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4 Hungary—Partial Successes and Remaining Challenges: The Emergence of a "Gradualist" Success Story?

Kemal Derviş and Timothy Condon

To both the observant visitor and the analyst comparing indicators of economic performance and welfare, Hungary appears to have at least some degree of success in a region where the tremendous difficulties of systemic transition have in many cases taken on crisis proportions. Table 4.1 summarizes some indicators of the economic situation at the end of 1991 that demonstrate the point in comparison with other East European countries, leaving aside the Yugoslav republics.

Official statistical estimates can, of course, be quite misleading these days in Eastern Europe. For example, the average 1991 exchange rates, which are used to compute the U.S. dollar value of GDP, may not be close to their long-run equilibrium values. Czechoslovakia in particular has an extremely competitive exchange rate, although it is difficult to project how much real appreciation is likely and warranted over the next few years. The real size of the emerging, still informal private sector is also hard to estimate, and, in some countries, the contraction of output and real income is not as catastrophic as the statistics seem to indicate. More inclusive measures of economic activity, however, would make Hungary look even better. There are now data suggesting that it is in Hungary that the small-scale private sector has grown most rapidly. Initial findings of a World Bank–sponsored research project looking at the development of private manufacturing firms in Poland, Hungary, and Czechoslovakia reveal that Hungarian firms have shown dynamic growth. A sample of 120 Hungarian manufacturing firms surveyed in September 1991 found that production and employment were growing rapidly and that over half the firms

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Table 4.1 **A Comparison of Macroeconomic Indicators in East European Economies**

	GDP per Capita, 1991 (U.S. dollars)	GDP Growth (%) 1990	GDP Growth (%) 1991	Unemployment Rate, Year-End 1991 (%)	Inflation, 1991 (%)[a]
Poland	1,800	−12	−8	12	76
CSFR	2,100	−3	−16	8	59[b]
Romania	740	−8	−14	4	220
Bulgaria	830	−12	−23	10	430
Albania	520	−10	−30	N.A.	80
Hungary	3,300	−4	−10	8	35

Source: World Bank staff estimates.

Note: CSFR = Czech and Slovak Federal Republic. N.A. = not available.

[a]Annual average change in the CPI.

[b]Reflects large once-and-for-all adjustments early in the year, with very low inflation in the second half of the year.

were exporting. Small-scale private-sector activity is also developing in Poland and Czechoslovakia, but in those countries it is still largely confined to services and trade. Informal observation confirms and reinforces the message, although the evidence can be only anecdotal. Serious problems remain, of course, particularly relating to fiscal balance and employment. However, Hungary appears to be getting some positive results in a part of the world that is facing the economic challenge of the century.

There is also little doubt that the path followed by the Hungarian systemic transformation has been very different from both the theory and the practice of the transition policies adopted by the other East European countries.[1] Not necessarily by grand design or as a result of some carefully planned social engineering of the type Vaclav Klaus (1991, 44) warns us against, but as a result of the particular political and historical circumstances prevailing, Hungary did not engage in any sudden shock therapy. There was no day zero of the reform with maxidevaluation, massive price and trade liberalization, and fixing of nominal anchors. Structural reforms in the enterprise and financial sectors have also proceeded gradually, although the "opening" to foreign private investment took place in 1988 and has been wholehearted. Table 4.2 summarizes some of the key events and policy actions characterizing the Hungarian systemic transformation, which most observers agree started in earnest in 1985. The table tries to capture some key quantitative aspects of this "gradualism" that, ex ante, would look so cautious and insufficient compared with many of the radical programs designed for other countries in recent years.

1. Economic reforms in Eastern Europe have been extensively described (see, e.g., Blanchard et al. 1991; Fischer and Gelb 1991; and Bruno, in this volume).

Table 4.2 Hungary: Indicators of Liberalization and Systemic Transformation

	1985	1987	1989	1990	1991
Private-sector share of GDP (%)	< 10	< 10	< 10	10–20	20–30
Share of imports liberalized (production weights) (%)	0	0	16	37	72
Maximum tariff in manufacturing (%)	50	50	50	50	50
Average tariff (simple average) (%)	18	16	16	16	13
CPI inflation (annual average) (%)	7	9	17	29	35
Real effective exchange rate index (1985 = 100)[a]	100	97	88	94	106
Share of consumer prices freed (%)	35	41	62	77	90
Share of subsidies in GDP (%)	15	16	13	9	7

Source: Data provided by the Hungarian authorities and World Bank staff estimates.
[a]Trade-weighted index using producer price indexes. An increase signifies an appreciation.

Again, it should be emphasized that the historical path described in table 4.2 was just that; it was *not* the implementation of a theoretical construct but the result of uneasy compromises between guardians of the old regime constantly loosing ground, "reform Communists" trying to improve the system and maintain control, more radical reformers trying to accelerate change, the Bretton Woods institutions trying to encourage moves toward freer markets, and, finally, since mid-1990, rather pragmatic center-right politicians seeking to accelerate the process of systemic transformation and integration with Europe while minimizing social hardship, with their political base more in the countryside and the small towns than with the intellectual elite in Budapest.[2]

In evaluating the Hungarian experience, it is, of course, important to remember that the reform process started very early with the adoption of the New Economic Mechanism in 1968 and was never fully reversed, as happened in post-1968 Czechoslovakia. Despite periods of recentralization, particularly in the mid-1970s, there is no doubt that Hungary has had much more time to develop practices and attitudes conducive to the functioning of markets than most other countries. While the journey toward private ownership, hard budget constraints, and free markets and prices started in earnest only in the mid-1980s, two decades of experiments with market socialism did prepare the ground.[3]

There is, however, more in the Hungarian "story" to think about than just the advantages of having started early. True, Hungary did not face the calamity of hyperinflation in the period that we are discussing and did not, therefore, have to administer stabilization shock therapy the way Poland *had* to in 1990

2. This difference between Hungary and Poland was recently emphasized by L. Balcerowicz in a luncheon address to the U.S.-Poland Action Commission, Chicago.

3. For an excellent description in English of the Hungarian reform process until the mid-1980s, see Kornai (1986). See also Balassa (1983) and Antal et al. (1987). Hare (1991), Boote and Somogyi (1991), and Erlich and Revesz (1991) describe the more recent reforms. Many good papers written by Hungarian economists are unfortunately not widely known outside Hungary.

and Russia has to today. There were, and are, however, real choices to be made regarding the speed of trade liberalization, the timing and form of fiscal reforms, exchange rate policy, and policies vis-à-vis the enterprise sector, including the tactics of privatization and the governance of enterprises remaining public. In these areas, Hungarian reforms followed a sequence and yielded certain results that we will describe in the paper.

The objective of this paper is *not* to take the years 1990 and 1991 and compare, using normative objectives, Hungarian performance with, say, Czechoslovak or Polish performance. Other authors in this volume and elsewhere attempt such a comparison. The recent phase of the Hungarian experience is, however, extremely interesting in itself, even if rooted in a particular historical and national setting, and even if it is not replicable by others at different times and is propelled by different political dynamics.

4.1 Balance of Payments and Debt: Success after Walking a Tightrope

By 1987, Hungary's total external debt had reached $20.5 billion, amounting to 75 percent of GDP and 312 percent of convertible-currency exports, putting Hungary into the group of the very highly indebted countries. Table 4.3 compares indicators of indebtedness for some of these countries, with Hungary appearing as one of the most difficult cases. Looking at the numbers in late 1987, many predicted that Hungary would go by the then familiar route of debt renegotiations, reschedulings, attempts at debt reduction, etc. Alone in this group, Hungary remained current and did not reschedule or ask for debt reduction. In 1991, an improvement can be perceived, at least in the ratios of debt and debt service to convertible-currency exports (which fell to 187 and 35 percent, respectively), and Hungary emerges in 1992 with a much strengthened balance of payments and good renewed access to international capital markets, a story worth telling, with some unusual features.

