to be the leading sector, and direct foreign investment was counted upon to bring to Hungary not only needed foreign exchange but also new technologies, management skills, and access to new markets. The reform program was geared to effect major changes not only in policy, but also in legal and other institutions, and most fundamentally, in behavior patterns

17. SAL I had two main objectives. On the policy side, the, objective was to assist the Government's launching of the Government's overall structural adjustment program (SAP) articulated in the Letter of Development Policy; as noted above, this program incorporated stabilization measures supported by the IMF's SBA. This PAR concludes that the objectives of both the 1990 SAP and the 1990 SAL were broadly appropriate to Hungary's conditions at that time.

18. On the financing sides, the Bank's objective was to help put together a financial package, inclusive of the funds to be made available through SAL I itself, that would enable Hungary to manage successfully its balance of payments crisis and strengthen its creditworthiness. The SAL conditionalities were addressed to achieving a combination of key policy and institutional reforms. These included: the elaboration of an ambitious privatization plan and the taking of selected privatization actions; import liberalization measures; subsidy reductions; the initiation of liquidation procedures against a number of large-scale state farms and other state enterprises; and reforms in major social programs, including those Seared to putting in place an adequate social safety not. The PAR concludes that these were appropriate and well-chosen conditionalities.

The Bank has been credited (by Hungarians involved at the time) with having made some significant contributions to the SAP, particularly in terms of helping to formulate the detailed subsidy reduction program, the trade liberalization policy, and the corporate restructuring program.

The SAL process was also credited with helping the Government „pull together" the multiple strands of the comprehensive reform program. Hungary's 1990 SAP was however very much a home-grown and 'organic" Hungarian program; its „ownership rating" was at the very top of the scale. It was 'owned*' moreover, not only by the Government and political leadership then extant, but also by all of main opposition parties contending in the 1990 elections.

20. The Bank itself played a role in facilitating this broad ownership by engaging (with the approval of the interim government) the opposition parties in the policy dialogue prior to and between elections, and by actually including representatives of several political parties in the negotiations of SAL I. This served to ensure that the reforms would be implemented however the elections turned out.

Implementation and Results

21. All performance targets/ceilings of the IMF Standby Arrangement were met and no waivers were required. Similarly, the SAL I conditionalities were satisfied on time. SAL I, in combination with IMF Standby, served to help launch Hungary's new reform program on a sound footing. The operations were also the catalysts for other official flows that enabled Hungary to close its financing gap and avoid default. The Bank and Fund's imprimatur on Hungary's SAP, served to enhance not only Hungary's „aidworthiness" among the official agencies but also its creditworthiness in commercial markets. And these events in turn enhanced Hungary's attractiveness to foreign investors.

22. The outcome on the balance of payments side exceeded expectations. The external balance (current account) vent from a deficit of US$1.4 billion in 1989 to a surplus of US$100 million in 1990 and US$300 million in 1991. This was facilitated by a creditable implementation of the 1990-91 stabilization program and by a remarkable redirection of exports from collapsing CMEA markets to convertible currency markets. Import demand also fell in response to the recession caused partly by the 1990 droughts but mainly by the CMKA collapse. That CMEA collapse is believed to have been responsible for at least two-thirds of the 4 percent decline in CDP in 1990 and the 10 percent decline in 1991.

23. The capital market was meanwhile strengthened by the inflow of official capital, the stabilization of not private flows (private creditors eventually maintained their exposure while official creditors increased their) and a surge of direct foreign investment (DFI) from levels of $200-300 million in 1989-90 to a yearly average of $1.5 billion in 1991-92. These developments served to enable Hungary to increase its external reserves by several billion dollars (from about one month's imports in 1990 to 6 months' in 1992) and to reduce the debt service ratio from 46 percent in 1990 to 30 percent in 1991.

24. With regard to the implementation of the SAL-supported adjustment program, Chapter III of this PAR provides a number of indicators that capture the story in quantitative terms. For example, these show that between 1989 and 1991; (i) the percent of consumer prices freed went from 62 percent to 90 percent; (ii) the share of import liberalized rose from 16 percent to 72 percent; (ii) subsidies fell from 13 percent of GDP to 7 percent; and (iv) unemployment rose from 0.3 percent to 8 percent of the labor force. These indicate that SAL I served to help launch a substantial adjustment effort.

Evaluation of SAL I and Sustainability

25. The PAR assesses the main strengths and shortcomings of SAL 1. Two of SAL I's principal positive attributes were its timeliness and the willingness of Bank management to accept the risks associated with mounting the operation even before the new elected government was in place. The uncertainties of the time were then leading commercial lenders to bail out, which of course created a burden-sharing problem. These factors

led some Bank advisers and managers to advocate delaying the operation. In the event, the decision not to delay SAL I was clearly the right one, as even a short delay would likely have led to default on the debt service, rescheduling, a postponement of some reforms, and a probable lower flow of DPI in 1991-92.

26. The PAR concludes that SAL I was well-prepared. It was founded upon generally high-quality ESW and grounded in good Bank/Borrower relations characterized by a mutually respectful policy dialogue. The Bank was correct in not seeking to force a strategy of generalized „shock therapy” but rather solutions tailor-made to Hungary’s special conditions. SAL I was also found to have been supervised satisfactorily and to have warranted its supervision ratings of „1” for both 1990 and 1991.

27. One SAL weaknesses was its risk assessment. The risk of shocks likely to stem from the conversion of CMEA trade to world prices and convertible currencies was acknowledged but was not assessed, e.g. in terms of implications for the sustainability of the SAP. (The rapid demise of the CMEA could not then be foreseen.) The performance indicators chosen for monitoring progress under the SAL were also deemed to be inadequate. The PAR concludes however that both the 1990 SAP and 1990 SAL avoided making any really big mistakes.

28. The PAR identifies a number of factors—some auspicious some worrisome—bearing upon the sustainability of Hungary’s reform. Among the more difficult challenges facing Hungary’s policymakers are the fiscal/budgetary problems and the interrelated problems of how to deal with the largest loss-making public enterprises and at the same time strengthen the balance sheets of the banks. In the areas of privatization and enterprise restructuring Hungary is seen to face still a long and difficult road ahead.

29. The PAR concludes, however, that in spite of these present and prospective difficulties, the reform program seems likely to be sustainable. The main reasons for this conclusion are that: (i) Hungary appears to be set upon a basically sound course of adjustment; (ii) the policymakers have shown a commendable pragmatism in adjusting the course as circumstances warrant; and (iii) there seems to be a broad and deep consensus in favor of staying the course. Lessons of Experience

30. Several lessons of experience emerge from this evaluation.

Timeliness and Risk Taking. An important lesson of SAL I is that Page: 15 timeliness can be a critical aspect of a project’s impact and importance. When a historical moment presents itself, as it did in Hungary in 1989-90, both the stakes and the risks may be high. At such times, the Bank needs to call upon its sense of history (and not just its technical analyses) in deciding whether and how to seize the moment.

Complexity and Difficulty of-the Dual Transformations. A number of lessons identified in the PCR stressed that adjustment takes times whether to restore creditworthiness, to privatize, or to generate a supply response. It is now clear that the transition from socialism to a fully-functioning market economy is more complex, more difficult and will be more lengthy than was envisaged in 1990, even for a country which had already gained considerable experience of market mechanisms within a socialist framework. Much progress has been made since then to put in place the policy and institutional frameworks geared to a market economy, but the largest and hardest parts of the privatizations and required restructurings lie ahead.

A related point is that the complexities are compounded by Hungary's simultaneous pursuit of systemic political and economic transformations. It is more difficult to achieve simultaneously all three of the objectives of democratization, stabilization and adjustment than any two of them. It follows that the analytical frameworks used to design Bank assistance strategies and adjustment operations should give due attention to governance and political economy considerations.

SAL I showed that innovative measures taken by the Bank to involve multiple political groups in the preparation and negotiation of an adjustment operation can be highly beneficial in broadening ownership of a reform program and in ensuring its sustainability during a period of political transition.

The Importance of ESW. A third lesson from SAL I is that a substantial volume of high quality economic and sector work is a sine qua non of high quality policy dialogue and of successful adjustment operations. This is conventional wisdom but warrants re-emphasis. The benefits of ESW may often be unpredictable and lagged. The Hungarian experience also points up the advantages of jointly-undertaken ESW and of maintaining continuity of the Bank staff involved, in the policy dialogue

Sequencing and Pacing. Hungary's adjustment experience confirms the (related) lesson that there are no generally-applicable blueprints or formulas for the sequencing or pacing of adjustment. While all countries are in various respects „special cases,” Hungary's „initial conditions” (as of the time of SAL I) were especially different from those of other transition countries owing to its prior experience of reforms. Especially in the context of complex dual transformations, adjustment programs must be „organic” and highly country-specific rather than formulaic. Hungary's adjustment experience suggests that labels such as „gradualism” (as often applied to Hungary as well as China) and „shock therapy” are likely to be unhelpful. In practice (if not in theory), the pacing as well as sequencing of reform in the transition countries is largely a matter of feasibility. And what is politically, technically and administratively feasible varies greatly from case to case. Hungary's experience therefore neither validates nor invalidates a case for „gradualism” partly because it is a misnomer to regard some Hungarian reforms, e.g. trade liberalization, as having been gradual.

<u>The Importance of Institutional Development. Hungary's recent</u>

experience points to the critical role of legal and institutional reforms in bringing about behavioral changes fundamental to the transition from socialism to a market economy. It has taken some years to accomplish, but Hungary now has in place a range of institutional arrangements geared to effect the transition. Of theset the combination of accounting banking and bankruptcy laws appears to be particularly significant insofar as they are making the behavior of agents at the enterprise level resemble that of agents in market (as distinguished from socialist) economies. The discipline of having to pay one's bill or be taken to bankruptcy court is seen to be salutary. The lesson is that the combination of financial discipline imposed at the firm level and fiscal discipline at the macro level (as represented by a hardened budget constraint) is going a long way to make inter-enterprise arrears disappear and adjustment happen.

A related point is that because behavioral change is the most fundamental kind of change to be effected in the transition increased attention is warranted to analyzing and understanding these behavioral dimensions of adjustment.

Projections, Indicators and Contingency Planning. Given the extent of changes underway in the transition countries, the parameters of the past provide little guidance for projecting the future movement of important variables. Projections and scenarios for the transition countries are bound to have wide margins of errors. Moreover, current statistics and indicators do not reveal much about what is really happening in the burgeoning informal economy, or about how much real adjustment, structural and behavioral, is taking place at the enterprise and household levels. Lessons which follow from this conclusion are that increased attention should be given to defining and measuring appropriate performance indicators, particularly at the micro level, and that more and better risk assessment and contingency planning is needed to cope with the new complexities and uncertainties.