During 1987–90, with 1990 being the worst year, Hungary was walking a tightrope, always very close to a liquidity crisis, with the ratio of debt service to convertible-currency exports one of the highest in the world. Table 4.4, summarizing the evolution of Hungarian debt by type of creditor, shows how important the Bretton Woods institutions, with associated cofinancing from the Japanese Export-Import Bank, were in supporting Hungary's strategy of remaining current and avoiding rescheduling. In the four years from January 1987 to December 1991, the net exposure of private creditors was almost unchanged, while the net exposure of the Bretton Woods institutions, including cofinancing arranged with the Export-Import Bank of Japan, increased by $1.4 billion.[4] The International Monetary Fund (IMF) supported Hungary through two standby arrangements in 1988 and 1990 and a three-year extended arrange-

4. In special drawing rights (SDRs), private exposure declines, and the overall increase in debt is somewhat smaller.

Table 4.3 **Debt Indicators for Selected Highly Indebted Middle-Income Countries (%)**

	1985	1986	1987	1988	1989	1990
Argentina:						
Debt/GDP	77.4	66.6	72.6	62.6	107.2	58.1
Debt/exports of GS	493.2	593.3	695.4	517.0	537.9	405.6
Total debt service/exports of GS	58.9	76.2	74.3	44.5	36.2	34.1
Brazil:						
Debt/GDP	47.5	42.3	42.1	35.2	24.9	24.5
Debt/exports of GS	361.5	451.8	430.4	314.1	286.8	342.4
Total debt service/exports of GS	38.6	47.0	41.9	48.2	29.8	21.8
Hungary:						
Debt/GDP[a]	67.7	71.2	75.0	68.0	69.6	64.7
Debt/exports of GS[a]	284.6	328.3	312.2	285.7	257.6	269.0
Total debt service/exports of GS[a]	75.2	81.2	59.7	51.2	45.1	53.5
Mexico:[b]						
Debt/GDP	52.5	77.6	77.9	57.8	45.5	40.7
Debt/exports of GS	326.0	422.7	363.6	312.8	253.0	222.0
Total debt service/exports of GS	51.5	54.2	40.1	48.0	37.9	27.8
Philippines:[b]						
Debt/GDP	87.7	95.5	89.5	76.1	67.1	69.4
Debt/exports of GS	335.6	324.2	317.6	262.1	223.0	229.2
Total debt service/exports of GS	31.8	34.6	38.0	32.0	25.3	21.2
Poland:						
Debt/GDP[a]	47.0	49.6	66.7	61.2	52.3	77.7
Debt/exports of GS[a]	570.6	602.2	602.2	513.3	493.2	386.7
Total debt service/exports of GS[a]	35.0	29.8	29.1	21.5	17.7	7.5
Venezuela:						
Debt/GDP	57.0	56.7	72.2	57.9	74.6	69.0
Debt/exports of GS	335.6	324.2	317.6	262.1	223.0	229.2
Total debt service/exports of GS	25.0	45.3	37.8	43.8	24.5	20.9

Sources: World debt tables, 1991 World Bank database, and data provided by the Hungarian authorities.

Note: GS = goods and services.

[a]For Hungary and Poland, debt stock and service and export figures are in convertible currency only.

[b]Debt and debt service reduction agreements were concluded with Mexico and the Philippines in 1990.

ment in 1991, the latter for $1.5 billion. Cumulative World Bank support was even more substantial, with commitments of $1.8 billion, including three loans for balance-of-payments support for a total of $650 million.

In mid-1990, this substantial effort on the part of the Bretton Woods institutions was complemented by a three-year, $1 billion loan from the European Community (EC), linked to the performance criteria and policy commitments agreed on with the IMF and the World Bank. If the end result of this massive multilateral support had been merely a substitution of official for private debt, with no real breakthrough in underlying creditworthiness, one would be justi-

Table 4.4 **Composition and Evolution of Hungary's External Debt (U.S.$ millions)**

	1987	1988	1989	1990	1991[a]	Total Change, 1987–91
Total debt	20,530.9	20,184.8	20,751.0	21,505.9	22,812.1	2,281.2
World Bank and cofinancing	976.9	1,146.9	1,275.4	1,624.5	1,999.5	1,022.6
IMF	808.5	634.2	456.2	329.6	1,214.9	406.4
Bilateral and other multilateral	509.7	613.5	718.5	1,090.0	1,791.5	1,281.8
Commercial	17,289.2	17,207.7	17,940.2	18,271.8	17,652.2	363.0
Medium and long term	14,186.5	13,844.7	14,633.7	15,331.3	15,475.0	1,288.5
Short term	3,102.7	3,363.0	3,306.5	2,940.5	2,177.2	−928.5
Nonconvertible debt	946.6	582.5	360.7	235.0	154.0	−792.60

Source: Estimated data provided by the Hungarian authorities.
[a]Estimated.

fied in questioning the wisdom of the strategy supported by the Bretton Woods institutions. A convincing breakthrough did, however, come in 1991, notwithstanding the regional economic collapse affecting Eastern Europe and what was then the Soviet Union.

The breakthrough has two components, which are seen in the evolution of the balance of payments (table 4.5). Comparing the 1991 results with the 1987–89 averages, with 1990 viewed as a transition year, and treating 50 percent of private transfers as a form of portfolio investment,[5] there is a $1 billion improvement in the adjusted current account and a $1.9 billion turnaround in the extended capital account. These figures taken together represent $2.9 billion, about 10 percent of GDP.

The current account improvement was due to rapid export growth to Western markets, the improvement in the balance on the travel account, and the compression of import demand. Exports to convertible currency markets increased by 25 percent in volume in 1990–91. Several factors have contributed to the growth of exports. First, with the transformation in 1991 to world prices and convertible currencies as the basis for this trade, there was an 87 percent contraction in ruble exports in the first ten months of 1991 (table 4.6). The peculiar modalities of ruble exports, especially the operation of the prompt payment system that guaranteed payment in domestic currency as soon as documents were presented at the Central Bank that the goods had crossed the border, made ruble exports a main factor fueling the expansion of liquidity (with effects on the balance of payments in convertible currencies) in 1989. Policy anticipated the decline of ruble trade; in 1990, ruble export licenses were sharply curtailed

5. Private transfers in both 1990 and 1991 are in fact a mixture of misrecorded current account receipts (services, tourism, and small-scale exports) and portfolio investments, which increased rapidly following the liberalization of restrictions on resident holdings of foreign exchange deposits in 1989 and the passage of the Foreign Investment Act in 1988.

Table 4.5 **Convertible-Currency Balance of Payments, Capital Flows, and Reserves (U.S.$ millions)**

	1987	1988	1989	1990	1991
Adjusted current account	−981	−919	−1,563	−236	−163
Capital account	332	978	1,525	−177	2,883
Direct foreign investment[a]	. . .	. . .	180	701	1,925
Net medium- and long-term borrowing	1,194	716	1,357	91	1,668
Net short-term capital	−778	288	−44	−893	−617
Net capital, not elsewhere included	−84	−26	32	−76	−83
Changes in net reserves[b]	547	−174	−88	413	−2,720
Memorandum items					
Total international reserves	2,159.2	1,976.3	1,725.3	1,166.5	4,017.3
Reserves in months of imports[c]	4.1	3.5	2.6	2.0	3.7
Net private transfers	102	115	126	727	866
Noninterest current account (% of GDP)	1.3	1.8	.6	5.5	5.9

Source: Data provided by the Hungarian authorities.

[a]Including 50 percent of net private transfers in 1990 and 1991.

[b]A minus sign indicates an increase.

[c]Imports of goods and services.

to halt the further buildup of accumulated ruble trade surpluses, giving producers a year to try to find new markets.

The end of the ruble trade, apart from filling some orders left over from 1990, created an "export or perish" mentality among Hungarian exporters. This led to an aggregate trade diversion from the Council for Mutual Economic Assistance (CMEA) toward the EC, as shown in table 4.7. Disaggregated Hungarian customs data show an even more pronounced decline in the former CMEA share (excluding the former East Germany). In industrial branches with a significant CMEA export orientation—mining and machinery—as well as in the agriculture sector, a large export shift to European markets occurred in 1991. However, the decline was not across the board, and nonruble exports to the countries of the former CMEA were equivalent to $1.2 billion in the first 10 months of 1991.

The expansion of new, export-oriented businesses also contributed to the strong export performance. This, in turn, was made possible by the liberalization of private-sector activity with the passage of the Company Act in 1988 and the near total liberalization of foreign trading rights in 1991. The growth in the number of economic organizations—from 10,000 at the beginning of 1989 to over 50,000 in 1991—and in the number of private entrepreneurs—from 225,000 to 340,000 during the same period—has swelled the number of individuals and organizations with foreign trading rights tenfold to 30,000 in 1991. Small exporters (those with fewer than fifty employees) accounted for 69 percent of the increase in the value of nonruble exports in 1991 as their