IMPLEMENTATION COMPLETION REPORT

HUNGARY

SECOND STRUCTURAL ADJUSTMENT LOAN (SAL 11)

(LOAN NO. 3347-HU)

EVALUATION SUMMARY

Introduction

1. Hungary has been implementing market-oriented economic reforms and trying to liberalize its economy since 1968. It was only after a peaceful transition to democracy in 1989-90, however, that the process of building a full-fledged market economy was dramatically accelerated. Economic performance in 1990-1991 showed that further acceleration of structural reforms was necessary to reach a break-even point and to start the economic growth. In 1991, the Government prepared a medium-term economic program, consistent with a vision of creating a market economy integrated with the European Union (Government of Hungary, Memorandum of Economic Transformation and Medium-Term Policies, 1991). The program represented a considerable deepening and acceleration of reforms. The aim of the program was to transform Hungary into a full-fledged market economy and to achieve sustainable economic growth.

2. The Bank's Second Structural Adjustment Loan (SAL II) of US$250 million equivalent was approved in support of this reform program. The loan received co-financing of $150 million from the Export-Import Bank of Japan (JEXIM). The Government's medium-term economic program was also supported by a three year Extended Arrangement with the IMF of SDR 1,114 million.

Project Objectives, Implementation Experience and Results

3. The program aimed at creating the basis for sustainable economic growth by completing the necessary market infrastructure (legal and institutional), stimulating a supply response, and eliminating potential risks of internal and external imbalances. To achieve these targets, SAL II supported the Government's program in four main areas:

(a) reducing the role of the state in the economy (reduction of administrative intervention in resource allocation, the size of the state-owned enterprise sector, transfers and taxes);

(b) intensifying competition (import and price liberalization, developing strict bankruptcy law);

(c) reforming the financial sector, within the framework of a new Banking Law (liberalization, improved prudential regulations, and enhanced supervision); and

(d) establishing a financially viable and well targeted social safety net.

4. The operation can be judged as only partially successful. The results were mixed due to the inconsistent implementation of the agreed policies and due to unfavorable internal and external conditions, many of which were beyond government control. In some crucial areas important achievements were obtained. During 1991-94, Hungary made considerable progress in liberalizing the economy and in creating competitive markets for products and factors. The basic legal and institutional market infrastructure was put in place. On the other hand, significant shortfalls in the execution of the medium-term program, particularly the slow path of reforms of the public sector and a loss of macroeconomic discipline, prevented Hungary from taking full advantage of these achievements.

5. Macroeconomic developments in Hungary since the beginning of the SAL II operation can be divided into two phases. During the first one, from 1991 to 1994, macroeconomic disequilibria continuously deteriorated, while the pace of structural reforms slowed down. During the second phase, from 1995 to the present, successful stabilization as well as an acceleration of privatization and structural reforms resulted in the rapid decrease of the size of the State (through fast privatization and control over public spending), bringing Hungary much closer to fulfilling targets of the reform program supported by the SAL II. However, crucial structural reforms, especially in the public sector, still lie ahead.

6. Despite these shortcomings, the achievements generated by the reform program supported by the SAL 11 are likely to be sustainable if remaining structural reforms are properly addressed. Significant progress has already been achieved during 1995-96. The stabilization program launched in March 1995 reversed unfavorable economic trends and helped to reduce macroeconomic disequilibria. The Government's commitment to reforms was also confirmed by a new strategy towards SOEs that resulted in a radical acceleration of privatization in the second half of 1995. After having established effective control over public spending, the Government is preparing an extensive program encompassing structural reform of the public sector, and reforms aimed at enhancing competition and restructuring of the enterprise and financial sector. Two operations currently being prepared in support of this program are the Enterprise and Financial Sector Adjustment Loan (EFSAL) and the Public Sector Adjustment Loan (PSAL).

<u>Key Lessons Learned</u>

7. The Hungarian experience with implementing reforms supported by the SAL II provides important lessons:

(i) Prudent macroeconomic management is crucial to the success of transformation. The Government's failure to maintain its commitment to tight fiscal policy resulted in a vicious circle of high fiscal deficits, high current account deficits, excessive taxation and low growth. In the absence of a stable macroeconomic environment that allows for sustainable growth no structural reform program will be completely successful.

(ii) Partial implementation of a reform package may not allow for overall satisfactory results. Although the SAL II was successful in identifying areas of crucial importance for the structural transformation of the economy, the agreed program was not implemented with the same speed in all areas. Radical liberalization was not able to compensate for a delay in public sector reforms. The important operational message from the SAL II is that more emphasis should be put on the balance in implementing reforms, as a success in one area does not necessarily compensate for a slippage in the other.

(iii) Reforms of the public sector in transition economies are even more difficult to implement than the initial liberalization and building of competitive markets. This is mainly because of the powerful political and social factors behind the existing structures of the public sector. The reforms are risky from a political and social point of view but crucial for long-term economic growth.

(iv) Transition economies remain strongly vulnerable to the external environment. This is particularly true of Central and Eastern European economies, that are heavily dependent on European Union markets. The analysis of risk factors, and more particularly of the European dimension of economic processes in this region, should be enhanced.