Table 4.6 **Growth of Exports (index with 1990 January–October = 100)**

	Ruble	Nonruble	Total	Share	Ruble	Nonruble	Total
Mining:							
CMEA	1	479	480	44	. . .	2,400	49
Europe[a] and others	0	614	614	56	. . .	212	206
Total	1	1,093	1,094	100	. . .	353	85
Electric energy:							
CMEA	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Europe[a] and others	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Total	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Metallurgy:							
CMEA	169	11,034	11,203	20	5	606	223
Europe[a] and others	3	44,230	44,233	80	1	89	88
Total	172	55,264	55,436	100	5	107	100
Machinery:							
CMEA	9,947	28,329	38,276	25	18	1,180	65
Europe[a] and others	143	113,874	114,017	75	1	166	142
Total	10,090	142,203	152,293	100	15	201	110
Building materials:							
CMEA	111	754	865	6	30	271	152
Europe[a] and others	22	12,442	12,464	94	36	180	179
Total	133	13,196	13,329	100	31	186	177
Chemical industry:							
CMEA	610	12,930	13,540	14	4	648	78
Europe[a] and others	66	84,360	84,426	86	6	143	140
Total	676	97,290	97,966	100	4	159	126
Light industry:							
CMEA	1,867	4,055	5,922	7	22	757	67
Europe[a] and others	107	77,911	78,018	93	10	178	174
Total	1,974	81,966	83,940	100	21	185	156
Miscellaneous industry:							
CMEA	49	124	173	6	9	1,378	31
Europe[a] and others	16	2,612	2,628	94	19	87	86
Total	65	2,736	2,801	100	10	91	77
Food processing:							
CMEA	1,720	24,825	26,545	25	13	265	117
Europe[a] and others	. . .	81,752	81,752	75	. . .	144	141
Total	1,720	10,657	108,297	100	12	161	134
Construction:							
CMEA	10	836	846	61	3	154	156
Europe[a] and others	. . .	545	545	39	. . .	12	12
Total	10	1,381	1,391	100	2	28	26
Agriculture:							
CMEA	656	7,288	7,944	19	10	114	61
Europe[a] and others	11	33,268	33,279	81	1	175	172
Total	667	40,556	41,223	100	10	160	127
Forestry:							
CMEA	4	4	0	. . .	. . .	. . .	. . .
Europe[a] and others	. . .	5,373	5,373	100	. . .	153	153
Total	. . .	5,377	5,377	100	. . .	153	153

Table 4.6 (continued)

	Ruble	Nonruble	Total	Share	Ruble	Nonruble	Total
Total:							
CMEA	15,140	90,658	105,798	19	14	390	82
Europe[a] and others	386	456,981	457,367	81	2	144	138
Total	15,526	547,639	563,165	100	13	162	122

Source: Data provided by the Hungarian authorities.

[a]Including East Germany.

Table 4.7 **Direction of Exports**

	Shares of Total Exports (%)					Annual Change (%)[a]			
	1987	1988	1989	1990	1991[b]	1988	1989	1990	1991[c]
EC	19.8	22.5	24.7	33.5	40.3	18.1	6.7	34.5	42.0
CMEA	50.2	44.8	40.8	30.2	25.7	−7.1	−11.4	−26.7	−4.8
Other	30.0	37.7	34.5	36.3	34.0	13.4	2.7	4.5	12.7
Total	100.0	100.0	100.0	100.0	100.0	4.1	−2.7	−.8	16.0

Source: IMF direction of trade statistics.

[a]In U.S. dollar value.

[b]Through the third quarter.

[c]1991:3 compared with 1990:3.

share of total exports rose from only 3 percent of total nonruble exports in 1990 to 29 percent in 1991 (table 4.8). The growth of small exporters was particularly strong in the large exporting sectors, machinery, chemical industry, light industry, and food processing. Although enterprises with export proceeds of less than $0.5 million accounted for only 4 percent of total exports, incremental exports from this size group accounted for over 9 percent of the growth in total export proceeds between 1989 and 1991 (table 4.9).

Better international trading conditions should also be mentioned in discussing Hungary's export success. The trade protocol signed with the EC in 1988 lowered quantitative import restrictions on Hungarian products entering the EC, with some exceptions, including textiles and iron and steel products. And, in 1991, Hungary became an associate member of the EC, with full membership expected within five to ten years. Hungary's "Europe Agreement" provides for the establishment of a free trade area in industrial goods, enhanced access for agricultural products, and eventual free trade in services. Other countries, notably the United States, have concluded trade agreements and extended GSP (general system of preferences) and MFN (most-favored nation) status to Hungary.

While there has been a significant improvement in the current account, it

Table 4.8 Structure and Growth of Exports, 1991 (millions of current forints)

	Jan. 1991–Oct. 1991			Exports of Jan. 1990–Oct. 1990		
	Ruble	Nonruble	Total	Ruble	Nonruble	Total
Industry						
All enterprises	14,831	500,325	515,156	13	164	123
Large enterprises	7,932	364,167	372,099	7	23	92
Small enterprises	6,899	136,158	143,057	227	1,404	1,124
(% of total)	(47)	(27)	(28)			
Mining:						
All enterprises	1	1,093	1,094	. . .	353	85
Large enterprises	1	867	868	. . .	283	68
Small enterprises	. . .	226	226	. . .	5,650	5,650
(% of total)	(. . .)	(21)	(21)			
Electric energy:						
All enterprises	. . .	. . .	. . .	. . .	. . .	. . .
Large enterprises	. . .	. . .	. . .	. . .	. . .	. . .
Small enterprises	. . .	. . .	. . .	. . .	. . .	. . .
(% of total)	(. . .)	(. . .)	(. . .)			
Metallurgy:						
All enterprises	172	55,264	55,436	5	107	100
Large enterprises	138	43,994	44,132	4	88	82
Small enterprises	34	11,270	11,304	486	736	735
(% of total)	(20)	(20)	(20)			
Machinery:						
All enterprises	10,090	142,203	152,293	15	201	110
Large enterprises	5,022	107,365	112,387	8	158	84
Small enterprises	5,068	34,838	39,906	230	1,211	785
(% of total)	(50)	(24)	(26)			
Building materials:						
All enterprises	133	13,196	13,329	31	186	177
Large enterprises	66	8,345	8,411	16	127	120
Small enterprises	67	4,851	4,918	319	942	918
(% of total)	(50)	(37)	(37)			
Chemical industry:						
All enterprises	676	97,290	97,966	4	159	126
Large enterprises	474	68,734	69,208	3	114	90
Small enterprises	202	28,556	28,758	119	4,373	3,494
(% of total)	(30)	(29)	(29)			
Light industry:						
All enterprises	1,974	81,966	83,940	21	185	156
Large enterprises	878	55,017	55,895	9	130	109
Small enterprises	1,096	26,949	28,045	241	1,529	1,265
(% of total)	(56)	(33)	(33)			
Miscellaneous industry:						
All enterprises	65	2,736	2,801	10	91	77
Large enterprises	8	1,343	1,351	2	52	43
Small enterprises	57	1,393	1,450	124	345	322
(% of total)	(88)	(51)	(52)			
Food processing:						
All enterprises	1,720	106,577	108,297	12	161	134
Large enterprises	1,344	78,502	79,846	9	122	102

Table 4.8 (continued)

	Jan. 1991–Oct. 1991			Exports of Jan. 1990–Oct. 1990		
	Ruble	Nonruble	Total	Ruble	Nonruble	Total
Small enterprises	376	28,075	28,451	281	1,440	1,366
(% of total)	(22)	(26)	(26)			
Construction						
All enterprises	10	1,381	1,391	2	28	26
Large enterprises	1	133	134	. . .	3	3
Small enterprises	9	1,248	1,257	35	150	147
(% of total)	(90)	(90)	(90)			
Agriculture						
All enterprises	667	40,556	41,223	10	160	127
Large enterprises	461	21,088	21,549	7	96	76
Small enterprises	206	19,468	19,674	49	565	501
(% of total)	(31)	(48)	(48)			
Forestry						
All enterprises	. . .	5,388	5,388	. . .	153	153
Large enterprises	. . .	3,509	3,509	. . .	106	106
Small enterprises	. . .	1,879	1,879	. . .	943	943
(% of total)	(. . .)	(35)	(35)			
Total						
All enterprises	15,508	547,639	563,147	13	162	122
Large enterprises	8,394	388,897	397,291	7	120	90
Small enterprises	7,114	158,742	165,856	200	1,120	936
(% of total)	(46)	(29)	(29)			

Source: Szabo (1992).

Note: Small enterprises are those with fewer than 50 employees.

Table 4.9 **Distribution of Exporters by Value of Exports**

	1989		1991[a]		
Value of Exports	No. of Enterprises	Total Exports[b]	No. of Enterprises	Total Exports[b]	Contribution to Growth (%)
> $10 million	136	4,421,848	158	5,267,552	45.1
$5–$10 million	97	698,530	144	994,177	15.8
$4–$5 million	33	142,155	53	237,225	5.1
$3–$4 million	72	248,214	83	289,023	2.2
$2–$3 million	91	217,940	148	357,314	7.4
$1–$2 million	170	244,271	278	389,835	7.8
$.5–$1 million	205	148,476	409	287,279	7.4
< $.5 million	1,899	172,425	5,108	346,943	9.3
Total	2,703	6,293,859	6,381	8,169,348	100.0

Source: Kopint-Datorg, Budapest.

[a]Estimate.

[b]Thousands of U.S. dollars.

should be emphasized that the situation remains fragile. Import demand could respond vigorously to an overall upturn in economic activity, and only continued good export performance would allow the consolidation of the recent improvement in the current account in a context of sustained economic growth. In this context, we recommend a supportive and competitive exchange rate policy. Significant real appreciation would endanger continued good export performance and the resumption of growth.

The elements of the breakthrough emerging from the extended capital account were the increase in private transfers and foreign direct investment, both of which were negligible prior to 1990. Administrative restrictions on resident holdings of foreign exchange were eliminated in late 1989, and the resulting surge in private transfers in 1990 was partly fueled by residents shifting foreign exchange holdings from "under the mattress" into the banking system. However, the activity of the expanding private sector—especially the establishment of joint ventures with foreign partners—helped sustain private transfers in 1991. Even more important than these transfers, the growth of direct foreign investment in 1991 is one of the most encouraging signs of Hungary's breakthrough, and there are many reasons for it, including Hungary's hospitable business climate, privatization policies, and the longer history of greater openness toward the West (for a discussion of privatization, see sec. 4.3 below).

Overall, the strength of private transfers and the remarkable growth of foreign direct investment represent a vote of confidence in the sustainability of the turnaround in Hungary's external position and prospects in the internal market. The breakthrough in the balance of payments significantly strengthened the international reserve position and helped Hungary regain solid access to international commercial capital markets, a vindication of Hungary's debt strategy in the eyes of the rest of the world. It has also disarmed domestic criticism of the National Bank of Hungary (NBH) for its policy of punctual repayment of the debt. Such criticism started during the election campaign in 1990 and became sharp when the Polish debt write-off was announced in early 1991. The growth of convertible-currency exports mitigated the decline in real GDP, thus helping preserve social peace and political stability. Things were bad in 1991, but looking at their former CMEA partners, Hungarians could take comfort from the observation that they could have been much worse.

4.2 Industrial Performance and Internal Adjustment

As noted by Rodrik (in vol. 2), almost all Hungary's real GDP decline in 1991 could be attributed to the CMEA shock. Industrial production fell by 21.5 percent in 1991, with some of the largest declines in the sectors most dependent on the former CMEA market (table 4.10).

Enterprise adjustment has resulted in job losses and growing unemployment but also real wage declines. Employment in the industry sector declined by 13.4 percent in 1991. Total unemployment increased from 1 percent at the end

Table 4.10 Industrial Production, 1991 (annual % change)

	Industrial Production[a]	Employment	Average Gross Productivity	Real Wages[b]	Ruble Exports/ Value Added (%)[c] 1989	1990
Mining	−10.9	−15.9	6.0	10.5	3.5	2.1
Electricity	−8.0	−5.5	−2.9	3.9	1.1	.2
Metallurgy	−32.7	−18.4	−17.5	.2	17.9	12.8
Machinery	−34.9	−16.8	−21.7	−2.3	75.6	56.4
Building materials	−33.0	−12.8	−23.2	−8.1	6.3	3.1
Chemical industry	−18.5	−7.3	−12.1	−5.0	30.4	25.3
Light industry	−24.9	−13.5	−7.3	.4	26.8	15.3
Food industry	−9.7	−7.1	−2.8	4.6	36.6	25.5
Total industry	−21.5	−13.4	−9.4	−1.4	37.2	25.0

Source: Central Statistical Office, *Monthly Statistical Bulletin,* Ministry of Finance, and World Bank staff calculations.

[a]Covering enterprises with more than 50 employees. Including enterprises with fewer than 50 employees would result in a decline of 19.1 percent for "total industry" in 1991.

[b]Product wages.

[c]Current forints.

of 1990 to 8 percent in December 1991. Bankruptcies are also on the rise. Liquidation of 1,268 firms was begun in 1991, and the process was completed for 480 enterprises. The corresponding figures for 1990 were 630 and 206. Industry-wide real product wages declined by 1.4 percent (table 4.10), which stands in marked contrast with the Polish experience in 1991 (see Berg and Blanchard, in this volume). In 1990 and 1991, wage policy relied on a tax-based incomes policy, which taxed excessive wage increases at the enterprise profit rate (40 percent). However, such policies have failed in Hungary in the past, and we suspect that it was probably the tightening of enterprise cash constraints resulting from the CMEA shock that forced enterprises to limit wage increases.

Evidence of tighter cash constraints abounds. First, gross and net enterprise profits and retained earnings, all expressed in relation to GDP, deteriorated in 1991 following even larger declines in 1990 (table 4.11). Second, as in Poland and Czechoslovakia, enterprises have used financial maneuvers to cushion the real shock, such as the buildup of interenterprise credit and payment arrears, including to the government. The NBH reports that, in general, companies are far in arrears with their contributions to the Social Security Fund (see NBH 1991, 44), and, according to unofficial reports, interenterprise credit adjusted for expost producer price inflation, after falling slightly in 1990, increased by about 20 percent in 1991, although this increase was far less than that recorded in 1988 when financial policies began to be tightened in response to the nar-

Table 4.11 Enterprise Profits, 1986–91

	1986	1987	1988	1989	1990	1991[a]
Gross domestic product	1,088.8	1,226.4	1,409.5	1,730.4	2,080.9	2,494.0
Less gross labor income	515.4	561.2	676.4	792.2	974.1	1,268.0
Less indirect taxes[b]	364.8	415.7	524.0	649.9	759.5	819.1
Plus indirect subsidies[c]	219.2	238.8	217.2	201.5	178.2	142.3
Gross operating surplus of enterprises	427.8	488.2	426.3	489.8	525.5	549.2
Less other deductions[d]	53.1	50.1	46.4	36.5	66.7	70.4
Gross enterprise profits before taxes	374.6	438.1	379.9	453.3	458.8	478.8
Less depreciation[e]	103.9	111.0	118.4	151.7	160.8	178.3
Net enterprise profits before taxes	270.8	327.1	261.5	301.6	298.0	300.5
Less direct taxes on income[f]	221.3	267.1	155.5	186.6	192.0	186.0
Plus subsidies received after profit	7.4	8.2	2.9	3.0	2.4	1.1
Less profit sharing	15.3	16.3	21.4	22.4	32.7	27.5
Net retained earnings	41.6	51.9	87.5	95.6	75.7	88.1
Memorandum items						
Gross labor income	47.3	45.8	48.0	45.8	46.8	50.8
Indirect taxes	33.5	33.9	37.2	37.6	36.5	32.8
Indirect subsidies	20.1	19.5	15.4	11.6	8.6	5.7
Gross enterprise profits	34.4	35.7	27.0	26.2	22.0	19.2
Direct taxes	20.3	21.8	11.0	10.8	9.2	7.5
Net retained earnings	3.8	4.2	6.2	5.5	3.6	3.5

Sources: Central Statistical Office, *Statistical Yearbook;* and Ministry of Finance.

Note: Figures are given in terms of billions of forints, except for "memorandum items," which are given in terms of percentage of GDP.

[a]Estimate.

[b]Taxes on production and on factors of production.

[c]Consumer price subsidies paid by the state budget, local governments, and social security (for medicines).

[d]Including allocations to welfare and cultural funds and to voluntary funds for import price equalization.

[e]Excludes depreciation of state flats.

[f]Includes tax on profits, wage tax, tax on fixed assets, and investment tax.

rowing of Hungary's access to international commercial credit markets (fig. 4.1).

The NBH's blacklist of companies in a "permanent state of imminent insolvency" for which it refuses to discount bills of exchange grew from 281 enterprises at the end of 1990 to 716 by the end of 1991. It is also noteworthy that a market in financial information about enterprises has developed, presumably because this information can reduce transaction costs in privatization. A magazine that publishes the names of delinquent debtors and the amounts owed was

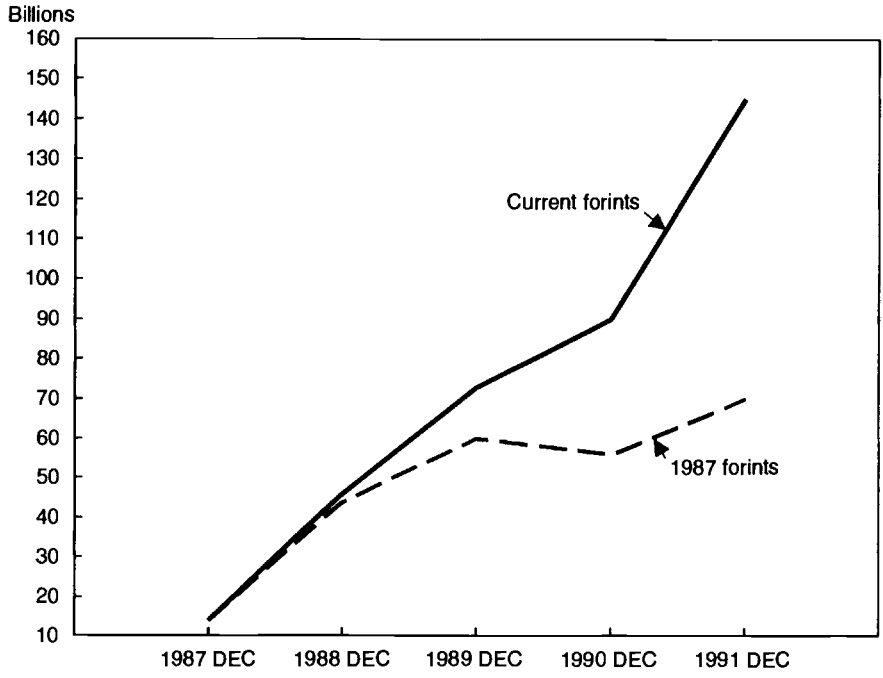

Fig. 4.1 Hungary: Interenterprise credit
Source: National Bank of Hungary.

started in 1991. An enterprise specializing in factoring has also been established.