NATIONAL BANK OF HUNGARY

Review of the Second Structural Adjustment Loan (SAL 11)
(3347-HU) from the Borrower's perspective

Objectives

The loan supported the Government's medium term economic reform program aimed at accelerating and completing the transition to a competitive market economy in Hungary and creating the basis of economic growth. These objectives were intended to be realized through the implementation of a wide-ranging reform program which incorporated (i) the reduction of the role of the state in the economy - regarding the administrative intervention in resource allocation and the ownership of productive assets; (ii) the intensification of competition by way of further import liberalization, the promotion of new private ventures, the implementation of effective anti-trust actions and the tightening of financial discipline, (iii) the reform of financial sector, and (iv) the establishment of financially viable, well targeted and efficient program of social assistance in order to alleviate the social costs of adjustment.

Implementation

Although the macroeconomic developments in Hungary were unfavourable during the implementation of the SAL H operation the basic legal and institutional market infrastructure was put in place during this period and substantial progress was achieved in some crucial areas covered by the program.

Hungary moved rapidly to liberalize external trade and domestic prices, which played an important role in attracting foreign direct investments.

Major advances were achieved in terms of subsidy reduction (including household energy subsidy), reform of Central Budgetary Institutions and Extrabudgetary Funds, bankruptcy proceeding and the privatisation.

Important measures to reform the system of direct taxes were introduced among others broadening of the Profit tax base by eliminating some exemptions, and reduction of effective rates by introducing a new depreciation system; broadening of PIT base by including some „wage-like' incomes. The measures related to the VAT reform were only partially implemented as the top rate has not been reduced. The overall tendency of reducing tax rates could not be continued consequently later due to fiscal problems.

Some important initial steps were taken in the field of social security and social assistance, which, however, have only a preparatory character.

Unfortunately, these reforms have been implemented in a very adverse environment, caused by the recession in Western Europe, the UN sanctions on Yugoslavia and two years of severe droughts, resulted in a significant fall in exports. The curtailment of loss-making activities - due to the implementation of a strict bankruptcy law - could also lead to some drops in exports.

Shortcomings in policy exacerbated this deterioration.

By early 1995 it was realized that external and fiscal deficit became unsustainable and the Government adopted a strong adjustment package in March 1995, which involved fiscal adjustment including a significant upfront devaluation of the forint followed by the introduction of a pre-announced crawling peg, tightening of wage policy in the public sector, introducing a temporary import surcharge to be lifted by mid 1997.

Macroeconomic stabilization accompanied by acceleration of structural reforms succeeded in several respects: fiscal imbalance was contained, external competitiveness improved leading to a decline of the current account deficit, enterprise profit margins recovered, the privatisation process proceeded rapidly, and the external debt decreased, bringing Hungary much closer to the targets of the program supported by the SAL II.

Relationship

The continuous intellectual and financial assistance of the Bank was of special significance in this difficult period of our transformation.

The cooperation between the Bank and the Hungarian authorities was very good throughout the preparation and implementation of the SAL II.

The SAL II program identified areas of crucial importance for structural reforming of the economy and it was realized that more emphasis should be put on public sector reform, which is complex and difficult from professional as well as political and social point of view but essential for long term in economic growth.

The Government has been committed to accelerate and complete these structural reforms and with close and fruitful cooperation with the World Bank intensive work is going on in the framework of preparation of the Public Sector Adjustment Loan, addressing the reform of the pension system, health care financing system, tax administration, public employment and local finance system. The Bank staff plays an important role in assisting the Hungarian counterparts to prepare a coherent concept and formulate the detailed design of these reforms.

IMPLEMENTATION COMPLETION REPORT

REPUBLIC OF HUNGARY

ENTERPRISE AND FINANCIAL SECTOR ADJUSTMENT LOAN

(Loan 4141-HU)

Evaluation Summary

Introduction

i. The Government of Hungary launched in 1990 a set of significant economic reforms aimed at establishing a market economy. The authorities, however, did not respond appropriately to the emergence of internal and external disequilibria, and did not push forward with the necessary structural reforms. By end 1994, the General Government deficit had increased to 8.3 percent of GDP and the current account deficit had reached about US$4.0 billion (9.5 percent of GDP).

ii. In March 1995, the Hungarian Government's new economic team announced a set of stabilization measures aimed at forestalling a pending crisis by reducing macroeconomic disequilibria and preparing the stage for more fundamental reforms. The stabilization package included substantial cuts in fiscal expenditures, increases in fiscal revenues, a 9 percent devaluation of the Forint, followed by a pre- announced crawling peg, and a strict wage policy. These measures contributed to a significant improvement in Hungary's external position. The 1996 budget resulted in a significant contraction in the General Government deficit, from around 6.7 percent of GDP in 1995 to about 4.0 percent of GDP in 1996, and decline in Hungary's current account deficit to around US$1.8 billion (4.1 percent of GDP), or very close to its long-run target. The Government's stabilization program was supported by an IMF Stand-by, which was approved in March 1996 and was centered on key reforms of public finances.

iii. Along with the stabilization efforts, structural reforms were reinitiated. A new privatization law was adopted in mid-1995 which radically contracted the previously mandated minimum State shareholdings in specified enterprises. This was accompanied by acceleration of privatization of State- owned banks and enterprises. These efforts resulted, in the second half of 1995, in exceptionally successful privatization of large utilities and transfer to private investors of two of the large State-owned banks, Due to these sales, foreign direct investment in 1995 increased to more than US$4.4 billion (10.1 percent of GDP). Privatization proceeds were used to substantially reduce the stock of Hungary's external debt.