The government has come under increasing pressure to take measures that help "manage" the transition. Some hard-hit branches of industry have been granted temporary one-year import protection. Tariffs were raised on imported televisions and cement, while a quota was introduced on steel imported from Czechoslovakia, Romania, and the former Soviet Union. Recognizing that the commercial banks will feel the crisis in the industrial sector, but unable to determine what the size of the problem has been, the government has undertaken to guarantee 50 percent (Ft 10 billion, or about $130 million) of the debts inherited by the banks when the two-tier banking system was created in 1987. Bad loans made after that will be provisioned out of taxable income over a three-year period. The NBH also opened a special credit facility in 1990 to provide additional short-term refinancing credit for commercial banks to help break closed circles of interenterprise arrears. Additional temporary credit facilities and selective government credit guarantees are under consideration to mitigate the adverse financial spillover effects on healthy enterprises of widespread enterprise liquidations.

4.3 Hungarian Enterprises and Systemic Reforms

Beyond the short-term measures designed to cope with the effects of the external shock lies the need to realize the systemic transformation of the Hungarian enterprise sector. It is success in the systemic transformation that can lead to an acceleration of growth essentially through much better total factor productivity performance. Just as the widening performance gap in total factor productivity between market and command economies brought about the demise of the latter, the expectation of a dramatic increase in productivity growth through systemic transformation justifies the painful transition and adjustment costs throughout Eastern Europe.

Despite a great deal of preparatory debate and the abolition of the pure command economy in the late 1960s, it was only in the mid-1980s that Hungary really became an economy regulated by "horizontal" rather than "vertical" relations between the majority of economic units. Until then, the fact that enterprise managers were appointed "from above" by bureaucratic superiors meant that vertical command relations still constituted the essence of the system, despite market contacts and relations between enterprises. In 1985, with new regulations instituting the election of top managers by the employees of most firms rather than their appointment by sectoral ministries, Hungary really made the qualitative leap to what one can call market socialism with self-managed enterprises.

On the positive side, market relations were strengthened by the 1985 reforms, and managers really did have a chance to determine most outcomes and rewards through market-oriented decisions rather than relations with ministerial bureaucracies. On the other hand, the incentive structure was not that of a Western, capitalist market economy. The 1985 reform led to a virtual elimination of the government's role as "owner," without establishing an alternative to exercise this role, thus eliminating any long-term interest in the preservation and appreciation of enterprise capital. This led to pressures for excessive wage increases, allowed various forms of decapitalization to become commonplace, and created insuperable obstacles for the kind of serious restructuring essential for long-term productivity growth and competitiveness.

Starting in 1988 and 1989, with the final disintegration of the Communist power structure in the entire region, Hungary launched the next phase of systemic transformation, this time with the building of a private ownership economy as the explicit objective.

Characteristically, the Hungarian approach has been pragmatic, ready to adjust policies rapidly to the lessons of experience and unwilling to embark on sudden and large-scale social engineering. The door to privatization was opened with the passage of the 1988 Company Act, which liberalized private business activities and permitted the establishment of company forms familiar in market economies. There ensued a quite vigorous process of partial self-privatization, with enterprises transferring some of their productive assets into

newly formed joint ventures, leaving the less productive assets and most debt in the untransformed parent enterprises, which remained effectively without owners. This process did transform some state-owned assets into corporate form with mixed ownership, rapidly enlarging the private sector. It was open to much manipulation and easy profit, however, for those who happened to control enterprises at that particular time, many close to the old Communist power structure. It also compounded the problems of the old parent enterprises.

In the face of substantial public dissatisfaction with the distributional implications, the process of privatization was greatly centralized in 1990 with new laws attempting to protect state-owned assets and with the creation of the State Property Agency (SPA), which was given the responsibility of overseeing all privatization and which was also to take an active role promoting and organizing direct sales and public offerings to foreign and domestic investors. Hungary did not consider adopting free distribution or voucher schemes to accelerate the process of the transformation, but the central bank did put in place a subsidized credit line for domestic investors wanting to buy state assets, a measure presented to the Bretton Woods institutions, particularly allergic to subsidized credit schemes, as a limited form of voucher distribution à la Poland and Czechoslovakia. To attract foreign capital, foreign investors were offered favorable tax treatment, including five-year tax holidays for some investments.[6]

This second phase of the privatization process produced mixed results. The excesses associated with unsupervised spontaneous privatization diminished, but, despite laudable efforts, the SPA, facing tight budget, skill, and experience constraints, was unable to deliver rapid privatization through its own proactive programs. Inside and outside Hungary, the perception was that privatization had been slowed down by too much central control.

In the second half of 1991, the overall strategy was again readjusted, in consultation with the Bretton Woods institutions and as part of a program supported by a special adjustment loan from the World Bank. The attitude toward self-privatization and management buyouts, but with SPA oversight, again became more permissive, with the emphasis shifting from concerns about valuation and distribution to the need for accelerating the emergence of new entrepreneurial groups with ownership stakes. Privatization of smaller establishments in the service and retail sector was also accelerated. Finally, for medium-scale enterprises employing fewer than 300 workers, it was decided that privatization could be effected by advisers chosen from a preapproved list,

6. When the Foreign Investment Act was passed in 1988, 20 percent profit tax relief was available to any foreign investor contributing at least 20 percent of the capital to the joint venture or Ft 5 million (about $65,000). That incentive was eliminated in 1991. For capital contributions of at least Ft 25 million or 30 percent of the entity's total capital, the tax relief increased to 60 percent for the first five years and 40 percent thereafter. Finally, for activities of "special importance," 100 percent relief was granted for the first five years and 60 percent thereafter. In 1991, the law was changed to limit the maximum period for profit tax relief to ten years. There is also a reinvestment incentive available to foreign partners in joint ventures. These preferences will be phased out as of 1994.

subject only to selective expost review by the SPA, thus effectively decentralizing the process and freeing scarce SPA management and staff resources for efforts directed at the largest enterprises.

Another major component of the strategic readjustment that took place in 1991 has been the recognition of the need for clear ownership and governance rules for that part of the enterprise sector that would remain under state ownership in the near future. Toward that end, virtually all state enterprises will now be corporatized—reestablished under Hungary's general Company Act—and provided with the same governing organs—boards of directors—as privately owned companies. This will remove the present different legal treatment of public and private enterprises and also facilitate the subsequent privatization of many of these enterprises. Most of the corporatized state enterprises will be made available for privatization, without any differentiation between foreign and local investors. For these "to-be-privatized" enterprises, ownership will be vested with the State Property Agency. A limited number of enterprises will be kept under majority state control for the time being, with ownership to be exercised by the State Asset Management Corporation (SAMC), a separate organization reporting directly to the Council of Ministers, which is expected to play a different role than the State Property Agency for its much larger group of more transient state-owned corporations. All the economies in Eastern Europe face a difficult trade-off. On the one hand, they want to move as rapidly as possible to true private ownership of productive assets. The conviction of almost all decision makers, political parties, even labor leaders, is that private ownership is desirable and that "simulating" it by asking publicly owned entities to behave "as if" they were private does not really work. What is often not well understood by some critics of the privatization process in the transition economies is that the obstacle is *not* political—certainly not ideological—but *practical.* The experience of the last two years shows that even give-away schemes, explicitly designed to achieve maximum speed for privatization, take time. One simply cannot establish effective forms of private ownership by decree overnight.

The trade-off arises because leaving large segments of these economies in a state of limbo, with managers and workers uncertain about their future and nobody responsible for the value of the productive assets, inflicts great damage. But building strong public ownership institutions, renationalizing, would also be a dangerous strategy. Why create bureaucracies only to dismantle them later when privatization takes place? Each country faces this trade-off, and there is no perfect solution. The approach that Hungary has chosen, after considerable debate and mixed initial results in the enterprise sector, is to have one agency, the SPA, with the overriding objective of rapidly privatizing 80 percent of existing assets. Its role as public owner will be minimal. The new State Asset Management Company, on the other hand, will have to fulfill a longer-term public ownership role for a list of assets that are judged difficult to privatize in the short run or for which privatization is not desired.

The advantage of this approach is that it dramatically reduces uncertainty for the enterprise and for potential investors. It also gives a clear role to both the privatization agency and the asset management corporation. It does not ask the same organization to behave as a long-term owner *and* to divest itself as quickly as possible with little regard for anything else.