Loan Objectives

iv. The Enterprise and Financial Sector Adjustment Loan (EFSAL) supported the Government's 1995-1997 enterprise and banking sector reform program. The main elements of the EFSAL program included:

- an enterprise privatization program targeting substantial reduction of remaining State shareholdings in enterprises over the 1995-1997 period;

- a strong program for curtailment and reduction of enterprise losses, and further improvement of the bankruptcy and mortgage legislation;

- radical improvement in bank governance in the context of a bank privatization program aimed at privatizing all remaining State-owned banks by end-] 997; and

- comprehensive regulatory development in the banking sector.

v. Thus, the EFSAL aimed at assisting Hungary to finalize its enterprise and banking reforms and successfully conclude an advanced and critical stage of the transformation of its economy. It supported an accelerated program of enterprise privatization, including the privatization of large utilities, which achieved unprecedented results and generated substantial demonstration effects throughout the region. The loan also supported the rapid curtailment of enterprise losses to help free resources for investments of much higher returns. It supported a program of privatization of State-owned banks and of regulatory development in the banking sector designed to preserve financial discipline and to ensure that scares resources are effectively allocated to the most dynamic enterprises.

vi. Subsequently, the Government also implemented a ma or overhaul of public finances, which was supported by an FY98 Public Sector Adjustment Loan which helped advance major reform of the pension system.

Implementation Experience and Results

vii. The EFSAL was designed as a two tranche operation of US$225 million. The loan became effective as expected following signature of the Loan Agreement in May 1997, at which time the first tranche of US$112.5 million was released. The second tranche of US$112.5 million was released 12 months later, as planned. By that time, the Government had exceeded most of the targets set as the conditions of the second tranche release. Overall macroeconomic performance had improved substantially and progress in implementing the enterprise and financial sector reform programs had gone well beyond expectations. The implementation record of the borrower was highly satisfactory.

viii. The program contained a large number of targets all of which were surpassed with the exception of three second tranche conditions relating to banking sector, which were not met in their entirety. In light of the overall impressive progress that had been made in implementing the entire program, waivers were given for these conditions (para 26).

ix. The most important factor leading to the speedy implementation of the EFSAL was the broad political consensus achieved in Hungary about the direction and pace of the reforms, and the commitment of the Government to implementation of this comprehensive reform program. Hungary's goal of becoming a full-fledged member of the E1U strengthened the Government's resolve to implement the reforms and to align its regulations with the EU requirements and the commitments entailed in OECD membership. The program was well designed and most of the legislation critical for its successful implementation was adopted in the early stage of the program, prior to the effectiveness of the loan.

Summary of Findings, Future Operations, and Key Lessons Learned

x. Hungary has made substantial progress in implementing a broad-based enterprise privatization program even when compared to some EU member countries. The Government has successfully privatized the majority of State-owned enterprises including a large share of enterprises in the telecommunications and energy sectors. Most major banks have been privatized to reputable international strategic investors, who have contributed 1.0 boosting competition and modernizing banking services. Today, foreign intermediaries own 60 percent of the banks' capital. Financial sector legislation substantially meets international standards. The enterprise and banking sector reforms are irreversible. The authorities are intent on meeting EU accession requirements, and are very likely to continue their efforts to upgrade Hungary's legislative and institutional framework to meet the challenges of an integrated European market.

xi. A CAS (Report No. 17257-HU) dated December 23, 1997 was discussed by the Board on January 27, 1998. The primary objectives of the Bank's current assistance strategy are to help Hungary sustain its economic recovery and to support the country's efforts to join the EU. To this end, the Bank has focused on helping Hungary to finalize the public sector reforms initiated in 1995 primarily in pension and health and municipal development, to strengthen institutions and markets in key EU-related sectors, to enhance social cohesion, and to protect the environment. The Bank is continuing its dialogue on the financial sector through regular exchanges of view and as part of ongoing work on a new CEM and the Sub-National Development Program.

xii. Some of the main lessons that can be drawn from the preparation and implementation of the EFSAL are summarized below:

- Ownership of the Program. Borrower ownership of the program, commitment to its objectives, and the drive for results are particularly critical to the successful implementation of an ambitious structural reform program. The Government of Hungary exerted a major effort in designing the stabilization and structural reform programs. It implemented these in- depth reforms with resolve and determination. The close co-operation and mutual trust between the Bank and the Government was instrumental in ensuring the quality of the design and the effective implementation of the EFSAL. According to the Borrower, this was as important as the formal covenants, targets and benchmarks provided for under the loan.

- Up-ftont Actions. It was determined from the beginning that a core set of up-front actions, including the adoption of major new legislation, was essential to ensuring effective implementation and sustainability of the objectives of the program. Insistence on this principle extended the period preceding Board presentation. However, this period was used very effectively to refine the program, gain political support at the highest levels in the country, and advance the implementation of privatization of banks and enterprises. Bank experience shows that when adoption of important legislation is postponed until second tranche release, this often substantially delays release of this tranche or generates requests from borrowers for the Bank to waive such conditionality.