It is too early to evaluate the results of these arrangements. Further readjustments in policies and regulations may well become desirable. A particular concern may well emerge if the share of foreign buyers remains as high as it has been so far. The tax holidays offered to foreign investors have been extremely and perhaps unnecessarily generous. The announcement that they will be phased out from 1994 onward is, in our view, appropriate. The overall results achieved by the end of 1991 by Hungary's privatization and private-sector development policies are, however, quite substantial. More than half of all foreign investment flows to Eastern Europe (excluding Germany) in the year 1991 went to Hungary, and close to 30 percent of "formal" GDP is in the private sector, compared with 10 percent in 1989. Efforts at counting the informal, unrecorded sector raise this percentage much higher. The next two years should also bring improved governance to enterprises remaining in the state sector, with full corporatization for almost all entities. If the reforms succeed, the systemic transformation of the enterprise sector from a mostly self-managed form of market socialism to a mixed market economy with a dominant private sector and also a large number of commercialized, wholly or majority state-owned corporations could be completed before 1995. A sensible design is there. The challenge is implementation.

4.4 Downsizing the Government and Restructuring the Budget

Commercialization and privatization in the enterprise sector is only one component of the overall systemic transformation in which Hungary and the other East European economies are engaged. In all these economies, the share of national income intermediated by the government remains very large. Under the old regime, low incomes and wages went hand in hand with an appropriation of profits by the state, which then transferred back parts of the "economic surplus" in the form of free or nearly free goods and services available to the entire population. Parallel to the systemic transformation in the enterprise sector is the need for systematic transformation of the role of government in society: an efficiently functioning market economy requires a "smaller" government. Public revenues should come from transparent and nondistorting taxes rather than from an appropriation of the profit wherever it appears, and public expenditures should be targeted to the provision of public goods—national defense, environmental cleanup, some public infrastructure—and to the support of the poorest and most vulnerable groups in society, instead of the entire population. Note that a *small* government does not at all mean an ineffective or unimportant government. On the contrary, as the scope of government activ-

Table 4.12 General Government Size (in % of market price GDP)

	Hungary	Turkey[a]	Chile	Korea[a]	Portugal	Germany	Austria	EC Avg.[b]
Revenues	61.3	18.4	30.3	18.2	37.1	45.7	46.9	43.6
Expenditures	63.8	22.8	30.6	16.7	45.3	46.6	44.5	46.5

Source: IMF, *Government Finance Statistics Yearbook, 1990.* Data are for 1989, except for Chile (1988).

[a]Central government only. For comparison, Hungary's central government revenues and expenditures were 54 percent of GDP and 56 percent, respectively.

[b]GDP-weighted average.

ities and responsibilities decreases, it should become more effective in fulfilling the important role of providing public goods and supporting the vulnerable. The reorientation of government activity is, of course, closely linked to fiscal policy and macroeconomic stability. Without this reorientation, it will not be possible to achieve a sustainable fiscal balance because the universal entitlements covering the entire population are inherently incompatible with the revenues that a modern tax system applied to a market economy can be expected to yield.

Table 4.12 compares the share of government revenues and expenditures in GDP in a selected group of advanced European countries, middle-income developing countries, and Hungary. The statistics are not strictly comparable. In Hungary, for example, there is considerable double-counting in the accounts because of failure to consolidate fully transactions between different levels of government. Nonetheless, the broad picture is clear: the share of government in Hungary is not only way above that in countries at similar levels of per capita GDP but even higher than in the advanced West European welfare states.

It is with the comparisons in table 4.12 as background and the conviction that an overall downsizing of the government is desirable that we look at fiscal policy over the next few years. First, what is likely to be the "financeable" deficit that is consistent with the macroeconomic targets for growth, inflation, seigniorage, and external debt?[7] What, then, is a reasonable medium-term projection for tax and other revenues as a share of GDP? The sum of the financeable deficit and of total revenues gives us the envelop for aggregate government expenditures. As we shall see, such calculations lead us to conclude that there is a need for quite drastic public expenditure reforms, as total expenditures must adjust to lower tax revenues and a reduced financeable deficit.

Stabilizing the rate of inflation at a considerably lower rate and limiting the growth of external debt impose limits on the sources available to the government for financing its deficits. For example, reducing inflation from 35 percent

7. Van Wijnbergen (1989) is an early example of the approach of using the concept of the financeable fiscal deficit to analyze consistent fiscal policy.

in 1991 to 10 percent in 1993 will result in a loss of seigniorage revenues equivalent to an estimated 2 percent of GDP, which must be factored into the calculation of the fiscal adjustment needed over the next few years.[8] The extent of the required fiscal adjustment is measured by the financeable deficit, which is the deficit consistent with the macroeconomic targets for growth, inflation, and external borrowing. The financeable deficit compatible with West European inflation levels and private-sector-led GDP growth in the 4–5 percent range is projected to average 1.5 percent of GDP in 1994–95 (table 4.13).

The analysis is explicitly medium term in nature. In any particular year, it may be possible to finance a larger deficit without triggering much higher inflation or reducing productive investment. This is, in fact, what appears to be in store for 1992–93. Medium-term consistency on an increasingly private investment-driven growth path does not, however, leave much room for government deficits in excess of 1.5 percent of GDP. It would be a disaster for Hungary if the fact that large deficits could be financed in 1992 and 1993 led to a belief that noninflationary recovery is possible without a major fiscal effort.

To translate the required adjustment into policy measures, the financeable deficit is split into its two components, central bank profits and the general government balance, net of receipts from and payments to the central bank. Real central bank profits or losses in Hungary can be approximated by the outflow of interest payments on net foreign liabilities, with real receipts on domestic credits approximately at zero.[9] Real NBH losses are projected to average 3.6 percent of GDP in 1994–95 compared with 4.6 percent in 1991, reflecting the real decrease in gross external debt and the real increase in international reserves. The consolidated state budget is the fiscal aggregate generally used in discussions of fiscal policy in Hungary, and the prescriptions for adjustment in the general government balance will, therefore, be directly translated into adjustments in the consolidated state budget.[10] Thus, the consolidated state budget primary deficit, which was an estimated 1.8 percent of GDP in 1991 (the overall deficit of 4.1 percent of GDP less estimated net transfers to NBH of 2.3 percent), should move to a surplus of about 2.0 percent in 1994–95, an adjustment equivalent to almost 4.0 percent of GDP.

At the same time, the authorities intend to reduce the tax burden on Hungarian businesses and citizens, and tax reforms planned for 1992–93 are expected

8. The detailed calculations are from World Bank (1991, chap. 2).

9. Real central bank losses arise from the burden of servicing the external debt (67 percent of GDP in 1991) and providing credit at below-market interest rates to the non-government sector. During 1990, the effective nominal interest rate on National Bank of Hungary refinancing credits to the nongovernment sector was 22 percent, while market rates ranged from 27 to 32 percent.

10. The balance of the general government is determined mainly by the balance of the consolidated state budget. It comprises the state budget, the Social Insurance Fund, the Housing Fund, and, beginning in 1991, the Employment and Solidarity funds. Levels of government excluded from the consolidated state budget—budgetary chapters and their institutes, extrabudgetary funds (except for those mentioned above), and local governments—have not contributed significantly to the general government deficit in the past.

Table 4.13 **The Fiscal Adjustment Required for Macroeconomic Consistency (share of GDP)**

	1991	Average, 1994–95
1. Financeable deficit/surplus (compatible with noninflationary rapid recovery)[a]	−6.4[b]	−1.5
Minus		
2. Real interest payments on net foreign liabilities[c]	−4.6	−3.6
Equals		
3. Consolidated state budget primary deficit/surplus[a]	−1.8	2.1
4. Required fiscal adjustment[d]		3.9

Source: World Bank staff estimates.

[a]Minus sign indicates deficit.

[b]Actual deficit, given by the consolidated state budget primary deficit net of transfers from the central bank plus estimated losses of the National Bank of Hungary, proxied by interest payments on net foreign liabilities, expressed in relation to GDP; not derived from sustainable medium-term sources of financing.

[c]Minus sign indicates outflow.

[d]Plus sign indicates equal improvement.

to result in a reduction of revenues equivalent to about 2 percent of GDP, mainly from reforms to increase the neutrality of the enterprise profits tax. Thus, macroeconomic consistency and the revenue implications of planned tax reforms require an adjustment in expenditures equivalent to about 6 percent of GDP in the medium term. Expenditure reductions of this magnitude could be achieved by reducing subsidies, reforming income maintenance programs, and privatizing commercial activities currently performed by the public sector. The savings that could be achieved by these measures would likely be partially offset by higher outlays on priority spending programs. The expected changes in the size and composition of government spending underlying the more ambitious reform program are summarized in table 4.14. Estimating the effect of reforms on the overall size of government expenditures is complicated by the fact that the implications of a proper consolidation of accounts cannot be estimated with great accuracy. However, on the basis of a preliminary analysis of the government accounts, which identifies the functional categories where double-counting is likely to be a problem, and evidence from other countries about what level of expenditure in these categories would be reasonable, a reduction in general government outlays from 58 percent of GDP in 1991 to 40–42 percent by 1995 could be targeted. This would be closer to the average size of government in the EC. The expenditure reforms would also make the composition of government spending resemble the EC average more closely by shifting expenditures from broad income maintenance programs toward human and physical infrastructure, where a social consensus exists on the need for significant improvements (see Ministry of Finance 1991, 23–25).

Table 4.14 Effect of Budget Reform Proposals (% of market price GDP)

	1991	1995	Change
Expenditure adjustment, net			−7 to −8
Reductions, gross			−12
Subsidies	7	1	−6
Housing purchase	3	0	−3
Consumer price subsidies	1.5	.4	−1.1
Transport	.7	.4	−.3
Producer subsidies	2.5	.6	−1.9
Production	1.5	0	−1.5
Export	1.0	.6	−.4
Pensions	10.3	8	−2
Family allowances	3.2	2	−1
Sick pay	1.2	.2	−1
Maternity and child care benefits	.9	.8	−.1
Privatization of profit-oriented CBIs	1.7	0	−1.7
Increases, gross			4 to 5
Employment and solidarity funds	1.4	2.4	1
Other social assistance (cash)	1.0	2.1	1
Education	4.5	5 to 6	1
Health care	5.5	6 to 7	1
Transport infrastructure	.6	1.3	.5 to 1
Effect of 1992–93 tax reforms			−2
Revenues of profit-oriented CBIs	1.5	0	−1.5
Net budgetary savings	3 to 4		
Adjustment required for macroeconomic consistency			3.5 to 4
Memorandum items			
General government expenditures, 1991			58
Account consolidation[a]			9 to 11
Adjusted expenditures, 1989			47 to 49
Net expenditure reduction			7 to 8
General government expenditures after reform			39 to 42

Source: Ministry of Finance and World Bank staff estimates.

Note: CBI = central budgetary institution.

[a]Inadequate accounting of CBI expenditures results in large unclassified expenditure and possibly large double-counting of expenditure and revenue. Recorded general public services expenditures and other economic affairs and services expenditures are thought to be the most affected accounts. In the EC, the average shares of GDP devoted to expenditures on general public services and other economic affairs and services are 2.5 percent (ranging from 1.0 percent in Spain to 4.1 percent in Ireland) and 1.1 percent (ranging from 1.0 percent in Ireland to 1.6 percent in the Netherlands), respectively. In Hungary, they are 7.5 percent and 7.4 percent, respectively. Proper account consolidation should result in a decline in recorded expenditures (and revenues) in these categories to the levels found in the EC, which would imply a reduction equivalent to about 9–11 percent of GDP in the size of measured general government expenditures.

4.4.1 Subsidy Reductions

Subsidies have come down from 13 percent in 1989 to 7 percent in 1991. Continued progress in reducing subsidies should permit their elimination, except for urban public transport and, possibly, agricultural exports. The authorities intend to reduce subsidies to no more than 4 percent of GDP in 1993. Apart from those already mentioned, all other consumer subsidies, including those for housing purchases, production, and enterprise investments in the competitive sectors, could be eliminated. Provided that inflation can be significantly reduced as planned, it should be feasible to reduce subsidies to around 1 percent of GDP by 1995 (0.6 percent for export subsidies, 0.4 percent for passenger transport), which would imply a budgetary savings equivalent to 6 percent of GDP.

4.4.2 Reforming Income Maintenance Programs

Hungary's numerous, but in some cases poorly designed and administered, income maintenance programs are a legacy of the Communist system. The largest programs are the pension system (with expenditures equivalent to 10 percent of 1991 GDP), the health care system (5 percent), maternity and family benefits (a combined 4 percent), and unemployment and labor retraining benefits (1.4 percent—but, with unemployment expected to reach 13–15 percent in 1992–93, spending is expected to increase to about 2.5 percent of GDP). To address the shortcomings of the income maintenance programs and reduce their heavy burden on the budget requires a shift in their orientation. In the pension system, for example, reforms are needed to reduce benefits but also to protect benefit levels from inflationary erosion, which has been a problem, particularly for aged pensioners. In other areas, especially family allowances and maternity and child care benefits, a reorientation away from broad and untargeted support toward smaller programs where the benefits are more clearly tied to needy beneficiaries is called for. Finally, greater use of incentives for cost consciousness is needed; the reform of sick pay benefits to require employers rather than the government to pay for the first ten days of sick leave is an example. The potential savings from these measures are estimated at 4 percent of GDP.

In view of the difficult adjustment period facing Hungary, it is more likely that expenditures on income maintenance programs will rise sharply in the next two to three years before declining over the medium to longer term. The main factor underlying an increase in income maintenance expenditures is the expected increase in unemployment in the next two years as a consequence of the privatization of state enterprises and the need to restructure enterprises previously dependent on sales to the CMEA market. Higher than anticipated unemployment in 1991 caused expenditures on unemployment compensation to exceed the projected level. To cope with higher unemployment, the maxi-

mum period for which an individual can receive unemployment compensation has been reduced from two years to eighteen months, the maximum benefit has also been reduced, and the contribution for unemployment insurance has been increased from 2 percent of wages in 1991 to 7 percent in 1992, which should be sufficient to handle a year-end 1992 unemployment rate of 10 percent and a peak of 12 percent in 1993. Under such a scenario for unemployment, expenditures on job retraining and unemployment compensation could increase to the equivalent of nearly 4 percent of GDP in 1993 and then decline to 2–2.5 percent by 1995. If social assistance payments keep pace with the growth of unemployment compensation benefits, spending could also rise to over 3 percent of GDP in 1993 and decline to about 2 percent by 1995.

4.4.3 Privatization of Government Commercial Activities

The privatization of large numbers of government tasks, which has the potential to give a significant boost to the development of the private sector, has yet to begin in Hungary. Lack of progress in privatizing government function is partly due to lack of adequate budget information about the operations of the very complicated government structure. The government has little ability to monitor or control revenues and expenditures, and improved budgeting is a priority. The draft Act on Government Finances is designed to improve the reporting system at all levels of government and make it easier to monitor government expenditures.

Budgetary chapters (spending ministries) are responsible for two types of institutions, those formed initially in order to administer traditional public-sector responsibilities (e.g., education, health, social security, public administration, defense, police) and those formed to engage in quasi-commercial activities (e.g., water and road management). The former are described in the Hungarian system as "interested in the remainder" (surplus); the latter are "interested in the result" (profit).[11] Expenditures by commercially oriented institutions were the equivalent of 1.7 percent of GDP in 1990, revenues were 1.5 percent of GDP, the state budget transfer was 0.3 percent of GDP, and employment was 53,000, or 1 percent of the total labor force. These institutions should be privatized and government employment reduced by at least 50,000 workers.

Subsidy reductions, the reform of social welfare programs, and privatization of government operations could yield savings equivalent to approximately 12 percent of GDP by 1995, although higher spending on priority programs and the revenue effects of the 1992 tax reforms could reduce the net budgetary savings to 3–4 percent of GDP. This would accommodate the 3.5–4 percent of GDP adjustment required for macroeconomic consistency.

Expenditure management during the transition will be difficult because,

11. However, some of those from the first group have important commercial activities. For example, Hungarian television (known in Hungary as MTV) has significant advertising revenues.

while it will be easy to increase expenditures in high-priority areas, there is likely to be political opposition to the expenditure reductions. In part, this reflects the nature of many of Hungary's social welfare programs; nearly everyone is a beneficiary because targeting is almost nonexistent. The result, as confirmed by analysis undertaken in Hungary of the incidence of the social welfare programs,[12] is that middle- and upper-class households—wielders of political influence—are the largest beneficiaries of many income maintenance programs. Nevertheless, in order that budget reform be carried out in a fiscally prudent fashion, measures to reduce expenditures should be introduced prior to embarking on reforms that will raise expenditures. The government has targeted a reduction in subsidies equivalent to 3 percent of GDP in 1992–94. Additional reductions could be achieved in subsidies for post-1989 housing purchase loans, provided that inflation can be stabilized. If progress in the Uruguay Round of the GATT negotiations permits, a significant reduction in agricultural export subsidies could be made. The privatization of government activities, including the reduction in the government work force, should also be accelerated.

4.5 Conclusion

Hungary has been able to overcome the debt crisis of the late 1980s and the devastating shock of collapsing CMEA markets in 1991 without major macroeconomic instability and suffering a decline in output that has remained moderate when compared with the region as a whole. The turnaround in the balance of payments in 1991–92 has been impressive, with Hungary's performance in attracting direct foreign investment setting a new standard. Present fiscal difficulties should not lead one to forget these remarkable achievements, which were realized without foreign debt forgiveness. The country's systemic transformation is only half completed, however, and, for Hungary to emerge as a full success story, the transformation of the enterprise sector and the restructuring of the budget constitute the twin challenges requiring a huge effort in the immediate future. Provided that events unfold as in the programs and laws already adopted, after decades of debate, five years of serious reforms, and a detour through self-management, the new economic "system," close in essence to that of neighboring Austria, Italy, or France, could be in place in the near future. If the next round of reforms really takes hold, an unprecedented, deep transformation could be achieved with hardship and sacrifice, but without massive socioeconomic dislocation. Success seems within reach, provided perseverance, renewed courage on the fiscal front, and the ability to reach political compromise continue to accompany the cautious realism that has so far characterized Hungary's management of the systemic transition.