- Role of Strategic Investors. From the outset of the privatization program, the Hungarian authorities were determined to sell the State-owned enterprises and banks to strategic owners who could bring in the necessary capital and know-how and provide appropriate governance. This approach has been vindicated both by the negative experience of Posta Bank, which had a very dispersed ownership, and the positive impact of strategic foreign direct investment in Hungary on restructuring banks and enterprises and on economic growth.

- Banking Supervision. While putting in place a modern regulatory and supervisory framework is crucial to reform of the financial sector, the framework by itself does not guarantee effective financial sector supervision. Whereas, political independence and strong regulatory and supervisory powers can be provided relatively rapidly through the passage of appropriate legislation, the development of supervisory skills, culture, and confidence is a more longer- term undertaking requiring resolve and persistence.

REVIEW OF THE

ENTERPRISE AND FINANCIAL SECTOR ADJUSTMENT LOAN (4141-HU)

The Borrower's Opinion

Background and Objectives

EFSAL supported with a USD 225 M loan the Government's program for improving corporate governance in the enterprise and banking sector, mainly in the context of further privatization and strengthening the legislative and regulatory framework.

Implementation, Benefits

After a long preparation period of the loan the implementation of the program went smoothly and the operation has been all in all very successful. Overall macroeconomic performance and progress in implementing the enterprise and financial sector privatization program have gone far beyond expectations at the time of the loan appraisal and Board approval. The magnitude of enterprise and bank privatization, privatization revenues to the state budget exceeded the targets set forth in the EFSAL by significant margins. In addition, in Hungary the structure of both the enterprise and financial sector has been transformed through exceptional levels of foreign direct investment, compared to other transition countries. Introduction of real owners has improved corporate governance and the management impact of strategic investors has been high. At the same time, regulatory framework and relevant regulatory agencies have been strengthened.

Relationship with the Bank

Various World Bank loans supported the wide-ranging policy, legislative and institutional reforms which helped to create much of the foundation of a functioning market economy in several ways.

Earlier cooperation with the Bank in the context of the Financial System Modernization Project (3191-HU) helped to establish the basis of a modern legislative, regulatory and supervisory framework for the financial sector and provide institutional development to financial institutions in the early 1990s and the Enterprise Reform Loan (3459-HU) supported privatization, commercialization and restructuring of the state enterprise sector in 1992-93.

In the preparation phase the World Bank has closely cooperated with the Hungarian partners and provided a lot of useful advice, After signing the loan supervision missions supported the Government in project implementation. The cooperation has been outstanding all along the operation.

Assessment of Outcome, Lessons Learnt

The EFSAL operation is the very example that in a complex environment strong ownership of the program, commitment to the objectives and decided actions, a flexible approach to changing circumstances and addressing new issues are key elements of successful implementation of a major program.

Budapest, May 1999

IMPLEMENTATION COMPLETITION REPORT
HUNGARY
PUBLIC SECTOR ADJUSTMENT LOAN (PSAL)-1998
US$150 MILLION (LOAN NO. 4275-HU)

Evaluation Summary and Lesson Learned

Hungary implemented a major reform of its pension system in 1998. The preparation of the reform was supported by the PSAL. The new system comprises a public PAYG system, much smaller than the initial one, and a new funded and privately-managed system. A voluntary, funded and privately-managed pillar existed before the reform. The new system started operating in January 1998, and became mandatory for all new workers entering the labor force from that year on. Workers with accrued rights in the old PAYG pension system could choose to stay in the reformed PAYG system or switch to the new multi-pillar system.

The new multi-pillar pension system is now in its third year of implementation. It has proved extremely popular among the working population, and has attracted a much larger number of workers than had been envisaged when it was designed.. Approximately half of the labor force has joined the new system voluntarily. Most of the switchers are workers below 40 years of age, and the young workers who switched account for more than 80 percent of the labor force in their age group. The decision to switch was motivated by a number of factors, the most important being the expectation of higher returns in the mixed system and the perception of political risk in the public system. However, some overselling of the new system probably occurred as well, making older workers switch, although they would be expected to be better-off staying in the reformed PAYG.

The new Government that took office in mid- 1998 proceeded with implementation of the pension reform, which had been designed and implemented by its predecessor, but introduced a number of changes to the original design. These reflected different policy objectives, e.g. with respect to the cost to employers of social security contributions, as well as concerns about impact of the reforms on public finances. The latter caused the Government not to proceed with the gradual increase in the rate of contribution to the second pillar from 6 percent, to to 8 percent as originally prescribed in the law passed in 1997. Unless this increase is effected over the next few year, there could be important implications for some cohorts and for market participants. Recently, Government has indicated its intention to proceed with the increases in the rate, but no timetable has been adopted thus far.

The government's decision not to proceed initially with the increase of the the contribution to the second pillar to 8 percent as originally planned was based on its concern that this would add to the size of the overall general government deficit beyond the level it had targeted. Analysis done as part of preparation of the ICR suggests that an increase in the contribution to the second pillar would not have any significant adverse impact on the economy: the increase in the PAYG deficit would amount to only 0.3-0.4 percent of GDP, and would not affect the rate of inflation or the external accounts, as it wouldbe offset by larger private savings. The government's decision, which was ratified by Parliament in an amendment to the original law, was not in line with the objectives and the internal consistency of the reform package as designed, in which contribution rates and accrual rates were jointly calculated so as to produce an equilibrium cut-off age around 36-40 years of age. A significant number of workers may have switched counting on a higher contribution rate, and this rate is not implemented in the next few years, some of these workers would be better-off switching back to the reformed PAYG, which would increase the implicit pension debt. Moreover, at the current contribution rate, efficiency gains in labor and capital markets are likely to be smaller than originally anticipated.