12. A team of Hungarian experts has analyzed the effect of taxes and social benefits in cash and kind on the distribution of income in Hungary (see Kupa and Fajth 1992).

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Comment Kalman Mizsei

It is not easy to serve as a rapporteur to a paper with which one has such far-reaching and fundamental agreement as I have with that of Derviş and Condon. The authors' main message is that Hungary has a fair chance to become a *gradualist success story,* although obviously among some particular, historically established circumstances with all the limited lessons that this might have for the other transforming countries. I fully agree with this statement and also with the choice of the authors to pick it up as the main theme of the Hungarian story. They are also right when emphasizing that the recent policy style is *not* an outcome of any "grand design" or "implementation of a theoretical construct" but that it has emerged out of different considerations, interests, historical situations, etc.

Furthermore, I also think that the authors have rightly structured their paper

around three crucial topics: foreign debt, privatization, and the public budget. I share their view that Hungarian debt management has been an incredible success so far, in spite of the fact that the story has obviously not yet ended. One might also add that the psychological implications of this strategy for society are also worth noticing: while the undoubtedly justified and right Polish debt strategy had the unpleasant side effect of "spoiling" the elites and teaching them that, whatever they do with the country, the West has an "inherent" duty to help them, in Hungary the public sense is that we have to help ourselves. This attitude in itself is an asset. (Again, I do not claim that the mentioned side effect would mean that the Poles should not have followed the applied debt strategy.)

The authors are somewhat too benign to the Hungarians when emphasizing the toughening of regulation on the ruble trade: during the first half of 1990, the policy was sufficiently tough, but this was not the case for the second half of the year, when a softer policy created a large trade surplus that was practically a form of implicit aid to the Soviet Union and that strained Hungary's monetary policy. Also, the authors are a bit too nice to the Hungarian policies when speaking about bankruptcy: especially the events of the first half of 1992 show that the institutional system of the country is still not ready to let the bankruptcy machinery function properly. Therefore, it will be necessary to readjust regulation soon; the courts are absolutely unable to cope with the filed cases, the chain of microeconomic financial crises is too long, etc. However, the other side of the coin is again that Hungary is the only country where this stop-and-go process has already achieved some significant progress. I also agree with the authors that, in order to support a revival of industrial growth, the policies of real appreciation of the currency cannot be maintained in the longer run.

It is very pleasant for me to be more critical than analysts of the Bretton Woods institutions on issues of Hungarian economic policy. In fact, I am more critical of the two remaining issues of the paper: privatization policy and public finance. First, for a minor correction, the authors overemphasize the stop-and-go nature of Hungarian spontaneous privatization. I completely agree with their general attitude toward decentralized privatization. (I can add that it is a small satisfaction for me personally to see that after almost three years the message about the necessity of decentralized privatization gets through in the Western analyses of East Central European economic transformation.) However, one should notice that, even right after the 1990 elections, the flow of "spontaneous" privatization cases has not stopped for a minute. We can speak only about a minor slowdown.

Where I really disagree with the authors is their endorsement of the formation of a "temporary" large holding company for firms that remain in state hands for a while. First, it would be good if only 20 percent of the state assets went to the new State Asset Management Corporation (SAMC). We do not have guarantees for that, and there are worrying signals that the share will be

more. Certainly, there are a number of firms that will be incorporated into the "superholding" for which there is no good justification to remain state owned. I am also more worried than the authors that Hungary might repeat the Italian or Austrian case where this kind of solution quickly generates clientelist political structures. Then it will be extremely difficult to get rid of these assets even when the state can theoretically concentrate on the issue. So I appreciate the dilemma presented by the authors, but I would certainly not create those superstructures.

The authors argue that the establishment of the SAMC will divide clearly the role of State Property Agency ("divesting itself") and that of the long-term state owner. Again, this might provide the system with some additional certainty but at the costs of creating a large institution with a vested interest in maintaining state property in sectors like manufacturing where it obviously should not be the owner.

Nonetheless, I agree with the authors, who find the achievements of Hungarian privatization so far "quite substantial." In fact, this is the only privatization machinery in the post-Communist world that has been working steadily and with notable successes. The Czech-Slovak mixture might also become quite successful because of its pragmatic part (enterprise privatization plans) and if the voucher-scheme does not become a major failure.

Finally, on the budget, the authors' contribution both in this paper and in their World Bank analysis (World Bank 1991) to understanding the alternatives to the recent situation has been very substantial. I think that their reform proposal is basically realistic and politically feasible. Where I have some doubts is their subsidy reduction program: it would probably squeeze the rural sector so much that it might cause unbearable social costs because of the extremely distorted international markets in agricultural products. Therefore, the reduction in general government expenditure from 58 percent of GDP to somewhere around 40 percent in four years is also probably too ambitious. It would, in fact, be a real shock treatment, something the authors seem to prefer to avoid in general. It is also quite questionable whether the expectations of the authors on the level of savings on income maintenance programs could be realistic.

Unfortunately, however, the whole debate is rather theoretical because the government has shown already in 1992 that its direction of action is quite the opposite to what Derviş and Condon have prescribed in the paper. Revenues have fallen further, and no reforms have been started on the expenditure side. Therefore, the official budget deficit plan has become totally unrealistic. The recent revised plans almost double the deficit target to the range of 5 percent of GDP. This might be close to reality. The government lives with the illusion that, because high savings ratios make deficit financing possible, they do not really need to act until the next elections on the expenditure side; consequently, cosmetics will do.

However, because financial deepening is very modest in postsocialist Hungary, the crowding-out effect of the deficit is very strong. Interest rates cannot

be cut along with the falling rate of inflation. Deficit financing, although quite possible, is also very costly because the public is, at the time being, cautious about buying government securities. So, the timetable outlined by the authors will certainly not be realized, and general government expenditures will be above 50 percent of GDP with an inflation rate much higher than the mentioned 10 percent in 1995. However, after the 1994 election, the new government will certainly be able to use the recent plans of deficit cuts and lower government spending. It is hoped that the macroeconomic situation will not deteriorate much so that the "economic miracle" of Hungary can continue beyond 1994.

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Discussion Summary

Michael Dooley warned that it is imperative that Hungary start to privatize the financial sector. He said that, until that happens, privatized nonfinancial firms will enjoy a soft budget constraint because they will have access to credits from excessively generous state-run banks.

Michael Bruno agreed with the authors that Hungary has had a relatively successful macroeconomic policy. He noted, however, that there is a gap between the objective success of the macroeconomic policy and a widely held negative public perception of that policy.

Olivier Blanchard said that the presentation of the authors gave the impression that Hungary's reform program has been much more successful than the reforms in Poland. Blanchard suggested that this was partially misleading, noting that foreign direct investment is the only category in which Hungary has done overwhelmingly better than Poland. Moreover, whatever success Hungary has had must be interpreted in light of the fact that Hungary had a substantial head start in the reform process.

Jeffrey Sachs also defended the performance of the Polish economy. Sachs noted that Poland's 1991 budget deficit was 2.7 percent of GNP, less than Hungary's deficit of 4 percent. Polish GNP fell by 8 percent in 1991, while Hungarian GNP fell by 10 percent. Poland has experienced faster growth in the private-sector share of GNP and faster growth in the volume of exports to the West. The Polish inflation rate fell in 1991, while the Hungarian inflation rate rose. Finally, Sachs noted that the Polish achievements are even more impressive when one remembers that Hungary started its reform program twenty years before the Poles did.

Andras Simon criticized the authors for overemphasizing the success of the gradualist approach. He agreed with other commentators that Hungary's purported success is explained by its early start.

Kemal Derviş's response covered several topics. First, he noted that the government is trying to improve the operations of the banking sector both by supervising and reforming the banks and by eventually privatizing them. Second, he emphasized the importance of the corporation program for the firms that will continue to be held under state ownership over the next few years. He praised the government for taking the ownership role away from the sectoral ministries and creating a new institution (the SAMC, or State Asset Management Corporation) to exercise that role. He noted that the existence of the SAMC reflected not ideological opposition to privatization but rather an awareness of the practical impossibility of successfully privatizing the entire state sector immediately. Third, Derviş addressed the gradualism debate. He said that shock therapy is clearly the right response to hyperinflation, but he said that gradualism may be a better approach to trade liberalization. He also noted that shock therapy runs the risk that a single shock may not be enough to stabilize the economy permanently and that multiple shocks may be more costly than a gradual reform program.

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