The program has been unsatisfactory is the area of disability pensions. None of the reforms which had been envisaged in the original design were incorporated into the reform package adopted by the previous Government in 1997, nor have they been implemented since then.

This preliminary assessment of the Hungarian pension reform concludes that although implementation of the pension reform did not follow the original design in all respects, the reform has been successful, partic ularly as measured by the much higher than expected number of workers opting for the new system, notwithstanding the less than expected contribution rate to the second pillar. Considering the severe constraints imposed by initial conditions including high fiscal deficits, high contribution rates, high tax rates and very adverse demographic trends, the reform has been successful because it has reduced significantly the imbalances of the PAYG system while also introducing a mandatory, funded, and privately-managed pillar that seems to be operating rather well despite some initial problems in the system of payments and registration and some remaining weaknesses in the regulatory framework. The remaining shortcomings can be corrected over time, and this could be achieved relatively easily over the next few years, by restoring the original 8 percent contribution rate to the second pillar and strengthening the regulatory and supervisory framework for private pension funds.

The precise impact of the reform on the welfare of different generations is difficult to assess. The reform has certainly substantially reduced the heavy bias against future generations in the old PAYG scheme, but the system is still projected to produce deficits in the long-run, despite the PAYG reforms. Addressing these deficits will probably require further adjustments, such as further increases in the retirement age and a shift to price (rather than wage) indexation, beyond the steps already taken in this respect effective this year, which may reduce the higher levels of benefits predicted for the new mixed system.

What are the lessons for other countries? The adoption by Parliament of the pension reform legislation in the summer of 1997, and the first two years of implementation of the reform demonstrate the political and economic feasibility of this type of reform for other countries in Central and Eastern Europe. In fact, many other countries enjoy smaller fiscal deficits and lower tax rates across the tax spectrum and, therefore, should face fewer constraints in designing and implementing a pension reform of the type that Hungary is implementing.

The Hungarian experience also indicates that a voluntary switching strategy achieves essentially the same switching outcome as a forced switch based on an arbitrary cutoff age, while avoiding legal problems and contributing to the reduction of the implicit pension debt. The disadvantage of this strategy is that it leaves a few individuals worse-off relative to their best option. A well-designed public information campaign may minimize further the occurrence of these cases. For the implementation of the second pillar met initial difficulties, the experience shows that well developed information, registration, and payments systems are critical and that more attention to practical and technical aspects of implementation is required from policy-makers. Finally, the

Hungarian reform would benefit from a stronger regulatory and supervisory framework, including several aspects of asset valuation and disclosure. Although no major problems have been reported, and these areas of the regulatory framework are expected to be improved in the near future, a stronger regulatory framework could have been introduced from the start of the program without major technical difficulties.

ANNEX A

REVIEW OF THE

PUBLIC SECTOR ADJUSTMENT LOAN

(4275-HU)

Borrower's Opinion

Background and objectives

Public Sector Adjustment Loan (PSAL) supported with USD 150 million the-Government's reform program of public finances. Structural reforms in public financial management and social insurance followed earlier reforms of enterprise and financial sectors. The most important achievement was in this area a comprehensive pension reform based on legislative packages adopted by the Parliament in summer 1997. This reform established a multi-pillar pension system, introducing a mandatory, fully funded and privately managed second pillar to the upgraded traditional PAYG type first pillar allowance and keeping. The voluntary private pension schemes as a third pillar. The objective of the pension reform was to ensure an adequate and balanced system of retirement income for the old, while eliminate the severe actuarial imbalances of the traditional public pension system and promote national savings and the capital market and reduce distortions of the labour market.

Preparation, implementation, sustainability

The preparation phase of the operation was rather long. It started on a broad basis of various aspects of public finances. After detailed assessment, however, both the Government experts and the Bank preferred to focus on the pension reform- The key elements of the reform have been put in place before appraisal and negotiation. This approach allowed designing a one tranche operation. Implementation of the program went smoothly.

The government clearly supported the implementation of pension reform through a smooth and on-schedule introduction thereof and creating the necessary legislation framework. The initial steps of the reform were so successful that the number of re-registered with the new system was more than I million in 1998 exceeding 700,000 as anticipated. By the deadline of re-registration, i.e. by 31 August 1999, the number of those who presented themselves in the new system was more than 2 million up against 1.3 million as previously calculated. This lead to a higher than anticipated lost of revenue in the government budget.

The Government did not want to deteriorate the balance of the bt4get by increasing the contribution to the second pillar to 8 per cent since the increase in question would have caused an additional a0vernment deficit of some 0.3 to 0.4 percent of GDP. The increase of the contribution rate is on the agenda in the next future.

In order to maintain the value of the pensions a new indexation has been introduced. As of January 1, 2000 or 2001 net average earnings and inflation would be taken into account with 70 and 30 per cent or 50 and 50 per cent, respectively in the calculation of pension benefit.

Relationship with the Bank

Several earlier World Bank loans supported wide-ranging policy, legislative and institutional reforms which helped to create much of the foundation of a functioning market economy. In the context of the PSAL operation, Bank staff provided valuable knowledge of this specific field, performed analysis of several scenarios, involved outside expertise, organized seminars etc. This excellent intellectual input contributed to the adequate design and eventually to the success of the program. An additional benefit was having expert Bank staff in the resident mission, available for day to day consultation. The cooperation between Bank staff and Hungarian counterparts has been outstanding throughout the project cycle.

Assessment of Outcome, Lessons Learnt

The PSAL operation is a good example that strong ownership of the program, flexible Papproach and clear design are key elements of successful implementation of a major program. One tranche operation and close cooperation proved very efficient.

Budapest, June 14, 2000

ANNEX III: Detailed Chronology Of The Crisis And Transition In Hungary

1974	In consequence of the oil price explosion Hungary suffers 20 percent loss in terms of trade
1974-78	Increasing foreign trade deficit; large government bank loans following the jump of interest rate the burden of indebtedness expands
1979	For avoiding insolvency the government introduces restrictive economic policy measures; from this time on the rate of growth declines on one third of the previous level
1979	New wave of the economic reform; transition to the world market price base
May 1982	To keep solvency Hungary enters the IMF and World Bank
Dec.1982	IMF stand-by arrangement SDR 475 million
1983	The first World Bank loan (corn program, USD 130,4 million)
Jan.1984	IMF stand-by arrangement SDR 425 million the first government bond issue raising of consumer prices, improving the budget balance authorisation of joint ventures with foreigners
Febr.1984	5 percent devaluation of the currency (forint) improving import possibilities for small enterprises
Apr.1984	Decrease of import duties
May 1984	Government decision on further reform of the economic mechanism (partial price liberalisation and relax of import restrictions)
June 1984	5 percent of devaluation of the forint
July 1984	Further import liberalisation, diminution of subventions, raise of consumer prices
Dec.1984	Decrease of import duties
Jan.1985	Raise of consumer prices – introduction of use of the bill of exchange entry of the first foreign owned enterprise
Oct. 1985	Opening of the Budapest office of Citybank (New York)
June 1986	Act on Bankruptcy
Sept.1986	Authorisation of private wholesale trade
Nov.1986	Establishment of the two-level bank system
Febr.1987	Further raise of consumer prices
March 1987	First enterprise liquidation – 8 percent devaluation of the forint extension of the range of free market prices
June 1987	National Bank starts to apply elements of monetary policy (control of money supply)
July 1987	Liberalisation of security market
Sept.1987	Parliament approves principles of radical economic reforms (liberalisation, deregulation and privatisation)
Nov.1987	Liberalisation of industrial foreign trade
Jan.1988	Introduction of VAT and personal income taxation
Febr.1988	Budapest Stock Exchange opens
May 1988	IMF stand-by arrangement SDR 265 million
June 1988	Termination of export subvention to CMEA countries
July 1988	World Bank: Industrial Structural Adjustment Loan, (ISAL) (USD 200 million)
Aug.1988	Introduction of use of deposit slips
Oct.1988	The Act on Associations is passed by the parliament

Nov.1988	Decrease of subventions on consumer prices and for enterprises
Dec.1988	Act on Authorisation of Foreign Investments in Hungary
Jan.1989	Increase of consumer prices
Apr.1989	Transition to dollar accounting in CMEA trade
May 1989	The Act on Transformation is passed by the parliament beginning of privatisation
July-Sept.1989	National Roundtable negotiations
Jan.1990	Referendum on the procedure of election of the president
March 1990	IMF stand-by arrangement SDR 159 million
Apr.1990	Election of the parliament and local authorities
May 1990	The Act on Securities and Stocks are passed by the parliament
June 1990	World Bank: Structural Adjustment Loan (SAL) (USD 200 million)
Sept.1990	Act on Pre-privatisation
1991	Dissolution of the CMEA and the Warsaw Pact, partnership agreement with the European Community
Febr.1991	IMF extended arrangement SDR 1114 million
Apr.1991	World Bank: Human Resources Development Program (USD 150 million)
May 1991	The Acts on Concessions and on Accounting are passed by the parliament
July 1991	World Bank: Second Structural Adjustment Loan (SAL II.) (USD 250 million)
Sept.1991	Act on Bankruptcy
Oct.1991	Act on the National Bank of Hungary
Nov. 1991	Act on Financial Institutions
Dec.1991	Ending of price liberalisation and liquidation of price subventions
	Completion of foreign trade liberalisation
	Convertibility of the national currency (forint)
Apr.1992	World Bank: Enterprise Reform Loan (ERL) (USD 200 million)
Sept.1993	IMF stand-by arrangement SDR 340 million
Dec.1993	Amendment of the Act on the National Bank of Hungary
1994	IMF suspends the call in of outstanding tranches of the arrangement
	apply for accession into the European Union
March 1995	Stabilisation package (see frame 3.)
	OECD membership
	IMF stand-by arrangement; Hungary doesn't call in the loan
	Act on Reform of the Pension System
	World Bank: Enterprise and Financial Sector Adjustment Loan (EFSAL) (USD 225 million)
Jan.1998	World Bank: Public Sector Reform Loan (PSAL) (USD 150 million)
March 1998	World Bank: Higher Education Reform Program (DEM 263,6 million)
1998	Beginning of negotiations for accession into the European Union
1999	NATO membership, participation in the war against Yugoslavia

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